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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA
वेबसाइट : www.rbi.org.in/hindi
Website : www.rbi.org.in
इ-मेल email: helpdoc@rbi.org.in

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई-400001
DEPARTMENT OF COMMUNICATION, Central Office, S.B.S.Marg, Mumbai-400001
फोन/Phone: 91 22 2266 0502 फैक्स/Fax: 91 22 22660358

December 16, 2010

Mid-Quarter Monetary Policy Review: December 2010

Monetary Measures

It has been decided to:

- retain the repo rate at 6.25 per cent and the reverse repo rate at 5.25 per cent under the Reserve Bank's liquidity adjustment facility (LAF);
- retain the cash reserve ratio (CRR) at 6.0 per cent of net demand and time liabilities (NDTL) of scheduled banks.

Liquidity Measures

It has been decided to:

- first, reduce the statutory liquidity ratio (SLR) of scheduled commercial banks (SCBs) from 25 per cent of their NDTL to 24 per cent with effect from December 18, 2010;
- second, conduct open market operation (OMO) auctions for purchase of government securities for an aggregate amount of ₹ 48,000 crore in the next one month, the schedule for which is being issued separately.

The above two measures are expected to inject liquidity on an enduring basis of the order of ₹ 48,000 crore.

Given the permanent reduction in the SLR by one per cent of NDTL, the additional liquidity support under the LAF announced by the Reserve Bank on November 29, 2010 will now be available up to the extent of 1.0 per cent (instead of 2.0 per cent) of the NDTL of SCBs from December 18, 2010 to January 28, 2011.

Global Economy

There have been significant global and domestic macroeconomic developments since the announcement of the Second Quarter Review of Monetary Policy on November 2, 2010. A slow recovery and persistent unemployment motivated another round of quantitative easing in the US. However, recent data show some signs of improvement, especially in respect of real GDP and consumer confidence, even though the unemployment rate has increased. Although economic recovery has been progressing in Europe, financial stability concerns have resurfaced as the sovereign debt problem spread further. Major emerging market economies (EMEs) continue to experience robust growth.

Significantly, despite the slow recovery and slack capacity in advanced economies, international commodity prices such as oil, food, industrial inputs and metals have risen noticeably in recent weeks. Reflecting the strength of demand and higher commodity prices, inflation has started creeping up in most EMEs.

Domestic Economy

Growth

GDP growth of 8.9 per cent in Q2 of 2010-11 suggests that domestic momentum remains strong. Agricultural growth has recovered on the back of a good monsoon. After flagging during August-September, the index of industrial production (IIP) grew by over 10 per cent in October 2010. Various indicators of industrial activity, including the Purchasing Managers' Index (PMI) also suggest a strong underlying momentum. Lead indicators of services sector activity have continued to increase at a robust pace. These developments reinforce the Reserve Bank's projection of 8.5 per cent for real GDP growth for 2010-11 which will be reviewed in the Third Quarter Review scheduled on January 25, 2011.

Inflation

After remaining in double digits for five successive months, year-on-year headline WPI inflation declined to 8.8 per cent in August 2010 and further to 7.5 per cent in November 2010. Consumer price (CPI) inflation for industrial workers and rural/agricultural labourers softened to single digit rates from August 2010, after remaining in double-digits for over a year. The overall reduction in inflation reflects moderation of food price inflation following a favourable monsoon. Food price inflation moderated from an average of 15.7 per cent in Q1 of 2010-11 to 12.3 per cent in Q2, to 10.0 per cent in October 2010 and further to 6.1 per cent in November 2010. Amongst food items, the moderation in inflation for cereals and pulses has been larger than that in inflation of protein related food items such as egg, fish, meat and milk reflecting the structural nature of food inflation. In addition, inflation for non-food primary articles such as raw cotton, raw rubber and minerals rose sharply. Reversing the declining trend in the last six months, non-food manufactured products inflation edged up to 5.4 per cent in November 2010.

Though inflation has moderated, inflationary pressures persist both from domestic demand and higher global commodity prices. The pace of decline in food price inflation has been slower than expected due largely to structural factors. There is a risk that rising international commodity prices will spill over into domestic inflation. Going forward, rising domestic input costs for the manufacturing sector combined with aggregate demand pressures could weigh on domestic inflation. The risk to the Reserve Bank's projection of 5.5 per cent inflation by March 2011 is on the upside.

Liquidity

While the overall liquidity in the system has remained in deficit consistent with the policy stance, the extent of tightness has been beyond the comfort level of the Reserve Bank. This has been mainly due to persistence of large government cash balances which have averaged ₹ 84,000 crore since the Second Quarter Review of November, mirroring in the average net LAF repo amount of ₹ 1,01,000 crore. In addition, the liquidity deficit has been accentuated by structural factors such as significantly above-trend currency expansion and relatively sluggish growth in bank deposits even as the credit growth accelerated in 2010-11. While the liquidity deficit improved transmission of monetary policy signals with several banks raising deposit and lending interest rates, excessive deficits induce unpredictability in both availability and cost of funds, making it difficult for the banking system to sustain credit delivery.

In view of the persistent liquidity pressures in November 2010, the Reserve Bank implemented some measures such as additional liquidity support to SCBs under the LAF up to 2.0 per cent of their NDTL, continuation of second LAF, and

OMO purchase of government securities. While these measures have helped stabilise overnight interest rates, the extent of deficit could constrain banks' ability to expand their balance sheets commensurate with the productive needs of the economy. The additional liquidity measures initiated by the Reserve Bank respond to these concerns.

As the economy expands, it needs primary liquidity, which will have to be provided in a manner consistent with the monetary policy stance. Such provision of liquidity should not be construed as a change in the monetary policy stance since inflation continues to remain a major concern. The measures taken in this review need to be appreciated in that context.

Summing Up

To sum up, the underlying growth momentum of the Indian economy remains strong. Even as inflation has moderated, it remains significantly above the comfort level of the Reserve Bank. Moreover, risks to inflation remain on the upside, both from domestic demand and higher global commodity prices. There is, therefore, a need for continued vigilance on the inflation front against the build-up of demand side pressures. A major challenge for the Reserve Bank in the recent period has been liquidity management. It is the Reserve Bank's endeavour to alleviate the liquidity pressure in a manner consistent with the monetary policy stance of containing inflation and anchoring inflationary expectations.

Expected Outcomes

The policy actions in this Review are expected to:

- release sizable primary liquidity into the system;
- bring down the liquidity deficit in the system close to the comfort zone of the Reserve Bank; and
- stabilise interest rates in the overnight inter-bank market closer to the operative policy rate of the Reserve Bank.

R.R.Sinha
Deputy General Manager

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