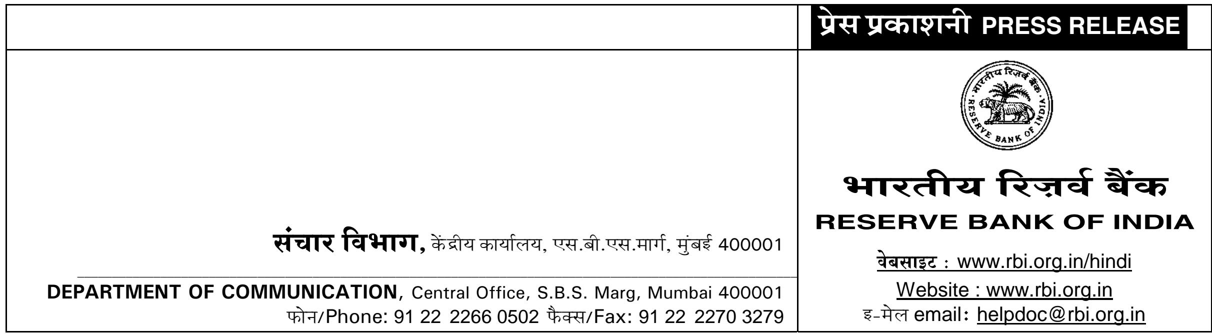

January 27, 2009

Third Quarter Review of Monetary Policy - Press Statement by Dr. D. Subbarao, Governor

"This Third Quarter Review of Monetary Policy of the Reserve Bank is set in the context of a deteriorating global economic outlook and heightened uncertainty about the global financial sector. In fact, there has been a rapid and marked downturn in the global economic outlook since the Reserve Bank's Mid-term Review in October 2008. The continued bad news from large international financial institutions on a regular basis renews concerns as to when the global financial sector might attain a semblance of stability.

India has rapidly integrated into the global system and has linkages with the rest of the world not just through trade channels, but also through two-way movements of capital and finance. As an integral part of a globalising world, India cannot be expected to remain immune to a global crisis of this nature and magnitude; and in responding to the crisis, India has to share the uncertainty on the way forward just like the rest of the world.

The Indian economy experienced a cyclical moderation in growth accompanied by high inflation in the first half of 2008-09. There is now distinct evidence of further slowdown as a consequence of the global downturn.

The knock-on effects of the global financial crisis, economic slowdown, and falling commodity prices are affecting the Indian economy in several ways. Capital flow reversals intensified in September and October 2008 though they have stabilised since then; international credit channels continue to be constrained; capital market valuations remain low; industrial production growth has slackened; export growth has turned negative during October-November 2008; and overall business sentiment has deteriorated. On the positive side, the headline inflation has decelerated, though consumer price inflation is yet to show moderation; and the domestic financial markets are functioning in an orderly manner. Although bank credit growth has been higher than during the previous year, rough calculation shows that flow of overall financial resources to the commercial sector in the current financial year has declined marginally as compared with the previous year. This was on account of decline in other sources of funding such as resource mobilisation from the capital market and external commercial borrowings.

Both the Government and the Reserve Bank have acted to protect the economy from the adverse impact of the crisis since mid-September 2008. While the Government has announced two major fiscal stimulus packages, the endeavour of the Reserve Bank has been to provide ample rupee liquidity, ensure comfortable dollar liquidity and maintain a monetary policy environment conducive for the continued flow of credit to productive sectors. Towards this endeavour, the Reserve Bank has adopted both conventional measures such as, for example, reduction of the cash reserve ratio (CRR), as well as unconventional measures such as, for example, the dollar swap facility for banks.

Measures aimed at expanding rupee liquidity included significant reduction in the CRR, a special repo window under the liquidity adjustment facility (LAF) for banks for on-lending to mutual funds (MFs), non-banking financial companies (NBFCs) and housing finance companies (HFCs), and a special refinance facility that banks can access without any collateral. The Reserve Bank is also unwinding the market stabilisation scheme (MSS) securities roughly synchronised with the government borrowing programme in order to manage liquidity. In addition, a special purpose vehicle (SPV) is being set up to provide liquidity support to non-banking financial companies (NBFCs).

Measures aimed at managing forex liquidity included upward adjustment of the interest rate ceilings on the foreign currency non-resident (banks) [FCNR(B)] and non-resident (external) rupee account [NR(E)RA] deposits, substantially relaxation of the external commercial borrowings (ECB) regime, allowing NBFCs/HFCs access to foreign borrowing and allowing corporates to buy back foreign currency convertible bonds (FCCBs) to take advantage of the discount in the prevailing depressed global markets. The Reserve Bank has also instituted a rupee-dollar swap facility for banks with overseas branches to give them comfort in managing their short-term funding requirements.

Measures to encourage flow of credit to sectors which are coming under pressure included extending the period of pre-shipment and post-shipment credit for exports, expanding the refinance facility for exports, counter-cyclical adjustment of provisioning norms for all types of standard assets barring some exceptions, reducing risk weights on banks' exposure to certain sectors which had been increased earlier counter-cyclically, and expanding the lendable resources available to the Small Industries Development Bank of India (SIDBI), the National Housing Bank (NHB) and the Export-Import (EXIM) Bank of India.

To improve the flow of credit to productive sectors at viable costs so as to sustain the growth momentum, the Reserve Bank signalled a lowering of the interest rate structure by significantly reducing both its key policy rates — the repo rate and the reverse repo rate. The statutory liquidity ratio (SLR) has also been reduced by one percentage point releasing funds to banks for credit deployment.

The Government has announced setting up an SPV for addressing the temporary liquidity constraints of systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI). The mechanism would be as follows: The SPV would issue government guaranteed securities to the Reserve Bank. The SPV will, in turn, use the funds to acquire only investment grade commercial papers and non-convertible debentures of the NBFCs. During its appraisal, the SPV will ensure that the NBFCs use the money only for addressing liquidity constraints and not for business expansion. The total support from the Reserve Bank will be limited to Rs. 20,000 crore with an option to raise it by a further Rs.5,000 crore. The facility will be available for a limited period to address current liquidity concerns of NBFCs.

The several measures taken since mid-September 2008 have resulted in augmentation of actual/potential liquidity of over Rs.3,88,000 crore, which has significantly improved the liquidity condition. In addition, the permanent reduction in SLR by 1.0 per cent of NDTL has made available liquid funds of the order of Rs.40,000 crore for the purpose of credit expansion.

The liquidity situation has improved significantly following several measures taken by the Reserve Bank. The overnight call money rate, which generally hovered above the repo rate during September-October 2008, has softened considerably and has moved towards the lower bound of the LAF corridor since early November 2008. Other money market rates have also softened in tandem with the overnight call money rate. The yield on 10-year government securities has remained below 6 per cent since mid-December 2008. The LAF window has been generally in an absorption mode since mid-November 2008. The liquidity problem faced by mutual funds appears to have eased considerably.

The Reserve Bank has acted aggressively and pre-emptively on monetary policy accommodation, particularly through interest rate cuts in terms of both magnitude and pace. In the space of just one quarter, the repo rate has been reduced from 9.0 per cent to 5.5 per cent and the reverse repo rate from 6.0 per cent to 4.0 per cent, thereby bringing down both of them to historically lowest levels.

The transmission of the policy interest rate signal has been effective in the money and government securities markets; however, the transmission in the credit market has so far been subdued. From the real economy perspective, however, for monetary policy to have demand inducing effects, lending rates will have to come down. Most banks have reduced lending and deposit rates to some extent, but a few have yet to do so. In the Reserve Bank's view, the policy easing done by it in the last few months allows for considerable room for banks to respond more actively to the policy cues.

The Reserve Bank has also assured market participants that it will endeavour to maintain the overnight money market rates within the LAF corridor. The Reserve Bank will continue to pursue this stance of ensuring ample liquidity in the market and maintaining the overnight money market rates within the LAF corridor. In order to do so, the Reserve Bank will, as in the past, employ both conventional and unconventional measures.

The demand for credit from the banking sector has increased as other sources of funds to the commercial sector have shrunk. Available information (as on January 23, 2009) suggests that the total flow of resources to the commercial sector from all sources, estimated at about Rs.4,85,000 crore during the fiscal year 2008-09 so far, has been lower than about Rs.4,99,000 crore in the corresponding period of the previous year. While bank credit has substituted for the shortfall in other sources of funds to some extent, a complete substitution has so far not taken place.

The Reserve Bank's Mid-Term Review of October 2008 had estimated real GDP growth for 2008-09 in the range of 7.5–8.0 per cent. Since then the outlook on real GDP growth has been affected further and the downside risks to growth have amplified because of slowdown of industrial activity and weakening of external demand as reflected in decline in exports. Services sector activities are likely to further decelerate in the second half of 2008-09. Keeping in view the slowdown in industry and services and with the assumption of normal agricultural production, the projection of overall real GDP growth for 2008-09 is revised downwards to 7.0 per cent with a downward bias.

Pressures on commodity prices have abated markedly around the world reflecting slump in global demand. In the domestic market, inflation in terms of wholesale price index is already below 7.0 per cent, which was projected earlier for end-March 2009 and, as per current assessment, is expected to moderate further in the last quarter of 2008-09. Keeping in view the global trend in commodity prices and the domestic demand-supply balance, WPI inflation is now projected to decelerate to below 3.0 per cent by end-March 2009.

Notwithstanding the projected decline in headline WPI inflation, it needs to be noted that consumer price inflation is yet to moderate and the decline in inflation expectations has not been commensurate with the sharp fall in WPI inflation. However, with WPI inflation having moderated significantly, consumer price inflation would also decline, though with a lag. Towards its policy endeavour of ensuring price stability with well-anchored inflation expectations, the Reserve Bank will take into account the behaviour of all the price indices and their components.

Given the uncertain outlook of resource availability from both external and non-bank domestic sources, the Reserve Bank has raised its indicative projection of the total flow of credit from the banking sector to the commercial sector to 24 per cent for 2008-09 from 20 per cent envisaged in the Annual Policy Statement. With a view to enabling banks to sustain the current level of credit flow alongside an enhanced government market borrowing programme, the Reserve Bank's monetary operations will be conducted so as to be consistent with the revised indicative money supply projection of 19.0 per cent for 2008-09, higher than the 16.5-17.0 per cent envisaged in the Annual Policy Statement.

To arrest the moderation in economic growth, it is critical that banks expand the flow of credit to productive sectors of the economy and do so at viable rates. At the same time, banks should monitor their loan portfolios and take early action to prevent delinquencies down the road, and safeguard the gains of last several years in improving asset quality. The Reserve Bank appreciates that risk management is a difficult task in normal circumstances; it is even more challenging in an environment of uncertainty and downturn. Towards this shared endeavour of maintaining the flow of credit to productive sectors, the Reserve Bank will take calibrated monetary policy actions as necessary and at the appropriate time.

Although the origins of the crisis are common around the world, the crisis has impacted different economies differently. Importantly, in advanced economies where it originated, the crisis spread from the financial sector to the real sector. In emerging economies, the transmission of external shocks to domestic vulnerabilities has typically been from the real sector to the financial sector. Countries have responded to the crisis depending on their specific country circumstances. In particular, while policy responses in advanced economies have had to contend with both the financial crisis and recession, in India, the policy response has been predominantly driven by the need to arrest moderation in economic growth. Our ability to respond has been facilitated by the continued smooth functioning of our financial markets and the well-capitalised and healthy banking system. Thus, even as policy responses across countries are broadly similar, their precise design, quantum, sequencing and timing have varied. This has been the case with India too. While we have certainly studied and evaluated measures taken by other central banks around the world, we have calibrated and designed our responses keeping in view India's specific economic context.

In taking a view of the overall outlook, it should be remembered that at the heart of the global financial crisis lie the non-functional and frozen financial markets. In sharp contrast to their international counterparts, the financial system in India has been resilient and stable. Barring some tightness in liquidity during mid-September to early October, the money, foreign exchange and government securities markets have been orderly as reflected in the market rates, spreads and transaction volumes relative to those observed during normal times. India's banking system remains healthy, well-capitalised, resilient and profitable. Credit markets have been functioning well and bank credit has expanded. However, bank credit expansion has not fully offset the shortfall in total flow of resources to the commercial sector.

Over the last five years, India clocked around 8.8 per cent average annual growth, driven largely by domestic consumption and investment even as the share of net exports rose. While the benign global environment, easy liquidity and low interest rates helped, at the heart of India's growth have been its growing entrepreneurial spirit and rise in productivity. These fundamental strengths continue to be in place. Nevertheless, the global crisis will dent India's growth trajectory as investments and exports slow. Clearly, there is a period of painful adjustment ahead of us. However, once the global economy begins to recover, India's turnaround will be sharper and swifter, backed by our strong fundamentals and the untapped growth potential. Meanwhile, the challenge for the Government and the Reserve Bank is to manage the adjustment with as little pain as possible.

Based on the assessment of the global scenario and domestic economy, particularly the outlook on growth and inflation, the stance of monetary policy for the rest of 2008-09 will be as follows:

- Provision of comfortable liquidity to meet the required credit growth consistent with the overall projection of economic growth.
- Respond swiftly and effectively with all possible measures as warranted by the evolving global and domestic situation impinging on growth and financial stability.
- Ensure a monetary and interest rate environment consistent with price stability, well-anchored inflation expectations and orderly conditions in financial markets.

Given the uncertain outlook on the global crisis, it is difficult to precisely anticipate every development. The Reserve Bank will continue to maintain vigil, monitor domestic and global developments, and take swift and effective action to minimise the impact of the crisis and restore the economy to its potential growth path with price stability. The response to the Reserve Bank's policy actions over the last several months is still unfolding. As demonstrated in the recent past, the Reserve Bank will act swiftly and decisively as and when evolving external and domestic conditions so warrant.

Consistent with the above assessment and the monetary policy stance, it has been decided to maintain the policy rates and the cash reserve ratio (CRR) at the current level. Two liquidity facilities, *viz.*, the special refinance facility under Section 17(3B) of the Reserve Bank of India Act, 1934 introduced on November 1, 2008 and the special term repo facility for enabling banks to meet the funding requirements of MFs, NBFCs and HFCs, which are currently available up to June 30, 2009, have been extended up to September 30, 2009."

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