RESERVE BANK OF INDIA

Third Quarter Review of Monetary Policy 2009-10

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Governor

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By
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This Policy Review statement should be read and understood together with the detailed review in Macroeconomic and Monetary Developments released yesterday by the Reserve Bank. The statement is organised in four sections. Section I provides an overview of global and domestic macroeconomic developments; Section II sets out the outlook and projections for growth, inflation, money and credit aggregates. Section III explains the stance of monetary policy and Section IV specifies the monetary measures.

I. The State of the Economy

Global Economy

2. The global economy is showing increasing signs of stabilisation. The growth outlook in virtually all economies is being revised upwards steadily, with the Asian region experiencing a relatively stronger rebound. Global trade is gradually picking up, but other indicators of economic activity, particularly capital flows and asset and commodity prices are more buoyant. However, even as most of the forecasts on recovery are generally optimistic, significant risks remain. The recovery in many economies is driven largely by government spending, with the private sector yet to begin playing a significant part. There are signs that high levels of global liquidity are contributing to rising asset prices as well as rising commodity prices. Emerging market economies (EMEs) are generally recovering faster than advanced economies. But they are also likely to face increased inflationary pressures due to easy liquidity conditions resulting from large capital inflows.

3. While conditions in the beginning of 2010 are significantly better than they were at the beginning of 2009, a different set of policy challenges has emerged for both advanced economies and EMEs. In 2009, while advanced economies were focused on dealing with the financial crisis, especially reviving the credit market and restoring the health of the financial sector, EMEs were engaged in mitigating the adverse impact of the global financial crisis on their real economies. In 2010, the effort in advanced economies will be to further improve the financing conditions and strengthen the growth impulses, while the endeavour in the EMEs will be to strengthen the recovery process without compromising on price stability and to contain asset price inflation stemming from large capital inflows.

Domestic Economy

4. As stated in the Second Quarter Review of October 2009, India's macroeconomic context is different from that of advanced and other EMEs in at least four respects. One, India is facing rising inflationary pressures, albeit largely due to supply side factors. Two, households, firms and financial institutions in India continue to have strong balance sheets, although there is a need to encourage domestic consumption and investment demand. Three, since the Indian economy is supply-constrained, pick-up in demand could exacerbate inflationary pressures. Four, India is one of the few large EMEs with twin deficits - fiscal deficit and current account deficit.

5. Growth during Q2 of 2009-10, at 7.9 per cent, reveals a degree of resilience that surprised many. Subsequent data releases, whether on industrial production, infrastructure or exports, confirm the assessment that the economy is steadily gaining momentum. Based on this better-than-expected performance, growth forecasts for 2009-10 have generally been revised upwards. As reassuring as this recovery is, it is still unbalanced. Public expenditure continues to play a dominant role and performance across sectors is uneven, suggesting that recovery is yet to become sufficiently broad-based.

6. For several months, rapidly rising food inflation has been a cause for concern. More recently, there are indications that the sustained increase in food prices is beginning to spill over into other commodities and services as well. The increases in the prices of manufactured goods have accelerated over the past two months. While food products, understandably, contribute significantly to this, pressures in other sectors are also visible. Further, prices of non-administered fuel items have increased significantly in line with rising international prices. With growth accelerating in the second half of 2009-10 and expected to gain momentum over the next year, capacity constraints could potentially reinforce supply-side inflationary pressures.

7. The inflation risk looms larger when viewed in the context of global price movements. As already indicated, global commodity prices are showing signs of firming up, driven both by the recovery in demand and the asset motive. Significantly, prices of important food items are also firming up. Going by the Food and Agriculture Organisation (FAO) data, the global rates of increase in the prices of sugar, cereals and edible oils are now appreciably higher than domestic rates. The opportunity to use imports as a way to contain domestic food prices is, therefore, quite limited.

8. Monetary aggregates during 2009-10 have so far moved broadly in line with their projections. However, non-food bank credit growth decelerated significantly from its peak of over 29 per cent in October 2008 to a little over 10 per cent in October 2009. Thereafter, it recovered to over 14 per cent by mid-January 2010. This credit performance should be seen in the context of improved access of corporates to non-bank sources of funds this year. Rough calculations show that the total flow of financial resources from banks, domestic non-bank and external sources to the commercial sector during

2009-10 (up to January 15, 2010) at Rs.5,89,000 crore was only marginally lower than Rs.5,95,000 crore in the corresponding period of the previous year. These numbers suggest that non-bank sources of finance have, to a large extent, mitigated the impact of the slow down in bank credit growth.

9. Our previous Reviews have commented on the monetary transmission during the crisis period. While the changes in the Reserve Bank's policy rates were quickly transmitted to the money and government securities markets, transmission to the credit market was slower. Evidently, the transmission is still in progress. The effective average lending rate of scheduled commercial banks declined from 12.3 per cent in March 2008 to 11.1 per cent in March 2009. Although relevant information for the subsequent period is not available, the effective average lending rates may have declined further as banks' benchmark prime lending rates (BPLRs) softened by 25-100 basis points during this period.

10. Financial markets have remained orderly. Overnight money market rates remained below or close to the lower bound of the liquidity adjustment facility (LAF) corridor. Liquidity conditions remained comfortable with the Reserve Bank absorbing about Rs.1,09,000 crore on a daily average basis during the current financial year. Yields on government securities could potentially have increased sharply because of the abrupt increase in government borrowings. However, the upward pressure on yields was contained by lower commercial credit demand, open market operation (OMO) purchases and active liquidity management by the Reserve Bank. Equity markets are behaving in a manner consistent with global patterns. Real estate prices have firmed up as has been the trend in several other EMEs. Increasing optimism about the recovery and high levels of liquidity are driving up real estate prices although they are still some distance away from the pre-crisis peaks.

11. On the fiscal front, the stimulus by the government in the second half of 2008-09 has clearly contributed significantly to the recovery. It may be recalled that the crisis-driven stimulus by way of reduction in excise levies, interest rate subventions and additional capital expenditure came on top of structural measures already built into the budget such as the Sixth Pay Commission Award and farm debt waiver.

12. We will have to await the forthcoming budget in end-February 2010 for the Government's decision on phasing out the transitory components of the stimulus. As regards the structural components, even though they were one-off, some of their impact is expected to continue over the next couple of years, as state governments and public sector enterprises align their compensation structures with the recommendations of the Sixth Pay Commission.

13. Managing the government borrowing programme to finance the large fiscal deficit posed a major challenge for the Reserve Bank. In order to address this, the Reserve Bank front-loaded the government borrowing programme, unwound MSS securities and undertook OMO purchases.

14. On the external front, exports have begun responding to the revival in global demand. Right through the difficulties of 2008-09 and the early months of the current financial year, there was never any pressure on the current account. However, capital outflows in the third quarter of 2008-09 led to some stress on the balance of payments, but we rode this out on the strength of our forex reserves. The Reserve Bank, however, had to initiate some conventional and non-conventional measures to ease the pressure on forex and rupee liquidity. In the space of a year, the situation has clearly stabilised.

15. The current account deficit during April-September 2009 was US$ 18.6 billion, up from US$ 15.8 billion during April-September 2008. Over the first half of 2009-10, capital inflows resumed, but were not significantly in excess of the current account deficit. India's improving growth prospects, combined with persistently high levels of global liquidity, may result in a significant increase in net inflows over the coming months. Depending on how these are handled, there will be implications in terms of a combination of exchange rate appreciation, larger systemic liquidity and the fiscal costs of sterilisation.

II. Outlook and Projections

Global Outlook

Global Growth

16. Global economic performance improved during the third and fourth quarters of 2009, prompting the IMF to reduce the projected rate of economic contraction in 2009 from 1.1 per cent made in October 2009 to 0.8 per cent in its latest World Economic Outlook (WEO) Update released on January 26, 2010. The IMF has also revised the projection of global growth for 2010 to 3.9 per cent, up from 3.1 per cent (Table 1). The IMF expects the growth performance, which will be led by major Asian economies, to vary considerably across countries and regions, reflecting different initial conditions, external shocks, and policy responses.

Table 1: Projected Global GDP Growth (%)*

Country/Region	**2009**	**2010**
US	(-) 2.5	2.7
UK	(-) 4.8	1.3
Euro Area	(-) 3.9	1.0
Japan	(-) 5.3	1.7
China	8.7	10.0
India	5.6	7.7
Emerging and Developing Economies	2.1	6.0
World	(-)0.8	3.9

Source: World Economic Outlook Update, IMF, January 26**.** 2010

17. The IMF has also revised upwards its projection of the real GDP growth of emerging and developing economies for 2009 to 2.1 per cent from its earlier number of 1.7 per cent. The estimates are even more optimistic for 2010. The growth of emerging and developing economies is now projected at 6.0 per cent, up from 5.1 per cent earlier. The growth in EMEs such as China and India and other emerging Asian economies is expected to be robust. Commodity-producing countries are likely to recover quickly in 2010 on the back of a rebound in commodity prices.

Global Inflation

18. The IMF expects that the high levels of slack in resource utilisation and stable inflation expectations will contain global inflationary pressures in 2010. In the advanced economies, headline inflation is expected to increase from zero in 2009 to 1.3 per cent in 2010, as rising energy prices may more than offset deceleration in wage levels. In emerging and developing economies, inflation is expected to rise to 6.2 per cent in 2010 from 5.2 per cent in 2009 due to low slack in resource utilisation and increased capital inflows.

Domestic Outlook

Growth

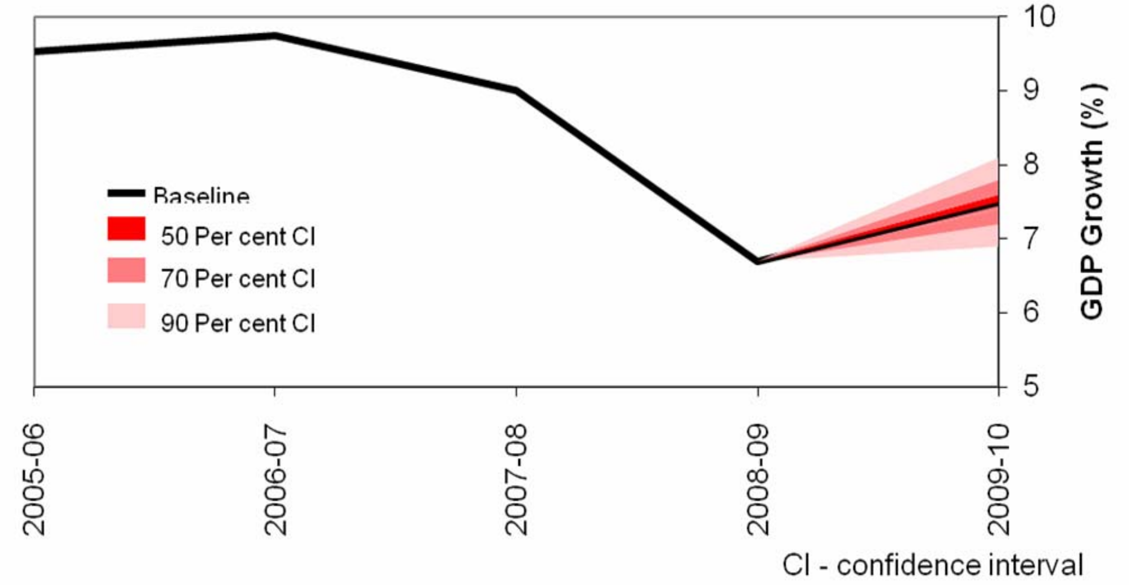
19. During 2009-10, real GDP growth accelerated from 6.1 per cent in Q1 to

7.9 per cent in Q2 driven by revival in industrial growth, and pick-up in services sector growth, aided by payment of arrears arising out of the Sixth Pay Commission Award. It is expected that Q3 growth, which will reflect the full impact of the deficient south-west monsoon rainfall on kharif crops, would be lower than that of Q2. As rabi prospects appear to be better, on the whole, agricultural GDP growth in 2009-10 is expected to be near zero.

20. As a result of the improvement in the global economic situation since the Second Quarter Review in October 2009, exports expanded in November 2009, after contracting for 13 straight months. This positive trend is expected to persist. The industrial sector recovery, some signs of which were noted in the Second Quarter Review, is now consolidating. The performance of the corporate sector has picked up. Increased business optimism also reflects brighter prospects for the industrial sector. Services sector activities have improved. Domestic and international financing conditions have eased considerably, and this too should support domestic demand.

21. In the Second Quarter Review of October 2009, we had placed the baseline projection for GDP growth for 2009-10 at 6.0 per cent with an upside bias. The movements in the latest indicators of real sector activity indicate that the upside bias has materialised. Assuming a near zero growth in agricultural production and continued recovery in industrial production and services sector activity, the baseline projection for GDP growth for 2009-10 is now raised to 7.5 per cent (Chart 1).

Chart 1: Projection of GDP Growth for 2009-10



22. Looking ahead to 2010-11, our preliminary assessment of the baseline scenario is that the current growth will be sustained. This is a tentative assessment. We shall formally indicate our growth projection for 2010-11 in our Monetary Policy in April 2010.

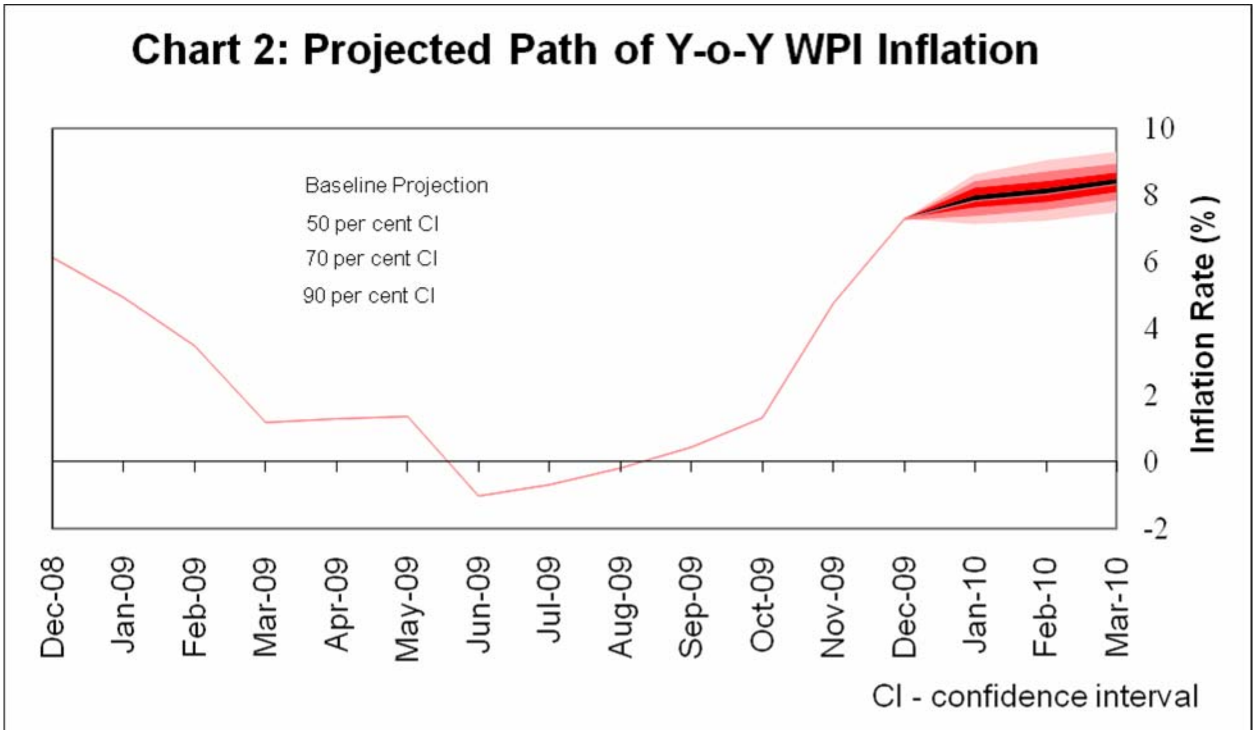
Inflation

23. Headline wholesale price index (WPI) inflation was 1.2 per cent in March 2009. It continued to decline and became negative during June-August 2009 due to the large statistical base effect. It turned positive in September 2009, accelerated to 4.8 per cent in November 2009 and further to 7.3 per cent in December 2009. On a financial year basis, between April-December 2009, WPI moved up by 8 per cent.

24. The deficient monsoon rainfall and drought conditions in several parts of the country have accentuated the pressure on food prices, pushing up the overall inflation rate – both of the WPI and consumer price indices (CPIs). Going forward, the rabi crop prospects are assessed to be better. The large stock of foodgrains with public agencies should help supply management. On the other hand, there is a risk that inflationary pressures may emanate from the rebound in global commodity prices.

25. Assessment of inflationary pressures has become increasingly complex in the recent period as the WPI and CPI inflation rates have shown significant divergence. All the four CPIs have remained elevated since March 2008 due to the sharp increase in essential commodity prices. The Reserve Bank monitors an array of measures of inflation, both overall and disaggregated components, in conjunction with other economic and financial indicators to assess the underlying inflationary pressures for formulating its monetary policy stance.

26. The Second Quarter Review of October 2009 projected WPI inflation of 6.5 per cent with an upside bias for end-March 2010. The upside risks in terms of higher food prices reflecting poor monsoon have clearly materialised. However, some additional factors have also exerted upward pressure on WPI inflation. One, the expected seasonal moderation has not taken place, other than in vegetables. Two, prices of the non-administered component of the fuel group, tracking the movement in global crude prices, have also risen significantly. Three, there have also been some signs of demand side pressures. The Reserve Bank's quarterly inflation expectations survey for households indicates that inflation expectations are on the rise. Keeping in view the global trend in commodity prices and the domestic demand-supply balance, the baseline projection for WPI inflation for end-March 2010 is now raised to 8.5 per cent (Chart 2).



27. As with growth, we shall formally announce our inflation projection for 2010-11 in our Monetary Policy in April 2010. However, on the assumption of a normal monsoon and global oil prices remaining around the current level, it is expected that inflation will moderate from July 2010. This moderation in inflation will depend upon several factors, including the measures taken and to be taken by the Reserve Bank as a part of the normalisation process.

28. As always, the Reserve Bank will endeavour to ensure price stability and anchor inflation expectations. The conduct of monetary policy will continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent. This will be in line with the medium-term objective of 3.0 per

cent inflation consistent with India’s broader integration with the global economy.

Money and Credit Aggregates

29. During the current financial year, the year-on-year growth in money supply (M_3) moderated from over 20.0 per cent at the beginning of the financial year to 16.5 per cent on January 15, 2010, reflecting deceleration in bank credit growth during 2009-10. Year-on-year increase in non-food bank credit to the commercial sector, at 14.4 per cent as on January 15, 2010, was significantly lower than the 22.0 per cent growth a year ago. Consequently, the more important source of M_3 expansion this year has been bank credit to the government, reflecting the enlarged support to the market borrowing of the government and unwinding of MSS securities.

30. Aided by the measures initiated by the Reserve Bank (see para 13), over 98 per cent of the net market borrowing programme of the Central Government for 2009-10 has already been completed by January 28, 2010. The anticipated increase in credit demand by the commercial sector in the remaining period of 2009-10 can, therefore, be easily met from the market as adequate liquidity is available in the system. In view of the increased availability of funds from domestic non-bank and external sources (see para 8), the 18 per cent growth in adjusted non-food credit growth projected earlier is unlikely to be realised. Accordingly, the indicative adjusted non-food credit growth projection for 2009-10 is now reduced to 16 per cent. Based on this projected credit growth and the remaining very marginal market borrowing of the government, the projected M_3 growth in 2009-10 has been reduced to 16.5 per cent for policy purposes. Consistent with this, aggregate deposits of scheduled commercial banks are projected to grow by 17 per cent. These numbers, as before, are provided as indicative projections and not as targets.

Risk Factors

31. While the baseline scenario is comforting, a number of downside risks to growth and upside risks to inflation need to be recognised.

(i) There is still uncertainty about the pace and shape of global recovery. There are concerns that it is too dependent on public spending and will unravel if governments around the world withdraw their fiscal stimuli prematurely. As the world discovered during the recent crisis, the global economy is heavily inter-linked through the business cycle. A downturn in global sentiment will affect not only our external sector but also our domestic investment.

(ii) Oil prices have been range-bound in the recent period. However, if the global recovery turns out to be stronger than expected, oil prices may increase sharply, driven both by prospects of demand recovery and the return of the investment motive, which will affect all commodities.

This could stoke inflationary pressures even as growth remains below potential.

(iii) Expectations of softening domestic inflation are contingent on food prices moderating. This, in turn, depends significantly on the performance of the south-west monsoon in 2010. If rainfall is inadequate, high food prices will continue to intensify inflationary pressures.

(iv) So far, capital inflows have been absorbed by the current account deficit. However, sharp increase in capital inflows, above the absorptive capacity of the economy, may complicate exchange rate and monetary management.

(v) As growth accelerates and the output gap closes, excess liquidity, if allowed to persist, may exacerbate inflation expectations.

32. Beyond the above risk factors, by far a bigger risk to both short-term economic management and to medium-term economic prospects emanates from the large fiscal deficit. The counter-cyclical public finance measures taken by the government as part of the crisis management were necessary; indeed they were critical to maintaining demand when other drivers of demand had weakened. But as the recovery gains momentum, it is important that there is co-ordination in the fiscal and monetary exits. The reversal of monetary accommodation cannot be effective unless there is also a roll back of government borrowing. As indicated earlier (para 13), even as the government borrowing had increased abruptly during 2008-09 and 2009-10, it could be managed through a host of measures that bolstered liquidity. Those liquidity infusion options will not be available to the same extent next year. On top of that, there will be additional constraints. Inflation pressures will remain and private credit demand will be stronger with the threat of crowding out becoming quite real.

33. There are standard, well-known and well-founded reasons for fiscal consolidation. For both short-term economic management and medium-term fiscal sustainability reasons, it is imperative, therefore, that the government returns to a path of fiscal consolidation. The consolidation can begin with a phased roll back of the transitory components. Beyond that, in the interest of transparency and predictability, the government should ideally do two things: first, indicate a roadmap for fiscal consolidation; and second, spell out the broad contours of tax policies and expenditure compression that will define this roadmap.

III. The Policy Stance

34. The Reserve Bank has pursued an accommodative monetary policy beginning mid-September 2008 in order to mitigate the adverse impact of the global financial crisis on the Indian economy. The measures taken instilled confidence in market participants and helped cushion the spillover of the

global financial crisis on to our economy. However, in view of rising food inflation and the risk of it impinging on inflationary expectations, the Reserve Bank announced the first phase of exit from the expansionary monetary policy by terminating some sector-specific facilities and restoring the statutory liquidity ratio (SLR) of scheduled commercial banks to its pre-crisis level in the Second Quarter Review of October 2009.

35. Against the above backdrop of global and domestic macroeconomic conditions, outlook and risks, our policy stance in this Quarter is shaped by three important considerations:

(i) A consolidating recovery should encourage us to clearly and explicitly shift our stance from 'managing the crisis' to 'managing the recovery'. We articulated this change in our stance in the October quarterly review, but the growing confidence in the recovery justifies our moving further in reversing the crisis-driven expansionary stance. Our main policy instruments are all currently at levels that are more consistent with a crisis situation than with a fast-recovering economy. It is, therefore, necessary to carry forward the process of exit further.

(ii) Though the inflationary pressures in the domestic economy stem predominantly from the supply side, the consolidating recovery increases the risks of these pressures spilling over into a wider inflationary process. Looking ahead into 2010-11, if the growth momentum turns out to be as expected, pressures on capacities in an increasing number of sectors are likely to strengthen the transmission of higher input and wage costs into product prices.

(iii) Even amidst concerns about rising inflation, we must remember that the recovery is yet to fully take hold. Strong anti-inflationary measures, while addressing one problem, may precipitate another by undermining the recovery, particularly by deterring private investment and consumer spending.

36. Against this backdrop, the stance of monetary policy of the Reserve Bank for the remaining period of 2009-10 will be as follows:

- Anchor inflation expectations and keep a vigil on the trends in inflation and be prepared to respond swiftly and effectively through policy adjustments as warranted.
- Actively manage liquidity to ensure that credit demands of productive sectors are adequately met consistent with price stability.
- Maintain an interest rate environment consistent with price stability and financial stability, and in support of the growth process.

IV. Monetary Measures

37. On the basis of the current assessment and in line with the policy stance as outlined in Section III, the Reserve Bank announces the following policy measures:

Bank Rate

38. The Bank Rate has been retained at 6.0 per cent.

Repo Rate

39. The repo rate under the Liquidity Adjustment Facility (LAF) has been retained at 4.75 per cent.

Reverse Repo Rate

40. The reverse repo rate under the LAF has been retained at 3.25 per cent.

Cash Reserve Ratio

41. It has been decided to:

- increase the cash reserve ratio (CRR) of scheduled banks by 75 basis points from 5.0 per cent to 5.75 per cent of their net demand and time liabilities (NDTL) in two stages; the first stage of increase of 50 basis points will be effective the fortnight beginning February 13, 2010, followed by the next stage of increase of 25 basis points effective the fortnight beginning February 27, 2010.

42. As a result of the increase in the CRR, about Rs. 36,000 crore of excess liquidity will be absorbed from the system.

43. The Reserve Bank will continue to monitor macroeconomic conditions, particularly the price situation closely and take further action as warranted.

Expected Outcomes

44. The expected outcomes of the actions are:

(i) Reduction in excess liquidity will help anchor inflationary expectations.

(ii) The recovery process will be supported without compromising price stability.

(iii) The calibrated exit will align policy instruments with the current and evolving state of the economy.

Monetary Policy 2010-11

45. The Monetary Policy for 2010-11 will be announced on April 20, 2010.

Mumbai

January 29, 2010