

Reserve Bank of India

Third Quarter Review of Monetary Policy 2009 – 10

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Section I Overview of Global Economy and domestic macroeconomic development

Global Economy

The Global economy is showing rising signs of stabilization. The growth outlook in almost all economies is being revised upwards steadily, the Asian region experiencing a relatively stronger return. The most of the forecasts on recovery are optimistic, significant risk remains. Emerging market economies (EMEs) are recovering faster than advanced economies but they have to face increased inflationary pressures due to easy liquidity conditions resulting from large capital inflow.

In 2009, the advanced economies were focused on dealing with the economic downturn, especially reviving the credit market and restoring the health of financial sector. EMEs engaged in mitigating the adverse impact of the global financial crises on their real economies.

In 2010, the effort in advanced economies will be to further improve the financing conditions and reinforce the growth impulses, while the efforts in the EMEs will be strengthen the recovery process without compromising on price stability and to contain asset price inflation stemming from large capital inflows.

Domestic Economy

As per *Second Quarter Review of October 2009*, India's macroeconomic context is different from advanced and other EMEs in following respects:

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1. Rising inflationary pressures, albeit largely due to supply side factors.
2. Households, firms and financial institutions in India continue to have strong balance sheets, although there is need to encourage domestic consumption and investment demand.
3. Supply- constrained, pick-up in demand could exacerbate inflationary pressure.
4. Fiscal deficit and current account deficit.

Growth during Q2 of 2009-10, at 7.9 per cent, reveals a degree of resilience. Public expenditure continues to play a dominant role and performance across sectors is uneven, suggesting that recovery is yet to become sufficient broad – based.

Rapid rising food inflation has been a cause for concern. The inflation risk looms larger as compare to global price movements. The global commodity prices are showing signs of firming up, driven both by the recovery in demand and asset motive.

The credit performance should be seen in the context of improved access of corporate to non – bank sources of fund this year. The non – bank source of finance have, to a large extent, mitigated the impact of slow down in bank credit growth.

Yields on government securities could potentially have increased sharply because of the sudden increased in government borrowings. However, the upward pressure on yields was contained by lower commercial credit demand, open market operation (OMO) purchases and actively liquidity management by the Reserve Bank.

Equity markets are behaving in a manner consistent with global pattern. Real Estate prices have firmed up as has been 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.

Managing the government borrowings programme to finance the larger fiscal deficit posed major challenges for the Reserve Bank. In order to address this, the Reserve Bank front – loaded the government borrowing programme, unwound MSS securities and undertook OMO purchase.

The current account deficit during April – September 2009 was US \$ 18.6 billion, up from US \$ 15.8 billion during April – September 2008.

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.

Section II Outlook and Projection

Global Growth and Inflation

Global economic performance improved during the third and fourth quarters of 2009. 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.

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

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.

In 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 utilization and increased capital inflows.

Domestic Growth and Inflation

During 2009-10, real GDP growth accelerated from 6.1 per cent in Q1 to 7.1 per cent in Q2 driven by revival in industrial growth, and pick up in service sector, aided by payment of arrears arising out of the Sixth Pay Commission Award.

As a result of the improvement in the global economic situation since Second Quarter Review in October 2009, exports expanded in November 2009, after contracting for 13 straight months. This positive trend is expected to persist. 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.

Headlines 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 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.

Money and Credit Aggregates

The most important source of money supply (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.

Risk Factor

There is still uncertainty about the pace and shape of global recovery. If the global recovery turns out to be stronger than expected, oil prices may increase sharply.

The high food prices will continue to intensify inflationary pressure. The bigger risk to both short-term economic management and to medium-term economic prospects emanates from the large fiscal deficit.

Section III Stance of Monetary Policy

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:

1. 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.
2. 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.
3. 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.

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

1. 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.
2. Actively manage liquidity to ensure that credit demands of productive sectors are adequately met consistent with price stability.
3. Maintain an interest rate environment consistent with price stability and financial stability, and in support of the growth process.

Section IV Monetary Measures

Bank Rate: Bank Rate, used to price long term loans remains unchanged at 6.00 per cent.

Repo Rate: The repo rate under the liquidity adjustment facility (LAF) has been retained at 4.75%.

Reverse Repo Rate: The reverse repo rate under the LAF has been retained at 3.25%.

Cash Reserve Ratio (CRR): 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.
- As a result of the increase in the CRR, about Rs. 36,000 crore of excess liquidity will be absorbed from the system.