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Monetary Policy Statement for 2011-12
Press Statement by Dr. D. Subbarao, Governor

"First of all, on behalf of the Reserve Bank of India, I want to welcome all of you to this announcement of our Annual Monetary Policy.

2. The Annual Policy for 2011-12 is set in conditions significantly different from those a year ago. Last year's policy was made in an environment of incipient domestic recovery and uncertainty about the state of the global economy. While signs of inflation were visible, they were driven primarily by food items. Nonetheless, there was a clear risk of food price pressures spilling over into more generalised inflation, as the recovery consolidated and domestic resource utilisation rose to levels which stretched capacities. Throughout last year, the goal of monetary policy was to nurture the recovery in the face of persistent global uncertainty, while trying to contain the spill-over of supply side inflation.

3. The Reserve Bank followed a policy of calibrated tightening last year. This was justified by the trend of moderating inflation and consolidating growth in the second and third quarters of 2010-11. However, the resurgence of inflation in the last quarter of last year became a matter of concern. Although the trigger for this was the sharp uptrend in international commodity prices, the fact that these have quickly passed through into the entire range of domestic manufactured goods indicates that pricing power is significant. In other words, demand has been strong enough to allow significant pass-through of input price increases. Importantly, this is happening even as there are visible signs of moderating growth, particularly in capital goods production and investment spending, suggesting that cumulative monetary actions are beginning to have an impact on demand.

4. Thus, three factors have shaped the outlook and monetary strategy for 2011-12.

- First, global commodity prices, which have surged in recent months are, at best, likely to remain firm, and may well increase further over the course of the year. This suggests that higher inflation will persist, and may indeed get worse.
- Second, headline and core inflation have significantly overshot even the most pessimistic projections over the past few months. This raises concerns about inflation expectations becoming unhinged.
- The third factor, one countering the above forces, is the likely moderation in demand, which should help reduce pricing power and the extent of pass-through of commodity prices. This contra trend cannot be ignored in the policy calculation. However, a significant factor influencing aggregate demand during the year will be the fiscal situation. The budget estimates offered reassurance of a fiscal rollback. However, the critical assumption, that

petroleum and fertiliser subsidies would be capped, is bound to be seriously tested at prevailing crude oil prices. Even though an adjustment of domestic retail prices may add to the inflation rate in the short run, the Reserve Bank believes that this needs to be done as soon as possible. Otherwise, the fiscal deficit will widen and will counter the moderating trend in aggregate demand.

5. The monetary policy trajectory that is being initiated in this Annual Statement is based on the following basic premise. Over the long run, high inflation is inimical to sustained growth as it harms investment by creating uncertainty. Current elevated rates of inflation pose significant risks to future growth. Bringing them down, therefore, even at the cost of some growth in the short-run, should take precedence.

Monetary Policy Stance

6. Against the above backdrop, the stance of monetary policy of the Reserve Bank will be as follows:

- First, to maintain an interest rate environment that moderates inflation and anchors inflation expectations.
- Second, to foster an environment of price stability that is conducive to sustaining growth in the medium-term, coupled with financial stability.
- Third, to manage liquidity to ensure that it remains broadly in balance, with neither a large surplus diluting monetary transmission nor a large deficit choking off fund flows.

Changes in Operating Procedure of Monetary Policy

7. Before announcing our policy measures, let me make a comment on the changes we are making to the operating procedure of monetary policy.

8. Last July, the Reserve Bank constituted a Working Group to Review the Operating Procedure of Monetary Policy. The report of the Group, chaired by our Executive Director, Deepak Mohanty, was put out in the public domain in March 2011 inviting feedback and comments.

9. Based on the Group’s recommendations, and in light of the feedback received, it has been decided to make the following changes to the operating procedure of monetary policy:

- First, the weighted average overnight call money rate will be the operating target of monetary policy of the Reserve Bank.
- Second, there will henceforth be only one independently varying policy rate, and that will be the repo rate. This transition to a single independently varying policy rate is expected to more accurately signal the monetary policy stance.
- Third, the reverse repo rate will continue to be operative, but it will be pegged at a fixed 100 basis points below the repo rate. Hence, the reverse repo rate will no longer be an independent variable.
- Fourth, we will be instituting a new Marginal Standing Facility (MSF). Banks can borrow overnight from the MSF up to one per cent of their respective net demand and time liabilities or NDTL. The rate of interest on amounts accessed from this facility will be 100 basis points above the repo rate.
- As per the above scheme, the revised corridor will have a fixed width of 200 basis points. The repo rate will be in the middle. The reverse repo rate will be 100 basis points below it, and the MSF rate 100 basis points above it.

10. These changes in the operating framework, except that pertaining to the MSF, will come into force immediately. The MSF will come into effect from the fortnight beginning 7th May, 2011.

Monetary Measures

11. On the basis of the policy stance that I outline above, and in accordance with changes in operating procedure as set out, we have decided to take the following policy measures:

i) The repo rate under the liquidity adjustment facility (LAF) has been increased by 50 basis points. Accordingly, it goes up from 6.75 per cent to 7.25 per cent.
ii) As per the new operating procedure, the reverse repo rate under the LAF, determined with a 100 basis point spread below the repo rate, will stand adjusted at 6.25 per cent.
iii) The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, gets calibrated at 8.25 per cent.
iv) The Bank Rate remains at 6.0 per cent.
v) The cash reserve ratio (CRR) remains unchanged at 6 per cent of NDTL of scheduled banks.

Savings Bank Deposit Interest Rate

12. Let me now turn to the savings bank deposit interest rate on which there has been a lot of media comment over the last week. A week ago, the Reserve Bank put out a discussion paper debating the pros and cons of this proposal. We will review the policy of deregulating the savings bank deposit rate based on the feedback that we get.

13. Pending a final decision on that, we have decided to increase the savings bank deposit interest rate from the present 3.5 per cent to 4.0 per cent with immediate effect.

Expected Outcomes

14. As regards outcomes, the above monetary policy actions are expected to:

- First, contain inflation by reining in demand side pressures, and anchor inflation expectations; and
- Second, the actions are expected to sustain growth in the medium-term by containing inflation.

15. Let me give you some guidance for the period forward. The Reserve Bank's baseline inflation projections are that inflation will remain elevated, close to the March 2011 level over the first half of 2011-12, before declining. These projections factor in an upward revision of petrol and diesel prices. While the persistence of inflation over the next few months has been incorporated into this policy, the Reserve Bank will continue to persevere with its anti-inflationary stance.

Overview

16. I now want to give you an overview of the global and domestic macroeconomic developments that guided our monetary policy stance, and our growth and inflation projections.

Global Outlook

17. On the global front, recovery is expected to sustain in 2011 even as it is projected to moderate marginally from its 2010 pace due to the phasing out of the fiscal stimulus, and high oil and other commodity prices. Growth in emerging market economies is also expected to decelerate on account of monetary tightening and rising

commodity prices. The advanced economies are facing inflation pressures from high commodity prices, while inflation pressures for the emerging market economies are stemming from both strong domestic demand and high commodity prices.

The Indian Economy

Growth

18. Turning to the domestic macroeconomic situation, the Indian economy is estimated to have grown by 8.6 per cent last year. Agricultural growth was above trend, following a good monsoon. The index of industrial production (IIP), which grew by 10.7 per cent during the first half of last year, moderated subsequently, bringing down the overall growth for April-February 2010-11 to 7.8 per cent. Particularly significant were the slowdown in capital goods production and investment spending.

19. Going forward, high oil and other commodity prices and the impact of the Reserve Bank's anti-inflationary monetary stance will moderate growth. Based on the assumption of a normal monsoon, and crude oil prices averaging $110 a barrel over the full year 2011-12, our baseline projection of real GDP growth for 2011-12, for policy purposes, is around 8 per cent.

Inflation

20. Inflation has been, and remains, a primary macroeconomic concern. Last year, inflation was driven by a combination of structural and transitory factors. Based on drivers of inflation, the year gone by, could broadly be divided into three periods.

- In the first period from April to July 2010, WPI increased by 3.5 per cent, and this was driven largely by food items.
- During the second period from August to November 2010, WPI increase decelerated to 1.8 per cent, with the major driver being non-food primary articles.
- In the third period, from December 2010 to March 2011, WPI increased sharply by 3.4 per cent, driven primarily by non-food manufactured products.
- Inflation pressures, which initially emanated from food, clearly became generalised as the year progressed.

21. Going forward, the inflation outlook will be shaped by the following factors:

- The first factor is, when administered fuel and power group prices might be revised and by how much.
- Second, the outlook for crude oil prices in the near future is uncertain given the geopolitical situation in the Middle East and North Africa. In any case, the likelihood of oil prices moderating significantly is low.
- The third factor that will shape the inflation outlook is the sharp increase in the prices of several important industrial raw materials such as minerals, fibres, rubber, coal and crude oil. In addition, there is also upward pressure on wages. To the extent the increase in input prices translates to output prices, it will have an influence on the inflation path.
- Finally, the behaviour of the monsoon will be a critical factor in shaping inflation expectations on the way forward.

22. Keeping in view the domestic demand-supply balance, the global trend in commodity prices, and the likely demand scenario, our baseline projection for WPI inflation for March 2012 is 6 per cent with an upward bias.

23. As regards the trajectory over the year, inflation is expected to remain at an elevated level in the first half of the year, before gradually moderating to 6 per cent by March 2012. This trajectory is conditional on appropriate policy actions over the year.

Monetary and Liquidity Conditions

24. Liquidity conditions remained abnormally tight for much of last year owing to a combination of structural and frictional factors. The LAF corridor stayed almost entirely in the injection mode during the year. You will recall that the Reserve Bank had instituted a number of measures to ease the excessive tightness in the system.

25. Liquidity conditions have eased significantly in recent weeks, following a sharp reduction in government cash balances, and moderation in the credit-deposit ratio of banks. The liquidity situation is now within the comfort zone of the Reserve Bank.

External Sector

26. A brief, albeit important, comment about the external sector. Exports showed remarkable buoyancy in the last quarter of last fiscal. The current account deficit (CAD) was 3.1 per cent of GDP for the first three quarters, April-December 2010. Factoring in the better performance in the last quarter, CAD is now estimated to have moderated to around 2.5 per cent of GDP for the full year, 2010-11 as compared with 2.8 per cent for the year before, 2009-10.

Risk Factors

27. Now let me highlight the risks to our growth and inflation projections:

- First, there are several downside risks to global growth at this stage such as: (a) sovereign debt problem in the euro area, (b) high commodity prices, especially oil prices, (c) possible abrupt rise in long-term interest rates in advanced economies with implications for fiscal adjustment; and (d) accentuation of inflationary pressures in emerging market economies. Should the global recovery slacken because of any or some of these factors, it will impact our economy through trade, finance and confidence channels.
- Second, global commodity prices are a significant risk factor for both domestic growth and inflation. The future path of crude oil prices is uncertain.
- Third, the budgeted fiscal deficit for the current year gives some comfort on the demand front. However, the achievement of the fiscal targets set out in the budget could be challenged by the higher subsidy burden stemming from higher international crude oil prices.
- Fourth, persistently high food prices are likely to exert sustained upward pressure on wages, thus transmitting through to wider cost pressure on prices.
- Finally, if oil and commodity prices remain elevated, both the level of current account deficit, and its financing could pose a challenge.

Developmental and Regulatory Polices

28. As is the standard practice, this Annual Monetary Policy Statement also includes developmental and regulatory policies. Let me briefly touch upon some of the important initiatives.

29. I will start with the Malegam Committee Report on Regulation of Micro Finance Institutions.

- The Reserve Bank has broadly accepted the framework of regulations recommended by the Malegam Committee. We have, however, adjusted some of the parameters recommended by the Committee.

- Bank loans to all MFIs, including NBFCs working as MFIs on or after April 1, 2011, will be eligible for classification as priority sector loans if, and only if, they conform to the regulations formulated by the Reserve Bank.
- As recommended by the Malegam Committee, the Reserve Bank has also decided to appoint a Committee to review the priority sector lending classification.

30. A broad goal driving our financial inclusion initiative is to provide banking access to all villages with population of over 2000 by March 2012. There are 72,800 villages identified as falling into this category. We are asking banks to ensure that at least 25 per cent of the new branches being opened during this year are located in tier 5 and tier 6 centres.

31. In the area of financial markets, there are three important initiatives:

- First, the Reserve Bank will shortly issue the final guidelines on credit default swaps.
- Second, the period of short sale in government securities will be extended from the existing five days to a maximum of three months.
- Third, FIIs will be allowed to cancel and rebook up to 10 per cent of the market value of the portfolio as at the beginning of the financial year.

32. Moving on to regulatory measures for commercial banks, I want to highlight two measures:

- First, the provisioning requirements on certain categories of non-performing advances and restructured advances will be enhanced.
- Second, investment by banks in liquid schemes of debt oriented mutual funds will be subject to a prudential cap of 10 per cent of their net worth as on March 31 of the previous year.

33. I invite you to please read the policy document for a full listing of our developmental and regulatory measures.

34. Before I close, I want to reiterate what I said earlier, by making a brief comment on the growth-inflation trade off, an issue that has been widely debated in the run up to this policy. High and persistent inflation undermines growth by creating uncertainty for investors, and driving up inflation expectations. An environment of price stability is a pre-condition for sustaining growth in the medium-term. Reining in inflation should therefore take precedence even if there are some short-term costs by way of lower growth".

Ajit Prasad
Assistant General Manager

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