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RESERVE BANK OF INDIA

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# Press Statement by Dr. D. Subbarao Governor, Reserve Bank of India

First of all, on behalf of the Reserve Bank, a hearty welcome to all of you to this annual Monetary Policy for 2012-13.

2. A short while ago, we put out our annual Monetary Policy Statement. Based on an assessment of the current macroeconomic situation, we have decided to:

- reduce the repo rate under the liquidity adjustment facility (LAF) by 50 basis points. The repo rate will accordingly drop from 8.5 to 8.0 per cent.

3. Consequent to this, the reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, gets calibrated to 7.0 per cent. Similarly, the marginal standing facility (MSF) rate, which has a spread of 100 bps above the repo rate, stands adjusted to 9.0 per cent.

4. In order to provide greater liquidity cushion, we have also decided to raise the borrowing limit of scheduled commercial banks under the marginal standing facility (MSF) from one per cent to two per cent of their net demand and time liabilities (NDTL).

5. These changes have come into effect immediately after the announcement.

## Considerations Behind the Policy Move

6. The decision to ease the monetary policy has been informed by two broad considerations.

7. First, growth decelerated significantly to 6.1 per cent in the third quarter of last year, although it is expected to have recovered moderately in the fourth quarter. Based on current assessment, the economy is clearly operating below its post-crisis trend.

8. The second consideration that shaped the policy decision is the decline in inflation. Headline WPI inflation which remained above 9 per cent for nearly two years has moderated significantly to below 7 per cent by March 2012. More importantly, non-food manufactured products inflation has dropped from a high of 8.4 per cent in November 2011 to 4.7 per cent in March 2012, actually coming below 5 per cent for the first time in two years.

**Monetary Policy Stance**

9. The policy document also spells out the three broad contours of our monetary policy stance. These are:

- first, to adjust the policy rates to levels consistent with the current growth moderation;
- second, to guard against risks of demand-led inflationary pressures re-emerging; and
- third, to provide greater liquidity cushion to the financial system.

**Guidance**

10. As in the past, we have also given guidance for the period forward.

11. The reduction in the repo rate is based on an assessment of growth having slowed below its post-crisis trend rate which, in turn, is contributing to a moderation in core inflation. However, it must be emphasised that the deviation of growth from its trend is modest. At the same time, upside risks to inflation persist. These considerations inherently limit the space for further reduction in policy rates.

12. Moreover, if subsidies are not contained as indicated in the Union Budget last month, demand pressures will persist, and will further reduce whatever space there is for monetary easing. Revisions in administered prices may adversely impact headline inflation. But I would like to underscore that the appropriate monetary policy response to this should be based on whether the higher prices translate into generalized inflationary pressures. The likelihood of a pass-through of higher administered prices to generalised inflation depends on the strength of the pricing power in the economy. The pricing power is currently abating, but the risk of a pass-through cannot be ignored altogether. Overall, from the perspective of vulnerabilities emerging from the fiscal and current account deficits, it is imperative for macroeconomic stability that administered prices of petroleum products are increased to reflect their true costs of production.

13. Liquidity management posed a major challenge for much of last year. However, liquidity conditions have eased in recent weeks, and are now steadily moving towards the comfort zone of the Reserve Bank. This is reflected in the decline in banks' borrowings from the LAF and the behaviour of money market rates. The increase in the MSF limit to banks that we just announced should provide additional liquidity comfort. However, should the situation change, appropriate and proactive steps will be taken with the objective of restoring comfort zone conditions.

**Expected Outcomes**

14. We expect that today's policy actions, and the guidance that we have given, will result in the following three outcomes:

- First, growth will stabilise around its current post-crisis trend.
- Second, risks of inflation and inflation expectations re-surging will be contained.
- Finally, the liquidity cushion available to the system will be enhanced.

## Global and Domestic Developments

15. As always, our decision has been based on a careful assessment of the global and domestic macroeconomic situation. Let me begin with our assessment of the global economy.

## Global Economy

16. Concerns about a crisis in the euro area have abated somewhat since the Reserve Bank's Third Quarter Review in January 2012. The US economy continues to show signs of modest recovery. Large scale liquidity infusions by the European Central Bank have significantly reduced the stress in global financial markets. However, a sustainable solution to the euro area debt problem is yet to emerge. Recent developments, for example in Spain, indicate that the euro area sovereign debt problem will continue to weigh on the global economy.

17. Growth also slowed down in emerging and developing economies (EDEs) reflecting the combined impact of monetary tightening and slowdown in global growth. And, amidst all these, international crude oil prices have risen by about 10 per cent since January and show signs of persisting at current levels.

## Indian Economy

18. Turning to the domestic macroeconomic situation, economic growth decelerated last year, dropping from 7.7 per cent in the first quarter to 6.9 per cent in the second quarter and further down to 6.1 per cent in the third quarter. This was mainly due to deceleration in industrial growth. Growth in the services sector held up relatively well. On the demand side, gross fixed capital formation contracted both in the second and third quarters of last year.

19. The Central Statistics Office (CSO) put out an advance estimate of GDP growth for last year of 6.9 per cent. More recent data on industrial production suggest that activity may have expanded at a slower pace last year.

20. Looking ahead, the overall growth outlook for the current year looks a little better than it was last year. Accordingly, the Reserve Bank's baseline projection of GDP growth for the current year is 7.3 per cent.

*Inflation*

21. Moving on to inflation, headline WPI inflation, which remained above 9 per cent during April-November 2011, moderated to 6.9 per cent by end-March 2012. This moderation was consistent with the Reserve Bank's indicative projection of 7 per cent.

22. Food articles inflation continues to be high. Significantly. inflation in protein items is in double digits, reflecting persistent structural demand-supply imbalances in protein foods.

23. Fuel inflation, on the other hand, moderated from over 15 per cent in November-December 2011 to 10.4 per cent in March 2012 even as global crude oil prices rose sharply. This reflects the absence of a commensurate pass-through to domestic consumers.

24. Non-food manufactured products inflation decelerated significantly from 8.4 per cent in November 2011 to 4.7 per cent in March 2012, on the back of a slowdown in domestic demand and softening of global non-oil commodity prices.

25. Even as WPI inflation has softened, inflation as measured by the new series of consumer price index (CPI) suggests that price pressures are still high at the retail level.

26. Looking ahead, based on an assessment of the domestic demand-supply balance, global trends in commodity prices and the likely demand scenario, the Reserve Bank's projection of inflation for March 2013 is 6.5 per cent.

*Monetary and Liquidity Conditions*

27. Let me now move on to monetary and liquidity conditions. Consistent with growth and inflation projections, $M_3$ growth for 2012-13 is projected at 15 per cent. Keeping in view the need to balance the resource requirements of the private sector and the public sector, growth in non-food credit of scheduled commercial banks (SCBs) is projected at 17 per cent.

28. As I said earlier, liquidity management remained a major challenge for the Reserve Bank during last year. Beginning November 2011, the liquidity deficit went much beyond the comfort level of the Reserve Bank. In order to redress this, we took steps to inject primary liquidity of a more durable nature. We injected liquidity of around ₹1.3 trillion through open market operations and ₹0.8 trillion through reduction in the cash reserve ratio (CRR) by 125 basis points. As a result of these measures and the easing of government's cash balances, the net borrowing under the LAF, which peaked at ₹2 trillion at end-March 2012, declined to ₹0.7 trillion on April 13, 2012.

*Risk Factors*

29. Finally, let me highlight the risks to our indicative projections of growth and inflation for 2012-13:

- First, a major risk to our growth and inflation projections stems from the outlook for global commodity prices, especially of crude oil. Although upside risks to oil prices from the demand side are limited, geo-political tensions are a concern. Any disruption in supplies is likely to lead to further increase in crude oil prices.

- The second risk emanates from the fiscal situation. Even though the Budget has proposed a reduction in the fiscal deficit in the current year, there are several upside risks. Any slippage in the fiscal deficit will have implications for inflation.

- Third, the large Government borrowing budgeted for 2012-13 has the potential to crowd out credit to the private sector. If that happens, the supply response required to accelerate growth could be inhibited.

- Fourth, the financing of the current account deficit will continue to pose a major challenge.

- And finally structural imbalances in protein-rich foods persist, and consequently, food inflation is likely to remain under pressure.

**Developmental and Regulatory Policies**

30. Since this is the Annual Policy, as per standard practice, it also includes developmental and regulatory policies. Let me briefly indicate some of the important initiatives in this regard.

31. I will begin with financial inclusion. There has been significant progress in providing banking services to villages with population above 2,000. The challenge now is to extend coverage to all the unbanked villages of the country. Accordingly, it is proposed to mandate state level bankers' committees (SLBCs) to prepare roadmaps covering all unbanked villages of population of less than 2,000, and notionally allot these villages to banks for providing banking services in a time bound manner.

32. The Reserve Bank attaches a lot of importance to customer service in banks. Three measures contained in this policy in this regard are the following:

- First, banks are being advised to offer a 'basic savings bank deposit account' with certain minimum common facilities and without the requirement of a minimum balance to all their customers.

- Second, banks will be mandated not to levy foreclosure charges or pre-payment penalties on home loans extended on a floating interest rate basis.

- Third, banks are being advised to initiate steps to allot a unique customer identification code (UCIC) number to all their customers.

33. Moving on to regulation and supervision, let me highlight some of the important measurers contained in this policy.

- On Basel III, final guidelines on the implementation of capital regulations will be issued by end-April 2012, and final guidelines on liquidity risk management and liquidity standards by end-May 2012.

34. There has been a significant increase in loans against gold by non-banking financial companies in the recent period, which has raised several concerns. This policy contains three measures to regulate this further:

- First, banks should reduce their regulatory exposure ceiling to a single NBFC, having gold loans to the extent of 50 per cent or more of its total financial assets, from the existing 10 per cent to 7.5 per cent of bank's capital funds.

- Second, banks should have an internal sub-limit on their aggregate exposure to all such NBFCs, having gold loans to the extent of 50 per cent or more of their total financial assets, taken together.

- Finally, the Reserve Bank has constituted a Working Group to undertake a detailed study of gold demand, trends in gold prices and lending by NBFCs against gold.

35. We have announced two measures relating to NBFCs.

- First, the draft guidelines on overseas investment by core investment companies (CICs) will be placed on the Reserve Bank's website for public comments by end-April 2012.

- Second, it has been decided to issue the draft guidelines on the regulatory framework for NBFCs by end-June 2012 based on the recommendations of the Usha Thorat Working Group.

36. Non-performing assets of banks have increased in the recent period. We are mandating banks to put in place a robust mechanism for early detection of signs of distress and take remedial measures.

37. Final guidelines on securitisation will be issued by end-April 2012.

38. Finally, let me touch upon two measures concerning currency management.

- First, with a view to address the issue of counterfeit notes in circulation, banks are advised to ensure that notes received over the counters are re-circulated only after ensuring their proper authentication through machines.

- Second, keeping in view the extended geographical spread of bank branch network and leveraging on technology, we have decided to channelize the distribution of currency and coins only through currency chests and bank branches.

39. For details of these measures, as also measures that I have not touched upon, I invite you to refer to the full Policy Statement, which is available on the Reserve Bank's website.

40. Let me now conclude by summarising our macroeconomic concerns. Though inflation has moderated in recent months, it remains sticky and above the tolerance level, even as growth has slowed. These trends are occurring in a situation in which concerns over the fiscal deficit, the current account deficit and deteriorating asset quality loom large. The challenge for monetary policy will thus be to maintain its vigil on controlling inflation while being sensitive to risks to growth and other vulnerabilities.

41. Thank you for your attention.

**R.R.Sinha**
Deputy General Manager

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