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Theme 221

RBI MONETARY POLICY STATEMENT 2010-11

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Theme No. 221 : RBI MONETARY POLICY STATEMENT 2010-11

Economic scenarios change in unpredictable manner and accordingly policy decisions have to address the new challenges. When it was the recession/ slowdown, monetary policy by the monetary authorities necessitated infusion of more liquidity at lower interest rates to prop up consumption and investment demand in the economy. The government action by fiscal policy required reduction of taxes and hiking up government expenditure to stimulate demand in the economy. These policies were pursued globally by the governments and the central banks. These are termed as easy monetary policy and expansionary fiscal policies. Thus there was gradual recovery from the recessionary state of the economy, and economic growth rates improved. But management of economic recovery posed new challenges in the Indian economy. Unlike in other countries, there were surging inflationary trends in the economy. This started with food prices inflation primarily owing to supply shortages resulting from the lower food production. There was a severe drought situation in the country and food output was lower. Gradually price increase became broad-based and there was noticeable increase in prices of manufactured products also. Now the policies are to be geared to target at containing inflation without choking economic growth. So this has become a balancing act on the part of the RBI to give clear signals to focus on price stability but also to maintain the tempo of economic recovery and growth.

What are the projections as regards India's economic performance for the year 2010-11?

The GDP – gross domestic product – growth for the year 2010-11 is placed at 8.0 percent with an upward bias. The wholesale price index inflation for March 2011 is placed at 5.5 percent. The money supply growth (M3) is estimated at 17.0 percent. The aggregate deposits of banks are projected to grow by 18.0 percent and non-food bank credit by 20.0 percent for the present fiscal year.

What are the risk factors for the Indian economy that are highlighted in the RBI Annual Policy Statement?

The annual policy statement analyzes some risk factors that may adversely affect the economic performance of the country. First, there is uncertainty about the pace and shape of global economic recovery. Fiscal stimulus measures played a major role in recovery process in many countries by compensating for the fall in private demand. Till now, private demand has not yet picked up. If stimulus measures are withdrawn, recovery and growth process will be affected. Even though recovery in India is predominantly driven by domestic demand, owing to the linkages of trade, finance and sentiments, an uncertain global environment can adversely impact the Indian economy. Second, if global recovery continues momentum, commodity and energy prices which have been on the rise during the last one year, may harden further, leading to inflationary pressures. Third, a normal south-west monsoon continues to be a critical factor for moderation in food prices and balanced economic growth. Any unfavourable monsoon could impose fiscal burden and dampen rural consumer and investment demand. Fourth, accommodative monetary policies and monetary expansion in advanced economies coupled with better growth prospects in emerging economies like India could trigger large capital inflows. This could pose challenges for exchange rate and monetary management. The appreciation of rupee will impact prospects of exporters and domestic producers competing with imports.

What are the major considerations that have guided monetary policy stance for 2010-11?

First, economic recovery is getting consolidated despite failure of monsoon rainfall in the last year. Economic growth is projected to be more broad-based in 2010-11. The monetary policy variables which were targeting crisis situation have now to address the near-normal situation. Second, there is an urgent requirement that demand side inflation is contained. Inflation which was earlier driven by supply side factors has become generalized and inflation expectations remain at an elevated level. Third, even as surplus liquidity has to be absorbed, government debt management with more issuance of securities compared to the previous year requires supportive liquidity conditions. The government borrowing programme has to be smooth while managing excess liquidity.

What are the monetary measures announced by the RBI?

The RBI has effected changes in the reserve ratios and policy interest rates to contain inflationary trends as well as to stimulate economic growth. So this has become a fine-tuning act on the part of the RBI and as such any drastic changes cannot be expected in the policy interest rates – bank rate, repo rate and reverse repo rate - and reserve ratios – cash reserve ratio (CRR) and statutory liquidity ratio (SLR). The Bank rate has been retained at 6.0 percent. Bank rate is regarded as the long term indicative interest rate which need not change according to fluctuating economic situations. The repo rate, considered to be the short-term lending rate and refinancing rate of the RBI to commercial banks has been increased by 25 basis points (0.25 percent) from 5.0 percent to 5.25 percent. It has been decided to increase the reverse repo rate – the rate of interest the RBI pays on excess funds that commercial banks park with the RBI - by 25 basis points from 3.5 percent to 3.75 percent. These measures would mean slight upward movement in the interest rates indicating costlier credit to the public. The CRR has been increased by 25 basis points from 5.75 percent to 6.0 percent of the commercial banks' net demand and time liabilities. As a result, the commercial banks have to deposit about Rs.12,500 crore of additional funds with the RBI. The lendable resources of the banks will be reduced to this extent.

What are the expected outcomes of the monetary policy announcements?

The expected outcomes of the policy changes are detailed in the policy statement. It is expected that inflation will be contained and inflationary expectations will be anchored. At the same time, it ensures that economic recovery process will be sustained. The monetary measures are expected to meet the Government borrowing requirements and also the private credit demand. Thus various policy instruments will be aligned to the evolving state of the economy.

What are the financial sector reforms and innovations proposed in the annual policy?

The financial sector reforms should improve financial intermediation and maintain financial stability. Financial stability requires a stronger supervisory regime for financial companies and financial conglomerates. Financial Stability Reports will be published half-yearly and accordingly suitable measures will be initiated.

The interest rate futures market will be deepened with introduction of Interest Rate Futures (IRFs) on 5-year and 2-year notional coupon bearing securities and 91-day Treasury Bills. IRFs on 10-year notional coupon bearing Government of India security were already introduced in 2009. Final guidelines for issuance of non-convertible debentures of maturity of less than one year will be published by the RBI. Credit Default Swaps (CDS) for corporate bonds will be introduced after finalizing a framework suitable for the Indian market. Exchange –traded foreign currency option contracts will be introduced on spot US Dollar/Rupee exchange rate for residents. Separate Trading for Registered Interest and

Principal of Securities (STRIPS) will be implemented through negotiated dealing system. An active repo market in corporate bonds will operationalised. A reporting platform will be introduced for all secondary market transactions in certificates of deposits (CDs) and commercial papers (CPs).

What are the policy announcements with implications for the banking sector?

The commercial banks will be mandated to switch over to the system of Base Rate in place of the present BPLR (Benchmark Prime Lending Rate) system from July 1, 2010. It is expected that the Base Rate system will facilitate better pricing of loans and enhance transparency in lending rates.

The banks will be allowed to classify their investments in non-SLR bonds issued by companies engaged in infrastructure activities and having a residual maturity of seven years under the held to maturity (HTM) category. Infrastructure loan accounts classified as sub-standard will attract a provisioning of 15 percent instead of the current 20 percent but subject to a mechanism to escrow cash flows and ensuring first legal claims on cash flows.

Banks are mandated not to insist on collateral security for loans up to Rs. 10 lacs extended to the micro and small enterprises ((MSE). The banks are also required to increase flow of credit to MSME sector, particularly to micro enterprises. The banks will be allowed to engage any individual, including those operating Common Service Centres (CSCs) as business correspondents (BC). RBI proposes to strengthen the monitoring mechanism on customer services of banks through on-site and off-site inspections. A roadmap will be prepared for introduction of a bank holding company / financial holding company structure together with the required legislative framework. A working group will be constituted for analyzing information security, electronic banking and technology risk management for tackling cyber frauds and improving systems. As banks have to comply with the IFRS (International Financial Reporting Standards) convergence process, detailed studies are proposed on the implications and operational guidelines relevant to the banking sector. The issue of mode of presence of foreign banks in India through branch or wholly owned subsidiary (WOS) will be further discussed before a final decision.

Thus the annual monetary policy statement takes care of the particular exigencies of the economic situation in the country and rightly focuses on the twin objectives of price stability and economic growth. Also it is properly aligned with the fiscal path of prudence and consolidation of the Union Government.

Highlights of the RBI Annual Monetary Policy 2010-11

Monetary Measures

- Repo rate has been raised by 25 basis points from 5.0 per cent to 5.25 per cent
- Reverse repo rate has been raised by 25 basis points from 3.5 per cent to 3.75 per cent
- Cash Reserve Ratio (CRR) of scheduled banks has been raised by 25 basis points from 5.75 per cent to 6.0 per cent of their net demand and time liabilities (NDTL)

Developmental and Regulatory Measures

- Financial Stability Reports will be published by RBI on a half-yearly basis
- Banks will be mandated to switch over to Base Rate system for pricing loans to ensure transparency, better pricing and effective monetary transmission
- Interest Rate Futures on 5-year and 2-year notional coupon bearing securities and 91-day Treasury Bills will be introduced
- Plain vanilla currency options on spot US Dollar/Rupee exchange rate for residents will be introduced
- Banks will be permitted to engage any individual as banking correspondents (BCs) subject to banks' comfort level and their carrying out suitable due diligence
- Implementation of Financial Inclusion Plans (FIPs) of banks will be monitored
- Banks cannot insist on collateral securities for loans up to Rs.10 lakh to units in the MSE (Micro and Small Enterprises) Sector
- Banks' performance on flow of credit to MSE Sector will be monitored
- Discussion papers will be prepared on mode of presence of foreign banks in India – through branch or wholly owned subsidiary – and on guidelines for issuance of additional banking licenses to private sector players
- Monitoring Customer Service of the banks with focus on retail and small customers

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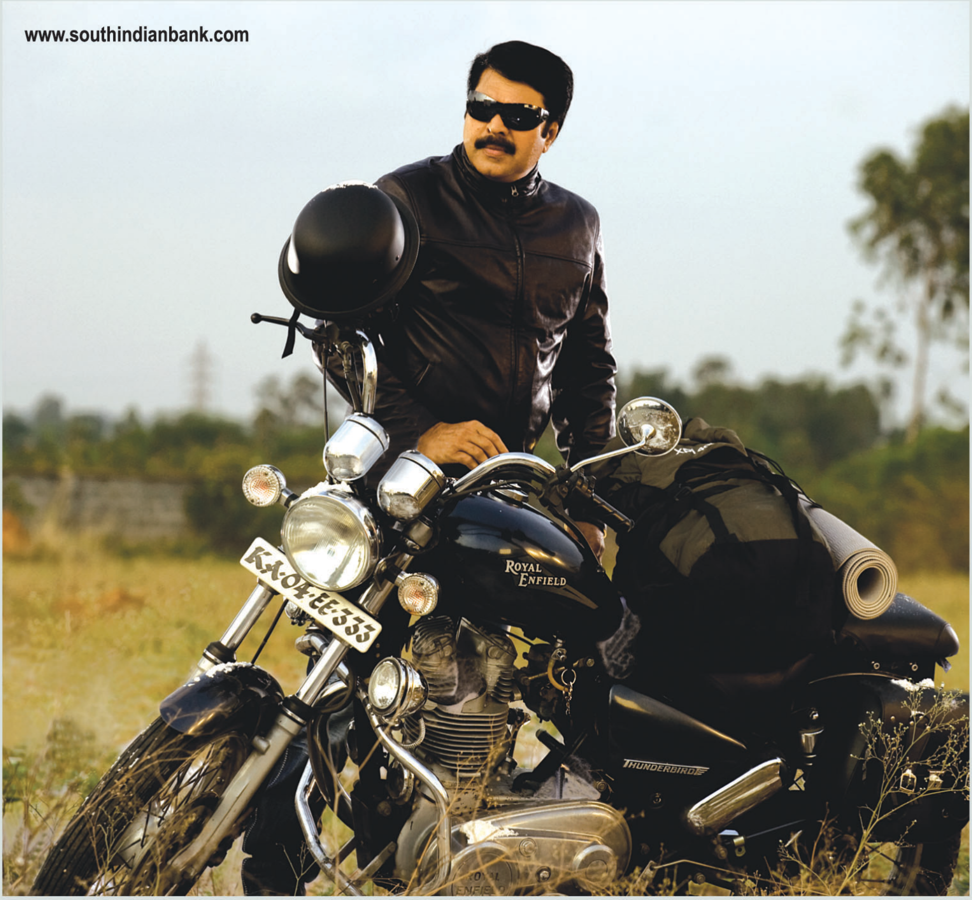
Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in



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