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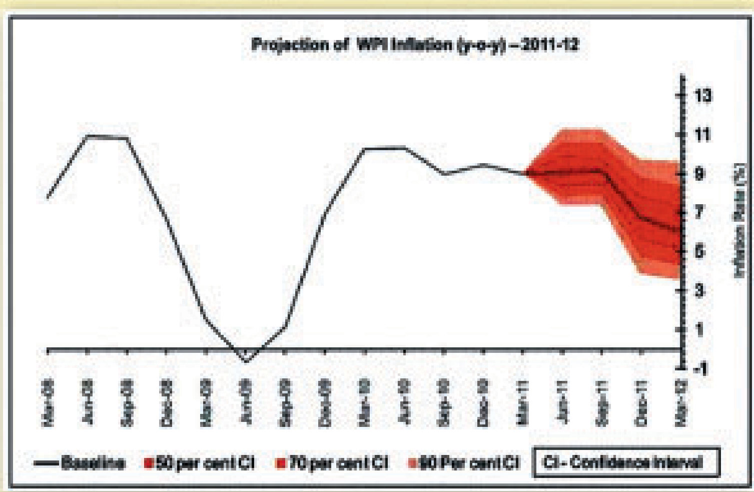

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Theme 234

RBI MONETARY POLICY STATEMENT 2011-12

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Experience Next Generation Banking

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THEME 234 : RBI MONETARY POLICY STATEMENT 2011-12

Monetary policy and action assume significance in the context of persistence of inflation at elevated levels, even though the fundamental causes of inflation may be predominantly supply side factors. Under the present scenario of increased headline and core inflation, the growth concerns are temporarily postponed, to focus at containment of inflation. Therefore, the 'baby step' approach or a cautious calibrated approach may be inadequate when the momentum of inflationary force gathers pace. The monetary policy unequivocally states the roadmap for the current year: '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.'

Explain the present global and domestic economic context that has influenced the monetary policy?

The economic recovery in advanced economies, which slowly started picking up owing to concerted efforts of the governments by way of stimulus packages, is now threatened by the surge in inflation. Monetary easing or accommodation is stated to be one of the reasons for the increased money supply leading to hike in price levels. Commodity prices comprising of oil and base metals are on the rise and now there is surge in prices of agricultural commodities. The IMF has projected oil price at USD 107 a barrel for the year 2011. There are now supply disruptions due to political developments in the Middle East and North Africa (MENA) region. There are chances of replacement of nuclear power generation with oil-based one in Japan. The commodity prices are also under pressure due to strong demand from the emerging market economies (EMEs). There is also the phenomenon of what is termed as 'financialisation' of commodity markets which also contributes to inflation. This is the influence of excessive liquidity and speculative trading in the commodities leading to 'pricing power' in markets. The Central banks in advanced economies are under pressure to withdraw monetary accommodation.

The growth rate of the domestic economy was estimated to be 8.60 percent for the year 2010-11. There was rebound of economic activity after the period of economic slowdown. However, inflation continued to the main concern during the last year. The inflationary pressures started from the food items, then it slowly spread to manufactured items and inflation became board-based. When food prices were at elevated levels, this was reflected in the increased consumer price indices (CPI). When food prices moderated, consumer price index declined from high levels. But then, there was hike in prices of fuel and non-food manufactured products, leading to elevated whole sale price indices (WPI). This led to a broad convergence of WPI and CPI inflation by the end of 2010-11.

Explain the terms 'headline inflation' and 'core inflation':
Economists distinguish between what are termed as headline inflation and core inflation. Headline inflation denotes wholesale price index and core inflation figure represents wholesale price index excluding food and fuel prices. Food and fuel prices are observed to be more volatile and do not reflect the trend in general prices levels. Thus, core inflation is regarded as reflecting the demand pressures in the economy. When both headline inflation and core inflation are at elevated levels, it is an indication that inflation has become generalized and broad-based and more stringent monetary action will be required.

What is the outlook on growth and inflation for 2011-12 as outlined in the monetary policy?
The real GDP (gross domestic product) growth for 2011-12 is estimated to be around 8 percent. This is based on the assumption of a normal monsoon and crude oil prices averaging USD 110 a barrel over 2011-12. Inflation is expected to remain at higher levels in the first half of the current year. This is owing to pass-through of increase in prices of oil and commodities to domestic prices. However, the WPI inflation for March 2012 is placed at 6 percent with an upward bias.

What is the guiding monetary policy stance and what are the changes in the operating procedures?

The RBI began exiting from the accommodative / expansionary monetary policy from October 2009. Since then, the cash reserve ratio (CRR) has been raised by 100 basis points (I percentage). Policy rates – repo rate and reverse repo rate – have been raised eight times. The monetary policy stance in 2010-11was calibrated – slow paced, measured, balanced – on the basis of the domestic growth-inflation dynamics amidst persistent global uncertainties. The current monetary policy stance is framed with the following objectives:

- Maintain an interest rate environment that moderates inflation and anchors inflation expectations.
- Foster an environment of price stability that is conducive to sustaining growth in the medium-term coupled with financial stability.

- 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.

The operating procedures of the monetary policy are reformulated as the following:

i. The weighted average overnight call money rate will be the operating target of the monetary policy.
ii. There will be only one independently varying policy rate – repo rate. This is expected to signal monetary policy more accurately.
iii. The reverse repo rate will continue to be operative but it will be pegged at a fixed 100 basis points below the repo rate. It will not be an independent rate.
iv. A new Marginal Standing Facility (MSF) will be instituted and banks can borrow overnight up to one percent of NDTL (net demand and time liabilities). The rate of interest for this facility will be 100 basis points above the repo rate.
v. The revised short-term interest corridor will have a fixed width of 200 basis points – the repo rate in the middle, reverse repo rate at 100 basis points below and the new MSF rate 100 basis points above repo rate.

What are the highlights of the monetary policy 2011-12?

Based on the policy stance and the changes in the operating procedures, the RBI announced the following monetary policy measures:

i. The repo rate under the liquidity adjustment facility (LAF) will be increased by 50 basis points from 6.75 percent to 7.25 percent.
ii. The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, automatically adjusts to 6.25 percent.
iii. The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, will be determined as 8.25 percent.
iv. The Bank Rate will be retained at 6 percent. The CRR will be retained at 6 percent of NDTL.
v. The savings bank deposit interest rate will be increased from 3.5 percent to 4 percent.

The increase in repo rate is expected to transmit to lending rates –base rate / BPLR - of commercial banks, thus making bank credit more costly than at present. This will have a dampening effect on the demand for credit, money supply and inflationary tendencies. Controlling inflation in the short term will facilitate higher growth in the medium / long term.

The monetary policy also includes developmental and regulatory policies pertaining to financial stability, interest rates, financial markets, credit delivery and financial inclusion, banking and institutional developments.

What are the new initiatives proposed in the monetary policy about financial markets / banking?

It is stated in the policy that final guidelines on plain vanilla single-name credit default swaps for corporate bonds for resident entities will be issued by the RBI. The product will be launched after necessary market infrastructure is set up. The period of short sale in government securities will be extended from the existing five days to a maximum of three months. The FIIs will be allowed to cancel and rebook foreign exchange amount up to 10 percent of the market value of the portfolio as at the beginning of the financial year. On regulatory measures for commercial banks, the provisioning requirements on certain categories of non-performing advances and restructured advances will be enhanced – advances classified as 'sub-standard will attract a provision of 15 percent as against 10 percent, restructured accounts will attract a provision of 2 percent in the first two years from the date of restructuring etc. Also, investment by banks in liquid schemes of debt oriented mutual funds (DoMF) will be subject to a prudential cap of 10 percent of their net worth as on March 31 of the previous year. This is meant to avoid systemic and liquidity risks in times of stress / liquidity crunch.

The RBI would adhere to the internationally agreed phased implementation of Basel III capital framework which includes increasing quality and quantity of capital with greater emphasis on common equity, increasing risk coverage, introducing leverage ratio as a back stop to the risk-based capital ratio, introducing capital conservation and counter-cyclical capital buffers to ensure build up of additional capital in good times, and introducing liquidity standards to maintain adequate liquidity buffers and to reduce maturity mismatches.

What are the guidelines proposed for regulation of Micro Finance Institutions?

The RBI has accepted the broad framework of Malegam Committee Recommendations on regulation of micro finance institutions. The committee was constituted by the RBI to study issues and concerns in the MFI (micro finance institution) sector, in the wake of the Andhra Pradesh micro finance crisis in 2010. The recommendations include creation of a separate category of NBFC-MFIs, margin cap and interest cap on loans, transparency in interest charges, criteria regarding income and total indebtedness of the borrowers, and tenure of loans etc. The bank loans to MFIs including NBFCs working as MFIs on or after April 1, 2011 will be eligible for classification as priority sector loans only if they conform to the regulations formulated by the RBI.

Even though monetary policy sets objectives such as economic growth and development, price stability, financial stability and institutional developments, the present exigencies have mandated for zeroing in on containment of inflation, which has turned out broad-based and widespread.

Highlights of RBI Monetary Policy Statement 2011-12

- **Short term lending rate of RBI (repo rate) hiked by 50 basis points to 7.25 percent**
- **Reverse repo rate to be fixed 100 basis points lower than the repo rate**
- **Short term borrowing rate of RBI (reverse repo rate) up by 50 basis points to 6.25 percent**
- **No change in cash reserve ratio and bank rate. These rates are retained at 6 percentages**
- **Increase in interest rate of savings bank accounts from the present 3.5 to 4 percent**
- **For the financial year 2012, the projected GDP growth rate is lowered to 8 percent**
- **Projection of wholesale price index lowered to 6 percent by end of March 2012.**
- **New overnight borrowing window for banks under marginal standing facility (MSF) at 8.25 percent - 100 basis points above repo rate**
- **Malegam committee recommendations on MFI sector broadly accepted.**
- **Repo rate to be only effective policy rate to better signal monetary policy stance**

Mid -quarter Monetary Policy Review

In the mid-quarter monetary policy review, as on 16 June 2011, the RBI persisted with anti-inflationary stance of monetary policy. It was decided to increase the repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.25 percent to 7.50 percent. Consequent to the increase in the repo rate, the reverse repo rate under the LAF got adjusted to 6.50 percent and the marginal standing facility (MSF) rate to 8.50 percent.

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 www.southindianbank.com

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