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RBI Governor presents Third Quarter Review of Annual Statement on Monetary Policy for 2007-08

Dr. Y Venugopal Reddy, Governor, Reserve Bank of India today presented the Third Quarter Review of Annual Statement on Monetary Policy for the Year 2007-08.

Highlights

- Bank Rate, Reverse Repo Rate, Repo Rate and Cash Reserve Ratio (CRR) kept unchanged.

- The flexibility to conduct overnight or longer term repo including the right to accept or reject tenders under the liquidity adjustment facility (LAF), wholly or partially, is retained.

- Overall real GDP growth projection for 2007-08 at around 8.5 per cent is retained.

- The policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08 while conditioning expectations in the range of 4.0-4.5 per cent.

- While non-food credit has decelerated, growth in money supply and aggregate deposits of scheduled commercial banks continue to expand well above indicative projections.

- High growth in reserve money is driven by large accretion to RBI's net foreign exchange assets.

- Liquidity management will assume priority in the conduct of monetary policy through appropriate and timely action.

- Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for growth and inflation, the overall stance of monetary policy in the period ahead will broadly continue to be:

    - To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment conducive to continuation of the growth momentum and orderly conditions in financial markets.

    - To emphasise credit quality as well as credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

    - To monitor the evolving heightened global uncertainties and domestic situation impinging on inflation expectations, financial stability and growth momentum in order to respond swiftly with both conventional and unconventional measures, as appropriate.

Details

Dr. Y.Venugopal Reddy, Governor today presented the Third Quarter Review of Annual Statement on Monetary Policy for the year 2007-08. The Review consists of three sections: I. Assessment of Macroeconomic and Monetary Developments; II. Stance of Monetary Policy; and III. Monetary Measures.

Domestic Developments

- Real GDP growth moderated to 9.1 per cent in the first half of 2007-08 from 9.9 per in the first half of 2006-07.
- Inflation, based on variations in the wholesale price index (WPI) on a year-on-year basis, eased to 3.8 per cent as on January 12, 2008 from its peak of 6.4 per cent at the beginning of the financial year and from 6.2 per cent a year ago.
- Prices of primary articles registered a year-on-year increase of 3.9 per cent as on January 12, 2008 as compared with 9.5 per cent a year ago.
- Manufacturing inflation eased to 3.9 per cent as on January 12, 2008 from 5.8 per cent a year ago.
- The price of the Indian basket of international crude has registered a sustained increase during 2007-08 from US $ 66.4 in April-June, US $ 72.7 in July-September, US $ 85.7 in October-December 2007 to US $ 88.9 per barrel as on January 25, 2008.
- Inflation based on the consumer price index (CPI) for industrial workers (IW) declined to 5.5 per cent on a year-on-year basis in November 2007 from 6.3 per cent a year ago.
- The CPI for urban non-manual employees (UNME), agricultural labourers (AL) and rural labourers (RL) also declined to 5.1 per cent, 5.9 per cent and 5.6 per cent, respectively, in December 2007 as compared with 6.9 per cent, 8.9 per cent and 8.3 per cent a year ago.
- As on January 4, 2008 money supply (M_3) increased by 22.4 per cent on a year-on-year basis which was higher than 20.8 per cent a year ago and well above the projected trajectory of 17.0-17.5 per cent indicated in the Annual Policy Statement for 2007-08.
- Reserve money increased by 30.6 per cent on a year-on-year basis as on January 18, 2008 as compared with 20.0 per cent a year ago.
- In the current financial year, the growth in aggregate deposits of scheduled commercial banks (SCBs), on a year-on-year basis, at Rs.6,00,761 crore (25.2 per cent) was higher than that of Rs.4,44,241 crore (22.9 per cent) a year ago.
- On a year-on-year basis, non-food credit of SCBs expanded by Rs.3,82,155 crore (22.2 per cent) as on January 4, 2008 on top of the increase of Rs.4,16,418 crore (31.9 per cent) a year ago.
- The year-on-year growth in total resource flow from SCBs to the commercial sector decelerated to 21.7 per cent from 30.1 per cent a year ago.
- Banks' holdings of Government and other approved securities at 29.1 per cent of their net demand and time liabilities (NDTL) as on January 4, 2008 was marginally higher than 28.6 per cent a year ago.
- The overhang of liquidity as reflected in the sum of LAF, MSS and the Central Government's cash balances increased from Rs.85,770 crore at end-March 2007 to Rs.2,58,187 crore on January 17, 2008 before declining to Rs.2,32,809 crore on January 24, 2008.

- During the third quarter of 2007-08, money, debt and foreign exchange markets remained generally stable, despite large movements in liquidity conditions.

- Rapid growth in turnover in the foreign exchange market was sustained by large surplus conditions in the spot market as average daily turnover increased to US $ 50.1 billion for the quarter ended December 2007 from US $ 27.6 billion in the corresponding quarter of the previous year.

- During March 2007-January 2008, pubic sector banks (PSBs) that were earlier paying higher interest rates on longer term deposits, readjusted their interest rates downwards by 25-50 basis points, while those offering lower deposit rates for similar maturity earlier increased their deposit rates by 50-75 basis points.

- During March 2007-January 2008, the benchmark prime lending rates (BPLRs) of PSBs increased by 25-75 basis points from a range of 12.25-12.75 per cent to 12.50-13.50 per cent.

- The BSE Sensex increased from 13,072 at end-March 2007 to 18,362 on January 25, 2008 registering an increase of 40.5 per cent over end-March 2007.

- The gross market borrowings of the Central Government through dated securities at Rs.1,47,000 crore (Rs.1,30,000 crore a year ago) during 2007-08 so far (up to January 25, 2008) constituted 94.6 per cent of the budget estimates (BE) while net market borrowings at Rs.1,03,092 crore (Rs.91,432 crore a year ago) constituted 94.1 per cent of the BE.

External Developments

- During April-November 2007, merchandise exports rose by 21.9 per cent in US dollar terms as compared with 26.2 per cent in the corresponding period of the previous year. Import growth was also lower at 26.9 per cent as compared with 27.4 per cent in the previous year. The merchandise trade deficit widened to US $ 52.8 billion from US $ 38.5 billion in the previous year.

- While oil imports recorded a lower growth of 9.8 per cent as compared with 42.0 per cent a year ago, non-oil imports increased by 35.3 per cent as compared with 21.3 per cent a year ago.

- Foreign exchange reserves increased by US $ 85.7 billion during the current financial year so far and stood at US $ 284.9 billion on January 18, 2008.

- Over the end-March 2007 level, the rupee appreciated by 9.61 per cent against the US dollar, by 8.85 per cent against the pound sterling and by 0.95 per cent against the Japanese yen, but remained unchanged against the euro as on January 25, 2008.

Global Developments

- According to the World Economic Outlook (WEO) of the International Monetary Fund (IMF) released in October 2007, the forecast for global real GDP growth on a purchasing power parity basis is placed at 5.2 per cent for 2007 as compared with 5.4 per cent in 2006 and is expected to decelerate further to 4.8 per cent in 2008.

- In the US, real GDP growth is expected to slow down from the fourth quarter of 2007 onwards as the deepening housing market correction and ongoing financial market turmoil are expected to curb growth more severely, although exports could play a mitigating role.

- Globally, inflationary pressures have re-emerged as a key risk to global growth. Inflation pressures have raised concerns in the US, UK, the euro area and in some of the emerging market economies (EMEs) such as China, Malaysia, Indonesia and Chile.

- The persistence of high food prices, oil prices sustained at elevated levels and continued high prices of other commodities pose significant inflation risks for the global economy and challenges for monetary policy worldwide.

- The turbulence in the international financial markets since July 2007, triggered by defaults in the US subprime mortgage market, deepened in subsequent months. These unusual developments indicated heightened uncertainties and emerging challenges for the conduct of monetary policy, especially for EMEs.

- With the beginning of the turbulence, central banks of advanced economies undertook an increasingly expansive monetary policy course by cutting policy rates (US Federal Reserve) and also supplying financial markets with additional liquidity.

- Some central banks such as the US Federal Reserve, Bank of England and the Bank of Canada have cut policy rates during the third and fourth quarters of 2007 after financial markets were significantly affected by turbulence.

- Central banks of several countries, including the euro area, New Zealand, Japan, Korea, Malaysia, Thailand and Brazil have not changed their rates in the last quarter of 2007.

- The central banks that have tightened their policy rates in recent months include the Reserve Bank of Australia, the People's Bank of China, the Banco Central de Chile and Banco de Mexico.

- Several central banks confronted with volatile and large capital flows have employed a variety of measures to manage and stabilise these flows with a view to reducing overheating, currency appreciation and the economy's vulnerability to sharp reversals of flows.

- A common feature among the policies adopted by most of them is monetary tightening involving either hikes in policy rates or hikes in reserve requirements or both.

- Measures directly aimed at managing capital flows are also in evidence in many EMEs.

Overall Assessment

- Real GDP originating in agriculture and allied activities has accelerated in the first half of 2007-08 in comparison with April-September 2006 and subsequent developments seem to confirm the positive outlook for agriculture.

- Assuming that there are no exogenous shocks, either global or domestic, the prospects for the industrial sector over the rest of 2007-08 remain reasonably positive at this juncture.

- While the prospects for services continue to be favourable at this juncture, uncertainties surrounding the evolution of global developments could affect the outlook.

- Domestic activity continues to be investment driven, supported by external demand. Building up of supply capacities, both new and existing, is strongly underway as reflected in the sustained demand for domestic and imported capital goods.

- Key indicators point to the persistence of aggregate demand pressures, including into the near-term.

- Indications are getting stronger of upside inflationary risks in the period ahead.

- Domestic monetary and liquidity conditions continue to be more expansionary than before and are likely to be amplified by global factors.

- There was a large increase in the total overhang of liquidity over the third quarter of 2007-08, reflecting the sizeable expansion in primary liquidity generated by the large accretions to the Reserve Bank's net foreign assets.

- In the foreign exchange market, large inflows have imposed persistent upward pressures on the exchange rate of the rupee which have become accentuated in the wake of cuts in the US Federal Funds target rate.

- There has been some improvement in the finances of the Central Government as the gross fiscal deficit has declined indicating that adherence to the Fiscal Responsibility and Budget Management (FRBM) rules in the current financial year is on track.

- Consensus forecasts indicate a slowing of the global economy in 2007 and 2008 with the US subprime crisis, food and crude prices posing the gravest risks. While the dangers of global recession are relatively subdued at the current juncture and consensus expectations seem to support a soft landing, the upside pressures on inflation have become more potent and real than before.

- Headline inflation has trended up in the US, the euro area, Japan and China. Overall, inflationary pressures have firmed up with implications for the outlook for 2008.

- Developments in global financial markets present several issues that need to be monitored carefully in the context of the implications for EMEs. First, corporate credit spreads and those on mortgage-backed securities have widened since early October as concerns relating to the possibility of prolonged disruption to credit intermediation have deepened. Second, the impact of the recent financial market turmoil has been sizeable on banks, particularly internationally active banks on both sides of the Atlantic. Third, the responses of central banks to recent events have demonstrated that ensuring financial stability can, under certain circumstances, assume overriding importance relative to other more explicitly pursued goals.

- In view of the evolving global macroeconomic prospects in the near-to-medium term, EMEs face several challenges. First, they face risks from tightening of credit standards in advanced economies. Second, dependence on imports and higher energy intensity of output may make EMEs more exposed to inflation shocks. Third, in the wake of some macroeconomic and political developments, international financial markets respond differently to the EMEs. Fourth, the self-correcting mechanisms in financial markets happen to operate far less efficiently in the EMEs. Fifth, real sector flexibilities may be far less in EMEs. Finally, the distinction between flexibility and volatility in the context of financial markets in EMEs has to be based on the preparedness of the markets and the market participants.

Stance of Monetary Policy

- The projection of overall real GDP growth in 2007-08 is maintained at around 8.5 per cent for policy purposes, assuming no further escalation in international crude prices and barring domestic or external shocks.

- The policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08 while conditioning expectations in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent becomes a medium-term objective.

- The rate of money supply has picked up coincident with a jump in the growth of reserve money, driven by the accretion to the Reserve Bank's foreign exchange assets. Moderating money supply in alignment with the indicative projections of 17.0-17.5 per cent set out in the Annual Policy Statement of April 2007 may warrant appropriate responses, given the considerations for ensuring macroeconomic and financial stability going forward.

- In view of the risks associated with international financial developments impacting balance sheets of corporates with sizeable external liabilities, banks are urged to review large foreign currency exposures and to put in place a system for monitoring such unhedged exposures on a regular basis so as to minimise risks of instability in the financial system under the current highly uncertain conditions. Banks are also urged to carefully monitor corporate activity in terms of treasury/trading activity and sources of other income to the extent that embedded credit/market risks pose potential impairment to the quality of banks' assets.

- In the context of a more open capital account and the size of inflows currently, public policy preference for a hierarchy of capital flows with a priority for more stable components could necessitate a more holistic approach, combining sectoral regulations with broader measures to enhance the quality of flows and make the source of flows transparent. In this context, it is critical for public policy to effectively, demonstrably and convincingly indicate commitment to managing capital flows consistent with macro fundamentals through appropriate and decisive policy actions.

- The setting of monetary policy in India has been rendered complex. On the one hand, the underlying fundamentals of the economy remain strong and resilient and the outlook continues to be positive. At the same time, while there is no visible or immediate threat to financial stability in India from global developments, the need for continued but heightened vigilance has increased with an emphasis on readiness to take timely, prompt and appropriate measures to mitigate the risks to the extent possible.

- A disaggregated analysis of supply and demand factors across select sectors would enable appropriate public policy responses keeping in view the employment intensity of some of these sectors. Monetary policy, *per se*, can essentially address issues relating to aggregate demand but the associated policies in the financial sector could, to the extent possible, take account of the evolving circumstances as reflected in the disaggregated analysis. In view of the prevailing liquidity conditions and the sustained profitability of banks as reflected in net interest margins, there is a need for banks to undertake institutional and procedural changes for enhancing credit delivery to sectors that are employment-intensive.

- Over the period ahead, liquidity management will continue to assume priority in the conduct of monetary policy and developments having implications for liquidity management would warrant appropriate and timely action.

- The Reserve Bank will continue with its policy of active demand management of liquidity through appropriate use of the CRR stipulations and open market operations (OMO) including the MSS and the LAF, using all the policy instruments at its disposal flexibly, as and when the situation warrants.

- Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for growth and inflation, the overall stance of monetary policy in the period ahead will broadly continue to be:

    - To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment conducive to continuation of the growth momentum and orderly conditions in financial markets.

    - To emphasise credit quality as well as credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

    - To monitor the evolving heightened global uncertainties and domestic situation impinging on inflation expectations, financial stability and growth momentum in order to respond swiftly with both conventional and unconventional measures, as appropriate.

Monetary Measures

- Bank Rate kept unchanged at 6.0 per cent.
- The reverse repo rate and the repo rate under the LAF are kept unchanged at 6.0 per cent and 7.75 per cent, respectively.
- The Reserve Bank retains the option to conduct overnight or longer term repo/reverse repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibility including the right to accept or reject tender(s) under the LAF, wholly or partially, if deemed fit, so as to make efficient use of the LAF in daily liquidity management.
- CRR kept unchanged at 7.5 per cent.

The Annual Policy Statement for the year 2008-09 will be announced on April 29, 2008.

Alpana Killawala
Chief General Manager

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