प्रेस प्रकाशनी PRESS RELEASE

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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August 24, 2010

RBI releases Annual Report for 2009-10

The Reserve Bank of India released today its Annual Report for 2009-10. This statutory Report of the Board of the Reserve Bank focusses on: (a) an analytical assessment of the key policy issues and macroeconomic challenges faced during the year, (b) the range of policy actions taken to address the challenges, besides initiatives launched during the year in relation to the broad macro-financial objectives of the Reserve Bank, and (c) how the operations of the Reserve Bank in pursuing the objectives were reflected in its financial accounts. The period since the middle of 2008-09 has been a particularly challenging one for the Reserve Bank, as it had to contend with balancing the concerns relating to financial stability, growth and inflation.

Highlights of the Report:

Overall Assessment of the Macroeconomic and Financial Conditions

- Following the global financial crisis, the domestic macroeconomic environment changed significantly over four distinct half-yearly phases starting from the second half of 2008-09. Each phase posed various challenges for the Reserve Bank.
- First, GDP growth decelerated in the second half of 2008-09, reflecting the impact of the global crisis. The Reserve Bank swiftly introduced a comprehensive range of conventional and unconventional measures to limit the impact of the adverse global developments on the domestic financial system and the economy.
- Second, in the first half of 2009-10, weakness in the economic activity necessitated continuation of the monetary policy stimulus. The low (headline) inflation environment also created the space for continuing an accommodative monetary policy stance. But, by the middle of the year, a deficient South-West monsoon triggered renewed concerns for recovery as well as food inflation.
- Third, despite the dampening pulls of the deficient monsoon and an adverse global economic environment, growth in GDP exhibited a robust recovery ahead of the global economy in the second half of 2009-10. Food inflation, that had started rising in response to the weak kharif production, turned out to be more persistent in the second half of the year. Rising and increasingly generalised inflation warranted withdrawal of the policy stimulus. Since the policy challenge for the Reserve Bank was to anchor inflationary expectations without harming the recovery, a calibrated approach to monetary unwinding was adopted.
- Fourth, headline inflation remained at or close to double digits over four successive months of 2010-11 and the inflation process had also become more generalised. The balance of policy attention, thus, had to shift from recovery to inflation.

The Near-term Outlook

- While the growth outlook for 2010-11 remains robust, inflation has emerged as a major concern. Going forward, as the monetary position is normalised, addressing structural constraints in several critical sectors is necessary to sustain growth and also contain supply side risks to inflation.

- Improving the overall macro-financial environment through fiscal consolidation, a low and stable inflation regime, strengthening of the financial stability framework and progress on structural reforms will help sustain growth and boost productivity.
- The Reserve Bank has stated its commitment to containing inflation through its calibrated monetary policy normalisation, with clarity on the direction of the policy rates in the near-term as well as timely actions in cautious steps based on careful assessment of risks to both inflation and growth.
- The conduct of monetary policy of the Reserve Bank, while being driven by the domestic outlook, will have to recognise the possibility of sudden changes in the global outlook. While managing global shocks, India will also have to increase its resilience and productivity levels so as to strengthen its position in the global economy.

Key Messages

- Since India avoided a financial crisis at home, the risk of a potential output shock is remote. With fiscal consolidation, favourable demography and further structural reforms, the potential growth could be raised to double digit level.
- While the performance of agriculture sector in 2009-10 in the face of a deficient monsoon has been better than in previous drought episodes, concerns still remain over the ability to withstand successive years of drought.
- The impact of a deficient monsoon on growth is weakening, whereas the impact on inflation continues to be significant.
- The average growth rate of foodgrains production at 1.6 per cent during 1990-2010 has trailed behind the average population growth of 1.9 per cent.
- The aggregate savings rate moderated in 2008-09, reflecting a sharp fall in public sector savings on account of the impact of the fiscal stimulus measures. Preliminary estimates based on the latest available information place financial savings (net) of the household sector in 2009-10 at 11.9 per cent of GDP at current market prices, which is higher than the estimates for 2008-09 at 10.2 per cent.
- Large divergence between inflation as measured by wholesale and consumer price indices was a major feature of inflation trends in India during 2009-10. The differences in inflation across states have also been significant.
- Despite the persisting ambiguity about the relationship between futures market activities and spot prices of commodities, activities in the futures market need to be better monitored, given the possible role this market may have for the overall inflation conditions.
- The identification of sources of inflation is important for the conduct of monetary policy. When the inflationary pressures are dominated by adverse supply shocks, monetary policy could be less effective in containing price pressures.
- Since November 2009, the relative price variability has declined, despite inflation remaining high, indicating that the inflation has become increasingly generalised, and hence, requiring appropriate monetary policy actions to anchor inflation expectations.
- The financial markets functioned smoothly during 2009-10 reflecting the stabilising operations of the Reserve Bank in various segments of the markets as also the sound regulatory framework put in place prior to the global crisis.
- The large market borrowing by the Government exerted upward pressure on the yields on government securities during 2009-10. However, this was contained by active liquidity management by the Reserve Bank.

- Housing prices rebounded during 2009-10. The exchange rate exhibited greater flexibility.
- Persistent large fiscal deficit has several adverse macroeconomic risks, ranging from higher inflation to lower savings, crowding-out pressures on private investment, decline in potential output, and worsening of external imbalances.
- While these concerns may be absent in the short-term in a phase of economic slowdown that requires the use of fiscal stimulus, in the medium-term these risks may materialise if the fiscal deficit is not brought down significantly under a credible fiscal consolidation strategy.
- In a globalised world, a congenial global economic environment and a sustainable balance of payments position are critical for achieving the policy goal of stable growth.
- Despite lower trade deficit, the decline in invisibles surplus led to a higher current account deficit of 2.9 per cent of GDP during 2009-10 as compared with 2.4 per cent of GDP a year ago. A higher current account deficit led to stronger absorption of foreign capital.
- Capital flows in the initial months of 2010-11 moderated somewhat, reflecting the drop in risk appetite of global investors in response to the sovereign risk concerns in the Euro zone. Given the stronger growth outlook of India and the probability of monetary exit being delayed by the advanced economies, capital inflows could be expected to accelerate, which will have to be managed, as in the past.
- India faces the daunting challenge of stepping up the growth potential by bringing the financially excluded within the ambit of the formal financial system, providing financial literacy and strengthening credit delivery mechanisms which, in turn, could improve the distribution of the benefits of high growth.
- Sound regulatory and supervisory framework for banks and non-banking financial entities proved crucial in containing the impact of the contagion from the global financial crisis on the Indian financial system. During 2009-10, several steps were taken to further strengthen the financial stability framework.
- Critical financial soundness indicators (FSIs) and stress test results suggested that the financial system remains sound and resilient.
- The borrowing programme for 2010-11 has to be managed, keeping in view the pressure on yield from the elevated inflation, gradual withdrawal of excess liquidity and stronger pick-up in the private sector credit demand.
- Reflecting the Reserve Bank's clean note policy, there was larger withdrawal of soiled notes from circulation alongside higher supply of fresh notes.
- Counterfeit notes detected during 2009-10 were of the same magnitude as in the previous year. The systems for prevention and detection of counterfeit notes are being strengthened on a continuous basis.

The Reserve Bank's Accounts for 2009-10 (July-June)

- The balance sheet of the Reserve Bank was managed prudently, and the asset and liability side developments reflected the result of operations of the Bank undertaken during the year in pursuit of its broad macroeconomic and financial sector objectives.
- On the liability side, there was a high growth in notes in circulation, banks' deposits with the Reserve Bank due to the policy driven increases in CRR as well as deposit growth in the banking system and the Central Government's deposits with the Reserve Bank. The outstanding balances maintained by the Central Government under the Market Stabilisation Scheme (MSS), however, declined.

- On the asset side, there was significant increase in Bank's portfolio of domestic assets in the form of government securities parked by the banks with the Reserve Bank for availing funds under repo. Foreign currency assets declined largely due to valuation effect and use of a part of such assets for purchase of gold from the IMF.
- The gross income of the Reserve Bank for the year 2009-10 declined. As return on foreign assets tracked the near zero policy rates maintained by the central banks of the advanced economies, income on such assets declined significantly. In monetary operations, sustained period of large net absorption of liquidity through reverse repo also involved higher net interest outgo.

Near to Medium-term Challenges for the Reserve Bank

Monetary Policy Response to Supply Shocks

- Repeated supply shocks pose a constant challenge to ensuring a low inflation regime in India, which is necessary for achieving inclusive high growth. A medium-term approach is required to augment the supply by addressing structural supply constraints, particularly in items of mass consumption.

Improving Monetary Policy Transmission

- In India, since the financial system did not face a crisis, the damage to the transmission channel was minimal, even though the pre-global crisis time structural rigidities continued to limit the effectiveness of Reserve Bank's monetary policy actions. The recent switch over to the new "base rate" system is expected to help in improving and enhancing the visibility of the transmission of monetary policy signals to credit markets.

Fiscal Space for Increasing the Flexibility of Monetary Policy

- Persistence of fiscal imbalances over extended periods tends to increase risks to inflation through money-financed pressures on aggregate demand, interest rates through crowding-out pressures, and exchange rate through the twin deficit channel. The fiscal space in India is critical not only for the usual output stabilisation requirements around a high growth path, but also for limiting the impact of temporary but large supply shocks on headline inflation.

Capital Flows – Managing Surges and Sudden Stops

- Volatile capital flows have been a potential source of instability for Emerging Market Economies. Costs could magnify for an economy during periods of both too little and too much of capital flows, unless they are managed judiciously. India, in recent years, had to manage phases characterised by large net inflows as well as sudden outflows in the midst of a global crisis.
- A judicious mix of flexible exchange rate, sterilisation of the impact of inflows on domestic liquidity, cautious approach to liberalisation of the capital account, and the cushion of foreign exchange reserves has been used to deal with the adverse ramifications of capital flows.

Financing of Infrastructure

- The infrastructure gap of India, both in relation to other major countries and its own growing demand, has been a key factor affecting the overall productivity of investments. The requirement of high initial capital outlay, that too over longer terms, necessitates measures to address the financing constraint to capacity expansion in infrastructure.
- Bank credit to the infrastructure sector witnessed significant growth during last ten years, taking the share of bank finance to infrastructure in gross bank credit from about 2 per cent to more than 12 per cent. While banks continue to be a prime source of financing for infrastructure projects, alternative non-banking financing has

to be attracted with appropriate policies to be able to address the financing constraint to growth in infrastructure.

Financial Inclusion – Strengthening the Contribution of Finance to Sustainable Growth

- The potential of the financial system has not been harnessed fully due to the extent of financial exclusion prevailing today. The Reserve Bank has significantly scaled up its efforts aimed at increasing the level of penetration of bank financing in the economy. Financial inclusion represents a critical component of the policy process that intends to make the financial system serve the needs of the real economy.

Financial Sector Reforms – What Next?

- Since the global crisis, there has been a decisive shift in trend towards assigning increased responsibility to the central banks for both “systemic oversight” and “macro-prudential regulation”. This greater responsibility is driven by the capability of the central banks among regulators and public institutions to perform the intended task. In order for the Reserve Bank to effectively discharge such responsibilities, the issue of institutional independence and autonomy becomes important.
- Going forward, three areas will continue to be important in policy debates, i.e., development of long-term corporate bond markets, derivative markets to facilitate better price discovery and risk transfers, and more competition by allowing greater foreign participation.

Systemic Stability Risks – The New Regulatory Architecture for the Financial System

- Much of the challenges in the domain of financial stability regulation would arise from complexities surrounding the assessment of systemic risk, interconnectedness, common exposures, risk concentrations in complex innovative products and use of models to manage and price risks which at times mask information.
- Countries like India are yet to fully benefit from the financial system in harnessing the growth potential and achieving various developmental objectives. Any regulatory actions that may limit the flow of credit to the productive sectors of the economy would clearly bring to the fore the trade-off between stability and growth.

Globalisation-induced Challenges to Monetary and Financial Sector Policies

- The global crisis revealed how countries are interlinked beyond the conventional channels of trade and capital flows. Globalisation will continue to be a source of opportunity to maximise the country’s growth potential, but there would be increasing pressures on current comparative advantages of India, besides raising the scope for faster transmission of shocks from the global economy to the domestic economy.
- Sound domestic policy environment is increasingly more important to minimise the impact of global shocks on domestic real economy. Past experience shows that some of the global shocks will emerge suddenly as black swans, and hence, policy space must be created and preserved at every stage to deal with such shocks.

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Press Release : 2010-2011/286