PART TWO: THE WORKING AND OPERATIONS OF THE RESERVE BANK OF INDIA

III MONETARY POLICY OPERATIONS

Monetary policy in 2011-12 had to address the risk of entrenchment of inflation pressures and unhinged inflation expectations during the first half of the financial year and the significant slowdown in domestic growth even while maintaining its anti-inflationary stance during the second half. Further, with the liquidity deficit remaining above the comfort level due to a mix of structural and frictional factors, the Reserve Bank had to undertake active liquidity management to inject durable primary liquidity. Thus in the evolving growth-inflation dynamics, the monetary policy stance continued to be tight, up to mid-December 2011 but policy rates were kept at a pause mode during the remainder of the year with cuts in cash reserve ratio and OMO operations for supporting liquidity. During 2012-13 so far, on growing evidence of slowdown in the economy, the Reserve Bank using available space to cut policy rates frontloaded the policy action in April 2012, but maintained status quo on rates in June and July 2012 as inflation concerns persisted. The SLR was reduced in July 2012, to provide liquidity to facilitate credit availability to productive sectors.

III.1 The Reserve Bank's monetary policy stance till December 2011 was predominantly guided by the objective of containing inflation and anchoring inflation expectations. However, subsequently as growth decelerated sharply the Reserve Bank had to strike a balance between the objectives of growth stabilisation and low and stable inflation. Liquidity conditions mostly remained within the comfort zone before turning tight during November 2011 - March 2012. Deficit liquidity conditions reflected autonomous factors - both frictional and structural – in the form of sharp turnaround in government cash balances from deficit to surplus, the wedge between the credit and deposit growth, rise in currency in circulation, and drain of rupee liquidity on account of the Reserve Bank's forex market intervention to stem excessive volatility in the rupee exchange rate. The Reserve Bank responded with large scale open market operations and CRR cuts to offset the autonomous drain in liquidity. Reflecting these initiatives, the liquidity deficit condition moved back in the comfort zone in the Q2 of 2012-13 so far (till August 13, 2012).

MONETARY POLICY OPERATIONS: CONTEXT AND RATIONALE

III.2 Monetary policy at the beginning of 2011-12 faced the challenge of a high and persistent inflation. There were signs of further accentuation of the underlying inflationary pressures, posing the risk of firming up inflation expectations further. Monetary policy was, therefore, geared to ensure containment of inflationary pressures, even if it was at the cost of sacrificing some growth in the short-run.

III.3 Headline WPI inflation during April-November 2011 continued to remain at an elevated level of 9.7 per cent on an average, significantly above the comfort zone of the Reserve Bank. Non-food manufacturing inflation, as an indicator of demand pressures, averaged at 7.7 per cent during April-November 2011, as compared with around 4.0 per cent during the last six years. Enduring non-food manufactured products inflation emanated partly from persistent pricing power of producers,

wherein they were able to pass on rising commodity input prices and wage costs to consumers on the back of strong demand.

III.4 In response to the prevailing inflationary pressures and anticipated inflation trajectory during April-November 2011, the Reserve Bank raised the policy repo rate five times cumulatively by 175 basis points, with the increase in May and July of the order of 50 basis points each (Table III.1).

III.5 While inflation trajectory indicated some softening of inflationary pressure by December 2011, there were signs of a marked deceleration of domestic growth brought about by the combined impact of a worsening global environment, the cumulative impact of past monetary policy tightening and domestic policy uncertainties. In the light of these developments, the mid-quarter review of December 2011 signalled a pause. In its guidance, the Reserve Bank noted that in light of the growing downside risks to growth, further monetary policy actions would be directed towards a reversal in cycle. However, that was to be contingent upon inflation remaining on its projected downward trajectory.

Table III.1: Movements in Key Policy Variables

(Per cent)

Effective	Repo Rate	Cash Reserve Ratio	Statutory Liquidity Ratio
1	2	3	4
May 3, 2011	7.25 (+0.50)	6.00	24.00
June 16, 2011	7.50 (+0.25)	6.00	24.00
July 26, 2011	8.00 (+0.50)	6.00	24.00
September 16, 2011	8.25 (+0.25)	6.00	24.00
October 25, 2011	8.50 (+0.25)	6.00	24.00
January 28, 2012	8.50	5.50 (-0.50)	24.00
March 10, 2012	8.50	4.75 (-0.75)	24.00
April 17, 2012	8.00 (-0.50)	4.75	24.00
June 18, 2012	8.00	4.75	24.00
August 11, 2012	8.00	4.75	23.00 (-1.00)

Note: 1. Repo indicates injection of liquidity.
2. Figures in parentheses indicate change in policy rate in percentage points.

III.6 From the beginning of the fourth quarter of 2011-12, there were indications of a moderating trend in inflation. However, during this period, the risks to growth increased further resulting in a downward projection of GDP growth for 2011-12 from 7.6 per cent to 7.0 per cent in the third quarter review. A major concern faced by monetary policy at this juncture was the overall liquidity deficit which remained much beyond the comfort zone of the Reserve Bank. Acknowledging that such structural liquidity constraints in the economy, if not addressed, could lead to disruption of credit flow and further exacerbate growth risks, the Reserve Bank reduced CRR in two steps effective January 28, 2012 and March 10, 2012, by a cumulative 125 basis points with the aim of injecting durable primary liquidity into the system. The challenge for monetary policy while undertaking measures aimed at active liquidity intervention was that, inflation was still above the comfort level despite some moderation and there was significant amount of suppressed inflation in the economy.

III.7 By April 2012, there was growing evidence that the economy was slowing down more than what was anticipated earlier. Considering the need to support the growth impulses, the key policy repo rate was reduced by 50 basis points to 8 per cent on April 17, 2012. Even while reducing the policy rate, the Reserve Bank noted that the risks to inflation persisted in the form of high fiscal deficit driven by revenue expenditure, lagged pass-through of administered price increases, crude price uncertainty and structural food demand-supply imbalances. It was noted that these risks could limit the scope for further reduction of rates.

III.8 A marked deterioration in global economic and financial conditions coupled with significant moderation in domestic growth raised several deepening concerns in June 2012. Concomitantly,

the headline inflation continued to be above levels consistent with sustainable growth. The Reserve Bank assessed that several factors were responsible for the slowdown in activity, particularly in investment, with the role of interest rates being relatively small. Accordingly, it was viewed that further reduction in the policy interest rate at that juncture, rather than supporting growth, could exacerbate inflationary pressures and accentuate macro-economic risks. In view of these factors, the Reserve Bank decided to keep the CRR as well as policy repo rate unchanged in its mid-quarter monetary policy review in June 2012.

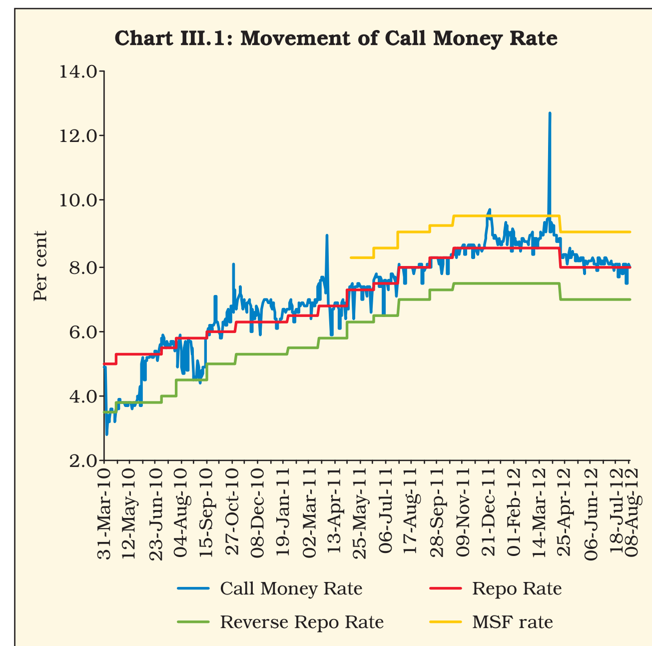
III.9 At the current juncture, the global economy is facing a synchronised slowdown, while domestic macroeconomic situation, particularly slowdown in growth and persistent inflation continues to raise concerns. Against this backdrop, the stance of monetary policy in July 2012 was shaped by considerations of containing inflation and inflationary expectations, supporting a sustainable growth path over the medium-term and continuing to provide liquidity to facilitate credit availability to productive sectors. In line with this policy stance, the Reserve Bank maintained a *status quo* on policy rates but reduced the statutory liquidity ratio (SLR) of SCBs from 24.0 per cent to 23.0 per cent of NDTL with effect from the fortnight beginning August 11, 2012.

III.10 Going forward, reflecting the setback to the global recovery and the resultant continuation of easy global monetary conditions as also weather related adversities in several parts of the world, the outlook for food and commodity prices, especially crude oil, has turned adverse. Risks to headline inflation persist from suppressed inflation and structural gaps between demand and supply of food. Additional risks to food inflation have emerged from the deficient and uneven monsoon. In turn, persistent elevated headline inflation driven by food and fuel price pressures carries the significant risk of unhinging inflation expectations. Further, the lowering of trend rate of growth in post crisis scenario due to sustained deceleration in investment activities and supply bottlenecks on a variety of fronts – infrastructure, energy, minerals and labour - has added to risks of a pick-up in inflation in response to even a moderate growth recovery. Monetary policy in such a scenario has to maintain a fine balance such that while addressing short-term growth concerns, price stability is maintained to ensure sustainable growth over the medium-term.

New Operating Procedure of Monetary Policy

III.11 The Reserve Bank introduced a new operating procedure of monetary policy in May 2011 to have an explicit operating target, a single policy rate and a formal corridor system with a 100 bps spread on either side of the policy rate to replace the earlier system of repo and reverse repo as policy rates without having an explicit target and a fixed-width formal corridor (Please see Box III.2 of Annual Report 2010-11 for details). Following the implementation of the new operating procedure of monetary policy, the call rate stabilised and hovered within the fixed corridor barring a few occasions when the call rate exceeded the upper bound of the corridor owing to tightness of liquidity on account of advance tax outflows (Chart III.1). The implementation of new operating procedure

Chart III.1: Movement of Call Money Rate



has also led to a greater integration of financial market, reflected in the call rate moving closely and in tandem with other money market rates than earlier. Debt market segment has also evidenced a better transmission from the call rate with increasing alignment between rates on debt market instruments and call rate.

Performance of the Base Rate System

III.12 The Base Rate system, which replaced the benchmark prime lending rate (BPLR) system introduced in 2003, and became effective from July 2010, has contributed to improvement in the pricing of loans, enhanced transparency in lending rates and improvement of the assessment of the transmission of monetary policy (Box III.1). This combined with freeing of interest rates on export credit in foreign currency effective May 5, 2012 have resulted in complete deregulation of interest rates on lending by commercial banks.

Deregulation of the Savings Bank Deposit Rate

III.13 As proposed in the Second Quarter Review of Monetary Policy 2010-11, a discussion paper on deregulation of savings bank deposit rate was prepared and placed on the Reserve Bank's website on April 28, 2011 for suggestions/feedback from the general public. Based on the feedback

Box III.1
Base Rate System: An Assessment

In order to address concerns posed by the non-transparent BPLR system, the Base Rate system was introduced on the recommendations of a Working Group (Chairman: Shri Deepak Mohanty) (See Box III.1 of Annual Report 2010-11). Since the inception of the Base Rate system, liquidity in the financial system has remained in deficit mode. During this period, banks have become by and large synchronous and more responsive in their change of Base Rates to changes in the policy rate by the Reserve Bank. This is evident from the fact that as the Reserve Bank progressively increased its Repo Rate, banks also increased their Base Rates. Initially, *i.e.* during July – December 2010, the pace was slower as the system had been migrating from surplus mode to a deficit mode. Reflecting this, Base Rates increased, on average, by 58 bps following the rise in Repo Rate by 75 bps. Thereafter, the momentum picked up and continued till March 2011 (Table).

Thereafter, following gradual moderation in the growth of economic activity and the resultant slowdown in the growth of non-food credit, particularly during the second half of 2011-12, the pace of increase in the Base Rate relative to that of the Repo rate slowed down while the number of days taken to raise the Base Rate also increased. Further, as the Reserve Bank reduced its Repo Rate by 50 bps on April 17, 2012, 24 banks accounting for around 63 per cent of aggregate credit reduced their Base Rates by, on average, 23 bps so far (till July 2012). The pass-through of reduction in Repo Rate and cumulative reduction in CRR to banks' deposit and lending rates was impacted by higher weighted average cost of outstanding deposits, higher government borrowing, increase in NPAs and sustained high inflation.

Overall, however, the transmission of monetary policy has been strengthened under the Base Rate system as compared with the BPLR system.

Table : Extent of Increase in both Deposit Rate and Base Rate and Time Taken by Public/Private Sector Banks

Period (Month over Month)	Change in Repo Rate (bps)	Change in Cash Reserve Ratio (CRR) (bps)	Change in Deposit Rate (bps)	Average change in Base Rate (bps)	Average no. of days taken to change the Base Rate*	No. of Banks changed the Base Rate	Share of Credit of banks that changed their Base Rate (%)#
1	2	3	4	5	6	7	8
Jul-Dec 10	75	-	25-325	58	141	41	93.1
Dec10-Mar 11	50	-	25-450	73	96	47	96.5
Mar-May 11	50	-	10-275	55	85	38	89.0
May-Oct 11	125	-	05-425	95	129	46	94.5
Oct 11-Mar 12	-	-125	05-500	29	93	13	9.7
Mar-Jul 12	-50	-	(-25)-(-400)	-23	247	24	62.6

- : Indicates no change. * : Since the date of last change in Base Rate. # : As at end-point.

received and after examining the pros and cons of such deregulation, on balance, the Reserve Bank decided to deregulate the savings bank deposit interest rate, effective October 25, 2011 (Box III.2).

Box III.2

Deregulation of Savings Bank Deposit Interest Rate – Rationale and Impact

The process of interest rate deregulation, which began in the early 1990s, was largely completed by 1997. On the liability side, apart from the interest rate on current account, the only interest rate that continued to remain regulated was the savings deposit interest rate until October 25, 2011. The discussion paper on deregulation of savings bank deposit rate delineated both the pros and cons of deregulation of savings bank deposit rate as under:

Pros

a) Deregulation of the interest rate on savings deposit will make the rate flexible along with other interest rates depending on the market conditions.

b) Regulation of savings deposit interest rate not only reduced its relative attractiveness, it also adversely affected the transmission of monetary policy.

c) Savings deposits constitute a large proportion of total deposits. However, owing to regulation of interest rate, there was hardly any competition in this segment with both banks and depositors acting passively. This inhibited product innovations.

Cons

a) Savings deposits have been a source of cheap funds for banks. In addition, banks treat a large portion of savings deposits as ‘core’ deposits, which are used to finance long-term assets. This, combined with skewed distribution of savings deposits, often raised the concern that deregulation might lead to an unhealthy competition resulting in a large shift of deposits from some banks exposing them to a serious risk of asset-liability mismatch.

b) Should unhealthy competition result in increase in interest rate and the overall cost of funds, banks might be discouraged from maintaining savings deposits with small amounts due to the associated high transaction costs.

c) In the event, if savings deposit interest rates decline markedly, income flow to small savers/pensioners may get affected adversely.

d) Following deregulation, some banks may introduce some complex products, which may not be so easily understood by savers. These strategies may result in increase in the mis-selling of savings bank products.

Deregulation and its Impact

The discussion paper evoked wide-ranging responses from a cross-section of stakeholders, ranging from the suggestion that savings bank deposit interest rate should not be deregulated at all to the suggestion that it should be deregulated completely. The Reserve Bank examined the suggestions. On balance, it was felt that the time was appropriate to move forward and complete the process of deregulation of rupee interest rates. Accordingly, it was decided to deregulate the savings bank deposit interest rate effective October 25, 2011 (announced in the Second Quarter Review of Monetary Policy 2011-12), subject to the following two conditions:

- First, each bank will have to offer a uniform interest rate on savings bank balance up to ₹100 thousand, irrespective of the amount in the account within this limit.
- Second, for savings bank balance over ₹100 thousand, a bank may provide differential rates of interest, if it so chooses. However, there should not be any discrimination from customer to customer on interest rates for similar amount.

Since the deregulation of savings deposit interest rate, five private sector banks, ten foreign banks and one co-operative bank have increased their savings deposit interest rate in the range of 100-500 basis points during the period so far. So far, none of the public sector banks has increased its savings deposit interest rate.

Any unhealthy competition has not been seen amongst banks so far. This is because 15 SCBs, which have raised saving deposit rate, account for only 4.2 per cent of aggregate deposits. However, these 15 banks witnessed above-average growth in their savings deposits during the period so far. As a result, the share of these banks to total savings bank deposits of the banking system increased from 1.8 per cent to 2.1 per cent in the post-deregulation period so far up to July 2012 and their contribution to the total growth of savings bank deposits stood at around 5 per cent during this period.

With regard to both free and chargeable services as admissible to savings bank account holders during the pre- and post-deregulation period, a quick survey of 11 banks comprising public sector, private sector and foreign banks reveals that banks that raised savings deposits interest rates have not changed their non-interest charges during post-deregulation period so far. However, in contrast, while two major private sector banks have made upward revisions in their non-interest charges, one public sector bank reduced such charges during the post-deregulation period. Since majority of banks are yet to change their savings deposits interest rates, the change in non-interest charges is yet to gather momentum.

Box III.3
Bank Rate Alignment with the MSF Rate

Section 49 of the Reserve Bank of India Act, 1934 requires the Reserve Bank to make public (from time to time) the standard rate at which it is prepared to buy or re-discount bills of exchange or other commercial papers eligible for purchase under that Act. Since discounting/rediscounting by the Reserve Bank has remained in disuse, the Bank Rate has not been active. Moreover, even for the conduct of monetary policy, instead of changing the Bank Rate, monetary policy signalling was done through modulations in the reverse repo rate and the repo rate under the Liquidity Adjustment Facility (LAF) (till May 3, 2011) and the policy repo rate under the revised operating procedure of monetary policy (from May 3, 2011 onwards). As a result, the Bank Rate had remained unchanged at 6 per cent since April 2003. Under the revised operating procedure, the marginal standing facility (MSF), instituted at 100 basis points above the policy repo rate, serves the purpose of the Bank Rate. Being the discount rate, the Bank Rate should technically be higher than the policy repo rate. The Reserve Bank consulted various organisations/ stakeholders relying on the Bank Rate as a reference rate and based on the feedback received, it was determined that the Bank Rate should normally stay aligned to the MSF rate. Accordingly, it was decided that with effect from the close of business on February 13, 2012, the Bank Rate will stand aligned with the MSF rate with the one-time technical adjustment. All penal interest rates on shortfall in reserve requirements, which are specifically linked to the Bank Rate, also stand revised accordingly.

Bank Rate - One-time Technical Adjustment

III.14 Effective from February 13, 2012, the Bank Rate has been aligned with the MSF rate through a one-time technical adjustment (Box III.3). This decision was based on a review of the relevance of the Bank Rate in the context of the current operating framework of monetary policy and it was clarified that the one-time adjustment should not be seen as a monetary policy action.

Liquidity Management

III.15 The Reserve Bank, like many other central banks keeps the systemic liquidity in deficit mode in order to enhance the transmission of monetary policy. Consistent with this objective, liquidity conditions generally remained in deficit mode throughout 2011-12. However, the deficit exceeded the indicative comfort level of one per cent of net demand and time liabilities (NDTL) of SCBs from the beginning of November 2011 due to both structural and frictional factors(Please see discussion on liquidity conditions in Part II.3: Money and Credit).

III.16 In order to ease the liquidity situation, the Reserve Bank undertook several measures (Box III.4).

Box III.4
Liquidity Management Operations

Liquidity conditions changed course significantly during 2011-12 on account of both structural and frictional factors. Liquidity conditions remained in surplus mode during early April 2011, turned into deficit but mostly remained within comfort zone up to October and subsequently turned into excessive deficit mode during the remainder of the year.

On April 8, 2011, the Reserve Bank had preemptively extended the additional liquidity support to SCBs under the LAF to the extent of up to one per cent of their NDTL till May 6, 2011. Moreover, the second LAF (SLAF) on a daily basis was also extended, synchronously. Following the introduction of MSF on May 9, 2011, as a part of the Modified Operating Procedures of Monetary Policy announced in the Annual Monetary Policy Statement 2011-12, the second LAF was discontinued.

While repo auction under LAF continued to be conducted between 9.30 am and 10.30 am, the Reserve Bank shifted the reverse repo auction under LAF to the afternoon time slot of 4.30 pm to 5.00 pm on all working days with effect from August 16, 2011. The prime reason for shifting the reverse repo window to the afternoon slot was to encourage the market participants to trade amongst themselves and to park any surplus with the Reserve Bank only after exhausting all other avenues to deploy the funds in the money market. Comfortable liquidity conditions during first half (H1) of 2011-12 were reflected in the access to MSF only on two occasions, *viz.*, ₹1 billion on June 10 and ₹41.05 billion on July 15, 2011.

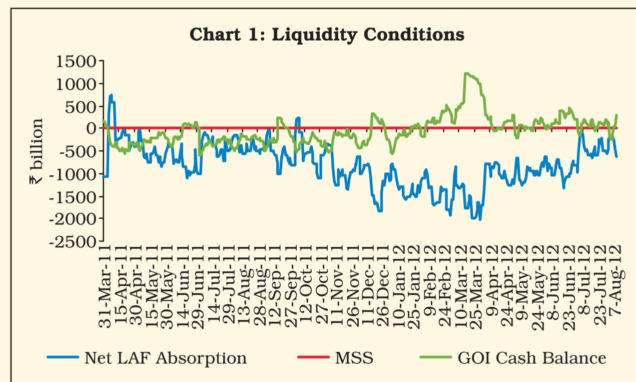
During the second half (H2) of 2011-12, liquidity conditions tightened reflecting the decline in the level of WMA/OD, rise

(Contd....)

in currency in circulation due to festive season currency demand and forex market operations by the Reserve Bank. As soon as the liquidity deficit exceeded the Reserve Bank's indicative comfort zone of (+/-) 1 per cent of NDTL from the second week of November 2011, the Reserve Bank began conducting OMO purchase auctions of Government securities from November 24, 2011. Reflecting quarterly advance tax outflows and forex market operations by the Reserve Bank, the average daily net liquidity injection under the LAF increased further to around ₹1,170 billion in December 2011 from around ₹920 billion in November 2011 (Chart 1). MSF was availed on six occasions during December 2011.

With a view to providing flexibility to SCBs in their liquidity management, the Reserve Bank conducted additional repo operation under LAF on December 16, 2011, over and above the existing LAF and MSF arrangements. Furthermore, keeping in view the prevailing overall liquidity conditions, the Reserve Bank permitted banks on December 21, 2011 to avail funds on overnight basis under the MSF against their excess SLR holdings in addition to the existing facility where they were already allowed to avail themselves of funds on overnight basis below the stipulated SLR, up to one per cent of their respective NDTL.

As the liquidity stress persisted through January 2012 partly reflecting forex market operations by the Reserve Bank, the Reserve Bank reduced the CRR of scheduled banks by 50 bps to 5.5 per cent of their NDTL, effective January 28, 2012. With a view to providing flexibility to market participants in their liquidity management, the Reserve Bank re-introduced additional Repo under LAF (second LAF Repo) on reporting Fridays, effective February 10, 2012. The average daily LAF



injection rose further to around ₹1,405 billion in February 2012 from around ₹1,290 billion in January 2012, partly reflecting the build-up of the centre's surplus balance.

Liquidity conditions tightened significantly during March 2012. The Reserve Bank pro-actively reduced the CRR by 75 bps effective March 10, 2012. The average daily net outstanding LAF injection reached around ₹1,570 billion in March 2012. The net liquidity injection through the LAF escalated to an all-time high on March 30, 2012 (₹2,028 billion) as banks tried to shore-up their balance sheets and front-load cash reserves. Banks availed MSF on nine occasions during the month.

With a view to providing flexibility to SCBs in their liquidity management, the Reserve Bank conducted additional LAF-Repo on March 30, 2012, and LAF and MSF on March 31, 2012.

The liquidity conditions continued to remain in deficit mode in April 2012, *albeit*, on a lower scale, reflecting seasonal draw-down of government cash balances. Subsequently, however, there has been an easing of the liquidity stress in the system brought about by the Reserve Bank's active management of liquidity through LAF and OMOs. The narrowing of the wedge between credit and deposit growth rates also helped in restricting the liquidity deficit in the situation. In order to provide greater liquidity cushion, the Reserve Bank also undertook several measures. In April 2012, the borrowing limit of SCBs under the MSF was raised from one per cent to two per cent of their NDTL. Further, the eligible limit of the Export Credit Refinance (ECR) facility for scheduled banks (excluding RRBs) was enhanced from 15 per cent of the outstanding export credit eligible for refinance to 50 per cent, effective fortnight beginning June 30, 2012. This was estimated to provide additional liquidity support to banks of over ₹300 billion. In response to suggestions received from the market participants for extending the timings of evening LAF, the Reserve Bank decided to conduct reverse repo auction under LAF and MSF operation between 4.45 pm and 5.15 pm with effect from July 16, 2012. The statutory liquidity ratio (SLR)of SCBs was reduced from 24.0 per cent to 23.0 per cent of NDTL with effect from the fortnight beginning August 11, 2012, with a view to providing additional liquidity to facilitate credit availability to productive sectors. This is expected to release additional liquidity to the tune of ₹680 billion.

III.17 Reflecting these measures, combined with decline in government cash balances, the liquidity stress has eased in Q2 of 2012-13 so far (till August 13, 2012) and the extent of deficit has remained close to the Reserve Bank's comfort level of one per cent of NDTL.

Overall Assessment

III.18 During April - November 2011, monetary policy was directed towards 'management of inflation' in response to an inflationary process that remained at a level much above the comfort zone of the Reserve Bank for almost two years. Monetary

policy in this scenario was guided by the consideration that persistent high inflation is inimical to sustained long-run growth as it harms both financial saving and investment by creating uncertainty. Hence, the objective of regaining price stability even at the cost of sacrificing some growth in the short-run, gained precedence. Towards the last quarter of the financial year, however, there were strong signals of a slowdown in growth to below post-crisis trend levels. Inflation started moderating since December 2011. Keeping in view the growth slowdown the Reserve Bank front loaded the policy rate reduction in April 2012 and adjusted the policy rates to levels consistent with the growth moderation. Nevertheless, with significant risk of inflation persisting, monetary policy had to maintain a fine balance between supporting growth impulses while at the same time anchoring inflation expectations and preventing any resurgence in inflationary pressures. Monetary policy, during the course of the year, also had to address structural liquidity constraints and actively manage liquidity to ensure that it remained in moderate deficit, consistent with effective monetary transmission. This further posed a challenge to communication, in trying to distinguish between liquidity easing measures from the monetary policy stance.