

## *Review of Monetary Policy Statement, 2011-12*

- **Short term** lending rate (repo) hiked by 50 bps to 7.25 per cent.
- **Repo rate** to become the only effective policy rate in indicating monetary policy stance.
- **Reverse repo** to be fixed 100 basis points lower than the repo rate, gets fixed at 6.25 per cent.
- **Banks to** get a new overnight borrowing window under Marginal Standing Facility at 8.25 per cent.
- **Cash reserve** ratio and **bank rate** left unchanged at 6 per cent each.
- **Interest rates** on savings bank deposits hiked to 4 per cent from 3.5 per cent.
- **New provisioning norms** for Banks.
- **Economic growth** projected at 8 % for 2011-12, lower than 8.6% estimated for 2010- 11.
- **Objective is** to contain inflation by curbing demand-side pressures.
- **WPI inflation** projection lowered to 6 per cent.
- **Aligning** of fuel prices with international crude prices to prevent widening of fiscal deficit favoured.
- **Low likelihood of oil prices** moderating.
- **Malegam Committee** recommendations on MFI sector broadly accepted.
- **Bank loan to MFIs** on or after April 1, 2011, will be treated as priority sector loans.

The Reserve Bank of India (RBI) is of the view that controlling inflation is imperative to sustaining growth over the medium-term and this has been signaled by increasing the repo and the saving rates by 50 basis points. According to the monetary policy document issued by RBI, three factors, namely: global factors, inflation and demand side pressures, have shaped the outlook and monetary strategy for FY 2011-12.

### **Indian Economy**

The Indian economy is estimated to have grown by 8.6 per cent last year. Agricultural growth has exhibited healthy trend of growth at 5.4 percent in 2010-11 vis-à-vis 0.4 in 2009-10, following a good monsoon. The index of industrial production (IIP), which grew by 10.7 per cent during the first half of the last year, moderated subsequently, bringing down the overall growth for April-February 2010-11 to 7.8 per cent, with marked slowdown in capital goods production and investment spending. As per RBI, the likely course of inflation over the year suggests that high inflation will persevere and may get worse.

## **Global Impact**

Global commodity prices, which have surged in recent months may well increase further over the course of the year. Uncertainty in the Middle East and North Africa (MENA) adds further upward risk in the international oil prices. The European Central Bank has recently raised its policy rate - the first central bank to do so among the major advanced economies - after maintaining them at historically low levels for almost two years. Central banks in other advanced economies are also under pressure to withdraw monetary accommodation. The above trend poses appreciable downside risks to global economic activity.

## **Banking Industry**

The Base Rate system replaced the Benchmark Prime Lending Rate (BPLR) system with effect from July 1, 2010. The weighted average lending rate in the banking system was 10.5 per cent as at end-March 2010. Data from select banks indicate that the weighted average yield on advances, which is a proxy measure for effective lending rates, is projected to increase from 9.7 per cent in 2010-11 to 10.3 per cent in 2011-12.

RBI has proposed higher and stringent provisioning norms for banks. As per the new policy, advances classified as sub-standard will attract a provision of 15 per cent as against the existing 10 per cent (the unsecured exposures classified as sub-standard assets will attract an additional provision of 10 per cent, *i.e.*, a total of 25 per cent as against the existing 20 per cent); the secured portion of advances which have remained in doubtful category up to one year will attract a provision of 25 per cent (as against the existing 20 per cent); the secured portion of advances which have remained in doubtful category for more than one year but upto 3 years will attract a provision of 40 per cent (as against the existing 30 per cent); restructured accounts classified as standard advances will attract a provision of 2 per cent in the first 2 years from the date of

restructuring, or in cases of moratorium on payment of interest/principal after restructuring, for the period covering moratorium and 2 years thereafter (as against existing provision of 0.25-1.00 per cent, depending upon the category of advances); and restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2 per cent in the first year from the date of up gradation (as against existing provision of 0.25-1.00 per cent, depending upon the category of advances).

Increase in savings rate and higher and stringent provisioning norms would negatively impact the profitability of the banking sector.

#### **Impact on MSMEs**

Following the RBI's decision to increase the savings rate by 50 basis points from 3.5% to 4% and increase of Repo rate by 50 basis point, the net income margins (NIM) of all the banks are set to decrease. It is expected that banks may pass this increased cost of funds to the MSMEs, i.e. the lending rates may go up. Increased cost of borrowing for the MSMEs could result in reduced profitability. Increase in short term lending rates may also result in costlier finance for home loans and auto loans segment, in particular.

The credit flow to the MSEs (Micro and Small Enterprises) may increase as RBI has advised the scheduled commercial banks to allocate 60% of micro and small enterprises (MSEs) advances to the micro enterprises based on recommendations of the High Level Task Force on MSMEs.

Further, banks are mandated to achieve a 10 per cent annual growth in the number of micro enterprise accounts and a 20 per cent year-on-year growth in credit to the MSE sector.

### **Impact on MFIs**

RBI has decided to accept the broad framework of regulations recommended by the Malegam Committee. Moreover, it is determined that bank loans to all MFIs, including NBFCs working as MFIs on or after April 1, 2011, will be eligible for classification as priority sector loans under the respective category of indirect finance only if the prescribed guidelines on assets and interest rate are followed. However, the loan must be given to the borrower with a rural household annual income not exceeding ₹ 60,000 or urban and semi-urban household income not exceeding ₹ 1,20,000. SMERA is of the opinion that MFIs would find it difficult to ascertain the household income of the borrower and a fine tuned process would have to be evolved to ascertain the same.

After being criticized for levying high interest rate from small borrowers by MFIs, RBI has set the interest rate cap of 26 percent i.e. 2 percent more than the rate recommended by the committee and to bring the transparency in interest charges.

Moreover, RBI has increased mobile-based transaction facility up from ₹ 1,000 to ₹ 5,000 without end-to-end encryption; this may aid small value transactions.

## Future Outlook

Growth is expected to moderate in 2011-12 from its pace in 2010-11. The baseline projection of real GDP growth for 2011-12 for policy purposes is placed at around 8 per cent. The inflation outlook will be shaped by the following factors:

- The first factor is the timing of the revision of administered fuel and power group prices and its quantum.
- Second, the un-certainty around the outlook for crude oil prices in the near future, given the geopolitical situation in the Middle East and North Africa. In any case, the likelihood of oil prices moderating in the short term appears to be low.
- The third factor that will shape the inflation outlook is the expected increase in the prices of several important industrial raw materials such as: minerals, fibres, rubber, coal and crude oil. In addition, there is also upward pressure on wages. To the extent the increase in input prices translates to output prices, it will have an influence on the inflation path.
- Finally, the behavior of the monsoon will be a critical factor in shaping inflation expectations on the way forward.
- Expectations of rising international prices in the Indian context indicate likely adverse impact on GDP. Similarly, sectors such as surface and air transport, synthetic fibre and chemicals, cotton textiles, paper products, rubber and plastic, cement and food grains have high input linkages with oil prices and its increase could add to inflationary expectations in the economy.