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RBI's Growth Stimulus

The global economic outlook has deteriorated sharply over the last two months. In its World Economic Outlook, published in early October, the International Monetary Fund (IMF) forecast global growth of 3.9 per cent in 2008, and of 3.0 per cent in 2009. The IMF has since revised its forecast for global growth downwards to 3.7 per cent for 2008, and 2.2 per cent for 2009. Many economists are now predicting the worst global recession since the 1970s. Several countries, notably the United States, the UK, the euro area and Japan are all officially in recession. More worryingly, current indications are that the recession will be deeper and the recovery longer than earlier anticipated.

2. Confidence in global credit markets continues to be low, and credit lines remain clogged. The tight and hesitant conditions in the credit markets are precipitating erosion of demand which, in turn, is feeding a recession - deflation vicious cycle. Central banks around the world are responding to the developments by aggressive and unconventional injection of liquidity, monetary easing and relaxation of collateral norms and eligibility criteria for their lending to financial institutions.

3. Contrary to earlier expectations that emerging economies will be affected only marginally, growth prospects of emerging economies have most definitely been undermined by the ongoing crisis with, of course, considerable variations across countries. The transmission to emerging economies is taking place *via* both trade and financial channels. Reflecting the contagion of the crisis, the IMF revised its growth forecast for emerging economies for 2009 to 5.1 per cent, down from its early October figure of 6.1 per cent.

4. The outlook for India going forward is mixed. There is evidence of economic activity slowing down. Real GDP growth has moderated in the first half of 2008/09. Industrial activity, particularly in the manufacturing and infrastructure sectors, is decelerating. The services sector too, which has been our prime growth engine for the last five years, is slowing, mainly in construction, transport and communication, trade, hotels and restaurants sub-sectors. For the first time in seven years, exports have declined in absolute terms in October. Recent data indicate that the demand for bank credit is slackening despite comfortable liquidity. Higher input costs and dampened demand have dented corporate margins while the uncertainty surrounding the crisis has affected business confidence.

5. On the positive side, headline inflation, as measured by the wholesale price index, has fallen sharply, and the decline has been sustained for the past four weeks, pointing to a faster than expected reduction in inflation. Clearly, falling commodity prices have been the key drivers behind the disinflation; however, some contribution has also come from slowing domestic demand. The reduction in prices of petrol and diesel announced last night should further ease inflationary pressures. To be sure, consumer price inflation for the months of September and October did increase. This is possibly owing to the firm trend in food articles inflation and the higher weight of food articles in measures of consumer price inflation. Historically there has been a correlation between wholesale and consumer price inflation, and given this correlation, consumer price inflation too can be expected to soften in the months ahead.

6. In response to the evolving global and domestic developments, the Reserve Bank has taken a number of measures since mid-September 2008. The aim of these measures was to augment domestic and forex liquidity and to enable banks to continue to lend for productive purpose while maintaining credit quality so as to sustain the growth momentum.

7. Measures aimed at expanding rupee liquidity included significant reduction in the cash reserve ratio (CRR), reduction of the statutory liquidity ratio (SLR), a special repo window under the liquidity adjustment facility (LAF) for banks for on lending to non-banking financial companies (NBFCs), housing finance companies (HFCs) and mutual funds (MFs), and a special refinance facility which banks can access without any collateral. The Reserve Bank is also unwinding the Market Stabilization Scheme (MSS) securities roughly synchronised with the Government borrowing programme in order to manage liquidity.

8. Measures aimed at managing forex liquidity include upward adjustment of the interest rate ceilings on the foreign currency non-resident (banks) [FCNR(B)] and non-resident (external) rupee account [NR(E)RA] deposits, substantially relaxing the external commercial borrowings (ECB) regime, allowing NBFCs/HFCs access to foreign borrowing and allowing corporates to buy back foreign currency convertible bonds (FCCBs) to take advantage of the discount in the prevailing depressed global markets. The Reserve Bank has also instituted a rupee-dollar swap facility for banks with overseas branches to give them comfort in managing their short-term funding requirements.

9. Measures to encourage flow of credit to sectors which are coming under pressure include extending the period of pre-shipment and post-shipment credit for exports, expanding the refinance facility for exports, contra-cyclical adjustment of provisioning norms for all types of standard assets (except in case of direct advances to agriculture and small and medium enterprises which continue to be 0.25 per cent) and risk weights on banks' exposure to certain sectors which had been increased earlier counter-cyclically, and expanding the lendable resources available to the Small Industries Development Bank of India (SIDBI) and the National Housing Bank (NHB).

10. To improve the flow of credit to productive sectors at viable costs so as to sustain the growth momentum, the Reserve Bank signaled a lowering of the interest rate structure by reducing its key policy repo rate by 150 basis points from 9.0 per cent as on October 19 to 7.5 per cent by November 3, 2008.

11. Taken together, the measures put in place since mid-September 2008 have ensured that the Indian financial markets continue to function in an orderly manner. The cumulative amount of primary liquidity made available to the financial system through these measures is over Rs.300,000 crore. This sizeable easing has ensured a comfortable liquidity position starting mid- November 2008 as evidenced by a number of indicators. Since November 18, the LAF window has largely been in the absorption mode. The weighted average call money rate has come down from a recent high of 19.7 per cent on October 10 to 6.1 per cent on December 5. The overnight money market rate has consistently remained within the LAF corridor (6.0 per cent to 7.5 per cent) since November 3. The yield on the 10 year benchmark G-Sec has declined from 8.6 per cent on September 29 to 6.8 per cent on December 5. Taking the signal from the repo rate cut, the top five public sector banks have reduced their benchmark prime lending rates (BPLR) from 13.75 – 14.00 per cent as on October 1 to 13.00 – 13.50 per cent presently.

12. The Reserve Bank has reviewed the evolving macroeconomic and monetary/liquidity conditions and has decided to take the following further measures:

- It has been decided to reduce the repo rate under the LAF by 100 basis points from 7.5 per cent to 6.5 per cent and the reverse repo rate by 100 basis points from 6.0 per cent to 5.0 per cent, effective December 8, 2008.
- In view of the need to enhance credit delivery to the employment- intensive micro and small enterprises (MSE) sector, it has been decided to provide refinance of an amount of Rs. 7,000 crore to the Small Industries Development Bank of India (SIDBI) under the provisions of Section 17(4H) of the Reserve Bank of India Act, 1934. This refinance will be available

against: (i) the SIDBI's incremental direct lending to MSE; and (ii) the SIDBI's loans to banks, NBFCs and State Financial Corporations (SFCs) against the latter's incremental loans and advances to MSEs. The incremental loans and advances will be computed with reference to outstandings as on September 30, 2008. The facility will be available at the prevailing repo rate under the LAF for a period of 90 days. During this 90-day period, the amount can be flexibly drawn and repaid. At the end of the 90-day period, the drawal can also be rolled over. This refinance facility will be available up to March 31, 2010. The utilisation of funds will be governed by the policy approved by the Board of the SIDBI.

- We are working on a similar refinance facility for the National Housing Bank (NHB) of an amount of Rs 4, 000 crore. We will announce the details after consideration of the proposal by the Central Board of the Reserve Bank which is meeting next week.
- On November 15, 2008, the Reserve Bank had announced that proposals by Indian companies for premature buyback of foreign currency convertible bonds (FCCBs) would be considered under the approval route, provided that the buyback is financed by the company's foreign currency resources held in India or abroad and/or out of fresh external commercial borrowings (ECBs) raised in conformity with the current norms for ECBs. Extension of FCCBs was also permitted at the current all-in cost for the relevant maturity. On a review, it has now been decided to permit Authorized Dealers Category - I banks to consider applications for premature buyback of FCCBs from their customers, where the source of funds for the buyback is: i) foreign currency resources held in India (including funds held in EEFC accounts) or abroad and/or ii) fresh ECB raised in conformity with the current ECB norms, provided there is a minimum discount of 15 per cent on the book value of the FCCB. In addition, the Reserve Bank will consider applications for buyback of FCCBs out of rupee resources provided that: (i) there is a minimum discount of 25 per cent on the book value; (ii) the amount of the buyback is limited to US \$ 50 million of the redemption value per company; and (iii) the resources for buyback are drawn out of internal accruals of the company as certified by the statutory auditor.
- It has been decided that loans granted by banks to Housing Finance Companies (HFCs) for on-lending to individuals for purchase/construction of dwelling units may be classified under priority sector, provided the housing loans granted by HFCs do not exceed Rs.20 lakh per dwelling unit per family. However, the eligibility under this measure will be restricted to five per cent of the individual bank's total priority sector lending. This special dispensation will apply to loans granted by banks to HFCs up to March 31, 2010.
- Under the current guidelines, exposures to commercial real estate, capital market exposures and personal/ consumer loans are not eligible for the exceptional regulatory treatment of retaining the asset classification of the restructured standard accounts in standard category. As the real estate sector is facing difficulties, it has been decided to extend exceptional/ concessional treatment to the commercial real estate exposures which are restructured up to June 30, 2009.
- In the face of the current economic downturn, there are likely to be more instances of even viable units facing temporary cash flow problems. To address this problem, it has been decided, as a one time measure, that the second restructuring done by banks of exposures (other than exposures to commercial real estate, capital market exposures and personal/ consumer loans) up to June 30, 2009, will also be eligible for exceptional regulatory treatment.

- In view of the difficulties faced by exporters on account of the weakening of external demand, it was decided that the interest rate on Post-shipment Rupee Export Credit up to 180 days will not exceed BPLR minus 2.5 percentage points. In respect of overdue bills, banks have been permitted to charge the rates fixed for Export Credit Not Otherwise Specified (ECNOS) for the period beyond the due date. It has now been decided that the prescribed interest rate as applicable to post shipment rupee export credit (not exceeding BPLR minus 2.5 percentage points) may also be extended to overdue bills up to 180 days from the date of advance.

13. Operational instructions covering the above measures will be issued separately.

14. The cumulative impact of the measures in today's package, together with earlier measures, should be to step up demand and arrest the growth moderation. In particular, the reduction in the repo/reverse repo rates should result in a reduction in the marginal cost of funds to banks and enable them to improve the flow of credit to productive sectors of the economy on viable terms. The liquidity support provided to the SIDBI under the refinancing arrangement is expected to alleviate the credit stress/tightening of lending conditions confronting micro and small enterprises and should revive activity in these employment-intensive drivers of growth. The facility for premature buyback of FCCBs will help Indian companies to take advantage of the current discounted rates at which their FCCBs are trading. The special dispensation for treating loans to HFCs as priority sector lending will boost lending to the housing sector. The facilities for restructuring exposures will help soften pressures being faced by the commercial real estate and other sectors in the current environment. The benefit of the concessional rate of interest available to the exporters up to 180 days irrespective of the original maturity of the export bills is intended to benefit exporters who have drawn bills for shorter maturities and are facing difficulties in realizing the bills on due dates on account of external problems.

15. Given the uncertain outlook on the global crisis, it is difficult to precisely anticipate every development. The Reserve Bank will continue to closely monitor the developments in the global and domestic financial markets and will take swift and effective action as appropriate. The Reserve Bank's policy endeavour will be to minimise the negative impact of the crisis and to ensure an orderly adjustment. In particular, we will try to maintain a comfortable liquidity position, see that the weighted average overnight money market rate is maintained within the repo-reverse repo corridor and ensure conditions conducive for flow of credit to productive sectors, particularly the stressed export and small and medium industry sectors.

16. The fundamentals of our economy continue to be strong. Once the crisis is behind us, and calm and confidence are restored in the global markets, economic activity in India will recover sharply. But a period of painful adjustment is inevitable.

Sabeeta Badkar
Assistant Manager

Press Release : 2008-2009/842

Related Press Releases/Notifications:

- 1.RBI announces Further Measures for Monetary and Liquidity Management
- 2.Special Fixed Rate Repo Under Liquidity Adjustment Facility
- 3.Temporary liquidity support for financing agricultural operations
- 4.Special Refinance Facility (SRF) under Section 17(3B) of the Reserve Bank of India Act, 1934
- 5.Trade Credits for Imports into India – Review of all-in-cost ceiling
- 6.Enhancement of NBFCs' capital raising option for capital adequacy purposes
- 7.Interest Rates on Non-Resident (External) Rupee (NRE) Deposits and FCNR(B) deposits
- 8.Short-term Foreign Currency Borrowings by Housing Finance Companies
- 9.Export Credit Refinance Facility: Relaxation
- 10.Review of Prudential Norms – Provisioning for Standard Assets and Risk Weights for Exposures to Corporates, Commercial Real Estate and NBFC- ND-SI
11. Standing Liquidity Facilities for Banks and Primary Dealers
12. Interest Rate on Special Refinance Facility