Third Quarter Review of Monetary Policy 2013-14 : Statement by Dr. Raghuram G. Rajan, Governor, Reserve Bank of India

Good morning and welcome to the Reserve Bank.

Today, on the basis of an assessment of the current and evolving macroeconomic situation, we have decided to increase the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points to 8.0 per cent.

2. Let me first address the balance of risks that confronts us in the evolving macroeconomic outlook. The slowdown in the economy is getting increasingly worrisome. Our current assessment is that growth is likely to lose momentum in Q3 of 2013-14, with industrial activity in contractionary mode, mainly on account of manufacturing. Lead indicators of services also suggest a subdued outlook, barring some pick-up in transport and communication activity. On the other hand, agricultural performance has so far been robust, and the strong pick-up in *rabi* sowing indicates that this should be sustained.

3. Another silver lining is the significant narrowing of the trade deficit on the back of resilient export growth. The current account deficit for 2013-14 is now expected to be below 2.5 per cent of GDP as compared with 4.8 per cent in 2012-13. The recent resumption of capital inflows should help finance the current account deficit comfortably. Reserves have been rebuilt since September, and are expected to increase further as oil marketing companies, that have been buying foreign exchange in the market, repay the Reserve Bank when their swaps come due. Nevertheless, given the uncertain external environment, the government and the RBI cannot pause in their efforts to ensure fiscal and monetary stability.

4. The gravest risk to the value of the rupee is from CPI inflation which remains elevated at close to double digits, despite the anticipated disinflation in vegetable and fruit prices. Moreover, inflation excluding food and fuel has also been high, especially in respect of services, indicative of wage pressures and other second round effects. Elevated levels of inflation erode household budgets and constrict the purchasing power of consumers. This, in turn, discourages investment and weakens growth. High inflation weakens the rupee. Inflation is also a tax that is grossly inequitable, falling hardest on the very poor. It is only by bringing down inflation to a low and stable level that monetary policy can contribute to reviving consumption and investment in a sustainable way. The so-called trade-off between inflation and growth is a false trade-off in the long run.

5. It is possible to bring inflation under control without a substantial sacrifice of short term growth, provided we do what is necessary, and are patient. In the Mid-Quarter Review on December 18, 2013, the policy decision was to wait for more data, and we offered guidance on what we would do contingent on the data. Although headline inflation has fallen significantly with the substantial fall in vegetable prices, CPI inflation excluding food and fuel has remained flat and WPI inflation excluding food and fuel has risen. Given these data, the increase in the policy rate undertaken today is consistent with the guidance given in the Mid-Quarter Review. Moreover, the Dr. Urjit Patel Committee has indicated a "glide path" for disinflation that sets an objective of below 8 per cent CPI inflation by January 2015 and below 6 per cent CPI inflation by January 2016. The Reserve Bank's baseline projections set out in the accompanying Review of Macroeconomic and Monetary Developments for Q3 of 2013-14 indicate that over the ensuing 12-month horizon, and with an unchanged policy stance, there are upside risks to the central forecast of 8 per cent. Accordingly, an increase in the policy rate by 25 basis points is needed to set the economy securely on the recommended disinflationary path.

6. If the disinflationary process evolves according to this baseline projection, further policy tightening in the near term is not anticipated at this juncture. In fact, if inflation eases at a pace that is faster than we currently anticipate, and that reduction is expected to be sustained, the Reserve Bank will have room to become more accommodative.

7. Of course, the Reserve Bank is fostering growth through steady reforms. For example, last week, cash settled interest rate futures started trading on various exchanges. The enhanced framework for resolution of distressed assets will be operational by April 1. The recommendations of the Dr. Nachiket Mor Committee on financial inclusion are being examined carefully as are the recommendations of the Dr. Urjit Patel Committee on the monetary policy framework.

On behalf of the Reserve Bank, I wish you all a very happy new year.