

*Third Quarter Review of Monetary Policy 2013-14**

On the basis of an assessment of the current and evolving macroeconomic situation, it has been decided to:

- increase the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.75 per cent to 8.0 per cent; and
- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.0 per cent of net demand and time liability (NDTL).

Consequently, the reverse repo rate under the LAF stands adjusted at 7.0 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 9.0 per cent.

Assessment

2. Since the Mid-Quarter Review of December 2013, the global recovery is gaining traction, led by the strengthening of the US economy, but it is still uneven and subdued in the Euro area and Japan, and a slowdown in China seems to be underway. Notwithstanding the boost from stronger external demand, uncertainty continues to surround the prospects for some emerging economies, with domestic fragilities getting accentuated. Financial market contagion is a clear potential risk.

3. Domestically, some loss of momentum of growth is likely in Q3 of 2013-14, despite a strong pick-up in *rabi* sowing. Industrial activity remains in contractionary mode, mainly on account of manufacturing, which declined for the second month in succession during Q3. Consumption demand continues to weaken and lacklustre capital goods production points to stalled investment demand. Fiscal tightening through Q3 and Q4 is likely to exacerbate the weakness in aggregate demand. Lead indicators of services suggest a subdued outlook, barring some pick-up in transport and communication activity.

4. While retail inflation measured by the consumer price index (CPI) declined significantly on account of the anticipated disinflation in vegetable and fruit prices, it remains elevated at close to double digits. Moreover, inflation excluding food and fuel has also been high, especially in respect of services, indicative of wage pressures and other second round effects. In terms of the wholesale price index (WPI), headline inflation eased to a four-month low with the sharp decline in vegetable and fruit prices. Non-food manufactured products (NFMP) inflation, however, rose in December on an uptick in prices of chemicals, non-metallic minerals and paper products. Hardening prices of services and key intermediates seen in conjunction with rising bank credit, increase in order books, pick-up in capacity utilisation and the decline in inventories of raw materials and finished goods in relation to sales suggests that aggregate demand pressures are still imparting an upside to overall inflation. It is critical to address these risks to the inflation outlook resolutely in order to stabilise and anchor inflation expectations, even while recognising the economy is weak and substantial fiscal tightening is likely in Q4.

5. Liquidity conditions were impacted by the mid-December advance tax outflows. Recourse to the MSF rose from an average of ₹27 billion during the first half of December to an average of ₹250 billion in the second half, and the weighted average call rate moved up to 8.4 per cent from sub-LAF overnight repo rate levels. Although liquidity eased in the first week of January 2014 due to large redemptions by the Government, it started tightening thereafter with the build-up of Government's cash balances with the Reserve Bank. In order to normalise liquidity conditions in the face of these frictional pressures, the Reserve Bank conducted 7-day term repos of ₹100 billion on January 10, followed by 28-day term repos on January 17 and 21 cumulating to ₹300 billion, in addition to the normal liquidity provision of ₹1.4 trillion under overnight, 7-day and 14-day repos, and export credit

refinance taken together. After assessing that market liquidity would likely remain tight for a while, and keeping in view the need to accommodate normal credit growth, open market purchase operations of ₹95 billion were conducted on January 22 in order to provide liquidity of a more permanent nature. The weighted average call rate has eased in response to these operations. The Reserve Bank is engaged in active management of liquidity to offset frictional and structural pressures so that there is adequate credit flow to the supply side of the economy.

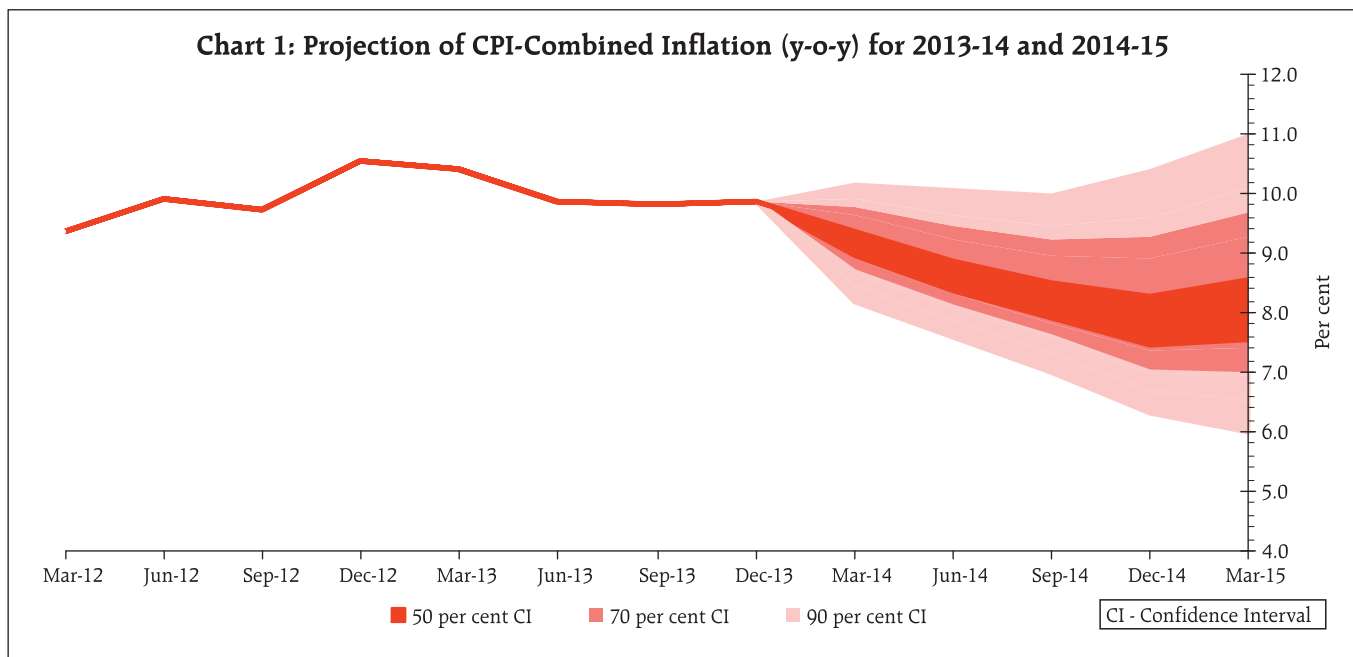
6. For the period April-December 2013, the trade deficit has shrunk by 25 per cent from its level a year ago, with merchandise exports increasing on a y-o-y basis for the sixth consecutive month in December, while non-oil imports have continued to decline. Accordingly, the current account deficit (CAD) for 2013-14 is expected to be below 2.5 per cent of GDP as compared with 4.8 per cent in 2012-13. The recent resumption of portfolio flows, both equity and debt, alongside the pick-up in FDI and external commercial borrowings that is underway should help finance the current account deficit comfortably. Reserves have been rebuilt since September, and oil marketing companies

have been buying foreign exchange in the market to repay the Reserve Bank when their swaps come due. Despite a significantly more comfortable external position than in the summer of 2013, both fiscal and monetary authorities need to continue their efforts at macroeconomic stabilisation.

Policy Stance and Rationale

7. In the Mid-Quarter Review on December 18, 2013, the policy decision was to wait for more data before acting. With the subsequent substantial fall in food prices, especially of vegetables, headline inflation has fallen significantly. Some of these effects will continue into the next round of data readings. CPI inflation excluding food and fuel has, however, remained flat and WPI inflation excluding food and fuel has risen.

8. 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 the current policy



stance, there are upside risks to the central forecast of 8 per cent. An increase in the policy rate will not only be consistent with the guidance given in the Mid-Quarter Review but also will set the economy securely on the recommended disinflationary path. The extent and direction of further policy steps will be data dependent, though if the disinflationary process evolves according to this baseline projection, further policy tightening in the near term is not anticipated at this juncture.

9. If policy actions succeed in delivering the desired inflation outcome, real GDP growth can be expected to

firm up from a little below 5 per cent in 2013-14 to a range of 5 to 6 per cent in 2014-15, with risks balanced around the central estimate of 5.5 per cent. A pick-up in investment in an environment in which external demand continues to be supportive of export performance could impart an upside to this forecast.

10. Hereafter, following the recommendation of the Dr. Urjit Patel Committee, monetary policy reviews will ordinarily be undertaken in a two-monthly cycle, consistent with the availability of key macroeconomic and financial data. Accordingly, the next policy review is scheduled on Tuesday, April 1, 2014.

