RESERVE BANK OF INDIA

First Quarter Review of Monetary Policy 2012-13

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July 31, 2012
Mumbai

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ABBREVIATIONS

bps	-	Basis Points
BRICS	-	Brazil, Russia, India, China and South Africa
CAD	-	Current Account Deficit
CI	-	Confidence Interval
CPI	-	Consumer Price Index
CRR	-	Cash Reserve Ratio
EC	-	European Commission
EDEs	-	Emerging and Developing Economies
GDP	-	Gross Domestic Product
IIP	-	Index of Industrial Production
IMF	-	International Monetary Fund
IOS	-	Industrial Outlook Survey
LAF	-	Liquidity Adjustment Facility
LPA	-	Long Period Average
M_3	-	Broad Money
MQR	-	Mid-Quarter Review
MSF	-	Marginal Standing Facility
NDTL	-	Net Demand and Time Liabilities
OBICUS	-	Order Books, Inventories and Capacity Utilisation Survey
OMO	-	Open Market Operation
PMI	-	Purchasing Managers' Index
POL	-	Petroleum, Oil and Lubricants
PWRI	-	Production Weighted Rainfall Index
Q	-	Quarter
REER	-	Real Effective Exchange Rate
SCBs	-	Scheduled Commercial Banks
SLR	-	Statutory Liquidity Ratio
UK	-	United Kingdom
US	-	United States of America
WALR	-	Weighted Average Lending Rate
WEO	-	World Economic Outlook
WPI	-	Wholesale Price Index
Y-o-Y	-	Year-on-Year

Reserve Bank of India
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By
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Introduction

Since the Monetary Policy Statement for 2012-13 in April 2012, macroeconomic conditions have deteriorated. Much of the global economy is in a synchronised slowdown, having lost the upward momentum seen in the early months of the year. Despite the slowing global economy, the outlook for commodity prices is uncertain. The situation in the euro area continues to cause concern even as the prospects of immediate default have been averted. While exports of emerging and developing economies (EDEs) have been dented by the weak global economic activity, capital flows into them have declined markedly because of the strains in the euro area financial market conditions.

2. Domestically, the macroeconomic situation continues to raise concerns. While growth has slowed down significantly, inflation remains well above the comfort zone of the Reserve Bank. The large twin deficits, *viz.* current account deficit (CAD) and fiscal deficit, pose significant risks to macroeconomic stability. Against this backdrop of heightened global uncertainty and domestic macroeconomic pressures, the challenge for monetary policy is to maintain its priority of containing inflation and lowering inflation expectations. At the same time, monetary policy has also to be sensitive to risks to growth and financial stability.

3. In the above context, this Statement should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

4. This Statement is organised in four Sections: Section I provides an overview of global and domestic macroeconomic developments. Section II sets out the outlook and projections for growth, inflation and monetary aggregates. Section III explains the stance of monetary policy. Section IV specifies the monetary and liquidity measures.

I. The State of the Economy

Global Economy

5. The global economy is slowing down. In its latest update of the World Economic Outlook (WEO), the International Monetary Fund (IMF) has revised its projection for global growth in 2012 marginally downwards to 3.5 per cent, but has emphasised further downside risks to growth. In the US, output growth decelerated to 1.5 per cent (seasonally adjusted annualised rate) in Q2 from 2.0 per cent in Q1 of 2012. In the euro area, growth was flat in Q1 after a contraction by 1.2 per cent in the previous quarter. In the UK, growth contracted by 2.8 per cent in Q2 of 2012 and 1.3 per cent in Q1. Output in Japan expanded by 4.7 per cent in Q1 after a low growth of 0.1 per cent in the previous quarter, supported by reconstruction related demand. The global manufacturing purchasing managers' index (PMI) fell below the neutral level of 50.0 to 48.9 in June 2012 - the lowest in 3 years - suggesting contraction in manufacturing activity. The global composite (manufacturing and services) PMI at 50.3 in June 2012 suggests near stagnation.

6. The decisions by the European Commission (EC) Summit on July 2, 2012 improved market confidence, but only temporarily. Without a sustained recovery in growth or moderation in sovereign debt stress, which are highly inter-linked, fiscal and financial stability pressures in the euro area remain the most significant source of systemic global risk. In recent weeks, renewed concerns about Greece and the need for greater collective support to Spain and Italy have amplified these risks. Consequently, the potential for negative spillovers to the euro area core countries and to the rest of the world have also increased.

7. Importantly, risks to global growth, which stem from persistent weakness in advanced economies, have increased with EDEs also exhibiting moderation in growth. Among the BRICS countries, growth in China fell from 8.1 per cent in Q1 of 2012 to 7.6 per cent in Q2. Growth also moderated significantly in Brazil and South Africa in Q1. According to the IMF, growth in a number of major EDEs turned out to be lower than forecast by it earlier.

8. Inflationary pressures softened across advanced and emerging economies, reflecting both weaker growth prospects and moderation in commodity prices. International (Brent) crude oil prices declined from an average of about US$ 125 per barrel in March 2012 to an average of about US$ 95 per barrel in June 2012. In July, however, the average price increased to above US$ 100 per barrel. In advanced

economies, spare capacity in both product and labour markets limits risks to core inflation. Among the BRICS countries, inflation fell significantly in China and Russia. It also eased in Brazil and South Africa. Even as growth in India is slowing, it is clearly an outlier insofar as inflation is concerned.

Domestic Economy

9. Gross Domestic Product (GDP) growth decelerated over four successive quarters from 9.2 per cent in Q4 of 2010-11 to 5.3 per cent in Q4 of 2011-12. Significant slowdown in industrial growth as well as deceleration in services sector activity pulled down the overall GDP growth to 6.5 per cent for 2011-12, below the Reserve Bank's baseline projection of 7 per cent.

10. On the expenditure side, significant weakness in investment activity was the main cause of the slowdown. Gross fixed capital formation, which grew by 14.7 per cent in Q1 of 2011-12, moderated to 5.0 per cent in Q2 and then contracted by 0.3 per cent in Q3 before recovering to a growth of 3.6 per cent in Q4. Growth in private consumption also decelerated in 2011-12, even as it remained the key driver of growth. The positive impact of the rupee depreciation on exports is yet to be seen.

11. Growth in the index of industrial production (IIP) decelerated from 8.2 per cent in 2010-11 to 2.9 per cent in 2011-12. Further, IIP growth during April-May 2012, at 0.8 per cent, was significantly lower than the expansion of 5.7 per cent registered in the corresponding period of last year. The PMI rose marginally to 55.0 in June 2012 from 54.8 in May. The composite (manufacturing and services) PMI also rose to 55.7 in June from 55.3 in May.

12. During the ongoing monsoon season, rainfall up to July 25, 2012 was 22 per cent below its long period average (LPA). The Reserve Bank's production weighted rainfall index (PWRI) showed an even higher deficit of 24 per cent. Further, the distribution of rainfall was very uneven, with the North-West region registering the highest deficit of about 39 per cent of LPA. If the rainfall deficiency persists, agricultural production could be adversely impacted.

13. Capacity utilisation levels in Q4 of 2011-12 as reflected in the results of the Reserve Bank's order book, inventories and capacity utilisation survey (OBICUS) revealed the usual seasonal improvement over the previous quarter. However, lead information from the Reserve Bank's industrial outlook survey (IOS) indicates that capacity utilisation dropped in Q1 and Q2 of 2012-13. Moreover, overall business sentiment also moderated in both the quarters.

14. Headline Wholesale Price Index (WPI) inflation increased from 7.5 per cent in April to 7.6 per cent in May before moderating to 7.3 per cent in June 2012.

The stickiness in inflation, despite the significant growth slowdown, was largely on account of high primary food inflation, which was in double-digits during Q1 of 2012-13 due to an unusual spike in vegetable prices and sustained high inflation in protein items.

15. Fuel group inflation moderated from 12.1 per cent in April 2012 to 11.5 per cent in May and further to 10.3 per cent in June on account of decrease in non-administered fuel prices, which in turn was due to decline in global crude oil prices. However, the reversal in crude oil prices in recent weeks may add to domestic inflationary pressure.

16. Non-food manufactured products inflation was at 4.8 per cent in May and June 2012. The momentum indicator of non-food manufactured products inflation (seasonally adjusted 3-month moving average annualised inflation rate), however, showed an upturn. Moreover, input price pressures persist due to both exchange rate movements and supply side constraints. Going forward, further pressure on non-food manufactured products inflation cannot be ruled out.

17. The Consumer Price Index (CPI new series) inflation remained in double-digits in Q1 of 2012-13, driven by both food and non-food prices. The divergence between WPI and CPI inflation was on account of two factors. First, there are differences in the composition and weights of commodities, especially of food items in the two indices. Second, even in respect of similar items, inflation was higher in CPI than in WPI, suggesting that besides the incidence of higher service taxes, moderation in non-food manufactured products prices has not yet been transmitted to the retail level. The rate of increase in the prices of services, which is included in CPI but not in WPI, was also high.

18. Among other factors, urban households' inflation expectations, as per the latest survey conducted by the Reserve Bank, increased slightly in Q1 of 2012-13 after a decline in the previous quarter. Notwithstanding some moderation, wage inflation in rural and urban areas remains relatively high.

19. An analysis of corporate performance in 2011-12, based on a common sample of 2,273 non-government non-financial companies, indicates that the sales growth remained positive for the year even after adjusting for inflation. However, earnings decelerated due to an increase in expenditure, indicating decline in pricing power. Early results for Q1 of 2012-13 suggest that pricing power remained subdued.

20. While the money supply (M_3) growth, at 14.3 per cent in mid-July, was marginally lower than the indicative trajectory of 15 per cent, non-food credit growth at 17.4 per cent was slightly above the indicative projection of 17 per

cent. If we include banks' investment in commercial paper and other instruments, non-food credit growth was even higher at 17.7 per cent.

21. The flow of resources to the commercial sector, from both bank and non-bank sources, increased to ₹1.9 trillion in 2012-13 so far (up to July 13, 2012) as compared with ₹1.4 trillion during the corresponding period of last year. Amongst non-bank sources, resources raised through commercial paper increased significantly.

22. Following the reduction in the repo rate in April, several commercial banks reduced their lending rates. The modal base rate of scheduled commercial banks (SCBs) declined by 25 bps to 10.50 per cent during April-June 2012. Significantly, on the basis of the weighted average lending rate (WALR) of commercial banks, adjusted for inflation, real rates are now lower than they were during the high growth five-year period of 2003-08. Banks' actions on deposit rates, however, were muted due to the slowdown in deposit growth.

23. Liquidity conditions have eased considerably since the April Policy. The average daily net borrowing under the liquidity adjustment facility (LAF), which was 2.2 per cent of average net demand and time liabilities (NDTL) in Q4 of 2011-12, declined sharply to 1.3 per cent in Q1 of 2012-13 and further to 0.7 per cent in July 2012 (up to July 26, 2012). The turnaround in liquidity conditions was due to a decline in government cash balances with the Reserve Bank, injection of liquidity of about ₹860 billion by way of open market operation (OMO) purchases of securities and increased use of the export credit refinance facility by banks after the increase in the limit effected in the June Mid-Quarter Review. Reflecting the improvement in the liquidity situation, the weighted average call money rate, which is the operating target of the Reserve Bank, stayed close to the policy repo rate.

24. During Q1 of 2012-13, yields on government securities softened reflecting an improvement in liquidity, moderation in inflation and concerns about weakening of domestic and global growth. The 10-year benchmark yield was significantly lower at 8.11 per cent on July 26, 2012 as compared with 8.63 per cent at end-March 2012.

25. Housing prices continued to rise despite the decline in volume of transactions. The Reserve Bank's quarterly housing price index suggests that prices increased in Q4 of 2011-12 in most of the 9 cities for which the index is compiled.

26. During April-May 2012, while food subsidies were lower, fertiliser subsidies were more than twice the previous year's level. Clearly, if the target of restricting the expenditure on subsidies to under 2 per cent of GDP in 2012-13, as set out in the Union Budget,

is to be achieved, immediate action on fuel and fertiliser subsidies will be required.

27. In 2011-12, the CAD rose to US$ 78 billion (4.2 per cent of GDP) from US$ 46 billion (2.7 per cent of GDP) in the previous year, largely reflecting a higher trade deficit on account of subdued external demand and relatively inelastic imports of petroleum, oil and lubricants (POL) as well as gold and silver. As capital inflows fell short of the CAD, there was a net drawdown of reserves (on a BoP basis) to the extent of US$ 13 billion in contrast to a net accretion to reserves of more or less of the same order in the previous year.

28. Reflecting the fragile global situation, India's merchandise exports declined by 1.7 per cent to US$ 75 billion during Q1 of 2012-13. However, imports declined even more sharply, by 6.1 per cent, to US$ 115 billions led by a decline in imports of non-oil non-gold commodities. As a result, the trade deficit was lower at US$ 40 billion in Q1 of 2012-13 as compared with US$ 46 billion in the corresponding period of the previous year. Based on preliminary data, services exports rose moderately by 3 per cent to US$ 35 billion, while services imports surged by 19 per cent to US$ 21 billion in Q1. Accordingly, net services exports of US$ 14 billion in Q1 of 2012-13 were lower by 12 per cent as compared with Q1 of 2011-12.

29. During 2012-13 so far (July 20, 2012), the 6-, 30- and 36-currency trade weighted real effective exchange rates (REER) depreciated in the range of 7-10 per cent, primarily reflecting the nominal depreciation of the rupee against the US dollar by around 9 per cent. The depreciation was mainly on account of the slowdown in capital inflows, the large current account deficit, domestic economic uncertainty and growing apprehensions about the euro area problem.

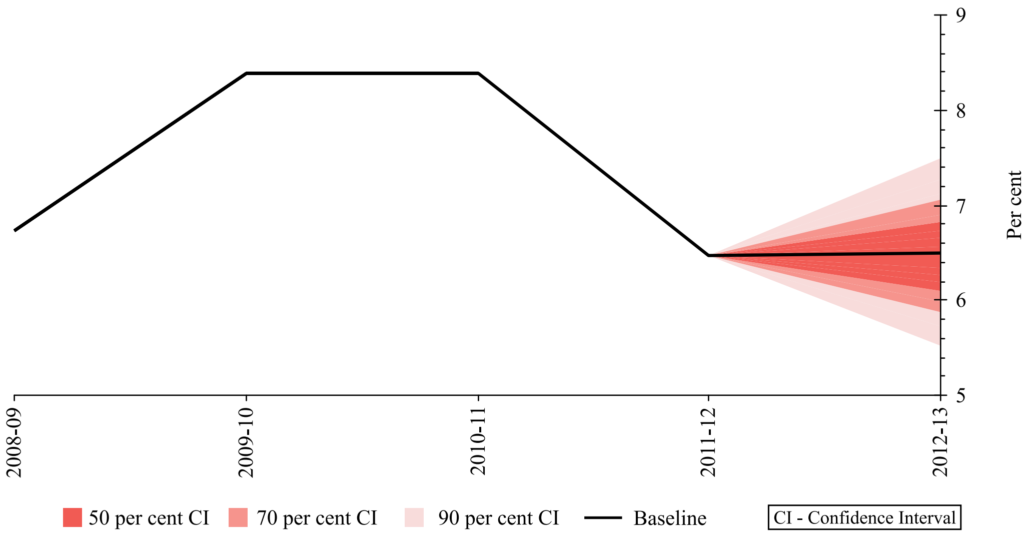
30. Exchange rate depreciation in Q1 of 2012-13 was not specific to India; most EDE currencies also depreciated. However, among the EDEs with large current account deficits, the depreciation of the Indian rupee was relatively large, reflecting moderation in capital inflows.

II. Domestic Outlook and Projections

Growth

31. In the April Policy, the Reserve Bank had projected GDP growth for 2012-13 at 7.3 per cent on the assumption of a normal monsoon and improvement in industrial activity. Both theses assumptions did not hold. The monsoon has been deficient and uneven so far. Also, data on industrial production for April-May suggest that industrial

Chart 1: Projection of GDP Growth (y-o-y) for 2012-13

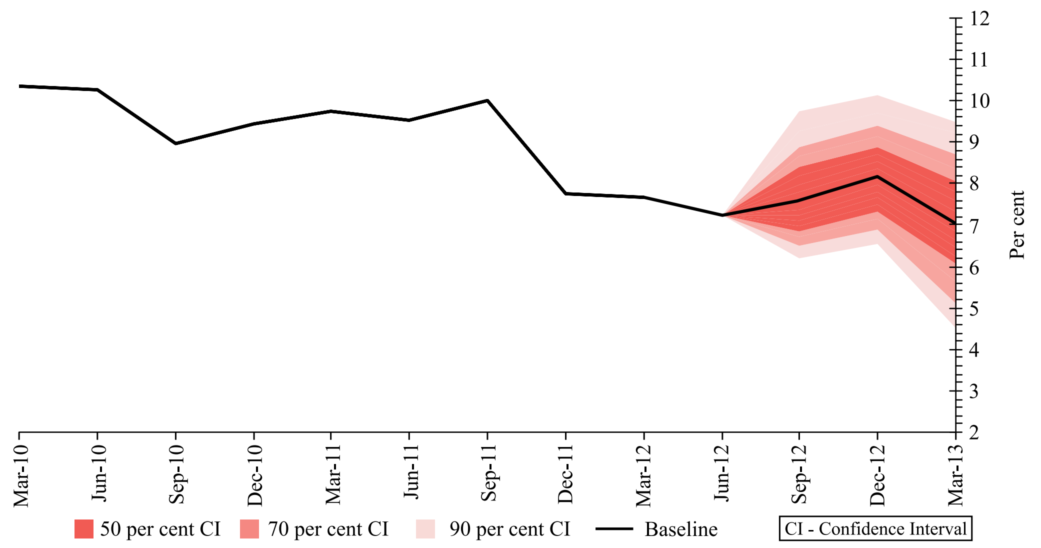


activity, despite some recovery, remains weak. In addition, several risks to domestic growth have intensified. First, global growth and trade volume are now expected to be lower than projected earlier. Given the greater integration of the Indian economy with the global economy, this will have an adverse impact on growth, particularly in industry and the services sector. However, the lagged impact of depreciation of the exchange rate could partly offset this. The impending "fiscal cliff" in the US in 2013, when temporary tax concessions expire and automatic spending cuts take effect, also entails additional risks to the growth outlook. Second, reflecting the lagged impact of weak industrial activity and global slowdown, the services sector growth is also expected to slow down. On the basis of the above considerations, the growth projection for 2012-13 is revised downwards from 7.3 per cent to 6.5 per cent (Chart 1).

Inflation

32. In the April Policy, the Reserve Bank made a baseline projection of WPI inflation for March 2013 of 6.5 per cent. This was based, in part, on an assumption of normal monsoon. The deficient and uneven monsoon performance so far will have an adverse impact on food inflation. Notwithstanding some moderation, international crude oil prices remain elevated. This, coupled with the pass-through of rupee depreciation to import prices, continues to put upward pressure on domestic fuel price inflation. In addition, with the adjustment of domestic prices of

Chart 2: Projection of WPI Inflation (y-o-y) for 2012-13



petroleum products to international price changes still incomplete, embedded risks of suppressed inflation could also impact fuel prices in India going forward. The decline in non-food manufactured products inflation has not been commensurate with the moderation in growth. Input price pressures on account of exchange rate movements and infrastructural bottlenecks in coal, minerals and power may exert upside pressure on non-food manufactured products inflation.

33. Keeping in view the recent trends in food inflation, trends in global commodity prices and the likely demand scenario, the baseline projection for WPI inflation for March 2013 is now raised from 6.5 per cent, as set out in the April Policy, to 7.0 per cent (Chart 2).

34. Although inflation has remained persistently high over the past two years, it averaged around 5.5 per cent during the 2000s, both in terms of WPI and CPI, down from its earlier trend rate of about 7.5 per cent. Given this record, the conduct of monetary policy will continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent. This is in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy.

Monetary Aggregates

35. With nominal growth remaining broadly at the level envisaged in the April Policy, monetary aggregates are expected to move along the trajectories projected in the Monetary Policy

Statement 2012-13. Accordingly, M_3 growth projection for 2012-13 has been retained at 15 per cent and the growth in non-food credit of SCBs at 17 per cent. As always, these numbers are indicative projections and not targets.

Risk Factors

36. The projections of growth and inflation for 2012-13 are subject to a number of risks as indicated below:

i) External risks to the outlook for the Indian economy are intensifying. Adverse feedback loops between sovereign and financial market stress in the euro area are resulting in increased risk aversion, financial market volatility, and perverse movements in capital flows. With the deteriorating macroeconomic situation in the euro area interacting with a loss of growth momentum in the US and in EDEs, the risks of potentially large negative spillovers have increased. India's growth prospects too will be hurt by this.

ii) Reflecting the setback to the global recovery as also weather-related adversities in several parts of the world, the outlook for food and commodity prices, especially crude oil, has turned uncertain. These developments have adverse implications for domestic growth and inflation.

iii) While inflation in protein items remains elevated due to structural demand supply imbalances, additional risks to food inflation have emerged from the deficient and uneven monsoon. This has the potential of aggravating inflation and inflation expectations.

iv) At current levels of the CAD and the fiscal deficit, the Indian economy faces the "twin deficit" risk. Financing the latter from domestic saving crowds out private investment, thus lowering growth prospects. This, in turn, deters capital inflows, making it more difficult to finance the former. Failure to narrow twin deficits with appropriate policy actions threatens both macroeconomic stability and growth sustainability.

III. The Policy Stance

37. Keeping in view the slowdown in growth, the Reserve Bank front-loaded the policy rate reduction in April with a cut of 50 basis points. Subsequent developments suggested that even as growth moderated, inflation remained sticky. Keeping in view the heightening risks to inflation, the Reserve Bank

decided to pause in the Mid-Quarter Review (MQR) of June 2012, even in the face of slowing growth.

38. Against the backdrop of global and domestic macroeconomic conditions, outlook and risks, the policy stance in this review is shaped by three major considerations.

39. First, after moderating for a short period during December-January, headline WPI inflation edged up again beginning February 2012 and has remained sticky, above 7 per cent, on account of increase in food prices, increase in input costs, and upward revision in prices of some administered items such as coal. Headline inflation has persisted even as demand has moderated and the pricing power of corporates weakened. Non-food manufactured products inflation has also not declined to the extent warranted by the growth moderation. This reflects severe supply constraints and entrenchment of inflation expectations.

40. Second, growth decelerated significantly to 6.5 per cent in 2011-12. Although more recent data suggest some pick up, overall economic activity remains subdued. Importantly, the current growth performance has to be seen in reference to the trend rate of growth in order to assess its inflationary implications. In this context, investment activity has remained subdued over the last two years. External demand has also remained weak due to the slowdown in global growth. Consequently, the post crisis trend rate of growth, which was earlier estimated at 8.0 per cent, has dropped to 7.5 per cent. While the current rate of growth is clearly lower than trend, the output gap will remain relatively small. Under these conditions, demand pressures on inflation can re-emerge quite quickly, exacerbating the existing supply pressures.

41. Third, liquidity conditions play an important role in the transmission of monetary policy signals. Although the situation has eased significantly in the recent period, it is necessary to ensure that liquidity pressures do not constrain the flow of credit to productive sectors of the economy.

42. Against this backdrop, the stance of monetary policy is intended to:

- contain inflation and anchor inflation expectations;
- support a sustainable growth path over the medium-term; and
- continue to provide liquidity to facilitate credit availability to productive sectors.

IV. Monetary and Liquidity Measures

43. On the basis of the current assessment and in line with the policy stance outlined in Section III, the Reserve Bank announces the following policy measures.

Repo Rate

44. It has been decided to retain the repo rate under the liquidity adjustment facility (LAF) at 8.0 per cent.

Reverse Repo Rate

45. The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, stands at 7.0 per cent.

Marginal Standing Facility (MSF) Rate

46. The MSF rate, determined with a spread of 100 basis points above the repo rate, stands at 9.0 per cent.

Bank Rate

47. The Bank Rate stands at 9.0 per cent.

Cash Reserve Ratio

48. The cash reserve ratio (CRR) of scheduled banks has been retained at 4.75 per cent of their net demand and time liabilities (NDTL).

Statutory Liquidity Ratio

49. It has been decided to:

- reduce the statutory liquidity ratio (SLR) of scheduled commercial banks from 24.0 per cent to 23.0 per cent of their NDTL with effect from the fortnight beginning August 11, 2012.

Guidance

50. The primary focus of monetary policy remains inflation control in order to secure a sustainable growth path over the medium-term. While monetary actions over the past two years may have contributed to the growth slowdown – an unavoidable consequence – several other factors have played a significant role. In the current circumstances, lowering policy rates will only aggravate inflationary impulses without necessarily stimulating growth. As the multiple constraints to growth are addressed, the Reserve Bank will stand ready to act appropriately.

51. Meanwhile, managing liquidity within the comfort zone remains an objective and the Reserve Bank will respond to liquidity pressures, including by way of OMOs.

52. In a turbulent global environment, the risks of external shocks are high and the Reserve Bank stands ready to respond to any such shocks swiftly, using all available instruments.

Expected Outcomes

53. The policy actions taken are expected to:

- anchor inflation expectations based on the commitment of monetary policy to inflation control; and

- maintain liquidity to facilitate smooth flow of credit to productive sectors to support growth.

Mid-Quarter Review of Monetary Policy 2012-13

54. The next Mid-Quarter Review of Monetary Policy for 2012-13 will be put out through a press release on Monday, September 17, 2012.

Second Quarter Review of Monetary Policy 2012-13

55. The Second Quarter Review of Monetary Policy for 2012-13 is scheduled for Tuesday, October 30, 2012.

Mumbai

July 31, 2012