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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

संचार विभाग, केंद्रीय कार्यालय, एस.बी.एस.मार्ग, मुंबई-400001
DEPARTMENT OF COMMUNICATION, Central Office, S.B.S.Marg, Mumbai-400001
फोन/Phone: 91 22 2266 0502 फैक्स/Fax: 91 22 22660358

वेबसाइट : www.rbi.org.in/hindi
Website : www.rbi.org.in
इ-मेल email: helpdoc@rbi.org.in

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Mid-Quarter Monetary Policy Review: June 2012

Monetary and Liquidity Measures

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

- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.75 per cent of their net demand and time liabilities; and
- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 8.0 per cent.

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

Introduction

2. Since the Reserve Bank's Annual Policy statement in April, global macroeconomic and financial conditions have deteriorated. At the same time, the domestic macroeconomic situation too raises several deepening concerns. While growth in 2011-12 has moderated significantly, headline inflation remains above levels consistent with sustainable growth. Importantly, retail inflation is also on an uptrend.

3. The Reserve Bank had frontloaded the policy rate reduction in April with a cut of 50 basis points. This decision was based on the premise that the process of fiscal consolidation critical for inflation management would get under way, along with other supply-side initiatives. Our assessment of the current growth-inflation dynamic is that there are several factors responsible for the slowdown in activity, particularly in investment, with the role of interest rates being relatively small. Consequently, further reduction in the policy interest rate at this juncture, rather than supporting growth, could exacerbate inflationary pressures.

Global Economy

4. The euro area sovereign debt problem has continued to weigh on the global recovery. After a brief phase of relative calm reflecting the large liquidity injection by the European Central Bank (ECB), renewed concerns have arisen about a sustainable solution to the sovereign debt problem and the increasing vulnerability of the banking sector. Consequently, risk aversion has increased. Recent data suggest that US economic recovery is weakening. Growth in major emerging and developing economies (EDEs) is also moderating. While slowing global growth has dampened commodity prices, heightened risk aversion and the resultant slowing of capital flows will have a significant adverse impact on EDEs, including India. Also, should there be an event shock, central banks in advanced economies will likely do another round

of quantitative easing. This will have an adverse impact on growth and inflation in EDEs, particularly on oil importing countries such as India, through a possible rebound in commodity prices.

Domestic Economy

Growth

5. Economic activity in 2011-12 moderated sequentially over the quarters to take growth to a low of 5.3 per cent in Q4, though for the year as a whole it was 6.5 per cent. Deceleration in industrial production from the supply side and weak investment from the demand side have, in particular, contributed to the growth slowdown. The index of industrial production (IIP) increased by just 0.1 per cent in April 2012. Even as the manufacturing Purchasing Managers' Index (PMI) for May suggested that industrial activity remains in an expansionary mode, there is no question that the pace of expansion has slowed significantly.

6. In this context, it is relevant to assess as to what extent high interest rates are affecting economic growth. Estimates suggest that real effective bank lending interest rates, though positive, remain comparatively lower than the levels seen during the high growth phase of 2003-08. This suggests that factors other than interest rates are contributing more significantly to the growth slowdown.

7. Further, one implication of the rupee depreciation over the past several months is that domestic producers have gained in competitiveness over foreign producers. Over time, this should result in expanding exports and contracting imports, thus acting as a demand stimulus.

Inflation

8. During 2011-12, headline WPI inflation rate moderated from a peak of 10.0 per cent in September 2011 to 7.7 per cent in March 2012. However, during 2012-13 so far, provisional data suggest that it inched up from 7.2 per cent in April to 7.6 per cent in May, driven mainly by food and fuel prices. Primary food articles inflation rose from negative [(-) 0.7 per cent)] in January to 10.7 per cent in May largely due to a sharp increase in vegetable prices. Protein inflation continued to be in double digits. With food prices contributing so heavily to headline inflation, the performance of the south-west monsoon will also play a role in determining inflationary conditions over the course of the current year.

9. Though international crude prices have fallen significantly from their levels in April 2012, the rupee depreciation has significantly offset its impact on wholesale prices. Further, even at the current lower level of global crude oil prices, significant under-recoveries persist in respect of administered petroleum product prices. The positive development on the inflation front is that core (non-food manufactured products) inflation has trended down.

10. Consumer price index (CPI) inflation (as measured by the new series, base year 2010) rose from 8.8 per cent in February to 9.4 per cent in March and further to 10.4 per cent in April. Significantly, CPI inflation, excluding food and fuel, was also in double digits suggesting that moderation in wholesale price inflation has not transmitted to the retail level.

11. Notwithstanding the moderation in core inflation, the persistence of overall inflation both at the wholesale and retail levels, in the face of significant growth slowdown, points to serious supply bottlenecks and sticky inflation expectations. Also, in the absence of pass-through from international crude oil prices to domestic prices, the consumption of petroleum products remains strong distorting price

signals and preventing the much needed adjustment in aggregate demand. The consequent subsidy burden on the Government is crowding out public investment at a time when reviving investment, both public and private, is a critical imperative. The widening current account deficit (CAD), despite the slowdown in growth, is symptomatic of demand-supply imbalances and a pointer to the urgent need to resolve the supply bottlenecks.

Liquidity Conditions

12. Although money supply (M_3) growth has been slightly under the projected trajectory, credit growth has moved above the projected rate. Notably, the widening wedge between deposit growth and credit growth is intensifying liquidity pressures. However, the open market operations (OMOs) have substantially eased liquidity conditions, as is reflected in the stabilization of the overnight call money rate close to the policy repo rate. To further augment liquidity and encourage banks to increase credit flow to the export sector, the Reserve Bank has increased the limit of export credit refinance from 15 per cent of outstanding export credit of banks to 50 per cent, which will potentially release additionally liquidity of over ₹300 billion, equivalent to about 50 basis points reduction in the CRR.

External sector

13. During 2011-12, the widening CAD, in the face of worsening global economic and financial conditions, exerted downward pressure on the rupee. As capital inflows continue to remain muted, the rupee has further depreciated since April. Prospects for increasing capital inflows depend on both global conditions, particularly a credible resolution of the euro area situation, and an improvement in the domestic investment climate.

Guidance

14. The evolving growth-inflation dynamic will continue to influence the Reserve Bank's stance on interest rates. Core inflation has moderated, reflecting demand conditions and lower pricing power. However, both headline and retail inflation rates are rising, which have a bearing on inflation expectations. Future actions will depend on a continuing assessment of external and domestic developments that contribute to lowering inflation risks.

15. Management of liquidity remains a priority. Even as the liquidity situation converges to the comfort zone, the Reserve Bank will continue to use OMOs as and when warranted to contain liquidity pressures.

16. Finally, recognizing that the global situation is turbulent, the Reserve Bank stands ready to use all available instruments and measures to respond rapidly and appropriately to any adverse developments.

Alpana Killawala
Chief General Manager

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