प्रेस प्रकाशनी PRESS RELEASE

भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA
वेबसाइट : www.rbi.org.in/hindi
Website : www.rbi.org.in
इ-मेल email: helpdoc@rbi.org.in

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

January 24, 2012

Third Quarter Review of Monetary Policy 2011-12
Press Statement by Dr. D. Subbarao, Governor

1. "At the outset, on behalf of the Reserve Bank of India, I have pleasure in welcoming all of you to this Third Quarter Review of Monetary Policy for 2011-12.

2. A short while ago, we put out the monetary policy measures accompanying this Review. Based on an assessment of the current macroeconomic situation, we have decided to:

- Cut the cash reserve ratio (CRR) of scheduled banks by 50 basis points from 6.0 per cent to 5.5 per cent of their net demand and time liabilities (NDTL). This will be effective the fortnight beginning January 28, 2012.

- This reduction in the CRR will inject around ` 320 billion of primary liquidity into the system.

3. There is no change in the policy interest rate. Accordingly, the repo rate under the liquidity adjustment facility (LAF) remains at 8.5 per cent.

4. Consequently, the reverse repo rate under the LAF, determined with a spread of 100 basis point below the repo rate, will continue at 7.5 per cent, and the marginal standing facility (MSF) rate, determined with a spread of 100 bps above the repo rate, at 9.5 per cent.

Considerations Behind the Policy Move

5. Three major considerations have informed our decision to reduce the CRR.

6. First, growth is decelerating. This reflects the combined impact of several factors: the uncertain global environment, the cumulative impact of past monetary policy tightening and domestic policy uncertainties. While some slowdown in the growth of demand was the expected outcome of our earlier monetary policy actions to contain inflation, at this juncture, risk to growth has increased.

7. Second, even as headline WPI inflation is moderating, it is coming largely from a sharp deceleration in prices of seasonal food items. In respect of other key components, particularly protein-based food items and non-food manufactured products, inflation remains high. Moreover, there are upside risks to inflation from global crude oil prices, the lingering impact of rupee depreciation, and slippage in the fiscal deficit.

8. The third consideration that informed our decision is that liquidity conditions have remained tight beyond the comfort zone of the Reserve Bank. Although the Reserve Bank has conducted open market operations, and injected liquidity of over ` 700 billion, the structural deficit in the system has increased significantly. This could hurt credit flow to productive sectors of the economy. The large structural deficit in the system presented a strong case for injecting permanent primary liquidity into the system.

Monetary Policy Stance

9. The policy document also spells out the three broad contours of our monetary policy stance. These are:

- to maintain an interest rate environment to contain inflation and anchor inflation expectations;

- to manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission;

- to respond to increasing downside risks to growth.

Guidance

10. As has become standard practice by now, we have also given guidance for the period forward.

11. In reducing the CRR, the Reserve Bank has attempted to address the structural pressures on liquidity in a way that is not inconsistent with the prevailing monetary stance. In our two previous guidances, we had indicated that the cycle of rate increases had peaked, and that further actions were likely to reverse the cycle.

12. Based on the current inflation trajectory, including the fact that there is considerable suppressed inflation, it is premature to begin reducing the policy rate. The reduction in the policy rate will be conditioned by signs of a sustainable moderation in inflation. At the same time, the persistence of tight liquidity conditions could disrupt credit flow, and further exacerbate growth risks. In this context, the CRR is the most effective instrument for permanent liquidity injection over a sustained period of time. The CRR reduction can also be viewed as a reinforcement of the guidance that the interest rate cycle has peaked and that future rate actions will be towards lowering the policy interest rate.

13. Having said that, I must emphasise that the timing and magnitude of future rate actions will depend on a number of factors. Policy and administrative actions, which encourage investment that will help ease supply constraints in food and infrastructure, are critical. Initiatives to narrow skill mismatches in labour markets will help ease the pressure on wages. The anticipated fiscal slippage, which is caused largely by high levels of consumption spending by the government, poses a significant threat to both inflation management, and more broadly, to macroeconomic stability.

Expected Outcomes

14. We expect that today's policy action and the guidance we have given will result in the following three outcomes:

- First, liquidity conditions will ease.

- Second, downside risks to growth will be mitigated.

- Finally, medium-term inflation expectations will remain anchored on the basis of a credible commitment to low and stable inflation.

Global and Domestic Developments

15. Our policy decision has been based on a detailed assessment of both the global and domestic macroeconomic developments. Let me begin with the global economy.

Global Economy

16. Since the Reserve Bank's October Review, there have been significant changes in the global scenario. On the one hand, concerns over the sustainability of sovereign debt problem in the euro area have intensified. On the other, there are modest signs of improvement in the US. In the emerging and developing economies (EDEs), growth has been moderating, reflecting the sluggishness in the advanced economies and the impact of earlier monetary tightening.

17. Overall, notwithstanding the signs of recovery in the US, global growth prospects have weakened since the October Review. In September last year, IMF projected that global growth during 2012 would be 4 per cent. We now expect it to be lower.

Indian Economy

18. Moving on to the domestic economy, real GDP growth moderated from 7.7 per cent in the first quarter of 2011-12 to 6.9 per cent in the second quarter. This was mainly due to deceleration in industrial growth, while the services sector held up relatively well. GDP growth in the first half of 2011-12 slowed to 7.3 per cent, down from 8.6 per cent in the first half of last year.

19. On the demand side, the contraction in fixed capital formation in the second quarter was the main factor behind the slowdown in growth. This pattern, should it persist, will hurt medium-term growth prospects, further aggravate inflationary pressures, and threaten external and internal stability.

20. The global environment is only partly responsible for the weak industrial performance and sluggish investment activity; several domestic factors – the unhealthy fiscal situation, high interest rates and policy and administrative uncertainty – are also playing a role.

21. In its October 2011 Review, the Reserve Bank projected GDP growth of 7.6 per cent for 2011-12, though with significant downside risks. These downside risks have since materialised. Accordingly, the baseline projection of GDP growth for this year is revised downwards from 7.6 per cent to 7.0 per cent.

22. Looking ahead to next year, while we will put out a formal projection in our Annual Policy Statement in April, at this time, the Reserve Bank's baseline scenario is that the economy will exhibit a modest recovery next year, with growth being slightly higher than during this year.

Inflation

23. Let me now turn to inflation. Inflation is beginning to moderate as projected despite the significant depreciation of the rupee. Headline WPI inflation, which averaged 9.7 per cent (y-o-y) during April-October 2011, moderated to 9.1 per cent in November and further to 7.5 per cent in December.

24. The higher than expected deceleration in food inflation has provided some relief. In particular, food articles inflation has come down sharply from 8.5 per cent in November to

0.7 per cent in December. The prices of vegetables have had a big role in this sharp decline. If we exclude vegetables, the decline in food articles inflation is modest - from 8.0 per cent in November to only 7.1 per cent in December. We should also note that inflation in protein items – 'eggs, fish and meat', milk and pulses – remains high, evidencing the structural component of food inflation.

25. Non-food manufactured products inflation continues to remain elevated and well above the comfort zone. While indicators of pricing power suggest that the moderating trend will continue, upside risks remain significant. The momentum indicator of non-food manufactured products inflation is yet to show a discernible downward trend. Accordingly, while the Reserve Bank's policy stance has to become more sensitive to growth risks, it also needs to guard against persistent inflation risks.

26. Keeping in view the expected moderation in non-food manufactured products inflation, domestic supply factors and global trends in commodity prices, the baseline projection for WPI inflation for March 2012 is retained at 7 per cent as set out in our October Review.

27. We have revised our estimate for growth downwards, but have not changed our inflation estimate. This runs counter to the expectation that a significant downgrade in the growth projection should lead to a downward revision in the inflation projection. Why has that not happened? That has not happened for two reasons. First, the rupee depreciation has been feeding into core inflation, delaying the adjustment of inflation to slower growth. Second, and very importantly, suppressed inflation in petroleum product and coal prices remains quite significant. Rationalisation of these prices is, of course, welcome for a variety of well-known reasons, but it will impact observed inflation in the short term. Our projection of inflation, accordingly, is based on the likelihood of some adjustments being made in these prices.

28. What will be the inflation scenario in 2012-13? We will make a formal projection in our Annual Policy Statement in April. At this time, the Reserve Bank's baseline scenario for next year is that headline inflation may show some moderation, though remaining vulnerable to a variety of upside risks, to which I will revert shortly.

Liquidity and Monetary Conditions

29. Liquidity management has been a major challenge for the Reserve Bank during this year. Liquidity conditions, which have generally remained in deficit, tightened further beginning the second week of November 2011, partly reflecting RBI's forex market operations and advance tax outflows around mid-December. The Reserve Bank is on record having said that it would like the LAF window to be in modest deficit, in the range of +/- 1 per cent of NDTL, which works out to around ` 600 billion. Current levels of access to LAF, at about `1,200 billion, are way beyond this band. To ease the tightness in liquidity, and consistent with its monetary policy stance, the Reserve Bank conducted open market operations (OMOs) aggregating to over ` 700 billion during November 2011-mid January 2012.

30. While broad money supply growth during the current year has evolved along the projected trajectory of 15.5 per cent, non-food credit growth has now slipped below the indicative trajectory of 18 per cent. Keeping in view the increased government borrowings and the slowdown in private credit demand, M_3 growth projection for 2011-12 has been retained at 15.5 per cent, while non-food credit growth has been scaled down to 16.0 per cent. These numbers, as always, are indicative projections and not targets.

Forex Market Developments

31. Before I turn to the risk factors, let me briefly touch upon the developments in the foreign exchange market, which remained under pressure in the third quarter of 2011-12,

reflecting adverse global sentiments and moderation in capital inflows. The Reserve Bank took a number of steps to stimulate capital inflows and curb speculation, besides also intervening in the market, consistent with our policy of containing volatility and preventing disruptive movements. The Reserve Bank continues to closely monitor developments in the external sector and their impact on the exchange rate. We will take action, as and when appropriate.

Risk Factors

32. Finally, let me turn to the risks to our projections of growth and inflation for 2011-12. We have listed seven of these.

- first, sovereign debt concerns in the euro area pose a major downside risk to the overall growth outlook.
- the second major risk emanates from the slowdown of capital flows in the face of a widening current account deficit.
- third, global energy prices continue to pose a risk to growth and inflation due to geo-political factors and the global macroeconomic situation.
- fourth on our list of risks is that there are signals of increasing risk aversion by banks, which could adversely affect credit flow to productive sectors of the economy.
- fifth, inflation in respect of protein-based items remains high due to structural imbalances. In the absence of appropriate supply responses, risk to food inflation will continue to be on the upside.
- Next, there is a large element of suppressed inflation as domestic prices of some administered products do not reflect the underlying market conditions. Revision in domestic administered prices will add to inflationary pressures, although I should note that such revisions are necessary to maintain the balance between supply and demand.
- finally, the fiscal deficit of the government could potentially crowd out credit to the private sector. Moreover, slippage in the fiscal deficit has been adding to inflationary pressures and it continues to be a risk for inflation.

33. Let me conclude by briefly reflecting on the critical area of fiscal-monetary policy coordination. Considering the egregious implications of large fiscal deficits, which are well-known, there is an urgent need for decisive fiscal consolidation, which will shift the balance of aggregate demand from public to private, and from consumption to capital formation. This is critical to yielding the space required for lowering rates without the imminent risk of resurgent inflation. The forthcoming Union Budget must exploit the opportunity to begin this process in a credible and sustainable way."

Ajit Prasad
Assistant General Manager

Press Release : 2011-2012/1185