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Third Quarter Review of Monetary Policy 2012-13 -
Statement by Dr. D. Subbarao, Governor, Reserve Bank of India

"First of all, on behalf of the Reserve Bank, a warm welcome to you all to this Third Quarter Review of Monetary Policy for 2012-13.

2. Earlier this morning, we put out the Policy Review document. Based on an assessment of the current macroeconomic situation, we have decided to reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 8.0 per cent to 7.75 per cent.

3. Consequent to this, the reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, gets calibrated to 6.75 per cent. Similarly, the marginal standing facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, and also the Bank Rate stand adjusted to 8.75 per cent.

4. These changes have since come into effect immediately after the announcement.

5. We have also decided to reduce the cash reserve ratio (CRR) of scheduled banks by 25 basis points from 4.25 per cent to 4.0 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning February 9, 2013.

6. This reduction in the CRR will inject primary liquidity of around ₹180 billion into the banking system.

Considerations Behind the Policy Move

7. Today’s decision to further ease the monetary policy stance was informed by three considerations.

8. First, both headline wholesale price inflation and its core component, non-food manufactured products inflation, have softened through the third quarter. This provided some relief from the persistence that dominated the first half of the year. Several indicators such as the weaker pricing power of corporates, excess capacity in some sectors, the possibility of international commodity prices stabilising as well as inflation momentum measures suggest that inflationary pressures have peaked. However, further moderation in inflation going into the next fiscal year is likely to be muted as the correction of under-pricing of administered items is still incomplete and food inflation remains elevated. Accordingly, the setting of monetary policy has to remain sensitive to these conflicting pressures and attendant risks.

9. Second, growth has decelerated significantly below trend through the last fiscal year and through this year so far, and overall economic activity remains subdued. On the demand side, investment activity has been way below desired levels and consumption demand too has started to decelerate. External demand has also weakened due to languid global growth. On the supply side, constraints in the availability of key raw materials and intermediates are becoming binding. While the series of policy measures announced by the Government has boosted market sentiment, the investment outlook is still lacklustre, especially in terms of demand for new projects.

10. The third consideration that informed our decision is that liquidity conditions have remained tight. Although the Reserve Bank lowered the cash reserve ratio, CRR, successively in September and October 2012, and carried out open market operations (OMO) injecting systemic liquidity of ₹470 billion during December and January to augment liquidity, the average net LAF borrowings at ₹910 billion in January have been above the Reserve Bank's comfort level. This tightness could potentially hurt credit flow to productive sectors of the economy. The structural deficit in the system provided a strong case for injecting permanent primary liquidity into the system.

Monetary Policy Stance

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

- first, to provide an appropriate interest rate environment to support growth as inflation risks moderate;
- second, to contain inflation and anchor inflation expectations; and
- third, to continue to manage liquidity to ensure adequate flow of credit to the productive sectors of the economy.

Guidance

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

13. With headline inflation likely to have peaked and non-food manufactured products inflation declining steadily over the last few months, there is an increasing likelihood that going into 2013-14, inflation will remain range-bound around the current levels. This provides space, *albeit* limited, for monetary policy to give greater emphasis to growth risks. This policy guidance will, however, be conditioned by the evolving growth-inflation dynamic and the management of risks from the twin deficits.

Expected Outcomes

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

- first, investment will be encouraged, thereby supporting growth;
- second, medium-term inflation expectations will remain anchored on the basis of a credible commitment to low and stable inflation;

- and, finally, there will be an improvement in liquidity conditions to support credit flow.

Global and Domestic Developments

15. Our policy decisions have been based on a detailed assessment of the global and domestic macroeconomic situation. Let me comment first on the global outlook.

Global Economy

16. Since the Reserve Bank's last quarterly Policy Review in October 2012, headwinds holding back the global economy have begun to abate gradually, although sluggish conditions prevail. In the US, activity gathered momentum in the third quarter of 2012 but this is unlikely to have been sustained in the fourth quarter. While a political consensus to avert the 'fiscal cliff' has calmed financial markets, how the debt ceiling is managed will be crucial in shaping the market sentiment on the way forward. The euro area economy is threatened by continuing contraction, notwithstanding the liquidity firewall of the European Central Bank (ECB) and the EU's commitment to act collectively to backstop the union. Overall, however, apprehensions that the sovereign debt crisis will disrupt the global financial system have ebbed.

17. A pick-up in the pace of growth of China is likely. But growth in other emerging and developing economies has slowed owing to a combination of a slump in external demand and domestic structural bottlenecks. Furthermore, inflationary pressures persist in some of them. Overall, global economic prospects have improved modestly since the Reserve Bank's last review in October 2012 even as significant risks remain.

Indian Economy

18. Moving on to the domestic economy, GDP growth slowed significantly this year, dropping to 5.5 per cent in the first quarter, and dropping even further to 5.3 per cent in the second quarter. The decline in the GDP growth rate became more broad based, with consumption demand also slowing alongside stalling investment and declining exports.

19. In July 2012, the Reserve Bank projected GDP growth for the current year, 2012-13, of 6.5 per cent. In the October Review, we revised this downwards to 5.8 per cent, signalling increasing global risks as well as accentuated domestic risks. As part of this review, we revisited this growth projection taking into account developments over the last three months. During this period, industrial activity has remained subdued. Sluggish external demand continues to inhibit improvement in services. While the coverage of *rabi* sowing has picked up, severe winter in certain parts of the country could affect crop prospects. New investment demand, which should be the key driver of an upturn, continues to be weak. While the series of recent policy initiatives by the Government has boosted market sentiment, it will take some time to reverse the investment slowdown and reinvigorate growth.

20. Accordingly, we have revised downwards our baseline projection of GDP growth for the current year from 5.8 per cent to 5.5 per cent.

Inflation

21. Let me now turn to inflation. Headline WPI inflation eased significantly from 8.1 per cent in September 2012 to 7.2 per cent by December. Notably, inflation on account of non-food manufactured products, which have a weight of 55 per cent in the WPI, fell sharply in November-December as input price pressures eased. The momentum indicators too suggest a moderation in headline as well as non-food manufactured products inflation. The Reserve Bank's industrial outlook survey also points to a softening of the rate of increase of output prices, suggesting that the pricing power of corporates has weakened. Fuel group inflation moderated in December, mainly reflecting the tempering of inflation of non-administered petroleum products as well as the range-bound exchange rate of the rupee.

22. Food inflation, on the other hand, showed a contrarian behaviour, moving into double digits in December, reflecting both cyclical and structural factors.

23. In contrast to WPI inflation, CPI inflation as measured by the new consumer price index, rose to 10.6 per cent in December, largely reflecting the surge in food inflation. Excluding food and fuel groups, CPI inflation remained unchanged at 8.4 per cent during the third quarter.

24. In the October Review, the Reserve Bank made a baseline projection of inflation for March 2013 of 7.5 per cent. An environment of slower growth and excess capacity in some sectors suggests that inflation has come off its peak. However, it is expected to be range-bound around the current levels due to persisting food inflation, the pass-through of diesel price adjustments over the next several months and the possibility of adjustment in other administered prices. If international commodity prices, including the price of crude, further decline, they should cushion the phased increase in diesel prices, to the extent they are not offset by exchange rate movements. A sustained reduction in inflation pressure is, however, contingent upon alleviation of supply constraints and progress on fiscal consolidation. This will also help mitigate the cost-push pressures stemming from the surge in wages.

25. Keeping in view the expected moderation in non-food manufactured products inflation, domestic supply-demand balances and global trends in commodity prices, we revised downwards the baseline WPI inflation projection for March 2013 from 7.5 per cent to 6.8 per cent.

Monetary and Liquidity Conditions

26. Let me now turn to monetary and liquidity conditions. Money supply remained below the indicative trajectory of the Reserve Bank. This essentially reflected the deceleration of growth in aggregate deposits and moderation in economic activity. On the other hand, the overall non-food credit growth was around the indicative trajectory. However, bank credit to industry showed a significant deceleration while credit to agriculture registered an increase.

27. Keeping in view the seasonal pattern for the last quarter, M_3 growth projection for the current year has been scaled down to 13.0 per cent while non-food credit growth projection is retained at 16.0 per cent.

28. Liquidity conditions tightened from the second week of November on account of a build-up in the Centre's cash balances, festival-related lumpy increase in currency demand, and structural pressures brought on by the widening wedge between deposit growth and credit growth. Anticipating liquidity pressures, the Reserve Bank lowered the CRR and conducted open market operations. Despite these measures, the liquidity deficit in the system remained above the Reserve Bank's comfort level.

Risk Factors

29. Macroeconomic management going forward is subject to a number of risks. Let me briefly address them.

- First, the widening of the current account deficit (CAD) to historically high levels, especially in the context of a large fiscal deficit and slowing growth, exposes the economy to the twin deficit risk. Financing the CAD with increasingly risky and volatile flows increases the economy's vulnerability to sudden shifts in risk appetite and liquidity preference, potentially threatening macroeconomic and exchange rate stability. Large fiscal deficits will accentuate the CAD risk, further crowd out private investment and stunt growth impulses.

- Second, despite the recent calm, global risks remain elevated, with the potential for spillover into the Indian economy through trade, finance and confidence channels. In the US, the risk of political inaction to manage the debt ceiling or even a sudden onset of fiscal austerity can lead to a turmoil in financial markets, followed by a downturn in economic activity. Escalation of the euro area sovereign debt stress in view of the continuing absence of credible and comprehensive policy responses remains a contingent global risk. Risks also stem from geopolitical tensions that can adversely impact supplies and prices of key commodities, particularly of crude oil. Furthermore, these forces can potentially increase global risk aversion with implications for financing of our CAD.

- Third, inflation over the last three years has been a result of demand pressures as well as supply constraints. With demand pressures now on the ebb, the supply constraints need to be urgently addressed. In the absence of an effective supply response, inflationary pressures may return and persist with adverse implications for macroeconomic stability.

- Fourth, the key to stimulating growth is a vigorous and sustained revival in investment. Achieving this will, however, depend on a number of factors such as bridging the infrastructure gaps, and resolute pursuit of structural and governance reforms.

- Finally, risk aversion in the banking system stemming from concerns relating to growing non-performing assets (NPAs) is constraining credit flow. Notwithstanding the importance of repairing asset quality, banks should be discerning in their loan decisions and ensure adequate credit flow to productive sectors of the economy.

30. Let me conclude by summarising our macroeconomic concerns. Inflation has come off from its peak, but its further downward movement is going to be slow and gradual. On the other hand, economic activity has slowed, trailing well below its potential and opening up a negative output gap. What the economy needs most of all and most urgently is new investment. This will step up currently flagging aggregate

demand and also ease the supply constraints so that existing capacity is fully utilised and new capacity is built up. A strong and effective supply response is particularly important for bridging the infrastructure gaps and correcting structural imbalances in other segments of the economy, including key food articles. Critical to this effort are a credible and comprehensive fiscal adjustment by the Government, implementation of structural reforms, hastening the approval process, and improving governance to inspire the trust and confidence of potential investors. The Reserve Bank, on its part, will have to calibrate monetary policy to the evolving growth-inflation dynamic and the management of the twin deficits risks.

31. Thank you for your attention".

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