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

"First of all, on behalf of the Reserve Bank of India, I want to welcome all of you to this First Quarter Review of Monetary Policy for 2011-12.

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

- increase the policy repo rate under the liquidity adjustment facility (LAF) by 50 basis points. The repo rate will accordingly move up from 7.5 per cent to 8.0 per cent.

3. Consequently, the reverse repo rate under the LAF, determined with a spread of 100 basis point below the repo rate, automatically adjusts to 7.0 per cent. Similarly, the Marginal Standing Facility (MSF) rate, determined with a spread of 100 bps above the repo rate, stands recalibrated at 9.0 per cent.

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

Considerations Behind the Policy Move

5. This policy decision has been informed by two broad considerations.

6. First, demand pressures have remained strong. As we indicated in our May 3 Policy Statement, inflation was expected to remain elevated in the first half of 2011-12. Actual inflation so far has been even higher than expected. In particular, non-food manufactured product inflation has been significantly higher than the average rate of 4 per cent over the last six years. Crude oil prices remain volatile and are a major risk factor. The recent increase in domestic administered fuel prices and the minimum support price for certain food items will also keep inflation under pressure.

7. The second consideration that shaped the policy decision is that there are signs that growth is beginning to moderate, particularly in respect of some interest rate sensitive sectors. However, there is no evidence, as yet, of a sharp or broad-based slowdown. Several indicators such as exports and imports, indirect tax collections, corporate sales and earnings and demand for bank credit suggest that demand is moderating, but only gradually.

8. Although the impact of past monetary policy actions is still getting transmitted, considering the overall growth-inflation scenario, we determined that it is necessary to persevere with the anti-inflationary stance.

Monetary Policy Stance

9. Let me now spell out the three broad contours of our monetary policy stance. These are:

- to maintain an interest rate environment that moderates inflation and anchors inflation expectations;
- to manage the risk of growth falling significantly below trend;
- and, finally, to manage liquidity to ensure that monetary transmission remains effective, without exerting undue stress on the financial system.

Expected Outcomes

10. The expected outcomes of today's policy actions are the following:

- First, the cumulative impact of past actions on demand will be reinforced;
- second, the credibility of the commitment of monetary policy to controlling inflation, and thereby to keeping medium-term expectations anchored, will be maintained;
- and, third, the policy actions will reinforce the point that in the absence of complementary policy responses on both demand and supply sides, stronger monetary policy actions are required.

Guidance

11. As regards guidance for the future, going forward, the monetary policy stance will depend on the evolving inflation trajectory, which in turn, will be determined by trends in domestic growth and global commodity prices. A change in stance will be motivated by signs of a sustainable downturn in inflation.

Global and Domestic Developments

12. As part of the policy review, we have made a careful assessment of the global and domestic macroeconomic situation. I will briefly summarise that.

13. You may recall that the Reserve Bank's Annual Policy Statement of May 3 had highlighted several risk factors to the growth-inflation outlook. Many of these risks have since materialised.

The Global Economy

14. On the global front, the sovereign debt problems that have beset the euro area over the past year now threaten larger economies in the region. There is heightened anxiety about whether the euro area will be able to agree on an economically viable, fiscally sustainable and politically feasible solution to the vexing sovereign debt problem. In this regard, the agreement reached by the euro zone leaders in their meeting on July 21 is a positive development. However, its effective implementation remains to be seen. In the US, concerns over a sovereign default loom over financial markets, with potentially disruptive consequences for global capital flows.

15. Despite sluggish economic activity, inflationary pressures also emerged in advanced economies under the impact of high commodity prices.

16. In striking contrast to advanced economies, emerging market economies (EMEs) are generally dealing with rising inflation, caused by a combination of elevated commodity prices and robust domestic demand. While there has been

talk of the two-speed recovery for some time, its very different impact on advanced economies and EMEs is now clearly visible.

17. From the perspective of India's macroeconomic policy imperatives, a critical consideration is the effect that global conditions will have on commodity prices. After the May 3 Policy Statement, the prices of many commodities, including that of crude oil, showed signs of softening, reflecting weakening demand in advanced economies. Had this trend consolidated, it would have provided some welcome relief from inflationary pressures. However, one quarter later, the downtrend has not yet proved to be very strong. Prices are generally still high compared with last year. With no immediate prospects of monetary tightening in the advanced economies, the impact of weakening demand appears to be offset by that of abundant liquidity.

The Indian Economy

18. Turning to the domestic economy, output expanded by 8.5 per cent during 2010-11. The revised and rebased index of industrial production (IIP) suggested that earlier signals of a growth deceleration in the second half of last year were exaggerated. In fact, the growth momentum remained strong throughout last year. However, data for the first two months of this fiscal, April-May 2011, suggest that some moderation might be under way.

19. The May 3 Policy Statement projected baseline real GDP growth for 2011-12 at around 8 per cent. This was based on the assumption of a normal monsoon and crude oil prices averaging US$ 110 per barrel. Subsequent data suggest that this projection remains valid. Therefore, the baseline projection of real GDP growth for the current year has been retained at 8.0 per cent.

20. It is important to recognise that in the absence of appropriate actions for addressing supply bottlenecks, especially in food and infrastructure, questions about the ability of the economy to sustain the current growth rate without significant inflationary pressures come to the fore. The economy's ability to grow rapidly for any length of time without provoking inflation is dependent on implementing policies, with corresponding resource allocations, which will allow the supply of various products and services to keep pace with demand.

Inflation

21. Inflation continues to be the dominant macroeconomic concern. The headline WPI inflation rate for the first quarter of this fiscal year remained stubbornly close to double digits and inflationary pressures continued to be broad-based. Both the level and the persistence of WPI inflation are a cause for concern. Non-food manufactured product inflation ruled above 7 per cent in the first quarter suggesting that producers, operating at high levels of capacity utilisation, are able to pass on rising commodity input prices and wage costs to consumers.

22. Inflationary pressures are clearly very strong, notwithstanding signs of moderation of economic activity. Importantly, the softening of commodity prices over the past three months did not translate into a decline in either headline WPI inflation or non-food manufactured products inflation. If the softening reverses, commodity prices are likely to exert inflationary pressures for some time, making moderation in demand necessary to bring inflation down.

23. In our May 3 Policy Statement, we indicated the upside risks to the inflation outlook. Some of the upside risks have since materialised. These include:

- the upward revision in prices of petroleum products;
- the significant increase in the minimum support prices (MSPs) for some agricultural commodities; and
- the persistence of non-food manufactured products inflation at elevated levels reflecting underlying demand pressures.

24. What factors will shape the inflation outlook going forward? Let me indicate the important ones.

- The first factor will be the overall performance of the south-west monsoon; both its spatial and temporal distribution will be important.
- The second factor will be crude oil prices whose outlook for the near future is uncertain. Going by the recent trend, the price of oil could remain volatile because of the pace of global recovery, liquidity conditions, and importantly, the overall oil supply situation; and,
- Finally, policy decisions with regard to increase in prices of petroleum products and other administered items will have a significant influence on inflation.

25. Our baseline projection for WPI inflation for March 2012, as indicated in the May 3 policy statement, was 6.0 per cent with an upward bias. We have reviewed that projection. Keeping in view the domestic demand-supply balance, global trends in commodity prices and the likely demand scenario, we have revised the baseline projection for WPI inflation for March 2012 upward to 7.0 per cent. Let me reiterate what we said earlier, which is that inflation is expected to remain elevated for a few more months, before moderating towards the later part of the year.

26. Notwithstanding the current inflation scenario, it is important to recognise that in the last decade, the average inflation rate, measured in terms of both WPI and CPI, had moderated to around 5.5 per cent. Monetary policy will, therefore, condition and contain perceptions of inflation in the range of 4.0-4.5 per cent. This will be in line with the medium-term objective of 3.0 per cent inflation consistent with India’s broader integration into the global economy.

Monetary Transmission

27. Now an important, *albeit* brief, comment on monetary transmission. Taking cues from the monetary policy actions of the Reserve Bank, scheduled commercial banks have been raising their deposit and lending rates. Since March 2010, banks have raised their modal term deposit rate by 225 basis points.

28. On the lending side, since July 2010, the modal Base Rate of banks has also increased by 225 basis points, suggesting strong transmission of policy rates.

Liquidity and Monetary Conditions

29. Turning to liquidity and monetary conditions, consistent with our anti-inflationary policy stance, liquidity conditions have generally remained in deficit mode so far in 2011-12. As per data on July 22, the average daily net injection

of liquidity through the LAF window during this year was around ₹48,000 crore, which was within one per cent of net demand and time liabilities (NDTL).

30. The current trends in money supply (M_3) and credit growth remain above the indicative trajectory of the Reserve Bank. Keeping in view the evolving growth-inflation dynamics, the indicative projection of M_3 growth for 2011-12 has been revised downwards from 16.0 per cent, as set out in the May 3 Policy Statement, to 15.5 per cent. Non-food bank credit growth projection has also been revised downwards from 19.0 per cent to 18.0 per cent.

Risk Factors

31. Let me now turn to some of the risks to our indicative projections of growth and inflation for 2011-12:

- First, uncertainty about the future path of global commodity prices, especially oil;
- second, uncertainty about capital flows from the perspective of financing the current account deficit;
- third, risks to food inflation stemming from the monsoon performance, higher minimum support prices and inadequate supply response pertaining to protein-rich items; and,
- fourth, significant upside risks to the projected fiscal deficit for 2011-12 as fiscal deficit has been a key source of demand pressures.

32. Before I close, let me mention that the Reserve Bank is strongly of the view that controlling inflation is imperative both for sustaining growth over the medium-term and for increasing the potential growth rate. This is a critical attribute of a favourable investment climate, on which the economy's potential growth depends. Fiscal consolidation can contribute to a sustainable growth path by rebalancing demand away from government consumption and towards investment. The Reserve Bank's efforts of achieving low and stable inflation could also be supported by concerted policy actions and resource allocations to address domestic supply bottlenecks, particularly in respect of food and infrastructure.

33. The challenge for the Government and the Reserve Bank is to ensure that demand is constrained in the short term to bring inflation down, but to encourage supply response so as to expand the potential output of the economy in the medium term."

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