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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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

"First of all, on behalf of the Reserve Bank, a warm welcome to all of you.

2. This morning, we put out the First Quarter Review of Monetary Policy for 2012-13. Based on an assessment of the current macroeconomic situation, we have decided to keep the policy rate and the CRR unchanged. Accordingly, the repo rate stays at 8 per cent and the CRR at 4.75 per cent of net demand and time liabilities (NDTL) of scheduled banks.

3. Consequently, the reverse repo rate under the liquidity adjustment facility (LAF), determined with a spread of 100 basis points below the repo rate, remains at 7 per cent. Similarly, the marginal standing facility (MSF) rate, which has a spread of 100 bps above the repo rate, also stands unchanged at 9 per cent.

4. Separately, we have decided to reduce the statutory liquidity ratio (SLR) of scheduled commercial banks from 24 per cent to 23 per cent of their NDTL with effect from the fortnight beginning August 11, 2012.

Considerations Behind the Policy Move

5. Let me explain the rationale behind this monetary policy stance.

6. The first question is: what is the rationale for our decision to hold the policy interest rate and the CRR unchanged? The rationale draws from our assessment of the growth-inflation dynamics.

- As regards inflation, the headline WPI inflation has remained sticky, above 7 per cent. This has been 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 growth has moderated and the pricing power of corporates has 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.
- Now coming to growth. Growth last year was 6.5 per cent, down from 8.4 per cent in the year before. Although more recent data suggest some pick up, the overall economic activity remains subdued. In order to assess inflationary implications, we need to see the current growth rate in comparison to the trend growth rate. The Reserve Bank's estimates suggest that the post crisis trend rate of growth, which was earlier estimated to be 8.0 per cent, has dropped to 7.5 per cent. This means that the current rate of growth is lower than the trend. However, the output gap, which is the difference between the

actual and trend rate of growth, will remain relatively small. Under these conditions, demand pressures on inflation can re-emerge quite quickly, exacerbating the existing supply pressures.

7. The second question on our policy stance is about the decision to reduce the SLR by 1 percentage point. Liquidity conditions play an important role in the transmission of monetary policy signals. Although the liquidity situation has eased significantly in the recent period, the reduction of SLR is expected to ensure that liquidity pressures do not constrain the flow of credit to the productive sectors of the economy. This will allow banks to shift their portfolio in favour of the private sector.

Monetary Policy Stance

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

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

Guidance

9. As per standard practice, we have also given guidance for the period forward. I will give the gist of that.

10. The primary focus of monetary policy remains inflation control. Low and stable inflation is an essential pre-condition for securing sustainable growth over the medium term. While monetary actions over the past two years may have contributed to the growth slowdown – which is an unavoidable consequence – several other factors have also 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 suitably adjust its monetary policy stance.

11. Meanwhile, managing liquidity within the comfort zone remains an objective. The Reserve Bank will respond to liquidity pressures, including by way of open market operations (OMOs).

12. In the current uncertain and turbulent global environment, the risk of external shocks is high. The Reserve Bank stands ready to respond to any such shocks swiftly, using all available instruments.

Expected Outcomes

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

- First, inflation expectations will be anchored based on the commitment of monetary policy to control inflation; and
- Second, liquidity will be maintained to facilitate smooth flow of credit to the productive sectors of the economy and thereby support growth.

Global and Domestic Developments

14. Our policy decisions have been based on a careful assessment of the global and domestic macroeconomic situation. Let me begin with our assessment of the global economy.

Global Economy

15. Since the Annual Monetary Policy Statement in April 2012, global macroeconomic conditions have deteriorated. There was some upward momentum in the early months of this year. But that has since petered out. Much of the global economy is now in a synchronised slowdown. Despite the slowing global economy, the outlook for commodity prices is uncertain. In the euro area, the possibility of an immediate default has been averted, but the situation continues to cause concern.

16. The two-speed recovery around the world that we were talking about a year ago has now dissipated. Economic activity in emerging and developing economies too has started slowing, but for most of them, inflation has also come down. India is clearly an outlier because even as our growth is slowing in line with the rest of the world, our inflation continues to be high.

Indian Economy

17. Moving on to the domestic macroeconomic situation, GDP growth last year was 6.5 per cent, below the Reserve Bank's projection of 7 per cent. In fact, growth decelerated over four successive quarters from 9.2 per cent in the fourth quarter of 2010-11 to 5.3 per cent in the fourth quarter of 2011-12. The growth slowdown was a result of deceleration in industrial growth as well as in services sector activity.

18. Coming to the current year, in the April Policy, we projected GDP growth of 7.3 per cent on the assumption of a normal monsoon and improvement in industrial activity. Both these assumptions have not held. The monsoon has been deficient and uneven so far. Also, data on industrial production for April-May suggest that industrial activity remains weak.

19. In addition, the risk from the global situation has intensified. 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 sectors.

20. On the basis of the above considerations, the growth projection for the current year (2012-13) has been revised downwards from 7.3 per cent to 6.5 per cent.

Inflation

21. Let me now turn to inflation. Headline 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 the first quarter of this year driven by a spike in vegetable prices and sustained high inflation in protein items.

22. 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 a decline in non-administered fuel prices. However, the reversal in crude oil prices in recent weeks may add to inflationary pressure.

23. Non-food manufactured products inflation was at 4.8 per cent in May and June 2012. However, 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.

24. In contrast to WPI inflation, CPI inflation, as measured by the new Consumer Price Index, remained in double-digits in the first quarter. This was driven by both food and non-food prices. The divergence between WPI and CPI inflation was on account of differences in the composition and weights of commodities in the two indices, as well as different rates of price increases for similar commodities represented in both indices.

25. In the April Policy, the Reserve Bank made a baseline projection of WPI inflation for March 2013 of 6.5 per cent. However, since then several upside risks have arisen:

- First, the monsoon has been deficient and uneven so far. This will have an adverse impact on food inflation.
- Second, notwithstanding some moderation, international crude prices remain elevated. On top of that, the rupee depreciation has added to import prices, putting upward pressure on domestic fuel prices.
- Third, the adjustment of domestic prices of petroleum products to international price changes is still incomplete. Going forward, the embedded risks of suppressed inflation could also impact fuel prices in India.
- Fourth, non-food manufactured products inflation has not moderated in line with the slowdown in growth.
- And finally, input price pressures on account of exchange rate movement and infrastructural bottlenecks in coal, minerals and power may exert upward pressure on non-food manufactured products inflation.

26. 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 our April projection of 6.5 per cent to 7.0 per cent.

Monetary and Liquidity Conditions

27. Let me now turn to monetary and liquidity conditions. 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 this year has been retained at 15 per cent and the growth in non-food credit of scheduled commercial banks (SCBs) at 17 per cent.

28. Liquidity conditions have eased considerably since the April Policy. This turnaround 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 operations (OMOs) and increased use of export credit refinance facility by banks after the increase in the limit effected in the June Mid-Quarter Review.

Risk Factors

29. Our projections of growth and inflation for 2012-13 are subject to a number of risks.

- First, 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 emerging and developing economies, the risk of potentially large negative spillovers has increased. India's growth prospects too will be hurt by this.

- Second, reflecting the setbacks to the global recovery, as also weather-related adversities in several parts of the world, the outlook for food and commodity prices, especially of crude oil, has turned uncertain. These developments have adverse implications for domestic growth and inflation.
- Third, inflation in protein items remains elevated due to structural demand supply imbalances. On top of that, there will be further pressure on food inflation because of the deficient and uneven monsoon, thus potentially aggravating inflation and inflation expectations.
- And finally, at current levels of current account and fiscal deficits, the Indian economy faces the "twin deficit" risk. Financing the fiscal deficit from domestic savings crowds out private investment, thus lowering growth prospects. This, in turn, deters capital inflows, making it more difficult to finance the current account deficit. Failure to narrow the twin deficits with appropriate policy actions will threaten both macroeconomic stability and growth sustainability.

30. Let me now conclude by summarising our macroeconomic concerns. While growth has slowed down significantly, inflation remains well above the comfort zone of the Reserve Bank. Against the backdrop of heightened global uncertainty and domestic macroeconomic pressures, the challenge for monetary policy is to maintain its commitment to firmly containing inflation and lowering inflation expectations. At the same time, monetary policy will remain sensitive to growth risks. I also want to reiterate that the Reserve Bank stands ready to respond to external shocks that may arise from the turbulent global environment.

31. Thank you for your attention."

R. R. Sinha
Deputy General Manager

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