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May 3, 2013

Monetary Policy Statement for 2013-14
Statement by Dr. D. Subbarao, Governor, Reserve Bank of India

"First of all, on behalf of the Reserve Bank, a hearty welcome to you all to this dissemination of the Monetary Policy Statement for 2013-14, which we put out a short while ago.

2. Based on an assessment of the current and prospective macroeconomic situation, we have decided to reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.5 per cent to 7.25 per cent.

3. Consequently, the reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, gets calibrated to 6.25 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 8.25 per cent.

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

Considerations Behind the Policy Move

5. Today's decision to further ease the monetary policy stance was informed by two considerations.

6. First, growth has decelerated continuously and steeply, more than halving from 9.2 per cent in the fourth quarter of year before last, 2010-11, to 4.5 per cent in the third quarter of last year, 2012-13. The Reserve Bank's current assessment is that activity will remain subdued during the first half of this year with a modest pick-up in the second half, subject to appropriate conditions ensuing.

7. The second consideration that went into the policy decision was the inflation outlook. Although headline WPI inflation had eased by March 2013 and came close to the Reserve Bank's tolerance threshold, it is important to note that food price pressures persist, and supply constraints are endemic. These could lead to generalisation of inflation and strains on the balance of payments.

Monetary Policy Stance

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

- first, to continue to address the accentuated risks to growth;
- second, to guard against the risks of inflation pressures re-emerging and adversely impacting inflation expectations, even as corrections in administered prices release suppressed inflation; and
- third, to appropriately manage liquidity to ensure adequate credit flow to the productive sectors of the economy

Guidance

9. As per standard practice, we have also given the following guidance for the period forward:

10. Today's decision to further cut the repo rate carries forward the measures put in place since January last year towards supporting growth in the face of gradual moderation of headline inflation. Nevertheless, it is important to note that recent monetary policy action, by itself, cannot revive growth. It needs to be supplemented by efforts towards easing the supply bottlenecks, improving governance and stepping up public investment, alongside continuing commitment to fiscal consolidation.

11. Upside risks to inflation in the near term are still significant in view of sectoral demand supply imbalances, the ongoing correction in administered prices and pressures stemming from increases in minimum support prices. In view of this, monetary policy cannot afford to lower its guard against the possibility of resurgence of inflation pressures. Monetary policy will also have to remain alert to the risks on account of the current account deficit (CAD) and its financing, which could warrant a swift reversal of the policy stance.

12. Overall, the balance of risks stemming from the Reserve Bank's assessment of the growth-inflation dynamic yields little space for further monetary easing. The Reserve Bank will endeavour to actively manage liquidity to reinforce monetary transmission, consistent with the growth-inflation balance.

Global and Domestic Developments

13. 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

14. Since the Reserve Bank's last quarter Review in January 2013, near-term risks in the advanced economies (AEs) have receded. This improvement, however, is yet to fully transmit to economic activity which remains sluggish. Risks in policy implementation and uncertainty about outcomes continue to threaten the prospects of a sustained recovery in advanced economies.

15. Emerging and developing economies (EDEs) are in the process of a multi-speed recovery. However, weak external demand and domestic bottlenecks continue to restrain investment in some of the major emerging economies. Inflation risks in EDEs appear contained, reflecting negative output gaps and the recent softening of international crude and food prices.

Indian Economy

16. Moving on to the domestic economy, with output expansion of only 4.5 per cent in third quarter of last year, the lowest in 15 quarters, cumulative GDP growth for the period April-December 2012 declined to 5.0 per cent, down from 6.6 per cent a year ago. This was mainly due to the protracted weakness in industrial activity aggravated by domestic supply bottlenecks, and slowdown in the services sector reflecting weak external demand.

17. The Central Statistics Office (CSO) put out the advance estimate of GDP growth for last year, 2012-13, of 5.0 per cent, lower than the Reserve Bank's January 2013 baseline projection of 5.5 per cent. The CSO's lower estimate reflects slower than expected growth in both industry and services.

18. Looking ahead, economic activity during the current year is expected to show only a modest improvement over last year, with a pick-up likely only in the second half of the year. Agricultural growth could return to trend levels if the monsoon is normal as recently forecast. The outlook for industrial activity remains subdued because the pipeline of new investment has dried up and existing projects remain stalled by bottlenecks and implementation gaps. Growth in services and exports may remain sluggish too, given that global growth is unlikely to improve significantly from 2012. Accordingly, the Reserve Bank's baseline projection of GDP growth for 2013-14 is 5.7 per cent.

Inflation

19. Let me now turn to inflation. Headline inflation, as measured by the wholesale price index (WPI), moderated to an average of 7.3 per cent last year from 8.9 per cent in the year before. The easing was particularly significant in the fourth quarter of last year. We ended the year with WPI inflation of 6.0 per cent in March 2013, the lowest in the last three years.

20. Even as headline inflation eased, there were upside pressures on food inflation through the year owing to an unusual spike in vegetable prices early in the year followed by rise in cereal prices.

21. Fuel inflation averaged in double digits during 2012-13, largely reflecting upward revisions in administered prices and the pass through of high international crude prices to freely priced items.

22. Non-food manufactured products inflation ruled above the comfort level in the first half of 2012-13 but declined in the second half, reflecting easing of input price pressures and erosion of pricing power.

23. Even as WPI inflation eased, retail inflation, as measured by the new consumer price index, averaged 10.2 per cent during 2012-13, largely driven by food inflation. Even after excluding food and fuel groups, CPI inflation remained sticky, averaging 8.7 per cent.

24. In the Reserve Bank's assessment, WPI inflation is expected to be range-bound around 5.5 per cent during 2013-14. This assessment factors in the domestic demand-supply balance, the outlook for global commodity prices and the forecast of a normal monsoon.

25. It is critical to consolidate and build on the recent gains in containing inflation. Accordingly, the Reserve Bank will endeavour to condition the evolution of inflation to a level of 5.0 per cent by March 2014.

Monetary and Liquidity Conditions

26. Let me now turn to monetary and liquidity conditions.

27. Consistent with the growth projections and the Reserve Bank's inflation tolerance threshold, M_3 growth for 2013-14 is projected at 13.0 per cent for policy purposes. Consequently, aggregate deposits of scheduled commercial banks (SCBs) are projected to grow by 14.0 per cent. Keeping in view the resource requirements of the private sector, the growth in non-food credit of SCBs is projected at 15.0 per cent. We would be guided by the evolution of monetary aggregates along these indicative trajectories in the conduct of monetary policy.

28. Liquidity remained under pressure throughout last year because of two factors – first, persistently high government cash balances with the Reserve Bank, and second, elevated incremental credit to deposit ratio for much of the year. In order to alleviate liquidity pressures, last year, the Reserve Bank lowered the cash reserve

ratio (CRR) cumulatively by 75 bps on three occasions and the statutory liquidity ratio (SLR) by 100 bps. In addition, the Reserve Bank injected liquidity to the tune of ₹1.5 trillion through open market operations (OMO). The net injection of liquidity under the LAF peaked at ₹1.8 trillion on March 28, 2013 reflecting the year-end demand. However, it reversed sharply to ₹800 billion by end-April 2013.

29. The Reserve Bank will endeavour to actively and appropriately manage liquidity to ensure adequate credit flow to the productive sectors of the economy and to reinforce monetary transmission consistent with the growth-inflation balance.

Risk Factors

30. The macroeconomic outlook for this year, as set out in the Policy Statement, is subject to a number of risks. Let me briefly address them.

- First, the biggest risk to the economy stems from the CAD which, last year, was historically the highest, and well above the sustainable level of 2.5 per cent of GDP as estimated by the Reserve Bank. A large CAD, appreciably above the sustainable level year after year, will put pressure on servicing of external liabilities.
- Second, even as the large CAD is a risk by itself, its financing exposes the economy to the risk of sudden stop and reversal of capital flows should global liquidity rapidly tighten. The global liquidity situation could quickly alter for EDEs, including India, for two reasons. First, the outlook for AEs remains uncertain, and even if there may be no event shocks, there could well be process shocks which could result in capital outflows from EDEs. Second, with quantitative easing (QE), AE central banks are in uncharted territory with considerable uncertainty about the trajectory of recovery and the calibration of QE.
- The third risk factor is that a sustained revival of growth is not possible without a revival of investment. But investment sentiment remains inhibited owing to subdued business confidence and dented business profitability. Both borrowers and lenders have become risk averse. Borrowers have become risk averse because of governance concerns, delays in approvals and tighter credit conditions. For lenders, risk aversion stems from the erosion of asset quality, deteriorating cash flow situation of borrowers eroding their credit worthiness and heightened risk premiums.
- And finally, the effectiveness of monetary policy in bringing down inflation pressures and anchoring inflation expectations could be undermined by supply constraints in the economy, particularly in the food and infrastructure sectors. Without policy efforts to unlock the tightening supply constraints and bring enduring improvements in productivity and competitiveness, growth could weaken even further and inflationary strains could re-emerge.

Developmental and Regulatory Policies

31. Since this is the Annual Policy, as per standard practice, it also includes developmental and regulatory policies. Let me briefly indicate some of important initiatives in this regard.

32. I will begin with initiatives for further strengthening the regulatory and supervisory framework.

- We have finalised the prudential guidelines on restructuring of advances by banks and financial institutions based on the Mahapatra Committee recommendations. They will be issued during the month.

- The unhedged portion of the foreign currency exposure of corporate has been a source of concern. To address this, we have decided to increase the risk weights and provisioning requirements on banks' exposure to corporates on account of corporates' unhedged forex exposure positions.
- As indicated in the guidelines for new bank licenses, we are in the process of preparing a discussion paper on the banking structure for India. The discussion paper will cover issues such as consolidation of large sized banks with a view to having a few global banks, the desirability and practicality of having small, localised banks as preferred vehicles for financial inclusion, the need for a differentiated licensing regime for investment banks, and conversion of urban cooperative banks into commercial banks. The discussion paper will take into account international experience as well as our domestic situation.

33. Let me now turn to a few initiatives for furthering financial inclusion.

- The Reserve Bank's website contains FAQs on KYC/AML/CFT requirements. The Reserve Bank has also made active efforts to disseminate these requirements. However, recent developments, as also the needs of financial inclusion, have made it necessary for us to disseminate the requirements in a more lucid way. We will revise the FAQs accordingly.
- The Reserve Bank attaches great importance to speedier branch expansion in unbanked rural centres for ensuring seamless roll out of the Direct Benefit Transfer Scheme of the Government. Towards this end, banks are being advised to front load the opening of branches in unbanked rural centres over a 3 year cycle co-terminus with their Financial Inclusion Plans (FIP). Furthermore, instructions are being issued to banks to open bank accounts for all eligible households.
- Improving credit delivery to micro and small enterprises is a focus area. In light of the feedback received from the stakeholders, we are enhancing the loan limits to micro and small enterprises for priority sector classification.
- In order to extend the institutional mechanism for financial inclusion to urban areas, we have decided to bring all districts in metropolitan areas under the fold of the Lead Bank Scheme.

34. The Statement contains several initiatives to strengthen the financial market infrastructure.

- We felt that there is a need to improve the interface of exporters with banks and financial institutions to cut delays and streamline procedures. Towards this end, we reported earlier that we would constitute a technical committee to study various issues such as availability of credit, transaction costs, insurance, factoring and other procedural aspects. The Technical Committee chaired by Executive Director Padmanabhan submitted its report last month. We are examining the recommendations and will put out the report on our website shortly.
- In a move towards further liberalization, we have decided to allow Foreign Institutional Investors to hedge their currency risk by using exchange traded currency futures in the domestic exchanges.

35. As envisaged in the Reserve Bank's vision document on 'Payment Systems in India', we have decided to allow non-bank authorised entities to be part of the payment system infrastructure. Separately, we will prepare a discussion paper for

examining the measures to be taken to mitigate and eliminate concentration risk in the payment system infrastructure.

36. Finally a comment on meeting the growing demand for banknotes and coins in the country. We are streamlining the system of distribution of banknotes and coins and are exploring alternative avenues for their distribution by banks. The mechanism for detection and reporting of counterfeit banknotes is also being improved. To further this, we will shortly introduce a scheme of incentives for banks.

37. I have highlighted only a few of the developmental and regulatory initiatives. There are a host of other initiatives in Part B of the policy document. I urge you to go through the policy document in detail.

38. Let me conclude by summarising our macroeconomic concerns. Growth slowed much more than anticipated, with both manufacturing and services activity hamstrung by supply bottlenecks and sluggish external demand. Most lead indicators suggest a turnaround this year, *albeit* at a slow pace. Inflation eased significantly in the fourth quarter of last year although upside pressures remain, both at wholesale and retail levels. The growth-inflation outlook indicated in the Policy Statement is also beset with risks such as the still high twin deficits, the vulnerability of our external sector to sudden stop and reversal of capital flows, inhibited investment sentiment and tightening supply constraints, particularly in the food and infrastructure sectors. The challenge for the Reserve Bank is to calibrate monetary policy to address these risks and bring inflation down to the tolerance threshold in order to return the economy to a sustainable high growth trajectory in the years ahead.

39. Thank you for your attention."

Alpana Killawala
Chief General Manager

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