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Mid-Quarter Monetary Policy Review: June 2011

Monetary Measures

On the basis of the current macroeconomic assessment, it has been decided to:

- increase the repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.25 per cent to 7.5 per cent with immediate effect.

Consequent to the above increase in the repo rate, the reverse repo rate under the LAF will stand automatically adjusted to 6.5 per cent and the marginal standing facility (MSF) rate to 8.5 per cent with immediate effect.

Introduction

Since the Reserve Bank' Annual Policy Statement of May 3, the global environment has changed for the worse, while domestic conditions are broadly consistent with the Statement's projections. Growth expectations in advanced economies are visibly moderating, even as inflationary pressures, primarily from commodity prices, have increased. The capacity for conventional policy responses appears limited, with many countries having already committed to fiscal consolidation amidst growing sovereign debt risks. From our monetary policy perspective, global commodity prices still remain the key external risk though some signs of moderation are becoming visible.

Domestically, inflation persists at uncomfortable levels. Moreover, the headline numbers understate the pressures because fuel prices have yet to reflect global crude oil prices. On the growth front, even as signs of moderation are visible in some sectors, broad indicators of activity – 2010-11 fourth quarter profit growth and margins and credit growth do not suggest a sharp or broad-based deceleration.

Going forward, notwithstanding both signs of moderation in commodity prices and some deceleration in growth, domestic inflation risks remain high. Against this backdrop, the monetary policy stance remains firmly anti-inflationary, recognising that, in the current circumstances, some short-run deceleration in growth may be unavoidable in bringing inflation under control.

Global Economy

The global economy weakened in Q2 of 2011. Lead indicators suggest that growth moderated in both advanced economies and emerging market economies

(EMEs) under the impact of high oil and other commodity prices, the spillover from the Japanese natural disasters and monetary tightening in EMEs to contain inflationary pressures. Uncertainty about the resolution of the sovereign debt problem in the euro area has increased. These developments increase downside risks to global growth prospects.

International commodity and oil prices showed signs of moderation on weak economic data and unwinding of financial positions. However, on a year-on-year (y-o-y) basis, commodity price inflation is still high. Consequently, headline inflation rose in major advanced economies despite negative output gaps. As inflation in EMEs remained elevated due both to high commodity prices and strong domestic demand, many EMEs persisted with monetary tightening during Q2 of 2011 to contain inflation.

Domestic Economy

Growth

GDP growth decelerated to 7.8 per cent in Q4 of 2010-11 from 8.3 per cent in the previous quarter and 9.4 per cent in the corresponding quarter a year ago. For the year as a whole, GDP growth in 2010-11 was 8.5 per cent. While private consumption was robust, investment activity moderated in Q4 of 2010-11. The Central Statistical Organisation (CSO) released the new series of industrial production with 2004-05 as the base. The new series represents a better coverage of the industrial structure in the country. The trend in industrial production as revealed by the new series is significantly different from that indicated by the old series (base: 1993-94). While the old series suggested a sharp deceleration from 10.4 per cent in the first half of 2010-11 to 5.5 per cent in the second half, the new series suggested broadly the same growth of a little over 8 per cent in both halves of the year. While the y-o-y IIP growth moderated to 6.3 per cent in April 2011, growth in capital goods production at 14.5 per cent was buoyant. During April-May 2011, both exports and imports increased sharply and the trade deficit widened. The progress of south west monsoon 2011 has so far been satisfactory, which augurs well for agricultural production.

Overall, even as there is deceleration in some important sectors, notably interest-sensitive ones such as automobiles, there is no evidence of any sharp or broad-based slowdown. Corporate earnings growth and profit margins in the fourth quarter of 2010-11 were broadly in line with the performance over the past three quarters, suggesting that demand remained steady, and in the face of sharp increases in input costs, pricing power remained intact. Credit grew steadily (see below), while the composite Purchasing Managers' Index (PMI) for May 2011 suggests reasonably good conditions.

Inflation

The headline WPI inflation rate was 9.7 per cent in March 2011. In April 2011, it was 8.7 per cent and rose to 9.1 per cent in May 2011. The numbers for April and May 2011 are as yet provisional and, given the recent pattern, these numbers are likely to be revised upwards. Thus, the headline WPI inflation rate remains elevated, consistent with the projections made in the Annual Policy Statement of May 3. The main drivers of WPI inflation in April-May 2011 were non-food primary articles, fuel group and non-food manufactured products. The consumer price inflation for industrial workers (CPI - IW) rose from 8.8 per cent in March 2011 to 9.4 per cent in April 2011.

Non-food manufactured products inflation was 8.5 per cent in March 2011. Provisional data indicate that it increased from 6.3 per cent in April to 7.3 per cent in May 2011, numbers much above its medium-term trend of 4.0 per cent. This pattern in non-food manufactured products inflation is a matter of particular concern. Besides reflecting high commodity prices, it also suggests more generalised inflationary pressures; rising wages and costs of service inputs are apparently being passed on by producers along the entire supply chain.

Credit Conditions

Year-on-year non-food credit growth moderated from 21.3 per cent in March 2011 to 20.6 per cent in early June 2011, but remained above the indicative projection of 19 per cent. The y-o-y deposit growth increased to 18.2 per cent in early June 2011 from 17.0 per cent in March 2011. Consequently, the incremental non-food credit-deposit ratio moderated to 80.5 per cent (y-o-y) in early June 2011 from 95.3 per cent in March 2011. The y-o-y increase in money supply (M_3) was at 17.3 per cent in early June 2011 as compared with 16.0 per cent in March 2011.

Monetary transmission has been quite strong with 45 scheduled commercial banks raising their Base Rates by 25-100 basis points after the May 3 Policy Statement. Cumulatively, 47 banks raised their Base Rates by 150-300 basis points during July 2010-May 2011. The higher cost of credit is restraining credit growth, but it still remains fairly high, suggesting that economic activity is holding course.

Liquidity Conditions

During the current fiscal year so far, liquidity conditions have remained consistent with the anti-inflationary stance of monetary policy. The Government’s cash balances moved from a surplus of ₹ 89,000 crore on an average during Q4 of 2010-11 to a deficit of ₹ 29,000 crore during Q1 of 2011-12 (up to June 15, 2011). Consequently, net injection of liquidity through LAF repos declined from an average of ₹ 84,000 crore during Q4 of 2010-11 to ₹ 41,000 crore in 2011-12 (up to June 15, 2011). The net liquidity injection by the Reserve Bank was higher at ₹ 60,000 crore as on June 15, 2011. As articulated in the May 3 Policy Statement, the Reserve Bank will continue to maintain liquidity conditions such that neither surplus liquidity dilutes the monetary policy stance nor large deficit chokes off fund flows to productive sectors of the economy.

Summing Up

To sum up, the domestic growth outlook as indicated in the Annual Monetary Statement of May 3 remains unchanged. However, given the high degree of integration with the global economy, recent global macroeconomic developments pose some risks to domestic growth. Domestic inflation remains high and much above the comfort zone of the Reserve Bank. Particularly, non-food manufactured products inflation rose in May 2011 after showing some moderation in April 2011. Domestic fuel prices do not yet reflect the current trends of global prices. Although global commodity prices moderated in recent weeks, it is too early to downgrade this as a risk factor. Monetary transmission has strengthened. The impact of the Reserve Bank’s recent monetary policy actions is still unfolding. The challenge of containing inflation and anchoring inflation expectations persists. Thus, while the Reserve Bank needs to continue with its anti-inflationary stance, the extent of policy action needs to balance the adverse movements in inflation with recent global developments and their likely impact on the domestic growth trajectory.

Expected Outcomes

The policy action in this Review is expected to:

- contain inflation and anchor inflationary expectations by reining in demand side pressures; and
- mitigate the risk to growth from potentially adverse global developments.

Guidance

Based on the current and evolving growth and inflation scenario, the Reserve Bank will need to persist with its anti-inflationary stance of monetary policy.

Alpana Killawala
Chief General Manager

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