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First Quarter Review of Monetary Policy 2013-14

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.

This morning, we put out the First Quarter Review of Monetary Policy for 2013-14.Based on an assessment of the present and prospective macroeconomic situation, we have decided to keep the policy repo rate under the liquidity adjustment facility (LAF) as also the cash reserve ratio (CRR) unchanged.

Accordingly, the repo rate stays at 7.25 per cent, the reverse repo rate at 6.25 per cent, and the CRR at 4.0 per cent of net demand and time liabilities (NDTL) of scheduled banks. The marginal standing facility (MSF) rate used to have a mark up of a 100 basis points above the repo rate. You will recall that earlier this month we raised that mark up to 300 basis points, raising the MSF rate to 10.25 per cent. As there is no change in the repo rate, the MSF rate stays at 10.25 per cent.

Considerations Behind the Policy Move

The policy stance in this review was informed by two considerations.

First, the need for continuous vigil and preparedness to pro-actively respond to risks to the economy from external developments, especially those stemming from global financial markets.

Second, managing the trade-off posed by increased downside risks to growth and continuing risks to inflation and inflation expectations.

Monetary Policy Stance

Accordingly, the four broad contours of our monetary policy stance are the following:

- first, to address the risks to macroeconomic stability from external shocks;
- second, to continue to address the heightened risks to growth;
- third, to guard against re-emergence of inflation pressures; and
- fourth, to manage liquidity conditions to ensure adequate credit flow to the productive sectors of the economy.

Guidance

Let me now indicate the forward guidance that we have given.

The monetary policy stance over the last two years has predominantly been shaped by the growth-inflation dynamic, even as external sector concerns have had a growing influence on policy calibration over the last one year. The current situation – moderating wholesale price inflation, prospects of softening of food inflation consequent on a robust monsoon, and decelerating growth – would have provided a reasonable case for continuing on the easing stance.

However, India is currently caught in a classic 'impossible trinity' trilemma whereby we are having to forfeit some monetary policy discretion to address external sector concerns. The liquidity tightening measures instituted by the Reserve Bank over the last two weeks are aimed at checking undue volatility in the foreign exchange market. They will be rolled back in a calibrated manner as stability is restored to the foreign exchange market, enabling monetary policy to revert to supporting growth with continuing vigil on inflation.

We have emphasised that the time available now should be used with alacrity to institute structural measures to bring the current account deficit down to sustainable levels.

The Reserve Bank stands ready to use all available instruments and measures at its command to respond proactively and swiftly to any adverse development.

Global and Domestic Developments

As always, our policy decision has been based on a detailed and careful assessment of the global and domestic macroeconomic situation. Let me begin with our assessment of the global outlook.

Global Economy

Global growth has been uneven and slower than initially expected. The tail risks to global recovery had eased in the early part of the year, but that improvement was overtaken by the flash turmoil in the financial markets because of the 'announcement effect' of the tapering of quantitative easing (QE) by the US Fed.

In advanced economies (AEs), activity has weakened. Emerging and developing economies (EDEs) are slowing, and are also experiencing sell-offs in their financial markets, largely due to the safe haven flight of capital. Market expectations of QE taper and the consequent increase in real interest rates in the US have translated into a rapid appreciation of the US dollar and consequent depreciation of EDE currencies.

Commodity prices have generally softened, but the price of crude remains elevated.

Indian Economy

Here at home, economic activity weakened in the first quarter of this year. Lead indicators point to continuing headwinds facing manufacturing and services sector activity.

Industrial production remained muted at 0.1 per cent during April-May; in May, there was an absolute decline of 1.6 per cent spread across all constituent sub-sectors, barring electricity generation. Capital goods production continues to contract, reflecting deteriorating investment conditions. Fortunately, the monsoon arrived on time and rainfall to date has been above the long period average. Consequently, *kharif* sowing has been significantly higher than a year ago.

In the May Policy, the Reserve Bank projected GDP growth for 2013-14 of 5.7 per cent, conditional upon a normal monsoon returning agricultural growth to its trend level. The outlook for industrial activity, however, was expected to remain subdued. Growth in services and exports was expected to stay sluggish owing to global growth not improving significantly.

While the onset of the monsoon and its spread have been robust, the persisting weakness in industrial activity has heightened the risks to growth. Moreover, global growth has been tepid, with consequent adverse spillovers on India's exports, manufacturing and services.

On the basis of the above considerations, the growth projection for the current year is revised downwards, from 5.7 per cent to 5.5 per cent.

Inflation

Let me now turn to inflation. Headline inflation, as measured by the wholesale price index (WPI), edged up slightly to 4.9 per cent in June after declining for five months on a clip. The pickup was mainly driven by a spurt in food inflation, especially in respect of vegetables and cereals.

Fuel inflation declined due to the reduction in coal prices in March and easing of inflation in electricity prices because of base effects. Non-food manufactured products inflation fell to 2.0 per cent in June, the lowest since December 2009.

Retail inflation, as measured by the new series of Consumer Price Index (CPI), had moderated somewhat during April-May, but it surged close to double digits in June, driven primarily by a sharp increase in food prices.

In the May Policy, the Reserve Bank indicated that during the current year, WPI inflation will be range-bound around 5.5 per cent, with some edging down in the first half and some edging up in the second half, mainly on base effects. The inflation trajectory in the first quarter of this year has moved largely in line with these expectations. Keeping in view the domestic demand-supply balance, the outlook for global commodity prices and on the expectation that the spatial and temporal distribution of the monsoon during the rest of the season will be normal, the Reserve Bank will endeavour to condition the evolution of inflation to a level of 5.0 per cent by March 2014, using all instruments at its command.

Monetary and Liquidity Conditions

Let me now turn to monetary and liquidity conditions.

Money supply (M_3), at 12.8 per cent y-o-y on July 12, was close to the indicative trajectory of 13.0 per cent. On the other hand, non-food credit growth at 14.3 per cent was lower than the indicative projection of 15.0 per cent, with the slowdown spread across all major sectors.

With nominal growth remaining broadly at the same level as envisaged in the May Policy, monetary aggregates are expected to move along the projected trajectories. Accordingly, M_3 growth projection for the current year has been retained at 13.0 per cent and aggregate deposit growth at 14.0 per cent. Non-food credit of scheduled commercial banks (SCBs) is projected to grow at 15.0 per cent. As always, these numbers are indicative projections and not targets.

Liquidity conditions have eased considerably since the May Policy. The average daily net liquidity injection under the liquidity adjustment facility (LAF) declined to ₹ 828 billion in the first quarter of this year from ₹ 1,078 billion during the last quarter of 2012-13. Government balances have been in deficit since June 28 and have bolstered liquidity, thereby significantly reducing the demand for funds under the LAF. The net drawal from the LAF declined significantly during the first week of July. On July 26, the net drawal was ₹ 558 billion, including a drawal of ₹ 229 billion from the marginal standing facility (MSF).

Risk Factors

I have so far given you the Reserve Bank's assessment of the global and domestic macroeconomic situation and our projections for the current year. Let me briefly indicate the risks to that macroeconomic outlook.

- First, the biggest risk to the macroeconomic outlook stems from the external sector. Financial markets around the world went into a flash turmoil beginning late May, on the perception of an earlier than expected tapering of its quantitative easing (QE) by the US Fed. The rupee depreciated in nominal terms by as much as 5.8 per cent between May 22 (the day of the first 'announcement effect') and July 26, consequent on sudden stop and reversal of capital flows in reaction to the prospective change in the US monetary policy stance. It is not clear if financial markets have factored in the full impact of the prospective tapering of QE or whether they will react to every future announcement of tapering. We are dependent on external flows for financing our current account deficit. India will, therefore, remain vulnerable to confidence and sentiment in the global financial markets.

- Second, we have been running a large current account deficit. The CAD has been well above the sustainable level of 2.5 per cent of GDP for three years in a row. This is a daunting structural risk factor. It has brought the external payments situation under increased stress, reflecting rising external indebtedness and the attendant burden of servicing external liabilities. Most external vulnerability indicators have deteriorated ,thereby eroding the economy's resilience to shocks. The recent measures by the Reserve Bank to restore stability to the foreign exchange market should be used as a window of opportunity to put in place policies to bring CAD down to sustainable levels. Furthermore, the growing vulnerability in the external sector reinforces the importance of credible fiscal consolidation with accent on both the quantum and quality of adjustment.

- Third, the investment climate remains weak and risk aversion continues to stall investment plans. The outlook for investment is inhibited by cost and time overruns, high leverage, deteriorating cash flows, erosion of asset quality and muted credit confidence.

- Fourth, an environment of low and stable inflation and well-anchored inflation expectations is necessary to sustain growth in the medium-term. To engender this benign growth-inflation environment, it is critical to ease the supply constraints in the economy, particularly in the food and infrastructure sectors. Without policy efforts to address the deterioration in productivity and competitiveness, the pressures from wage increases and upward revisions in administered prices could weaken growth even further and exacerbate inflation pressures.

Let me conclude by summarising our macroeconomic concerns.

Risks to growth have increased notwithstanding the robust onset and spread of the monsoon. Industrial production has slumped, with lead indications of declining order books and input price pressures building on rupee depreciation. Meanwhile, depressed global conditions are undermining export performance, even as heightened volatility in capital flows has raised external funding risks. Wholesale price inflation pressures are on the ebb, but retail inflation remains high.

Monetary policy going forward will be shaped by considerations of supporting growth, anchoring inflation expectations and maintaining external sector stability.

The foreign exchange market came under severe stress starting May, prompting the Reserve Bank to institute liquidity tightening measures to contain the volatility. The recent measures by the Reserve Bank to restore stability to the foreign exchange market should be used as a window of opportunity to put in place policies to bring the CAD down to sustainable levels.

Over the last one year, the Government has taken several policy initiatives to improve the investment environment. As these initiatives work through the system and are further built upon, the current slowdown can be reversed, returning the economy to a higher growth trajectory. The Reserve Bank will have to ensure that the economy traverses that high growth trajectory in an environment of price stability and financial stability.

Thank you for your attention."

Alpana Killawala
Principal Chief General Manager

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