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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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Mid-Quarter Monetary Policy Review: September 2010

Monetary Measures

On the basis of the Reserve Bank's assessment of macroeconomic situation, it has been decided to:

- increase the repo rate under the Liquidity Adjustment Facility (LAF) by 25 basis points from 5.75 per cent to 6.0 per cent with immediate effect.
- increase the reverse repo rate under the LAF by 50 basis points from 4.5 per cent to 5.0 per cent with immediate effect.

The Global Scenario

The Reserve Bank's First Quarter Review of Monetary Policy on July 27, 2010 expressed concerns over the global outlook. Indicators of economic activity in advanced economies continue to suggest that the recovery is slowing and that the second half of 2010 will post slower growth than the first, although expectations have generally not been revised downwards since end-July. Belying earlier apprehensions, Europe has demonstrated remarkable resilience in the face of the sovereign debt pressures that severely threatened the recovery a few months ago. The European Central Bank has revised its forecast for second-half growth upwards. China, after showing some signs of slowdown in the second quarter of 2010, appears to have bounced back, with industrial production and trade numbers reviving sharply.

Overall, even as the global environment continues to be a cause for caution, the big picture has not worsened significantly since July**.**

The Domestic Scenario

Growth in Q1 of 2010-11 was estimated at 8.8 per cent. Although some of this is attributable to a favourable base effect, the growth rate indicates that the recovery is consolidating and the economy is rapidly converging to its trend rate of growth. The index of industrial production (IIP) showed some slippage in the last month of the quarter (June 2010) with the revised numbers showing growth to be a relatively sluggish 5.8 per cent. The trend was sharply reversed in July, with growth surging to 13.8 per cent, led by capital goods, which grew by 63 per cent. Although the year-on-year growth rate for the first four months of the year remains robust at 11.4 per cent, the high volatility over the past two months raises some doubts about how effectively the index reflects the underlying momentum in the industrial sector.

Growth prospects in agriculture have clearly been boosted by the monsoon, which, by virtue of substantial replenishment of reservoirs and ground water, will also

contribute to a good *rabi* harvest. Virtually all leading indicators of service sector activity point to sustained growth.

Inflation remains the dominant concern in macroeconomic management. The published wholesale price index (WPI) inflation rate for August 2010 was based on the new series (base year: 2004-05=100) for the first time. The new series has better coverage of items and the manufacturing products group has a slightly higher weight. Both the old and the new series, however, indicate similar broad trend of inflation. For instance, average monthly WPI inflation for Q1 of 2010-11, based on either series, is in double digits. However, the monthly average of WPI inflation for Q1 of 2010-11 under the new series at 10.6 per cent was about 50 basis points lower than the rate of 11.1 per cent under the old series. In July 2010, there was a slight moderation in the provisional WPI inflation under both the series. There has been further moderation in the provisional WPI inflation to 8.5 per cent in August from 9.8 per cent in July 2010 as per the new series. The direction of the inflation rate movement is consistent with the Reserve Bank's projection made in the July review, though the magnitude could be slightly different.

Inferences from both the series are similar. Essentially, inflation rates have reached a plateau, but are likely to remain at unacceptably high levels for some months. While prices of food articles, which according to the new series, rose by over 14 per cent in August, are still contributing to the pressure, about two-thirds of the August inflation can be attributed to items other than food articles and products. Notwithstanding slight moderation in August 2010, the headline inflation remains significantly above the trend of 5.0–5.5 per cent in the 2000s. There is, therefore, need for continued policy response to contain inflation and anchor inflationary expectation.

Another aspect of the concern with inflation is its implications for real interest rates. The policy actions taken over the past three quarters have been partly motivated by the need to end the prevalence of negative real interest rates. This was sought to be accomplished by a combination of increasing policy rates in a non-disruptive manner and declining inflation rates. Both factors are at work, but the process is still incomplete. One important consequence of negative real rates is that banks have seen a deceleration of deposit growth, as savers look for higher returns elsewhere. If bank credit is not to become a constraint to growth, real rates need to move in the direction of encouraging bank deposits.

With reference to government finances, the fiscal deficit appears to be conforming to the estimates made in the Union Budget for 2010-11. Higher than expected realisations on 3G and broadband wireless access (BWA) auctions combined with buoyant tax revenues have virtually eliminated the risk of the fiscal deficit overshooting the targeted 5.5 per cent, even after the supplementary demand for grants is taken into account. This will help stabilise market expectations of liquidity and interest rate movements.

Liquidity has been a significant factor in monetary policy considerations in recent months. The lead-up to the July policy review saw the liquidity situation transit from a large surplus to a mainly deficit one, making the repo rate the operative policy rate. Consequent on this transition, the transmission from policy rates to market rates has strengthened, with 40 banks raising their deposit rates and 26 raising their lending rates. These circumstances are expected to prevail, maintaining the repo

rate as the effective policy rate and sustaining the strength of the transmission mechanism.

On the external front, the continuing sluggishness of the global economy constrains export growth while the strong domestic recovery has increased demand for imports. As a result, the trade deficit, and with it the current account deficit, are widening. In its July policy review, the Reserve Bank had highlighted the risks associated with a widening current account deficit in the face of increasingly volatile capital inflows. The apparent stabilisation in advanced economies visible over the past few weeks appears to have improved global investor sentiment, resulting in a steady increase in capital inflows into EMEs, including India. If this trend continues, the risks on the external front will clearly abate despite exports remaining sluggish.

Overall, our assessment is that growth remains steady, though the recent volatility in industrial production raises some concerns. Inflation also appears to have stopped accelerating though the rate may remain high for some months. The early signs of a downturn in non-food manufacturing inflation suggest that recent monetary actions are having an impact on both inflationary expectations and demand in a non-disruptive way. Should the global situation stabilise, it will help contain volatility in capital flows. But the flip side of that will be possible firming of commodity prices and consequent inflationary pressures.

Expected Outcome

The measures undertaken in this review should:

- contain inflation and anchor inflationary expectations without disrupting growth.
- reduce the volatility in overnight call money rates, thereby strengthening the monetary transmission mechanism.
- continue the process of normalisation of the monetary policy instruments.

The Reserve Bank's rate and liquidity actions since October 2009 have been driven by two considerations: normalisation of the monetary policy stance as the crisis abated and inflation management. The Reserve Bank believes that the tightening that has been carried out over this period has taken the monetary situation close to normal. Consequently, the role of normalisation as a motivation for further actions is likely to be less important. Current and expected macroeconomic conditions will be the more important considerations going forward. The Reserve Bank will continue to monitor these conditions, particularly the price situation, and take further action as warranted.

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