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RESERVE BANK OF INDIA

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Second 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, I want to welcome you all to this Second Quarter Review of Monetary Policy for 2012-13.

2. A short while ago, we put out the Second Quarter Review. Based on an assessment of the current macroeconomic situation, we have decided to:

- Cut the cash reserve ratio (CRR) of scheduled banks by 25 basis points from 4.5 per cent to 4.25 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning November 3, 2012.
- The reduction in the CRR, will inject around ₹175 billion of primary liquidity into the banking system.

3. There is no change in policy interest rate. Accordingly, the repo rate under the liquidity adjustment facility remains at 8.0 per cent.

4. Consequently, the reverse repo rate under the liquidity adjustment facility (LAF), determined with a spread of 100 basis points below the repo rate, will continue at 7.0 per cent, and the marginal standing facility (MSF) rate, determined with a spread of 100 bps above the repo rate, at 9.0 per cent.

Considerations Behind the Policy Move

5. Let me begin with an explanation of the rationale behind this monetary policy action.

6. The decision to cut the CRR and keep the policy interest rate unchanged draws from our assessment of the evolving liquidity situation and the growth-inflation dynamic.

- First on liquidity. Systemic liquidity deficit has been high because of several factors: the wedge between deposit and credit growth, the build-up of Government's cash balances from mid-September and the drainage of liquidity on account of festival-related step-up in currency demand. This high systemic deficit will have adverse implications for the flow of credit to productive sectors and for the overall growth of the economy going forward.

- As regards the growth-inflation balance, headline WPI inflation moderated from its peak of 10.9 per cent in April 2010 to an average rate of 7.5 per cent over the period January-August 2012. During this time, growth has slowed and is currently below trend. This slowdown is due to a host of factors, including monetary tightening.

- Since April 2012, the Reserve Bank's monetary policy stance has sought to balance the growth–inflation dynamic through calibrated easing. The transmission of these policy impulses through the economy is still underway. In conjunction with the fiscal and other measures recently announced by the Government, the Reserve Bank's monetary policy stance should work towards arresting the loss of growth momentum over the next few months. Yesterday's statement by the Finance Minister reaffirming commitment to fiscal consolidation will open up space for monetary policy to restrain inflation and support growth.

- Now coming to inflation. It turned up again in September, reflecting the partial pass-through of adjustment of diesel and electricity prices, and elevated inflation in non-food manufactured products. It is, therefore, critical that even as the monetary policy stance shifts further towards addressing growth risks, the objective of containing inflation and anchoring inflation expectations is not de-emphasised.

Monetary Policy Stance

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

- first, to manage liquidity to ensure adequate flow of credit to the productive sectors of the economy;

- second, to reinforce the positive impact of government policy actions on growth as inflation risks moderate; and

- third, to maintain an interest rate environment to contain inflation and anchor inflation expectations.

Guidance

8. As in the past, we have also given guidance for the period forward.

9. In reducing CRR, the Reserve Bank intended to pre-empt a prospective tightening of liquidity conditions, thereby keeping liquidity comfortable and supportive of growth. The policy stance anticipates the projected inflation trajectory which indicates a rise in inflation over the next few months before easing in the last quarter. While there are risks to this trajectory, the baseline scenario suggests a reasonable likelihood of further policy easing in the fourth quarter of this fiscal year. Let me add though that this guidance will, however, be conditioned by the evolving growth-inflation dynamic.

Expected Outcomes

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

- first, liquidity conditions will facilitate a turnaround in credit growth to productive sectors so as to support growth;
- second, as inflation risks moderate, the growth stimulus of the policy actions announced by the Government will be reinforced;
- and, finally, the policy action will anchor medium-term inflation expectations on the basis of a credible commitment to low and stable inflation.

Global and Domestic Developments

11. As always, our policy action has been based on a careful assessment of the global and domestic macroeconomic situation. Let me comment first on the global economy.

Global Economy

12. Over the last quarter, policymakers around the world have confronted increasingly difficult challenges. Globally, even as the growth momentum has slowed, governments have had to manage the balance between fiscal consolidation and growth stimulus amidst visible signs that the two objectives are in conflict with each other. As the advanced economies deal with these tensions and global demand conditions weaken, emerging and developing economies are also slowing down.

13. Liquidity infusions by central banks in advanced economies during the quarter have contributed to some stability in global financial markets. It is important to note though that liquidity infusions are only a stop-gap measure intended to maintain financial stability and arrest further downturn. They cannot substitute for robust structural solutions that can return the advanced economies to the path of recovery. At this stage, growth risks have risen and could well overwhelm the positive effects of enhanced liquidity. Moreover, notwithstanding some muted softening recently, commodity prices are still at elevated levels. Consequently, there is a significant risk of liquidity-driven price increases. Even as the global recovery process moves forward, the months ahead will be a period of heightened uncertainty for the global economy.

Indian Economy

14. Let me now turn to the domestic macroeconomic situation. Growth decelerated over four successive quarters, from 9.2 per cent year-on-year in the fourth quarter of 2010-11 to 5.3 per cent in the fourth quarter of 2011-12. In the first quarter of this year, growth was marginally higher at 5.5 per cent. This slight improvement in GDP growth in the first quarter was mainly driven by growth in construction, and supported by better than expected growth in agriculture. On the demand side, the growth of gross fixed capital formation decelerated, while the slowdown in growth of private consumption expenditure continued. The external demand conditions and crude oil prices also remained unfavourable, adversely impacting net exports.

15. Over the last quarter, global risks have increased and domestic risks have become accentuated owing to halted investment demand, moderation in consumption spending and continuing erosion in export competitiveness accompanied by weakening business and consumer confidence. The industrial outlook remains uncertain. Notwithstanding the improvement in rainfall in the months of August and September, the first advance estimates of the 2012 kharif production are about 10 per cent lower than last year's production.

16. On the basis of the above considerations, the baseline projection of GDP growth for 2012-13 is revised downwards from 6.5 per cent to 5.8 per cent.

Inflation

17. Moving on to inflation. Headline WPI inflation remained sticky, at above 7.5 per cent on a y-o-y basis, through the first half of the current year. Furthermore, in September there was a pick-up in the momentum of headline inflation owing to the increase in fuel prices and elevated price levels of non-food manufactured products. This is, in part, attributable to some suppressed inflation in the form of earlier under-pricing being corrected. However, even after adjusting for this, the momentum remains firm.

18. While WPI primary food articles moderated since July due to the softening of prices of vegetables, prices of cereal and protein items edged up. WPI food products inflation increased in September, mainly due to the firming up of the prices of sugar, edible oils and grain mill products.

19. Fuel group inflation registered a significant rise in September, reflecting the sharp increase in prices of electricity effected from June, the partial impact of the increase in prices of diesel in mid-September and significant increase in non-administered fuel prices on account of rising global crude prices.

20. Non-food manufactured products inflation was persistent at 5.6 per cent through July-September. This upside pressure was a result of firm prices of metal products and other inputs and intermediates, especially goods with high import content due to a depreciating rupee.

21. Consumer price inflation, as measured by the new CPI, remained elevated, reflecting the build-up of food price pressures. CPI inflation excluding food and fuel groups ebbed slightly during June-September, from double digits earlier.

22. Looking ahead, the path of inflation will be shaped by two sets of counteracting forces.

- First, on the downside, slower growth and excess capacity in some sectors will help moderate core inflation. Stable, or in the best case scenario, declining commodity prices will reinforce this tendency. An appreciating rupee will also help to contain inflationary pressures by bringing down the rupee cost of imports, especially of commodities.

- Balancing those downside forces are some on the upside. Persistent supply constraints may aggravate as demand revives, resulting in price pressures. Global financial instability could put downward pressure on the rupee and that will add to imported inflation. Also, the upsurge in both rural and urban wages will exert cost-push pressures on inflation.

- Finally, as under-pricing in several products is corrected as part of the fiscal consolidation process, suppressed inflation is being brought into the open. This correction is necessary and important. Nevertheless, it will result in higher inflation readings.

23. Taking the above factors into consideration, the baseline projection for headline WPI inflation for March 2013 is raised to 7.5 per cent from 7.0 per cent indicated in July. Importantly, inflation is expected to rise somewhat in the third quarter before beginning to ease in the fourth quarter.

Monetary and Liquidity Conditions

24. Let me now move on to monetary and liquidity conditions. Money supply (M_3), deposit and credit growth have so far trailed below the indicative trajectories of the Reserve Bank indicated in the April Policy and reiterated in the July Review. Deposit growth has decelerated with the moderation in interest rates, especially term deposits. Credit growth has ebbed with the slowdown in investment demand, especially with regard to infrastructure, and lower absorption of credit by industry, in general. Keeping in view the developments during the year so far and the usual year-end pick-up, the trajectories of the monetary aggregates for 2012-13 are projected at 14 per cent for M_3, 15 per cent for deposit growth and 16 per cent for growth of non-food credit.

25. Liquidity conditions, as reflected in the average net borrowing under the LAF at ₹486 billion during July-September, remained within the comfort zone of (+/-) one per cent of NDTL. However, liquidity conditions tightened in October, mainly on account of the build-up in the Government's cash balances and the seasonal increase in currency demand, taking the average LAF borrowing to ₹871 billion during October 15-25, well above the band of (+/-) one per cent of NDTL

Risk Factors

26. Now, let me highlight the risks to our growth and inflation projections:

- First, the downside risks to growth stemming from the global macroeconomic environment now seem likely to be stronger than earlier thought. Domestically, a revival in investment activity, which is key to stimulating growth, depends particularly on the recent policy announcements by the Government being translated into effective actions;

- Second, despite recent moderation, global commodity prices remain high. Also, under recoveries in domestic prices of administered petroleum products persist and will need to be corrected. While corrections are welcome from the viewpoint of overall macroeconomic stability, we will have to guard against their second-round effects on inflation.

- Third, the behaviour of food inflation will depend on the supply response in respect of commodities characterised by structural imbalances, particularly protein items;

- Fourth, the persistent increase in rural and urban wages, unaccompanied by commensurate productivity increase, has been and will continue to be a source of inflationary pressures;

- Fifth, the large twin deficits, *i.e.,* the current account deficit and the fiscal deficit pose significant risks to both growth and macroeconomic stability; and

- Finally, while liquidity pressures pose risks to credit availability for productive purposes and could adversely affect overall investment, excess liquidity could aggravate inflation risks.

Developmental and Regulatory Policies

27. This review also includes developmental and regulatory policies which focus on carrying forward the initiatives taken for strengthening the financial system and for efficiently providing financial services to the widest sections of society. Let me briefly indicate some of the important initiatives in this regard.

28. I will begin with financial markets and market infrastructure. Some important measures contained in the policy are the following:

- The settlement cycle of the primary auction in Treasury Bills (T-Bills) will be reduced from T+2 to T+1.

- IRS contracts will be standardised to facilitate centralised clearing and settlement of these contracts.

- We will move towards developing a trade repository for OTC derivatives.

29. Now let me move on to initiatives for financial inclusion, credit delivery and customer service. Drawing on extensive consultation with banks, we have rationalised the guidelines on priority sector lending. Important initiatives in this regard are the following:

- Loans up to ₹20 million to partnership firms, cooperatives and corporates directly engaged in agriculture and allied activities under partnership, rural co-operative and corporate categories will also be classified as direct finance to agriculture.

- Bank loans to Housing Finance Companies (HFCs) for on-lending for housing up to ₹1 million per borrower will be included under the priority sector, provided the interest rate charged to the ultimate borrower by the HFC does not exceed two percentage points above the lowest interest rate of the lending bank for housing loans.

30. As regards the cooperative sector, scheduled urban cooperative banks (UCBs) have been allowed to undertake repo transactions in corporate bonds.

31. Another important step relates to micro and small enterprises. The definition of sickness of these enterprises is modified to facilitate early rehabilitation of potentially viable sick units and to lay down a procedure for assessing viability of sick units in the sector.

32. Moving on to regulation and supervision, we are carrying forward the implementation of Basel III capital regulations by issuing draft guidelines on capital requirements for bank exposures to central counterparties by mid-November 2012 and on composition of capital disclosure requirements by end-December 2012.

33. Given the larger objectives of financial stability, and keeping in view international best practices to ensure that banks have sufficient provisioning buffer, the provision for restructured standard accounts is being raised from the existing 2 per cent to 2.75 per cent.

34. To address the issue of rise in NPAs and restructured advances of banks, and with a view to improving effective information sharing among banks on credit, derivatives and unhedged foreign currency exposures, banks are being advised to put

in place, by end-December 2012, an effective mechanism for information sharing. Any sanction of fresh loans/ad-hoc loans/renewal of loans to new or existing borrowers with effect from January 1, 2013 should be made only after obtaining/sharing necessary information.

35. Turning to unhedged foreign currency exposures of corporates, which is a source of risk to them as well as to the financing banks and the financial system, we are advising banks to put in place a proper mechanism to rigorously evaluate the risks arising out of unhedged foreign currency exposures of corporates, and price them in the credit risk premium. Banks are also being advised to consider stipulating a limit on the unhedged position of corporates on the basis of bank's Board-approved policy.

36. We are in the process of strengthening the regulatory framework for dealing with Systemically Important Financial Institutions (SIFIs) which may come under stress and may require resolution. Accordingly, the Government and the Reserve Bank are setting up a High Level Working Group to recommend a comprehensive resolution regime for all types of financial institutions in India.

37. Before I close, let me note that the persistence of inflation pressures, even as growth has moderated, remains a key challenge. Of particular concern is the stickiness of core inflation, mainly on account of supply constraints and the cost-push of rupee depreciation. Consequently, managing inflation and inflation expectations must remain the primary focus of monetary policy. A central premise of monetary policy is that low and stable inflation and well-anchored inflation expectations contribute to a conducive investment climate and consumer confidence, which is key to sustained growth on a higher trajectory in the medium-term.

38. Accordingly, over the past few quarters, monetary policy had to focus on inflation, even as growth risks have increased. As recent policy initiatives by the Government start yielding results in terms of revitalising activity, they will open up space for monetary policy to work in concert to stimulate growth. However, in doing so, it is important not to lose sight of the primary objective of managing inflation and inflation expectations.

39. Thank you for your attention. On behalf of the Reserve Bank, my best wishes to everyone for a Happy Diwali.

Alpana Killawala
Chief General Manager

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