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भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA

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Mid-Quarter Monetary Policy Review: March 2013

Monetary and Liquidity Measures

Based on an assessment of the current macroeconomic situation, it has been decided to:

• reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.75 per cent to 7.5 per cent with immediate effect;

Consequently, the reverse repo rate under the LAF stands adjusted to 6.5 per cent and the marginal standing facility (MSF) rate and the Bank Rate to 8.5 per cent with immediate effect.

Introduction

2. Since the Reserve Bank's Third Quarter Review (TQR) of January 2013, global financial market conditions have improved, but global economic activity has weakened. On the domestic front too, growth has decelerated significantly, even as inflation remains at a level which is not conducive for sustained economic growth. Although there has been notable softening of non-food manufactured products inflation, food inflation remains high, driving a wedge between wholesale price and consumer price inflation, and is exacerbating the challenge for monetary management in anchoring inflationary expectations.

Global Economy

3. Global economic developments over the last few months present a mixed picture. US GDP estimates for Q4 of 2012 indicate a tentative upturn on the back of improvement in housing and payroll employment. However, US macroeconomic prospects are clouded by the uncertainty surrounding the temporary appropriations and the debt ceiling. In the euro area, plagued by contingent risks of political uncertainty and adjustment fatigue, GDP shrank for the third successive quarter in Q4. Output in Japan too contracted in Q4, and it is as yet unclear how effective the emerging package of stimulus measures will be and how quickly they will turn around the economy. While some emerging and developing economies (EDEs), including China, are gradually returning to faster growth, activity is slowing in others, hobbled by weak external demand and slack domestic investment. International non-fuel commodity prices have softened in Q4, but fuel prices have remained firm, despite the growth slowdown, portending persisting inflationary pressures, particularly for net energy importers.

Domestic Economy

Growth

4. India's GDP growth in Q3 of 2012-13, at 4.5 per cent, was the weakest in the last 15 quarters. What is worrisome is that the services sector growth, hitherto the mainstay of overall growth, has also decelerated to its slowest pace in a decade. While overall industrial production growth turned positive in January, capital goods production and mining activity continued to contract. The composite purchasing managers' index (PMI) declined in February, largely reflecting slower expansion in services. In the agriculture sector, the second advance estimates of *kharif* production indicate a decline in relation to the level last year. However, that may be offset, at least partly, by the *rabi* output for which sowing has been satisfactory.

Inflation

5. The year-on-year headline WPI inflation edged up to 6.8 per cent in February 2013 from 6.6 per cent in January, essentially reflecting the upward revisions effected to administered prices of petroleum products. On the other hand, non-food manufactured products inflation, and its momentum, continued to ebb along the trajectory that began in September 2012, enabled by softening prices of metals, textiles and rubber products. Worryingly, retail inflation continued on the upward path that set in from October 2012, with the new combined (rural and urban) CPI (Base: 2010=100) inflation at a high of 10.9 per cent in February 2013 on sustained price pressures from food items, especially cereals and proteins. Consequently, the divergence between wholesale and consumer price inflation continued to widen during the year.

Monetary and Liquidity Conditions

6. Money supply (M_3) and bank credit growth have broadly moved in alignment with their revised indicative trajectories. With government cash balances with the Reserve Bank persisting at a higher than normal level, the liquidity deficit, as reflected by the net drawals by banks under the liquidity adjustment facility (LAF), has remained above the indicative comfort zone. The reduction in the cash reserve ratio (CRR) of banks by 25 basis points, effective from February 9 and open market purchases of ₹200 billion since February have enabled money market rates to remain anchored to the policy repo rate. The Reserve Bank will continue to actively manage liquidity through various instruments, including open market operations (OMO), so as to ensure adequate flow of credit to productive sectors of the economy.

Fiscal Situation

7. The Union Budget for 2013-14 has made a firm commitment to fiscal consolidation. According to the revised budget estimates for 2012-13, the gross fiscal deficit (GFD)-GDP ratio, at 5.2 per cent, was contained around its budgeted level, mainly by scaling down plan and capital expenditures. The GFD-GDP ratio is programmed to decline to 4.8 per cent in 2013-14 and further down to 3.0 per cent by 2016-17, in line with the revised road map for fiscal consolidation.

External Sector

8. With merchandise exports recording positive growth for the second successive month in February and non-oil imports contracting, the trade deficit narrowed significantly. For April-February 2012-13, however, the trade deficit was higher than its level a year ago with adverse implications for the current account deficit (CAD), already at a record high. Although capital inflows, mainly in the form of portfolio investment and debt flows, provided adequate financing, the growing vulnerability of the external sector to abrupt shifts in sentiment remains a key concern.

Outlook

9. There are several risks to the global outlook. The impact of sequestration in the US on the global economy is likely to be muted in view of legislation initiated to avert the debt ceiling. Nevertheless, lead indicators point to sluggish global growth. Political economy risks that block or delay credible and determined policy actions in advanced economies (AEs) are inhibiting recovery. For EDEs, risks of spillovers from AEs remain significant. While global inflationary pressures are likely to be subdued, given still large output gaps, several EDEs could potentially face the threat of elevated energy prices.

10. On the domestic front, the key macroeconomic priorities are to raise the growth rate, restrain inflation pressures and mitigate the vulnerability of the external sector. These are briefly addressed in the following paragraphs.

11. The Central Statistics Office (CSO) has projected GDP growth for 2012-13 of 5.0 per cent, lower than the Reserve Bank's baseline projection of 5.5 per cent set out in the TQR, reflecting slower than expected growth in both industry and services. Key to reinvigorating growth is accelerating investment. The government has a critical role to play in this regard by remaining committed to fiscal consolidation, easing the supply bottlenecks and improving governance surrounding project implementation.

12. On the inflation front, some softening of global commodity prices and lower pricing power of corporates domestically is moderating non-food manufactured products inflation. However, the unrelenting rise in food inflation is keeping headline wholesale price inflation above the threshold level and consumer price inflation in double digits. Also, there is still some suppressed inflation related to administered prices which carries latent inflationary pressures. All this complicates the task of inflation management and underscores the imperative of addressing supply constraints. From an inflation perspective, upward revisions in the minimum support prices (MSP) should warrant caution in view of their implications for overall inflation.

13. On the external sector front, the key challenge is to reduce the CAD, which is well above the sustainable threshold. This adjustment, requiring as it does, measures to improve the competitiveness of exports and wean away demand for unproductive imports, will inevitably take time. Meanwhile, financing of the CAD with stable flows remains a challenge.

14. The foremost challenge for returning the economy to a high growth trajectory is to revive investment. A competitive interest rate is necessary for this, but not sufficient. Sufficiency conditions include bridging the supply constraints, staying the course on fiscal consolidation, both in terms of quantity and quality, and improving governance.

Guidance

15. Notwithstanding moderation in non-food manufactured products inflation, headline inflation is expected to be range-bound around current levels over 2013-14 in view of sectoral demand-supply imbalances, the ongoing corrections in administered prices and their second-round effects. In addition, elevated food prices, including pressures stemming from MSP increases, and the wedge between wholesale and retail inflation have adverse implications for inflation expectations. Risks on account of the CAD remain significant notwithstanding likely improvement in Q4 over an expected sharp deterioration in Q3 of 2012-13. Accordingly, even as the policy stance emphasises addressing the growth risks, the headroom for further monetary easing remains quite limited.

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Press Release : 2012-2013/1565 Chief General Manager