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Mid-Quarter Monetary Policy Review: June 2013

Monetary and Liquidity Measures

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

- keep the cash reserve ratio (CRR) of scheduled banks unchanged at 4.0 per cent of their net demand and time liabilities; and
- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 7.25 per cent.

Consequently, the reverse repo rate under the LAF will remain unchanged at 6.25 per cent, and the marginal standing facility (MSF) rate and the Bank Rate at 8.25 per cent.

2. The above monetary policy stance has been informed by the evolving growth-inflation dynamic, the balance of risks as well as recent developments in the external sector.

Introduction

3. Since the Reserve Bank’s Annual Policy statement in May, global economic activity has slowed and risks remain elevated, most recently on account of uncertainty over policies of systemic central banks. On the domestic front, macroeconomic conditions remain weak, hamstrung by infrastructure bottlenecks, supply constraints, lacklustre domestic demand and subdued investment sentiment. Inflation has moderated as projected. However, upside pressures on the way forward from the pass-through of rupee depreciation, recent increases in administered prices and persisting imbalances, especially relating to food, pose risks of second-round effects. As recent experience has shown, shifts in global market sentiment can trigger sudden stop and reversal of capital from a broad swath of emerging economies, swiftly amplifying risks to the outlook. India is not an exception.

Global Economy

4. Global growth has been patchy and uneven. Among advanced economies (AEs), during Q1 of 2013, growth in US and Japan improved while that in the euro area contracted. Growth in most emerging and developing economies (EDEs) has been relatively resilient, although in some large emerging economies, sluggish external demand and stalled domestic investment are dragging down economic

activity. Inflation has been easing in the AEs due to weak demand conditions. EDEs, however, present a mixed picture: inflation remains elevated in the BRICS except China. Commodity prices, other than the price of crude, have generally softened in recent months.

Domestic Economy

Growth

5. In May, the Central Statistics Office (CSO) reported India's GDP growth in Q4 of 2012-13 of 4.8 per cent, a marginal improvement over the previous quarter. During the current financial year, the growth of industrial production decelerated to 2.3 per cent in April after picking up in the preceding month. All constituent categories of industry have slowed, with a persistent contraction in mining activity. The sharp weakening in the growth of capital goods production points to still damped investment demand whereas a pick-up in consumer non-durables could be indicative of a fragile return of consumer confidence. On the other hand, the services sector purchasing managers' index rose in May on order flows. The onset of the south-west monsoon has been strong and on time.

Inflation

6. Headline WPI inflation eased for three months in succession with the May reading at 4.7 per cent, down from an average of 7.4 per cent in 2012-13. All constituent categories, barring food, have moderated. In the fuel category, coal and mineral oil prices declined, partly offsetting the upward revision in administered prices of electricity. Non-food manufactured products inflation too ebbed, driven by metal prices which fell for the eighth successive month in response to softening of global prices. Still elevated food inflation, particularly in respect of cereals and vegetables, sustained upside pressures on overall inflation. Retail inflation, as measured by the new combined (rural and urban) CPI, edged down from an average of 10.2 per cent last fiscal year to 9.3 per cent in May.

Liquidity Conditions

7. Net average daily borrowings under the LAF have declined gradually, from ₹ 1.2 trillion in March 2013 to ₹ 0.7 trillion in June 2013 so far (up to June 14) reflecting the sizable injection of primary liquidity through the reduction in the cash reserve ratio (CRR) in January, open market operations (OMO) purchases during Q4 of 2012-13, a significant reduction in the government's cash balances with the Reserve Bank as well as two OMOs of ₹ 0.2 trillion in the current financial year so far.

External Sector

8. The most significant development in the external sector has been the movement in the exchange rate. The rupee depreciated by 5.8 per cent against the US dollar during the current financial year up to June 14. It fell by 6.6 per cent during May 22-June 11 due to sell-off by foreign institutional investors, reflecting risk-off sentiment triggered by apprehensions of possible tapering off of quantitative easing by the US Fed. While the trade deficit has widened sharply due to a surge in festival-related/seasonal gold imports, available evidence suggests that a moderation in gold imports could be underway in June. Capital flows, which met the external financing requirement during April-May, moderated in June.

Outlook

9. At the global level, the International Monetary Fund (IMF) has warned of non-trivial risks of the global economy encountering a soft patch in the months ahead. On the domestic front, last year's robust *rabi* production and the monsoon performance so far augur well for growth prospects. The spatial and temporal distribution of rainfall over the next three months will be crucial in determining the performance of agriculture. The continuing weakness in manufacturing activity needs to be urgently reversed. Key to reinvigorating growth is accelerating investment by creating a conducive environment for private investment, improving project clearance and implementation and leveraging on the crowding-in role of public investment.

10. On the inflation front, easing commodity prices at the global level and weaker pricing power of corporates at the domestic level are having a softening influence. Given that food inflation remains high, the inflation outlook will be influenced by concerted efforts to break food inflation persistence. The inflation outlook going forward will be determined by suppressed inflation being released through revisions in administered prices, including the minimum support prices (MSP) as well as the recent depreciation of the rupee.

11. Softer global commodity prices and recent measures to dampen gold imports are expected to moderate the CAD in 2013-14 from its level last year. The main challenge is to reduce the CAD to a sustainable level; the near-term challenge is to finance it through stable flows. The most recent number on the Centre's fiscal deficit, at 4.9 per cent of GDP for 2012-13, has turned out better than expected and instils confidence in the Government's commitment to contain the fiscal deficit for 2013-14 at 4.8 per cent. Perseverance with this consolidation should help in mitigating the twin deficit risks to the outlook. These positive developments, which have been acknowledged by international credit rating agencies, should have a favourable impact on investor confidence.

Guidance

12. The Reserve Bank's monetary policy stance will be determined by how growth and inflation trajectories and the balance of payments situation evolve in the months ahead. It is only a durable receding of inflation that will open up the space for monetary policy to continue to address risks to growth. While several measures have been taken to contain the current account deficit, we need to be vigilant about the global uncertainty, the rapid shift in risk perceptions and its impact on capital flows. The Reserve Bank stands ready to use all available instruments and measures to respond rapidly and appropriately to any adverse developments.

Alpana Killawala
Chief General Manager

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