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Mid Quarter Monetary Policy Review: December 2011

Monetary Measures

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

- keep the cash reserve ratio (CRR) unchanged at 6 per cent; and
- keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 8.5 per cent.

Consequently, the reverse repo rate under the LAF will remain unchanged at 7.5 per cent and the marginal standing facility (MSF) rate at 9.5 per cent.

Introduction

Since the Reserve Bank's Second Quarter Review (SQR) of October 25, 2011, the global economic outlook has worsened significantly. The recent European Union (EU) summit agreement did not assuage negative market sentiments, thereby increasing the likelihood of persistent financial turbulence as well as a recession in Europe. Both factors pose threats to emerging market economies (EMEs), including India. Significantly, despite these developments, crude oil prices remain elevated.

On the domestic front, growth is clearly decelerating. This reflects the combined impact of several factors: the uncertain global environment, the cumulative impact of past monetary policy tightening and domestic policy uncertainties.

Both inflation and inflation expectations are currently above the comfort level of the Reserve Bank. However, reassuringly, inflationary pressures are expected to abate in the coming months despite high crude oil prices and rupee depreciation. The growth deceleration is contributing to a decline in inflation momentum, which is also being helped by softening food inflation.

Global Economy

The global economic situation continues to be fragile with no credible solution as yet to the immediate euro area sovereign debt problem. At the EU summit on December 8-9, the European leaders agreed on a new fiscal compact, involving stronger coordination of economic policies to strengthen fiscal discipline. While the agreement is necessary for medium and long-term sustainability of the euro area, its ability to resolve short-term funding pressures was questioned by markets. Q3 euro area growth, at 0.8 per cent, was anaemic and 2012 growth is now expected to be weaker than earlier projected. Reflecting these projections, the European Central Bank (ECB) cut its policy rate twice in the last two months, and also implemented some non-standard measures. By contrast, growth in the US in Q3 of 2011 was better than in Q2, although still substantially below trend.

Growth in EMEs is also moderating on account of sluggish growth in advanced economies and the impact of monetary tightening to contain inflation. In view of the slowing down of their economies, Brazil, Indonesia, Israel and Thailand cut their policy rates, while China cut its reserve requirements. EME currencies have also come under varying degrees of downward pressure as a result of global risk aversion and financial stress emanating from the euro area.

Domestic economy

Growth

GDP growth moderated to 6.9 per cent in Q2 of 2011-12 from 7.7 per cent in Q1 and 8.8 per cent in the corresponding quarter a year ago. The deceleration in economic activity in Q2 was mainly on account of a sharp moderation in industrial growth. On the expenditure side, investment showed a significant slowdown. Overall, during the first half (April-September) of 2011-12, GDP growth slowed down to 7.3 per cent from 8.6 per cent last year.

Industrial performance has further deteriorated as reflected in the decline of the index of industrial production (IIP) by 5.1 per cent, y-o-y, in October 2011. This was mainly due to contraction in manufacturing and mining activities. The contraction was particularly sharp in capital goods with a y-o-y decline of 25.5 per cent, reinforcing the investment decline story emerging from the GDP numbers.

Other indicators also suggest a similar tendency, though by no means as dramatic as the IIP. The HSBC purchasing managers' index (PMI) for manufacturing suggested further moderation in growth in November 2011. However, PMI-services index recovered in November from contractionary levels in the preceding two months. Corporate margins in Q2 of 2011-12 moderated significantly as compared with their levels in Q1. The decline in margins was largely on account of higher input and interest costs. Pricing power is evidently declining.

On the food front, the progress of sowing under major *rabi* crops so far has been satisfactory, with area sown under foodgrains and pulses so far being broadly comparable with that of last year.

Inflation

On a y-o-y basis, headline WPI inflation moderated to 9.1 per cent in November from 9.7 per cent in October, driven largely by decline in primary food articles inflation. Fuel group inflation went up marginally. Notably, non-food manufactured products inflation remains elevated, actually increasing to 7.9 per cent in November from 7.6 per cent in October, reflecting rising input costs. The new combined (rural and urban) consumer price index (base: 2010=100) rose further to 114.2 in October from 113.1 in September. Inflation in terms of other consumer price indices was in the range of 9.4 to 9.7 per cent in October 2011. Reassuringly, headline momentum indicators, such as the seasonally adjusted month-on-month and 3-month moving average rolling quarterly inflation rate, show continuing signs of moderation.

External sector

Merchandise exports growth decelerated sharply to an average of 13.6 per cent y-o-y in October-November from an average of 40.6 per cent in the first half of 2011-12. However, as imports moderated less than exports, the trade deficit widened, putting pressure on the current account. This, combined with rebalancing of global portfolios by foreign institutional investors and the tendency of exporters to defer repatriating their export earnings, has led to significant pressure on the rupee.

As on December 15, 2011, the rupee had depreciated by about 17 per cent against the US dollar over its level on August 5, 2011, the day on which the US debt

downgrade happened. In the face of this, several measures were taken to attract inflows. Limits on investment in government and corporate debt instruments by foreign investors were increased. The ceilings on interest rates payable on non-resident deposits were raised. The all-in-cost ceiling for external commercial borrowings was increased. Further, a series of administrative measures that discourage speculative behaviour were also initiated. The Reserve Bank is closely monitoring the developments in the external sector and it will respond to the evolving situation as appropriate.

Fiscal Situation

The central government's key deficit indicators worsened during 2011-12 (April-October), primarily on account of a decline in revenue receipts and increase in expenditure, particularly subsidies. The fiscal deficit at 74.4 per cent of the budgeted estimate in the first seven months of 2011-12 was significantly higher than 42.6 per cent in the corresponding period last year (about 61.2 per cent if adjusted for more than budgeted spectrum proceeds received last year). The likely slippage in this year's fiscal deficit has inflationary implications.

Money, Credit and Liquidity Conditions

The y-o-y money supply (M_3) growth moderated from 17.2 per cent at the beginning of the financial year to 16.3 per cent on December 2, 2011, although still higher than the projected trajectory of 15.5 per cent for the year. Y-o-y non-food credit growth at 17.5 per cent on December 02, 2011, however, was below the indicative projection of 18 per cent.

Consistent with the stance of monetary policy, liquidity conditions have remained in deficit during this fiscal year. However, the deficit increased significantly beginning the second week of November 2011. The average borrowings under the daily LAF increased to around ₹ 89,000 crore during November-December (up to December 15, 2011) from around ₹ 49,000 crore during April-October 2011. The Reserve Bank conducted open market operations (OMOs) on three occasions in November-December 2011 for an amount aggregating about ₹ 24,000 crore to ease liquidity conditions.

There are currently no significant signs of stress in the money market. The overnight call money rate is stable around the policy repo rate and liquidity facilities such as marginal standing facility (MSF) remain unutilised. However, in view of the fact that borrowings from the LAF are persistently above the Reserve Bank's comfort zone, further OMOs will be conducted as and when seen to be appropriate.

Outlook

Global growth for 2011 and 2012 is now expected to be lower than earlier anticipated. Increased strains in financial markets on the back of growing concerns over euro area sovereign debt, limited monetary and fiscal policy manoeuvrability, high unemployment rates, weak housing markets and elevated oil prices are all contributory factors. These factors have also contributed to moderating growth in the EMEs. As a consequence of all-round slower growth, inflation has also started declining, both in advanced countries and EMEs.

On the domestic front, agricultural prospects look promising on the back of expected record *kharif* output and satisfactory progress on *rabi* sowing. However, industrial activity is moderating, driven by deceleration in investment, which is a matter of serious concern. Overall, the growth momentum in the economy is clearly moderating. Further, considering the global and domestic macroeconomic situation, the downside risks to the Reserve Bank's growth projection, as set out in the SQR,

have increased significantly.

Between the First Quarter Review (FQR) and the SQR, while non-oil commodity prices had declined significantly, the rupee too had depreciated sharply. Consequently, the headline inflation projection at 7 per cent for March 2012, as set out in the FQR, was retained in the SQR. With moderation in food inflation in November 2011 and expected moderation in aggregate demand and hence in non-food manufactured products inflation, the inflation projection for March 2012 is retained at 7 per cent.

The Reserve Bank will make a formal numerical assessment of its growth and inflation projections for 2011-12 in the third quarter review of January 2012.

Guidance

While inflation remains on its projected trajectory, downside risks to growth have clearly increased. The guidance given in the SQR was that, based on the projected inflation trajectory, further rate hikes might not be warranted. In view of the moderating growth momentum and higher downside risks to growth, this guidance is being reiterated. From this point on, monetary policy actions are likely to reverse the cycle, responding to the risks to growth.

However, it must be emphasised that inflation risks remain high and inflation could quickly recur as a result of both supply and demand forces. Also, the rupee remains under stress. The timing and magnitude of further actions will depend on a continuing assessment of how these factors shape up in the months ahead.

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