RESERVE BANK OF INDIA
BULLETIN

AUGUST 2013

VOLUME LXVII NUMBER 8

The Reserve Bank of India Bulletin is issued monthly by the Department of Economic and Policy Research, Reserve Bank of India, under the direction of the Editorial Committee.

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MONETARY POLICY STATEMENT 2013-14

First Quarter Review of Monetary Policy 2013-14
by Duvvuri Subbarao, Governor, Reserve Bank of India

Macroeconomic and Monetary Developments -
First Quarter Review 2013-14

*First Quarter Review of Monetary Policy 2013-14**

Introduction

Since early May when the Reserve Bank issued its Monetary Policy Statement for 2013-14, global growth has been uneven and slower than initially expected. The tail risks to global recovery had eased in the early part of the year, but that improvement was overtaken by the turmoil in financial markets because of the 'announcement effect' of the likely tapering of quantitative easing (QE) by the US Fed. In advanced economies (AEs), activity has weakened. Emerging and developing economies (EDEs) are slowing, and are also experiencing sell-offs in their financial markets, largely due to the safe haven flight of capital. Market expectations of QE taper and the consequent increase in real interest rates in the US have translated into a rapid appreciation of the US dollar and consequent depreciation of EDE currencies. Commodity prices have generally softened, but the price of crude remains elevated. Although the inflation outlook in AEs is still benign, upside risks remain in several EDEs.

2. On the domestic front, the foreign exchange market came under severe stress starting late May, prompting the Reserve Bank to initiate liquidity tightening measures to contain the volatility. As regards economic activity, risks to growth have increased notwithstanding the robust onset and spread of the monsoon. Industrial production has slumped, with lead indications of declining order books and input price pressures building on rupee depreciation. Meanwhile, depressed global conditions are undermining export performance, even as heightened volatility in capital flows has raised external funding risks. Wholesale price inflation pressures are on the ebb, but retail inflation remains high. Monetary policy going forward will be shaped by the considerations of supporting growth, anchoring inflation expectations and maintaining external sector stability.

3. In the above context, this Statement should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

4. This Statement is organised in four Sections: Section I provides an overview of global and domestic macroeconomic developments. Section II sets out the domestic outlook and projections for growth, inflation and monetary aggregates. Section III explains the stance of monetary policy. Section IV specifies the monetary measures.

I. The State of the Economy

Global Economy

5. Global economic activity remains subdued with still elevated downside risks. In the US, incoming data point to a slower recovery in domestic demand and weak export activity. In the UK, recovery is gradually gathering momentum on the back of consumer spending. The euro area continues to be in recession with high unemployment. Japan's economy is returning to positive growth with improved industrial production and retail sales.

6. Among the BRICS countries, although retail sales in China have maintained the impetus of recent months, the manufacturing purchasing managers' index (PMI) and industrial production declined in June. Growth has clearly lost momentum in Brazil, Russia and South Africa.

7. Inflation remains subdued in AEs, but in several EDEs upside pressures persist. In China, inflation quickened in June, although it is expected to stay benign due to weak demand conditions. Inflation dropped sharply in Russia in June due to softening food prices.

* Announced by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India on July 30, 2013 in Mumbai.

8. Non-fuel commodity prices have been easing, reflecting subdued global demand and comfortable supply levels. On the other hand, energy prices have firmed up due to a decline in US crude oil inventories and geo-political tensions in the Middle East.

Domestic Economy

9. Domestic economic activity weakened in Q1 of 2013-14. Lead indicators point to continuing headwinds facing manufacturing and services sector activity.

10. Industrial production remained muted at 0.1 per cent during April-May; in May, there was an absolute decline of 1.6 per cent spread across all constituent sub-sectors, barring electricity generation. Capital goods production continues to contract, reflecting deteriorating investment conditions. Although the manufacturing PMI improved modestly in June, the pace of expansion was anaemic. With the decline in the services sector PMI in June, the composite PMI fell too, suggesting broad-based sluggishness in economic activity.

11. Spurred by the timely arrival of the monsoon and above long period average rainfall so far (17 per cent excess up to July 26, 2013), *kharif* sowing has been significantly higher than a year ago, with total sown area at 74.8 million hectares as on July 26 as against 63.5 million hectares recorded by the same time last year. To date, all regions, except the east and the northeast, have received normal/excess rainfall.

12. The deceleration in new orders growth reported in the Reserve Bank's order books, inventories and capacity utilisation survey (OBICUS) indicates low activity levels in Q1. This is corroborated by the Reserve Bank's industrial outlook survey (IOS) which indicates that the overall business sentiment remained subdued in Q1 and may improve only marginally in Q2. Early results of corporate performance in Q1 suggest that sales growth and profit margins remained subdued.

13. Headline inflation, as measured by the wholesale price index (WPI), edged up slightly to 4.9 per cent in June 2013 after declining for five months on a clip. The pickup was mainly driven by a spurt in food inflation, especially in respect of vegetables and cereals. Fuel inflation declined due to the reduction in coal prices in March 2013, supported by base effects in the case of electricity prices. Non-food manufactured products inflation fell to 2.0 per cent in June, the lowest since December 2009, mainly due to a decline in inflation in respect of chemicals and continuing deflation in metal prices.

14. Retail inflation, as measured by the Consumer Price Index [(CPI) new series], had moderated somewhat during April-May, but it surged close to double digits in June, driven primarily by a sharp increase in food prices.

15. Among other indicators, urban households' inflation expectations, as per the latest round of the Reserve Bank's survey, remained at elevated levels in Q2. Rural wages, which had been rising at an annual average of 20 per cent for 28 months, moderated since January 2013. According to the Reserve Bank's quarterly house price index, increase in house prices also moderated in Q4 of 2012-13.

16. Money supply (M_3), at 12.8 per cent y-o-y on July 12, was close to the indicative trajectory of 13.0 per cent. On the other hand, non-food credit growth at 14.3 per cent was lower than the indicative projection of 15.0 per cent, with the slowdown spread across all major sectors. The Reserve Bank's credit conditions survey shows that overall credit conditions are expected to remain broadly unchanged in Q2, though some tightening is expected in sectors such as construction, infrastructure, commercial real estate and finance.

17. The flow of resources to the commercial sector, from both bank and non-bank sources, at ₹2.6 trillion in 2013-14 so far (up to July 12), was higher than a year ago. While the contribution of domestic non-bank sources declined, there was an increase in resources raised from domestic banks and from abroad, especially

through external commercial borrowings (ECBs) and foreign direct investment (FDI).

18. Liquidity conditions have eased considerably since the May Policy. The average daily net liquidity injection under the liquidity adjustment facility (LAF) declined to ₹828 billion during Q1 from ₹1,078 billion during Q4 of 2012-13. Government balances have been in deficit since June 28 and have bolstered liquidity, thereby significantly reducing the demand for funds under the LAF. The net drawal from the LAF declined significantly during the first week of July. On July 26, it stood at ₹558 billion [including ₹229 billion from the marginal standing facility (MSF)].

19. Following the reduction in the repo rate in May and easing of liquidity conditions, the modal term deposit rate of scheduled commercial banks (SCBs) declined by 5 basis points (bps) during Q1. Although the modal base rate remained unchanged during the quarter, the weighted average lending rate (WALR) on the outstanding rupee loans of SCBs declined by 6 bps during Q1. The WALR for fresh loans, particularly for housing and commercial vehicles sectors, declined significantly during this period.

20. During April-May, the Central Government's key deficit indicators as a proportion to the budget estimates were higher than a year ago, mainly on account of higher plan and capital expenditures, and decline in tax revenues by as much as 7.9 per cent. Up to July 25, 40.8 per cent of the net market borrowings of the Central Government was completed.

21. The CAD moderated to 3.6 per cent of GDP in Q4 of 2012-13, down from 6.5 per cent in Q3, due to a narrowing of the trade deficit. However, for the year 2012-13 as a whole, the CAD was 4.8 per cent of GDP, well above the sustainable level of 2.5 per cent of GDP estimated by the Reserve Bank.

22. In the current year, the trade deficit widened during Q1 over its level a year ago, mainly on account of deteriorating export performance. Financing came by way of higher FDI, net ECBs and accretion to non-resident deposits, with some use of reserves.

23. Beginning late May, following some comments of the US Fed, apprehensions of likely tapering of QE in the US triggered outflows of portfolio investment, particularly from the debt segment. Several measures were instituted to contain the ensuing exchange market volatility and to reverse unidirectional expectations. First, to curb import demand, import of gold on consignment basis was restricted on June 4 and customs duty was raised on June 5. Second, this was followed up on July 8 with further measures, including restricting banks to trade only on behalf of their clients in currency futures/options markets, tightening of exposure norms, and raising margins on currency derivatives to check speculative activities.

24. On July 15, the Reserve Bank put in place additional measures to restore stability to the foreign exchange market. They included raising the MSF rate by 200 bps to 10.25 per cent, restricting the overall access by way of repos under the LAF to ₹750 billion and conducting open market sales of government securities of ₹25 billion on July 18, 2013. As a contingency measure and in anticipation of redemption pressures on mutual funds, the Reserve Bank opened a dedicated Special Repo window for a notified amount of ₹250 billion for liquidity support to mutual funds.

25. On July 22, the Reserve Bank rationalised import of gold by making it incumbent on all nominated banks/entities to ensure that at least one fifth of imported gold is exclusively made available for the purpose of exports. Any import of gold under any type of scheme will have to follow this 20/80 formula. Consequent to this, the earlier instructions banning the import of gold on consignment basis were withdrawn.

26. On July 23, the Reserve Bank modified the liquidity tightening measures by regulating access to LAF by way of repos at each individual bank level and restricting it to 0.5 per cent of the bank's own NDTL. This measure

came into effect from July 24, 2013. The cash reserve ratio (CRR), which banks have to maintain on a fortnightly average basis subject to a daily minimum requirement of 70 per cent, was modified to require banks to maintain a daily minimum of 99 per cent of the requirement.

II. Domestic Outlook and Projections

Growth

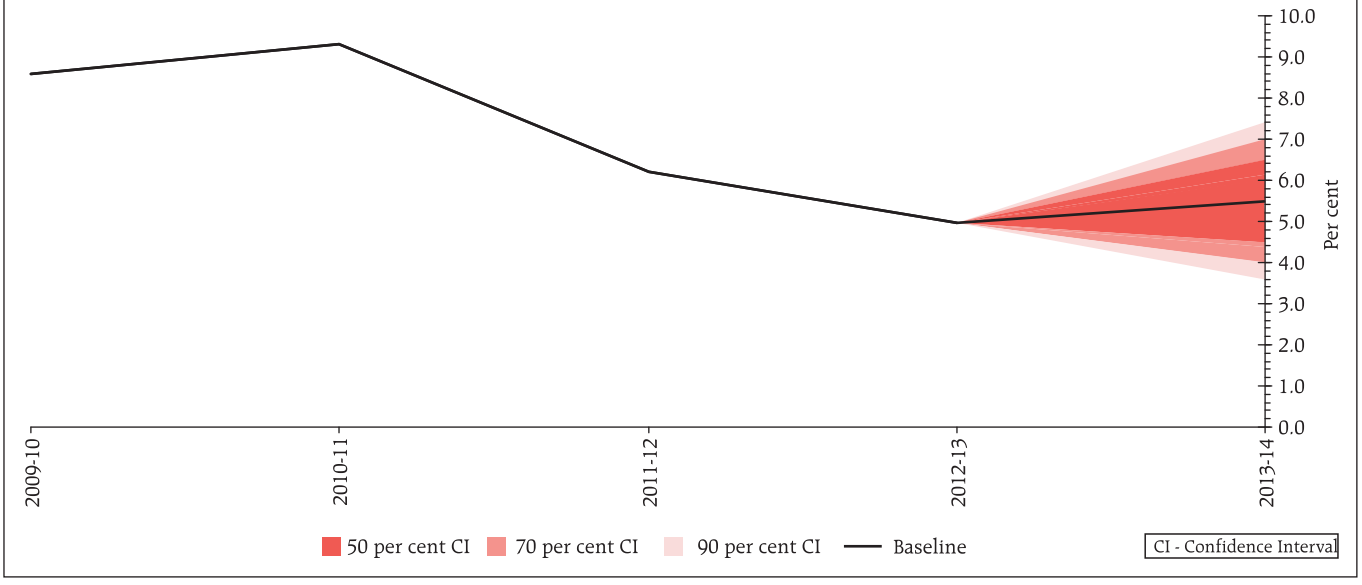
27. In the May Policy, the Reserve Bank projected GDP growth for 2013-14 of 5.7 per cent, conditional upon a normal monsoon returning agricultural growth to its trend level. The outlook for industrial activity, however, was expected to remain subdued, and growth in services and exports was expected to stay sluggish owing to global growth not improving significantly.

28. Activity, both domestic and global, has evolved in line with these expectations. While the onset of the monsoon and its spread have been robust, the persisting weakness in industrial activity has heightened the risks to growth. Moreover, global growth has been tepid, with some signs of loss of momentum in the US and in EDEs on top of the ongoing contraction in the euro area. This has impacted world trade with consequent adverse spillovers on India's exports, manufacturing and services. Over the last one year, the Government has taken several policy initiatives to improve the investment environment. As these initiatives work through the system and are further built upon, the current slowdown could be reversed, returning the economy to a higher growth trajectory. On the basis of the above considerations, the growth projection for 2013-14 is revised downwards from 5.7 per cent to 5.5 per cent (Chart 1).

Inflation

29. In the May Policy, the Reserve Bank indicated that during 2013-14, WPI inflation will be range-bound around 5.5 per cent, with some edging down in the first half and some increase in the second half, mainly on base effects. During Q1 of 2013-14, the inflation trajectory has moved largely in line with these expectations, although some risks to the path of inflation have surfaced in June. The stronger than expected monsoon has not yet softened food inflation as much as it should have. In particular, vegetable prices have been impacted by weather-driven supply disruptions. While the outlook for global non-oil commodity prices remains benign, international crude oil prices are firming up. This is reflected in an upward

Chart 1: Projection of GDP Growth (y-o-y) for 2013-14



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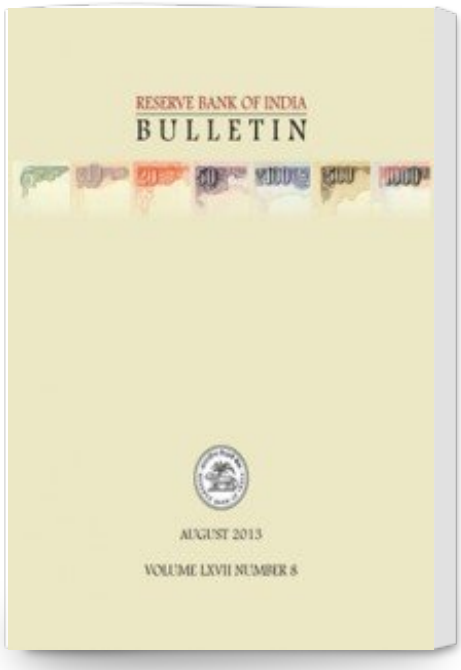

Publisher : ICSI

Author : Reserve Bank of India