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Introduction

Since the Second Quarter Review (SQR) of Monetary Policy in October 2012, headwinds holding back the global economy have begun to abate gradually, although sluggish conditions prevail. In the US, activity gathered momentum in Q3 of 2012 but this is unlikely to have been sustained in Q4. While a political consensus to avert the 'fiscal cliff' has calmed financial markets, how the debt ceiling is managed will be crucial in shaping market sentiment on the way forward. The euro area economy is threatened by continuing contraction, notwithstanding the liquidity firewall of the European Central Bank (ECB) and the commitment to act collectively to backstop the union. Overall, however, risks of the sovereign debt crisis disrupting the global financial system have ebbed. Japan has re-entered recession. Among the emerging and developing economies (EDEs), a pick-up in the pace of growth in China is likely. A combination of a slump in external demand and domestic structural bottlenecks has slowed down growth in most other EDEs. Furthermore, inflationary pressures persist in some of them. Overall, global economic prospects have improved modestly since the SQR even as significant risks remain.

2. Domestically, growth remains sluggish, notwithstanding some tentative signs of the slowdown beginning to level off. Industrial activity weakened, reflecting subdued manufacturing, deceleration in electricity generation and contraction in mining activity. While the series of policy measures announced by the Government has boosted market sentiment, the investment outlook is still lacklustre, especially in terms of demand for new projects. Consumption demand too is slowing. As regards prospects for agriculture, whether the *rabi* output will offset the shortfall in the *kharif* output is as yet unclear. Lead indicators of service sector activity point to an expansion in the months ahead, *albeit* constrained by the drag imposed by depressed global demand conditions.

3. Headline wholesale price inflation, led by non-food manufactured products inflation, has softened through Q3, providing some relief from the persistence that dominated the first half of the year. On the other hand, food inflation has edged up, pushing up consumer price inflation in turn. Lead indicators such as weaker pricing power of corporates, excess capacity in some sectors, the possibility of international commodity prices stabilising as assessed by the International Monetary Fund (IMF) and momentum measures suggest that inflationary pressures have peaked. However, further moderation in domestic inflation going into 2013-14 is likely to be muted as the correction of under-pricing of administered items is still incomplete and food inflation remains elevated. Accordingly, the setting of monetary policy has to remain sensitive to conflicting pressures and attendant risks.

4. This policy review is accordingly set in the context of a slowly improving global environment and a tipping point in the balance of risks between growth and inflation on the domestic front. It should be read and understood together with the detailed review in*Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

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

I. The State of the Economy

Global Economy

6. Signs of stabilisation in global economic activity have been in evidence in recent months, led by stronger than expected growth in the US in Q3, acceleration in the pace of activity in China and a pick-up

in industrial production in EDEs in Q4. Activity in the euro area continues to be in a contraction mode, though financial market confidence has improved. Japan has embarked on a fresh fiscal stimulus following contraction in Q3. In the UK, a modest GDP growth in Q3 was followed by a decline in Q4. The HSBC Emerging Market Index rose in Q4. The global composite purchasing managers' index (PMI) also rose marginally in December.

7. According to the IMF, consumer price inflation has eased in both advanced economies (AEs) and EDEs in 2012. However, risks to the inflation outlook from commodity price pressures persist.

Domestic Economy

8. Year-on-year (y-o-y) real GDP growth slowed from 5.5 per cent in Q1 of 2012-13 to 5.3 per cent in Q2. The decline in the GDP growth rate became broad based, with consumption demand also slowing alongside stalling investment and declining exports. On the supply side, there are indications of weakening resilience of services to sluggish global growth.

9. Looking ahead, there are some tentative signs of a reversal in momentum. While industrial production slowed to a y-o-y increase of 1.0 per cent in April-November 2012, the seasonally adjusted three-month moving average of the index of industrial production (IIP) points to a pick-up. The manufacturing PMI rose in December on the back of higher order book volumes and new export orders. The services purchasing managers' index (PMI) also rose in December on expectations of a revival of demand. The Reserve Bank's industrial outlook survey indicates positive business sentiment in Q3 and Q4. Coverage under *rabi* sowing has been broadly the same as in the corresponding period of last year.

10. Headline wholesale price index (WPI) inflation eased significantly from 8.1 per cent in September 2012 to 7.2 per cent by December. Notably, inflation on account of non-food manufactured products, which have a weight of 55 per cent in the WPI, fell sharply in November-December as input price pressures eased primarily on the back of ebbing metal, non-metallic minerals and chemicals group inflation. The seasonally adjusted three-month moving average annualised inflation also suggests a moderation in headline as well as non-food manufactured products inflation. With the industrial outlook survey also pointing to softening of the rate of increase of output prices, the pricing power of corporates seems to have weakened. Fuel group inflation moderated in December, mainly reflecting the tempering of inflation of non-administered petroleum products as well as the range-bound exchange rate of the rupee.

11. Food inflation, on the other hand, showed a contrarian behaviour, moving into double digits in December. Significant price pressures emanated from cereals. Prices of pulses and other protein-based food items remained elevated. Furthermore, with the firming up of prices of edible oils and grain mill products, the overall momentum in food inflation remained firm.

12. Inflation based on the new combined (rural and urban) consumer price index (CPI) (Base: 2010=100) rose to 10.6 per cent in December, largely reflecting the surge in food inflation. Excluding food and fuel groups, CPI inflation remained unchanged at 8.4 per cent during Q3.

13. According to the latest Reserve Bank's urban households' survey, inflation expectations for Q4 edged up marginally. Wage inflation in rural areas remained high, notwithstanding some recent moderation; as these wage increases have not been accompanied by improvement in productivity, they have imparted inflationary pressures. House price inflation, as measured by the Reserve Bank's quarterly house price index, also remains elevated on a y-o-y basis.

14. Analysis of the early results of corporate performance in Q3 indicates that both sales and expenditure growth moderated while profit margins remained broadly unchanged.

15. Y-o-y money supply (M_3) growth fell to 12.9 per cent by mid-January and remained below the indicative trajectory of 14.0 per cent. This essentially reflected the deceleration of growth in aggregate deposits and moderation in economic activity.

16. Y-o-y non-food credit growth, at 16.2 per cent by mid-January, was around the indicative trajectory. However, bank credit to industry showed a significant deceleration while credit to agriculture registered an increase.

17. The estimated total flow of financial resources to the commercial sector for the current financial year up to mid-January was`9.6 trillion, higher than `8.1 trillion during the corresponding period last year. This was mainly due to increase in bank credit and subscriptions by non-banks to commercial paper.

18. As regards monetary policy transmission during Q3 of 2012-13, the average term deposit rates of scheduled commercial banks (SCBs) declined marginally. Although a few banks reduced their Base Rates modestly during the quarter, the weighted average lending rate as well as the modal Base Rate remained broadly unchanged over the quarter.

19. Liquidity conditions tightened from the second week of November on account of a build-up in the Centre's cash balances, festival-related lumpy increase in currency demand, and structural pressures brought on by the widening wedge between deposit growth and credit growth. Anticipating liquidity pressures, the Reserve Bank had lowered the cash reserve ratio (CRR) successively in the Mid-Quarter Review (MQR) in September and in the SQR in October. In addition, the Reserve Bank conducted open market operations (OMOs) on five occasions during December 2012 to January 2013, thereby injecting liquidity of `470 billion into the banking system. Despite these measures, the average net LAF borrowings at `910 billion in January (up to January 27), were above the Reserve Bank's comfort level.

20. The government securities (G-Secs) market recorded increased turnover, with yields easing substantially in January. The equity market rose further in Q3 of 2012-13 on account of improved sentiment and pick-up in inflows from foreign institutional investors (FIIs).

21. Exports contracted in December for the eighth month in succession, reflecting depressed external demand conditions and structural bottlenecks. On the other hand, imports rose on the back of higher oil and gold imports, consequently widening the merchandise trade deficit in Q3 compared to its level a year ago. On top of the large trade deficit, the slowdown in net exports of services and larger outflows of investment income payments is expected to widen the current account deficit (CAD) further in Q3, beyond the level of 5.4 per cent of GDP recorded in Q2 of 2012-13.

22. So far, net capital flows have been sufficient to finance the CAD. Higher net inflows of portfolio investment and accretions to non-resident deposits compensated for lower net external commercial borrowings and foreign direct investment (FDI) into India. Even though net capital flows have been strong, the sheer size of the external financing requirement imposed by the large CAD has brought to bear downward pressures on the rupee which depreciated in nominal and real terms by January 2013 relative to its level in March 2012.

23. Various measures undertaken by the Government since mid-September, including liberalisation of FDI in retail, aviation, broadcasting and insurance, deferment of general anti-avoidance rules (GAAR), reduction in withholding tax on overseas borrowings by domestic companies and setting up of the Cabinet Committee on Investment have significantly lifted market sentiment which, in due course, should spur investment. Alongside, measures such as progressive deregulation of administered fuel prices, with concerted efforts to adhere to fiscal discipline and carry forward consolidation can potentially correct the twin deficits. These policy actions could help engender stable macroeconomic conditions and return the economy to its high growth trajectory. Further reforms to raise productivity, improve competitiveness and manage the supply constraints, including augmenting energy availability, are crucial for raising the potential growth path in the medium-term.

II. Outlook and Projections

Global Outlook

Growth

24. While the improvement in global financial conditions is supportive of global growth prospects for 2013, the recovery is likely to be anaemic and is also fraught with significant downside risks. The outlook for AEs generally remains weak. Despite manufacturing stabilising in Q4 of 2012 and forward-looking indicators of services activity showing an uptick, growth in 2013 is most likely to be tepid in view of the persisting drag from high unemployment, continuing deleveraging, financial fragility, persisting sovereign risks and fiscal tightening, all feeding into one another through negative feedback loops. Breaking out of this downward spiral will depend on resolute structural reforms and credible fiscal consolidation. For EDEs, weakness in external demand is expected to be a major factor holding back resumption of strong growth in 2013. Taking stock of all this in its latest World Economic Outlook update (January 2013), the IMF revised its forecast of global growth for 2013 downwards to 3.5 per cent from 3.6 per cent projected in October 2012.

Inflation

25. Inflation rates remain subdued in most AEs, reflecting large output gaps and downward pressure on wages. Although inflation receded in a majority of EDEs during 2012, it remained stubbornly high in South Asia, Latin America and the Caribbean. Elevated oil prices and country-specific supply-side constraints may continue to put upward pressure on inflation in EDEs through 2014. Given the subdued global demand, the IMF forecasts oil prices to somewhat soften in 2013. However, there are upside risks from geo-political factors and supply disruptions.

Domestic Outlook

Growth

26. The Reserve Bank's projection of GDP growth for 2012-13 in the First Quarter Review (FQR) of July 2012 was 6.5 per cent. In the SQR of October, this was revised downwards to 5.8 per cent, signalling increasing global risks as well as accentuated domestic risks on account of halted investment demand, moderation in consumption spending and erosion in export performance. Since then, industrial activity has remained subdued. Sluggish external demand continues to inhibit improvement in services. While the coverage of *rabi* sowing has picked up, severe winter in certain parts has endangered crop prospects. New investment demand, which should be the key driver of the upturn, continues to be weak. While the series of policy initiatives by the Government has boosted market sentiment, it will take some time to reverse the investment slowdown and reinvigorate growth. Accordingly, the baseline projection of GDP growth for 2012-13 is revised down from 5.8 per cent given in the SQR to 5.5 per cent (Chart 1).

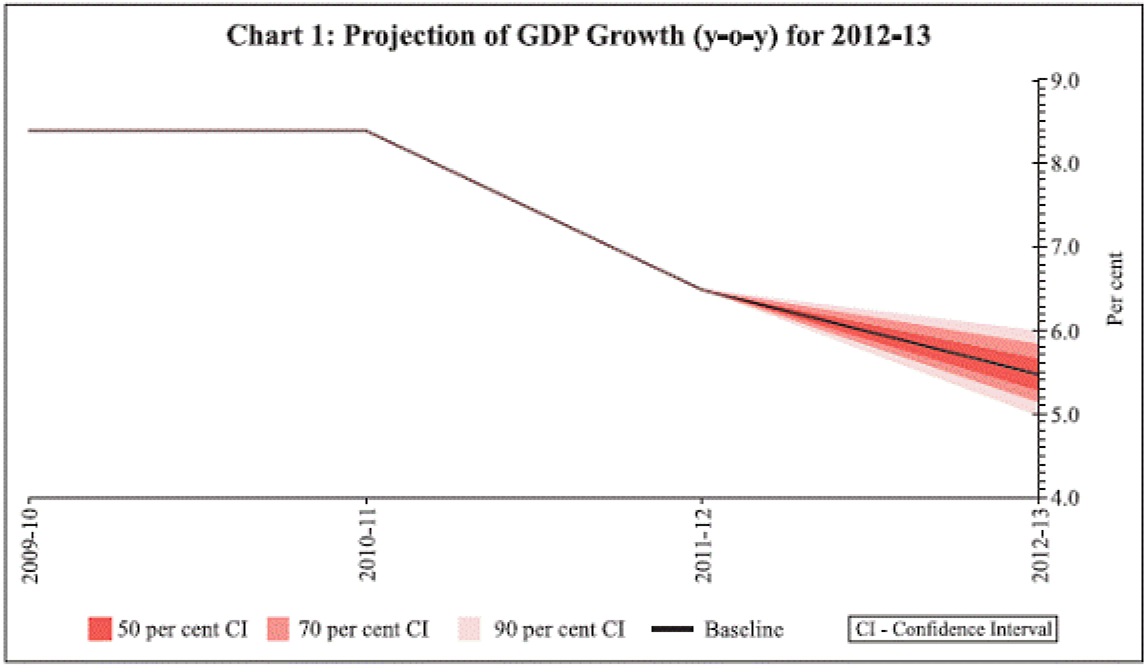
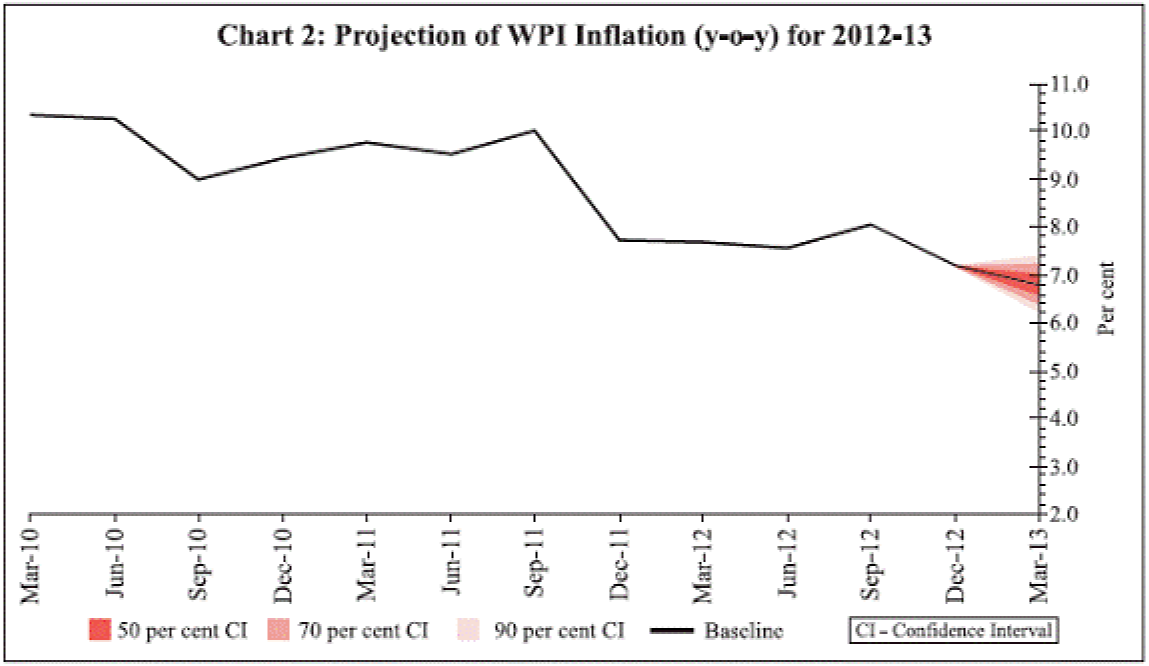


Chart 1: Projection of GDP Growth (y-o-y) for 2012-13

Inflation

27. The substantial easing of non-food manufactured products inflation over Q3 in an environment of slower growth and excess capacity in some sectors suggests that inflation has come off its peak. However, it is expected to be range-bound around current levels due to persisting food inflation, the pass-through of diesel price adjustments over the next several months and the possibility of adjustment in other administered prices. If international commodity prices, including of crude, move further downwards, they should cushion the phased increase in diesel prices, provided they are not offset by currency movements. A sustained reduction in inflation pressure is, however, contingent upon alleviation of supply constraints and progress on fiscal consolidation. This will also help mitigate the cost-push pressures stemming from the surge in wages. Keeping in view the expected moderation in non-food manufactured products inflation, domestic supply-demand balances and global trends in commodity prices, the baseline WPI inflation projection for March 2013 is revised downwards from 7.5 per cent set out in the SQR to 6.8 per cent (Chart 2).



28. Although inflation has remained persistently high over the past two years, it is important to note that during the 2000s, it averaged around 5.5 per cent, both in terms of WPI and CPI, down from its earlier trend rate of about 7.5 per cent. Given this record, the conduct of monetary policy will continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent. This is in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy.

Monetary Aggregates

29. Money supply (M_3) growth has been below its indicative trajectory for 2012-13 so far, while non-food credit growth has been around the projection. Keeping in view the seasonal pattern for the last quarter, M_3 growth projection for 2012-13 has been scaled down to 13.0 per cent from 14.0 per cent while non-food credit growth projection is retained at 16.0 per cent. These numbers, as always, are indicative projections and not targets.

Risk Factors

30. Macroeconomic management going forward is subject to a number of risks as indicated below:

i) Domestically, the widening of the CAD to historically high levels in the context of a large fiscal deficit and slowing growth exposes the economy to the risks from twin deficits. Financing the CAD with increasingly risky and volatile flows increases the economy's vulnerability to sudden shifts in risk appetite and liquidity preference, potentially threatening macroeconomic and exchange rate stability. Large fiscal deficits will accentuate the CAD risk, further crowd out private investment and stunt growth impulses.

ii) Global risks remain elevated, with the potential for spillovers on the Indian economy through trade, finance and confidence channels. In the US, the risk of political inaction to manage the debt ceiling or even a sudden onset of fiscal austerity can lead to turmoil in financial markets, followed by a downturn in economic activity. Escalation of the euro area sovereign debt stress in view of the continuing absence of credible and comprehensive policy responses remains a contingent global risk, along with geopolitical tensions that can adversely impact supplies/prices of key commodities, particularly of crude oil. These forces can potentially increase global risk aversion with implications for financing of the CAD.

iii) Inflation over the last three years has been a result of demand pressures as well as supply constraints. With demand pressures now on the ebb, the supply constraints need to be urgently addressed. This will require developing an adequate, credible and flexible supply response in respect of those commodities and segments of the economy characterised by structural imbalances. In the absence of an effective supply response, inflationary pressures may return and persist with adverse implications for macroeconomic stability.

iv) The key to stimulating growth is a vigorous and sustained revival in investment. Achieving this will, however, depend on a number of factors such as bridging the infrastructure gaps, especially in power and transport, hastening approvals, removing procedural bottlenecks, and improving governance.

v) Risk aversion in the banking system stemming from concerns relating to asset quality is constraining credit flow. Notwithstanding the importance of repairing asset quality, banks should be discerning in their loan decisions and ensure adequate credit flow to productive sectors of the economy.

III. The Policy Stance

31. Since October 2011, the stance of monetary policy shifted to addressing increasing growth risks as reflected in the slowing down of the economy. The monetary policy response was, however, constrained because of inflation broadening and persisting at a level much above what is conducive for sustained growth. The risk of expectations getting entrenched in the event of a premature change in the policy stance was significant. Notwithstanding the constraints, the CRR was reduced cumulatively by 125 basis points during January-March 2012 to prepare liquidity conditions for a front-loaded 50 basis points reduction in the policy repo rate in April. However, the Reserve Bank had to pause in its policy rate reduction as the expected complementary policy actions towards fiscal adjustment and improving the investment climate did not follow, and inflation risks persisted. Nevertheless, the Reserve Bank persevered with efforts to ease credit and liquidity conditions through a 100 basis points reduction in the statutory liquidity ratio (SLR) in July and a cumulative 50 basis points reduction in the CRR during September-October.

32. Against this backdrop of global and domestic macroeconomic conditions, outlook and risks, the policy stance in this review is shaped by two major considerations.

33. First, headline WPI inflation and its momentum edged down in November-December on the back of softening of non-food manufactured products inflation, even though food inflation has risen, adversely impacting households' inflation expectations. The staggered increase in diesel prices announced earlier this month will percolate through to overall costs and inflation; however, these price pressures will dissipate over time, and the consequent reduction entailed in the fiscal deficit will bring about an enduring reduction in inflation and inflation expectations. At the same time, still high input costs and wages continue to impart upward pressures on prices. Accordingly, it is critical that even as the monetary policy stance shifts further towards mitigating growth risks, the objective of containing inflation and anchoring inflation expectations is not de-emphasised.

34. Second, growth has decelerated significantly below trend through 2011-12 and 2012-13 so far and overall economic activity remains subdued. On the demand side, investment activity has been way below desired levels and consumption demand has started to decelerate. External demand has also weakened due to the slowdown in global growth. On the supply side, constraints in the availability of key raw materials and intermediates are becoming binding. In turn, this is being reflected in a widening of the CAD with adverse implications for external sustainability. While the monetary policy stance has sought to balance the growth-inflation dynamic through calibrated easing, it is critical now to arrest the loss of growth momentum without endangering external stability. The moderation in inflation conditions provides the opportunity for monetary policy to act in conjunction with fiscal and other measures to stem the growth risks.

35. Against this backdrop, the stance of monetary policy in this review is intended to:

- provide an appropriate interest rate environment to support growth as inflation risks moderate;
- contain inflation and anchor inflation expectations; and
- continue to manage liquidity to ensure adequate flow of credit to the productive sectors of the economy.

IV. Monetary Measures

36. On the basis of current assessment and in line with the policy stance outlined in Section III, the Reserve Bank announces the following policy measures:

Repo Rate

37. It has been decided to:

- reduce the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 8.0 per cent to 7.75 per cent with immediate effect.

Reverse Repo Rate

38. The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, stands adjusted to 6.75 per cent with immediate effect.

Marginal Standing Facility (MSF) Rate

39. The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, stands adjusted to 8.75 per cent with immediate effect.

Bank Rate

40. The Bank Rate stands adjusted to 8.75 per cent with immediate effect.

Cash Reserve Ratio

41. It has been decided to:

- reduce the cash reserve ratio (CRR) of scheduled banks by 25 basis points from 4.25 per cent to 4.0 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning February 9, 2013.

42. As a result of this reduction in the CRR, around `180 billion of primary liquidity will be injected into the banking system.

Guidance

43. With headline inflation likely to have peaked and non-food manufactured products inflation declining steadily over the last few months, there is an increasing likelihood of inflation remaining range-bound around current levels going into 2013-14. This provides space, *albeit* limited, for monetary policy to give greater emphasis to growth risks. The above policy guidance will, however, be conditioned by the evolving growth-inflation dynamic and the management of risks from twin deficits.

Expected Outcomes

44. The policy actions and the guidance in this Statement given are expected to:

i) support growth by encouraging investment;

ii) continue to anchor medium-term inflation expectations on the basis of a credible commitment to low and stable inflation; and

iii) improve liquidity conditions to support credit flow.

Mid-Quarter Review of Monetary Policy 2012-13

45. The next mid-quarter review of Monetary Policy for 2012-13 will be announced through a press release on Tuesday, March 19, 2013.

Monetary Policy 2013-14

46. The Monetary Policy for 2013-14 is scheduled on Friday, May 3, 2013.

Mumbai
January 29, 2013

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