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Mid-Quarter Monetary Policy Review: September 2013

Monetary and Liquidity Measures

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

- reduce the marginal standing facility (MSF) rate by 75 basis points from 10.25 per cent to 9.5 per cent with immediate effect;
- reduce the minimum daily maintenance of the cash reserve ratio (CRR) from 99 per cent of the requirement to 95 per cent effective from the fortnight beginning September 21, 2013, while keeping the CRR unchanged at 4.0 per cent; and
- increase the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 7.25 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 Bank Rate stands reduced to 9.5 per cent with immediate effect. With these changes, the MSF rate and the Bank Rate are recalibrated to 200 basis points above the repo rate.

Assessment

2. Since the First Quarter Review (FQR) in July, a weak recovery has been taking hold in advanced economies, with growth picking up in Japan and the UK and the euro area exiting recession. However, activity has slowed in several emerging economies, buffeted by heightened financial market turbulence on the prospect of tapering of quantitative easing (QE) in the US. The decision by the US Federal Reserve to hold off tapering has buoyed financial markets but tapering is inevitable.

3. On the domestic front, growth has weakened with continuing sluggishness in industrial activity and services. The pace of infrastructure project completion is subdued and new project starts remain muted. Consumption, while relatively firm so far, is starting to weaken even in rural areas, with durable goods consumption hit hard. Consequently, growth is trailing below potential and the output gap is widening. Some pick-up is expected on account of the brightening prospects for agriculture due to *kharif* output and the upturn in exports. Also, as infrastructure investments are expedited, and as projects cleared by the Cabinet Committee on Investment come on stream, growth could pick up in the second half of the year.

4. WPI inflation, which had eased in Q1 of 2013-14, has started rising again as the pass-through of fuel price increases has been compounded by the sharp depreciation of the rupee and rising international commodity prices. The negative output gap will exercise downward pressure on inflation, and the process will be aided as supply side constraints, especially relating to food and infrastructure, ease. However, the current assessment is that in the absence of an appropriate policy response, WPI inflation will be higher than initially projected over the rest of the year.

What is equally worrisome is that inflation at the retail level, measured by the CPI, has been high for a number of years, entrenching inflation expectations at elevated levels and eroding consumer and business confidence. Although better prospects of a robust *kharif* harvest will lead to some moderation in CPI inflation, there is no room for complacency.

5. Turning to the external sector, weakening domestic saving, subdued export demand and the rising value of oil imports - most recently due to geopolitical risks emanating from the Middle East - have led to a larger current account deficit (CAD). Concerns about funding the CAD, amplified by capital outflows precipitated by anticipated tapering of asset purchases by the US Federal Reserve, increased volatility in the foreign exchange market. More recently, as these concerns have been mitigated after steps taken by the Government and the Reserve Bank to contain the CAD and improve the environment for external financing, the focus has turned to internal determinants of the value of the rupee, primarily the fiscal deficit and domestic inflation.

Policy Stance and Rationale

6. Since mid-July, the Reserve Bank has put in place a number of exceptional measures to tighten liquidity with a view to dampening volatility in the foreign exchange market. These measures have raised the effective policy rate for monetary policy operations to 10.25 per cent, aligned to the re-calibrated MSF rate. The intent has been to maintain tight liquidity conditions at the short end of the term structure until the measures designed to alter the path of the CAD and improve prospects for its stable funding take effect. As a number of these measures are now in place and because the external environment has improved, it is now possible for the Reserve Bank to contemplate easing these exceptional measures in a calibrated manner. As a first step, therefore, the MSF rate is reduced by 75 basis points. Furthermore, the minimum daily maintenance of the CRR prescribed by the Reserve Bank is brought down from 99 per cent of the requirement to 95 per cent. The timing and direction of further actions on exceptional measures will be contingent upon exchange market stability, and can be two-way. Further actions need not be announced only on policy dates. However, any further change in the minimum daily maintenance of the CRR is not contemplated.

7. As the measures are unwound, the objective is to normalise the conduct and operations of monetary policy so as to allow the LAF repo rate to resume its role as the operational policy interest rate. However, inflation is high and household financial saving is lower than desirable. As the inflationary consequences of exchange rate depreciation and hitherto suppressed inflation play out, they will offset some of the disinflationary effects of a better harvest and the negative output gap. The need to anchor inflation and inflation expectations has to be set against the fragile state of the industrial sector and urban demand. Keeping all this in view, bringing down inflation to more tolerable levels warrants raising the LAF repo rate by 25 basis points immediately.

8. The Reserve Bank will closely and continuously monitor the evolving growth-inflation dynamics with a readiness to act pre-emptively, as necessary. The policy stance and measures set out in this review begin the process of cautious unwinding of the exceptional measures, which will restore normalcy to financial flows. They are also intended to address inflationary pressures so as to provide a stable nominal anchor for the economy, thereby mitigating exchange market pressures and creating a conducive environment for the revitalisation of sustainable growth.

Alpana Killawala

Press Release : 2013-14/604 Principal Chief General Manager