

## **Mid-Quarter Monetary Policy Review: March 2011**

### **Monetary Measures**

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

- **increase the repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 6.5 per cent to 6.75 per cent with immediate effect; and**
- **increase the reverse repo rate under the LAF by 25 basis points from 5.5 per cent to 5.75 per cent with immediate effect.**

### **Global Economy**

The global scenario presents a mixed picture. While growth in emerging market economies (EMEs) remains strong, that in the US and the Euro area is clearly gaining momentum. However, the sharp increase in oil prices as a result of the turmoil in the Middle East and North Africa is adding uncertainty to the pace of global recovery. Further, coming on top of already elevated food and other commodity prices, the spike in oil prices has engendered inflation concerns.

Inflationary pressures in EMEs are already high as output gaps have narrowed, while headline inflation has risen noticeably in a number of advanced economies, especially in the Euro area and the UK. Consequently, an increasing number of EMEs have begun monetary tightening, while the debate on exit from the accommodative monetary stance has come to the fore in the advanced economies.

It is as yet too early to assess the macroeconomic consequences of the natural disaster in Japan. As normalcy is restored, expenditure on reconstruction may provide a boost to the economy. However, substitution of thermal for nuclear energy in Japan may exert further pressure on petroleum prices.

### **Domestic Economy**

#### ***Growth***

Central Statistical Organisation's recently released estimate of GDP growth of 8.6 per cent for 2010-11 is consistent with the Reserve Bank's projection set out in the Third Quarter Review. The area sown under the Rabi crop is higher than in last year which augurs well for agricultural production. Even as the index of industrial production (IIP) continues to be volatile, other indicators, such as the latest Purchasing Managers' Index (PMI), direct and indirect tax collections, merchandise exports and bank credit, suggest that the growth momentum persists. Lead indicators of services sector activity also remain robust. However, continuing uncertainty about energy and commodity prices may vitiate the investment climate, posing a threat to the current growth trajectory. In particular, the weak performance of capital goods in the IIP suggests that investment momentum may be slowing down.

#### ***Inflation***

After a slight moderation in January, headline WPI inflation reversed in February 2011 accompanied by a sharp increase in non-food manufactured products inflation.

As expected, the food article prices have declined substantially since January 2011. However, the prices of protein sources such as milk and 'eggs, meat and fish' continued to remain high reflecting structural demand-supply imbalances. A number of measures contained in the Budget for 2011-12 to improve the agricultural supply response in the medium-term will aid in redressing these imbalances. Fuel prices remain high, reflecting the global trend, with potential for further rise. Significantly, non-food manufactured products inflation, an indicator of demand side pressure, rose sharply from 4.8 per cent in January to 6.1 per cent in February and continues to stay well above its medium-term trend. The acceleration was spread across manufacturing activities, indicating that producers are able to pass on higher input prices to consumers.

In its Third Quarter Review, the Reserve Bank had projected year-on-year WPI inflation for March 2011 at 7 per cent. However, further upside risks have stemmed from high international crude prices, their impact on freely priced petroleum products, the increase in administered coal prices and pick-up in non-food manufactured product prices. The March 2011 WPI inflation is now estimated to be higher - around 8 per cent.

### ***Fiscal Deficit***

While the budgeted level of fiscal deficit for 2011-12 gives some comfort on the demand front, a potential increase in the subsidies on petroleum products and fertilizers as a result of high crude prices could put pressure on expenditure. It is critical, therefore, to focus on the quality of expenditure, keeping the aggregate under control without compromising on the delivery of services. Only by doing this can the fiscal situation contribute to demand-side inflation management.

### ***Current Account***

The Reserve Bank had expressed concern about the widening of the current account deficit (CAD) and the nature of its financing in its Third Quarter Review. Going by the recent robust export performance, CAD for 2010-11 is now estimated to come lower than earlier expected, at around 2.5 per cent of GDP. While the CAD this year has been financed comfortably, it is necessary to focus on the quality of capital inflows with greater emphasis on attracting long-term components, including foreign direct investment (FDI), so as to enhance the sustainability of the balance of payments (BoP) over the medium-term.

### ***Credit Conditions***

While the year-on-year non-food credit growth at 23 per cent in February remains above the indicative projection of 20 per cent, the pace of credit expansion has moderated since December 2010. Monetary transmission is increasingly visible as banks continue to raise their lending rates.

### ***Liquidity***

Net liquidity injection through LAF declined from an average of around ` 93,000 crore in January to ` 79,000 crore in February 2011, and further to ` 68,000 crore in March (up to March 16) due mainly to increase in government spending and consequent decline in government cash balances with the Reserve Bank. Going forward, the overall liquidity situation is expected to move close to the comfort level of the Reserve Bank (+/- 1 per cent of net demand and time liabilities of banks) although it is likely to come under some temporary pressure in the second half of March due to advance tax collections.

### ***Summing Up***

To sum up, the underlying inflationary pressures have accentuated, even as risks to growth are emerging. Rising global commodity prices, particularly oil, are a major contributor to both developments. As domestic fuel prices are yet to adjust fully to global prices, risks to inflation remain clearly on the upside, reinforced by the persistence of demand-side pressures as reflected in non-food manufacturing inflation. The Union Budget for 2011-12 indicates some easing of demand pressures from the fiscal side, thus creating space for private investment, but this will materialise only if commitments to contain subsidies are adhered to. Measures to increase agricultural productivity, particularly in items facing structural supply-demand imbalances, will contribute to easing food inflation over time.

### **Expected Outcomes**

The policy action in this Review is expected to:

- Continue to rein in demand-side inflationary pressures while minimising risks to growth; and
- Manage inflationary expectations and contain the spillover of food and commodity prices into more generalised inflation.