

**RESERVE BANK OF INDIA**

**Third Quarter Review of  
Monetary Policy 2011-12**

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Governor

January 24, 2012  
Mumbai



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**ABBREVIATIONS**

Bps	-	Basis Points
CAD	-	Current Account Deficit
CPI	-	Consumer Price Index
CRR	-	Cash Reserve Ratio
EDEs	-	Emerging and Developing Economies
ECB	-	European Central Bank
FIIIs	-	Foreign Institutional Investors
GDP	-	Gross Domestic Product
IIP	-	Index of Industrial Production
IMF	-	International Monetary Fund
LAF	-	Liquidity Adjustment Facility
LTROs	-	Longer-term Refinancing Operations
M <sub>3</sub>	-	Broad Money
MSF	-	Marginal Standing Facility
MQR	-	Mid-Quarter Review
NDTL	-	Net Demand and Time Liabilities
OBICUS	-	Order Books, Inventories and Capacity Utilisation Survey
OMOs	-	Open Market Operations
PMI	-	Purchasing Managers' Index
Q	-	Quarter
Q-o-Q	-	Quarter-on-Quarter
REER	-	Real Effective Exchange Rate
SAAR	-	Seasonally Adjusted Annualised Rate
SQR	-	Second Quarter Review
SLR	-	Statutory Liquidity Ratio
US	-	United States of America
WPI	-	Wholesale Price Index
Y-o-Y	-	Year-on-Year



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**By**  
**Dr. D. Subbarao**  
**Governor**

**Introduction**

Since the Second Quarter Review (SQR) of Monetary Policy in October 2011, there have been significant changes in the global scenario. On the one hand, concerns over the sustainability of sovereign debt problem in the euro area have intensified. On the other, there are modest signs of improvement in the US. In the emerging and developing economies (EDEs), growth has been moderating, reflecting the sluggishness in the advanced economies and the impact of earlier monetary tightening. Overall, notwithstanding the signs of recovery in the US, global growth prospects have weakened since the SQR.

2. Growth in India has also moderated. In particular, investment activity has decelerated sharply, reflecting heightened global uncertainty and domestic fiscal, monetary, political and administrative conditions.

3. Inflation is beginning to moderate as projected, despite the significant depreciation of the rupee. In particular, the higher than expected deceleration in food inflation has provided some relief,

even though this was caused largely by a seasonal decline in vegetable prices. Consistent with the Reserve Bank's earlier projections, inflation is likely to decelerate further to 7 per cent by March 2012.

4. Non-food manufactured products inflation, however, continues to remain high and well above the comfort zone. While indicators of pricing power suggest that the moderating trend will continue, upside risks remain significant. The momentum indicator of non-food manufactured products inflation is yet to show a discernible downward trend. Accordingly, while the Reserve Bank's policy stance has to become more sensitive to growth risks, it also needs to guard against persistent inflation risks.

5. This policy review is set in the context of a highly uncertain global environment and a delicately poised domestic balance between growth and inflation. It should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

6. 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

7. US GDP growth in Q3 of 2011 [quarter-on-quarter (q-o-q), seasonally adjusted annualised rate (saar)] was revised downwards from 2 per cent to 1.8 per cent. Although this is better than the sub-one per cent growth in the first half of 2011, it is still substantially below trend. In the euro area, GDP growth (q-o-q, saar) decelerated from 0.8 per cent in Q2 to 0.4 per cent in Q3. In Japan, growth (q-o-q, saar) recovered to 5.6 per cent in Q3 from the setbacks suffered in Q2 (-2.0 per cent) and Q1 (-6.6 per cent) due to earthquake/tsunami.

8. Amongst the major EDEs, growth [year-on-year (y-o-y)] in China slowed to 8.9 per cent in Q4 of 2011 from 9.1 per cent in Q3 and 9.5 per cent in Q2; it also slowed in Brazil to 2.1 per cent in Q3 from 3.3 per cent in Q2 and in South Africa to 3.1 per cent from 3.2 per cent. Growth in Russia, however, accelerated to 4.8 per cent in Q3 from 3.4 per cent in Q2 of 2011. Various international agencies have scaled down their growth estimate for 2011 and projection for 2012 both for the advanced economies and EDEs.

9. The global purchasing managers' index (PMI) for manufacturing recovered to an expansionary mode in December after remaining below the benchmark 50-mark (suggesting contraction) in both October and November 2011. The services index remains above the 50-mark (suggesting expansion) and improved from 52.7 in November to 53.2 in December. The composite PMI of the euro area has remained well below the benchmark of 50 since September 2011, although the index improved marginally to 48.3 in December from 47.0 in November.

10. Beginning the fourth week of December 2011, increase in international crude oil prices has been driven largely by geo-political uncertainties. In contrast, weak global economic activity has led to some softening of non-oil commodity prices. The World Bank's index of non-energy prices declined by 11 per cent (y-o-y) in December 2011.

11. Reflecting international commodity price dynamics, headline measures of inflation moderated in

November-December 2011 in a number of countries, but still remain at elevated levels. Among the major advanced economies, headline inflation was 3.0 per cent in the US and 2.7 per cent in the euro area. Amongst the EDEs, headline inflation was 4.1 per cent in China, 6.5 per cent in Brazil and 6.1 per cent in Russia and South Africa. Notably, in many EDEs, the softening, in varying degrees, of the impact of global commodity prices on inflation was offset by the sizeable depreciation of their currencies in the second half of 2011.

12. Given the renewed strains in global financial markets, six major central banks announced coordinated actions in November 2011 to enhance their capacity to provide liquidity support to the global financial system. The European Central Bank (ECB) also announced longer-term refinancing operations (LTROs) with a maturity of 36 months. These measures are intended to encourage bank lending in money markets and sovereign bond markets.

### **Domestic Economy**

13. At home, GDP growth moderated from 7.7 per cent in Q1 (April-June) to 6.9 per cent in Q2 (July-September) of 2011-12. This was mainly due to deceleration in industrial growth from 6.7 per cent to 2.8 per cent. However, the services sector held up relatively well. Consequently, GDP growth during H1

(April-September) of 2011-12 slowed to 7.3 per cent from 8.6 per cent in H1 of last year.

14. On the demand side, the contraction in fixed capital formation in Q2 was the main factor behind the slowdown in growth. The real gross fixed capital formation to GDP ratio declined from 31.2 per cent in Q1 to 30.5 per cent in Q2. This pattern, should it persist, will hurt medium-term growth. Private consumption grew by 5.9 per cent in Q2, slightly slower than 6.3 per cent in Q1, but substantially slower than 9.0 per cent a year ago. The global environment is only partly responsible for the weak industrial performance and sluggish investment activity; several domestic factors – the unhealthy fiscal situation, high interest rates and policy and administrative uncertainty – are also playing a role.

15. The index of industrial production (IIP) remained volatile. The y-o-y industrial growth recovered from (-) 4.7 per cent in October to 5.9 per cent in November. Over the year, however, growth in industrial production slowed down to 3.8 per cent during April-November 2011 from 8.4 per cent a year ago. The slowdown was mainly on account of the manufacturing and mining sectors. In terms of the use-based classification, weakness in the capital goods, intermediate goods and consumer durables sectors dragged

down industrial production. However, the PMI-Manufacturing rebounded to 54.2 in December 2011 from 51.0 in November. The PMI-Services also recovered markedly to 53.2 in November and further to 54.2 in December from the below 50 levels in the preceding two months. On the agriculture front, *rabi* sowing as of January 20, 2012 was marginally lower (-1.1 per cent) than that in last year.

16. According to the Reserve Bank's order books, inventories and capacity utilisation survey, capacity utilisation of the manufacturing sector in Q2 of 2011-12 remained broadly the same as in the preceding quarter. Business confidence, as measured by the business expectations indices of the Reserve Bank's industrial outlook survey, showed a slight pick-up in Q3 of 2011-12, while it pointed towards moderation in the next quarter.

17. Headline wholesale price index (WPI) inflation, which averaged 9.7 per cent (y-o-y) during April-October 2011, moderated to 9.1 per cent in November and further to 7.5 per cent in December. The decline in inflation was driven largely by a decline in primary food and non-food articles inflation. The momentum indicator of WPI, as measured by the seasonally adjusted 3-month moving average inflation rate, also showed a decline.

18. Primary articles inflation, which was in double digits for over two

years from September 2009 to October 2011, moderated to 8.5 per cent in November and further to 3.1 per cent in December. This was essentially on account of vegetables and non-food articles, particularly, fibres. However, inflation in protein items – 'eggs, fish and meat', milk and pulses – remained in double digits. Excluding vegetables, food articles inflation moderated only marginally from 8.0 per cent in November to 7.1 per cent in December in contrast to the sharp decline in food articles inflation (including vegetables) from 8.5 per cent to 0.7 per cent during the same period.

19. Fuel group inflation remained high at 14.9 per cent in December 2011, reflecting high global crude oil prices and rupee depreciation. In fact, there is sizeable suppressed inflation in the fuel-group as administered prices do not fully reflect the market prices.

20. Notably, non-food manufactured products inflation remains elevated. It declined from 8.1 per cent in October to 7.9 per cent in November and further to 7.7 per cent in December. However, going by the revision in the number for October 2011, the inflation numbers for November and December too are likely to be revised upwards. This indicator is sensitive to international commodity prices and currency movements and the recent rupee depreciation has accentuated price pressures as reflected by this indicator.

21. As measured by the consumer price index (CPI) for industrial workers, inflation moderated from double digits in September to 9.3 per cent in November. Inflation in terms of consumer price indices for agricultural and rural labourers moderated significantly in December. The new combined (rural and urban) consumer price index (base: 2010=100) declined marginally from 114.4 in November to 113.9 in December, reflecting softening of food prices.

22. Money supply ( $M_3$ ) growth, which was 17.2 per cent at the beginning of the financial year, reflecting the strong growth in time deposits following increase in interest rates by banks, moderated to 15.6 per cent by end-December 2011 consistent with the projected trajectory of 15.5 per cent for the year.

23. However, non-food credit growth moderated from 21.3 per cent at end-March to 15.7 per cent by end-December 2011, a rate below the indicative projection of 18 per cent set out in the SQR. Credit deceleration was particularly sharp for public sector banks, with growth moderating from 21 per cent to about 15 per cent during the same period. Disaggregated data for November showed that there was a general deceleration in the credit flow across sectors, except for personal loans. The deceleration was particularly sharp in agriculture, real estate, infrastructure,

engineering, cement and cement products.

24. Resource flows to the commercial sector from other sources partly offset the deceleration in bank credit. The estimated total flow of financial resources from banks, non-banks and external sources to the commercial sector during April-December of 2011 at around ₹9.2 trillion was, however, lower than that of ₹9.5 trillion during the same period of last year.

25. During Q3 of 2011-12, the modal deposit rate of banks increased by 44 basis points for maturity up to 1 year, and 9 basis points for maturity between 1 to 3 years. During Q3, 23 banks raised their base rates by 10-100 basis points even as the modal base rate of banks remained unchanged at 10.75 per cent. The slowdown in total resource flow to the commercial sector and the peaking of base rates of banks reflect slowing down of investment activity.

26. Liquidity conditions, which have generally remained in deficit during 2011-12, tightened further beginning the second week of November 2011, partly reflecting the Reserve Bank's forex market operations and advance tax outflows around mid-December. Average borrowings under the Reserve Bank's daily liquidity adjustment facility (LAF) increased from around ₹480 billion during April-September 2011 to around ₹920 billion during November

and further to ₹1,170 billion in December 2011. Average daily borrowings under the LAF were about ₹1,200 billion during January (up to January 20, 2012). To ease the tightness in liquidity, and consistent with its monetary policy stance of managing liquidity to ensure that it remained in moderate deficit, the Reserve Bank conducted open market operations (OMOs) aggregating over ₹700 billion during November 2011-mid January 2012.

27. Under the marginal standing facility (MSF), banks can drawdown up to one per cent of their net demand and time liabilities (NDTL) from their prescribed statutory liquidity ratio (SLR) portfolio. On December 21, 2011, the Reserve Bank clarified that banks could access the MSF even if they had excess SLR holdings. In view of the tight liquidity conditions, some banks accessed funds from the MSF window during December 2011-January 2012.

28. With the introduction of the new operating procedure of monetary policy in May 2011, overnight money market rates have become more stable. The overnight interest rates generally remained close to the repo rate during 2011-12 (up to January 20, 2012), barring a few days when the call rate breached the interest rate ceiling determined by the MSF rate owing to tightness of liquidity on account of advance tax outflows.

29. The Central Government's key deficit indicators widened during 2011-12 (April-November) relative to the levels in the corresponding period of last year, and were higher even when compared with the deficit levels adjusted for the one-off spectrum receipts last year. This was reflected in the increase in borrowings by the Government. Beyond the budgeted estimate of ₹4,170 billion, the Central Government announced an increase in borrowings through dated securities of about ₹530 billion in September and further ₹400 billion in December. Consequently, the revised gross (net) borrowings for the year now work out to about ₹5,100 billion (₹4,360 billion). About 83 per cent of revised gross (₹4,220 billion) and 80 per cent of net market borrowings (₹3,480 billion) were raised up to January 16, 2012. The Central Government has also announced an increase in the borrowing through net issuances of Treasury Bills by ₹1,025 billion over the budgeted amount of ₹150 billion for 2011-12.

30. The 10-year benchmark government security yield, which remained range-bound during the first half of 2011-12, rose during October, after the commencement of second half borrowing programme of the government. The yield, however, eased subsequently from 8.89 per cent at end-October to 8.74 per cent at end-November and further to 8.22 per cent as on January 20, 2012. The moderation

in yield reflected improved demand for government securities as credit demand slackened, OMO purchases by the Reserve Bank, increase in debt cap for foreign institutional investors (FIIs) for investment in government securities, and expectation of moderation in inflation.

31. The foreign exchange market remained under pressure in Q3 of 2011-12, reflecting adverse global sentiments and moderation in capital inflows. Between end-March 2011 and January 13, 2012, the 6, 30 and 36-currency trade weighted real effective exchange rates (REER) depreciated by about 9 per cent each, primarily reflecting the nominal depreciation of rupee against the US dollar by about 13.2 per cent. Much of the depreciation happened during August-December. The Reserve Bank took a number of steps to stimulate capital inflows and curb speculation, besides also intervening in the market consistent with its policy of containing volatility and preventing disruptive movements.

The Reserve Bank continues to closely monitor developments in the external sector and their impact on the exchange rate and, as indicated in the Mid-Quarter Review (MQR) of December 2011, will take action, as appropriate.

32. During H1 (April-September) of 2011-12, the current account deficit (CAD), in absolute terms, widened relative to H1 of last year, reflecting widening of the trade deficit due to significant increase in international prices of imported commodities, especially crude oil and gold as well as moderation of growth in exports of services. However, as a proportion of GDP, the CAD at 3.6 per cent was a shade lower than 3.7 per cent in H1 of last year. During Q3 of 2011-12, merchandise exports growth decelerated, on an average, to 7.7 per cent y-o-y from an average of 36.9 per cent during the first half of 2011-12. With imports growth moderating more slowly than exports growth, the trade deficit for Q3 widened further.

## II. Outlook and Projections

### Global Outlook

#### *Growth*

33. Global growth prospects for 2012 have deteriorated in an environment of increasing concerns over the sovereign debt crisis in the euro area amidst limited monetary and fiscal policy space. Given the weak growth prospects in advanced

economies and past monetary tightening undertaken by EDEs to contain inflation, growth in the EDEs has also been moderating. Accordingly, global growth during 2012 is expected to be lower than the International Monetary Fund's September 2011 projection of 4.0 per cent.

*Inflation*

34. Although non-oil commodity prices showed some correction in 2011, crude oil prices have remained firm. Supply limitations and continued ultra accommodative monetary policies in major advanced economies pose upside risks to commodity prices in 2012. Currency depreciation in EDEs witnessed in the second half of 2011 and the lagged pass-through to domestic prices could also add to inflationary pressures in EDEs.

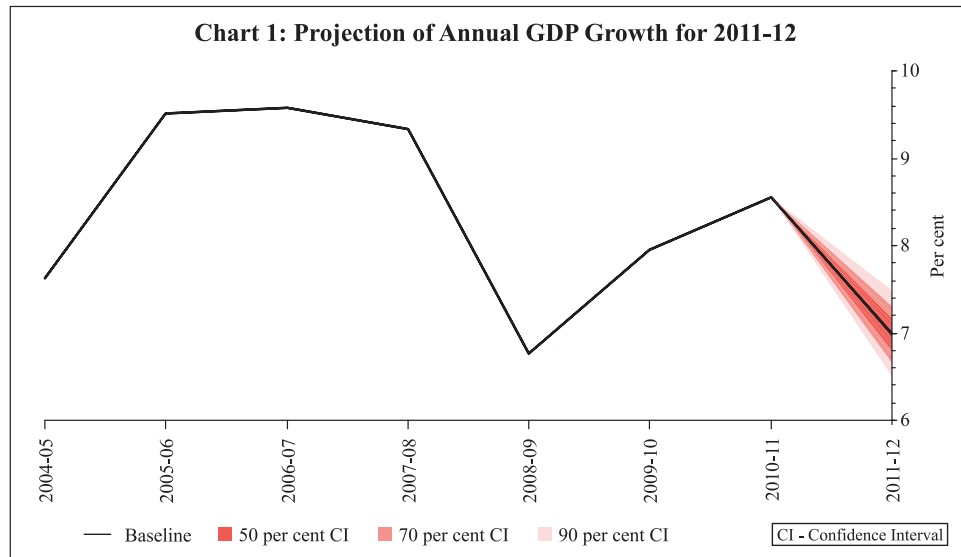
**Domestic Outlook**

*Growth*

35. In the SQR of October 2011, the Reserve Bank projected GDP growth of 7.6 per cent for 2011-12, though with significant downside risks. In the MQR of December 2011, the Reserve Bank

indicated that some of these risks were indeed materialising such as increase in global uncertainty, weak industrial growth, slowdown in investment activity and deceleration in the resource flow to the commercial sector. Consequently, while agricultural prospects look buoyant, industrial production has decelerated. The slowdown in industrial production will also impact service sector growth. Further, weaker global growth will also have an adverse impact. Accordingly, the baseline projection of GDP growth for 2011-12 is revised downwards from 7.6 per cent to 7.0 per cent (Chart 1).

36. Looking ahead to 2012-13, while a formal projection will be made in the Annual Policy Statement in April, the Reserve Bank’s baseline scenario is that the economy will exhibit a modest



recovery, with growth being slightly faster than that during the current year.

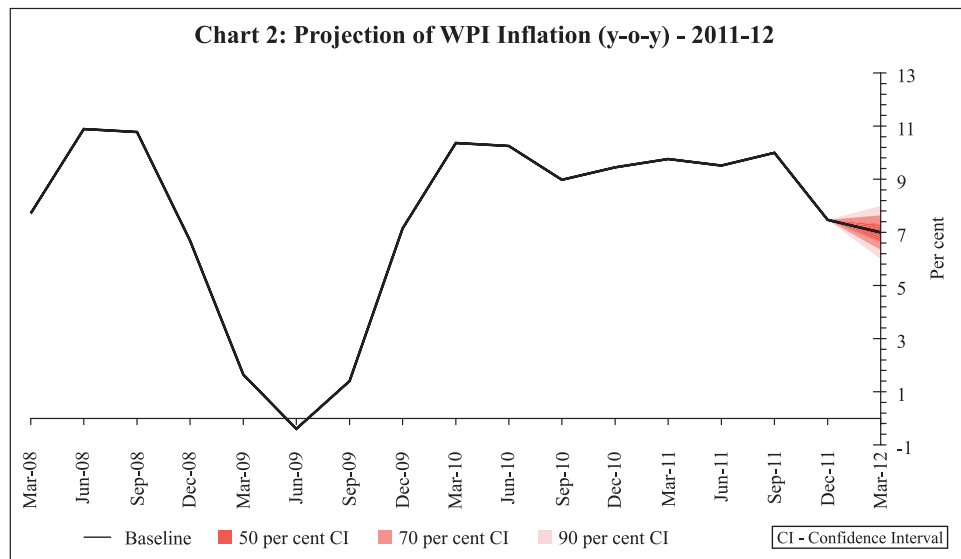
37. It must be emphasised that investment activity has slowed down significantly. As indicated above, while global factors are contributing, domestic conditions are also responsible and a change in the investment climate is contingent on these adverse conditions being addressed by policy actions. Without this, a continuing decline in investment will push the economy's trend rate of growth down, further aggravating inflationary pressures and threatening external and internal stability.

*Inflation*

38. Food inflation has moderated more than anticipated because of a sharp drop in vegetable prices. This benefit has, however, been offset to a large extent by the lower than expected

moderation in non-food manufactured products inflation. Fuel inflation remains well above double digits. Keeping in view the expected moderation in non-food manufactured products inflation, domestic supply factors and global trends in commodity prices, the baseline projection for WPI inflation is retained at 7 per cent as set out in the SQR (Chart 2).

39. A significant downgrade in the growth projection would normally have been accompanied by a downward revision in the inflation projection. However, in the current circumstances, two factors have prevented this from happening. First, rupee depreciation has been feeding into core inflation, delaying the adjustment of inflation to slower growth. Second, very importantly, suppressed inflation in petroleum product



and coal prices remains quite significant. While a rationalisation of prices is welcome for a variety of well known reasons, it will impact observed inflation in the short-term. This projection is based on the likelihood of some adjustments being made in these prices.

40. Looking ahead to 2012-13, while a formal projection will be made in the Annual Policy Statement in April, the Reserve Bank's baseline scenario is that headline inflation may show some moderation, though remaining vulnerable to a variety of upside risks, indicated later in this Review.

41. 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**

42. Money supply ( $M_3$ ) growth at 15.6 per cent (y-o-y) in December 2011 was in line with the indicative trajectory of 15.5 per cent for 2011-12. However,

non-food credit growth at 15.7 per cent was below the indicative projection of 18 per cent, reflecting the combined effect of a slowing economy and increasing risk aversion by banks. The deceleration in non-food bank credit is explained, to a large extent, by the expansion in net bank credit to the government which increased at a significantly higher rate of 24.4 per cent as compared with 17.3 per cent last year. Keeping in view the increased government borrowings and slowdown in private credit demand,  $M_3$  growth projection for 2011-12 has been retained at 15.5 per cent, while non-food credit growth has been scaled down to 16.0 per cent. These numbers, as always, are indicative projections and not targets.

#### **Risk Factors**

43. The indicative projections of growth and inflation for 2011-12 are subject to a number of risks as indicated below:

- i) Sovereign debt concerns in the euro area pose a major downside risk to overall growth outlook. The absence of a credible solution to the euro area problem is weighing on global growth prospects even as recent data suggest that there is some improvement in the US recovery. Continuing uncertainty in the euro area will adversely affect Indian growth through trade, finance and confidence channels.

- ii) Capital inflows to India have slowed down on account of portfolio re-balancing by FIIs due to global uncertainty. This raises concerns, especially because the current account deficit of India has widened. The exchange rate has already come under significant pressure, which has also added to inflationary pressures. If the global situation does not improve, capital inflows could continue to be adversely affected. In this scenario, the size of the current account deficit poses a significant threat to macroeconomic stability.
- iii) Even as global food and metal prices have moderated further, global energy prices have increased. Should crude prices spike due to supply constraints on account of geo-political factors or decline significantly due to a deterioration in the global macroeconomic situation, they will have implications for domestic growth and inflation. Exchange rate movements will also be an important factor in shaping the impact of global crude prices on domestic prices.
- iv) Non-food credit growth has slowed down. Although some slowdown in credit growth was expected on account of monetary tightening, credit growth has decelerated more than expected and is currently below the indicative trajectory of 18 per cent. Apart from slowdown of economic activity, it also reflects increasing risk aversion by banks due to increase in non-performing assets. Although banks need to be prudent while sanctioning credit proposals, risk aversion by the banking sector could adversely affect credit flow to productive sectors of the economy.
- v) Although food inflation has declined in the recent period, this was mainly due to a seasonal decline in vegetable prices. Going by past trends, the extent of decline in vegetable prices seen in December this year is usually observed in the winter season (December-February). As such, the decline in food inflation is likely to be limited in coming months. Beyond this, inflation in respect of protein-based items remains high. In the absence of appropriate supply responses of those commodities where there are structural imbalances, particularly protein-based items, risks to food inflation will continue to be on the upside. Significantly, there has been reduction in *rabi* acreage for pulses, which may have an adverse impact on prices.
- vi) There is still a large element of suppressed inflation as domestic prices of some administered products

do not reflect the underlying market conditions. This is particularly true of coal which had seen an increase towards the end of last year but no increase this year so far. Since coal is an input for electricity, coal prices, as and when raised, will also have implications for electricity tariffs. Further, the current levels of domestic prices of petroleum products do not reflect international prices. Petroleum product prices have also not been revised in response to crude oil prices, contributing to both fiscal slippages and suppressed inflation. Revision in domestic administered prices will add to inflationary pressures, although such revisions are necessary to maintain the balance between

supply and demand. Particularly, as the food subsidy bill is expected to rise, it will be prudent to fully deregulate diesel prices to contain both aggregate demand and trade deficit.

- vii) The fiscal deficit of the government has remained elevated since 2008-09. If the increase in government borrowing already announced is an indication, the gross fiscal deficit for 2011-12 will overshoot the budget estimate substantially. At the current juncture when there is a need to boost private investment, the increase in fiscal deficit could potentially crowd out credit to the private sector. Moreover, slippage in the fiscal deficit has been adding to inflationary pressures and it continues to be a risk for inflation.

### III. The Policy Stance

44. The Reserve Bank began exiting from the crisis driven expansionary policy in October 2009. Between January 2010 and October 2011, the Reserve Bank cumulatively raised the cash reserve ratio (CRR) by 100 basis points and the policy rate (the repo rate) 13 times by 375 basis points. This monetary policy response was calibrated on the basis of India specific growth-inflation dynamics. The focus of the monetary policy stance during May-October

2011 was on containing inflation and anchoring inflation expectations even as it meant sacrificing some growth. However, in view of slowdown in growth, especially investment activity and expected moderation in inflation beginning December, it was decided to pause in the MQR of December 2011.

45. Since November 2011, inflation has broadly followed the projected trajectory and has shown moderation

as expected. Even as inflation remains elevated, despite moderation, downside risks to growth have increased. The growth-inflation balance of the monetary policy stance has now shifted to growth, while at the same time ensuring that inflationary pressures remain contained. Accordingly, the policy stance in this review is shaped by the following three major considerations.

46. First, growth is 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. Credit offtake has also been below the projected trajectory. While slowdown in the growth of demand was the expected outcome of monetary policy actions that were taken to contain inflation, at this juncture, risks to growth have increased. This is also reflected in the scaling down of the growth projection for 2011-12 by the Reserve Bank.

47. Second, though headline WPI inflation is moderating, it largely reflects a sharp deceleration in prices of seasonal food items. Inflation in respect of other key components, particularly protein-based food items and non-food

manufactured products remains high. Moreover, upside risks to inflation arise from global crude oil prices, the lingering impact of rupee depreciation and slippage in the fiscal deficit.

48. Third, liquidity conditions have remained tight beyond the comfort zone of the Reserve Bank. Although the Reserve Bank has conducted open market purchase of government securities to inject liquidity of over ₹700 billion, the structural deficit in the system has increased significantly, which could hurt the credit flow to productive sectors of the economy. The large structural deficit in the system presents a strong case for injecting permanent primary liquidity into the system.

49. Against this backdrop, the stance of monetary policy is intended to:

- Maintain an interest rate environment to contain inflation and anchor inflation expectations.
- Manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission.
- Respond to increasing downside risks to growth.

## IV. Monetary Measures

50. 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:

### Cash Reserve Ratio

51. It has been decided to:

- reduce the cash reserve ratio (CRR) of scheduled banks by 50 basis points from 6.0 per cent to 5.5 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning January 28, 2012.

52. As a result of the reduction in the CRR, around ₹320 billion of primary liquidity will be injected into the banking system.

### Repo Rate

53. The policy repo rate under the liquidity adjustment facility (LAF) has been retained at 8.5 per cent.

### Reverse Repo Rate

54. The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, stands at 7.5 per cent.

### Marginal Standing Facility (MSF) Rate

55. The Marginal Standing Facility (MSF) rate, determined with a spread

of 100 basis points above the repo rate, stands at 9.5 per cent.

### Bank Rate

56. The Bank Rate has been retained at 6.0 per cent.

### Guidance

57. In reducing the CRR, the Reserve Bank has attempted to address the structural pressures on liquidity in a way that is not inconsistent with the prevailing monetary stance. In the two previous guidances, it was indicated that the cycle of rate increases had peaked and further actions were likely to reverse the cycle. Based on the current inflation trajectory, including consideration of suppressed inflation, it is premature to begin reducing the policy rate. The reduction in the policy rate will be conditioned by signs of sustainable moderation in inflation. However, the persistence of tight liquidity conditions could disrupt credit flow and further exacerbate growth risks. In this context, the CRR is the most effective instrument for permanent liquidity injections over a sustained period of time. The reduction can also be viewed as a reinforcement of the guidance that future rate actions will be towards lowering them.

58. However, it must be emphasised that the timing and magnitude of future

rate actions is contingent on a number of factors. Policy and administrative actions, which induce investment that will help alleviate supply constraints in food and infrastructure, are critical. Initiatives to narrow skill mismatches in labour markets will help ease the pressure on wages. The anticipated fiscal slippage, which is caused largely by high levels of consumption spending by the government, poses a significant threat to both inflation management and, more broadly, to macroeconomic stability.

59. Strong signs of fiscal consolidation, which will shift the balance of aggregate demand from public to private and from consumption to capital formation, are critical to create the space for lowering the policy rate without the imminent risk of resurgent inflation. In the absence of credible fiscal consolidation, the Reserve Bank will be constrained from lowering the policy rate in response to decelerating private consumption and investment spending. The forthcoming Union

Budget must exploit the opportunity to begin this process in a credible and sustainable way.

### **Expected Outcomes**

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

- i) Ease liquidity conditions.
- ii) Mitigate downside risks to growth.
- iii) Continue to anchor medium-term inflation expectations on the basis of a credible commitment to low and stable inflation.

### **Mid-Quarter Review of Monetary Policy 2011-12**

61. The next mid-quarter review of Monetary Policy for 2011-12 will be announced through a press release on Thursday, March 15, 2012.

### **Monetary Policy 2012-13**

62. The Monetary Policy for 2012-13 will be announced on Tuesday, April 17, 2012.

**Mumbai**

**January 24, 2012**