

Policy prescriptions, monetary measures taken in Q3 by RBI

Since the Second Quarter Review (SQR) of the 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. 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.

Domestic sectors

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.

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.

The index of industrial production (IIP) remained volatile. The year on

year 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.

Fuel group inflation remained high at 14.9 per cent in December 2011, reflecting high global crude oil prices and rupee depreciation.

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.

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 and 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.

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.

Exchange rate

The foreign exchange market remained under pressure in Q3 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 percent 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.

Current Account Deficit

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.

Global economy

US GDP growth in Q3 of 2011 quarter-on-quarter, seasonally adjusted annualised rate 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 decelerated from 0.8 per cent in Q2 to 0.4 per cent in Q3. In Japan, growth 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 the earthquake / tsunami.

Amongst the major EDEs, growth (year-on-year) 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.

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 percent.

Risk factors

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 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.

Policy prescriptions / monetary measures taken

Cash Reserve Ratio: It has been decided to reduce the Cash Reserve Ratio (CRR) of scheduled banks by 50 basis points from 6 per cent to 5.5 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning January 28, 2012. As a result of the reduction in the CRR, around \$320 billion of primary liquidity will be injected into the banking system.

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

Reverse Repo Rate: 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: The Marginal Standing Facility rate, determined with a spread of 100 basis points above the repo rate, stands at 9.5 per cent.

Bank Rate: The Bank Rate has been retained at 6 per cent. ■

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