MACROECONOMIC AND MONETARY DEVELOPMENTS FIRST QUARTER REVIEW 2011-12

Overview

1. Drivers of inflation changed over the course of 2010-11. With evidence emerging that not only did headline inflation persist at around 9 per cent, but that it had become generalised with significant price pressures in non-food manufacturing since December 2010, monetary policy was tightened more aggressively. Following up on a series of rate hikes through 2010-11, policy rates were raised by 75 bps in Q1of 2011-12, through a 50 bps hike in May and 25 bps in June. Altogether, in a span of 15 months starting March 2010, operational policy rates were raised by 425 bps – one of the sharpest monetary tightenings seen across the world.

2. Monetary transmission improved further during this quarter. In response to the monetary tightening, most banks raised their deposit and lending rates. As a result, deposit growth picked up and credit growth decelerated, though it remained above the projected trajectory. Also, real lending rates remained positive despite high inflation. These dynamics helped limit the overheating pressures in the economy. However, inflationary pressures have persisted due to a series of supply-side shocks that spilled over in the face of strong demand stoking generalised inflation. While growth has showed some signs of softening in Q1 of 2011-12, it is likely to stay around the trend. Inflationary pressures are likely to stay, if not intensify, in Q2 of 2011-12, before moderating.

Global Economic Conditions

Recovery at risk with global growth entering soft patch

3. Globally, the momentum of recovery appears to be stalling. High oil and commodity prices, the Middle East political strife, Japanese earthquake, sovereign debt problems in the Euro zone and the impasse on the fiscal and debt problems in the US have taken a toll on economic activity and business as well as consumer confidence.

4. In its June 17, 2011 update of the World Economic Outlook, the IMF marginally lowered its global growth projection for 2011 to 4.3 per cent from 4.4 per cent. The IMF lowered the estimate for advanced economies by 0.2 percentage points, but projected that growth in most emerging and developing economies will stay. It also retained its growth forecast for India at 8.2 per cent at market prices corresponding to 8.0 per cent at factor cost.

Inflation surprise in advanced economies increases global risks

5. Global inflation is rising rapidly. The IMF revised its 2011 consumer price inflation forecast for advanced economies upwards by 0.4 percentage points. There are indications that inflation may start cooling off in some key emerging market economies. However, the wedge between producer price and headline consumer price inflation, as also between the latter and the core inflation component have widened disconcertingly. This has triggered a debate over how much longer advanced economies can defer an exit from an excessively accommodative monetary policy stance. The ECB has already raised policy rates twice this year, but policy dilemmas are palpable elsewhere.

6. Unemployment is proving to be intransigent to policy action, and with growth relapsing amidst increasing fiscal and debt burdens, the fragility of global recovery and its vulnerability to macroeconomic shocks remains.

Indian Economy: Developments and Outlook

Output

Signs of moderation after acceleration in 2010-11

7. Growth showed signs of some moderation during Q1 of 2011-12 after it reverted to the recent trend in 2010-11. Signs of moderation were visible from deceleration in IIP growth in April-May, poor performance of certain core industries, especially cement and natural gas and consumption deceleration in cement, steel and automobiles. Manufacturing and services PMIs also show that growth is turning softer. Even as some deceleration is expected in 2011-12, overall growth is likely to stay around trend growth of about 8 per cent in the face of still strong consumption demand. The monsoon may be close to normal and services sector momentum has been maintained.

Aggregate demand

Investment demand slows down, private spending still strong

8. Aggregate investment dipped in H2 of 2010-11 and is yet to show signs of improvement. Corporate investment intentions in projects that received financial assistance dropped by 43 per cent sequentially during the second half of the year. Private consumption demand remains strong but is adjusting downwards. Corporate sales growth remained strong during Q4 of 2010-11 and is expected to retain the pace in Q1 of 2011-12. Profits, however, have been impacted by margin pressures from high interest rates and raw material costs. A rebalancing of demand from government consumption to private investment is necessary in 2011-12. This rebalancing will require shifting of government expenditure from revenue expenditure to capital expenditure, beyond what has been envisaged in the budget. Reduction in subsidies through better targeting is also needed. Despite recent initiatives to scale down subsidies, there is likelihood of a fiscal slippage in 2011-12. In face of decelerating investment, improved project execution and governance can also help in improving investment demand.

External sector

Trade diversification, invisibles turnaround help moderate CAD

9. A significant pick-up in exports, supported by a strategy of trade diversification in composition and direction, and strong software services exports, helped in moderating the CAD during 2010-11. Going forward, CAD is expected to remain manageable. However, risks to current account persist from a slowdown in global growth. Risks to capital account arise from rising sovereign debt risks in the Euro zone and the uncertainties on in the US debt ceiling.

10. FDI flows have picked up in 2011-12 so far. Portfolio flows have started to rise again since the last week of June. The inflows at the current rate can be absorbed by the CAD, but it is necessary to adjust the structural balance of flows by attracting larger FDI inflows.

Monetary and Liquidity Conditions

Tight monetary and liquidity conditions bringing desired adjustment

11. Liquidity conditions, though still in a deficit mode, have eased during the first quarter of 2011-12. The increase in deposit rates by banks helped deposit growth to pick-up, which eased the structural liquidity gap. The runaway growth in currency has also been arrested consequent to the rising opportunity cost of holding cash. Reserve money growth decelerated with low primary liquidity creation, but monetary growth increased with accelerating time deposit growth. Credit growth decelerated during the quarter, but remains above the indicative trajectory.

Financial Markets

Indian markets see range bound fluctuations, amidst low volatility

12. Notwithstanding the firming up of interest rates, there has been no stress visible across the financial markets. Financial asset prices have shown low volatility. Conditional volatility in equity prices that had dropped significantly after the global financial crisis continued to be low during Q1 of 2011-12. Exchange rate movements remained orderly obviating the need for interventions. The yield curve flattened, largely in response to policy rate hikes. Property prices and volume of transactions were on the upswing after a subdued movement in Q3 of 2010-11.

Price Situation

Generalised inflation with near-term upside risks do not provide any comfort

13. Inflation became generalised in Q4 of 2010-11 and has remained unchanged in trajectory as also in composition in 2011-12 so far. This was in line with the Reserve Bank's projections. While some revision in fuel prices hike was factored in the projected path of inflation, the pass-through is yet incomplete which will keep up the near term pressure. The softening of global commodity prices since May 2011 may provide some relief in the short run, but price pressures will persist as a result of a combination of demand side factors and structural drivers. Food inflation may not soften much even with a normal monsoon as the increase in MSP will provide a higher floor to food prices. Electricity prices are yet to reflect the rising input costs. Near term trends on non-food manufacturing inflation will be critical in shaping the future macroeconomic dynamics.

Macroeconomic Outlook

In the midst of downside risks to growth, inflation stays above comfort level

14. Monetary and liquidity conditions have remained tight in the wake of inflation persistence. The anti-inflationary monetary policy stance adopted by the Reserve Bank since October 2009 continued well into the first quarter of 2011-12 as inflation persisted beyond Reserve Bank's comfort level. Inflationary pressures, which initially emanated from supply side constraints, spilled over to wages and output prices as demand conditions remained buoyant. Currently, inflationary expectations are further feeding on themselves and warrant a close watch. While consumer demand remains strong, higher input costs and increased cost of borrowing are now eroding profit margins impacting the pricing power of corporate. On the other hand, indications of moderation in growth have surfaced, making the policy challenge even more complex. However, the persisting high inflation and its expected slow decline warrant that the Reserve Bank continue with its anti-inflationary policy stance.