MACROECONOMIC AND MONETARY DEVELOPMENTS IN 2012-13

Overview

1. Monetary policy eased during 2012-13, in response to some softening of inflation and significant moderation in growth. However, monetary policy response to addressing growth concerns was constrained by inflation persistence and the twin deficit risks that prevailed for the most part of the year. Although fiscal risks were lowered during H2 of 2012-13, current account deficit (CAD) risks intensified during Q2 and Q3.

2. The impact of monetary policy in boosting GDP growth is contingent upon resolution of supply bottlenecks, governance issues impeding investments and the government's efforts towards fiscal consolidation. Domestic energy price adjustments, inadequate supply response and sustained wage pressures on inflation are expected to drag down growth for some more time. These factors, coupled with subdued domestic business confidence, are likely to keep recovery in 2013-14 modest. The challenge is to counter the growth slowdown by reviving investment while managing the trade-off between objectives of reviving demand and restraining the CAD.

3. While non-food manufactured products inflation has moderated, there is always the risk that the current high food inflation could spill over to broader price formation, undermining the efforts of monetary policy to contain inflation. In the long run, structural measures, including reforms, improved governance and increased government investment to crowd in private investment, would play the catalytic role in moving growth towards its potential levels.

Global Economic Conditions

Global growth likely to stay sluggish in 2013

4. Global growth turned weaker in 2012 and is expected to stay sluggish in 2013 as fiscal adjustments drag growth in advanced economies (AEs) and, in turn, delay cyclical recovery in emerging market and developing economies (EMDEs). The International Monetary Fund (IMF) in its World Economic Outlook has forecast global growth to stay sluggish at 3.3 per cent in 2013 before improving to 4.0 per cent in 2014. While downside tail risks have reduced in early 2013 because of the supportive policy action in the euro area and the measures to tackle the fiscal cliff in the US, risks to global recovery have increased consequent to the Chinese economy slowing down.

Global commodity price inflation likely to remain soft, although with some risks from QE

5. The outlook for global commodity prices during 2013 remains benign, with a further decline expected in metal and oil prices. This should help reduce imported inflation in the domestic economy, subject to prevalence of stable exchange rate movements. However, global commodity price inflation risks remain from the large and continuous doses of quantitative easing (QE).

Global financial markets bolstered by policy actions aimed at reducing tail risks

6. Notwithstanding weak global growth and austerity measures imposed in the

US and in the euro area, international financial markets gained traction following unconventional monetary easing. However, this has not translated into growth revival. Although the tail risks have reduced, they remain significant, calling for committed action to trim the balance sheet exposures and prepare adequate buffers against possible contagion effects.

Indian Economy: Developments and Outlook

Output

Slow-paced recovery likely to shape 2013-14

7. The Indian economy remained sluggish in Q3 of 2012-13, with slowdown turning visibly pervasive across most sectors. The deceleration in the services sector growth, which has been the mainstay of high growth in the recent period, had dragged down overall economic activity and employment creation. The agriculture output was dented by deficient rainfall that impacted kharif crop. Domestic policy uncertainties, governance concerns, the impact of earlier monetary tightening and the slacking of external demand continue to adversely impact growth.

Aggregate Demand

Resolving structural bottlenecks and providing public investment stimulus can turnaround falling investment

8. Aggregate demand remained sluggish during Q3 of 2012-13 with inflation impacting real consumption and cyclical and structural factors affecting investment. Corporate results suggest weak demand, with moderation in investment as well as consumption. Government consumption expenditure has decelerated, reflecting expenditure-cutting as part of its fiscal consolidation strategy. Corporate data on planned fixed investments indicate that investment slowed further during Q3 of 2012-13. Given the intensity of the slowdown, a public investment stimulus balanced with offsetting reductions in current expenditures, along with concerted action to remove supply-side bottlenecks, are needed to shape the revival of the economy.

External sector

Sustained efforts needed to reduce the CAD, though fall in global commodity prices brings temporary respite

9. External imbalances were in focus as the current account deficit (CAD) to GDP ratio reached a historic high of 6.7 per cent in Q3 of 2012-13. However, CAD in Q3 was adequately financed by capital inflows, without any reserve depletion. Current account in 2013-14 is likely to benefit from moderation in global commodity prices of oil, gold and other metals. Yet, sustainability of the CAD continues to face risk from event shocks that may cause a sudden stop or reversals of capital inflows. As such, there is need to initiate policy actions to bring structural improvements in the current account through productivity enhancements to boost competitiveness. Going forward, the government's recent initiatives to curtail the fiscal deficit, if pursued along the indicated path, are likely to reduce pressure on the CAD and lower twin deficit risks.

Monetary and Liquidity Conditions

Reserve Bank calibrated monetary policy easing to evolving growth-inflation dynamic and macroeconomic imbalances

10. The Reserve Bank eased monetary policy to revive investment and growth. It was guided by the imperative to optimally use the limited monetary space while balancing the concerns of persisting inflation and historically high CAD. In this vein, the Reserve Bank cumulatively reduced the repo rate by 100 bps in 2012-13. Furthermore, amidst increasing structural and frictional liquidity deficits, it injected `1.5 trillion of primary liquidity through outright open market operations

(OMOs). Also, `1.3 trillion of primary liquidity was infused through cuts in the Cash Reserve Ratio (CRR) since January 2012. Further liquidity requirements were met through LAF repos.

Financial Markets

Strong FII flows augured well for the Indian rupee and equity market

11. Policy actions, both domestic and global, augured well for the Indian financial markets in Q4. Nonetheless, limited policy space and political uncertainties continued to weigh down the markets. The easing trend in G-sec yields reversed at the end of the year due to same reasons. Primary equity markets remained subdued. Sustained commitment to reforms and policy action to reduce external sector risks, and improvement in the global economy are crucial to boosting market sentiments and support capital raising. On the asset price front, house price inflation remains high.

Price Situation

Headline inflation and demand side price pressures moderate, but suppressed inflation poses risks

12. Headline, and especially the non-food manufactured product inflation pressures, softened during 2012-13, even as consumer price inflation firmed up. The average headline WPI inflation during 2012-13 at 7.4 per cent was significantly lower than the 9.0 per cent recorded in the preceding year. The year-end inflation turned out to be even lower at 6.0 per cent. However, consumer price inflation stays in the double digits, reflecting substantially food inflation pressures. Headline inflation in 2013-14 is likely to exhibit a downward bias on account of expected lower global commodity prices, but face an upward bias from significant pass-through from suppressed inflation.

Macroeconomic Outlook

Slow-paced recovery, range-bound inflation and macro-financial risks require a cautious monetary policy response

13. Growth continued to slow down in 2012-13, but could witness a slow-paced recovery later this year, contingent on improved governance and concerted action to resolve structural bottlenecks. Subdued business and consumer confidence, reflected in various surveys, is expected to drag growth down. Headline inflation is likely to remain range-bound in 2013-14, with some further moderation in H1 but slight increase in H2 on account of strong base effects. Most surveys anticipate modest gains, both on growth and inflation. Currently, significant macro-financial risks prevail from slow growth, high CAD and inflation above the threshold over which it becomes inimical to growth sustainability. Therefore, monetary policy would need to be calibrated recognising the very limited policy space available to ease further.