MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2012-13

Overview

1. Growth since Q4 of 2012-13 is expected to stage a gradual recovery aided by some revival in investment demand and the favourable effect of some moderation in inflation on consumption. Inflation in Q3 of 2012-13 has trended down, though upside risks remain from suppressed inflation which could impart stickiness to inflation trajectory in 2013-14. Core inflation pressures have receded markedly and are unlikely to re-emerge quickly on demand considerations. However, high food and fuel inflation still remain a concern and this in part is reflected in high CPI inflation.

2. Since the beginning of 2012, the Reserve Bank has worked towards easing monetary and liquidity conditions in a calibrated manner so as to not jeopardise the trend of moderating inflation. The strategy yielded dividends, as headline and core inflation moderated during Q3 of 2012-13. However, monetary policy needs to continue to be calibrated in addressing growth risks as inflation remains above the Reserve Bank's comfort level and macroeconomic risks from twin deficits persists.

Global Economic Conditions

Fiscal adjustments likely to keep global recovery muted in 2013

3. Though the US registered high growth in Q3 of 2012 and the pace of economic contraction moderated in the euro area, growth prospects for advanced economies (AEs) in 2013 remain subdued. While the immediate risk of the fiscal cliff in the US has been averted due to a hurried deal on tax rate hikes, the debt ceiling limit and the sequester issue pertaining to expenditure reduction are still unsettled. Growth in emerging market and developing economies (EMDEs) may have bottomed out, but an enduring recovery hinges on global headwinds.

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

4. Inflation in AEs is likely to remain moderate as demand remains weak, leaving the global inflation scenario benign in the near term. As a baseline case, improved supply prospects in key commodities such as oil and food are also likely to restrain commodity price pressures. However, upside risks persist, especially on the back of some recovery in EMDEs and large quantitative easing (QE) by AE central banks. In the presence of significant excess global liquidity, triggers for supply disruptions or incremental news flow on reduced slack could exacerbate price volatility and become a source of inflationary pressure.

Unconventional monetary policies reduce global financial stress in the interim, but risks remain ahead

5. International financial market stress moderated greatly following aggressive monetary easing measures by the central banks of AEs, as also recent policy initiatives on fiscal consolidation in the euro area *economies, encouraging capital flows into EMDEs. However, in the absence of credible long-term fiscal consolidation in the US, and generally reduced fiscal space in AEs, the efficacy of monetary policy actions may get subdued. Risks to the global financial sector, although moderating, are likely to persist.*

Indian Economy: Developments and Outlook

Output

Growth remains below trend, recovery likely in 2013-14

6. The Indian economy further decelerated in the first half (H1) of 2012-13, with moderation in all three sectors of the economy. The weak monsoon dented agricultural performance. Policy constraints, supply and infrastructure bottlenecks and lack of sufficient demand continued to keep industrial growth below trend. Subdued growth in other sectors and weak external demand pulled down the growth of services as well. Though a modest recovery may set in from Q4 of 2012-13 as reforms get implemented, sustaining recovery through 2013-14 would require all-round efforts in removing impediments to business activity.

Aggregate Demand

Improvement in investment climate is a pre-requisite for economic recovery

7. Demand weakened in H1 of 2012-13. There was significant moderation in consumption as private consumption decelerated even as government expenditure accelerated. On the fiscal side, near-term risks have diminished due to the government's repeated avowal of commitment to the revised fiscal deficit target of 5.3 per cent of gross domestic product (GDP) for the year. However, sustainable fiscal consolidation would require bringing current spending, especially on subsidies, under control and protecting, if not enhancing capital expenditure. Going forward, the key to demand revival lies in improving the investment climate as well as investor sentiments through sustained reforms.

External sector

Widening of CAD and its financing remains a key policy challenge

8. The current account deficit (CAD) to GDP ratio reached a historically high level of 5.4 per cent in Q2 of 2012-13. Low growth and uncertainty in AEs as well as EMDEs continued to adversely impact exports in Q3 of 2012-13. This, combined with continuing large imports of oil and gold, resulted in a deterioration of the trade balance. For the time being, strong capital flows have enabled financing of CAD without a significant drawdown of foreign exchange reserves. However, the possibility of volatility in these flows, which may put further pressure on the external sector, cannot be ruled out. A two-pronged approach, of lowering CAD in the medium term while ensuring prudent financing of CAD in the interim, is necessary from the policy perspective.

Monetary and Liquidity Conditions

With tightening cycle gradually impacting inflation, the Reserve Bank takes measures to combat tight liquidity conditions

9. Monetary policy in India has sought to balance the growth-inflation dynamics that included a frontloaded policy rate cut of 50 basis points (bps) in April 2012 and several liquidity enhancing measures. These included lowering of the cash reserve ratio (CRR) by 50 bps on top of a 125 bps reduction in Q4 of 2011-12 and the statutory liquidity ratio (SLR) by 100 bps in a bid to improve credit flows. The Reserve Bank also infused liquidity of over ₹1.3 trillion through outright open market operation (OMO) purchases during 2012-13 so *far. However, growth in monetary aggregates remains below the indicative trajectory.*

Financial Markets

Domestic reform initiatives and surging capital flows improve market sentiment and revive the IPO market

10. Improved global sentiments along with recent policy reforms by the government beginning September 2012, and market expectations of a cut in the policy rate in the face of moderation in inflation, aided FII flows into the domestic market. The equity markets showed significant turnaround, while the rupee remained range-bound. In addition, revival is witnessed in the IPO segment. Although Indian financial market sentiments improved significantly in Q3 of 2012-13, some macroeconomic concerns persist, as witnessed in the inverted yield curve. Sustained commitment to curtail twin deficits and nurture growth without fuelling inflation is critical to support investor confidence.

Price Situation

Headline and core inflation moderated, but suppressed inflation poses risks

11. Headline inflation moderated in Q3 of 2012-13 with significant moderation in non-food manufactured products inflation. Both weakening domestic demand and lower global commodity prices contributed to the softening of headline inflation. Though the recent hike in diesel prices will put some pressure on the overall price level, the near-term inflation outlook indicates that the moderation may continue through Q4 of 2012-13. While the pressure from generalised inflation remains muted at the current juncture, risks from suppressed inflation, pressure on food prices and high inflation expectations getting entrenched into the wage-price spiral need to be reckoned with. The inflation path for 2013-14 could face downward rigidity as some of the risks from suppressed inflation materialise.

Macroeconomic Outlook

Balance of macroeconomic risks suggest continuation of calibrated stance

12. Reforms since September 2012 have reduced immediate risks, but there is a long road ahead to bring about a sustainable turnaround for the Indian economy. Business sentiments remain weak despite reform initiatives and consumer confidence is edging down. The Reserve Bank's survey of professional forecasters anticipates a slow recovery in 2013-14 with inflation remaining sticky. Fiscal risks have somewhat moderated in 2012-13, but a sustained commitment to fiscal consolidation is needed to generate monetary space. Widening CAD, which is at historically high level, remains a constraint on monetary easing. Against this backdrop, while growth can be supported by monetary policy if inflation risks recede, credible fiscal correction with improved execution in infrastructure space to boost investment would be needed for a sustained revival. The balance of macroeconomic risks suggest continuation of the calibrated stance while increasingly focussing on growth risks.