

MACROECONOMIC AND MONETARY DEVELOPMENTS FIRST QUARTER REVIEW 2012-13

Overview

1. *Monetary and liquidity conditions have eased during 2012-13 as cuts in cash reserve ratio (CRR) and policy rates worked through the system. The Reserve Bank cut CRR by 125 basis points (bps) and front-loaded the policy rate reduction by cutting the repo rate by 50 bps in April 2012. It, however, paused at its Mid-Quarter Review in June 2012 factoring in inflation persistence and macro-economic risks that emanated from lack of momentum in fiscal consolidation. Significantly, while there is slack in the economy, inflation remains persistent. Going forward, monetary policy space needs to be created through fiscal adjustment and structural measures to improve supply conditions and boost the investment climate, so that the revival is supported in a non-inflationary manner.*

2. *Growth in Q1 of 2012-13 is likely to have stayed low after having dropped to a 29-quarter low in the sequentially preceding quarter. While the slowdown has been primarily driven by investment, more recently and to a lesser extent, consumption has also slowed. Global growth prospects have worsened during Q1 of 2012-13, thus putting domestic recovery at greater risk. Inflation, after falling in Q4 of 2011-12 has turned sticky. Price pressures remain with significant suppressed inflation in domestic energy prices and rupee depreciation, which have partly off-set the gains from lower global commodity prices.*

Global Economic Conditions

Global growth prospects worsen with growth also slowing in EDEs

3. *Debt overhang and persistent euro area problems coupled with still incomplete*

adjustment of the US economy from the 2008 financial crisis are keeping growth in Advanced Economies (AEs) low. Deceleration in growth in BRICS economies, which have so far been the drivers of growth in Emerging and Developing Economies (EDEs), has worsened global growth prospects further.

Financial market stress accentuates

4. *Global financial market stress eased significantly during Q1 of 2012 after ECB made a large liquidity injection, but was accentuated again by the deepening crisis in the euro area, especially in Greece and Spain. The recent Libor fixing case has also added to the uncertainty by drawing attention to how a few large global financial institutions allegedly manipulated one of the most commonly used market rates. Meanwhile, falling commodity prices and subdued inflation in large economies provided additional space for monetary easing. This fresh round of monetary easing has, however, increased the risks of inflation in EDEs even while inflation is likely to remain subdued in most AEs.*

Indian Economy: Developments and Outlook

Output

Growth risks accentuate, negative output gap likely to persist during 2012-13

5. *Economic activity slowed down considerably during Q4 of 2011-12 and has likely stayed weak during Q1 of 2012-13. Growth in 2012-13 is likely to remain below potential. Newer risks to growth have arisen from slowing global trade, domestic supply*

bottlenecks of industrial inputs, coal and electricity and less-than-satisfactory monsoon so far. Services growth is also showing signs of slowing in line with slowing industrial growth and weak global economy.

Aggregate Demand

Need for curtailing subsidies and propelling a government investment stimulus to address investment slack

6. *Aggregate demand weakened further during Q4 of 2011-12. The investment slowdown seen since H2 of 2010-11 has extended to Q4 of 2011-12. Apart from the sharp fall in investment, private consumption moderated during Q4 of 2011-12. Fiscal and monetary space to stimulate the economy remain limited in the presence of an already large fiscal deficit and persistent inflation. The fiscal deficit target for 2012-13 is at a risk of being breached due to likely overshooting of subsidies and shortfall in receipts. To address this risk, fiscal space needs to be created by curtailing subsidies and significantly boosting government capital expenditures to provide an investment stimulus to the economy, which would help crowd-in private investment.*

External Sector

CAD risks and concerns about sustainability persist

7. *Softening of global crude oil prices and moderation of gold imports may bring some relief to the balance of payments, but Current Account Deficit (CAD) risks remain significant for 2012-13. Slowing global growth and trade are likely to keep expansion in exports of goods and services low. Services exports net of services imports have declined notably in Q1 of 2012-13. With lower growth, the sustainable level of CAD has also come down to around 2.5 per cent of GDP. Financing a large CAD may pose difficulties in face of slowing foreign investment flows. External debt is likely to rise*

as increased debt flows bridge financing gap. As a result, external vulnerability indicators may deteriorate and would make economy susceptible to external shocks unless trade balance is compressed and FDI flows improve.

Monetary and Liquidity Conditions

Monetary and liquidity conditions ease during 2012-13

8. *A 50 basis points (bps) rate cut, following a 125 bps CRR reduction, coupled with active open market operation purchases have significantly eased monetary and liquidity conditions during 2012-13 so far. While these measures are supportive of growth, the rate of deposit expansion has slowed which could adversely affect liquidity. Credit growth has picked up in the current financial year and is in line with the indicative projections. The flow of resources from non-bank sources has also been good. In spite of a relative improvement in monetary and liquidity conditions during Q1 of 2012-13, the Reserve Bank would need to closely monitor the liquidity and monetary conditions ahead so that they remain consistent with the evolving growth-inflation mix.*

Financial Markets

Currency and equity markets remained under pressure

9. *Spillovers from global financial market uncertainties and waning investor confidence amidst deteriorating macroeconomic conditions, kept domestic currency and equity markets under pressure. The rupee depreciated by nearly 10 per cent during Q1 of 2012-13, before staging some recovery in July 2012. Equity markets remained range bound, with sharp gains in May 2012 being nullified during June 2012. Money market rates and G-sec yields eased reflecting improved liquidity and falling global commodity prices. However, going forward, financial stress is likely to remain with falling earnings and high leverage for non-financial firms.*

Price Situation

Inflation pressures persist despite weakening growth momentum

10. *Headline WPI inflation persisted above 7 per cent, while consumer price inflation, as per the new CPI, remains in double-digits. Inflationary pressures have persisted, with significant contribution from food and energy segments. Going forward, the decline in global commodity prices will provide some relief, but the gains have been partly offset by rupee depreciation. While core inflationary pressures are currently muted, a continued rise in real wages could spill over to core inflation. Persistence of inflation, even as growth is slowing, has emerged as a major challenge for monetary policy.*

Macroeconomic Outlook

Outlook remains weak, need to support recovery in a non-inflationary manner

11. *Growth risks in 2012-13 have been amplified by decelerating global trade and domestic supply constraints. At the same time, inflation risks remain significant due to suppressed inflation, poor supply responses and deficit monsoon conditions. Various surveys suggest that business and consumer confidence remain low. Revival of investor confidence would, therefore, need to be supported by addressing concerns over policy stasis, while putting in place complimentary actions that address macro-economic weaknesses.*