MACROECONOMIC AND MONETARY DEVELOPMENTS FIRST QUARTER REVIEW 2013-14

Overview

1. *After reducing policy rates by 100 basis points (bps) in 2012-13, the Reserve Bank cut its policy rate further by another 25 bps in May 2013, but paused in its Mid Quarter Review in June 2013. The forward guidance in May and the more cautious monetary policy stance in June substantially reflected concerns with the current account deficit (CAD) and its financing. While monetary policy is largely guided by the growth-inflation dynamics, it is also tempered by considerations of risks of external imbalances. Accordingly, policy initiatives were taken in mid-July to address exchange rate volatility so that it does not risk macroeconomic stability and growth sustainability. The measures taken included capping allocation of funds under LAF for each individual bank to 0.5 per cent of its own NDTL, increasing marginal standing facility (MSF) rate and bank rate by 200 bps each to 10.25 per cent and mopping up some liquidity through open market operations (OMO) sales and stipulating banks to maintain a minimum daily CRR balance of 99 per cent of the average fortnightly requirement.*

2. *Developments in the external sector since the third week of May 2013 brought to fore not just stress in the financial markets and asset prices, but also their impact on other macroeconomic parameters, including growth, public finances and inflation, as also financial stability. The buffers built and the fresh responses during the stress period have helped India to contend with a precipitous situation. However, global financial conditions remain stressed and domestic policy changes have not sufficiently improved business conditions. Growth continues to be slack, while inflation concerns, especially in the form of high consumer price inflation linger. Consequently, policy choices will need to be carefully evaluated and would need to preserve stable macroeconomic and financial conditions while addressing the growth concerns. In this context, structural reforms become important to reduce CAD to sustainable levels and to support growth.*

Global Economic Conditions

Global recovery prospects remain weak

3. *Global growth remained subdued, with improvements in some advanced economies (AEs), especially the US and Japan, getting counterbalanced by slowing growth in key emerging market and developing economies (EMDEs), including China and India. The International Monetary Fund (IMF) in its World Economic Outlook has revised the global growth down to 3.1 per cent in 2013 from 3.3 percent earlier.*

Global commodity price cycle stay benign, but with upside risks to crude prices

4. *With weak global growth, global commodity price inflation is expected to remain contained in the near term. The ongoing deleveraging and slowing growth in China is expected to put further downward pressure on global commodity prices. However, upside risks to global crude oil prices remain from rising geo-political uncertainties in the oil producing*

regions. Also, the impact of softer commodity prices has been offset in varying degrees for various countries due to depreciation of EMDE currencies vis-à-vis the US dollar.

Global financial markets have entered into a period of fresh turbulence

5. *Volatility and spillovers from the likely tapering of quantitative easing (QE) have gripped global financial markets since mid-May 2013. Financial markets are re-pricing risks factoring in the inevitability of monetary stimulus getting withdrawn at some stage. The global bond sell off in May and June 2013 has resulted in most currencies depreciating against the US dollar, causing further portfolio outflows across equities and commodities. Going forward, as a baseline case, global interest rates may continue to harden over the medium term. This is likely to tighten financial conditions further and episodically keep markets under stress.*

Indian Economy: Developments and Outlook

Output

Slow-paced recovery likely to shape later in 2013-14

6. *The Indian economy continued to remain sluggish in Q4 of 2012-13, though it still maintained a pace faster than most of the EMDEs. The growth in the full year, 2012-13, slipped to 5.0 per cent. The persistence in slowdown is reflected in below trend growth for seventh consecutive quarters since Q2 of 2011-12. The slowdown has also turned pervasive with most sectors growing below trend. Leading indicators do not suggest immediate improvement in production activity and a slow-paced recovery is likely to shape only later in 2013-14, supported by good monsoon that could shore up rural demand.*

Aggregate Demand

Improvement in aggregate demand requires overcoming high consumer price inflation and infrastructure bottlenecks

7. *Aggregate demand of the Indian economy during Q4 of 2012-13 remained slack with little improvement in investment activity and deceleration in consumption demand. Private consumption in real terms has decelerated due to persistent high inflation, while investment is hobbled by structural constraints. Corporate results indicate weak sales growth with corporate investment intentions remaining listless. In this situation, key to turning around the economy lies in re-balancing government spending from current to capital expenditures with a view to crowding-in private investment.*

External sector

Reducing CAD and ensuring its financing through stable flows are needed

8. *Even though the current account deficit (CAD) to GDP ratio moderated to 3.8 per cent in Q4 of 2012-13 from its historic high of 6.5 per cent in Q3 of 2012-13, indications are that it may have widened again in Q1 of 2013-14. Going forward, the current account is expected to show improvement with likelihood that gold imports may fall. However, risks to CAD financing have increased due to capital outflows from EMDEs. This has put rupee under pressure. Vulnerability indicators of the external sector have deteriorated. In this milieu, concerted policy reforms are needed to reduce CAD and to improve financing by attracting more stable capital flows to the Indian economy.*

Monetary and Liquidity Conditions

Policy recalibration became necessary with increased macro-financial risks

9. *The Reserve Bank eased monetary policy during 2012-13 and Q1 of 2013-14 while*

guarding against re-emergence of inflation. The transmission of this easing has reduced lending rates significantly. There was marked easing in liquidity conditions in Q1 of 2013-14, which broadly remained in line with policy objectives. However, the policy was recalibrated and availability and cost of rupee liquidity was tightened in July 2013, with a view to restoring stability to the foreign exchange market. Broad money (M3) growth remained broadly in line with the indicative trajectory. The deceleration in domestic growth and deterioration in asset quality of the banking sector has kept credit growth below the indicative trajectory in Q1 of 2013-14.

Financial Markets

Contagion from global bond sell off generates stress in Indian markets

10. *The policy statements by the Fed in May 2013 accentuated the global bond sell off. It also made markets jittery, leading to significant volatility in bonds, currencies, commodities and equities in EMDEs. Contagion from markets across Asia spilled over to India. Policy action was taken on a wide front to limit these spillovers. This helped stabilise rupee exchange rate, though interest rates increased. The subsequent policy indications by the Fed in July also appear to have temporarily calmed investor sentiments, but the overall situation remains in a state of flux.*

Price Situation

Headline inflation moderates but upside risks persist

11. *Moderation of global commodity prices, negative output gap and past monetary policy actions contributed to disinflationary momentum in the headline WPI inflation which fell below 5 per cent by May 2013. Non-food manufactured product inflation declined sharply to its lowest level in the past three years. However, food inflation has risen in May and June 2013 and is putting pressures on general price-level. These pressures could moderate somewhat if the monsoon remains on track during the rest of the season. Meanwhile, consumer price inflation remains stubbornly high and recent currency depreciation and upward revisions in fuel prices have increased upside risks to both wholesale and consumer price inflation.*

Macroeconomic Outlook

Amplifying macro-financial risks warrant cautious monetary policy stance

12. *Recovery in growth may take time and is expected to shape slowly as the year progresses. Moreover, sustainable recovery requires control over consumer price inflation that has continued to hover around double digits for the past 15 months. Going forward, business confidence remains subdued and the latest expectations surveys show a further fall in business sentiments. Meanwhile macro financial risks have amplified with global interest rate cycle starting to turn and causing capital outflows. External sector stress has increased and rupee has depreciated significantly. With recent liquidity tightening measures the Reserve Bank has curbed exchange rate volatility providing a temporary breather. While monetary policy focuses on restoring stability in the currency market it is important to push through structural reforms to support growth. The strategy will succeed only if structural reforms help reduce CAD and augment savings and investment.*