MACROECONOMIC AND MONETARY DEVELOPMENTS IN 2011-12

Overview

1. *Monetary policy was strongly anti-inflationary until October 2011. Subsequently, decelerating growth and declining inflation momentum prompted monetary policy to move to a neutral stance since December 2011. Some easing in liquidity was effected through a total of 125 basis points reduction in the Cash Reserve Ratio (CRR) during January-March 2012. Going forward, the policy stance will need to ensure that inflationary tendencies remain under control, even as growth adjusts to its trend.*

2. *Growth in Q3 of 2011-12 dropped to 6.1 per cent as investment and external demand contracted and private consumption decelerated. Growth is likely to improve moderately in 2012-13, supported mainly by a pick up in industry on the back of consumption demand and some improvement in investment. However, the depleted investment pipeline and depressed new investment may keep the pace of recovery slow.*

3. *Inflation has fallen in Q4 of 2011-12, but is likely to remain sticky at about current levels during 2012-13. Price pressures persist with considerable suppressed inflation in oil, electricity, coal and fertilisers, the incomplete pass-through of rupee depreciation, slow supply responses and increase in indirect taxes as well as demand effects of large government transfers.*

Global Economic Conditions

Global growth likely to remain moderate in 2012

4. *The recovery in Advanced Economies (AEs) that seemed to be shaping well at the start of 2011 lost steam towards the fag-end of the year and is clouding the prospects for global growth during 2012. It lost momentum as the protracted debt crisis in the euro area and fiscal fragilities dampened business and consumer confidence. However, contrary to fears that came to the fore time and again during 2011-12, global growth did not stall.*

5. *Going into 2012, the global economy appears to be in a continuing phase of multi-speed growth. Most recent assessments indicate that the euro area is entering into a mild recession, while growth and employment conditions in the US are improving. Growth in emerging markets, especially China and India, is slowing beyond what was anticipated but these two economies are still likely to provide some support for global recovery. In sum, in spite of a dip in growth, the world economy is unlikely to lapse into another recession.*

Financial market stress eases

6. *Global financial market stress eased significantly during Q1 of 2012 after the ECB made a large liquidity injection. However, stability and structural improvements in the euro area still remain the unfinished agenda. The recovery and financial stability can still be derailed by global inflation engendered by liquidity infusion and high crude oil prices.*

Indian Economy: Developments and Outlook

Output

Growth may have bottomed out in Q3 of 2011-12, but recovery ahead likely to be slow

7. *Early indicators suggest that growth may have bottomed out in Q3 of 2011-12 but recovery may be slow during 2012-13. Lower global demand, domestic policy uncertainties*

and the cumulative impact of monetary tightening lowered the growth rate to below seven per cent over the last two quarters. Industrial growth remains subdued due to supply-side bottlenecks, particularly in the mining sector, and moderation in investment demand. With measures being taken to remove supply-side bottlenecks, progress on fiscal consolidation could create conditions for a more favourable growth-inflation dynamic.

Aggregate demand

Investment downturn extends, speeding of public investment could crowd in private investment

8. *The growth slowdown has been driven by a sharp fall in investment, some moderation in private consumption and fall in net external demand. The drag from investment is likely to continue in the near term. Corporate investment intentions continued to drop during Q3 of 2011-12. Consultations with industry and banks suggest that new project investment continue to be sluggish. However, if increased capital outlays in the latest budget are speedily translated into government capital expenditure, it could crowd in private investment.*

External sector

BoP risks accentuate

9. *The balance of payments (BoP) came under significant stress during Q3 of 2011-12 as the current account deficit (CAD) widened substantially and capital inflows declined. This resulted in a drawing down of foreign exchange reserves. The wider CAD, increase in external debt, weakening net international investment position (NIIP) and deteriorating vulnerability indicators underscore the need for more prudent external sector management and demand management policies to limit the absorption impact that is keeping import demand high. While capital inflows have revived somewhat in 2012, BoP risks remain due to high oil prices and uncertainties in the global economy.*

Monetary and Liquidity Conditions

Reserve Bank responds to tight liquidity conditions by injecting primary liquidity

10. *With falling inflation and growth, the Reserve Bank shifted gears to a more neutral policy, preparing to ease ahead if inflation trends down further. Amidst increasing structural and frictional liquidity deficits during Q4 of 2011-12, the Reserve Bank injected large amounts of primary liquidity through Open Market Operations (OMOs) and Cash Reserve Ratio (CRR). Liquidity conditions have eased substantially in April 2012 with large government spending. Going forward, barring shocks to autonomous drivers, liquidity conditions may stay comfortable in Q1 of 2012-13.*

Financial Markets

Financial market stress ease but risks remain

11. *With reduced stress in global financial markets and revival of capital inflows, financial conditions improved in India. However, tight liquidity conditions saw money market rates firm up. G-sec yields also firmed up post-budget in response to the large market borrowing programme. Going forward, there are risks of disruptive movements from euro area and financialisation of commodities.*

Price Situation

Inflation path for 2012-13 likely to be sticky

12. *Inflation has moderated in recent months to under 7 per cent, in line with the Reserve Bank's projections. However, the path of inflation in 2012-13 could remain sticky with high oil prices, large suppressed inflation, exchange rate passthrough, impact of tax hikes, wage pressure and structural impediments to supply response. The pricing power of companies* has waned with moderation in demand as also *lower non-oil commodity prices. This should*

help keep inflationary pressures under control in 2012-13.

Macroeconomic Outlook

Macroeconomic challenges warrant careful calibration of monetary policy

13. *Various surveys suggest that growth is likely to be only slightly higher in 2012-13 than in 2011-12. Alongside, inflation is likely to remain within a relatively narrow range during the year with probability of further significant moderation being small. The output gap is unlikely to be closed. Recent experience suggest that the non-inflationary growth rate for India may have somewhat declined from the pre-Lehman crisis period. Monetary policy would, therefore, need to support growth without risking external balance or inflation by excessively fuelling demand. Fiscal policy has a key role to speed up public investment to crowd in private investment while staying on the path of fiscal consolidation. As such, monetary actions will need to be calibrated to evolving growth-inflation dynamics and the fiscal response.*