MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2011-12

Overview

1. *Global growth is slowing down again, after a contraction in 2009 and a recovery in 2010. The euro area appears headed for recession. A slowing global economy will continue to drag domestic recovery in 2012-13. However, available information suggests that in spite of a dip in growth, the world economy is unlikely to enter another recession.*

2. *Growth in India is moderating more than was expected earlier. It is likely to be below potential during 2011-12, but is expected to recover at a modest pace in 2012-13. The slack in investment and net external demand components of aggregate demand may keep the pace of recovery low. Inflation has started to fall, broadly in line with the projected trajectory. Nonetheless, price pressures remain, with risks emanating from suppressed domestic energy prices, the incomplete pass-through of rupee depreciation and slippage in fiscal deficit. The decline in food inflation is likely to reverse ahead with the waning of base effects and seasonal factors behind the fall.*

3. *The growth slowdown, high inflation and currency pressures, complicate policy choices. While monetary policy's main goal is to maintain low and stable inflation, it also has to take into account the downturns in growth for possible counter-cyclical responses. These responses need to factor in the overall macro-economic situation, including fiscal and current account gaps. So, while the course of monetary policy ahead will be largely calibrated and shaped by the evolving growth-inflation dynamics, the impact of other macro-variables would have to be considered as they condition these dynamics.*

Global Economic Conditions

Global growth moderates, hinging on euro area debt resolution

4. *Global recovery is likely to lose traction due to the continuing euro area debt crisis. The news flow from the US has been mixed, with growth accelerating in Q3 of 2011 but getting revised downwards substantially from the initial estimates. Unemployment rate fell to 8.5 per cent in December 2011 and consumer confidence improved. However, growth in euro area is already stagnating and as fiscal austerity progresses, the area could enter into a recession. With growth decelerating in emerging and developing economies (EDEs), the spillovers from euro area are likely to pull down global growth. As such, global growth hinges on resolution of euro area debt problem, which, notwithstanding significant policy responses in recent months, faces impediments.*

Financial market stress rises as sovereign credit risks mount with private sector bailouts

5. *Global financial markets came under stress during Q3 of 2011-12. An adverse feedback loop between bank and sovereign debt generated significant refinancing risks that could only be contained in the interim through policy actions in the euro area. These*

measures may still fall short of successful debt resolution and the risk of contagion may continue to loom. The S&P's sovereign rating downgrade of nine euro area countries on January 13, 2011, with four of them being downgraded by two notches, was reflective of the rising sovereign balance sheet problems. Tightening credit conditions, rising risk premiums, deleveraging, weakening economic growth in the euro area are keeping global financial markets under stress.

Global commodity prices continue to moderate, but oil prices hold

6. *Global commodity prices, especially those of metals, continue to moderate. The LME Metals index has softened and the FAO food index has also dropped. However, oil prices have defied the trend. The current Brent crude oil price is still 30 per cent higher than its average for 2010-11, reflecting a combination of demand and supply factors along with financial impact of large quantitative easing by Advanced Economies (AEs). Going forward, some further softening in commodity prices on the back of weaker global growth is likely in 2012-13. However, upside risk to oil price remain from rising geo-political uncertainty.*

Indian Economy: Developments and Outlook

Output

Global linkages reinforce domestic factors to slow down economy

7. *Global spillovers through trade and capital flow channels are slowing down India's growth more than earlier anticipated. The impact has been exacerbated by domestic factors, both cyclical and structural. Industrial growth has been adversely affected by contraction in mining, deceleration in manufacturing and slowdown in construction activity. This will have some adverse impact on the growth of services sector.*

Aggregate Demand

External and investment demand may drag growth ahead

8. *Growth in the economy has been impacted by lower external and investment demand during last three quarters. There has been a sharp decline in new corporate fixed investment since H2 of 2010-11 and this trend continues. Going forward, investment may start recovering in 2012-13 contributing to growth recovery. There is need to contain fiscal slippage and rebalance public spending from consumption to investment to support medium-term growth.*

External Sector

CAD risks amplify as capital flows moderate

9. *Early indicators suggest that the current account came under increased pressure during Q3 of 2011-12. Inelastic demand for oil and rising gold imports have widened the trade deficit, while exports decelerated. As capital flows have also moderated since August 2011, financing pressure on the current account deficit (CAD) translated into exchange rate pressures. While various external vulnerability indicators deteriorated, India's net international investment position improved. To reduce external sector pressures, moderation in import demand and acceleration in domestic reforms are needed.*

Monetary and Liquidity Conditions

Monetary growth keeps pace even as money market liquidity tightens

10. *Monetary policy rate was kept on hold in December 2011 based on forward-*

looking assessment of risk to growth and moderation in inflation. However, a turnaround in the monetary cycle would depend on how growth-inflation dynamics shape ahead. Money market liquidity tightened significantly since November 2011 partly due to dollar sales by RBI, but monetary growth has kept pace with the money multiplier rising endogenously. Credit growth slowed below the indicative projection due to demand as well as supply side factors. Demand for credit weakened in response to slack in real activity. Supply also slowed down with rising risk aversion stemming from deteriorating macroeconomic conditions and rising non-performing loans.

Financial Markets

Markets come under pressure from global spillovers

11. *Global spillovers and macroeconomic deterioration resulted in pressures on equity and currency markets. The sharp depreciation of the rupee during August-December 2011 contributed to the drying up of foreign equity inflows and in turn, further weakened the rupee. The sudden stop of equity financing also impacted investment financing. The impact was compounded by poor resource mobilisation in the primary capital market. The stress in the financial markets was mitigated by policy measures that included infusion of rupee and dollar liquidity. As a result, call money rates largely remained within the interest rate corridor and the spikes were effectively contained.*

Price Situation

Inflation trending down but exchange rate pass-through to limit fall

12. *Inflation is moderating as result of fall in vegetable prices, favourable base effects and some fall in pricing power of the manufacturers. The current momentum of decline in inflation is likely to persist through Q4 of 2011-12. However, the as yet incomplete exchange rate pass-through, pressures from suppressed energy prices and structural factors contributing to protein-based food inflation are likely to limit the decline in inflation. Furthermore, expansionary fiscal policy is likely to impact price stability by affecting aggregate demand. Since the fiscal expansion is largely on revenue account and capital spending remains low, it can adversely affect the supply responses needed to lower long-run inflation.*

Macroeconomic Outlook

Growth outlook weakens, calibrated response needed as inflation risks stay

13. *The Growth outlook has weakened as a result of adverse global and domestic factors that have been mentioned above. Business and consumer confidence has been impacted. Professional forecasters now see a weaker growth in the economy. However, inflation and expectations of inflation remain high and upside risks emanate from exchange rate pass-through, revisions in administered prices and higher-than-expected current fiscal spending. Consequently, monetary actions will need to strike a balance between risks to growth and inflation.*