MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2013-14

Overview

1. *During the course of 2013-14, monetary policy had to face an extraordinary spell of financial turbulence arising from the US Fed contemplating tapering its large scale asset purchase programme. The news heralded the turning of the global interest rate cycle with volatile movements for cross-border capital flows and asset prices. Like most emerging market and developing economies (EMDEs), India faced capital outflows and intense exchange rate pressures. Monetary policy had to depart from its charted course of calibrated monetary easing that had started in April 2012 using the monetary policy space that was gradually becoming available. Past monetary tightening was dampening the pricing power of the corporates and the return to fiscal consolidation in H2 of 2012-13 was reducing the twin deficit risks. Though macroeconomic weaknesses were evident in the form of persistence in inflation, falling growth, weaker corporate balance sheet, deteriorating asset quality of the banks, fiscal imbalances and external sector vulnerabilities, the economy seemed to be mending. However, the prospect of tapering interrupted this.*

2. *The event resulted in a rapid deterioration of financial conditions across emerging markets, including India. The rupee exchange rate depreciated by 17 per cent against the US dollar, amid a foreign exchange reserve depletion of nearly US$17 billion, between the first indication of tapering and September 3, 2013. There were net FII disinvestments of over US$13.4 billion (US$10.5 billion in debt and US$2.8 billion in equity) over this period. Large capital outflows and sliding currency brought to fore the underlying macro-economic weaknesses. Stabilisation of the economy by restoring exchange rate stability became the overriding task.*

3. *Short-term interest rates were raised by hiking the Marginal Standing Facility (MSF) rate by 200 bps and siphoning off excess liquidity with a view to defending the rupee exchange rate. Several other measures were introduced, either to restrain the current account deficit (CAD) or to improve its financing. These policies, along with a forward-looking blueprint for further financial market reforms laid down by the Reserve Bank on September 4, helped turn the tide and stabilise financial market conditions. Since that point, rupee has appreciated 6.7 per cent (till January, 27, 2014) against the US dollar and the reserve loss has been more than fully recouped. Capital flows resumed, with net investment of US$9.1 billion in equities during September 4, 2013 to January 24, 2014. Though there were large disinvestments in the debt segment aggregating US$ 14.5 billion from May 22 to end-November 2013, debt flows have turned positive thereafter with net investments of US$ 3.8 billion. More importantly, the looming external sector risks*

were mitigated with CAD shrinking from 4.9 per cent in Q1 of 2013-14 to 1.2 per cent of GDP in Q2. With the resultant improved stability in the foreign exchange market, the Reserve Bank quickly moved to normalise exceptional liquidity and monetary measures and recalibrate monetary policy, taking into account, the prevailing inflation and growth conditions. The MSF rate was lowered by 150 bps in three steps, while the repo rate was raised by 50 bps in two steps. Besides liquidity conditions were eased to realign operational policy rate to the repo rate that is now 25 bps higher than at the start of the year. The Reserve Bank has maintained a tight monetary policy stance but has desisted from stiff tightening keeping in mind the weak state of economy. It has been evolving its policy action with rapidly changing financial and macroeconomic conditions.

4. *This Report explains the recent policy actions and provides a macroeconomic backdrop to global and domestic economic conditions that have gone into formulating the monetary policy response to the third quarter review. The highlights of the report are the following:*

Global Economic Conditions

Global growth prospects improve, though downside risk still exist

5. *Global growth, after decelerating for the last three years is poised to improve in 2014, but risks to outlook remain with uncertainties arising from moves to unwind unconventional monetary policies and possibility of a renewed deflation in the euro area. Economic expansion in the US is gaining firmer footing and will aid recovery in global activity and trade. Recovery in large EMDEs could stay moderate as supply-side constraints, tight monetary policies and tightening of financial conditions with tapering by the US could act as a drag on growth acceleration.*

6. *Inflation has continued to be low in advanced economies (AEs) aided by high unemployment and large spare capacities. After a year of deflation, inflation picked up in Japan. Among the emerging economies, monetary policy was tightened further by Indonesia, India, and Brazil, as they confronted high inflation and pressures on their exchange rates. Going forward, inflation risks for EMDEs are likely to stay in the near-term conditioned by structural factors and demand pressures emanating from narrowing output gap. However, global commodity price cycle is likely to stay benign on the back of improved supplies of oil, metals and food.*

7. *The US Fed's announcement on December 18 of tapering of its large scale asset purchase programme had a limited impact on global financial markets in sharp contrast to the May indication. India, having rebuilt its buffers during Q3, withstood the announcement better than many of its peers. Going forward, the spacing of the Fed's tapering moves over the course of 2014 could influence market movements even though some of it seems to have been priced in.*

Indian Economy: Developments and Outlook

Output

Growth may improve a tad in H2 of 2013-14 due to rebound in agriculture and improved exports

8. *Growth in H2 of 2013-14 may turn out to be marginally higher than H1, mainly due to a rebound in agriculture output and improved export performance. However, industrial growth continues to stagnate and leading indicators of the services sector exhibit a mixed picture.*

Clear signs of a pickup are yet to emerge, though a modest recovery is likely to shape up in 2014-15. Durable recovery remains contingent on addressing persistent inflation, and the bottlenecks facing the mining and infrastructure sectors.

Aggregate Demand

Aggregate demand slowly picking up, but would require support through public investment to crowd-in private investment

9. *Aggregate demand in the economy exhibited some improvements during Q2 of 2013-14 mainly on account of surge in net exports. However, private consumption expenditure, the mainstay of aggregate demand stayed low in the face of high inflation that has caused discretionary demand to fall. The investment cycle is yet to turnaround. However, corporate sales have improved during Q2, indicating that demand may have started improving. Overall, aggregate demand is expected to receive support from rural demand and exports, though downside risks emanate from public spending cuts. The pick-up in demand in the coming year depends critically on the successful resolution of bottlenecks facing infrastructure and energy-intensive industrial projects. It is also important to create fiscal space in 2014-15 to support public investment by restraining revenue spending, so as to crowd in private investment. As such the quality of government spending has to improve to support growth.*

External sector

Lower trade deficit in Q2 and Q3 of 2013-14 brings CAD to sustainable levels

10. *In response to the adjustment of the rupee exchange rate, disincentivising on gold imports, as also improvement in global trade, India's trade deficit during April-December 2013 has been 25 per cent lower than last year. Consequent to lower trade deficit, CAD declined from 4.9 per cent of GDP in Q1 to 1.2 per cent of GDP in Q2 of 2013-14 and the full year CAD is likely to be below 2.5 per cent of GDP. This, along with recouping the reserve loss due to the Reserve Bank's swap windows helped mitigate external sector risks. However, as capital flows to EMDEs could moderate over 2014-15, there is no scope for complacency and the breather provided by a reduction in the immediate risks, needs to be used to develop the resilience of the external sector over the medium-term.*

Monetary and Liquidity Conditions

Monetary policy evolving with changing macro-financial conditions

11. *Large capital outflows and consequent exchange rate pressures since May changed the course of monetary policy. Short-term interest rates were raised and liquidity conditions were tightened considerably through exceptional measures till such time as the exchange rate stabilised. Since then the exceptional measures have been normalised, though resurgence in inflation prompted policy rate increases. Also, additional liquidity was provided through term repos and forex swaps. The latter added to net foreign assets (NFAs) and turned out to be a significant driver of reserve money growth in Q3 of 2013-14.*

Financial Markets

Normalcy restored in financial markets but political outcomes and commitment to reforms hold the key

12. *Normalcy was restored in both global and domestic financial markets after the May tapering indications abruptly tightened financial*

conditions. Due to rebuilding of buffers, the Indian financial markets successfully withstood the effect of the Fed's tapering decision in December 2013. In fact, equity markets gained by over 9 per cent during Q3 as markets priced in macroeconomic improvement arising mainly from lower external sector risks and better-than-expected corporate results. However, primary capital markets remained subdued. While global investors had turned overweight on Indian equities in the 2014 asset allocations, the performance of markets in the near term will be conditioned by political risks and commitment to reforms.

Price Situation

Inflation declines significantly on vegetable price correction but CPI ex-food and fuel inflation exhibits persistence

13. *Inflation declined significantly in December 2013, both in terms of the CPI and WPI, driven by falling food prices which had firmed up considerably during April-November. Despite the moderation, CPI inflation continued to remain high near 10 per cent with inflation excluding food and fuel components also remaining persistent at 8.0 per cent. Earlier, the path of disinflation was disrupted by a series of food price shocks during June-November and a weaker rupee. Food price pressures reflect rising input costs, including higher agriculture wages, output shortfalls and uncompetitive supply chains. Non-food manufactured products WPI inflation has remained subdued so far in the presence of a negative output gap, though it has increased recently due to cost-push pressures. These pressures, along with second-round impacts, have also caused consumer price inflation, ex-food and fuel to remain persistently high.*

Macroeconomic Outlook

Gradual recovery likely in 2014-15; risks to inflation stay despite some moderation

14. *Various surveys, including the Reserve Bank's Industrial Outlook Survey, show that business confidence has started to rebuild. On current reckoning, growth in 2013-14 is likely to fall somewhat short of the Reserve Bank's earlier projection of 5.0 per cent. However, a moderate paced recovery is likely to shape in the next year with support from rural demand, a pick-up in exports and some turnaround in investment demand. The growth in 2014-15 is likely to be in the range of 5 to 6 per cent, with likelihood of it being in higher reaches of this forecast range if project clearances translate into investment. Despite moderation in December and some further softening expected in near term, inflation risks have to be watched carefully as we enter into the next year. This is due to upward revision in domestic energy prices, expected growth acceleration, structural bottlenecks affecting food inflation and adverse base effects. Headline CPI inflation is expected to remain above 9 per cent in Q4 of 2013-14 and range between 7.5 to 8.5 per cent in Q4 of 2014-15, with the balance of risks tilted on the upside.*