Macroeconomic And Monetary Developments Second Quarter Review 2012-13

Overview

1. Since the beginning of 2012, monetary policy has been aimed at maintaining monetary conditions in line with the objective of containing inflation, while ensuring that liquidity conditions remain supportive of recovery. In this direction, the Reserve Bank used the available space to support growth by lowering the cash reserve ratio (CRR) by 150 basis points on a cumulative basis, the statutory liquidity ratio (SLR) by 100 bps, the repo rate by 50 basis points and infusing over ₹1.7 trillion of liquidity through outright open market purchases. As a result, liquidity in 2012-13 so far has stayed in line with policy objective. Going forward, there is a need to calibrate monetary policy factoring in the evolving growth-inflation dynamics as also the progress that may be made in containing the twin deficits.

2. Growth in Q2 of 2012-13 is likely to have stayed low with no perceptible signs of improvement from the preceding quarter. Saving and investment rates have declined in recent years, pushing the economy's potential growth rate down to about 7 per cent. The reform measures announced since mid-September 2012 can help improve growth subject to quick implementation. As the policy environment, pace of clearances for projects and input supplies improve, the drag of stalled infrastructure investment on growth would decline.

3. Inflation has stayed sticky at around 7.5 per cent in 2012-13 so far. Non-food manufacturing inflation has not softened in spite of the negative output gap that has emerged as a result of slowing growth. Fiscal imbalances, past exchange rate depreciation and feeble supply response have impacted inflation. Going forward, inflation is likely to remain sticky in near months, but some relief may follow as demand-side inflationary pressures ebb after a period of high wage and cost push inflation.

Global Economic Conditions

Global growth prospects weaken

4. Growth prospects, both in advanced economies (AEs) and emerging and developing economies (EDEs) have weakened in Q2 of 2012. In October 2012, the International Monetary Fund (IMF) revised its global growth projections for both these groups downwards. Weaker growth prospects largely reflect the impact of sovereign debt overhang and banking fragilities in the euro area coupled with fiscal multipliers impacting growth with on-going fiscal consolidation. Euro area risks have affected business confidence and caused world trade to decelerate. Consequently, several EDEs face weaker external demand on top of an already slowing domestic demand. Further downside risks to global growth stem from a possible "fiscal cliff" leading to sudden and sharp fiscal consolidation in the US.

Global inflation likely to stay benign

5. With the slack in output and employment in AEs and falling growth in many large EDEs, global inflation pressures are likely to stay muted during rest of 2012. Global commodity prices are expected to remain range bound, but event risks can disturb the current stability. The renewed quantitative easing in some AEs poses some upside risks through liquidity and exchange rate channels.

Contagion risks persist in global financial markets

6. Risks of spillovers in global financial markets remain large despite of credible policy actions by major central banks. Unconventional monetary policies hinging on exceptional liquidity support and easy money have transitorily moderated uncertainties in the financial markets keeping them in a risk-on, risk-off mode. However, the underlying stress has not

diminished with incomplete deleveraging and unfinished financial sector reforms. This has kept the financial systems fragile and markets impacted by risk aversion.

Indian Economy: Developments and Outlook

Output

Growth remains sluggish, reforms may arrest downturn

7. Economic indicators suggest that the slowdown has continued in Q2 of 2012-13 with slack industrial activity and sub-par services sector performance. However, recent policy reforms should help, albeit with some lag, in contributing to arresting the downturn. They may support the recovery later upon successful implementation. The improved prospects for Rabi, following the reduction in monsoon deficit with late rains are also expected to contribute to improving growth and inflation outlook, even though the recovery may take some time to set in.

Aggregate Demand

Fiscal consolidation and removal of impediments to infrastructure investments hold the key to growth revival

8. Aggregate demand is weakening in 2012-13 led by investment slowdown. Corporate sales growth has also moderated significantly. In spite of recent measures aimed at lowering fiscal deficits, fiscal slippage is likely in 2012-13 reinforcing the need for further measures for fiscal consolidation to crowd-in private investment. Rebalancing of aggregate demand towards investment holds the key to growth revival. It is, therefore, necessary to remove the pending constraints in the power, coal and road sectors at the earliest.

External sector

CAD wider than comfortable in spite of BoP improvement

9. External sector risks remain in spite of the improved balance of payments (BoP) during Q1 of 2012-13. Though the merchandise trade deficit in 2012-13 so far has been lower, it largely reflects contraction in import demand on the back of growth deceleration. Services trade surplus is lower, leaving the current account deficit (CAD) wide enough for re-emergence of financing pressures should global risk aversion increase or domestic recovery falter. Recent measures, including those to augment FDI, should help in CAD financing. However, external sector vulnerability and sustainable level of CAD would need to be considered, while framing medium-term trade and capital account policies.

Monetary and Liquidity Conditions

Reserve Bank infuses liquidity, calibrates monetary policy with evolving growth-inflation dynamics

10. Active liquidity management through reductions in the CRR, and the SLR backed by OMOs has kept liquidity largely in line with the policy objective, factoring in inflation persistence and the need to ensure credit supply to support growth. Liquidity conditions remained comfortable during Q2 of 2012-13. Monetary and credit aggregates, however, remained below the indicative trajectory. The current credit slowdown largely reflects tepid demand conditions and distinctively lower credit expansion in case of public sector banks, reflecting mainly their risk aversion engendered by deteriorating asset quality. Looking ahead, monetary policy will need to factor in output and inflation gaps, keeping in view the current trajectory of liquidity, monetary and credit aggregates.

Financial Markets

Markets respond to reform measures, but more needed to revive primary capital markets

11. Policy reform measures have shifted market sentiments, strengthening the equity prices and the rupee exchange rate. Gains for the bond markets have been limited despite the G-sec auction calendar for the second half of the year remaining in line with the budgeted numbers. This may be due to markets factoring in the inadequate fiscal adjustment in the current year. There is need for steps to revive the primary capital markets so that financing constraints for corporate investments are reduced.

Price Situation

Inflation remains on a sticky path warranting caution for some more time

12. Inflation has stayed sticky at around 7.5 per cent. Persistent non-food manufactured products inflation, despite the growth slowdown, has emerged as a concern. While the near-term inflation risks are on the upside, inflation should start moderating from Q4 of 2012-13. These expectations factor in the late revival of the monsoon that can have a salutary effect on current food inflation. With global inflation likely to remain benign and suppressed inflation pressures starting to recede, inflation could soften further in H1 of 2013-14. However, improved supply-responses and moderation of wage inflation is vital for bringing down inflation to comfort levels.

Macroeconomic Outlook

Policy calibration needed as inflation risks persist, while growth remains weak

13. Business sentiments remain weak at the moment and global growth projections, including that for India, are getting revised downwards. Domestic constraints, especially in infrastructure space, have continued to impede investments. However, the falling growth cycle appears to have reached its trough. Recent policy measures have reduced macroeconomic risks, but speedy implementation and sustained reforms are important for turning the economy around. Meanwhile, inflation risks persist, warranting a cautious policy calibration. If macro-risks from inflation and twin deficits recede further, that could yield space down the line for monetary policy to respond to growth concerns.