Macroeconomic and Monetary Developments Second Quarter Review 2011-12

Overview

During Q3 of 2011, global growth prospects further deteriorated, which may have an adverse impact on the Indian economy. The intensity of the impact will depend on how deep is the global downturn which, in turn, is related to how the current and future financial stress in global markets are addressed. In a baseline scenario, growth in India in 2011-12 is likely to be somewhat below trend.

2. Inflationary pressures are strong and persistent due to structural rigidities, continuing strong demand and the adaptive nature of inflation expectations. The path of inflation is sticky and remains broadly in line with earlier projections. With falling global commodity prices partly offset by rupee depreciation, the risks to inflation projections are now balanced.

3. Monetary policy has been tightened considerably with an effective 500 bps rate hike cumulatively and a 100 bps reserve requirement increase in a span of 20 months since February 2010. Monetary transmission has helped raise deposit and lending rates, correct the mismatch between deposit and credit growth and dampen aggregate demand. Though the risks to growth are becoming visible, the challenge of bringing down inflation to an acceptable level on a sustainable basis still remains significant.

Global Economic Conditions

Global growth risks intensify as debt crisis erodes confidence

4. Global growth prospects appear to be declining, even though recovery has not stalled. There have been significant downward revisions in growth projections for the advanced economies. Risks to global growth have amplified with business and consumer confidence dampening on the back of the deepening sovereign debt crisis in Europe. Private sector balance sheets are at risk and significant banking sector weakness is re-emerging as a result. Importantly, financial stress could extend beyond euro area boundaries. If the euro area slows down further, as currently expected, it may have a domino effect on the global economy with spillovers to emerging markets.

5. In its World Economic Outlook of September 2011, the International Monetary Fund (IMF) significantly lowered its global growth forecast by 0.3 percentage points for 2011 and 0.5 percentage points for 2012. The world economy is still expected to grow at 4.0 per cent in both these years. The cuts in growth projections were deeper for advanced economies (AEs), but were also pervasive among emerging and developing economies (EDEs). The IMF also lowered its growth forecast for India. Its current projections of 7.8 per cent for 2011 and 7.5 per cent for 2012 in market prices correspond to a projection of 7.6 per cent growth at factor cost for 2011-12 and 2012-13.

Global commodity prices softening, but consumer inflation persists

6. Global commodity prices, especially those of metals, have softened significantly. However, even after some correction, the current Brent crude oil price is still over 25 per cent higher than its average for 2010-11. The IMF has revised upwards its consumer price inflation forecast for EDEs by 0.6 percentage point to 7.5 per cent for 2011, while leaving the projection for AEs unchanged at 2.6 per cent.

7. The global inflation path remains unclear. A strong softening bias has been induced in by the impending global slowdown. Producers' pricing power remains low in AEs. Wage inflation is also likely to be restrained as unemployment still remains a significant challenge in these economies. However, this is

counterbalanced by inflation persistence in EDEs backed by demand conditions. Also, there are upside risk to global commodity prices stemming from excessively accommodative monetary policy stance in AEs.

Indian Economy: Developments and Outlook

Output

Growth moderating below trend in 2011-12

8. Growth in 2011-12 is likely to moderate to below trend. Agriculture prospects remain encouraging with the likelihood of a record Kharif crop. However, moderation is visible in industrial activity and some services, mainly construction and community, social and personal services. Given the linkage of domestic industrial growth with global cycle, some further moderation is likely ahead given the weak global PMIs. Capacity constraints seem to be easing in some manufacturing activity, especially cement, fertilizers and steel. Construction activity has slowed and leading indicators suggest that services growth may slightly weaken ahead.

Aggregate demand

Investment slowdown may impact growth ahead

9. Indications are that investment demand is softening as a result of combination of factors including monetary tightening, hindrances to project execution and deteriorating business confidence. Planned corporate fixed investment in new projects declined significantly since the second half of 2010-11. Consequently, the pipeline of investment is likely to shrink, putting 2012-13 growth at risk. Private consumption is also starting to soften in parts, but it still remains robust as is evident from corporate sales performance. There are also risks to demand management if government consumption spending overshoots budget estimates. As such, a key to growth sustainability lies in supporting investment by rebalancing demand from government consumption to public and private investment.

External sector

Widening CAD poses risk if global trade and capital flows shrink

10. The Current Account Deficit (CAD) widened in Q1 of 2011-12. Exports are expected to decelerate in H2 of 2011-12. If global financial market stress increases further and affects capital flows to the emerging markets, financing of CAD could pose a challenge. The Indian rupee has seen significant nominal and real depreciation in Q2 of 2011-12. However, this trend has been in line with that of other emerging market currencies, which too depreciated significantly as US dollar appreciated with flight to safety amidst rising risk aversion.

Monetary and Liquidity Conditions

Liquidity conditions remain comfortable, credit growth stays above trajectory

11. Though during Q2 of 2011-12, liquidity conditions remained in deficit mode in line with the policy objective, it remained comfortable. Base money has decelerated as currency growth moderated. Money (M_3) growth, however, moderated less sharply as the money multiplier increased. Bank credit growth is also presently above the indicative trajectory. This has been supplemented by increased resource flows from non-banking sources. Going forward, credit growth is expected to moderate as growth slows down. Monetary transmission is still unfolding in response to significant monetary tightening since February 2010. However, real interest rates are still low and supportive of growth.

Financial Markets

Spillovers contained in domestic equity and currency markets as risk aversion and volatility is back in global markets

12. The US sovereign rating downgrade and the deteriorating sovereign debt situation in the euro area caused significant pressures in global financial markets during Q2 of 2011-12. Rising risk aversion caused credit spreads to widen, and most markets experienced increased volatility. Volatility spillovers impacted domestic equity and currency markets, but were

contained by providing adequate rupee and forex liquidity. Rupee depreciation and the fall in equity indices in Q2 of 2011-12 were comparable to the patterns in most other emerging markets. Money market rates remained in line with policy signals, while G-sec yields hardened after the announcement of additional market borrowing.

Price Situation

High inflation likely to persist in near-term before moderating as falling global commodity prices provide limited comfort

13. Upside risks to inflation persist in EDEs which have experienced elevated inflation for more than a year. Global commodity prices have eased, but the levels remain high, especially for crude oil. Financialisation of commodities has made the future commodity price path uncertain. With incomplete pass-through of the earlier rise in global commodity prices, the favorable impact, arising from the transmission of falling global commodity prices is also likely to be limited. Moreover, the benefit from the recent fall in global oil prices has been offset by rupee depreciation. Domestic price pressures still remain significant and broad-based. Food price inflation remains high as a result of structural mismatches in non-cereal primary food articles and large MSP revisions. Real wage inflation has been significant in 2010-11 and the wedge between wage inflation and CPI inflation has increased further in Q1 of 2011-12. In sum, the inflation challenge remains significant.

Macroeconomic Outlook

Growth risks amplify while sticky inflation makes policy choices difficult

14. Growth risks have increased on account of global headwinds and domestic factors. The baseline inflation path still remains sticky and broadly unchanged from earlier projections. This has made policy choices more complex. Some sacrifice of growth is inevitable in the current milieu of high inflation. On the current assessment the growth in 2011-12 is likely to moderate slightly from that projected earlier. Various surveys conducted suggest that business expectations have suffered, while inflation expectations remain high. At the same time inflation risk persists. In this backdrop, the monetary policy trajectory will need to be guided by the emerging growth-inflation dynamics even as transmission of the past actions is still unfolding.