Macroeconomic and Monetary Developments Second Quarter Review 2013-14

Overview

1. With improved stability in the foreign exchange market, the marginal standing facility (MSF) rate, which had become the effective anchor for money market rates, was reduced by 75 bps in the Mid-Quarter Review on September 20 and further by 50 bps on October 7 to 9.0 per cent. The Reserve Bank further introduced 7-day and 14-day variable rate term repos to provide additional liquidity up to 0.25 per cent of net demand and time liabilities (NDTL) of banks.

2. Given the tight liquidity conditions in line with the policy intent, the MSF rate had served as the effective policy rate in the short-run. So the effective cost of funds in the money market was reduced by lowering the MSF rate. However, keeping in view the concerns emanating from high and persistent consumer price index (CPI) inflation and some rise in the wholesale price index (WPI) inflation, as also the impact of low real interest rates on saving behaviour, the Reserve Bank hiked the repo rate by 25 bps on September 20. This signalled that the policy rate needed to respond to inflation risks so as to secure macroeconomic stability, even as the process of normalisation of monetary policy with a rollback of exceptional measures proceeds.

3. The Reserve Bank has been adopting a judicious mix of policy under a difficult macroeconomic scenario of high inflation, low growth and financial fragilities. Unlike countries which could go for quantitative easing to support growth on the back of deflation or very low inflation, India has faced markedly higher inflation even when compared to its emerging market peers in recent years. This makes it important to keep liquidity under check and the policy rate at a reasonable level to anchor inflation expectations, with a view to ensuring stable macro-financial conditions and positive real returns to savers. As the exceptional measures are rolled back with the improvement in exchange market conditions, it is important to keep this balance in view.

Global Economic Conditions

Sluggish global growth continues to be a drag on the domestic economy

4. Global growth continues to be sluggish, as reflected in the downward revisions in projections by various international agencies. Notwithstanding a distinct improvement in growth in the advanced economies, as also some key emerging market and developing economies (EMDEs), new risks to global recovery have arisen from fiscal discord in the US and uncertainties arising from expectations related to withdrawal from unconventional monetary easing by advanced economies.

5. The global inflation remains benign with slack in labour markets, expected stable commodity prices on the back of improved capacities and receding geo-political risks.

6. Global financial markets got a breather with the Fed decision to maintain the pace of its bond purchases and its signal that the withdrawal of QE may take longer. However, financial markets could be disrupted again when the extraordinary monetary accommodation in the advanced economies is withdrawn.

Indian Economy: Developments and Outlook

Output

Moderate recovery expected during H2 on the back of a rebound in agriculture and an improvement in exports

7. The slowdown facing the Indian economy extended into 2013-14 with growth in Q1 falling to a 17-quarter low. The growth slowdown was broad-based reflecting moderation in the services and *agriculture sectors, and contraction in the industrial sector. Modest improvement in growth is likely in H2 of 2013-14 on the back of a good monsoon and some improvements in industrial growth. A fuller recovery is likely to start taking shape towards the end of the fiscal year when current steps to clear the logjams constraining economic activity seep through the various inter-sectoral linkages in the economy.*

Aggregate Demand

Demand management requires balancing fiscal consolidation with investment support

8. The aggregate demand of the economy remained weak during Q1 of 2013-14 despite government final consumption expenditure increasing sharply. Private consumption decelerated, while fixed investment contracted. There was a sharp fall in fresh investment proposals from the private corporate sector. Weak demand conditions were also reflected in decelerating corporate sales. However, a good monsoon this year and consequent encouraging crop prospects are expected to shore up rural demand. The recent uptick in exports, if sustained, could provide added momentum. Revival of investment demand will take some more time. Meanwhile, further measures are needed to avert fiscal slippage by reduction in revenue spending, especially poorly targeted subsidies. At the same time, public investments need to be boosted to crowd-in private investment with a view to supporting a revival in the economy.

External sector

External sector risks lowered as CAD likely to moderate since Q2

9. The current account deficit (CAD) which widened again in Q1 of 2013-14, is likely to moderate in Q2, broadly in line with the narrower trade deficit. The trade balance has responded to the policy measures taken, especially as gold imports declined and exports picked up. While external risks have lowered somewhat, it is important to build on the recent CAD improvement through further structural adjustments. Focus will also be needed to encourage stable long-term capital inflows and to exercise caution with regard to private external debt that has been rising in recent years.

Monetary and Liquidity Conditions

Growth-inflation dynamics to shape monetary policy as normalisation of exceptional liquidity measures make headway

10. Since mid-July 2013, exceptional measures were put in place by the Reserve Bank to maintain liquidity conditions such that volatility in the forex market is contained. The policy rate was effectively recalibrated to the MSF rate, leading to the hardening of money market rates. However, to facilitate adequate credit to productive sectors, significant primary liquidity injection was provided via LAF, MSF, OMOs and standing facilities. Notable pick-up in credit off-take since mid-July has occurred as corporates have substituted costlier money market sources by bank credit. As such, monetary and liquidity conditions are evolving broadly in sync with the policy. Further monetary policy actions would have to be recalibrated keeping in mind the growth-inflation dynamics, going forward.

Financial Markets

Near-term uncertainties remain a lingering concern

11. Forward guidance by the Fed in September 2013 appears to have calmed near-term market uncertainties to a significant extent. Equity markets have rallied, currencies have appreciated and bond yields appear to have stabilised after a spell of volatility. The Indian financial markets also reacted positively to these developments. With a hesitant global recovery still unfolding, the challenge would be to put the domestic economy back on track quickly before a new world of less abundant liquidity becomes a reality.

Price Situation

Risks to inflation in H2 of 2013-14 broadly in balance, but persistence in CPI inflation remains a concern

12. The trajectory of softening WPI inflation reversed in Q2 of 2013-14 mainly due to an increase in food and fuel inflation. Vegetable prices increased sharply, impacting food inflation, while exchange rate depreciation and rise in crude oil prices led to a rebound in fuel inflation. However, manufactured non-food inflation remained subdued. While food inflation pressures could recede somewhat on the back of a normal south-west monsoon, upside risks exist. These stem largely from second-round effects of high food and fuel inflation. This, to an extent, is already reflected in the stubborn non-food and non-fuel component of CPI inflation. Risks also arise from high wage growth and rising costs of transport, education and health services. Besides, structural elements and the ratchet effect may check the fall in food inflation arising from good harvest.

Macroeconomic Outlook

Macro risks and inflationary pressures to underpin policy actions

13. A modest improvement in growth is anticipated in H2 of 2013-14. Both WPI and CPI inflation may stay range-bound around the current levels that remain above comfort levels. Various surveys, including those by the Reserve Bank show that business confidence remains weak, while inflation expectations have risen again. In this milieu, monetary and fiscal policies will have to be crafted so as to allow structural policy measures and ground-level actions to shape a sustainable recovery by next year. The monetary policy will need to aim at anchoring inflation expectations, while appropriately addressing growth risks.