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Macroeconomic and Monetary Developments:
Third Quarter Review 2011-12

The Reserve Bank of India today released the Macroeconomic and Monetary Developments Third Quarter Review 2011-12. The document serves as a backdrop to the Monetary Policy Statement to be announced on January 24, 2012. Highlights:

Overall Outlook

While growth outlook weakens, inflation risks remain

- The Growth outlook has weakened as a result of adverse global and domestic factors. 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 government revenue spending. Consequently, monetary actions will need to strike a balance between risks to growth and inflation.
- Growth in 2011-12 is moderating more than was expected earlier. The business climate has weakened. The slack in investment and net external demand may keep the pace of recovery slow in 2012-13.
- While in the short run, moderating inflation will provide some space for monetary policy to address growth concerns, in the absence of structural measures to address supply bottlenecks, this will be, at best, a temporary respite. In addition, the expansionary fiscal stance has emerged as an upside risk to inflation.

Global Economic Conditions

Global growth moderates, financial market stress rises

- The global economy seems to be headed for another downturn after just three years. The recovery is likely to lose traction due to the continuing euro area debt crisis. As fiscal austerity progresses, the euro area could enter into a recession. With growth decelerating even in emerging and developing economies (EDEs), the spillovers from euro area are likely to pull down global growth.
- An adverse feedback loop between bank and sovereign debt brought euro area closer to contagion across the region. Tightening credit conditions, rising risk premia, deleveraging, weakening growth in the euro area are keeping global financial markets under stress. Going forward, further softening in commodity prices on the back of weaker global growth is likely in 2012-13. However, upside risks to the oil price remain, including from recent geo-political uncertainty.

Indian Economy

Output

Global linkages reinforce domestic factors to slow down economy

- Agricultural prospects remain encouraging but moderation is visible in industrial activity and some services. Industrial slack has emerged as export and domestic demand has decelerated. A strong co-movement between domestic and global IIP series is observed. The RBI survey shows significant growth in new orders for some industries, but flat capacity utilisation in Q2 of 2011-12.
- Growth in 2011-12 is likely to moderate to below trend given the external conditions, dampened investment demand and prevailing high level of inflation. Growth outlook will depend on global conditions and domestic policy reforms

Aggregate Demand

External and investment demand may drag growth

- Growth has been impacted by lower external and investment demand which may also act as a drag during 2012-13. There has been a sharp decline in planned corporate fixed investment since H2 of 2010-11 and this trend has accentuated further in Q2 of 2011-12.
- Private consumption continues to moderate. There has been some slackening of corporate sales growth, reflecting a gradual waning of demand. Available early results for Q3 of 2011-12, however, indicate healthy sales growth.
- The central government's deficit indicators are under duress due to higher subsidies and lower tax collections. Fiscal slippages during 2011-12 may complicate the task of aggregate demand management. Fiscal reforms, including the Direct Tax Code and the Goods and Services Tax are, therefore, needed to contain deficits in 2012-13.
- With a widening current account deficit (CAD), larger fiscal spending could affect growth and stability in the economy. The mounting revenue deficit is already putting fiscal position under strain and impacting the Government's ability for capital spending. There is need for budgetary solutions to growing subsidy commitments and to rebalance public spending from consumption to investment, in order to enhance the potential growth rate of the economy.

External Sector

CAD risks have amplified as capital flows moderate

- Early indicators suggest that the current account came under increased pressure during Q3 of 2011-12. Notwithstanding rupee depreciation, exports decelerated but import demand remained strong, with inelastic demand for oil and rising gold imports. Upward risks to CAD have become more pronounced with likely moderation of software earnings.
- As capital flows also moderated since August 2011, financing pressure on the CAD translated into exchange rate pressures. Currencies of other EDEs running CAD came under similar pressures. Following the revival of equity flows in January 2012, exchange rate pressures have reduced somewhat.
- The composition of capital inflows has shifted in favour of debt, with a rise in the proportion of short-term flows. Vulnerability indicators have weakened moderately, though the net international investment position has improved. Going forward, there is need to reduce dependence on debt flows by encouraging renewed equity flows through acceleration of policy reforms aimed at improving the investment climate

Monetary and Liquidity Conditions

Monetary growth keeps pace even as money market liquidity tightens

- Money market liquidity tightened significantly since November 2011 partly due to dollar sales by RBI. However, monetary growth has kept pace with projections, on account of a rising money multiplier. The liquidity stress was handled by the Reserve Bank by injecting liquidity through open market operations, including repos under the LAF.
- 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.
- Monetary policy has been significantly tightened since February 2010 with an effective increase of 525 bps in policy rates and a 100 bps increase in CRR. Factoring in increased downside risks to growth and the expected moderation in inflation, the policy rate was kept on hold in December 2011. The trajectory of the monetary cycle ahead will be shaped by the evolving growth-inflation dynamics.

Financial Markets

Financial markets come under pressure from global spillovers

- Global spillovers and macroeconomic deterioration resulted in pressures on the equity and currency markets. The sharp depreciation of the rupee during August-December 2011 contributed to a drop in foreign equity inflows which in turn, further weakened the rupee. The sudden stop in equity inflows 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, the rupee exchange rate appreciated and equity markets recovered in January 2012. Call money rates have largely remained within the interest rate corridor and spikes were effectively contained.

Price Situation

Inflation is trending down, but upside risks remains significant

- Inflation is moderating led by sharp decline in food inflation and is broadly in line with the 7 per cent projection for March 2012.
- Primary food inflation declined sharply reflecting seasonal fall in vegetable prices and high base. However, as protein inflation continues due to structural demand-supply imbalances, the decline is expected to be short-lived.
- Inflation in non-food manufactured products remains persistently high, reflecting input cost pressures, partly resulting from the rupee depreciation that has offset the impact of softer global prices of some commodities.
- Upside risks to inflation persist from insufficient supply responses, exchange rate pass-through, suppressed inflation and an expansionary fiscal stance.

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