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Macroeconomic and Monetary Developments : Third Quarter Review 2012-13

The Reserve Bank of India today released the Macroeconomic and Monetary Developments Third Quarter Review 2012-13. The document serves as a backdrop to the Third Quarter Review of Monetary Policy Statement 2012-13 to be announced on January 29, 2013.

Highlights:

Overall Outlook

Balance of macroeconomic risks suggests monetary policy needs to be calibrated in addressing growth risks as inflation turns sticky

- Growth in 2012-13 is likely to fall below the Reserve Bank's baseline projection of 5.8 per cent. However, output gap may start closing in 2013-14 although at a slow pace on the back of some revival in investment and consumption demand.
- Inflation is likely to moderate below the Reserve Bank's baseline projection of 7.5 per cent. However, suppressed inflation continues to pose a significant risk to the inflation in 2013-14. As some of the risks materialises, inflation path may turn sticky.
- Various surveys show that business confidence remains subdued. Survey shows that forecasters outside the Reserve Bank anticipate growth to recover from 5.5 per cent in 2012-13 to 6.5 per cent in 2013-14. Average WPI inflation is expected to moderate from 7.5 per cent in 2012-13 to 7.0 per cent in 2013-14.

Global Economic Conditions

Unconventional monetary policies reduce stress, but risks remain ahead

- Fiscal risks are likely to keep global recovery muted in 2013. While the immediate risk of the fiscal cliff in the US has been averted, risks to global growth emanating from euro area remain significant. There are some signs of growth bottoming out in Emerging Market and Developing Economies (EMDEs).
- Global inflation scenario may stay benign as demand in advanced economies (AEs) remains weak. Improved supply prospects in commodities like oil and food are likely to restrain commodity price pressures. However, upside risks persist, with possible recovery in EMDEs and large quantitative easing in AEs.

Indian Economy

Output

Growth slowdown continues, revival may take some more time

- Growth slowdown in India continues with growth remaining below potential for the fifth successive quarter. Policy initiatives of the government are yet to show up fully or definitively in data. Revival may take some more time.
- Rabi crop is expected to be normal despite deficient rains, but is unlikely to fully compensate for kharif deficiency. Sowing under rabi crop has been broadly the same as the level in the previous year.
- Weak industrial performance is likely to persist. Subdued external demand and lack of reliable power supply amidst coal shortages are constraining capacity utilisation. Lead indicators of service sector and the Reserve Bank's Service Sector Composite Indicator signal moderation.
- The Reserve Banks' Order Books, Inventory and Capacity Utilisation Survey shows capacity utilisation increased marginally in Q2 of 2012-13. On a sequential basis, new orders moderated in Q2 of 2012-13.

Aggregate Demand

Improvement in investment climate is a prerequisite for economic recovery

- Demand conditions remained tepid, with private consumption continuing to decelerate and with investment yet to recover.
- Investment intentions in new projects improved marginally in Q2 of 2012-13, but investment is held back by project delays. Coal supply issues facing power sectors are yet to be fully resolved. Road investments have stalled due to issues relating to environmental clearances, land acquisition and financial closures.
- Sales growth moderated further in Q2 of 2012-13 to its lowest level in three years, but net profit growth improved markedly. Early results for Q3 of 2012-13 indicate continuation of the trend of sluggish sales.
- Quality of fiscal adjustment remains a concern, even as fiscal risks have reduced in 2012-13. Government is working towards achieving revised fiscal deficit target of 5.3 per cent of GDP by restricting both plan and non-plan expenditure during the last quarter of the year, even as significant shortfall in tax revenue is likely.
- Increased public investment to crowd in private investment along with removal of structural impediments that is slowing private investment is needed to pull the economy out of the current slowdown.

External Sector

Widening of CAD and its financing remains a key policy challenge

- Widening current account deficit (CAD) has emerged as a major constraint in easing monetary policy. With the likelihood that CAD/GDP ratio may exceed 4 per cent of GDP for the second successive year in 2012-13, prudence is necessary while stimulating aggregate demand.
- The CAD/GDP ratio reached its highest ever peak of 5.4 per cent of GDP in Q2 of 2012-13. Early indications are that it may increase further in Q3 of 2012-13. CAD has widened mainly due to worsening trade deficit.
- Weak external demand alongside structural bottlenecks has led to contraction in exports of India as also of other EMDEs. In addition, continuing large imports of oil and gold has resulted in deterioration in India's trade balance.

- Strong capital flows have facilitated financing of CAD, resulting only in marginal draw down of reserves. While increased FII debt investment limits may enhance inflows, they do not provide a solution to CAD financing on a sustainable basis.

Monetary and Liquidity Conditions

With moderating inflation, Reserve Bank takes measures to infuse liquidity

- Since the start of 2012, the Reserve Bank has worked towards easing monetary and liquidity conditions in a calibrated manner without jeopardising moderating inflation. With consequent moderation in inflation, the Reserve Bank took measures to combat tight liquidity conditions.
- Liquidity conditions tightened in Q3 of 2012-13 due to build up of government cash balances and strong currency demand. The Reserve Bank resumed outright open market operations (OMOs). In 2012-13 so far, it has infused liquidity of ₹1.3 trillion through outright OMOs.
- Broad money growth remains below indicative trajectory. Deposit growth has decelerated, while credit expansion has been in line with the trajectory. Even as asset quality concerns have impacted credit expansion, the increased wedge between deposit and credit growth remains a concern.

Financial Markets

Reforms and inflows improve market sentiments and revive the IPO market

- Improved global liquidity and recent policy reforms have aided FII inflows, leading to a turnaround in equity markets and revival of the Initial Public Offering (IPO) market.
- Rupee remained largely range-bound in Q3 of 2012-13. Money market remained stable despite liquidity deficit. G-sec yields softened markedly since December 2012 on expectations of no additional government borrowing and policy rate cut, as also resumption of OMOs and deferment of an auction.
- The Reserve Bank's House Price Index (HPI) increased by 3 per cent quarter-on-quarter in Q2 of 2012-13 alongside increase in transaction volumes.

Price Situation

Headline and core inflation moderated, but suppressed inflation poses risks

- Headline inflation moderated in Q3 of 2012-13 with significant moderation of core inflation, but CPI inflation edged up to double digits. Core inflation pressures are unlikely to re-emerge quickly on demand-side considerations. Near-term inflation outlook indicates that the moderation may continue in Q4 of 2012-13.
- Wage inflation remains a source of concern. Rural wage inflation declined marginally but remained high at 18 per cent. In organised manufacturing, increases in staff costs remained in double digits.
- Going forward, risks remain from suppressed inflation, pressure on food prices and high inflation expectations getting entrenched into the wage price spiral. The inflation path for 2013-14 could face downward rigidity.

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