प्रेस प्रकाशनी PRESS RELEASE

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July 25, 2011

Macroeconomic and Monetary Developments : First Quarter Review 2011-12

The Reserve Bank of India today released the Macroeconomic and Monetary Developments First Quarter Review 2011-12. The document serves as a background to the Monetary Policy Statement 2011-12 to be announced on July 26, 2011. The major highlights of the document are set out below.

Overall Outlook

Taming inflation warrants continuation of anti-inflationary monetary stance

- Inflation risks stay, while growth showed signs of moderation. On current reckoning, growth is likely to stay around trend growth of around 8.0 per cent. However, downside risks have increased. Overall some moderation in growth is expected in 2011-12. Various expectation surveys also indicate the same.

- Near-term upside risks to inflation remain significant. Price pressures are expected to persist through Q2 as well and then moderate towards the later part of 2011-12. Breaking inertial dynamics of wage and food price rise is important for arresting inflation.

- Risks to baseline growth and inflation projections may arise from three factors: (1) significant departure of monsoon from normal, (2) a collapse or re-build of global commodity price bubble, and (3) Euro zone debt crisis assuming full-blown proportions.

- Notwithstanding the slowdown in growth, high inflation requires continued anti-inflationary bias with a close watch and responsiveness to new information.

Global Economic Conditions

Recovery at risk with softer growth and inflation surprise in advanced economies

- Globally, the momentum of recovery appears to be stalling. High oil and commodity prices, the Middle East political strife, Japanese earthquake, sovereign debt problems and the impasses on the fiscal and debt problems in the US have taken a toll on economic activity as well as consumer confidence.

- Global inflation is rising rapidly prompting debate over how much longer advanced economies can defer an exit from an excessively accommodative monetary policy. Meanwhile, commodity prices exhibited some decline in Q1 of 2011-12 with global growth weakening, but it is unclear if this is transitory.

Indian Economy

Output

Signs of moderation after acceleration in 2010-11

- Growth showed some moderation during Q1 of 2011-12. These were visible from deceleration in IIP during April-May 2011 and in consumption of cement, steel and automobiles during Q1 of 2011-12. Manufacturing and services PMIs also show that growth is turning softer.

- There has been timely arrival and advancement of monsoon. However, after a good rainfall in June, the monsoon appears to be weakening a bit. Sowing till July 22, 2011 has been marginally less than that in corresponding period last year. On balance, agricultural growth is expected to stay broadly on track.

- IIP growth, though having moderated, has turned more broad-based. Services sector has sustained its momentum. Going forward, there is a possibility of some softening in industrial growth, as a result of implied input costs.

Aggregate Demand

Investment demand slows down, private consumption demand remains strong

- Aggregate investment as well as corporate investment intentions dipped in the second half of 2010-11 and are yet to show signs of improvement. Corporate sales growth remains robust but profits are moderating due to higher costs. Despite some deceleration, private consumption demand continues to be strong.

- The improvement in deficit indicators augurs well for growth rebalancing, but subsidies are likely to overshoot budget estimates. Even after the administered price hike in June 2011, total fiscal slippage for the Centre from the oil sector may still be about 1 per cent of GDP.

External Economy

CAD is expected to remain manageable in 2011-12, FDI pick-up augurs well

- Export momentum and strong invisible receipts lead by software exports are expected to keep Current Account Deficit manageable in 2011-12. Exports have continued to grow aided by diversification in its composition.

- FII inflows remain volatile, but FDI inflows have picked up in 2011-12 so far. External debt indicators had exhibited mixed movement, but international investment position deteriorated in 2010-11.

- Balance of Payments outlook remains stable, but going forward, oil prices and the pattern of capital flows is likely to impact external balance. It is necessary to adjust the structural balance of capital flows by attracting larger FDI inflows.

Monetary and Liquidity Conditions

Tight monetary and liquidity conditions bringing desired adjustment, trend likely to persist

- Policy rates were raised another 75 bps in Q1 of 2011-12. This has raised operational policy rates by 425 bps in a span of 15 months since mid-March 2010 – one of the sharpest monetary tightening seen across the world. It helped keep the real lending rates positive despite high inflation.
- Tight monetary and deficit liquidity conditions are bringing desired adjustments and are likely to prevail in near term. Deposit growth picked up and credit growth decelerated, reducing divergence between the two. Rise in currency growth was also reversed with increased opportunity cost.
- Credit growth though having decelerated in Q1 of 2011-12 still remains above indicative trajectory and has not showed the seasonal slack. Non-bank finance to commercial sector also increased significantly. Reserve money growth has decelerated, but money supply remains above trajectory.

Financial Markets

No stress visible though interest rates firm up as monetary transmission improves

- Notwithstanding the firming up of interest rates, indicating improved monetary transmission, there has been no stress visible across the financial markets. Monetary transmission led to further increase in deposit and lending rates during Q1 of 2011-12.
- The yield curve has flattened reflecting policy rate hikes and larger-than-anticipated issuances at the short-end including cash management bills. The exchange rate exhibited two-way movement. Equity markets remained sluggish during Q1 of 2011-12 but housing prices and transactions volumes rose in Q4 of 2010-11.

Price Situation

Generalised inflation with near-term upside risk do not provide any comfort

- Inflation remained high in Q1 of 2011-12, in line with the projections made in the May Policy Statement. There has been generalisation of inflation since December 2010 with dominant contribution from non-food manufacturing products. Inflation is being driven by both cost-push and demand-side factors.
- Food inflation has declined. However, near-normal monsoon may not ease pressure on food inflation further due to increases in wage costs and support prices. These trends necessitate structural reforms to enhance supply response, while the anti-inflationary bias of monetary policy anchors inflation expectations.

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Press Release : 2011-2012/129