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Macroeconomic and Monetary Developments in 2011-12

The Reserve Bank of India today released the Macroeconomic and Monetary Developments in 2011-12. The document serves as a backdrop to the Monetary Policy Statement 2012-13 to be announced on April 17, 2012.

Highlights:

Overall Outlook

Macroeconomic challenges warrant careful calibration of monetary policy

- Growth is likely to improve moderately in 2012-13. While inflation has moderated, risks to inflation are still on the upside. Accordingly, monetary policy needs to support growth without inflation and external imbalances by excessively fuelling demand.
- Inflation is likely to remain sticky at about current level during the year with the probability of further significant moderation being small.
- Fiscal policy has a key role to play in speeding up public investment to crowd in private investment while ensuring fiscal consolidation.

Global Economic Conditions

Global growth likely to remain moderate in 2012

- The global economy appears to be in a continuing phase of multispeed growth. Euro area is entering into a mild recession, while growth and employment conditions in the US are improving.
- Growth in emerging markets, especially China and India, is slowing beyond what was earlier anticipated.
- In spite of a dip in growth, the world economy is unlikely to lapse into another recession.

Indian Economy

Output

Growth may have bottomed out in Q3 of 2011-12, but recovery ahead likely to be slow

- Global uncertainties and domestic cyclical and structural factors lowered the growth to below seven per cent in 2011-12.
- Early indicators such as pick up in credit, cement off-take, expansion mode in PMIs, uptick in Reserve Bank's services composite indicator suggest that growth may have bottomed out.
- Prospects for agriculture are encouraging. The Reserve Bank's own assessment of leading indicators suggests that the 2012 monsoon may be normal. However,

a clearer picture will emerge after the forecast by the India Meteorological Department.

- Revival in the industrial sector hinges on the impetus to ease supply-side constraints, especially in the energy and mineral deficits. Government initiatives to revive the power sector would be helpful in reviving the growth momentum.
- The Reserve Bank's Order Books, Inventory and Capacity Utilisation Survey indicates that even though there was a narrowing of slack in Q3 of 2011-12 compared to Q2, capacity utilisation remained well below the peak reached in 2010-11.

Aggregate Demand

Investment downturn extends, speeding of public investment could crowd-in private investment

- The growth slowdown has been driven by a sharp fall in investment, some moderation in private consumption and a fall in net external demand.
- The drag from investment is likely to continue in the near term due to low pipeline investment and new corporate investment intentions.
- Decline in saving and investment rates constitute a concern for long-term growth performance.
- Increased capital outlays in the latest budget and brisk pace of tendering of road projects suggest some improvement in investment in latter part of 2012-13.
- Commitment to cap subsidies to 2 per cent of GDP is a positive step. Upside risks stem if phasing-in of flexible pricing of administered petroleum products is delayed. Under-recoveries would then exceed those in 2011-12 causing a large fiscal slippage. This poses challenges for aggregate demand management during 2012-13.

External Sector

Balance of Payments risks accentuate, warrants caution

- A wider current account deficit, rising external debt, weakening net international investment position (NIIP) and deteriorating vulnerability indicators underscore the need for greater prudence in external sector and demand management policies.
- Export growth may weaken despite continued trade diversification as growth in emerging and developing economies slows down.
- The imports bill will remain high unless prices of petroleum products are raised for a complete pass-through and demand for precious metals is curbed.
- While capital inflows have improved in Q4 of 2011-12, global uncertainties aggravate downside risks to the external outlook.
- Dependence on debt-creating capital inflows needs to be reduced by encouraging renewed equity flows through accelerated reforms to attract FDI.

Monetary and Liquidity Conditions

Liquidity deficit eases on Reserve Bank injecting primary liquidity

- Though inflation remains high, declining inflation and growth rates motivated the Reserve Bank to shift to a neutral monetary policy stance since December 2011, leaving policy rates unchanged.
- The liquidity deficit has turned large since November 2011 due to both structural and frictional factors, mainly forex operations and a build up of Government's

cash balances, respectively. Liquidity deficit eased in April 2012 due to large government spending.

- The Reserve Bank injected durable primary liquidity of over ₹2 trillion through open market operations (OMOs) purchase and a 125 basis point reduction in Cash Reserve Ratio (CRR) to address the structural liquidity deficit.
- Reserve money growth decelerated in Q4 of 2011-12, reflecting the CRR cuts. However, the pace of adjusted reserve money creation has recently picked up. Broad money growth fell below the indicative trajectory of the Reserve Bank for end-March 2012, reflecting a deceleration in deposit growth.

Financial Markets

Financial market stress eases but risks remain

- Global market sentiments have improved following policy interventions in the euro area and positive data from the US.
- Taking cues from favourable international developments and improved financial conditions, Indian financial markets revived in Q4 of 2011-12.
- The revival, however, has been primarily liquidity-driven. For recovery to be sustained, macroeconomic fundamentals need to improve.
- Tight liquidity conditions saw money market rates firm up. G-sec yields also firmed up post-budget in response to the large market borrowing programme.
- Stress in financial markets eased significantly during Q1 of 2012 after the ECB made large liquidity injection. Going forward, there are risks of disruptive movements from euro area and financialisation of commodities, especially oil, in the global markets.

Price Situation

Inflation path for 2012-13 likely to be sticky

- Generalised price pressures softened as growth deceleration eased demand. This is also evident in a significant decline in core inflation during Q4 of 2011-12. The pricing power of companies has waned with moderation in demand.
- However, the path of inflation in 2012-13 could remain sticky around current levels due to high oil prices, large suppressed inflation, exchange rate pass-through, impact of freight and tax hikes, wage pressure and structural impediments to supply response.
- Primary food inflation reversed after a sharp decline as transitory effects waned. Energy prices are likely to remain a significant source of inflation ahead, as suppressed domestic prices of oil, coal and electricity prices are adjusted upwards.
- Wage price pressures in both rural and urban areas are yet to soften. Consumer price inflation also remains high.
- Inflation expectations moderated in Q4 of 2012-13 but remain high. With significant upside risks to inflation, monetary policy needs to keep them anchored, while shifting the balance of policy to arrest the deceleration in growth momentum.

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