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Macroeconomic and Monetary Developments - First Quarter Review 2013-14

The Reserve Bank of India today released the [Macroeconomic and Monetary Developments First Quarter Review 2013-14](#). The document serves as a backdrop to the First Quarter Review of Monetary Policy Statement 2013-14 to be announced on July 30, 2013. Highlights:

Overall Outlook

Amplifying macro-financial risks warrant cautious monetary policy stance

- ❖ Growth is expected to improve slowly as the year progresses, but recovery is likely to be slow.
- ❖ Various surveys indicate further drop in business confidence. The Reserve Bank's Industrial Outlook Survey shows weakening of business sentiments in Q1 of 2013-14 to a three year low, though expectations showed improvement for Q2.
- ❖ Headline inflation based on wholesale price index (WPI) has moderated to below 5 per cent, while consumer price inflation has remained at an elevated level of near double digits. Upside risks persist with recent rupee depreciation and rise in crude prices amidst political uncertainties in the Middle East.
- ❖ Professional forecasters outside the Reserve Bank project modest recovery in 2013-14 at 5.7 per cent. The latest forecast is a downward revision from 6.0 per cent in May 2013. Their average WPI inflation projection of 5.3 per cent for 2013-14 marks a sharp downward revision from 6.5 per cent in May 2013.
- ❖ Recent liquidity tightening measures taken by the Reserve Bank to curb volatility in the exchange rate provide, at best, some breathing time. This strategy will succeed if reinforced by structural reforms to reduce the current account deficit (CAD) and step up savings and investment.

Global Economic Conditions

Global growth stays weak, financial markets enter period of fresh turbulence

- Global growth remained subdued, with improvements in some advanced economies (AEs), especially the US and Japan, getting counterbalanced by slowing growth in key emerging market and developing economies (EMDEs).
- Global commodity price inflation is expected to remain contained in the near term, in part helped by slowing growth in China. However, upside risks to

global crude oil prices remain from rising geo-political uncertainties in the Middle East.

- Global financial markets have entered into a period of fresh turbulence, with re-pricing of risks from likely tapering of quantitative easing (QE). Going forward, interest rates could continue to harden and financial conditions could tighten further, keeping markets episodically under stress.

Indian Economy

Output

Slow-paced recovery likely to take shape later in 2013-14

- The Indian economy continued to remain sluggish in Q4 of 2012-13. Leading indicators do not suggest immediate improvement in production activity and a slow-paced recovery is likely to take shape only later in 2013-14, supported by good monsoon that could shore up rural demand.
- The progress of monsoon has been encouraging and agricultural growth is likely to pick up. The Reserve Bank's production weighted rainfall index indicates that the rainfall so far was 17 per cent higher than the long period average. Water levels in major reservoirs are now 66 per cent above past average.
- Industrial growth remains subdued and supply-side bottlenecks are constraining core industries. Lead indicators of service sector and the Reserve Bank's Service Sector Composite Indicator signal moderation in Q1 of 2013-14.
- The Reserve Banks' Order Books, Inventory and Capacity Utilisation Survey shows that the capacity utilisation recorded a seasonal increase in Q4 of 2012-13 over the previous quarter. However, it remained well below the peaks observed in Q4 of 2010-11 and 2011-12.

Aggregate Demand

Slack exists in aggregate demand with decelerating consumption and investment

- Aggregate demand continues to be weak with deceleration in consumption and investment. Government initiatives have started addressing infrastructure bottlenecks, although the progress is slow. Nearly half of 566 large central sector projects are delayed and have cost overruns of about 18 per cent.
- Based on data filed with banks and financial institutions on projects sanctioned financial assistance by them, envisaged investment in new projects improved somewhat in Q4 of 2012-13, but the full year investment in 2012-13 at ₹ 2.0 trillion stayed almost the same as in the previous year and below ₹ 3.8 trillion in 2010-11.
- Sales growth of 2,419 non-government, non-financial companies decelerated further to 4.9 per cent during Q4 of 2012-13 from 9.4 per cent in Q3. Early results for Q1 of 2013-14 indicate further deceleration in sales.
- Tax collection has remained weak during 2013-14 so far. If the revenues fall short of the budget estimates due to growth slowdown, a cutback in

expenditure will be required. Therefore, currently it is important to restrain subsidy commitments and increase public investment to crowd-in private investments.

External Sector

Need to reduce CAD and ensure its financing through stable flows

- Even though the current account deficit (CAD) to GDP ratio moderated to 3.8 per cent in Q4 of 2012-13 from its historic high of 6.5 per cent in Q3 of 2012-13, indications are that it may have widened again in Q1 of 2013-14. Trade deficit has widened in Q1 of 2013-14 on account of contraction in exports and sharp increase in gold imports.
- Going forward, the current account is expected to show improvement. The demand for gold is likely to decline with increase in customs duty and rationalisation of gold import policy.
- While CAD may fall in 2013-14, risks to CAD financing have increased with firming up of US yields that caused global bond sell off and capital outflows from EMDEs, including India.
- Vulnerability indicators of the external sector have deteriorated. Short-term debt (residual maturity) constituted 44 per cent of the total debt at end-March 2013. India's net international investment position was (-)16.7 per cent of GDP. In this milieu, structural policy reforms are needed to reduce CAD and to improve its financing by attracting more stable capital flows to the Indian economy.

Monetary and Liquidity Conditions

Policy recalibration became necessary with increased macro-financial risk

- The Reserve Bank eased monetary policy in 2012-13 and in early May 2013 with 125 bps cut in policy rate. The transmission of this easing has reduced weighted average lending rates of banks by 47 bps.
- The policy, however, was recalibrated and liquidity was tightened in July 2013, with a view to restoring stability to the foreign exchange market. The Reserve Bank raised the marginal standing facility rate and the bank rate, restricted access to borrowing under liquidity adjustment facility, stipulated higher daily maintenance of cash reserve ratio and undertook open market sales of government securities.
- Broad money (M_3) growth stayed in line with the indicative trajectory, but the deceleration in domestic growth and deterioration in asset quality of the banking sector has kept credit growth below the indicative trajectory in Q1 of 2013-14.
- Going forward, the Reserve Bank will endeavour to actively manage liquidity to reinforce monetary transmission that is consistent with the growth-inflation balance and macro-financial stability.

Financial Markets

Contagion from global bond sell off generates stress in Indian financial markets

- The policy statements by the US Fed in May 2013 accentuated the global bond sell off. It also made markets jittery, leading to significant volatility in bonds, currencies, commodities and equities in EMDEs. Contagion from markets across Asia spilled over to India.
- Policy action was taken on a wide front to limit these spillovers. This helped stabilise exchange rate of rupee, though money market rates and bond yields hardened. The exchange rate of the rupee that had depreciated following the Fed's May 22, 2013 testimony by 7.5 per cent till the July 15, subsequently appreciated by 1.9 per cent till July 26 following the Reserve Bank measures.
- The Reserve Bank's House Price Index (HPI) increased by 19.4 per cent y-o-y and 2.1 per cent q-o-q in Q4 of 2012-13.

Price Situation

Headline inflation moderates, but upside risks persists

- Moderation of global commodity prices, negative output gap and past monetary policy actions contributed to fall in headline WPI inflation. Non-food manufactured products inflation declined sharply to its lowest level in the past three years. CPI inflation, however, has hovered around double digit-levels for the last 15 months.
- Food inflation rose in May and June 2013 and put pressures on general price-level. These pressures could moderate somewhat if the monsoon remains on track during the rest of the season.
- Recent currency depreciation and upward revisions in fuel prices have increased upside risks to both wholesale and consumer price inflation.