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RESERVE BANK OF INDIA

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Macroeconomic and Monetary Developments: Second Quarter Review 2011-12

The Reserve Bank of India today released the Macroeconomic and Monetary Developments Second Quarter Review 2011-12. The document serves as a background to the Monetary Policy Statement 2011-12 to be announced on October 25, 2011. Highlights:

Overall Outlook

While inflation remains sticky, growth risks add to policy complexity

- The baseline inflation path still remains sticky and broadly unchanged from earlier projections. On the other hand, growth risks have increased on account of global headwinds and domestic factors. On current assessment, growth in 2011-12 is likely to moderate slightly from that projected earlier.
- While persistent high inflation is impacting growth, investment is slowing down. The fall in new corporate fixed investment since the second half of 2010-11 has been significant and can impact the pipeline investment in coming years.
- Inflation risk, however, persists. The policy choices have become more complex. In this backdrop, the monetary policy trajectory will need to be guided by the emerging growth-inflation dynamics even as transmission of the past actions is still unfolding.
- Various surveys conducted, both by the Reserve Bank and the outside agencies, suggest that business expectations have suffered, while inflation expectations remain high. As a further step for increased transparency in monetary policy formulation, the Reserve Bank for the first time is releasing surveys conducted by it along with the ‘Macroeconomic and Monetary Developments’, one day ahead of the policy.

Global Economic Conditions

Global growth in siege from debt overhang

- Prospects for global growth appear to be declining, even though recovery has not stalled so far. There have been significant downward revisions in growth projections. Business and consumer confidence have dampened on the back of euro area sovereign debt crisis. Private sector balance sheets are at risk and significant weakness in the banking sector has re-emerged.
- Global commodity prices, especially those of metals, have softened but have stayed elevated. Even after some correction, the current Brent crude oil price is still over 25 per cent higher than its average for 2010-11. The IMF has revised upwards its consumer price inflation forecast for EDEs.

Indian Economy

Output

Growth moderating below trend in 2011-12

- Growth in 2011-12 is likely to moderate to below trend. Agriculture prospects remain encouraging with the likelihood of a record Kharif crop. However, moderation is visible in industrial activity and some services.
- In addition to domestic factors, global factors may slow down growth. With the increasing linkage of domestic industrial growth with global industrial cycle, some further moderation is likely ahead, given the weak global PMIs.
- Capacity constraints seem to be easing in some manufacturing segments, especially cement, fertilizers and steel. Construction activity has slowed and leading indicators suggest that going forward, services growth may slightly weaken.

Aggregate Demand

Investment slowdown may impact growth ahead

- Investment demand is softening as a result of combination of factors including monetary tightening, hindrances to project execution, deteriorating business confidence and slowing global economy.
- Planned corporate fixed investment in new projects declined significantly since the second half of 2010-11 and has stayed low in Q1 of 2011-12. Consequently, the pipeline of investment is likely to shrink, putting growth in 2012-13 at risk.
- Private consumption is also starting to soften in parts, but it remains robust overall as is evident from corporate sales performance. Sales growth continues to be healthy, but profits are under pressure.
- Fiscal slippages during 2011-12 may complicate the task of aggregate demand management. Key to growth sustainability lies in supporting investment by rebalancing demand from government consumption to public and private investment.

External Sector

Widening CAD poses risk if global trade and capital flows shrink

- The Current Account Deficit (CAD) widened in Q1 of 2011-12, despite a surge in exports and higher net invisibles receipts. Going forward, exports could decelerate as global growth slows down. Invisible earnings may also decelerate as slow down in US and euro area could impact software exports.
- Sharp decline in FII flows in Q2 of 2011-12 has been largely offset by strong FDI flows. However, capital flows are entering an uncertain phase with increased financial stress and worsening global growth prospects. External sector outlook, although stable, warrants close monitoring.

Monetary and Liquidity Conditions

Liquidity remains comfortable, credit growth stays above trajectory

- During Q2 of 2011-12, liquidity conditions, though in deficit mode in line with the policy objective, remained comfortable. Base money decelerated as currency growth moderated. Money (M3) growth, however, moderated less sharply and remained above the indicative trajectory as the money multiplier increased.

- Bank credit growth is presently above the indicative trajectory. This has been supplemented by increased resource flows from non-banking sources. Going forward, credit growth is expected to moderate as growth slows.
- Monetary policy has been significantly tightened since February 2010 with an effective increase of 500 bps in policy rates and a 100 bps increase in CRR; but monetary transmission is still unfolding and real interest rates remain low and non-disruptive to growth.

Financial Markets

Volatility spillovers to domestic equity and currency markets are contained

- Volatility was high in global financial markets in Q2 of 2011-12. Rising risk aversion caused credit spreads to widen. Volatility spillovers impacted domestic currency and equity markets in a limited way.
- Rupee depreciation and the fall in equity indices in Q2 of 2011-12 were comparable to the patterns in most other emerging markets. Money market rates remained in line with policy signals, while G-sec yields hardened after the announcement of additional market borrowing.

Price Situation

Inflation risks stay as falling global commodity prices provide limited comfort

- High inflation is likely to persist over next couple of months before moderating as falling global commodity prices so far has been offset by rupee depreciation. Incomplete pass-through is likely to limit the impact of falling global commodity prices. Financialisation of commodities leaves future commodity price path uncertain.
- Domestic price pressures still remain significant and broad-based. Food inflation is likely to stay elevated due to demand-supply mismatches in non-cereals and large MSP revisions. Real wage inflation has extended into Q1 of 2011-12. In sum, the inflation challenge remains significant.

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