प्रेस प्रकाशनी PRESS RELEASE

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October 29, 2012

Macroeconomic and Monetary Developments : Second Quarter Review 2012-13

The Reserve Bank of India today released the Macroeconomic and Monetary Developments Second Quarter Review 2012-13. The document serves as a backdrop to the Second Quarter Review of Monetary Policy Statement 2012-13 to be announced on October 30, 2012. Highlights:

Overall Outlook

Growth-inflation balance warrants careful policy calibration as growth slows but inflation risks persist

- As macro-risks from inflation and twin deficits recede further, that could yield space down the line for monetary policy to respond more effectively to growth concerns.
- Speedy implementation of recent policy measures announced by the government and sustained reforms are important for turning the economy around.
- Various surveys, including the Reserve Bank's Industrial Outlook Survey suggests that business sentiments remain weak. Global growth projections, including that for India, are getting revised downwards.
- The median projection for 2012-13 in the Reserve Bank's Survey of Professional Forecasters has been lowered to 5.7 per cent from 6.5 per cent for growth, while that for average WPI inflation is revised upwards to 7.7 per cent from 7.3 per cent.

Global Economic Conditions

Global growth prospects weaken, contagion risks remain

- Global growth prospects, both in advanced economies (AEs) and in emerging and developing economies (EDEs) have weakened. In October 2012, the International Monetary Fund lowered its growth projections for both these groups.
- Euro area risks have affected business confidence and caused global trade to decelerate, thus impacting external demand. Downside risks to global growth stems from a possible US fiscal cliff leading to a sudden and sharp fiscal consolidation.
- With slack in output and employment in AEs and falling growth in many large EDEs, global inflation pressures are likely to stay muted for the rest of 2012.
- Risks of spillovers from global financial markets remain. Unconventional monetary policies have transitorily moderated uncertainties, but the underlying stress has not diminished with incomplete deleveraging and unfinished financial sector reforms.

Indian Economy

Output

Growth remains sluggish, reforms may arrest downturn

- Economic indicators suggest that slowdown has continued in 2012-13. However, recent policy reforms should help in arresting the downturn. They may, on their successful implementation, support recovery later.
- The potential growth rate of the Indian economy that peaked around the middle of 2007-08, has since continued its downward slide into Q1 of 2012-13 to around 7.0 per cent. With negative output gap persisting, growth in 2012-13 is likely to fall short of the Reserve Bank's earlier projection.
- Improved prospects for *Rabi*, following the late monsoon revival will partly offset the fall in *Kharif* output. Contraction in the mining sector continues following a clamp-down on illegal mining. Manufacturing output has stagnated due to weak investment and external demand. Leading indicators of services signals moderation.
- The Reserve Banks' Order Books, Inventory and Capacity Utilisation Survey show capacity utilisation was at its lowest in 13 quarters, though notably, the new order positions has improved.
- Revival of the investment cycle hinges on resolution of policy uncertainties, particularly those facing the power and coal sectors. While substantive progress has been made towards new fuel supply agreements (FSAs), coal shortages are likely to persist.

Aggregate Demand

Fiscal consolidation and removal of impediments to infrastructure investments hold the key to growth revival

- Aggregate demand is weakening, led by the investment slowdown. Investment intentions in the new projects sanctioned financial assistance remained low in Q1 of 2012-13.
- Sales of private, non-financial firms moderated further in Q1 of 2012-13, while operating profits of these firms declined. Early results for Q2 of 2012-13 indicate some improvement in operating profits, though sales continued to decelerate.
- Fiscal slippage is likely in 2012-13 despite recent measures by the government. Food, fertiliser and petroleum subsidies remain high and are likely to overshoot Centre's budget estimates.
- Financial restructuring of state distribution companies (discoms) may not have immediate implications for state finances, but will have medium to long-term impact.

External Sector

CAD wider than comfortable in spite of BOP improvement

- External sector risks remain in spite of the improved balance of payments (BOP) during Q1 of 2012-13. Though the merchandise trade deficit in 2012-13 so far has been lower than in the previous year, it largely reflects contraction in imports on the back of slower growth.
- Global growth uncertainties continue to impinge on India's export growth. Weak external demand has affected exports of engineering goods, gems and jewellery, textiles and petroleum products.
- Services trade surplus is also lower, leaving the current account deficit (CAD) wide enough for a possible re-emergence of financing pressures should global risk aversion increase or domestic recovery falters. Recent measures, including those to augment FDI, should help reduce these risks.

- External debt increased only marginally in Q1 of 2012-13, due to valuation gains. Vulnerability indicators deteriorated during the quarter, but have remained comparable with peer countries.

Monetary and Liquidity Conditions

Reserve Bank infuses liquidity, calibrates monetary policy to the evolving growth-inflation dynamics

- Active liquidity management through reductions in the cash reserve ratio (CRR) and statutory liquidity ratio (SLR) backed by open market operations (OMOs) has kept liquidity largely in line with policy objective, balancing inflation concerns and the need to ensure credit supply to support growth.
- Monetary and credit aggregates remain below their indicative trajectory. The current credit slowdown largely indicates tepid demand conditions and distinctively lower credit expansion by public sector and foreign banks partly reflecting their risk aversion.
- The ratios of gross and net non-performing assets of the public sector banks increased further during Q1 of 2012-13. Deteriorating asset quality may have affected their credit expansion.

Financial Markets

Markets respond to reform measures

- Policy reforms measures have improved market sentiments, strengthening the equity prices and rupee exchange rate. However, there is need for steps to revive the sluggish primary capital market, so that financing constraints for corporate investments are reduced.
- G-sec yields were range bound, though with a softer bias, reflecting improved liquidity conditions. Gains for the bond markets have been limited due to concerns about the likely fiscal slippage during the year.
- The Reserve Bank's House Price Index (HPI) show that house prices increased further during Q1 of 2012-13 in almost all cities. Transaction also picked up in most cities after a fall in the preceding quarter.

Price Situation

Inflation remains on a sticky path, warranting caution

- Inflation has stayed sticky around 7.5 per cent. Persistent non-food manufactured product inflation, despite the growth slowdown has emerged as a concern.
- Consumer price inflation continues to be above the inflation in wholesale price index. This divergence is observed even for ex-food and fuel components of the two indices.
- Wage pressures remain persistent, though the year-on-year increase in rural wages moderated from 22 per cent in August 2011 to 18 per cent in August 2012. In organised sector, growth in staff costs was about 17 per cent in 2011-12 and maintained about the same pace in Q1 of 2012-13.
- While the near-term inflation risks are on the upside, inflation is expected to moderate from Q4 of 2012-13. However, improved supply responses and moderation of wage inflation is vital for bringing down inflation to comfort level.

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Press Release : 2012-2013/708