MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2009-10

Overview

Global Economic Conditions

1. The global outlook improved significantly in the third quarter of 2009 with most advanced economies posting positive growth. The pace and shape of recovery, however, continue to remain uncertain. By far the biggest anxiety is about the recovery losing momentum once the props of fiscal stimulus and monetary accommodation are withdrawn. In advanced economies, there are concerns about higher unemployment levels, growing fiscal deficits and continued credit recession to productive sectors. Emerging economies, which are already on the recovery path, face various challenges from capital flows, inflationary pressures and credit revival. While the short-term debate is centered around the timing and sequencing of exit policies, several medium term issues have come to the fore. These include the growing debt burden of governments, permanent loss of output owing to capital destruction, addressing global imbalances and reforming the regulatory architectures.

2. Emerging Market Economies (EMEs) of Asia have led the global recovery, driven by domestic demand and recovering exports. As a result, the pace of growth across regions in the world has turned uneven. Despite weak global recovery from recession, commodity prices, particularly oil and metals, staged significant rebounds by the end of 2009. In 2010 commodity prices may firm up further, even though above average levels of inventories and significant spare capacity could slowdown the pace of the increase. WTO data suggest that world merchandise exports in the third quarter of 2009 increased by 10 per cent (sequential, quarter-on-quarter), though on year-on-year basis the growth continued to exhibit negative growth, at (-) 26 per cent.

3. The IMF's current (October 2009) projections for global growth suggest a recovery to 3.1 per cent in 2010, from (-) 1.1 per cent in 2009, which will be led by the emerging and developing economies that are expected to exhibit stronger recovery from 1.7 per cent in 2009 to 5.1 per cent in 2010. The recovery in the advanced economies could be from -3.4 per cent to 1.3 per cent during the corresponding period. These projections may be revised upwards, taking into account the signs of global recovery emerging since the third quarter of 2009 in the advanced economies as well as the strong growth in China in the fourth quarter. OECD outlook also suggests a similar recovery from -3.5 per cent in 2009 to 1.9 per cent in 2010 in OECD countries. What could be a concern is the expected increase in OECD unemployment rate from 8.2 per cent in 2009 to 9.0 per cent in 2010, suggesting job-less recovery, which in turn could influence the timing of exit from policy stimulus. Global financial market conditions have improved further, notwithstanding the temporary unease in *response to the Dubai World's decision on debt standstill. With improvement in appetite for risk, prices of financial assets have recovered in general, led by EME stocks. Money, bond and equity market conditions have already recovered to their respective long-run average levels.*

Indian Economy

Output

4. At 7.9 per cent, GDP growth in the second quarter of 2009-10 showed a significant recovery in relation to the 5.8 per cent growth recorded during the slowdown phase in the second half of 2008-09, but still remained lower than the average 8.8 per cent growth achieved during 2003-08. Among the major components of the GDP on the supply side, agriculture and allied activities registered a better than expected growth of 0.9 per cent, which though reflects only a part of the overall adverse impact of the deficient south-west monsoon on kharif output. According to the first advance estimates, production of kharif foodgrains and oilseeds is expected to decline by 16 per cent over the previous year.

5. Strong industrial recovery has been the key underlying strength behind the recovery of GDP in the second quarter. During April-November 2009, the Index of Industrial Production (IIP) increased by 7.6 per cent, which is higher than 4.1 per cent growth experienced during the corresponding period of the previous year. During August-November 2009, the acceleration in the IIP growth was evident in the double digit growth. However, even though twelve out of seventeen industries, accounting for about 57.2 per cent of the total weight in the IIP, contributed to the recovery, it is still driven by a few segments. The core infrastructure sector showed a higher growth at 4.8 per cent during April-December 2009, as compared with 3.2 per cent growth in the corresponding period of the previous year. The higher growth was driven mainly by cement, coal, electricity and finished steel.

6. Services activities (accounting for 64.5 per cent of the GDP) registered a growth of 9.0 per cent in the second quarter of 2009-10. The recovery was largely driven by 12.7 per cent growth in "community, social and personal services" reflecting payouts of arrears relating to the Sixth Pay Commission award. Excluding the arrears, the services sector growth would have been 7.0 per cent during the second quarter of 2009-10. Lead indicators for services activities suggest that services dependent on domestic demand exhibited robust growth during April-December 2009, whereas services dependent on external demand (which include tourist arrivals, export and import cargo, and passengers at international terminals) exhibited some improvement in recent months.

Aggregate Demand

7. Sharp deceleration in the growth of private consumption demand to 1.6 per cent in the first quarter of 2009-10, besides the subdued growth in investment demand, had emerged as the key constraint to a faster recovery in GDP growth. In the second quarter of 2009-10, however, private consumption demand registered a growth of 5.6 per cent, which is the highest in last six quarters. Investment demand, in terms of growth in gross fixed capital formation, *also exhibited a growth of 7.3 per cent, which is the highest in the last four quarters. These trends reflect the improving overall business and consumer confidence. Growth in government consumption expenditure, which had to offset the impact of deceleration in private demand on economic growth in the wake of the global recession, continues to outpace growth in private demand in the last four quarters. In the second quarter of 2009-10, government consumption expenditure increased by 27 per cent, which is partly on account of the payment of arrears relating to the Sixth Pay Commission Award.*

8. Net direct tax collections of the Central Government increased by 8.5 per cent during April-December 2009, with the increase in corporate tax collections in December 2009 exhibiting a growth of 44 per cent. Corporate performance data up to the second quarter of 2009-10 also indicate that despite the persistence of dampened (y-on-y) growth in sales, sequential quarterly growth remained positive and profitability has also improved in the two successive quarters, which partly explains both the recovery in stock prices and the collections under corporate tax. In the third quarter of 2009-10, partial data indicate significant (Y-o-Y) growth in sales.

External Economy

9. With the improvement in global macro-financial conditions, the performance of the external sector has exhibited increasing signs of turnaround. Merchandise exports registered a positive growth of 18.2 per cent in November 2009 after a phase of decline over thirteen consecutive months and the pace of decline in imports also moderated significantly to 2.6 per cent. The current account deficit in the balance of payments in the second quarter of 2009-10 remained at the same level as in the corresponding period of last year. Signs of resumption in capital inflows that were evident in the first quarter of 2009-10, improved significantly in the second quarter. Latest information on specific components of capital flows suggests that even in the third quarter of 2009-10, net inflows have sustained the revival. Due to allocation of SDRs by the IMF and purchase of gold by the Reserve Bank from the IMF, the level and composition of the country's foreign exchange reserves have changed in the recent period. It increased from US$ 252 billion at end-March 2009 to US$ 285.2 billion as on January 15, 2010. In the context of the expected surge in capital flows to EMEs, assessment and monitoring of the macroeconomic ramifications of large capital inflows would be a challenge.

Monetary Conditions

10. The overall monetary and liquidity conditions prevailing in the system continue to reflect the accommodative monetary policy stance of the Reserve Bank, which has remained geared towards meeting the goals of supporting a stronger recovery in growth while ensuring completion of the large borrowing programme of the Government without exerting pressures on the overall interest rate structure. Broad money (M_3) growth exhibited some moderation in recent months and was at 16.5 per cent as on January 15, 2010, as against the indicative money growth projection of 17.0 per cent presented in the Second Quarter Review of Monetary Policy

2009-10. On the component side of money growth, deposit growth of scheduled commercial banks at 16.8 per cent was lower than the 18.0 per cent indicative projection in the Second Quarter Review of Monetary Policy 2009-10. There was a noticeable shift in the composition of deposits - growth in time deposits decelerated, partly reflecting the decline in time deposit interest rates during the year. On the sources side of money growth, as the banking system's growth in credit to the private sector decelerated, credit to the Government remained the key driver of money growth. Since the third quarter of 2009-10, however, growth in commercial banks' credit to the Government has also moderated. Non-food credit growth, which decelerated over twelve months following the peak in October 2008, has shown a reversal in the trend since November 2009. Non-food credit growth of Scheduled Commercial Banks (SCBs) at 14.4 per cent as on January 15, 2010 remains lower than both 21.9 per cent growth seen in the corresponding period of last year and 18.0 per cent indicative growth presented in the Second Quarter Review of Monetary Policy 2009-10.

11. Availability of resources from the non-banking sources increased significantly by about Rs.50,000 crore during April-January 2009-10, primarily in the form of IPOs, private placement, net issuance of CPs by corporates, and inflows under foreign direct investment. Total flow of resources to the commercial sector from banks and non-banks taken together, however, remained lower, as incremental increase in non-food credit in absolute terms during April-January 2009-10 was lower than the increase during the corresponding period of the previous year. Pattern of capital flows, pace of the recovery in demand for credit from the private sector and the fiscal stance would influence the monetary and liquidity conditions in the near term.

Financial Markets

12. The financial markets in India remained orderly and reflected the overall expectations of stronger recovery in the economy, the impact of higher capital inflows, and the overriding influence of the accommodative monetary policy stance of the Reserve Bank. Money market rates remained well anchored within the LAF corridor, and in the CBLO market, which accounts for about 80 per cent of the volume in the money market, the rates remained below the call money rates. In the government securities market, 95.5 per cent of the net market borrowing programme of the Central Government has been completed so far. In the secondary market, the yield on government securities exhibited some hardening in the recent months, reflecting large supply of government securities and emerging inflationary pressures. In the credit market, both deposit and lending rates showed moderation, reflecting lagged transmission of the policy rate changes of the Reserve Bank. In the capital market, stock markets, though volatile, sustained the gains of previous months. Among the EMEs, India was one of the strongest performers. In the primary market, activities picked up in terms of IPOs and private placements. Net resource mobilisation by the mutual funds exhibited significant increase. With the return of capital inflows, and the resultant surplus *conditions in the forex market, the Indian rupee appreciated against major international currencies.*

Inflation Situation

13. Inflation emerged as a major concern during the third quarter, dominated by significant supply factors. While in 2008-09 the shock originated from volatile global commodity prices, in particular oil, the source of the pressure on headline inflation in 2009-10 has been concentrated in food articles, and the intensity of the shock has aggravated after the deficient south-west monsoon and its impact on kharif output. On year on year basis, WPI headline inflation in December 2009 was at 7.3 per cent, whereas WPI inflation excluding food articles was 2.1 per cent, which suggests the concentrated nature of the inflation so far. Food items (i.e. primary and manufactured) with a combined weight of 27 per cent in the WPI basket have exhibited 21.9 per cent increase in prices. In December 2009, there have been signs of emergence of generalised inflation. Weekly WPI data on primary articles indicate that primary food articles prices have increased by 16.8 per cent (y-o-y) as on January 9, 2010.

14. The acceleration in inflation is also evident from the fact that the overall WPI has increased by 8.0 per cent in December 2009 over March 2009, and different measures of CPI inflation remain inflexibly high in double digits (in the range of 13.5 per cent to 17.2 per cent in November-December 2009). The concentrated pressure on headline inflation arising from high food prices entails the risk of getting transmitted over time to other non-food items through expectations driven wage-price revisions, and thereby magnifying into a generalised inflation. While anchoring inflation expectations becomes important in such a situation, addressing supply constraints would be critical for enhancing the effectiveness of any anti-inflationary policy measures, given particularly the nature of the current sources of pressure on the headline inflation.

Growth and Inflation Outlook

15. The growth and inflation mix in India is increasingly diverging from the pattern being seen in other G-20 countries. While some countries continue to experience weak recovery with no risk of inflation, some others have witnessed strong revival in growth with modest inflation, whereas in India recovery has coincided with significant build up of inflationary pressures. In view of the dominance of food price inflation, however, balancing the policy needs of supporting durable return to the high growth path while avoiding a situation of generalised increase in inflation through monetary policy actions has emerged as a delicate challenge for the Reserve Bank.

16. The upside prospects for further acceleration in growth in the near term derive support from several factors, including signs of revival in private demand, both consumption and investment; possibility of strong industrial recovery continuing; outlook for a better Rabi crop; export growth remaining positive; favourable capital market conditions; and the general improvement in business sentiments as per the Reserve Bank's business expectations survey as well as similar surveys of other agencies.

17. The downside risks to growth in the near-term could be seen in terms of the adverse impact of the deficient monsoon on kharif crop in the GDP of next quarter, weakness in services activities that are dependent on external demand, notwithstanding the signs of improvements in recent months; and possible pressures on interest rates that may emerge from revival in demand for credit from the private sector as well as inflation expectations. Risks to global growth and higher oil prices also need to be given due consideration.

18. The outlook for inflation will be conditioned by the upside risks in terms of persistence of supply side pressures in the near term, possible return of pricing power with stronger recovery in growth, further revival in private demand with improving consumer and business confidence, possible spurt in global commodity prices in response to recovery in the EMEs and advanced economies, and the possibility of high CPI and food price inflation spilling over to cause a generalised inflation. The possible sources of comfort that could ease some of the pressures on inflation include arrival of certain new crops in the market – particularly vegetables, additional release from the high level of buffer stocks of foodgrains, and negative output-gap persisting for some more time, which would contain the demand side pressures.

19. The growth and inflation mix for India, thus, is increasingly becoming asymmetric vis-à-vis the pattern in other G-20 countries. The possibility of surges in capital inflows and the associated domestic liquidity conditions may also affect inflationary expectations, besides the impact of the rebound in international commodity prices in response to global recovery. With a stronger recovery in India, the risks of food price inflation causing generalised inflation cannot be ignored.