MACROECONOMIC AND MONETARY DEVELOPMENTS FIRST QUARTER REVIEW 2010-11

Overview

Global Economic Conditions

1. The global economy recovered faster than expected, led by robust growth in Emerging Market Economies (EMEs). Global output increased by over 5 per cent in Q1 of 2010 but it has hit a soft patch thereafter due to concerns stemming from the sovereign debt situation in the euro area. The IMF revised upwards its global growth projections for 2010 to 4.6 per cent from 4.2 per cent earlier. Recovery continues to remain uneven across countries in terms of both pace as well as sustainability. Fiscal austerity measures being adopted in many advanced economies could potentially dampen the growth impulses in these economies.

2. EMEs are expected to continue the process of normalisation of monetary policy in view of their stronger recovery, emerging inflationary pressures, and risks of asset price build-up. Advanced economies, on the other hand, may further delay monetary exit, due to the emergence of new risks to recovery, as also their well anchored inflation expectations. According to the IMF, while headline inflation in advanced economies could remain subdued at around 1.5 per cent or below, in emerging and developing economies inflation will edge up to more than 6 per cent in 2010.

3. The IMF assessment suggests that because of the low risk appetite of global investors in general after the euro area developments, capital flows to EMEs may decline initially before recovering again driven by their higher growth prospects and lower public debt. Exchange rates of key currencies have been highly volatile in recent months. While the Chinese yuan exhibited some appreciation, the euro has depreciated significantly. World trade, though recovering, is yet to revert to the pre-crisis level. Divergent growth and inflation conditions are likely to increase the asymmetry in the stance of monetary and fiscal policies across countries, which in turn could feed into the equity, foreign exchange and commodities markets to accentuate volatility.

Indian Economy – Trends and the Outlook

Output

4. Economic recovery gained further momentum, with robust growth in GDP recorded in the last quarter of 2009-10. Going by the progress of the monsoon so far, the agricultural output is expected to be better than last year. Industrial production continues to exhibit strong double digit growth in the current year, and notwithstanding some moderation in May 2010, the downside risks to growth are low. Lead indicators for services activities suggest continuation of the momentum. Thus, in 2010-11, GDP growth can be expected to be higher than 8.0 per cent projected in the April 2010 Monetary Policy Statement.

Aggregate Demand

5. Private investment demand recovered sharply, with gross fixed capital formation accelerating significantly in the last quarter of 2009-10. Production trends in capital goods point to continuation of the strong investment activities in the near-term. Disaggregated information such as production of consumer durables and non-durables, auto sales and non-oil imports suggest recovery in private consumption demand going forward. Government consumption demand would moderate reflecting the fiscal consolidation programmed in the budget. The recovery in export demand that began in November 2009 may slow in the months ahead because of developments in the euro area. Pick-up in demand for credit from the private sector, rapid growth in corporate sales, and information on order books available from forward looking surveys indicate strengthening of domestic demand. Overall, private consumption and investment demand would be the two major drivers of growth during 2010-11.

Fiscal Conditions

6. The fiscal consolidation plans programmed in the Union Budget for 2010-11 will benefit from the larger than expected mobilisation from 3G/ Broadband Wireless Access (BWA) spectrum auctions, which alone could reduce the fiscal deficit by 1 percentage point of GDP. The partial deregulation/upward revision to the prices of petroleum products in June 2010 will contain pressure on the fiscal situation from under-recoveries of the public sector oil companies. While the price adjustment in the petroleum sector may add to headline inflation in the near-term, improved fiscal situation would be congenial to both inflation and growth outlook in the medium run.

External Sector

7. With recovery in growth of exports and the return of capital flows, the external sector conditions improved during 2009-10. The current account deficit, however, widened to 2.9 per cent of GDP in 2009-10, from 2.4 per cent in 2008-09, which contributed to the recovery through higher absorption of foreign capital. In 2010-11 so far, import growth remains strong while capital inflows have moderated led by the decline in portfolio flows. During 2009-10, foreign exchange reserves increased by US$ 13.4 billion (excluding valuation gains) and by US$ 27.1 billion (including valuation gains). As on July 16, 2010, the reserves stood at US$ 281.9 billion.

Monetary and Liquidity Conditions

8. The surplus liquidity conditions that prevailed all through 2009-10 started moderating in early 2010-11 in response to the calibrated normalisation of monetary policy by the Reserve Bank. In June 2010, however, there was a severe tightness in liquidity conditions resulting from a sudden and sharp increase in the government cash balances arising out of significantly higher mobilisation under 3G/BWA spectrum auctions. While mitigating the liquidity pressure, the Reserve Bank persevered with calibrated monetary tightening keeping in view the higher level of inflation. Between April and July 2010, the repo and reverse repo rates were raised cumulatively by 50 basis points and the CRR was raised by 25 *basis points. Reflecting increased demand for credit associated with recovery in growth, non-food credit growth to the private sector remained buoyant.*

Financial Markets

9. In the first quarter of 2010-11, the volatility in global markets emanating from concerns about fiscal sustainability in the euro area, spilled over to the Indian markets, particularly the equity market. Reflecting the tight liquidity conditions in June 2010, interest rates at the short end of the term structure edged up, while medium to long-term yields moderated, in view of the improved fiscal position after 3G/BWA auction revenues. In the credit market, credit spreads moderated while credit growth accelerated, suggesting improved credit conditions. The banking sector switched over to a new "base rate" system of lending effective July 1, 2010, which is expected to enhance transparency in loan pricing, promote competition in the credit market and also improve the transmission of monetary policy. The base rates set by major public sector banks were in the narrow range of 7.25-8.0 per cent. In the housing market, the pace of increase in house prices over successive quarters moderated somewhat in the fourth quarter of 2009-10.

Inflation

10. Headline WPI inflation has been in double digits since February 2010 and also become increasingly generalised in every successive month. Non-food manufacturing inflation accelerated from near zero in November 2009 to 7.3 per cent in June 2010, reflecting the impact of rising input costs, recovering private demand and associated return of pricing power. In the last few months, price increases also reflected upward revisions in several administered prices or delayed reporting of data. Monetary policy may not be the most effective instrument to deal with supply side pressures on inflation. But repeated supply shocks and administrative price increases not only increase inflation persistence but also aggravate inflation expectations. For containing the inflation persistence and anchoring inflation expectations, anti-inflationary monetary policy actions become a necessity, notwithstanding the importance of supply augmenting structural measures to ensure a sustained low inflation regime.

Overall Assessment

11. The normalisation of monetary policy has been conditioned by the growth-inflation dynamics characterised by robust acceleration in growth and increasing generalisation of the double digit inflation. While external conditions have turned more uncertain after the sovereign debt related stress in the euro area, the outlook in India points to further consolidation in growth during the course of the year, driven largely by pick-up in private consumption and investment demand. For the conduct of monetary policy, emerging demand side pressures on inflation, increasing generalisation of the inflation path and persistence of high food price inflation need to be assessed along with the expected favourable impact of a better monsoon than last year on food prices. With receding concerns relating to the recovery and given the emerging risks of generalised inflation, monetary policy measures have to continue the calibrated normalisation process.