MACROECONOMIC AND MONETARY DEVELOPMENTS in 2008-09

Overview

The global economic conditions deteriorated sharply during the year 2008 with several advanced economies experiencing their sharpest declines in the post-World War II period. The associated adverse shocks spreading across emerging market economies (EMEs) particularly by the fourth quarter of the year, accentuated the synchronised global slowdown. The global inflation conditions witnessed sharp volatility during the year as headline inflation in major advanced economies firmed up considerably up to July 2008 but fell sharply thereafter. The global financial environment entered a crisis phase in mid-September 2008, following the growing distress among large international financial institutions and the declaration of bankruptcy of Lehman Brothers. As credit markets froze, central banks across the world, along with the respective governments, responded with both conventional and unconventional measures. The knock-on effect of these unprecedented adverse global developments became evident in the macroeconomic performance of the Indian economy, particularly in the second half of 2008-09.

The Indian economy, which was on a robust growth path up to 2007-08, averaging at 8.9 per cent during the period 2003-04 to 2007-08, witnessed moderation in 2008-09, with the deceleration turning out to be somewhat sharper in the third quarter. While the growth deceleration was primarily driven by the knock on effects of the global economic crisis, it also reflected to some extent the slowdown associated with cyclical factors. Industrial growth experienced a significant downturn and the loss of growth momentum was evident in all categories, viz., the basic, capital, intermediate and consumer goods. A hitherto key growth driver, services sector, witnessed some moderation, notwithstanding a counter-cyclical rise in the growth of community, social and personal services on the back of implementation of the Sixth Pay Commission recommendations. Although agriculture also recorded a deceleration in growth, the agricultural outlook remains satisfactory, with the sowing in the rabi season being higher than that in the previous year.

The slowdown in the Indian economy during 2008-09 has been associated with a deceleration in investment demand, which had been an important driver of growth in recent years. The adverse conditions for access to external capital, and the depressing effects of the global crisis on domestic business confidence contributed to the moderation in investment demand. The deceleration in private consumption expenditure was partly offset by a sharp increase in

Government consumption expenditure during the third quarter emanating from the discretionary fiscal stimulus measures and committed expenditures. The key deficit indicators of the Central Government, viz., the revenue deficit and the gross fiscal deficit as per the revised estimates for 2008-09 were, therefore, significantly higher than the budgeted level as well as those of the preceding year. *Implementing the fiscal stimulus packages required the Government to defer the attainment of the stipulated deficit targets under the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. Corporate performance remained subdued during the year, with the impact on profitability being particularly adverse during the third quarter, when growth in sales, which had been strong in earlier quarters, also decelerated. External demand conditions weakened, particularly since October 2008, with the decline in exports resulting in a sharp widening of the merchandise trade deficit during April 2008-February 2009. Saving and investment rates, which had peaked in 2007-08, are likely to be affected adversely by the slowdown in economic growth during 2008-09.*

The balance of payments (BoP) developments during April-December 2008 reflected the impact of shocks emanating from the global economy through both trade and financial channels. There was a large expansion in trade deficit led by relatively higher growth in imports on account of high oil prices in the earlier part of the year, and slowdown in exports. During the third quarter of 2008-09 both imports and exports recorded sharp deceleration under the impact of contraction in the external demand, slowing domestic demand and falling commodity prices. Despite relative resilience of software services exports and remittances from overseas Indians, the large trade deficit led to an expansion in current account deficit to US$ 36.5 billion in April-December 2008 as compared with US$ 15.5 billion in April-December 2007. Large net outflows under portfolio investment and large repayments under short-term trade credit, along with a wider current account deficit led to a decline in reserves. It is indeed remarkable that the contagion spreading from a severe global crisis could be managed with a reserve loss (excluding valuation) of only US$ 20.4 billion over the period April-December 2008, out of which US$ 17.9 billion was incurred in the last quarter of 2008 alone. As on April 10, 2009 the foreign exchange reserves stood at US $ 253.0 billion, showing a decline of US$ 56.7 billion (including valuation) over the level at end-March 2008. India's external debt, debt sustainability indicators and the level of foreign exchange reserves continue to remain at comfortable levels and would ensure external stability.

Monetary growth witnessed moderation during 2008-09, reflecting deceleration in bank credit on the back of the slowdown in economic activity emanating from the deepening of the international financial turmoil. The consequent capital outflows contributed to the contraction of reserve money. The Reserve Bank, therefore, undertook a number of measures such as cuts in the cash reserve ratio (CRR), *unwinding/de-sequestering of balances held by the Government with the Reserve Bank under Market Stabilisation Scheme (MSS), open market operations (OMOs) and other measures to ensure ample rupee liquidity in the system. Consequently, the expansion of reserve money, adjusted for the CRR cuts, was substantial at 19.0 per cent in 2008-09, albeit, lower than that of 25.3 per cent in 2007-08. The expansion in non-food credit, after reaching a peak in October 2008, decelerated thereafter, reflecting the downturn in demand conditions in both the international economy and the domestic economy. The flow of resources to the commercial sector from non-banking and external sources declined sharply during the year. As a result of net capital outflows and consequent foreign exchange operations of the Reserve Bank, net foreign exchange assets of the Reserve Bank declined. On the other hand, net Reserve Bank credit to Centre increased reflecting its increased investments in government securities through open market operations (OMO) as also the decline in MSS.*

India also experienced the knock-on effects of adverse international developments in conjunction with domestic factors affecting liquidity conditions. Simultaneously capital flow reversals took place, which impacted the equity markets as well as the foreign exchange market. The Reserve Bank has taken a number of measures since mid-September 2008 to augment the domestic currency and foreign exchange liquidity through the banking system. Consequently, the liquidity conditions in India have been normal since mid-November 2008. The level of Government borrowings in 2008-09 was much higher than what was initially budgeted, which impacted market sentiment during the last quarter of 2008-09. The equity markets, which had remained subdued throughout 2008-09, began to pick-up in the last week of March, in line with the international developments.

During the first half of 2008-09, headline inflation increased in major economies but recorded sharp decline subsequently in consonance with movements in international energy and commodity prices. The recent declining trend in these prices was also contributed by moderation in demand pressures following the impact of the financial crisis. In India also, inflation as measured by year-on-year variation in the wholesale price index (WPI), declined from its intra-year peak of 12.9 per cent recorded on August 2, 2008 to 0.3 per cent as on March 28, 2009 led by the reductions in the administered prices of petroleum products and electricity as well as decline in the prices of freely priced petroleum products, oilseeds/edible oils/oil cakes, raw cotton, cotton textiles and iron and steel. It may be noted that the effective supply management measures and other policy actions have contributed to relatively lower volatility in key commodity prices in India as compared to the international trends. On the other hand, high food prices have kept consumer inflation at elevated levels in the range of 9.6-10.8 per cent during January/ February 2009 as compared with 7.3-8.8 per cent in June 2008 and 5.2-6.4 per cent in February 2008.

In sum, the Indian economy has experienced some loss of growth momentum with major drivers of growth witnessing moderation. In particular, the broad-based industrial slowdown, dampened services sector growth, deceleration in private consumption and investment demand along with declining export demand are some of the major concerns facing the Indian economy in the wake of the global recession at the present juncture. The fiscal stimulus packages of the Government and the monetary easing of the Reserve Bank will, however, arrest the moderation in growth and revive consumption and investment demand, though with some lag, in the months ahead. Furthermore, prospects of the agricultural sector also remain bright, and this will continue to support the rural demand. Notwithstanding widened current account deficit in 2008-09, the balance of payments position remains sustainable in the context of the present level of foreign exchange reserves and external debt. Finally, in the wake of expected improvement in agricultural production as well as low international commodity prices, inflationary pressures are also anticipated to remain at a low level through the greater part of the 2009-10.

An important challenge in the macroeconomic and monetary policy making during 2008-09 has been to manage the volatility emerging in respect of several key economic indicators of the Indian economy. During the course of the year, while overall growth moderated from its high growth momentum, headline WPI inflation declined sharply from a double digit level to near zero per cent by the end of the year. India's financial sector activity confronted a sudden shift from a phase of high to that of sharply receding capital inflows. This was manifested in reversal of the appreciating trend in the exchange rate during the year. The consequent policy response to contain excessive volatility in the foreign exchange market by increasing the supply of foreign exchange posed a challenge in managing liquidity in the money markets. The knock-on impact from the global financial markets since September 2008 further tested the Reserve Bank's monetary management operations through both quantity as well as price instruments as the stance shifted from a contractionary to an accommodative mode. However, concious monetary policy measures pursued by the Reserve Bank restored orderly conditions in the money and foreign exchange markets by November 2008. Furthermore, in the wake of receding non-banking and external sources of funding of the commercial sector, bank credit availability provided some substitution. However, the moderating economic activity eventually resulted in decelerating growth of bank credit by the end of the year. Notwithstanding several challenges, particularly from the global economy, the Indian economy remained resilient, its financial institutions and private corporate sector remained sound and solvent. Furthermore, the macroeconomic management helped in maintaining lower volatility in both the financial and the real sectors in India relative to several other advanced and emerging market economies.