Current Macroeconomic Developments in India[1]

The Indian economy continues to be one of the fastest growing economies in the world, and the recovery from the slowdown in growth witnessed in the aftermath of the global crisis has been sharper than what was generally anticipated for the second quarter of 2009-10. The slowdown in growth from the average of 8.8 per cent during 2003-08 to 5.8 per cent in the second half of 2008-09 had necessitated clear prioritization of policy focus on management of recovery, which was evident in the adoption of expansionary fiscal and accommodative monetary policy stance. The decline in inflation in the second half of 2008-09 had created space for adoption of an accommodative monetary policy stance to support a faster recovery. In 2009-10, however, CPI inflation has remained inflexibly high and WPI inflation has also started firming up – led by significant acceleration in food prices – which has raised the risk of endangering generalized inflation through adverse inflation expectations. The strong recovery in growth in the second quarter of 2009-10 at 7.9 per cent has now created an 'inflation-growth' outcome for India, which is divergent from the pattern being seen in the advanced economies as well as several major emerging economies.

Early signs of the end of global recession that started to emerge in the second quarter of 2009, became clearly evident by the 3rd quarter with all G-20 countries (excluding UK) witnessing positive economic growth. In the advanced economies, however, there is significant uncertainty about the sustainability of the recovery. The excessive dependence of the recovery on the policy stimulus operates as the key risk to sustainability of recovery, and hence the generalized preference has been towards the policy stance to err on the side of caution. Presence of significant negative output gap on account of the output losses suffered over 4 to 5 quarters by the advanced economies in relation to their production has minimized the risk to inflation from excess liquidity, notwithstanding though the concerns about risks to asset price bubbles. The compulsion of exit for different countries, thus, could arise at different points of time, depending on the risks to inflation, extent of recovery in relation to the potential growth path and the policy assessment of risk to sustainable recovery from errors in exit.

I. Economic Growth

After a phase of distinct deceleration in growth during the second half of 2008-09, the Indian economy exhibited signs of recovery with accelerated

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[*] Address by Smt. Shyamala Gopinath, Deputy Governor, Reserve Bank of India at the Bangalore Chamber of Industry & Commerce on December 28, 2009. She is grateful to Shri Sitikanth Pattnaik, Director ,Department of Economic Analysis and Policy for his valuable assistance.

growth in GDP during the first half of 2009-10. According to the estimates of the Central Statistical Organisation (CSO), real GDP growth during the first quarter of 2009-10 was placed at 6.1 per cent, higher than 5.8 per cent recorded during the preceding two quarters of 2008-09 (Table-1). Furthermore, the real GDP growth accelerated to 7.9 per cent in the second quarter of 2009-10, representing a modest recovery from the 7.7 per cent registered during the corresponding period of 2008-09(Q2) though still lower than the 8.8 per cent average growth experienced during 2003-08. The sequential recovery over the first quarter of 2009-10 was driven by notable turnaround in industrial output (9.0 per cent), and services sector (9.0 per cent), while agriculture sector also came to record a positive growth (0.9 per cent), despite drought like conditions and floods in some parts of the country.

During the second quarter of 2009-10, accelerated growth emanated from revival in private consumption expenditure (5.6 per cent in Q2 compared to 1.6 per cent in Q1). Government consumption expenditure support to aggregate demand also strengthened further (26.9 per cent compared to 10.2 per cent in Q1). There has been absolute decline in inventory level in the second quarter of 2009-10 over both the preceding as well as the corresponding quarter, pointing towards recovery process. Net exports also made significant contribution to overall growth as rate of decline in imports has been much higher than the decline in exports.

Table-1: Growth Rates of Real GDP

(Per cent)

Sector		2007-08*	2008-09#	2008-09				2009-10	
				Q1	Q2	Q3	Q4	Q1	Q2
1		2	3	4	5	6	7	8	9
1.	**Agriculture and Allied Activities**	**4.9**	**1.6**	**3.0**	**2.7**	**-0.8**	**2.7**	**2.4**	**0.9**
2.	**Industry**	**7.4**	**2.6**	**5.1**	**4.8**	**1.6**	**-0.5**	**4.2**	**9.0**
	(i) Mining & Quarrying	3.3	3.6	4.6	3.7	4.9	1.6	7.9	9.5
	(ii) Manufacturing	8.2	2.4	5.5	5.1	0.9	-1.4	3.4	9.2
	(iii) Electricity, Gas & Water Supply	5.3	3.4	2.7	3.8	3.5	3.6	6.2	7.4
3.	**Services**	**10.8**	**9.4**	**10.0**	**9.8**	**9.5**	**8.4**	**7.7**	**9.0**
	(i) Community, Social & personal services	6.8	13.1	8.2	9.0	22.5	12.5	6.8	12.7
4. Real GDP at Factor Cost		**9.0**	**6.7**	**7.8**	**7.7**	**5.8**	**5.8**	**6.1**	**7.9**

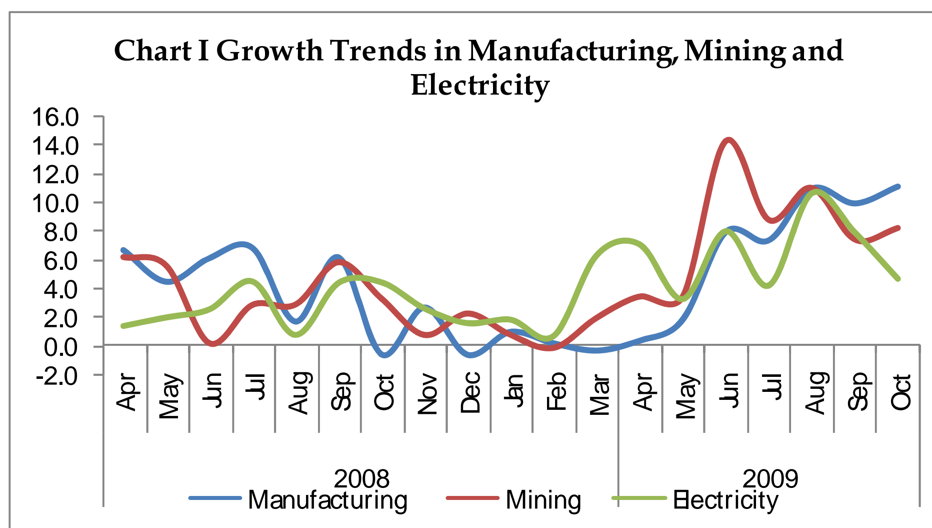
@: At 1999-2000 Prices *: Quick Estimates. #: Revised Estimates.
Note : Figures in parenthesis indicate shares in real GDP
Source: Central Statistical Organisation

Agriculture Situation

The deficient South-West monsoon and consequent drought like conditions in several States have adversely impacted Kharif production. As per the revised First Advance Estimates for 2009-10, total *kharif* foodgrains and oilseeds production is estimated at 114 million tonnes as against 135.6 million tonnes in 2008-09, registering a decline of 15.9 per cent over the previous year. Crop wise, a decline is expected for all crops except urad, tur and cotton. Considering that *rabi* prospects are promising this year in view of delayed withdrawal of South West monsoon and planned Government efforts towards enhancing *rabi* production, it is expected that *rabi* production would partly compensate for lower kharif this year, as in 2008-09. The Government has also indicated that *Rabi* season might see an additional 10 million tonnes of production comprising 8.5 million tonnes of foodgrains and 1.5 million tonnes of oilseeds. The Government's recent hike in MSPs of the *rabi* crops is likely to incentivise *rabi* crop production. The progress of the North East monsoon (up to December 16, 2009) has been 9 per cent above normal as against 29 per cent below normal during corresponding period last year. Reservoir levels have been improving from their lows during summer 2009. As on December 17, 2009, it is placed at 56 per cent of Full reservoir level (FRL) as against 58 per cent during corresponding period last year and 55 per cent during last 10 years. The sowing position for *Rabi* crops is progressing well. The area coverage (as on December 10, 2009) particularly for wheat, rice and pulses has been higher than last year, though oilseeds have shown some shortfall. The agricultural sector is also expected to derive support from the 'allied sector' comprising horticulture, livestock and fisheries that has been growing at above 5 per cent during last few years. On the whole, agricultural production during 2009-10 hinges critically on the performance of the North East monsoon and *rabi* production.

Sector wise Analysis of Index of Industrial Production

During the current financial year (April-October, 2009-10), the industrial production exhibited recovery from the loss of growth momentum witnessed during the second half of 2008-09. After a short phase of deceleration, the industrial growth turned negative in December 2008 and thereafter turned positive, but remained depressed till the end of 2008-09. Since April 2009, the recovery has been more visible and industrial output clocked double digit growth at 11.0 per cent in August 2009, which is the highest recorded since November 2007, before showing a marginal moderation to 10.3 per cent in October 2009 (Chart I).



The growth in industrial production accelerated to 7.1 per cent during the current financial year 2009-10 (April-October), which is higher than the growth recorded during the corresponding period of the previous year (4.3 per cent). A growth of 9.3 per cent was observed for the period of June-October 2009. The recovery in industrial growth has been broad-based with acceleration in growth of all the three sectors, *viz.,* mining, electricity and manufacturing (Table 2 and Chart II). The relative contribution of manufacturing in industrial growth, however, was 85 per cent during April-October 2009, lower than 88 per cent in April-October 2008. Out of 17 two-digit manufacturing industry groups, 11 industry groups, accounting for 54.4 per cent weight in the IIP recorded acceleration in growth during April-October 2009-10.

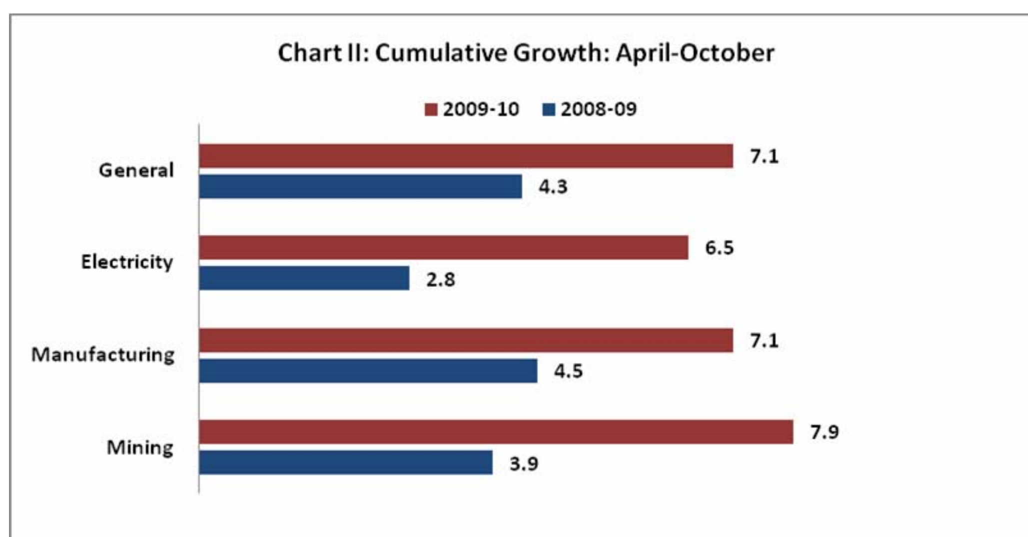


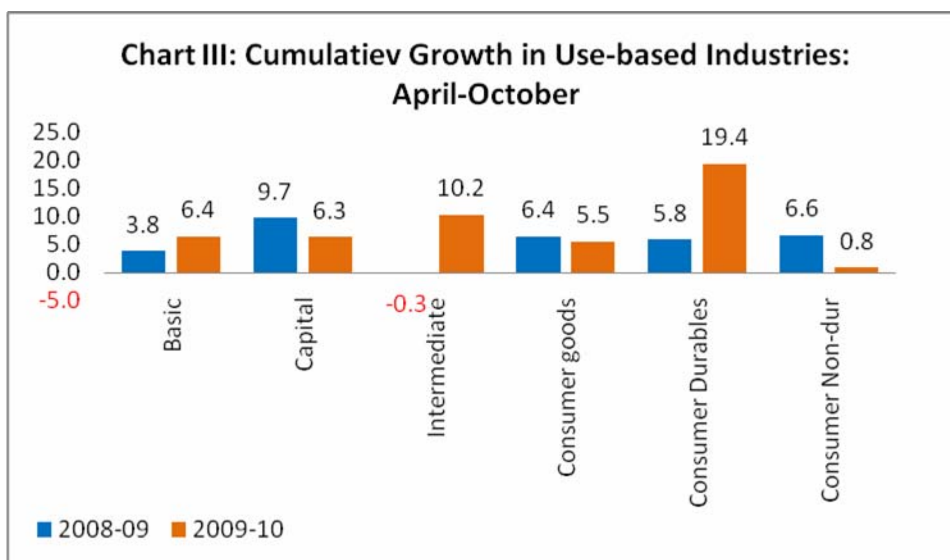
Table 2: Quarterly Industrial Growth and Relative Contribution				
	Growth (Y-o-Y) (%)			
Period	**Mining**	**Manufacturing**	**Electricity**	**General**
2008-09: Q1	4.0	5.8	2.0	5.3
2008-09: Q2	3.8	4.9	3.2	4.7
2008-09: Q3	2.0	0.5	2.9	0.8
2008-09: Q4	0.9	0.3	3.0	0.5
2009-10: Q1	6.8	3.4	6.0	3.8
2009-10: Q2	9.0	9.4	7.5	9.2

Disaggregated analysis of Use-based Industries

In terms of use-based classification, sharp acceleration was recorded in the case of basic goods, intermediate goods and consumer durables. Capital goods output growth showed a marginal deceleration, while the growth of consumer non-durables output was substantially lower, reflecting negative/ subdued growth during April-June 2009 (Table 3).

Table 3: Quarterly Growth and Relative Contribution of Use-based Industries						
Period	**Basic Goods**	**Capital Goods**	**Intermediate Goods**	**Consumer Goods**	**Consumer Durables**	**Consumer Non-Durables**
Growth (Y-o-Y) (%)						
2008-09: Q1	3.1	7.9	2.6	8.6	3.5	10.1
2008-09: Q2	4.7	13.2	-1.7	6.6	10.8	5.1
2008-09: Q3	2.4	3.8	-5.8	3.3	-1.8	4.9
2008-09: Q4	0.4	5.0	-2.7	1.2	5.6	-0.1
2009-10: Q1	6.3	2.0	7.4	-0.5	15.6	-5.3
2009-10: Q2	6.9	8.3	11.7	9.9	22.2	5.4

The basic goods sector has manifested steady acceleration during April-October 2009-10, mainly on account of improved performance in electricity, non-metallic mineral products like cement and basic metals (Chart III). After a loss of growth momentum for seven consecutive months (August 2008 to February 2009), intermediate goods sector has recovered strongly since March 2009 and showed a double digit growth during August-October 2009, reflecting revival in demand for intermediate products.



The consumer non-durables showed a positive growth during April-October 2009 on account of sharp upturn during July-October 2009. The trends in consumer durables production show steady rise with double digit growth since April 2009.

The industrial recovery mainly propelled by intermediate and basic goods in April-May 2009, has now become broad-based with capital and consumer non-durables recording the rise. The recovery in industrial sector has been driven by the domestic demand backed by fiscal stimulus that is expected to work during the remaining months of the current year. The increasing mobilisation of funds through IPOs, private placements, and ECBs coupled with sequential pick up in bank credit over the last few months also indicate revival in investment activities of corporates, which in turn reflected in capital goods production. World economic prospects show signs of improvement with export growth at 18.3 per cent in November 2009, after remaining in negative territory for last 13 months. The steep rise in the sale of automobiles in general and October-November 2009 in particular (including commercial vehicle) indicates pick up in general industrial environment. Manufacturing PMI for October and November 2009 at 54.5 and 53.0, respectively demonstrate continued expansion of the sector although lower than September 2009.

II. Inflation: Trends and outlook

Inflation in India exhibited significant volatility during 2008-09 with WPI inflation moving to double digits during June-October 2008 before declining to below one per cent by end-March 2009. External supply side shocks were the key drivers of inflation during this period and the volatility in international oil and metal prices induced similar pattern in domestic prices. During 2009, year-on-year WPI inflation turned negative during June-August 2009, mainly on account of the statistical reason of high base and returned to

positive zone subsequently in the wake of a spurt in prices of food items and increase in global crude oil prices. The annual year-on-year inflation for the month of November 2009 based on monthly WPI, increased to 4.8 per cent as compared with 1.3 per cent in the previous month.

Inflation assessment for the conduct of monetary policy has become increasingly complex in recent times with the WPI inflation rate exhibiting significant volatility and CPI inflation measures remaining elevated at double digits for an extended period causing significant divergence between these different measures of inflation. CPI inflation has remained at an elevated level since March 2008 and did not decline as expected in line with fall in WPI inflation. Indeed, it hardened due to sharp increase in essential commodity prices. The situation was aggravated by the deficient monsoon rainfall and drought condition in several parts of the country. The Reserve Bank monitors an array of measures of inflation, both overall and disaggregated components, in conjunction with other economic and financial indicators, to assess the underlying inflationary pressures and articulates its policy stance in terms of WPI.

WPI food inflation, which had moved into double digits in April 2009, hardened further to 19.8 per cent in November 2009, with deficient monsoon exacerbating supply conditions. Prices of essential commodities have been steadily increasing during 2009-10, and the inflation in this group was 21.2 per cent in November 2009 on a y-o-y basis. On a financial year basis, WPI has increased by 7.5 per cent in November 2009 over March 2009 as compared to 3.9 per cent in the corresponding period of the previous year. WPI inflation excluding food, however, continued to remain negative at (-) 0.4 per cent in November 2009 largely on account of the year on year decline in the prices of minerals oil and iron and steel.

The major contributors to the annual inflation were food items, particularly sugar, eggs, fish, meat, milk, rice, vegetables and pulses, all of which had recorded double-digit inflation, ranging from 53.8 per cent (sugar) to 11.5 per cent (milk). The sharp increase in the prices of these commodities was partially offset by the decline in the prices of minerals oil, iron and steel, edible oils, raw cotton, man-made fibres and minerals. It may, however, be noted that even those commodities, which are currently exhibiting negative inflation on a year on year basis, registered increase in prices in November over March 2009. The increase in minerals oil prices were in line with the international commodity prices.

The recent divergence between WPI and CPI inflation could be attributed to the higher weight of food articles in CPIs, which have displayed higher inflation in recent months. When there is an upward pressure on food

prices, CPI (IW) food inflation in general appears to increase at a faster rate and remain at the elevated level for a longer period than the WPI inflation. There has, however, been a dip in CPI food inflation in August 2009, bringing it closer to WPI food inflation. The higher order of inflation in the same commodities at the retail level (as captured in CPI) could be on account of intermediation costs, higher transportation and labour costs between wholesale and retail markets, as well as better pricing power in the retail market in relation to wholesale markets. Thus, the divergence between WPI and CPI inflation is not only because of differences in weights and coverage, but also because of the actual price differences for similar commodities at the wholesale and retail levels.

In contrast to the last year when external factors conditioned inflation volatility, during the current episode, price pressures are emanating from domestic sources reflecting increase in prices of food articles and food products. Risks of the inflationary pressure persisting and escalating further arise from challenges in improving the supply situation of essential commodities in the short-run, gradual re-emergence of pressure on global commodity prices in the wake of signs of global recovery and rising inflation expectations on account of elevated CPI inflation.

Factors which could counter the inflationary impact of increases in food prices are adequate buffer stocks of foodgrains (48.4 million tonnes as on December 1, 2009); expectations of improved rabi crop that could partly offset the adverse impact of deficient kharif production; selective import of certain commodities and normal trend reversal seen in prices of food articles over different crop seasons. Oil prices, which have remained mostly range bound despite the spurt witnessed in October 2009, could also dampen the inflationary pressures. Recognising the emerging inflationary pressures, the Reserve Bank, in its Second Quarter Review (October 2009), had placed the baseline projection for WPI inflation at end-March 2010 at 6.5 per cent with an upside bias. Since the presentation of the policy, food prices have increased further and there is a general policy concern of price pressures spilling over to other segments through adverse expectations, given particularly the stronger than expected recovery in growth in the second quarter of 2009-10.

III. Credit and Monetary Conditions

While broad money growth has witnessed some moderation in growth (year-on-year) during 2009-10 so far, it remains above the Reserve Bank's projected trajectory of 17.0 per cent growth for 2009-10, as set out in the Second Quarter Review of Monetary Policy 2009-10 (October 2009). On the sources side of monetary expansion, the banking system's credit to the Government continued to be the major driver, as bank credit to the commercial

sector continued to exhibit deceleration. On the components side of monetary expansion, the key driver has been growth in aggregate deposits.

Non-food credit by scheduled commercial banks (SCBs) decelerated significantly, with the growth rate (y-o-y) falling to 11.0 per cent as on December 4, 2009 from 26.3 per cent a year ago. On a financial year basis (up to December 4, 2009) too, the growth in SCBs' non-food credit at 5.3 per cent is significantly lower than the growth of 11.8 per cent in the corresponding period of last year. Several factors have contributed to the slowdown in non-food bank credit, most notable being the impact of the slowdown in economic activity. Besides, drawdown of inventories, improved access to non-bank domestic sources of funds and external financing which had almost dried up during the crisis, fall in oil marketing companies' borrowings from the banking sector, flow of a significant amount of bank finance to the corporate sector indirectly through banks' investment in units of mutual funds and tightening of credit to the retail sector due to the perceived increase in risk on account of the general economic slowdown and concern relating to asset quality also contributed to the deceleration in demand. With the economy, however, posting strong growth in the second quarter of the year, credit demand could be expected to pick up, which has already started in the recent fortnights.

The availability of surplus liquidity in the system is evident from the large daily absorption through reverse repo by the Reserve Bank. With the persistence of deceleration in bank credit to the commercial sector, high deposit growth and the Reserve Bank's liquidity augmenting measures created space for market absorption of the large government borrowing programme.

Sectoral Deployment of Gross Bank Credit

On a year-on-year basis, non-food gross bank credit increased by 9.9 per cent in October 2009 as compared with 29.4 per cent in the previous year. Among the major sectors, credit flow (y-o-y) to agriculture recorded the highest growth of 19.9 per cent (23.4 per cent during the year ended October 2008), followed by industry (14.8 per cent as against 37.4 per cent) and services sector (6.3 per cent as against 35.5 per cent). Personal loans declined by (-) 0.1 per cent from 15.0 per cent during the year ended October 2008. Within the services sector, loans to real estate and non-banking finance companies continued to record high growth of 21.2 per cent (44.2 per cent in October 2008) and 20.8 per cent (60.5 per cent), respectively.

In absolute terms, the highest incremental non-food gross bank credit was absorbed by industry (61.2 per cent during the year ended October 2009 as against 48.8 per cent in the previous year), followed by agriculture (23.3 per

cent against 9.6 per cent), services (15.8 per cent against 28.4 per cent) and personal loans (-0.2 per cent against 13.2 per cent). Among services sub-sectors, incremental credit off-take was the highest for trade (8.0 per cent against 4.1 per cent) followed by non-banking financial companies (7.5 per cent against 5.9 per cent), real estate (6.4 per cent in October 2009 against 4.0 per cent in October 2008) and professional services (3.6 per cent against 3.3 per cent in October 2008).

Among the priority sub-sectors, credit to micro and small enterprises (MSEs) (including service sector enterprises) recorded a growth of 23.9 per cent (y-o-y) in October 2009 as compared with 18.8 per cent a year ago. While credit to manufacturing MSEs grew by 24.6 per cent in October 2009 (18.9 per cent in the previous year), services MSEs recorded a credit growth of 23.0 per cent (18.6 per cent in October 2008). Credit to weaker sections grew (y-o-y) by 25.0 per cent in October 2009 as compared with 23.0 per cent in October 2008. Export credit (by foreign banks under priority sector) fell by 30.8 per cent in October 2009 as compared with a growth of 41.4 per cent in the previous year.

Within industry, bulk of incremental credit was absorbed by infrastructure (70.6 per cent), basic metal and metal products (16.9 per cent), textiles (4.1 per cent) and construction (2.9 per cent). The shares of infrastructure, basic metal and metal products, beverages and tobacco and paper and paper products in total incremental credit to industry increased in October 2009 from its level a year ago.

IV. Corporate Performance

The corporate sector in India has responded to increased global competition by improving its productivity and efficiency through increased application of technology. One of the main objectives behind seeking a higher integration and financial development is also to provide firms with appropriate financial access for productive applications, which in turn help promote growth. In particular, financial deepening in terms of bank dependence or access to capital markets plays a key role in the link between finance and economic growth. Borrowed funds have been by far the largest type of external funds available to Indian corporates, comprising debt and other short-term current liabilities. Within overall debt, the funds mobilised from banks formed significant share. Recent years saw the outstanding bank borrowings forming around one third of total borrowings. Also, lately, low-cost funds from foreign sources are competing with banks with their share rising. The improved productivity, financial restructuring and lowering of tax rates enabled corporates to de-leverage their balance sheets. This was reflected in the sharp decline in the debt equity ratio. The substantial reduction in debt servicing costs added to the corporate sector's competitiveness and profitability. Corporates funded a large part of their investment in the on-going long capex cycle from retained earnings.

Corporate performance during the third quarter of 2009 had dipped in the face of global financial crisis that led to economic slowdown in several countries. Corporate profits started decelerating from the last quarter of 2007-08, reflecting recessionary demand conditions and rising commodity prices. However, collapse of Lehman Brothers in September 2008 acted like a sharp trigger for the business confidence. 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. The slowdown in the Indian economy was associated with a deceleration in investment demand, which had been an important driver of growth in recent years. There was a crisis of confidence in the financial markets. The resulting heightened uncertainty led to slowing demand for goods and declining production activity as reflected in the escalation in the inventory to sales ratio. Sales growth, after averaging at about 22 per cent year-on-year for 20 quarters, moderated to less than 10 per cent in third quarter of 2008-09. Impacted further by high commodities prices, forex translation losses on the foreign liabilities, provision for marked to market losses and high finance charges amidst continuing high provisioning on depreciation, margins deteriorated sharply, resulting in more than 50 per cent decline in third quarter of 2008-09.

However, the profitability over the last three quarters has witnessed almost 'V shape' recovery, led importantly by decline in input costs including power and fuel, decline in interest payments and some support from non-core other income. Sales over the last three quarters though sluggish on account of recovering demand, are gradually catching up with pre-crisis level. Data on institutional assisted projects during first half indicate comparable fixed investment plans as were observed during first half of previous year, indicating the continuation of conducive investment climate. Power, telecom and metal projects continue to drive capital expenditure. Anecdotal evidence though indicated increased concerns about continuation of the momentum in project implementation due to problems in securing equity funds; it is believed that most companies at present do not feel to be constrained on account of availability of funds from capital market or from the banks as liquidity conditions have eased.

In sum, the trends during the last three quarters suggest that the impact of global slow down on our corporates has been gradually waning down with the recovery process already set in as indicated by renewed growth in industrial production, improved profitability and positive business sentiments indicated by industrial outlook survey and other similar business confidence surveys. In particular, the business expectations index for October-December 2009 quarter reached 116.4 indicating improved business outlook by the manufacturing companies.

V. Growth Outlook

Emerging upside prospects as well as possible downside risks condition the current assessment of India's growth outlook for 2009-10. Factors that support the prospects of a sustained recovery include: (i) the impact of policy stimulus, (ii) visible signs of strong industrial recovery, (iii), stronger performance of the core infrastructure sector (iv) significant upturn in the business confidence as per different business expectations surveys, including Reserve Bank's Industrial Outlook Survey, (v) revival in capital flows, (vi) revival in the stock market and higher resource mobilisation through public issues and private placements and (vii) improving overall global economic and financial conditions.

Notwithstanding the positive factors, a number of downside risks may weigh down the growth prospects such as: deceleration in private consumption and investment demand, deficient South-West monsoon and impact on kharif production, persistence of deceleration in non-food credit growth, growth in credit card and consumer durables related credit turning negative suggesting possible continuation of the deceleration in private consumption demand, persistence of decline in exports for the 13th consecutive month, notwithstanding the reports about recovery in November 2009 and external demand dependent services activities remaining sluggish, such as tourism and cargo handled at ports and weak growth in capital goods.

Conclusion

The near term policy challenges are clearly conditioned by the evolving growth-inflation outcome that supports shifting the balance of policy focus on managing the recovery and on containment of inflation. Given the dominance of food price inflation in shaping the overall course of the inflation path, the policy challenge though is to address the supply constraints. Since supply shocks take time to taper off, there is a risk that high inflation in essential commodities could affect inflation expectations over time and give rise to generalized inflation. Effective assessment of the inflation process, and using monetary policy actions at the right time would then be critical to enhance the effectiveness of the policy. In India, besides the industrial and overall recovery in growth, the overall business confidence has improved significantly. While capital inflows have resumed after the period of net outflows in the second half of 2008-09, there is a perception that India may experience surges in capital inflows again, because of easy global liquidity conditions and superior growth prospects of India in the global economy. Once the recovery gains further strength and sustainability in India, return to the fiscal consolidation path would be critical to contain the constraints to the high growth path. With revival in demand for credit from the private sector, the significance of fiscal consolidation would become more apparent. While higher growth itself would contribute to some consolidation from the revenue side, the quality of fiscal

consolidation need to be guided by rationalization of expenditure. The RBI has already started the first phase of 'exit' in its October 2009 policy statement, though primarily in terms of signaling the stance rather than affecting the liquidity conditions or the interest rate. The evolving growth-inflation conditions will dictate the future course of actions from the RBI.

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