Reserve Bank of India

India - Macroeconomic Situation Assessment and Prospects

Indian Merchants' Chamber

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India
Macroeconomic Situation

Cause for Concern?

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- Growth has moderated
- Inflation is still high and stubborn
- Rupee has depreciated
- Investment has declined

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Growth

2009/10	8.4%
2010/11	8.4%
2011/12	6.5%

Activity has moderated sequentially over the last four quarters.

Inflation

WPI (May 2012) - came off from the peak but still high at 7.55%.

Rupee (Reference rate)

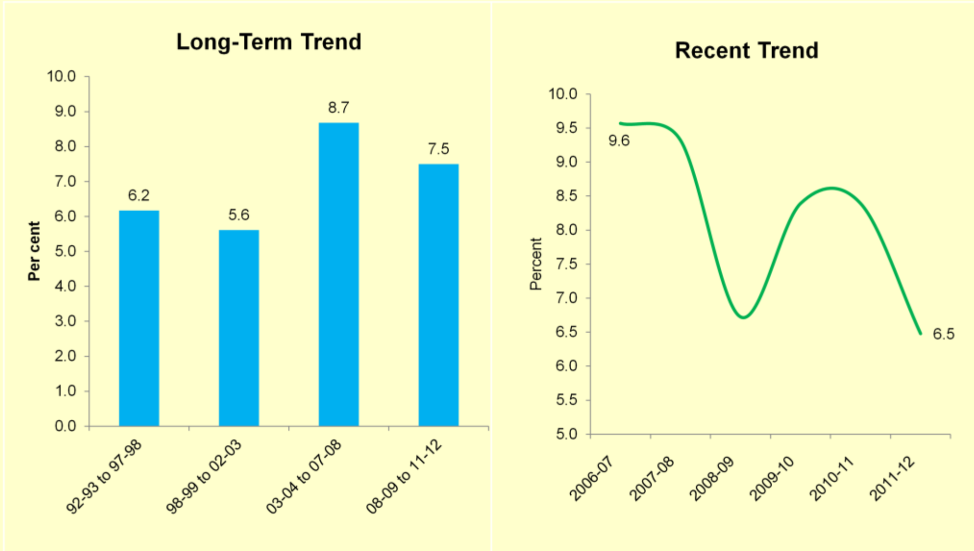
Depreciated in nominal terms June 18, 2012 over June 17, 2011 [19.3 per cent].

Investment (Gross Fixed Capital Formation) (constant prices) growth has decelerated considerably.

2009/10 : 8.8% 2010-11: 7.5% , 2011-12: 5.5%

Investment has actually declined during the last three quarters.

India - Macroeconomic Situation
Trends in Growth Rate



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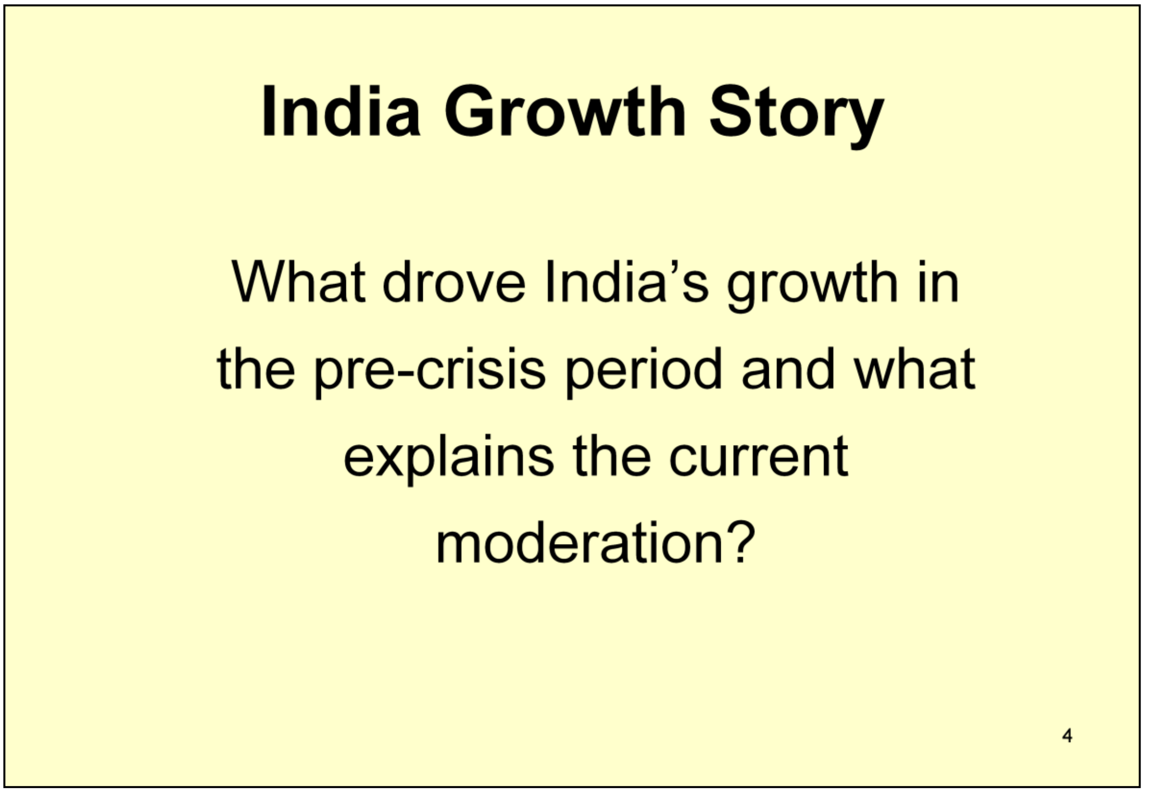
- India clocked 8.7% growth in the five year period 2003-08.
- Average growth during the three year period 2005/06 to 2007/08 was 9.5%
- Celebrated since this was seen as India breaking from the Hindu rate of growth.
- Set off aspirations for double digit growth.

But trend growth rate has clearly declined in the post-crisis period.

- Growth moderated in the crisis year of 2008-09 but revived smartly in 2009/10 and 2010/11.
- Growth in 2011/12 of 6.5% not only poor
  - compared to pre-crisis growth
  - but also compared to immediate post crisis years
  - lowest annual growth in the last 9 years



What drove India's growth in the pre-crisis period? Several explanations.

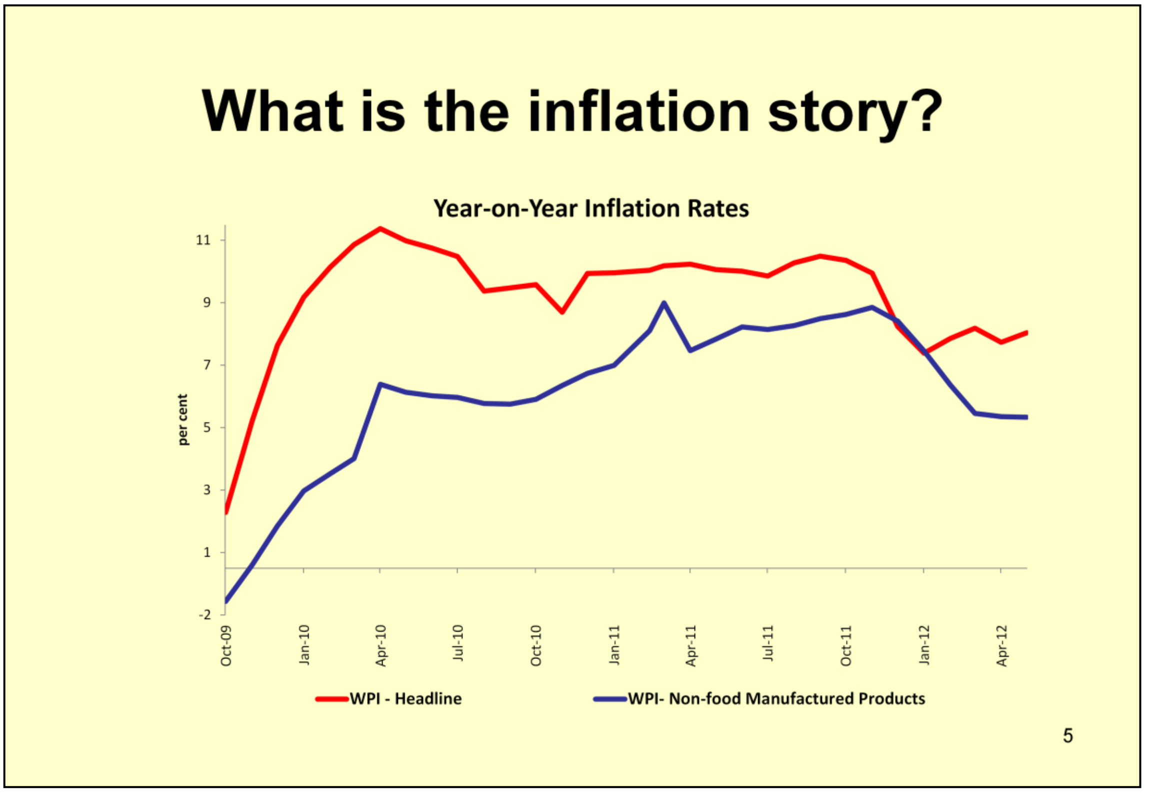
- Role of reforms
- Globalization
- Entrepreneurship
- Happenstance because of the global expansion. Rode on the back of Great Moderation.

What was underlying all these factors?

- Massive increase in capacity as investment jumped from 24% of GDP in 2003 to 33% of GDP in 2008.
- Rise in investment was accompanied by rise in productivity.
- Domestic consumption increased smartly, but its share in GDP fell.
- But exports share grew from 15% of GDP in 2003 to 23% in 2008.
- At the margin, additional capacity was being absorbed by foreign demand more than by domestic consumption.

What explains the current moderation in growth?

- Private consumption which has been holding growth has moderated.
- Investment growth has decelerated
- Net exports remained the fastest growing sub-sector

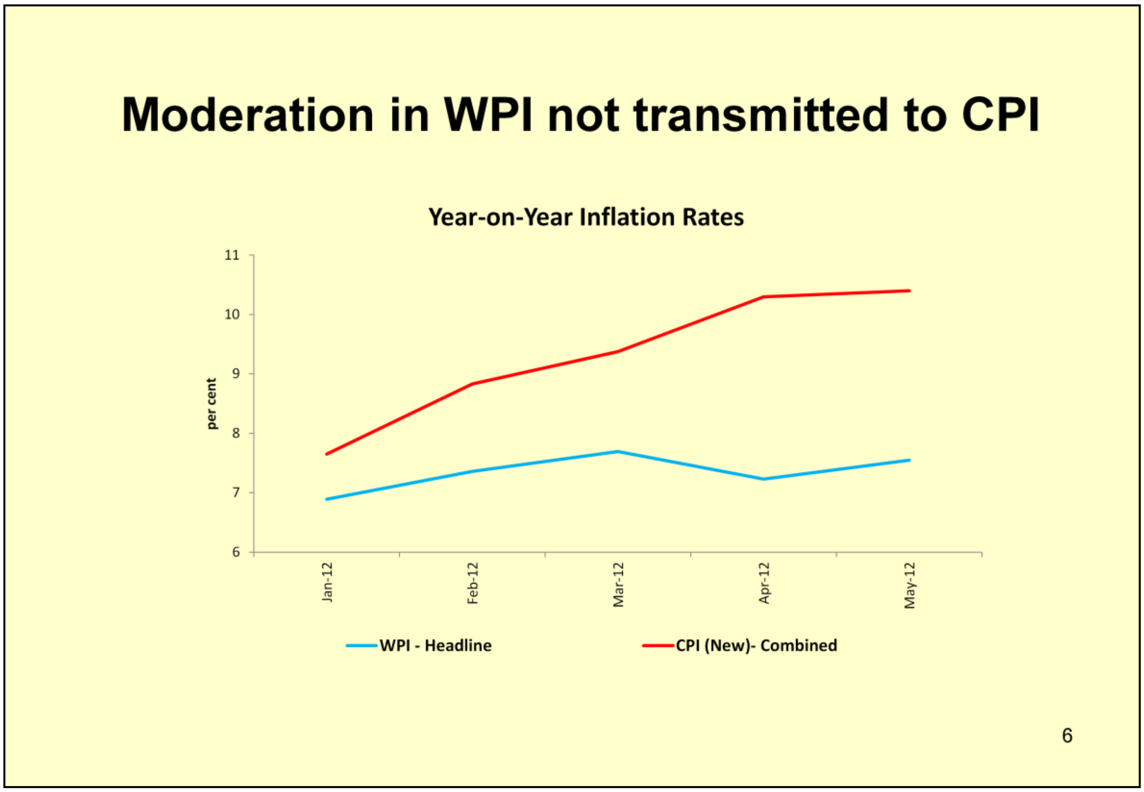


- Headline wholesale price index (WPI) inflation, which was negative in June-July 2009, rose sharply beginning October 2009.

Average Inflation Rates
[Percentage]

	2010/11	2011/12
WPI	9.6	8.9
WPI Core	6.1	7.3

- Both headline and core inflation remained elevated during 2010/11 and during April-Nov. 2011.
- WPI peaked at 10% in September 2011, and WPI core peaked at 8.4% in November 2011.
- WPI and core inflation have started moderating starting December 2011.
- But still above acceptable levels.



Moderation in wholesale inflation, particularly at the core level, has not transmitted to the retail level.

	WPI	CPI
January 2012	6.9	7.6
February 2012	7.4	8.8
March 2012	7.7	9.4
April 2012	7.2	10.3
May 2012	7.5	10.4

What is driving Inflation?

- Food (structural)
- Fiscal deficit
- Demand pressures
- Commodity prices + depreciation

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- Food inflation remains close to double digits.
  - Both cyclical and structural factors are responsible.
  - Protein food inflation nearly 15%
- Fiscal deficit is bad for a number of reasons. It also exacerbates inflation.
  - Even as investment has moderated, consumption remained strong benefitting from fiscal expansion. Fiscal deficit is adding to consumption demand.
  - Note that rural wages have gone up by 20% (10% in real terms)
  - In an economy with per capita income of $1500, any increase in income translates quickly to consumption
- Commodity prices
  - Have softened but softening largely offset by rupee depreciation.
- Oil prices - how they will move is uncertain
  - More QE by FED/EU - speculation - upward pressure on prices
  - Deeper recession - downward pressure on prices

What has RBI done to control inflation?

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During 2010/11 and 2011/12

- Raised CRR by 100 bp (5% to 6%)
- Raised policy rate 13 times by 375 bp (4.75% to 8.5%)

However in the wake of change in growth-inflation dynamics

- Started easing cycle in January 2012.
- Reduced CRR by 125 bp**.**
- Reduced policy repo rate by 50 bps on April 17, 2012.

Has RBI succeeded in controlling inflation?

- Inflation has come off from the peak.

  - Since 2009, WPI inflation declined from peak of 10.9 per cent in April 2010 to 7.55 per cent in May 2012.

  - Core inflation declined from a peak of 8.5 per cent in March 2011 to 4.8 per cent in May 2012.

- But

  - WPI inflation is still high and above tolerance level

  - Core inflation is higher than the recent long period average of 4%

  - CPI (new index) inflation at 10.4% (for May 2012) is high and still on the uptrend.

  - Contrary to popular perception, RBI studies all inflation indicators at disaggregated level to assess the inflation dynamics.

Has RBI's tight monetary policy hurt growth?

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Criticism :

RBI's monetary tightening has stiffened growth.

- Response at several levels

  - Some sacrifice in growth is an unavoidable price to pay (need to restrain demand)

  - Growth sacrifice only in the short-term. In the medium term, inflation is inimical to growth. Low inflation is an essential precondition for securing medium term growth. High inflation makes investment decisions uncertain.

  - Note also that the relationship between growth and inflation is non-linear. The non-linearity increases as inflation crosses the threshold and every point reduction in inflation requires higher sacrifice of growth.

  - Pro growth voice - vociferous. Poor people are hit by inflation. Inflation is a regressive tax. Hurts the poor the most. Their voice, silent as it is, must also be heard.

Question:

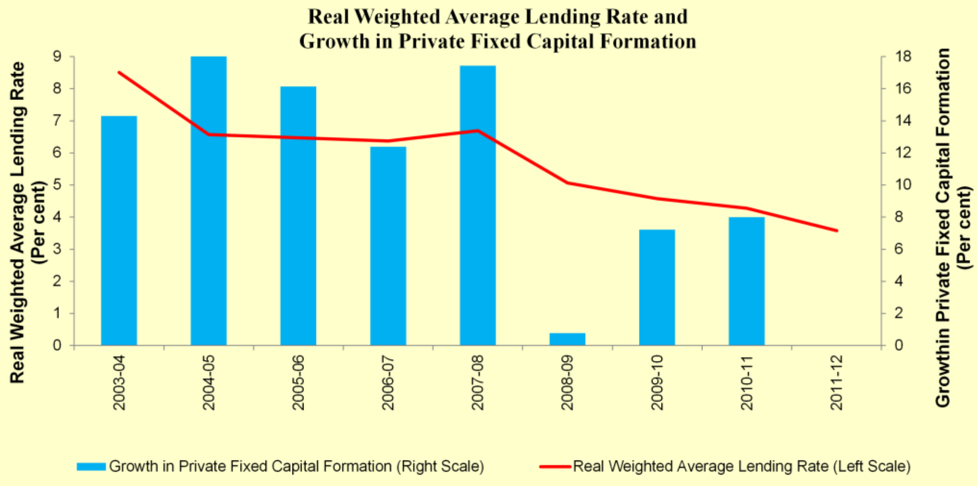
- Why, even with growth deceleration, inflation hasn't come down?

- Core inflation has come down.

- However, while inflation has come off from peak levels, reduction in inflation is proportionately smaller than the slow down in growth.

- Has potential growth rate declined? If economy is growing faster than its potential, there will be inflationary pressures.

Is it the high interest rate that is inhibiting investment?



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- Interest rate is only one of the many factors in an investment decision.
- Investment decisions take into account not just the current rate of interest but interest rate over several cycles.
- What proportion is interest cost in the total cost? Just about 3%.
- Most importantly, historical data show an inverse relation between real weighted average lending interest rate and investment activity. Real interest rates today are lower than they were in the pre-crisis years when investment boomed. Investment today is sluggish suggesting that there are factors other than interest rate at play in the investment slow down.

If inflation is caused by supply side pressures, is tight monetary policy an appropriate response?

Criticism:

Inflation is driven by supply shocks - food, oil and commodities. RBI’s monetary tightening is an inappropriate policy response.

Response:

- Need to distinguish between temporary and permanent supply shocks. Protein food and oil. Need to respond to structural shocks.

- If left unchecked, persistent inflation, no matter what the drivers, could unhinge inflation expectations. And eventually inflation gets generalised as indeed has happened.

- It was not just supply shocks. There were demand pressures too – consumption, especially rural consumption had gone up as a result of increase of real rural wages.

- Corporate margins were not under pressure for much of 2011 evidencing pricing power and demand pressures.

What is required to revive growth?

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- Growth can be accelerated by raising
    - Consumption
    - Investment
    - Exports
- Can't depend on consumption. Consumption without capacity addition will only lead to inflationary pressures.
- Rising CAD is a reflection of higher demand and inadequate supply response.
- Need supply response to raise growth rate.
- At the heart of supply response is raising investment.
    - public investment in infrastructure
    - corporate investment, especially in equipment
- What needs to be done to raise investment?

  (i) Fiscal deficit needs to come down

  - Crowds out private sector
  - Quality of fiscal adjustment is important too. Is fiscal consolidation coming from tax increase or expenditure compression? Is it the case that productive expenditure is being cut and unproductive expenditure is being protected?

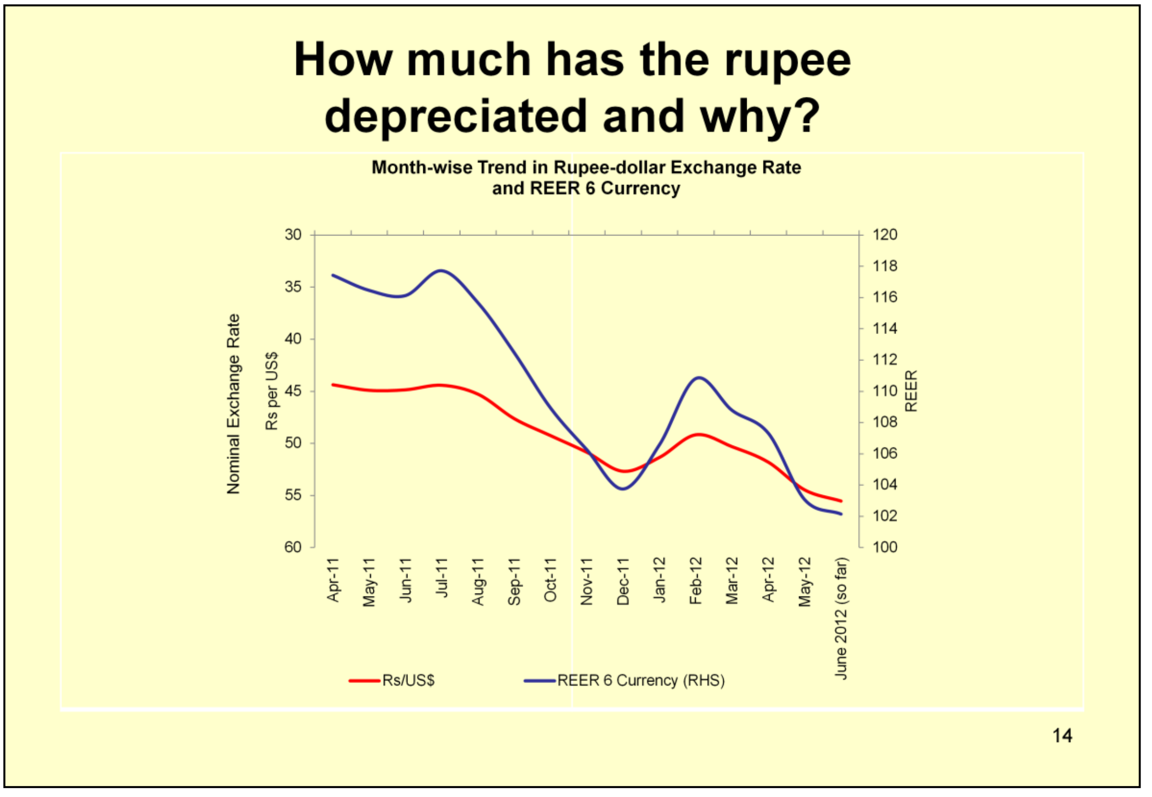
  (ii) Infrastructure has to improve

  (iii) Stable, predictable, transparent tax regime

  (iv) Reforms in domestic taxation, foreign investment regime

  (v) Clearance needs to be accelerated

  (vi) Reforms in governance



4 Stages of Rupee Movement Since April 2011

Stage - I (Apr-July 2011)

Range Bound

Stage - II (Aug-Dec 2011) - external factors

US debt downgrade and flight to safety

All EME currencies depreciated

EME with CAD saw larger depreciation

Rupee too depreciated reflecting trade, capital and confidence channels

Stage - III (Jan-Feb 2012) - Stabilization and Appreciation

Rupee moved in a narrow range

LTRO, Relative calm in Europe

Measures taken by Government and RBI to encourage inflows and curb unproductive speculation

Stage - IV (March-June 2012) - Global and domestic factors

Renewed apprehensions about eurozone stability. Tepid US recovery.

Domestic - GAAR, inability to move forward on reforms.

What is causing rupee depreciation?

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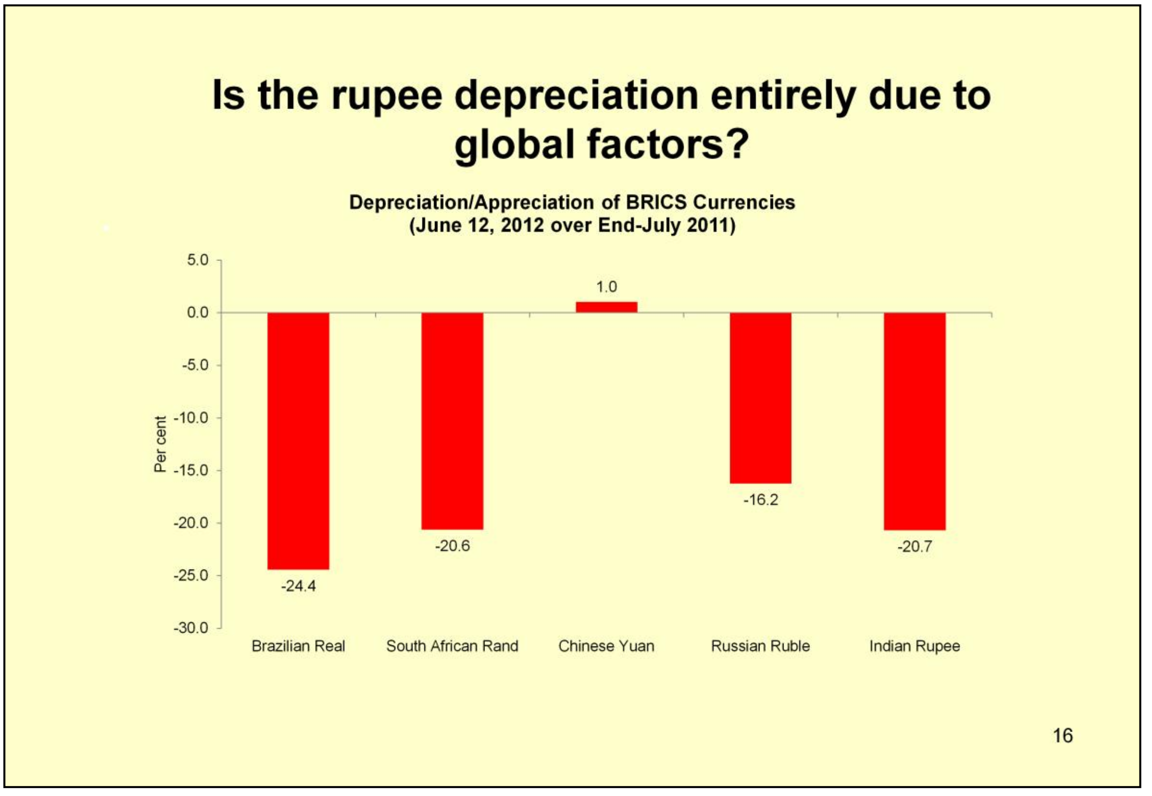
- Currency depreciation both on account of global and domestic factors.

- External Factors: Eurozone uncertainty

- Domestic factors - current account
  - Demand pressures at home resulting in higher CAD
  - Oil - inelastic demand given absence of pass through
  - Higher imports of gold - as an investment?

- Domestic factors - capital account
  - Slow down in capital flows since April 2012 (FDI, FII, ECB)



- Largest depreciation in Brazil followed by India.

- Big differences in the macroeconomic circumstances of BRICS

  - Brazil, Russia are commodity exporters

  - Fall in commodity prices. Both Russia and Brazil would want currency depreciation.

  - China - current account surplus.

  - South Africa is reference because of capital account convertibility and no intervention policy.

  - India - large and growing CAD. Currency depreciation reflects domestic factors. Inelasticity of imports. High inflation in India has eroded the competitiveness of exports although in recent months, this has been partly offset by nominal depreciation.

What has RBI done to contain the movement in the exchange rate?

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- Intervention consistent with our policy

- **Increase in FII limits in G-Sec and Corporate Debt**

On November 17, 2011, the FII limit for investment in government securities and corporate bonds has been increased by US$ 5 billion each to US$ 15 billion and US$ 20 billion, respectively, from earlier limits of US$ 10 billion and US$ 15 billion.

- **Increase in all-in-cost ceiling for ECBs**

The all-in-cost ceiling for ECBs with average maturity of three and up to five years was enhanced to 6 months Libor + 350 bps (+500 basis points for more than five years) with effect from November 23, 2011 which was later extended upto September 30, 2012.

- **Deregulation of interest rates on NRE and NRO accounts in December 2011**

- **Increase in ceiling rate on FCNR(B) deposits** was increased from 125 basis points (bps) above the corresponding LIBOR/Swap rates to 200 bps for maturity period of 1 year to less than 3 years, and to 300 bps for maturity period of 3 to 5 years.

- **Deregulation of ceiling rate on export credit**

- **ECB raised for Rupee Outlay to be brought in immediately**

The proceeds of the ECB raised abroad for Rupee expenditure in India, such as, local sourcing of capital goods, on-lending to Self-Help Groups or for micro credit, payment for spectrum allocation, *etc*., should be brought immediately for credit to Rupee accounts with Authorized Dealer banks in India. ECB proceeds meant only for foreign currency expenditure can be retained abroad pending utilization. However, the Rupee funds will not be permitted to be used for investment in capital markets, real estate or for inter-corporate lending.

What is RBI's policy on exchange rate?

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- Debate on whether RBI should intervene at all, and how it should intervene. Views span the entire spectrum. Views at the extreme ends of the spectrum.

  One extreme - Hands off - No intervention

  Other extreme - Target an exchange rate

- Our policy has been consistent.
  - Intervene to smooth volatility and steep movement.

What drives the exchange rate?

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- Text book theory: When an economy is growing faster than its trading partners, its currency must appreciate in real terms.
- It is this growth differential that explains the real effective appreciation of the rupee over the last several years.
- The nominal movement of the exchange rate is a function of real effective exchange rate plus inflation differential.
- Because of India's higher inflation, the nominal exchange rate has appreciated less (or depreciated more) relative to the real exchange rate.
- Exchange rate movement will depend on developments in both current account and capital account which in turn will depend on both global and domestic factors.
- Global factors
    - global recovery, eurozone problem resolution
    - policy action by advanced economy governments and central banks
    - commodity prices
- Domestic factors
    - Export performance
    - Import restraint (especially oil and gold)
    - Capital flows

Why 2012 is not 1991?

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1. Is 2012 going to be a repeat of 1991?

2. Basis for this question:

    (i) 1991 crisis triggered by BoP pressures, which in turn were a consequence of fiscal profligacy of the 1980s.

    (ii) In 2012, twin deficits once again

    (iii) Large fiscal and current account deficits are lead indicators of stress building up in the system.

3. In 1991, an implosion was imminent. In 2012, an implosion is not imminent. Why?

    (i) Structure of the economy has changed in fundamental ways. The share of services sector in the economy has increased from 41% in 1991 to 67% in 2012. Performance of the services sector of the economy is less variable than that of agriculture and industry.

    (ii) Today, Indian financial markets are more mature, diverse and deep. Have resilience to absorb shocks.

    (iii) Our regulatory systems and crisis response mechanisms are more robust and sophisticated.

    (iv) In 1991, rupee was overvalued by more than 20%. Today, exchange rate is largely market determined, and therefore able to absorb shocks.

    (v) Foreign exchange reserves are much larger; provide 8 months of import cover as against 2 months of import cover in 1991.

    (vi) External sector vulnerability indicators have deteriorated over the last year, but they are still at safe levels and much better when compared to 1991.

Is there a new normal for inflation?

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- Lower average inflation in the period preceding the global crisis.

- The episode of inflation starting late 2009 is a result of
  - demand and supply factors
  - structural and cyclical factors
  - global and domestic factors

- We can bring inflation down with appropriate policies. The task for the Reserve Bank is to restrain demand to keep growth close to the potential growth rate. The task for the government is to support a supply response to raise the potential growth rate.

- No new normal for inflation. Medium term inflation goal is still 4%-5%.

Has India's potential growth rate declined?

- As per RBI's estimates, potential growth rate
  - was 8.5% pre-crisis
  - may have declined to 8% post crisis
- Why?
  - Decline in growth of gross fixed capital formation from more than 15% pre-crisis to less than half that rate
  - Adverse external environment dampening domestic sentiment
  - Large fiscal deficit
  - Growing supply side constraints
  - Persistent inflation
- It is possible potential growth has further declined below 8% as core inflation not softening significantly even as growth has been moderating.
- But the potential growth rate needs to be estimated more robustly.

What are the risks to the growth-inflation outlook?

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- Global situation - especially eurozone sovereign debt and US recovery.
- Global commodity prices, especially of oil.
- Fiscal deficit
- Policy and governance reforms to encourage investment
- Monsoon Outlook

Is the "India Growth Story" still credible?

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India is a supply constrained economy. Should grow faster to bridge the income gap.

India Growth Story is still credible because the drivers of growth are intact

- entrepreneurism
- productivity
- demographic dividend - large market + potentially large savings
- democracy and decent legal system

But India Growth Story not inevitable!