Macroeconomic and Monetary Developments Second Quarter Review 2010-11

Overview

Global Economic Conditions

1. The momentum of global recovery, which exceeded expectations in the first half of 2010, has slowed down in the last few months. The IMF revised its projection of global growth for 2010 to 4.8 per cent, up from its earlier projection of 4.6 per cent, on the strength of performance in the first half. However, the IMF projects global growth to decelerate to 4.2 per cent in 2011.

2. In advanced economies, the weakening of recovery has raised concerns about both unemployment and deflation. With capacity for fiscal stimulus already stretched and given the concerns about sovereign debt, further quantitative easing seems the preferred option to address the weakness in growth. The persisting output gap could tempt advanced economies to resort to protectionist measures along with preference for undervalued exchange rates, and that could pose downside risks to global recovery.

3. EMEs, which had led the global recovery, continue to exhibit strong growth momentum. Notwithstanding some likely moderation in the momentum in the second half of the year, the growth imbalance relative to advanced economies is expected to persist. The widening asymmetry in monetary exit points to the possibility of larger capital inflows into EMEs, exerting potential pressures on their asset prices and exchange rates. Furthermore, given the visible pressure on capacity in certain EMEs relative to buoyant domestic demand, as well as rising global commodity and food prices since the mid-year, risks to inflation in EMEs have increased.

4. While corporate profits and stock prices have generally recovered globally, the dampening effects of unfinished deleveraging and depressed bank lending in advanced economies continue to hinder global recovery. The growing uncertainty in the global markets impacted Indian financial markets through two different channels, viz., pressure on the Indian Rupee to appreciate and rise in equity prices due to sharp increase in portfolio flows.

Indian Economy-Trends and the Outlook

Output

5. The sharp and broad-based recovery of the Indian economy, which started in the second half of 2009-10 continued through Q_1 of 2010-11, leading to further consolidation of growth around the trend. A normal monsoon, following a severely deficient monsoon last year, is expected to lift the agriculture sector growth to above the trend rate of growth in 2010-11. Industrial production showed robust growth though with wide volatility around the trend. The core infrastructure sector continues to lag behind the pace of growth in industrial production. Lead indicators of services activities, however, suggest continuation of the momentum. The current data and indicators of economic performance remain consistent with the 8.5 per cent growth projected in the July 2010 Monetary Policy Statement.

Aggregate Demand

6. Given the weakening external demand conditions and the need for fiscal consolidation, sustained growth will hinge increasingly on private consumption and investment demand. Trends in production of capital goods, capital expenditure plans of corporates, non-oil imports and growth in credit as well as financing from non-banking sources during 2010-11 so far suggest strong conditions for investment activities. Private consumption expenditure data for the first quarter of 2010-11, and the trends in corporate sales as well as production of consumer durables point to a pick up. The contribution of government demand to growth in 2010-11 is expected to weaken given the policy emphasis on fiscal consolidation. While both revenue deficit and fiscal deficit, as percentage of GDP, have been lower so far in the current year relative to the corresponding period of last year, there has been higher growth in both revenue and capital expenditure this year, thereby providing demand support to the growth process. The contribution of net exports to growth on the expenditure side of GDP was negative in the first quarter of 2010-11, a trend expected to continue during the rest of the year. Overall aggregate expenditure trends point to persistence of momentum.

External Sector

7. The current account deficit in the balance of payments widened in the first quarter of 2010-11 due to a higher trade deficit and moderation of the surplus in the invisibles account. Capital flows, led by FII flows in recent months, have met the financing needs of the current account deficit. Despite the appreciation of the Indian rupee on the basis of 6-currency real effective exchange rate (REER) during the year so far, over and above the significant appreciation *last year, the 36 currency REER remains largely stable. The higher inflation differential between India and its major trading partners, however, is a source of pressure on the competitiveness of Indian exports. The current account deficit, as percentage of GDP, could be expected to be higher in 2010-11 than the 2.9 per cent recorded in 2009-10. While capital inflows into EMEs including India are expected to remain buoyant, a higher level of current account deficit is a concern. While the deficit may be fully financed by capital inflows, the potential volatility in such flows poses some risk. The exchange rate of the Indian rupee remained flexible moving both ways, as net intervention in the foreign exchange market since 2009-10 has remained negligible. As on October 22, 2010, the foreign exchange reserves stood at US$ 295.4 billion.*

Monetary and Liquidity Conditions

8. Liquidity conditions became tight in the month of May 2010 consequent to the transfer of liquidity from the markets to the government in the wake of the 3G/BWA auctions. Since then, liquidity conditions have generally remained in the deficit mode, which is consistent with the monetary policy stance of the Reserve Bank. Policy interest rates have been raised five times since the beginning of March 2010, raising the repo rate by 125 basis points and the reverse repo rate by 175 basis points. This asymmetric tightening narrowed the policy corridor from 150 basis points to 100 basis points. With repo replacing reverse repo as the operative rate in the LAF, the effective policy interest rate has increased by 275 basis points since March 2010. Broad money (M_3) continues to exhibit subdued growth reflecting the pattern in the growth of aggregate deposits. With non-food credit growth converging to the 20 per cent growth trajectory indicated in the First Quarter Review of Monetary Policy, banks have scaled up their deposit mobilisation efforts as evident from the higher deposit rates being offered since July 2010. Non-bank financing has emerged as a major source of financing for investment, and in the first half of 2010-11, financing from external sources in particular increased.

Financial Markets

9. In the global financial markets, concerns about sovereign defaults eased, but they were replaced by concerns about risks stemming from the slowdown in global recovery. The multi-speed recovery across the world and the consequent differential exit from the accommodative monetary stance has strengthened both the push and pull factors underlying the significant pick up in private capital flows to EMEs. In the Indian financial markets, the impact of this trend has been visible in the appreciation of the exchange rate of the rupee against the US dollar and the bullish spikes in equity prices. The transmission of higher policy interest rates and deficit liquidity conditions strengthened across different segments of the financial markets, ranging from CPs, CDs, CBLO, Treasury Bills, government securities and bank deposits. The transmission to bank lending rates is evident with a lag. Some banks have recently announced increase in their Base Rates. Since the introduction of the Base Rate, activities in the CPs market have picked up, as corporates explored alternative financing. Banks also resorted to CDs for raising bulk deposits. Housing prices in major cities generally increased.

Inflation

10. The headline inflation data since August 2010 are based on the new series, reflecting the altered consumption pattern and the price trends at a disaggregated level and hence capture the current structure of the economy better. As per the new series, the headline inflation after remaining in double digits for five successive months up to July 2010, has begun to moderate. Inflation in non-food manufactured products, which could be seen as most sensitive to monetary policy measures, has shown some moderation. But food inflation remains disconcertingly high despite a normal monsoon. This can be partly attributed to a change in the consumption pattern in favour of protein-rich items such as eggs, milk, fish and meat where price increases have been high. Different measures of CPI inflation have edged below the double digits levels after more than a year. Despite moderation in recent months, elevated WPI and CPI inflation remain a challenge for monetary policy.

Overall Assessment

11. As the growth outlook continues to be robust, the objective of non-disruptive normalisation of the policy rate seems to have been generally met. While non-food manufacturing inflation, which could be seen as most responsive to monetary policy, has shown some moderation, elevated food price inflation is a cause for concern. The monetary policy measures introduced since January 2010 could be expected to help in moderating the headline inflation by March 2011. The possibility of rigidity in food inflation, however, cannot be ruled out, unless the supply situation is improved with structural measures to match the growing demand for non-staple food products. This is particularly so because such downward rigidity in inflation at an elevated level has resulted despite a normal monsoon and range-bound international oil prices for most part of the year. Anchoring inflation expectations in such an environment is a difficult challenge for monetary policy. While moderating momentum of the non-food manufactured inflation suggests that recent monetary actions are having an impact, inflation still remains above the comfort level. Going forward, the growth-inflation outlook will dominate the policy response, and the nature and timing of monetary policy actions would have to be conditioned by their expected effectiveness in attaining the intended goal.