Macroeconomic and Monetary Developments in 2010-11

Overview

Monetary policy was tightened in a calibrated manner through 2010-11 with transmission improving distinctly in Q4 on the back of liquidity deficit. While growth reverted to its recent trend, inflation remained above trend on the back of supply-side shocks. In the event, policy response focused on containing the spillover of supply side inflation and anchoring inflation expectations. This was important as cost-push pressures were significant and pricing power prevailed amidst strong aggregate demand.

2. Core inflationary pressures were effectively contained in the earlier part of the year but new shocks emerged: first in terms of vegetable prices spiking up in November and December 2010 and then spiraling up of global fuel and non-fuel prices. These supply-side shocks coming in quick succession elevated the path of inflation, and in the process price pressures became broad-based in the later part of the year.

Global Economic Conditions

Recovery outpacing expectations but oil, Euro zone risks remain

3. Even as recovery remains multi-speed, growth in both advanced economies and emerging/developing economies outpaced initial expectations. This raises hope for sustained, though moderately paced global recovery during 2011, with risks emerging from high oil prices. The Indian economy continued to outperform most emerging markets during 2010-11 retaining its position as the second fastest growing economy, after China, amongst the G-20 countries. China and India contributed nearly a quarter of the incremental world output.

4. The IMF World Economic Outlook of April 2011 has left its global growth forecast unaltered from its January 2011 estimate of 4.4 per cent for 2011 and 4.5 per cent for 2012. It has, however, projected a 36 per cent rise in global crude oil prices in 2011 and noted the potential of oil prices to surprise further on the upside. This is a key downside risk to growth. Sovereign balance sheet risks in the Euro zone and dormant real estate markets have also been cited as downside risks to growth in advanced economies (AEs).

Inflation risks on the rise, and not just in the emerging markets

5. Global inflation risks have risen significantly over the last quarter, not just in emerging markets but also in advanced economies. The pressures for rate cycle turning even in advanced countries can no longer be ignored with ECB raising its policy rates by 25 bps on April 7, 2011. Inflation in several emerging markets, especially in Asia, is now running above trend. As a result, central banks of several emerging markets have significantly tightened monetary policy. Besides India, these include China, Brazil, Israel, Thailand and Korea.

6. Notwithstanding the monetary tightening, risks to inflation in most countries are skewed on the upside. These risks emanate from commodity prices across food, fuel, and other industrial inputs that have firmed up significantly over the year.

Indian Economy: Developments and Outlook

Output

Activity levels remain strong

7. GDP growth during 2010-11 reverted to the high growth trajectory. Growth had moderated in the preceding two years as the global economy slowed down as a result of global financial crisis. The growth during 2010-11 reflects a rebound in agriculture and sustained levels of activity in industry and services.

8. Overall growth indicators are mixed. Prospects for agriculture appear encouraging, given IMD's forecast of a normal monsoon and a good outturn of Rabi in 2010-11. Industrial growth, however, moderated in the second half largely reflecting the waning of base effects and contraction in capital goods output. The deceleration has, however, been exacerbated by few items with volatile output. Other indicators, such as the Purchasing Managers' Index (PMI), direct and indirect tax collections, merchandise exports and bank credit suggest that the growth momentum persists. Indicators on services sector activity also remain robust, not withstanding some deceleration in the government-spending related services. However, high energy and commodity prices may impact output and investment climate, and pose a threat to maintaining high growth at a time when the investment momentum may be slowing down.

Aggregate Demand

Aggregate demand robust even as government spending decelerates on fiscal consolidation

9. Aggregate demand accelerated further in 2010-11 even as rebalancing took place from government consumption spending to private consumption and investment. Momentum in overall demand conditions was reflected in indicators like corporate sales growth, improving capacity utilisation, higher employment and pricing power with the producers. However, aggregate investment moderated somewhat in Q3 of 2010-11. This slackening was also reflected in the contraction in capital goods output and weaker new project investment indicated by banks. This process needs to be reversed to bolster the potential growth of the economy.

10. Though revenue buoyancy was witnessed in 2010-11, there are risks to the deficit projections of 2011-12 as subsidies are likely to exceed the budgetary provisions, given sharply higher international commodity prices. The process of fiscal consolidation needs to be carried forward on both revenue and expenditures sides, with a sharper focus on the latter. Containment of subsidies by raising domestic prices of petroleum products and fertilizers should be a building block of this strategy.

External Sector

CAD risks moderate, but have not dissipated

11. Improvement in exports during 2010-11 facilitated moderation of the current account deficit (CAD). However, if oil and other commodity prices stay elevated, CAD may widen in 2011-12. This will necessitate higher external financing. The dominance of more volatile portfolio equity flows requires that CAD be contained within prudent limits, especially as the net international liabilities and the debt creating flows have risen. Overall, diversification in exports and robust invisible earnings are expected to bulwark in any events of capital flow reversals.

12. While global recovery remains on course, the size and direction of capital flows can be impacted by the pace of US recovery, the reconstruction in Japan and the balance sheet risks in the Euro zone.

Monetary and Liquidity Conditions

Tightening helps keep stable monetary conditions

13. As inflation stayed above the indicated projections during 2010-11, monetary policy was continually tightened through the year. Monetary and liquidity conditions responded to the policy measures, though with a lag.

14. Even as reserve money growth remained strong, money supply growth stayed below indicative trajectory. Lower growth in aggregate deposits and reduction in money multiplier emanating from higher currency demand led to this divergent trend. Credit expansion was above the indicative trajectory for the year, though it moderated towards the later part. Deposit growth which lagged behind the credit expansion, picked up in Q4 of 2010-11, responding to the rise interest rates. Liquidity conditions were tight for most part of the year with some easing towards the last quarter.

Financial Markets

Stronger monetary transmission impacts interest rates

15. Interest rates firmed up responding to monetary policy signals. Banks progressively passed on the increased costs in the form of higher lending rates. Monetary transmission was observed to be strong particularly in the Q4 of 2010-11.

16. Conditions in various financial markets remained orderly. Asset prices generally remained range bound. Equity markets witnessed good buying interest from

FIIs during July-November 2010 followed by some correction alongwith greater volatility. While price correction has not materialized, house price pressures remained moderate in Q3 of 2010-11.

Price Situation

Inflation persists with supply-side shocks and return of manufacturing inflation

17. Headline inflation exhibited strong persistence in 2010-11. It reflected both supply shocks and gradual generalisation of price pressures. The generalization was reflected in non-food manufacturing price pressures from December 2010 as producers were able to pass on cost increases amidst strong demand. Notwithstanding some moderation in food prices during Q4, hike in prices of a number of manufactured products following input cost pressures kept headline inflation firm and significantly above the medium-term trend. Inflation during 2011-12 is likely to moderate slowly but remain above the comfort level as the passthrough of international commodity prices is likely to continue.

Macroeconomic Outlook

Costly oil a risk to growth sustainability and inflation

18. High global crude oil and other commodity prices pose the biggest risk to India's growth and inflation. Persistently high inflation has kept inflation expectations elevated. Fresh pressures from commodity prices do make 2011-12 a challenging year for inflation management. Cross-country experience suggests that phases of high growth have generally been accompanied by low inflation. While growth risks are on the downside, emanating from high oil prices and some moderation in investment, GDP growth during 2011-12 is expected to stay close to the trend. However, the risks to inflation are on the upside and it may remain elevated for some more time despite the current anti-inflationary bias in the monetary stance.