Macroeconomic and Monetary Developments Second Quarter Review 2009-10

Overview

Global Economic Conditions

1. The global economy is showing tentative signs of recovery signalling, albeit hesitantly, the winding down of the global recession. For several advanced economies the pace of contraction in output has declined in the second quarter of 2009. The emerging outlook for recovery is still dependent on sustained policy stimulus that has spurred aggregate demand while also reducing overall uncertainty. The recovery is widely perceived to remain slow and gradual, with receding but significant downside risks.

2. The downside risks could arise from premature withdrawal of policy stimulus, the possibility of some permanent loss in output in the advanced economies owing to the crisis, need for improving domestic savings in several advanced economies to make growth less dependent on global imbalances, unfinished financial and corporate restructuring that would involve further deleveraging and tight credit market conditions, current level of high excess capacity, large and rising unemployment and the associated pressures on both aggregate demand and protectionism, anaemic private consumption and investment demand, and the costs of sustained large fiscal stimulus.

3. These possibilities point to the risks of a job-less recovery, and a W-shaped double-dip recession where another mild phase of recession may intervene before a durable recovery. The timing of the exit from the policy stimulus will, thus, be critical to the recovery path of the global economy; both premature exit as well as delayed exit would have concomitant costs. In September 2009 *the G-20 highlighted the importance of continuing the stimulus till the recovery is secured, consistent though with the other important objectives of price stability and fiscal sustainability.*

4. After a series of successive and frequent downward revisions to the growth outlook of the world economy for 2009 from (+) 3.9 per cent in July 2008 to (-) 1.4 per cent in July 2009, the IMF, for the first time, revised the projected growth outlook upwards in October 2009, recognising the emerging signs of recovery. The latest forecast is for a contraction in the world output by (-) 1.1 per cent. The recovery is expected to be led by emerging market economies (EMEs), particularly from Asia. According to the WTO, world merchandise exports increased by about 8.0 per cent in the second quarter of 2009 over the preceding quarter, even though year-on-year growth continued to decline by 33.0 per cent. The outlook of the Institute of International Finance (IIF) for October 2009 suggests that net private capital flows to the EMEs which had recovered in the second quarter of 2009 gained pace in the third quarter; 30 EMEs are projected to receive US$ 349 billion in 2009, which will still be only about one fourth of the peak level of net flows received in 2007.

Outlook - Indian Economy

Output

5. In India, economic growth in the first quarter of 2009-10 at 6.1 per cent represents a mild recovery over the 5.8 per cent growth recorded during the preceding two quarters in the second half of 2008-09. In comparison to the high average growth of 8.8 per cent recorded during the five-year period 2003-08, however, the first quarter growth in 2009-10 still points to persistence of the slowdown. Information available on various lead indicators of economic activity in the second quarter of 2009-10 suggests that because of the deficient monsoon, kharif output may be adversely affected. The industrial sector has started exhibiting recovery, with 10.4 per cent growth in August 2009 and 5.8 per cent growth during April-August 2009, as against 1.7 per cent and 4.8 per cent during the corresponding periods of the previous year, respectively. Growth in core infrastructure witnessed notable acceleration in August 2009, and the growth over April-August 2009 was higher at 4.8 per cent as against 3.3 per cent during the corresponding period of the previous year. Lead indicators for services suggest pick up in activities relating to construction and telecommunications, even though external demand dependent services, such as tourism and cargo handled at ports, continue to be depressed.

Aggregate Demand

6. The deceleration in aggregate demand that was witnessed in the second half of 2008-09 continued during 2009-10. Growth in private consumption demand fell to as low as 1.6 per cent in the first quarter of 2009-10. Investment demand also decelerated further, and the high growth in government consumption demand that was witnessed in the last two quarters of 2008-09 also moderated. Corporate performance data indicate that growth in sales, which had decelerated significantly in the second half of 2008-09, exhibited negative growth in the *first quarter of 2009-10, notwithstanding improvement in profitability. The deficient monsoon and the associated drought like conditions in several parts of the country, and the more recent floods could also dampen rural demand. Given the predominant role of domestic demand in conditioning the growth outlook in India, weak private consumption and investment demand, thus, continue to be a key drag on faster recovery.*

External Economy

7. Weak external demand conditions persisted, as reflected in the sustained decline in India's exports. In the first quarter of 2009-10, exports continued to decline while imports increased, primarily reflecting higher oil prices, resulting in a higher trade deficit in the balance of payments in relation to the preceding quarter. The surplus in net invisibles, led by buoyant remittance inflows, contributed to finance close to 78 per cent of the trade deficit. The current account, thus, remained in deficit of about US$ 5.8 billion. Reflecting India's resilience to the crisis in 2008-09 and the growth prospects of the economy, capital flows, which had turned negative in the last two quarters of 2008-09, reversed in the first quarter to ensure financing of the current account deficit without any depletion of foreign exchange reserves. The rebound in capital inflows has persisted through the second quarter of 2009-10. Including valuation gains on foreign exchange reserves and the SDRs allocated by the IMF to India, India's foreign exchange reserves increased by USD 32.8 billion during 2009-10 (up to October 16, 2009) to a level of USD 284.8 billion.

Monetary Conditions

8. The accommodative monetary policy stance adopted by the Reserve Bank in response to the global financial crisis, particularly post-September 2008, continued in 2009-10. The aim of this policy stance was to maintain ample rupee liquidity, comfortable dollar liquidity and ensure flow of credit to productive areas of the economy. Reflecting the accommodative policy stance, the liquidity conditions remained in surplus on a sustained basis, which was absorbed by the Reserve Bank through reverse repo operations under the LAF. Growth in broad money (M3) also remained high at 18.9 per cent (as on October 09, 2009), supported by high growth in deposits (by 19.4 per cent). On the sources side, monetary expansion was driven by the large borrowing programme of the Government, while bank credit to the commercial sector continued to decelerate (with a growth of 10.7 per cent).

Financial Markets

9. The financial markets in India which functioned normally even at the height of the crisis, posted further decline in risk spreads and higher volume of activities. The overnight call rate hovered around the floor of the LAF corridor reflecting the abundant liquidity in the system. In the collateralised segments, namely market repo and collateralised borrowing and lending obligation (CBLO), the interest rates remained below the inter-bank call rates while there was increase in activities. Volumes in the CP and CD markets also increased.

10. In the government securities market, 80.4 per cent of the net borrowing requirement has been completed so far; weak demand for credit in the private sector and comfortable liquidity conditions helped in containing the pressures on yield. Corporate bond yields hardened somewhat but the risk spread fell to the pre-Lehman levels.

11. In the credit market, the gradual moderation in lending and deposit rates continued through the second quarter of 2009-10, demonstrating the transmission of lower policy rates, though with lags. Despite some reduction in interest rates, the flow of credit to the private sector remained sluggish due to subdued overall private consumption and investment demand. Credit card and consumer durables related credit exhibited negative growth, corroborating the impact of significant deceleration in private consumption demand. The flow of resources from the non-banking sources, however, increased marginally in the first half of 2009-10.

12. In the foreign exchange market, the rupee appreciated by about 10.0 per cent against the US dollar over the end-March level. The equity market sustained the recovery seen since April 2009, and outperformed most of the EMEs in terms of the extent of recovery in stock prices. The primary market activities also picked up significantly, with higher funds mobilised through public issues and private placements, large oversubscription of certain new issues indicating the return of risk appetite in the market, and manifold increase in mobilisation of resources by mutual funds.

Inflation Situation

13. The sharp decline in headline WPI inflation from the peak level of 12.9 per cent in August 2008 yielded space for adoption of growth-supportive accommodative monetary policy to mitigate the impact of the crisis. After remaining negative for 13 consecutive weeks, WPI inflation turned modestly positive in September 2009. Despite the low headline (year on year) WPI inflation at 1.2 per cent (as on October 10, 2009), inflationary pressures have started to emerge, with WPI showing 5.9 per cent increase over March 2009 level and CPI inflation remaining stubbornly elevated at double digit levels. The changing inflation environment, however, is being driven by strong escalation in the prices of food articles, which have increased by 14.4 per cent (year-on-year) so far. Excluding food items, the WPI inflation remains depressed at (-) 3.4 per cent. This suggests both short supply as well as inefficient distribution channels. From the stand point of monetary policy, anchoring inflation expectations in the face of sustained high inflation in essential commodities will be a key challenge.

Growth and Inflation Outlook

14. The growth and inflation mix could change over time, creating conflicting demands on the stance of monetary policy. While premature reversal of the monetary policy stance entails the risk of stifling recovery, persistence of accommodative stance could adversely impact inflation expectations.

15. The current growth outlook for 2009-10 has both upside prospects as well as down side risks. Upside prospects to growth include the impact of the growth- supportive policy stimulus, recovery in industrial production and core infrastructure sector, significant upturn in overall business

confidence as per different surveys, strong recovery in the stock market with higher mobilisation of resources, return of capital inflows and the improving outlook for the global economy which could boost the sluggish consumer and investor confidence. The downside risks include the unexpectedly large deceleration in private consumption demand and some decline in corporate sales in the first quarter of 2009-10, impact of the deficient monsoon and recent flood in certain parts of the country on agricultural output and rural demand, sustained deceleration in credit growth and decline in exports. The Reserve Bank's professional forecasters survey points to downward revision to the growth outlook from 6.5 per cent to 6.0 per cent in 2009-10, reflecting the drought situation in the agriculture sector.

16. The inflation outlook is currently driven by the emerging signs of inflationary pressures, even though certain developments could neutralise these pressures. These include sluggish aggregate demand and negative output-gap, stabilisation of oil prices in last few months – notwithstanding the recent increase in October 2009, adequate buffer stocks of foodgrains and the prospects of a better rabi crop that could partly offset the adverse impact of deficient kharif, selective import of certain commodities and the normal trend reversal seen in prices of food articles over different crop seasons. On the other hand, the visible inflationary pressures may also persist and escalate further on account of the fading away of the base effect, cost push pressures through wage-price revisions in the face of elevated CPI inflation, challenges in improving the supply situation in the short-run of essential commodities, gradual pressure on global commodity prices along with global recovery, and rising inflation expectations on account of elevated CPI inflation.

17. Financial conditions have improved significantly in India, ahead of a stronger recovery in growth. This is evident from the return of capital flows, significant recovery in the stock markets, and better transmission from low policy rates to declining lending rates. There also need be no concerns about private credit getting crowded out since over 80.4 per cent of the government borrowing programme has been completed so far as there is adequate liquidity in the system. The deceleration in private consumption and investment demand needs to be reversed from the low levels seen in the first quarter of 2009-10 for ensuring a sustainable recovery. Lead information in terms of growth in non-oil imports and demand for credit in the second quarter of 2009-10, however, does not point to any major recovery in demand from the private sector. The overall economic outlook is, therefore, a mixture of upside prospects of recovery and downside risks. Managing this trade-off between supporting growth and reining in inflation expectations poses a complex policy challenge.