Macroeconomic and Monetary Developments First Quarter Review 2009-10

Overview

1. The global economic environment continues to remain uncertain, although the rate of contraction in economic activities and the extent of pressures on financial systems eased in the first quarter of 2009-10. Nascent and sporadic signs of improvements in the global conditions do not suggest any clear trend, and as a result, the uncertainty on the timing and pace of global recovery persists. Projections of various international institutions indicate the persistence of global recession, with expectations of beginning of recovery towards the later part of the year, which may get extended into the next year. Reflecting the persistence of the global recession, unemployment rates in advanced countries continue to rise and trade activities remain depressed, affecting the export performance of most of the countries. Appetite for risk seems to have improved modestly in the global financial system, as compared to the earlier flight to safety. Consequently, the stock markets have recovered part of their crisis induced sharp losses. Credit spreads have moderated and the market volatility also has gradually waned. Credit Default Swap spreads, reflecting the cost of insurance against credit risk, have improved. Spreads on emerging market bonds have flattened, suggesting improving access to the international markets for EMEs. The volatility in the exchange rate of the EMEs has generally declined. These signs of improvements in the global financial conditions in the first quarter of 2009-10 are necessary, but not sufficient, to induce a firm global recovery, particularly in view of the depressed demand conditions.

2. Reflecting the contagion from the synchronised global recession, growth *impulses remained subdued in India, which was evident from the growth deceleration in the second half of 2008-09. At 6.7 per cent, GDP growth for 2008-09, however, was better than what most had expected, though it reflected a deceleration in relation to the average 8.8 per cent rate recorded during the high growth phase of 2003-04 to 2007-08. The impact of the contraction in global demand was evident in the decline in Indian exports, which also accelerated the rate of deceleration in manufacturing output growth. Services, which account for 64.5 per cent of the GDP, also experienced a modest slowdown.*

3. In the first quarter of 2009-10, the core infrastructure sector exhibited higher growth in relation to the growth recorded during the corresponding period of the previous year; the Index of Industrial Production (IIP) registered positive growth (during April-May 2009). However, exports continued to decline. The leading indicators for the services sector such as new cellphone connections (up to May 2009) and cement production (up to June 2009) indicate signs of improvement. The slow progress of monsoon up to end- June 2009 has affected the kharif sowing, which could have implications for the agricultural production. The progress of monsoon in July 2009, however, has improved considerably.

4. The growth deceleration in 2008-09 was due to slowdown in both external and domestic demand. The slowdown in domestic demand, in the form of private consumption demand as well as investment demand, warranted appropriate policy response. The fiscal response of the Government came in the form of a large stimulus, which led to an increase in the fiscal deficit from 2.5 per cent of GDP in 2007-08 to 6.2 per cent in 2008-09 (Provisional Accounts). The Union Budget for 2009-10 has placed the fiscal deficit at 6.8 per cent of GDP in 2009-10. While the fiscal stimulus raised aggregate demand, there is a need to address the challenges for fiscal consolidation with a view to returning to the high growth path at the earliest.

5. The balance of payments, which had come under considerable pressure in the third quarter of 2008-09, exhibited a surplus of US$ 4.7 billion in the current account in the fourth quarter. For the year as a whole, the current account deficit widened to 2.6 per cent of GDP from 1.5 per cent of GDP in the previous year. Reflecting the impact of the contagion operating through capital flow channel, net capital inflows fell to US$ 9.1 billion in 2008-09 as compared with net capital inflows of US$ 108.0 billion in 2007-08. The challenge of dealing with one of the severest external shocks was managed by the Reserve Bank with reserve loss of only US$ 20.1 billion (net of valuation).

6. The conduct of monetary policy had to contend with the scale and pace of external shocks and their spillover effects through the real, financial and confidence channels. The thrust of the various policy initiatives has been on providing ample rupee liquidity, ensuring comfortable US dollar liquidity and maintaining a market environment conducive for continued flow of credit to the productive sectors. Since September 2008, the policy repo rate has been reduced by 425 basis points, the reverse repo rate has been brought down by

275 basis points and the actual/potential liquidity injection/availability was over Rs.5,61,700 crore (excluding Rs. 40,000 crore under SLR reduction). The liquidity enhancing measures taken by the Reserve Bank since mid-September 2008 ensured availability of ample liquidity in the banking system, which was evident in the large and regular absorption of the surplus from the system through LAF by the Reserve Bank.

7. The Indian financial markets continued to function normally and exhibited stability with lower volatility and higher volume in the first quarter of 2009-10. The call rates hovered around the reverse repo rate. The commercial paper market exhibited greater activity, reflecting revival in demand for funds by the NBFCs and the working capital needs of corporates. The government securities market witnessed increase in volume in the primary segment reflecting the large borrowing programme of the Government. The yield curve at the end of June 2009 had steepened at the short-end due to ample liquidity.

8. The credit market, which had functioned normally even when the global markets were experiencing a severe freeze, witnessed better transmission of monetary policy rates, as both deposit and lending rates showed signs of moderation in the first quarter of 2009-10. With the return of capital flows, the foreign exchange market showed appreciation of the rupee, reversing part of the depreciation in the previous quarter. The equity market recovered a large part of its earlier losses.

9. The WPI inflation, which was on a path of sharp decline from the peak level of August 2008, turned negative in June 2009. The decline in year-on-year inflation in the first quarter of 2009-10 essentially reflects the statistical factor of high base that emanated from sharp increases in commodity prices during the first half of 2008-09. Inflation as per Consumer Price Indices (CPIs) continues to remain at elevated levels.

10. In sum, the deceleration in growth in the second half of 2008-09 reflected the significant impact of global economic crisis through the trade and confidence channels on exports, private consumption and investment demand. This necessitated use of a large fiscal stimulus coupled with accommodative monetary policy to enable offsetting expansion in government expenditure, which ensured the overall growth remained at 6.7 per cent for the full year, which is one of the highest in the world and reasonable in the context of the intensity of the synchronised global crisis. The resultant fiscal stance, however, has led to considerable deterioration in the fiscal position, and faster return to the Fiscal Responsibility and Budget Management Act, 2004 guided fiscal consolidation path remains a key medium-term challenge. Subdued demand for credit from the private sector and negative WPI inflation have allowed both monetary and fiscal stance to support the overriding goal of faster recovery. The inflation outlook, however, could change with the waning of the last year's high base effect. For achieving the higher growth objective, credit flows to the private sector must also increase from the current depressed levels. The monetary policy response to these developments would require continuous coordination with fiscal policy, similar to last year's swift *and comprehensive policy action that had to be put in place in response to the contagion from the global financial crisis.*

11. The growth outlook for 2009-10 needs to be assessed in the context of indications emerging from lead information so far. While indicators such as growth in IIP, the core infrastructure sector, gradual revival in demand for non-food credit, improved business expectations could be viewed as signs of recovery from the slowdown, there are other factors which may dampen the growth outlook such as the delayed progress of monsoon, decline in exports due to the persistence of global recession, lagged impact of the negative growth in manufacturing in the last quarter of 2008-09 on services demand, negative growth in capital goods, decline in the production of commercial vehicles, and an accelerated fall in import growth suggesting dampened demand conditions.

12. On the inflation front, there are indications of inflation firming up by the end of the year due to the waning base effect of last year, increase in commodity prices, delayed progress of monsoon potentially driving up food prices, expansionary fiscal policy, accommodative monetary policy and inflation expectations not declining in step with the WPI inflation in the face of CPI inflation remaining firm. The low inflation environment, on the other hand, could prevail if the protracted global recession leads to dampened commodity prices, agricultural growth remains unaffected despite the delayed progress of monsoon, and the accommodative monetary policy stance returns to normal levels.

13. India's structural growth impulses continue to remain strong, given the high domestic saving rate, sound financial system, and growth supportive macroeconomic policy environment. Domestic deceleration in demand and persistent uncertainty in the global conditions, however, operate as the major drag on a faster recovery. Early indications for India suggest that the revival impulses need to strengthen further to boost the consumer and investor confidence, which could then set off a positive feedback loop to lift the growth momentum over time.