

Macroeconomic and Monetary Developments in 2009-10

Overview

Global Economic Conditions

1. *Recovery in the global economy picked up momentum in the fourth quarter of 2009. The speed of recovery, however, remains significantly divergent. The projections for global output for 2010 generally point to consolidating recovery, led by the Emerging Market Economies (EMEs). The WTO projects world trade to stage a strong recovery in 2010. The risks to the overall global macroeconomic environment have, however, increased because of large public debt in advanced economies, on the back of concerns relating to reduction in potential output, high unemployment rates, impaired financial systems and premature exit from the policy stimulus. Closer home, the improvement in global macroeconomic conditions is reflected in the turnaround in India's exports and the return of capital flows. With stronger recovery in EMEs driven largely by domestic demand, improving exports and return of capital flows, EMEs face the risks of inflation and asset price build up.*

Output

2. *Concerns about domestic output growth are now subdued as the recovery is getting more broad-based. This is the result of a rebound in industrial output, better prospects for the Rabi crop and continuing resilience of the services sector. Survey data suggest increasing levels of capacity utilisation in recent months. Subject to normal monsoons, output growth during 2010-11 is expected to gain further momentum.*

Aggregate Demand

3. *Final consumption expenditure remained subdued during 2009-10, as growth*

in both private final consumption expenditure and government final consumption expenditure decelerated. Investment demand, particularly gross fixed capital formation, however, showed a gradual recovery during the year. While the momentum in investment demand is expected to continue, pick-up in private consumption demand could drive the recovery in growth. The fiscal exit, as planned in the Union Budget for 2010-11, would contribute to improving the overall medium-term growth outlook, even as going forward, greater emphasis on quality of fiscal adjustment would be necessary.

External Sector Developments

4. India's external sector position improved alongside the recovery in the global economy. After declining for 12 consecutive months, exports recovered in October 2009. Similarly, imports recovered in November 2009 following a phase of decline. Despite a lower trade deficit, the current account deficit widened during April–December 2009, as compared with the corresponding period of the previous year. This is attributable to a fall in invisibles, particularly on account of business services. During 2009-10, foreign exchange reserves increased by US\$ 27.1 billion, comprising mainly of increase in gold holdings (US\$ 8.4 billion), SDRs (US\$ 5.0 billion) and foreign currency assets (US\$ 13.3 billion). The bulk of the increase in foreign currency assets was on account of valuation. Net capital inflows can be expected to increase further during the current year, reflecting the prospects of higher growth and larger interest rate differentials between India and the advanced economies. Like other EMEs, however,

higher capital inflows could influence asset prices, domestic liquidity conditions and the exchange rate. This will have implications for monetary management.

Monetary and Credit Conditions

5. Reflecting the stronger recovery in economic activities, growth in broad money (M_3) and flow of credit to the private sector exceeded the Reserve Bank's indicative projections for 2009-10. While the increase in CRR effected by the Reserve Bank in its Third Quarter Policy Review of January 2010 led to some moderation in excess liquidity, overall liquidity conditions remain comfortable as reflected in the daily reverse repo operations. The banking system's credit to the Government was the prime driver of monetary expansion during the year. The flow of resources to commercial sector distinctly improved from both bank as well as non-bank sources. Going forward, the demand for money may increase with acceleration in recovery and the elevated level of inflation.

Global Financial Markets

6. Global financial markets exhibited significant stabilisation during 2009, despite the drag from the global financial crisis. However, volatility increased in the beginning of 2010 due to concerns about unsustainable fiscal positions, as reflected in sovereign risks. Episodes such as the Dubai World debt standstill and the sovereign debt problems in Greece and East European countries pose a major risk to the stability of financial markets going forward.

Domestic Financial Markets

7. With market activity returning to the pre-global crisis level, volatility in the

domestic financial markets was much lower during 2009-10 than in the year before, when the crisis erupted. Despite considerable stability and the commencement of exit, markets faced concerns emerging from large government borrowings and the increase in inflation. This affected yields in the government bond market. The transmission of lower policy rates to the credit markets improved, albeit, slowly. Asset prices increased at a relatively faster pace in the recent months. With the revival of capital inflows, nominal exchange rate appreciated. Given higher domestic inflation, the appreciation in real terms was even higher.

Inflation Situation

8. Headline WPI inflation firmed up significantly during the fourth quarter of 2009-10. The initial inflationary pressure was predominantly conditioned by rising food and fuel prices, reflecting the impact of a deficient monsoon on agricultural output and the increase in international crude prices. In the second half of the year, with persistent supply side pressures, inflation became increasingly generalised. This is evident from the acceleration of inflation in non-food manufactured products from -0.4 per cent in November 2009 to 4.7 per cent in March 2010. Inflation, as measured by consumer price indices (CPIs) also remained high, though there was some moderation in February 2010. These inflationary conditions, coupled with the stronger momentum seen in the pace of economic recovery, created the compelling ground for altering the Reserve Bank's balance of policy focus to anchoring inflation expectations.

Growth Outlook

9. Output growth in 2010-11 is expected to be higher than in 2009-10, assuming a normal monsoon. Support for sustained momentum in growth can be expected from all three major components, viz., agriculture, industry and services. Nevertheless, apart from monsoon-related uncertainty, other downside risks to growth need to be recognised. First, private consumption demand needs to improve significantly to support the growth momentum. Second, global recovery, despite gaining strength, is expected to remain fragile, which has implications for exports. Third, the exit from fiscal stimulus and the growth-supportive monetary policy, unless calibrated carefully, could impact the growth process. Finally, the domestic saving rate has exhibited some decline, led by significant decline in public sector savings. This has adverse implications for the potential growth of the economy.

Inflation Outlook

10. Inflation can be expected to moderate over the next few months, from the peak levels seen in recent months. There are, however, upside risks to inflation. First, international commodity prices, particularly oil, have started to increase again. In several commodities, the import option for India to contain domestic inflation is limited, because of higher international prices. Second, the revival in private consumption demand and the bridging of the output gap will add to inflationary pressures. Finally, it is important to guard against the risk of hardening of inflation expectations conditioned by near double digit headline WPI inflation.

Overall Assessment

11. With the improving growth outlook, monetary and fiscal exit measures have started. While recovery in private demand needs to be stronger to reinforce the growth momentum, the already elevated headline inflation suggests that the weight of policy

balance may have to shift to containing inflation, since high inflation itself will dampen recovery in growth. In the emerging macroeconomic scenario, monetary policy management in 2010-11 will be dominated by the challenge of moderating inflation and anchoring inflation expectations, while remaining supportive of growth impulses.