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Macroeconomic and Monetary Developments in 2008-09

The Reserve Bank of India today released the document "Macroeconomic and Monetary Developments in 2008-09" to serve as a backdrop to the Annual Policy Statement for 2009-10 being announced on April 21, 2009.

The highlights of macroeconomic and monetary developments during 2008-09 are:

Overview

- The global economic conditions deteriorated sharply during the year 2008 with several advanced economies experiencing their sharpest declines. The associated adverse shocks spread across emerging market economies (EMEs) particularly by the fourth quarter of the year and accentuated the synchronised global slowdown.
- Inflation conditions witnessed sharp volatility during the year as headline inflation in major advanced economies firmed up considerably up to July 2008, but declined sharply thereafter.
- The global financial environment entered a crisis phase in mid-September 2008, following the growing distress among large international financial institutions.
- The knock-on effect of these unprecedented adverse global developments became evident in the macroeconomic performance of the Indian economy, as it experienced some loss of growth momentum with major drivers witnessing moderation. While private consumption and investment are witnessing moderation, the fiscal stimulus along with other committed expenditures of the Government could, however, arrest the moderation in growth.
- An important challenge in the macroeconomic and monetary policy making during 2008-09 has been to manage the volatility emerging in respect of several key economic indicators of the Indian economy. Notwithstanding several challenges, particularly from the global economy, the Indian economy remained relatively resilient, its financial institutions and private corporate sector remained sound and solvent. Furthermore, the macroeconomic management helped in maintaining lower volatility in both the financial and the real sectors in India relative to several other advanced and emerging market economies.

Output

- The global financial crisis interrupted the growth momentum of India, despite the strong dominance of domestic sources of growth. There was clear moderation in growth by the third quarter of 2008-09. In relation to the agricultural sector, industry and services sectors have been affected more by the adverse external shocks, with some contribution to their growth deceleration arising from cyclical slowdown in certain sectors after a prolonged phase of high growth.
- The Central Statistical Organisation (CSO)'s estimates (February 2009) of real GDP growth was placed at 5.3 per cent during the third quarter of 2008-09 as

compared with 8.9 per cent during the corresponding quarter of the previous year, reflecting deceleration in growth of all its constituent sectors.

- During 2008-09, the area covered under sowing of various crops declined marginally during the kharif season on account of moderate shortfall in rainfall. On the other hand, the prospects for rabi production remain favourable with area sown under rabi crops being higher than a year ago. Total foodgrains production during 2008-09 was placed at 227.9 million tonnes (Second Advance Estimates) as compared with 230.8 million tonnes during 2007-08.
- In the wake of a near normal long range monsoon forecast of the India Meteorological Department (April 17, 2009) during the South-West monsoon season 2009, the prospects for agricultural production remain satisfactory.
- The loss of growth momentum in the industrial sector was evident as the year-on-year expansion in the Index of Industrial Production was of 2.8 per cent during 2008-09 (April-February) as against 8.8 per cent in the corresponding period of the previous year. The manufacturing sector and the electricity sector registered growth of 2.8 per cent and 2.4 per cent as compared with 9.3 per cent and 6.6 per cent, respectively, during the above period.
- The infrastructure sector recorded growth of 3.0 per cent during 2008-09 (April-February), down from 5.8 per cent during the corresponding period of the previous year, reflecting deceleration in all the sectors except coal.
- In the context of the severity of the impact of the crisis on the real economy of countries around the world, the growth outcome reflects the resilience of the Indian economy.

Aggregate Demand

- The role of aggregate demand in a phase of weakening growth impulses came to the forefront of public policy in 2008-09. The sharp contraction in external demand - as evident in falling global output, employment and global trade – clearly affected India’s export performance.
- Domestic demand, in the form of both private consumption and investment expenditure moderated, particularly in the third quarter of 2008-09. However, Government final consumption, however, rose on account of discretionary fiscal stimulus measures and committed expenditures of the Central Government.
- During 2008-09, the combined finances of the Central and State Governments were adversely impacted due to the economic slowdown. The Central Government finances came under stress during 2008-09, both on the revenue and the expenditure sides, on account of fiscal measures taken to reduce inflationary pressures during the first half and to arrest the moderation of economic growth in the second half of the year. As a result, the key deficit indicators *viz.,* revenue deficit and fiscal deficit widened to 4.4 per cent and 6.0 per cent, respectively, in the revised estimates for 2008-09 from 1.0 per cent and 2.5 per cent, respectively, in the budget estimates.
- The Union Interim Budget for 2009-10 has indicated the relaxation in the FRBM targets for 2008-09 and 2009-10, in order to ensure expansion in aggregate demand through fiscal stimulus measures. However, as a medium-term objective, it has recognised the need to revert to fiscal consolidation process at the earliest.
- Corporate performance remained subdued during 2008-09 with the impact on profitability being particularly adverse during the third quarter.
- The rate of Gross Domestic Saving (GDS) peaked at 37.7 per cent GDP in 2007-08, mainly due to improved saving performance of the private corporate and

public sectors. The rate of Gross Domestic Capital Formation (GDCF) also peaked to 39.1 per cent of GDP in 2007-08. The saving-investment balance widened during 2007-08 reflecting continuous surge in investment activity ahead of the saving rate. The slowing of economic activity in 2008-09 may, however, affect both saving and investment rates for the year.

The External Economy

- In the face of deteriorating external environment, the adverse effects of the contagion transmitting through different components of India's balance of payments (BoP) could largely be contained through policy actions. A noteworthy feature during 2008-09 was that the effect of external shocks transmitting to India through the BoP could be contained with loss of reserves mainly in the third quarter of the year, when the global crisis deepened and spread significantly with more visible real effects.
- India's BoP position in 2008-09 (April-December) was characterised by a widened trade deficit leading to a higher current account and lower net capital inflows. In the face of deteriorating external environment, the adverse effects of the contagion transmitting through different components of India's balance of payments (BoP) remained largely contained.
- The rapid contraction in the global trade was reflected in negative growth experienced during the third quarter, which was last observed in 2001-02. The growth in imports also decelerated to single digit level during the third quarter, led by lower crude oil prices and weakening domestic demand. The merchandise trade deficit further widened to US$ 113.8 billion during April-February 2008-09 (US $ 82.2 billion a year ago).
- Net surpluses under invisibles increased in April-December 2008, primarily led by private transfers and software services, though a moderation in such inflows set in the third quarter. Thus, the current account deficit widened to a level of US$ 36.5 billion (US$ 15.5 billion in April-December 2007)
- The adverse impact of the global financial market turmoil was also felt in terms of reduced inflow of the long and short-term debt and reversal of portfolio inflows. A positive development was, however, relative resilience of FDI inflows (US $ 31.7 billion in April-February 2008-09) in the face of reversal of capital flows, reflecting the attractiveness of India as a long term investment destination.
- As on April 10, 2009, the foreign exchange reserves stood at US $ 253 billion, showing a decline of US$ 56.7 billion (including valuation) over the level at end-March 2008.
- India's external debt, debt sustainability indicators and the level of foreign exchange reserves continue to remain at comfortable levels and would ensure external stability.

Monetary Conditions

- The global crisis, which created intense uncertainties for funding liquidity in the face of tight market liquidity for financial instruments trading in almost all financial markets, brought to the fore the strong interactions between funding liquidity and market liquidity. As the global liquidity crisis started to affect the domestic money and foreign exchange markets in the last quarter of 2008, the Reserve Bank ensured adequate provision of both domestic and foreign exchange liquidity to the market through banks, with the aim of restoring normal functioning of the market, and thereby facilitating adequate flow of credit to the productive sectors of the economy.

- The monetary policy stance of the Reserve Bank shifted from concerns related to inflation in the first half of 2008-09 to maintaining financial stability and arresting the moderation of growth in the second half. While money supply evolved consistent with indicative projections, credit to private sector reflected the conditions evolving in the real sector of the economy.
- Growth in broad money (M_3), year-on-year (y-o-y), was 18.4 per cent at end-March, 2009 as compared with 21.2 per cent a year ago, reflecting deceleration in the expansion of bank credit and capital inflows.
- Aggregate deposits of banks, y-o-y, was 18.8 per cent at end-March 2009 as compared with 21.7 per cent a year ago.
- Non-food credit growth (y-o-y) of SCBs to the commercial sector remained strong up to October 2008 on the backdrop of drying up of other sources of funds to industry but witnessed sustained deceleration thereafter. Non-food credit by SCBs was moderated to 17.5 per cent, y-o-y, at end-March 2009 as compared with 23.0 per cent a year ago.
- The contractionary impact of decline in net foreign exchange assets on reserve money and domestic liquidity was offset by expansion through open market operations (OMOs), unwinding of MSS and other measures to augment rupee liquidity. Adjusted for the first round effect of the changes in CRR, reserve money growth (y-o-y) as on March 31, 2009 was lower at 19.0 per cent as compared with 25.3 per cent a year ago.

Financial Markets

- The process of deleveraging and dysfunctional financial markets in the advanced economies, which accentuated into a global financial crisis, has highlighted the importance of orderly functioning of markets for achieving macroeconomic objectives.
- In the third quarter of 2008-09, when liquidity dried down in the global economy markets and credit markets almost froze, there were knock-on effects on domestic money and foreign exchange markets, which prompted the Reserve Bank to initiate measures to ensure adequate provision of rupee and foreign exchange liquidity.
- An important distinction between the actions taken by the Reserve Bank and the other central banks is that the interaction is still largely through the banking channel. Another noticeable distinction is that there has not been any dilution of the collateral taken by the Reserve Bank. The array of instruments available allow for flexibility in Reserve Bank's operations.
- While orderly conditions could be restored in the money market by November 2008, the pressure on the exchange rate continued, alongside pressure on the country's balance of payments and draw down of foreign exchange reserves. The equity markets followed the general global sentiments and market trends and after a phase of sharp downward movement, the market has shown some recovery since March 2009.
- In the government securities market, reflecting the economy's need for large fiscal stimulus, the gross market borrowings of the Government in 2008-09 were substantially higher than those for 2007-08, and the entire market borrowing programme was managed smoothly by the Reserve Bank.
- In the credit market following significant reduction in policy rates by the Reserve Bank, the lending rates of banks have begun to exhibit some moderation.

- In the context of the high volatility that was witnessed in global financial markets in 2008-09, one notable aspect of the Indian markets was that all markets functioned normally, with occasional volatility for short periods.

Price Situation

- The large order of volatility in the inflation outcome witnessed in India during 2008-09 is unprecedented. The sharp volatility in international commodity prices largely contributed to the spiralling inflation in the first half, and then to the subsequent decline from a higher base at fast pace in the second half of 2008-09.
- In India, inflation, as measured by year-on-year variations in the Wholesale Price Index (WPI), reached an intra-year peak of 12.91 per cent on August 02, 2008. Subsequently, it fell sharply to 0.26 per cent as at end-March 2009 and further to 0.18 per cent as on April 4, 2009.
- As external and supply side factors along with demand pressures conditioned the inflation trend during 2008-09, demand management policy measures had to be employed in a calibrated manner. While the first half of 2008-09 warranted for adjustment of aggregate demand on an economy wide basis, the sharp fall in inflation in the second half facilitated aggressive monetary easing, which aim at arresting the economic slowdown.
- Unlike the WPI based inflation, CPI based inflation in India, however, remains high, with recent evidence of very modest moderation, and the transmission process of lower inflation at the wholesale level to inflation at the retail level has emerged as an important issue in the conduct of Reserve Bank's monetary policy.
- Various measures of consumer price inflation, though started declining, still remained high in the range of 9.6-10.8 per cent during January/February 2009 as compared with 5.2-6.4 per cent in February 2008.

Macroeconomic Outlook

- An assessment of the economic conditions at the current juncture indicates that the global economic conditions have deteriorated sharply during 2008 and the forecasts of the various international agencies point to deepening of recessionary conditions during 2009 as well.
- Reflecting global developments and their impact on the Indian economy, as well as domestic cyclical factors, the various surveys of economic activity point towards prevalence of less than optimistic sentiment for the outlook of the Indian economy in the coming months. The Professional Forecasters' Survey conducted by the Reserve Bank in December 2008 suggested moderation in economic activity in 2008-09 and 2009-10.
- The Reserve Bank's Industrial Outlook Survey of Manufacturing Companies in the Private Sector indicates that the business expectations indices based on the assessment for January-March 2009 and expectations for April-June 2009 declined sharply by 20.7 per cent and 13.9 per cent, respectively, over the previous quarters.

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