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Macroeconomic and Monetary Developments in the Third Quarter of 2010-11

The Reserve Bank of India today released its Macroeconomic and Monetary Developments: Third Quarter Review 2010-11 document. The document serves as a background to the Third Quarter Review of Monetary Policy 2010-11 to be announced on January 25, 2011.

Overall Assessment

Robust and broad-based growth is expected to coexist with elevated inflation in the near-term.

- While downside risks to growth have receded, upside risks to inflation have increased.
- Since a lower inflation regime is essential for sustainable high growth, containing inflation becomes the dominant policy objective in the current environment.

Global Economic Conditions

While the outlook for recovery in advanced economies has improved, concerns persist over the durability of the momentum.

- Global economic activity in the second half of 2010 turned out to be stronger than earlier expectations. However, the uneven pace of growth across regions and uncertainty about the durability of recovery in the advanced economies persist.
- Emerging Market Economies (EMEs) face the risk of inflation from strong growth and hardening of commodity prices.
- A number of EMEs resorted to soft capital controls and foreign exchange market intervention to limit the adverse impact of excess capital inflows on their economies.

Indian Economy

Output

Strong growth puts the economy back on its earlier high growth trajectory but sectoral imbalances pose risks to inflation.

- The robust GDP growth in the first half of 2010-11 suggests that the economy has returned to its earlier high growth path.
- Satisfactory *kharif* production and higher *rabi* sowing point to stronger contribution of the agriculture sector to overall GDP growth in 2010-11.

- Industrial production has exhibited near double digit growth but the significant volatility adds uncertainty to the outlook.
- Lead indicators of services sector show sustained buoyancy.
- In certain sectors, particularly non-cereal food items, however, the supply response to market signals in the form of higher prices has been weak, thereby exerting upward pressures on inflation.

Aggregate Demand

Private consumption expenditure and gross capital formation emerge as the key growth drivers.

- Growth in private consumption expenditure, after remaining subdued over several quarters, exhibited significant acceleration in the first half of 2010-11.
- As per trends in the growth of gross fixed capital formation, the strong recovery in investment demand that had started in the last quarter of the previous year, has consolidated and remained strong.
- Fiscal trends during the year to date suggest that the fiscal deficit could remain within the budgeted level, but high growth in capital expenditure would add to the overall growth momentum from private demand.

External Sector

Higher current account deficit fully buffered by higher capital inflows, but sustainability concerns could stem from the composition of capital flows.

- As expected, the current account deficit widened significantly in the second quarter of the year.
- Even as exports expanded faster than imports, the trade deficit widened. From the current account perspective, the cushion to a widening trade deficit from net invisibles declined.
- Higher net capital inflows did not pose any immediate challenge, unlike in many other EMEs, because of the widening deficit in the current account.
- The shift in the composition of capital flows, particularly the sharp jump in portfolio inflows and significant decline in net FDI inflows, however, raise questions about the sustainability of the external sector in the medium-term.

Monetary and Liquidity Conditions

Large primary liquidity injected by the Reserve Bank to ease the liquidity pressures without diluting its anti-inflationary focus.

- The liquidity conditions tightened significantly to the point of imposing constraints on growth in the terminal months of 2010.
- The severe tightness in liquidity was caused by both frictional factors associated with unusually large surplus balances of the Government and structural factors as reflected in stronger credit growth relative to deposit growth as well as higher demand for currency.
- The Reserve Bank introduced a number of measures with the aim of limiting the scale of the deficit, which remained consistent with its anti-inflationary policy stance.

- The growth in non-food credit exceeded the indicative trajectory of the Reserve Bank and remained strong on account of growing credit demand associated with robust economic growth.
- Recognising the need to firmly anchor inflationary expectations and contain inflation, the Reserve Bank has raised policy rates six times since March 2010.
- As a result, along with the impact of the shift in the LAF mode from reverse repo to repo, the effective increase in policy rate has been 300 basis points.

Financial Markets

Deficit liquidity conditions helped in strengthening the transmission of policy rate actions to deposit and lending rates.

- Reflecting the tight liquidity conditions, interest rates in the money market, particularly CBLO, T-bill, CP and CD segments hardened.
- Recognising the structural imbalance between deposit growth and credit growth, as well as the underlying signals of the anti-inflationary monetary policy stance, banks raised their deposit rates to improve deposit mobilisation.
- Several banks also revised their base rates upwards in the range of 25-100 basis points during July 2010 -January 17, 2011, and the associated increase in effective lending rates could be expected to contain demand pressures, going forward.
- The pace of increase in housing prices varied across cities. The Reserve Bank has used macroprudential measures recently to restrain excessive leverage in asset price build-up.

Inflation

Upside risks to inflation from structural demand-supply imbalance in certain sectors and hardening global commodity prices have increased.

- WPI inflation had witnessed modest softening during August-November 2010 after remaining in double digits for five consecutive months up to July 2010.
- In December 2010, however, renewed price pressures surfaced, driven by factors that were largely unanticipated.
- Food inflation exhibited a strong rebound, led by onion and other vegetables, largely due to unseasonal rains and supply chain frictions.
- The hardening of international commodity prices, in particular oil, happened sooner than anticipated.
- The expected significant softening of food inflation after a normal monsoon did not materialise, reflecting the impact of growing structural imbalances in certain sectors, particularly non-cereal food items.
- Non-food manufactured products inflation, which is a broad indicator of generalised and demand side price pressures, has remained stable in the range of 5.1 to 5.9 per cent so far during the year.
- High month-over-month (annualised, seasonally adjusted) inflation in recent months as also the rising price index of the non-food manufactured group,

however, suggest the combined impact of both input costs and demand pressures.

- Even if inflation softens in the near-term, sustaining a low inflation regime would require addressing structural rigidities from the supply side in specific sectors, particularly in those items where supply-demand imbalances exert disproportionately larger impact on the headline inflation.
- Since persistent high inflation could endanger the growth objective and also amplify risks to inclusive growth, containing inflation will have to be the predominant objective of monetary policy in the near-term.

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