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Macroeconomic and Monetary Developments: First Quarter Review 2009-10

The Reserve Bank of India today released the document "Macroeconomic and Monetary Developments: First Quarter Review 2009-10" which serves as a background to the First Quarter Review of Monetary Policy 2009-10 being announced on July 28, 2009.

The highlights of macroeconomic and monetary developments are the following:

Global Economic Conditions

- 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.
- Signs of improvements in the global financial conditions observed 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.
- According to the current available assessment of the IMF, the global economy is projected to contract by 1.4 per cent in 2009 and to expand by 2.5 per cent in 2010. The growth outlook of India and China for 2009, however, has been revised upwards by the IMF.

Output

- Reflecting the contagion from the synchronised global recession, domestic 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 overall GDP growth in the fourth quarter of 2008-09 remained at the same level as in the previous quarter, primarily on account of a turnaround in growth in agriculture and allied activities, even as industry and services continued to exhibit sustained deceleration over the four successive quarters of the year, with the rate of deceleration rising in the second half reflecting the contagion from the global synchronised recession.

Agriculture, Industry and Services

- The fourth Advance Estimates place the total food grain production during 2008-09 at a record 233.9 million tonnes.
- The slow progress of monsoon up to end-June 2009 has affected the kharif sowing, which could have implications for the agricultural production. The rainfall in July so far, however, has improved enabling better sowing position as on July 17, 2009 for pulses, oilseeds and coarse cereals at close to last year's levels, though paddy sowing still remains substantially below last year's level. During 2008-09, the lower Kharif output was made good by the Rabi output and, as a result, the overall agricultural production exhibited a turnaround in the fourth quarter of the year.

- The core infrastructure sector grew by 4.8 per cent during the first quarter of 2009-10 as compared with 3.5 per cent growth during the corresponding quarter of the previous year, led by growth in electricity, cement and coal. The cement sector recorded acceleration, indicating revival of construction activity.
- The Index of Industrial Production (IIP), which had registered a significant deceleration in growth to 0.1 per cent in the last quarter of 2008-09, exhibited growth at 1.9 per cent during April-May 2009, even though that reflected deceleration in relation to 5.3 per cent growth recorded during April-May 2008. Out of the 17 two-digit manufacturing industry groups, however, 10 groups recorded positive growth during April-May 2009-10 as compared to 11 industry groups recording positive growth in the corresponding period of last year.
- The lead indicators of services sector activity such as railway freight and new cell phone connections showed positive signs. Tourist arrivals also improved in June 2009. Production of commercial vehicles, cargo handled at major ports, and passengers handled at domestic and international terminals, however, exhibited deceleration during the first two months of 2009-10.

Aggregate Demand

- Weakening aggregate demand emerged as a major constraint to growth in 2008-09. The significant deceleration in private consumption expenditure as well as the moderation in investment demand required expansionary fiscal policy to arrest the slowdown in growth. Government consumption expenditure, therefore, increased sharply in the third and fourth quarters and contributed 32.5 per cent of real GDP growth (at market prices) in 2008-09, as against an average contribution of 5.9 per cent in the previous five years.
- Reflecting the fiscal response to the growth slowdown, key deficit indicators of the Central Government, viz., the revenue deficit and the gross fiscal deficit in the revised estimates for 2008-09 were significantly higher than the budgeted levels as well as those of the preceding years.
- Corporate performance remained subdued, and the impact of moderation in demand was visible in the substantial deceleration in sales growth in the second half of 2008-09. Corporate profitability also exhibited negative growth in the last three successive quarters of the year.
- The Union Budget for 2009-10, presented against the backdrop of persistent global economic slowdown and the associated dampened domestic demand, has placed the fiscal deficit at 6.8 per cent of GDP in 2009-10 with a view to providing the necessary boost to demand and thereby support a faster recovery. Notwithstanding the necessity of an expansionary fiscal response to the growth slowdown, there is a need to address the challenges for fiscal consolidation with a view to returning to the high growth path at the earliest.

External Economy

- Reflecting the contraction in global demand due to the synchronised global recession, exports have declined since October 2008 for eight successive months. Imports growth also witnessed a deceleration during October-November 2008, before turning negative thereafter. The merchandise trade deficit declined during 2009-10 (April-May) over the corresponding period of the previous year, reflecting the sharper decline in the imports in relation to exports.
- The lower trade deficit emanating from moderation in oil prices resulted in a turnaround in the current account to a modest surplus during the fourth quarter of 2008-09, after recording deficits for seven consecutive quarters.
- For the year as a whole, net capital flows fell from US$ 108.0 billion in 2007-08 to US$ 9.1 billion in 2008-09, while the current account deficit widened from 1.5 per cent of GDP to 2.6 per cent of GDP during the same period. The impact of a severe

external shock on India's BoP was managed with a loss of reserves of only US$ 20.1 billion (net of valuation) without resorting to any extraordinary measures.

- The lead information on certain indicators of the capital account suggests revival in capital flows to India during first quarter of 2009-10, after the net outflows in successive two quarters in the second half of 2008-09. The contraction in exports and imports, however, continues. India's foreign exchange reserves increased from US$ 252 billion at end-March 2009 to US$ 266 billion by July 17, 2009. The debt sustainability indicators remained at comfortable levels at end-March 2009.

Monetary Conditions

- 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 mid-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 is over Rs.5,61,700 crore (excluding Rs.40, 000 crore under SLR reduction). These measures taken by the Reserve Bank have 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.
- Broad money growth (year-on-year) remained high at 20.0 per cent (up to July 3, 2009), driven by robust growth in deposits (21.0 per cent) on the components side and significant increase in banking system's credit to the Government (48.0 per cent) on the sources side. Market absorption of the government borrowing programme was facilitated by dampened demand for credit from the private sector in the face of a high deposit growth.

Financial Markets

- The Indian financial markets continued to function normally and exhibited stability with lower volatility and higher volumes in the first quarter of 2009-10. The call rates hovered around the reverse repo rate. The commercial paper market exhibited greater activity. The government securities market witnessed increase in volume in the primary segment reflecting the large borrowing programme of the Government. The yield curve has steepened, particularly at the short end reflecting ample liquidity, and in response to the large government borrowing programme.
- Gross and net issuances of dated securities of the Central Government during 2009-10 are budgeted higher by 65.2 per cent and 83.4 per cent, respectively, over 2008-09. During 2009-10 (up to July 22, 2009), the Central Government completed a large part (45.4 percent) of the budgeted net borrowing programme (including amounts raised through 364-day Treasury Bills and de-sequestering of MSS account). Ample liquidity available in the system has facilitated the borrowing programme.
- 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 which moderated in the fourth quarter of 2008-09 exhibited further moderation in the first quarter of 2009-10. The growth in non-food credit which witnessed deceleration since October 2008 has also reversed from June 2009, indicating signs of revival in demand for credit.

Inflation Situation

- The WPI inflation, which was on a path of sharp decline from the high peak level of August 2008, turned negative in June 2009, and since then the negative inflation continues (-1.2 per cent as on July 11, 2009). The decline in the year-on-year inflation essentially reflects the statistical factor of high base that emanated from sharp increases in commodities prices during the first half of 2008-09.

- Notwithstanding the negative WPI inflation, food articles inflation (i.e. primary as well as manufactured) remains high at 8.9 per cent (as on July 11, 2009). Inflation as per Consumer Price Indices (CPIs) also continues at elevated levels (in the range of 8.6 per cent to 11.5 per cent for different consumer price indices in May/June 2009).

Growth and Inflation Outlook

- The Industrial Outlook Survey of the Reserve Bank conducted in April-May 2009 shows a turnaround in the business sentiment. For the manufacturing companies in the private sector, the business expectations indices based on an "assessment for April-June 2009" and on "expectations for July-September 2009" improved sharply by 20.3 and 14.0 per cent, respectively, over the previous quarter, when these indices had recorded their lowest levels since the inception of the Survey. The results of the latest round of Survey of Professional Forecasters' conducted by the Reserve Bank in June 2009 indicate overall (median) growth rate for 2009-10 at 6.5 per cent, which is higher from 5.7 per cent that was reported through the findings of the earlier survey conducted in March 2009. The Survey also indicates average inflation in the fourth quarter of 2009-10 to be about 5.4 per cent.
- The growth outlook for 2009-10 needs to be assessed in the context of indications emerging from lead indicators so far. While indicators such as the higher growth in core infrastructure sector, positive growth in IIP, gradual revival in demand for non-food credit, improving performance of the corporate sector in terms of both sales and profitability, gradual return of risk appetite in the capital market, more optimistic business expectations and forecasts as reflected in the Reserve Bank's surveys 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.
- 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, the inflationary implications of expansionary fiscal policy and accommodative monetary policy, and inflation expectations not declining in step with the WPI inflation in the face of CPI inflation remaining firm. The inflationary pressures may remain moderate 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.
- 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.

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