प्रेस प्रकाशनी PRESS RELEASE

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May 2, 2011

Macroeconomic and Monetary Developments in 2010-11

The Reserve Bank of India today released the Macroeconomic and Monetary Developments in 2010-11. The document serves as a background to the Monetary Policy Statement 2011-12 to be announced on May 3, 2011.

Overall Outlook

Persistence of inflation warrants continuation of anti-inflationary monetary policy stance for sustaining growth over the medium term

- Growth in 2011-12 is expected to stay close to the trend. Growth risks emanate from high oil prices and some moderation in investment. Business expectations surveys exhibit moderation. Survey of professional forecasters also predicts weaker growth and firmer inflation.
- Inflation may remain elevated for some more time despite the current anti-inflationary bias in the monetary stance. Upside risks to inflation arise from high oil and other commodity prices, incomplete pass through and its likely impact on fiscal deficit, elevated inflation expectations and price stickiness.
- Going forward, policy trade-offs may arise as downside risks to growth and upside risks to inflation have increased. High global crude oil and other commodity prices pose a risk to growth and inflation. Experience suggests that high growth phases have coexisted with low inflation.

Global Economic Conditions

Recovery outpacing expectations, but oil, Euro-zone risks remain

- Even as recovery remains multi-speed, growth in both, advanced economies and emerging/developing economies, outpaced initial expectations. This raises hopes for sustained, though moderately paced global recovery during 2011.
- Global recovery has advanced, but downside risk to global growth arises from oil prices and significant sovereign and banking sector default risks.
- Global inflation risks have risen significantly over the last quarter, not just in emerging markets but also in advanced economies. The pressures for rate cycle turning even in advanced economies can no longer be ignored.

Indian Economy

Output

Economy grew around its trend, likely to sustain close to the trend

- GDP growth during 2010-11 reverted to its recent trend, aided by a rebound in agricultural growth. Non-agricultural growth, however, was slightly below trend.

- Industrial growth decelerated in the second half on account of high base effect and moderation in investment demand. Manufacturing activity was spread more evenly and the recent slowdown in IIP was exacerbated by volatility in output of a few industries.
- Services sector exhibited sustained momentum in 2010-11, though most services decelerated somewhat in Q3 of the year.
- Growth momentum is likely to sustain close to trend in 2011-12 aided by predicted normal monsoon, demand conditions and positive lead indicators for services. Risks to growth, however, arise from input cost pressures.

Aggregate Demand

Aggregate demand remained robust, government spending decelerated on fiscal consolidation

- Demand conditions were supportive of growth in 2010-11. Private consumption and investment were the key drivers, even though aggregate investment moderated in Q3. Investment intentions of the corporate also moderated further in Q3 after beginning to moderate from the previous quarter.
- Government consumption expenditure decelerated in 2010-11 reflecting resumption in fiscal consolidation. This rebalancing should be maintained.
- The key fiscal indicators of the Central Government showed an improvement in 2010-11 (RE). However, the key deficit indicators are likely to remain above those recommended by the 13th Finance Commission.
- Expenditure on subsidies is subject to upside risks. Fertiliser and oil subsidies are likely to exceed budgetary provisions and generate pressures on fiscal situation in case there is a delay in adjusting the domestic prices to rise in international prices.

External Economy

Concerns on current account deficit receded, but not dissipated

- Current account deficit (CAD) in 2010-11 is likely to be around 2.5 per cent of GDP, having moderated in Q3 of 2010-11 with significant acceleration in exports.
- While concerns on CAD have receded, the spike in oil prices poses the risk of CAD widening in 2011-12.
- The decline in FDI, volatility in portfolio flows and rising debt flows pose risk to CAD sustainability, though pressures on financing CAD have eased.
- The impact of Middle East and North Africa (MENA) unrest can be significant while that of Japan's natural disaster will be marginal. The affected economies' share in India's trade is not large. However, oil constitutes about one-third of India's total imports. Further, there may be some transitory impact on investment flows from Japan.

Monetary and Liquidity Conditions

Monetary and liquidity conditions remained consistent with the anti-inflationary bias

- Monetary and liquidity conditions responded, though with a lag, as monetary policy was continually tightened through the year. Tight liquidity conditions eased somewhat during Q4 of 2010-11 as structural and frictional liquidity drivers eased.

- Even as reserve money growth remained strong, money supply growth stayed below indicative trajectory. Lower growth in aggregate deposits and reduction in money multiplier emanating from higher currency demand led to this divergent trend.
- Credit growth was above the indicated trajectory, though it moderated in later part of 2010-11. Deposit growth picked up, responding to a rise in interest rates.
- Growth momentum has continued so far, though inflation has remained elevated. Risk to growth from high persistent inflation could condition the stance of monetary policy in near term.

Financial Markets

Stronger monetary transmission impacted interest rates

- Monetary transmission strengthened in Q4 of 2010-11 with interest rates firming up gradually across the spectrum as liquidity remained in deficit mode. Deposit rates rose rapidly to accommodate rise in credit amidst tight liquidity. Banks progressively passed on the increased costs in the form of higher lending rates.
- Money market rates firmed up reflecting tight liquidity conditions. The yield curve flattened in Q4 of 2010-11 reflecting monetary actions and lower budgeted borrowings. Equity markets witnessed an orderly correction during the quarter. Rupee remained stable and orderly without any interventions.

Price Situation

Inflation emanating from supply-side shocks increasingly became generalised

- Headline inflation exhibited strong persistence in 2010-11 due to supply-side shocks and gradual generalisation of price pressures.
- Inflation drivers have changed over three distinct phases. Headline inflation during 2010-11 was impacted primarily by food inflation during April-July, by primary non-food articles during August-November and in a more generalised manner by non-food manufacturing articles since December 2010.
- Inflation path remains sticky and risks are on the upside. Headline inflation could remain elevated in the first half of 2011-12 before declining gradually in the second half, but could remain above the Reserve Bank’s comfort level.
- Passthrough of global commodity prices, especially oil, has been as yet incomplete and constitute a significant medium-term risk.

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Press Release : 2010-2011/1584