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Macroeconomic and Monetary Developments: Second Quarter Review 2009-10

The Reserve Bank of India today released the document "[Macroeconomic and Monetary Developments: Second Quarter Review 2009-10](#)", which serves as a background to the Second Quarter Review of Monetary Policy 2009-10 being announced on October 27, 2009.

Highlights

Global Economic Conditions

- Global economy has started exhibiting tentative signs of recovery, signalling the winding down of global recession. Global recovery is, however, widely perceived to remain slow and gradual, with receding but significant downside risks.
- After a series of successive and frequent downward revisions to the growth outlook of the world economy for 2009, the IMF has revised the projected growth upwards for the first time from (-) 1.4 per cent to (-) 1.1 per cent in October 2009.
- According to the WTO, world merchandise exports increased by about 8.0 per cent in the second quarter of 2009 over the preceding quarter, even though year-on-year growth continued to decline by 33.0 per cent.
- Estimates of the Institute of International Finance (IIF) suggest that net private capital flows to the Emerging Market Economies (EMEs), which had recovered in the second quarter of 2009, gained pace in the third quarter; 30 EMEs are projected to receive US\$ 349 billion in 2009. This, however, will still be only about one fourth of the peak level of net flows received in 2007.

Outlook: Indian Economy

Output

- In India, GDP growth in the first quarter of 2009-10 at 6.1 per cent represents a modest recovery over the 5.8 per cent growth recorded during the preceding two quarters in the second half of 2008-09. In comparison to the high average growth of 8.8 per cent recorded during the five-year period 2003-08, however, the first quarter growth in 2009-10 still points to persistence of slowdown.
- Information available on various lead indicators in the second quarter of 2009-10 suggests that because of deficient monsoon, kharif output may be adversely affected.
- Industrial sector has started exhibiting recovery, with 5.8 per cent growth during April-August 2009, as compared with 4.8 per cent during the corresponding period of the previous year.
- Growth in core infrastructure witnessed notable acceleration in August 2009, and for April-August 2009 it was higher at 4.8 per cent as against 3.3 per cent during the corresponding period of the previous year.

- Lead indicators for services suggest pick up in activities relating to construction and telecommunication, even though external demand dependent services, such as, tourism and cargo handled at ports, continue to be depressed.

Aggregate Demand

- Deceleration in aggregate demand that was witnessed in the second half of 2008-09 continued during 2009-10. Growth in private consumption demand fell to as low as 1.6 per cent in the first quarter of 2009-10. Investment demand also decelerated further, and the high growth in government consumption demand that was witnessed in the last two quarters of 2008-09 moderated.
- Corporate performance data indicate that growth in sales declined in the first quarter of 2009-10, though profitability showed improvements.
- Deficient monsoon and the associated drought like conditions in several parts of the country, and the more recent floods in some other parts, could also dampen rural demand.
- Given the predominant role of domestic demand in conditioning the growth outlook in India, weak private consumption and investment demand continue to impede faster recovery.
- Reflecting the continuation of the expansionary fiscal response to the growth slowdown, key deficit indicators of the Central Government, viz., revenue deficit and gross fiscal deficit were significantly higher during April-August, 2009 over the corresponding period of the previous year. Slowdown induced decline in revenue receipts, though, partly contributed to this trend.

External Economy

- External demand continues to be weak. Trade data show that during April-August 2009, merchandise exports and imports declined by 31.0 per cent and 33.4 per cent, respectively, over the corresponding period of the previous year.
- On a balance of payments basis, during the first quarter of 2009-10 while exports declined, imports increased over the preceding quarter, primarily reflecting higher oil prices, resulting in a higher trade deficit. The surplus in net invisibles, led by buoyant remittance inflows financed close to 78 per cent of the trade deficit.
- The current account, thus, remained in deficit of about US\$ 5.8 billion. Reflecting India's resilience to the crisis in 2008-09 and the growth prospects of the economy, capital flows, which had turned negative in the last two quarters of 2008-09, reversed in the first quarter. This ensured financing of current account deficit without any recourse to foreign exchange reserves.
- The rebound in capital inflows persisted through the second quarter of 2009-10. Including valuation gains on foreign exchange reserves and the SDRs allocated by the IMF to India, India's foreign exchange reserves increased by US\$ 32.8 billion during 2009-10 (up to October 16, 2009) to a level of US\$ 284.8 billion.

Monetary Conditions

- The accommodative monetary policy stance adopted by the Reserve Bank in response to the global financial crisis, particularly post-September 2008, has continued so far in 2009-10. The aim of this policy stance has been to provide ample rupee liquidity, ensure comfortable dollar liquidity and maintain a market environment conducive for flow of credit to the productive sectors.

- The liquidity conditions remained in surplus on a sustained basis, which was absorbed by the Reserve Bank through reverse repo operations under the Liquidity Adjustment Facility (LAF).
- Growth in broad money (M3) exhibited modest moderation in the recent period, but at 18.9 per cent (as on October 09, 2009) it remained higher than the Reserve Bank's indicative trajectory of 18.0 per cent for 2009-10.
- On the sources side, monetary expansion was driven by the large borrowing programme of the Government, while bank credit to the commercial sector continued to decelerate (with a growth of 10.7 per cent).

Financial Markets

- Financial markets in India, which functioned normally even at the height of the crisis, posted further decline in risk spreads and higher transaction volumes. The overnight call rate hovered around the floor of the LAF corridor reflecting the abundant liquidity in the system.
- In the collateralised segments, namely, market repo and collateralised borrowing and lending obligation (CBLO), interest rates remained below the inter-bank call rates while there was increase in activities. Volumes in the CP and CD markets also increased.
- In the government securities market, 80.4 per cent of the net borrowing requirement has been completed so far; weak demand for credit in the private sector and comfortable liquidity conditions helped contain the pressures on yields.
- Corporate bond yields increased somewhat but the risk spread fell to the pre-Lehman levels.
- In the credit market, the gradual moderation in lending and deposit rates continued through the second quarter of 2009-10. The flow of credit to the private sector, however, remained sluggish due to subdued overall private consumption and investment demand.
- Flow of resources from the non-banking sources increased marginally, led by domestic sources in the form of issuance of CPs and private placements.
- In the foreign exchange market, the rupee appreciated by about 10.0 per cent against the US dollar over its end-March level.
- Equity market outperformed most of the EMEs in terms of the extent of recovery in stock prices seen since April 2009. The primary market activities also picked up significantly, with higher funds mobilised through public issues and private placements, large oversubscription of certain new issues indicating the return of risk appetite in the market, and manifold increase in mobilisation of resources by mutual funds.

Inflation Situation

- The sharp decline in headline WPI inflation from its peak level of 12.9 per cent in August 2008 had created the space for adoption of growth-supportive accommodative monetary policy to mitigate the impact of the global crisis.
- After remaining negative for 13 consecutive weeks, WPI inflation turned modestly positive in September 2009. Despite the low headline WPI inflation (year on year) at 1.2 per cent (as on October 10, 2009), inflationary pressures have started to emerge, which is evident from WPI showing 5.9 per cent

increase over its March 2009 level and CPI inflation remaining stubbornly elevated at double digit levels.

- The changing inflation environment, however, is being driven by strong escalation in prices of food articles, which have increased by 14.4 per cent (year-on-year) so far. Excluding food items, the WPI inflation remains negative at (-) 3.4 per cent.
- From the stand point of monetary policy, anchoring inflation expectations in the face of sustained high inflation in essential commodities will be a key challenge.

Growth and Inflation Outlook

- The current growth outlook for 2009-10 has both upside prospects as well as down side risks. Upside prospects to growth include the impact of the growth supportive fiscal-monetary policy stance, recovery in industrial production and core infrastructure sector, significant upturn in overall business confidence as per different surveys, strong recovery in the stock market with higher mobilisation of resources, return of capital inflows and improving outlook for the global economy which could boost the sluggish consumer and investor confidence.
- The downside risks include the unexpectedly large deceleration in private consumption demand and some decline in corporate sales in the first quarter of 2009-10, the impact of deficient monsoon and recent flood in certain parts of the country on agricultural output and rural demand, sustained deceleration in credit growth and decline in exports.
- The Reserve Bank's professional forecasters survey points to downward revision to the growth outlook from 6.5 per cent to 6.0 per cent in 2009-10.
- Inflation outlook is currently driven by the emerging signs of inflationary pressures, even though certain developments could neutralise the pressures. These include sluggish aggregate demand and negative output-gap, stabilisation of oil prices in last few months – notwithstanding the increase in October 2009, adequate buffer stocks of foodgrains and the prospects of a better rabi crop that could partly offset the adverse impact of deficient kharif, selective import of certain commodities and the normal trend reversal seen in prices of food articles over different crop seasons.
- Emerging inflationary pressures may also persist and escalate further on account of the fading away of the base effect, cost push pressures through wage-price revisions in the face of elevated CPI inflation, challenges in improving the supply situation of essential commodities in the short-run, gradual pressure on global commodity prices along with global recovery, and rising inflation expectations on account of elevated CPI inflation.
- The overall economic outlook is, therefore, a mixture of upside prospects of recovery and downside risks. Managing the trade-off between supporting growth and reining in inflation expectations poses a complex policy challenge.