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Macroeconomic and Monetary Developments
Third Quarter Review 2008-09

The Reserve Bank today released the document "Macroeconomic and Monetary Developments Third Quarter Review 2008-09" to serve as a backdrop to the Third Quarter Review of Monetary Policy 2008-09.

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

Overview

- The Indian economy, after exhibiting strong growth during the second quarter of 2008-09, has experienced moderation in the wake of the global economic slowdown. Although agricultural outlook remains satisfactory, industrial growth has decelerated sharply and services sector is slowing. The economic slowdown, during the second quarter *vis-à-vis* the first quarter of 2008-09, was primarily driven by a moderation of consumption growth and widening of trade deficit, offset partially by an acceleration in investment demand.
- The balance of payments (BoP) for the first half of 2008-09 reflected a widening of the current account deficit and moderation in capital flows. Net capital inflows reduced sharply and remained volatile during 2008-09 with foreign direct investment inflows showing an increase, while portfolio investments recording a substantial outflow.
- The growth of non-food credit remained high during 2008-09, so far, *albeit* with some moderation in recent months. Continued high growth in time deposits enabled the banking system to sustain the credit expansion while the non-banking sources of funds to the commercial sector declined.
- The total flow of resources from banks and other sources to the commercial sector during 2008-09, so far, has been somewhat lower than the comparable period of 2007-08.
- Financial markets in India, which, by and large, remained orderly from April 2008 to mid-September 2008, witnessed heightened volatility subsequently reflecting the knock-on effects of the disruptions in the international financial markets and the uncertainty that followed. This necessitated the Reserve Bank to undertake a series of measures to inject rupee and foreign exchange liquidity from mid-September 2008 onwards. Liquidity conditions turned around and became comfortable from mid-November 2008.
- Headline inflation has declined in major economies since July/August 2008. In India, inflation measured as year-on-year variation in the wholesale price index (WPI) has declined sharply since August 2008 and was at 5.6 per cent as of January 10, 2009.
- On the macroeconomic front, the downside risks for economic growth emanate from global economic slowdown, deterioration in global financial markets and slowing down in domestic demand. On the positive side, factors include expected increase in consumption demand mainly reflecting rise in basic exemption limits and tax slabs, Sixth Pay Commission awards, debt waiver for farmers and pre-election expenditure. The easing of international oil prices and commodity prices may help in softening the inflationary pressure.

Output

- According to estimates released by the Central Statistical Organisation (CSO) in November 2008, the real GDP growth was placed at 7.6 per cent during the second quarter of 2008-09 as compared with 9.3 per cent during the corresponding quarter of 2007-08, reflecting deceleration in growth of industry and services.
- The Ministry of Agriculture has set a target for foodgrains production for 2008-09 at 233.0 million tonnes. According to the First Advance Estimates, the *kharif* foodgrains production during 2008-09 was placed at 115.3 million tonnes (Fourth Advance Estimates) as compared with that of 121.0 million tonnes during the previous year.
- The index of industrial production during April-November 2008-09 recorded year-on-year expansion of 3.9 per cent as compared with 9.2 per cent during April-November 2007-08. The manufacturing sector recorded growth of 4.0 per cent during April-November 2008-09 (9.8 per cent during April-November 2007-08) and the electricity sector recorded growth of 2.9 per cent (7.0 per cent during April-November 2007-08).
- Available information on the leading indicators of services sector activity during April-October 2008-09 indicate some acceleration in growth in respect of several indicators such as railway revenue earning and freight traffic and export cargo handled by civil aviation as compared with the corresponding period of 2007-08. On the other hand, growth decelerated in respect of cargo handled at major ports and other indicators of civil aviation excluding export cargo, commercial vehicles, cement and steel.

Aggregate Demand

- Aggregate demand in the Indian economy is primarily domestically driven, though exports have been gaining progressively higher importance in recent years. The economic slowdown, during the second quarter *vis-à-vis* the first quarter of 2008-09, was primarily driven by a moderation of consumption growth and widening of trade deficit, offset partially by an acceleration in investment demand. On the other hand, the government consumption expenditure accelerated during the same period.
- According to the latest information on Central Government finances for 2008-09 (April-November), the revenue deficit and fiscal deficit were placed higher than those in April-November 2007 both in absolute terms and as per cent of budget estimates (BE) primarily on account of higher revenue expenditure.
- Tax revenue as per cent of BE was lower than a year ago on account of lower growth in income tax, corporation tax and customs duties owing to economic slowdown. Aggregate expenditure as per cent of BE, was higher than a year ago on account of higher revenue expenditure, particularly, subsidies, defence, other economic services, social services and plan grants to States/Union Territories.
- While expenditure is slated to increase on account of the fiscal stimulus measures undertaken by the Government to address the problem of economic slowdown, growth of tax revenue is likely to decelerate in the coming months of 2008-09 due to moderation in economic activity. The net cash outgo on account of the two supplementary demand for grants is placed at Rs. 1,48,093 crore. This, in turn, will be reflected in the non-attainability of the deficit targets for 2008-09 as envisaged in the Union Budget 2008-09.
- During 2008-09 (up to January 13, 2009), special bonds amounting to Rs.44,000 crore and Rs.14,000 crore have been issued to oil marketing companies and fertiliser companies, respectively.
- Sales performance of select non-Government non-financial public limited companies in the private corporate sector during the first two quarters of 2008-09 was impressive; however, profits performance was subdued as compared with 2007-08. Higher increase in expenditure in relation to sales growth was primarily on account of rising input costs, interest expenses and large provisioning towards mark to market (MTM) losses on foreign exchange related transactions which exerted pressure on profits.

The External Economy

- India's balance of payments position during the first half of 2008-09 (April-September) reflected a widening of trade deficit resulting in large current account deficit, and moderation in capital flows. Merchandise trade deficit recorded a sharp increase during April-November 2008 on account of higher crude oil prices for most of the period and loss of momentum in exports since September 2008. Net surplus under invisibles remained buoyant, led by increase in software exports and private transfers. Net capital inflows reduced sharply and have remained volatile during 2008-09 so far.

- The large increase in merchandise trade deficit during April-September 2008 led to a significant increase in the current account deficit over its level during April-September 2007. The widening of trade deficit during April-September 2008 could be attributed to higher import payments reflecting high international commodity prices, particularly crude oil prices.
- The surplus in the capital account moderated during April-September 2008 reflecting increased gross capital outflows on the back of global financial turmoil. While the net inward FDI (net direct investment by foreign investors) remained buoyant reflecting relatively strong fundamentals of the Indian economy and continuing liberalisation measures to attract FDI, net outward FDI (net direct investment by Indian investors abroad) also remained high during April-September 2008. The gross capital inflows were higher on account of higher FDI inflows and NRI deposits during the period.
- In terms of residual maturity, the revised short-term debt (below one year) comprising sovereign debt, commercial borrowings, NRI deposits, short-term trade credit and others maturing up to March 2009, was estimated at around US $ 85 billion as at end-March 2008.
- According to the provisional data released by DGCI&S, India's merchandise exports during April-November 2008 increased by 18.7 per cent while imports recorded a higher growth of 32.5 per cent, largely due to the rise in petroleum, oil and lubricants (POL) imports. The rise in oil imports was primarily due to the elevated international crude oil prices, while the volume of oil imports moderated. Merchandise trade deficit during April-November 2008 widened to US $ 84.4 billion from US $ 53.2 billion a year ago.
- As of January 16, 2009, foreign exchange reserves at US $ 252.2 billion declined by US $ 57.5 billion over the level at end-March 2008, including changes due to valuation losses.

Monetary Conditions

- Monetary and liquidity aggregates that expanded at a strong pace during the first half of 2008-09 showed some moderation during the third quarter reflecting the decline in capital flows and consequent foreign exchange intervention by the Reserve Bank.
- Growth in broad money (M_3), year-on-year (y-o-y), was 19.6 per cent (Rs. 7,36,777 crore) on January 2, 2009 lower than 22.6 per cent (Rs. 6,91,768 crore) a year ago.
- Aggregate deposits of banks, y-o-y, expanded 20.2 per cent (Rs.6,49,152 crore) on January 2, 2009 as compared with 24.0 per cent (Rs. 6,21,944 crore) a year ago.
- The growth in bank credit continued to remain high. Non-food credit by scheduled commercial banks (SCBs) was 23.9 per cent (Rs.5,01,645 crore), y-o-y, as on January 2, 2009 from 22.0 per cent (Rs.3,79,655 crore) a year ago.
- The intensification of global financial turmoil and its knock-on effect on the domestic financial market, and downturn in headline inflation, necessitated the Reserve Bank to ease its monetary policy since mid-September 2008.
- Reserve money growth at 6.6 per cent, y-o-y, as on January 16, 2009 was much lower than that of 30.6 per cent a year ago. Adjusted for the first round effect of the changes in CRR, reserve money growth was 18.0 per cent as compared with 21.6 per cent a year ago.

Financial Markets

- The crisis in global financial markets deepened since mid-September 2008, triggered by the collapse of Lehman Brothers followed by the failure of a number of other financial firms across countries. The pressure on financial markets mounted with the credit spreads widening to record levels and equity prices crashing to historic lows leading to widespread volatility across the market spectrum. The turmoil transcended from credit and money markets to the global financial system more broadly. The contagion also spilled over to the emerging markets, which saw broad-based asset price declines amidst depressed levels of risk appetite.
- Added to this, there was a significant deterioration in the global economic outlook. As a result, authorities in several countries embarked upon an unprecedented wave of policy initiatives to contain systemic risk, arrest the plunge in asset prices and shore up the confidence in the international banking system. While these initiatives did help in restoring some level of stability, the financial market conditions remained far from normal during the period October-December 2008.
- Liquidity conditions tightened significantly in India between mid-September and October 2008 emanating from adverse international developments and some domestic factors. Financial markets in India came under pressure since mid-September 2008, reflecting the knock-on effects of the disruptions in the international financial markets. This necessitated the Reserve Bank to undertake a series of measures to inject rupee and foreign exchange liquidity from mid-September 2008 onwards.
- Accordingly, money markets in India came under some pressure mirroring the impact of capital outflows and redemption pressures faced by mutual funds and other investors. The pressure on money markets was reflected in call rates breaching the upper bound of Liquidity Adjustment Facility (LAF) corridor but settling back within the corridor by November 2008. Interest rates in the collateralised segments of the money market moved in tandem with but remained below the call rate during the third quarter of 2008-09.
- In the credit market, lending rates of scheduled commercial banks, which had increased initially, started declining in December 2008. Yields in the government securities market also came to soften during the third quarter 2008-09.
- In the foreign exchange market, Indian rupee generally depreciated against major currencies. Indian equity markets witnessed downswings quite in line with trends in major international equity markets.
- The Reserve Bank swiftly initiated a series of measures, which helped to assuage liquidity conditions, while reassuring the market that the Indian banking system continued to be safe and sound, well capitalised and well regulated.

Price Situation

- The accommodative monetary policy, which was pursued by most central banks since September 2008, aimed at mitigating the adverse implications of the recent financial market crisis on economic growth and employment.
- Headline inflation moderated in major economies since July/August 2008 on account of the marked decline in international energy and commodity prices as well as slowdown in aggregate demand emerging from the persistence of financial market turmoil following the US sub-prime crisis.
- After remaining at elevated levels for an extended period, global commodity prices declined sharply since the second quarter of 2008-09 led by decline in the prices of crude oil, metals and food. The WTI crude oil prices have eased from its historical high of US $ 145.3 a barrel level on July 3, 2008 to around US $ 42.3 a barrel as on January 22, 2009 reflecting falling demand in the Organisation for Economic Co-operation and Development (OECD) countries as well as some developing countries, notably in Asia, following the economic slowdown. Metal prices eased further during the third quarter of 2008-09, reflecting weak construction demand in OECD countries and some improvement in supply, especially in China.

- In India inflation, based on the year-on-year changes in wholesale price index (WPI), declined sharply from an intra-year peak of 12.9 per cent on August 2, 2008 to 5.6 per cent as on January 10, 2009. The recent decline in WPI inflation was driven by decline in prices of minerals oil, iron and steel, oilseeds, edible oils, oil cakes, raw cotton.
- Amongst major groups, primary articles inflation, year-on-year, increased to 11.6 per cent on January 10, 2009 from 4.5 per cent a year ago and (it was 9.7 per cent at end-March 2008). This mainly reflected increase in the prices of food articles, especially of wheat, fruits, milk, and eggs, fish and meat as well as non-food articles such as oilseeds and raw cotton.
- The fuel group inflation turned negative (-1.3 per cent) as on January 10, 2009 as compared to an intra-year peak of 18.0 per cent on August 2, 2008. This reflected the reduction in the price of petrol by Rs. 5 per litre and diesel by Rs. 2 per litre effective December 6, 2008 as well as decline in the prices of freely priced petroleum products in the range of 30-65 per cent since August 2008.
- Manufactured products inflation, year-on-year, also moderated to 5.9 per cent on January 10, 2009 as compared with the peak of 11.9 per cent in mid-August 2008 but remained higher than 4.6 per cent a year ago. The year-on-year increase in manufactured products prices was mainly driven by sugar, edible oils/oil cakes, textiles, chemicals, iron and steel and machinery and machine tools.
- Inflation, based on year-on-year variation in consumer price indices (CPIs), increased further during November/December 2008 mainly due to increase in the prices of food, fuel and services (represented by the ‘miscellaneous’ group). Various measures of consumer price inflation were placed in the range of 10.4-11.1 per cent during November/December 2008 as compared with 7.3-8.8 per cent in June 2008 and 5.1-6.2 per cent in November 2007.

Macroeconomic Outlook

- The various business expectations surveys released recently reflect less than optimistic sentiments prevailing in the economy. The results of Professional Forecasters’ Survey conducted by the Reserve Bank in December 2008 also suggested further moderation in economic activity for 2008-09.
- According to the Reserve Bank’s Industrial Outlook Survey of manufacturing companies in the private sector, the business expectations indices based on assessment for October-December 2008 and on expectations for January-March 2009 declined by 2.6 per cent and 5.9 per cent, respectively, over the corresponding previous quarters.
- The global economic outlook has deteriorated sharply since September 2008 with several countries, notably the US, the UK, the Euro area and Japan experiencing recession. In India too, there is evidence of a slowing down of economic activity. Unlike in the advanced countries where the contagion of crisis spread from the financial to the real sector, in India the slowdown in the real sector is affecting the financial sector, which in turn, has a second-order impact on the real sector.
- On the positive side factors include expected increase in consumption demand mainly reflecting rise in basic exemption limits and tax slabs, Sixth Pay Commission awards, debt waiver for farmers and pre-election expenditure.
- WPI inflation has fallen sharply driven by falling international commodity prices especially those of crude oil, steel and selected food items, although, some contribution has also come from the slowing domestic demand. Going forward, the outlook on international commodity prices indicate further softening of domestic prices.

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