# MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2010-11

## *Overview*

### *Global Economic Conditions*

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

*1. 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. The positive sentiments arising from the growth momentum in major advanced economies was neutralised by the persistence of high unemployment and downside risks from weak housing markets and unfinished deleveraging. The combination of developments resulted in additional policy stimulus. While in the US the second dose of quantitative easing (QE2) was followed up with extension of fiscal stimulus, other advanced economies faced a difficult choice between delaying fiscal exit to support growth on the one hand and early exit to contain the sovereign debt concerns on the other. The risk of sovereign debt crisis spreading from the Euro-zone periphery has resurfaced in recent months.*

***EMEs face the risk of inflation from potential overheating and hardening of commodity prices***

*2. Emerging Market Economies (EMEs), which had recovered ahead of the advanced economies, exhibited robust growth momentum driven by domestic demand. Inflation and overheating risks have, however, prompted monetary tightening at varied pace. Commodity prices also firmed up, largely reflecting easy liquidity conditions in advanced economies, as well as growing demand pressures in EMEs.*

*3. The asymmetry in monetary and liquidity conditions between the advanced and the emerging economies and the imbalance in their growth outlook have led to larger capital inflows to EMEs. The familiar policy challenges of asset price inflation and upward pressure on exchange rates have re-emerged. A number of EMEs resorted to soft capital controls and exchange market intervention to limit the adverse impact of excess capital inflows on their economies.*

### *Indian Economy: Developments and Outlook*

***Output***

***Robust broad-based growth puts the economy back on its earlier high growth trajectory but sectoral imbalances pose risks to inflation***

*4. 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 the 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. Core infrastructure sector has grown slower than both the overall GDP and the industrial sector, suggesting that it remains a constraint to higher growth. Capacity utilisation levels have generally remained steady, which juxtaposed with high growth suggests that capacity addition is keeping pace with growth in demand.*

## *Aggregate Demand*

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

*5. 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 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. Lead indicators of private demand, such as corporate sales, capital expenditure plans, non-oil imports and credit demand point to sustained momentum in growth. Weak demand conditions in advanced economies have not affected the domestic growth momentum much in 2010-11 so far, even though global uncertainty remains a downside risk to the growth process.*

## *External Sector*

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

*6. 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. While 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 raises questions about the sustainability of the external sector in the medium-term.*

## *Monetary and Liquidity Conditions*

### *Large primary liquidity injected by the Reserve Bank eased the liquidity pressures without diluting its anti-inflationary focus*

*7. The liquidity conditions had started to tighten by mid-2010 reflecting the normalisation of monetary policy and large increase in Government's surplus balances with the Reserve Bank due to revenues generated through 3G/BWA spectrum auctions. While sustained deficit liquidity conditions were consistent with the anti-inflationary monetary policy stance of the Reserve Bank during the year, the magnitude of the deficit widened significantly in the terminal months of 2010 to the point of posing concerns for growth. 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, including reduction in SLR by 1 per cent of NDTL accompanied by a roughly equivalent amount of OMOs, which remained consistent with its anti-inflationary policy stance. The magnitude of liquidity deficit has moderated in recent weeks.*

*8. The growth in non-food credit has remained above the indicative trajectory of the Reserve Bank since October 2010, reflecting* *growing credit demand associated with robust economic growth. Flow of financing from non-banking sources lagged behind the incremental flow of bank credit. Money supply ($M_3$) growth, however, was slightly below the projected level on account of sluggish deposit growth as well as some moderation in money multiplier resulting from higher growth in currency.*

## Financial Markets

### Deficit liquidity conditions strengthened the transmission of policy rate actions to deposit and lending rates

*9. The global financial markets continued to reflect the uncertainty about sovereign debt sustainability and the changing growth outlook of advanced economies. Markets in EMEs, including India, were influenced more by the domestic growth outlook, normalisation of monetary policy, corporate earnings prospects and the portfolio capital inflows that entailed a potential source of pressure on exchange rate and asset prices. In India, reflecting the tight liquidity conditions, interest rates in the money market, particularly in CBLO, T-bill, CP and CD segments hardened significantly. 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 while also raising the lending rates, which could be expected to moderate the aggregate demand, going forward. Asset prices generally remained firm, notwithstanding some correction in equity prices that partly reflected expectations about monetary policy actions associated with the abrupt reversal in the inflation path. The pace of increase in housing prices varied across cities. The Reserve Bank has recently used macroprudential measures to restrain the role of excessive leverage in asset price build-up.*

## Inflation

### Upside risks from structural demand supply imbalance in certain sectors and firming global commodity prices have increased

*10. WPI inflation had witnessed modest softening during August-November 2010 after remaining in double digits for five consecutive months. 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 Reserve Bank has already recognised the upside risks to inflation from higher global commodity prices, but this hardening happened sooner than anticipated. The pace of moderation in WPI inflation over a few months prior to December 2010 was also weak due to persistent elevated levels of food and fuel inflation, which are largely insensitive to anti-inflationary monetary policy measures. 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. While the high growth in per capita income and the shift in the composition of demand have led to stronger growth in demand for items such as vegetables, fruits, pulses, eggs and meat, the supply response has generally lagged behind. The impact of this imbalance on food inflation has been magnified by rigidities in the supply chain management.*

*11. Non-food manufactured 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 in the year. Besides the expected better supply response in non-food manufactured items to price signals and the pressure of imports, normalisation of the policy rate would have contributed to this trend. High month-over-month (annualised) 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. The factors underlying the inflation process pose a major challenge for monetary policy since the impact of anti-inflationary monetary policy measures on inflation expectations and core inflation could be weakened considerably by structural factors, particularly in an environment of firming global commodity prices.*

## *Growth and Inflation Outlook*

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

*12. The return to the high growth path in 2010-11 materialised despite an uncertain global environment. Though the overall global outlook suggests some moderation in growth in both advanced and emerging economies in 2011, downside risks to India's growth momentum have receded considerably. The inflation outlook, which is being conditioned by both demand side and supply side factors, suggests slow paced moderation in inflation, with the possibility of rigidity at above the comfort level in the near-term. Recognising the need to firmly anchor inflationary expectations and contain inflation, the Reserve Bank has raised policy rates six times since the beginning of 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.*

*13. Going forward, the Reserve Bank's monetary policy measures would have to be guided by not only the anti-inflationary thrust that is necessary in an environment of persistent high inflation, but also their expected effectiveness in a condition of entrenched supply side pressures on inflation. Oil prices moving permanently to a higher trading range looks more probable now. Moreover, sectoral imbalances in several non-cereal food items that reflect weak supply side adjustments in response to rising demand could persist in the near-term, and higher policy rates may not ensure the desirable degree of demand adjustment, even with the usual transmission lags, given the nature of the items in which the imbalances are growing. Aggregate demand side pressures on inflation, however, would have to be contained in a forward looking manner. Recent trends in sales growth and earnings of corporates point to their improving pricing power. MGNREGS, in turn, has the potential to raise the wage bargaining power even in the unorganised sector, particularly in the agriculture and construction sectors, besides raising rural demand at a faster pace relative to production of cereals and non-cereal food items. The demand side risks are also visible in the growing size of the current account deficit, and high inflation differential is a potential factor for eroding export competitiveness.*

*14. Thus, given the fact that elevated inflation and current account deficit are the two major macroeconomic concerns at the current juncture, demand management measures need to acquire centre stage in the near-term, with structural measures in the medium-run addressing sectoral imbalances and export competitiveness. The anti-inflationary focus of monetary policy would have to continue, recognising though the limits of monetary policy in dealing with structural pressures on inflation, and the need for forward looking response to demand side pressures. Since a lower inflation regime is essential for sustainable high growth, containing inflation becomes the dominant policy objective in the current environment.*