MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2008-09

Overview

The Indian economy, after exhibiting strong growth during the second quarter of 2008-09, has experienced moderation since, in the wake of the global economic slowdown. Agricultural outlook remains satisfactory with rabi sowing being higher than the previous year. Industrial growth, however, decelerated sharply during April-November 2008-09 encompassing continued slowdown in all the constituent sectors. The slowdown occurred in the use-based categories, viz., the basic, capital and intermediate goods, while the growth in consumer goods accelerated. The services sector too, which has been the prime growth engine over the years, is slowing, mainly in transport and communication, trade, hotels and restaurants sub-sectors.

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 fixed investment demand. On the other hand, the government consumption expenditure accelerated during the same period. The progress of Central Government finances indicated a widening of both gross fiscal deficit and revenue deficit during 2008-09 (April-November) over the same period of 2007-08. The external demand conditions weakened as reflected in deterioration in net exports. The merchandise trade deficit widened during April-November 2008 on account of higher crude oil prices for most of the period coupled with loss of momentum in exports since September 2008.

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. As on January 16, 2009, India's foreign exchange reserves at US $ 252.2 billion showed a decline of US $ 57.5 billion, including valuation losses, over end-March 2008 level. India's external debt indicators as well as the level of foreign exchange reserves, however, continue to be comfortable.

Monetary aggregates witnessed some moderation during the fiscal year 2008-09. Intra-year movements in reserve money largely reflected the Reserve Bank's market operations and movements in bankers' deposits with the Reserve Bank in the wake of changes in the CRR. The growth of non-food bank credit remained high, albeit, with some moderation in recent months.

Continued high growth in time deposits enabled the banking system to sustain the credit expansion while the flow of resources from 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. In order to facilitate bank lending, several counter cyclical measures taken earlier were reviewed in view of the prevailing macroeconomic, monetary and credit conditions and measures were announced to strengthen credit delivery while maintaining credit quality.

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. Liquidity conditions tightened significantly between mid-September and October 2008, emanating from adverse international developments and some domestic factors. Consequently, the money markets in India came under some pressure, the Indian rupee generally depreciated against major currencies and the equity market continued to witness downswings in consonance with volatility in major international equity markets. 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), 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 on account of decline in fuel, metals and select food items prices. The decline in prices of most of these commodities was in line with the decline in international commodity prices since July 2008. Some contribution to recent decline in WPI inflation has also come from the slowing domestic demand. 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 8.5-10.3 per cent in August 2008.

On the macroeconomic front, the downside risks for economic growth emanate from the ongoing global economic slowdown, and deterioration in global financial markets along with the corresponding slowing down in domestic demand. On the other hand, some positive 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. While the downside risks would be extending to the future, the fall in commodity prices including oil prices and the coordinated fiscal and monetary stimulus are expected to revive the growth momentum. The easing of international oil prices and commodity prices may help in softening the inflationary pressure.