

Summary of the Second Quarter Monetary Policy Review 2009-10

Overview of Macro-Economic Developments

Global Economic Conditions

- ⇒ Global recovery is widely perceived to remain slow and gradual, with receding but significant downside risks. For several advanced economies the pace of contraction in output has declined in the second quarter of 2009. 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.
- ⇒ The global financial markets which had witnessed signs of stabilisation in Q2 of 2009 further extended the steady improvement in Q3 of 2009 with significant reduction in liquidity and credit risk across asset classes, though some segments in the credit and mortgage markets still remain weak.
- ⇒ The equity markets in developed as well as EMEs have witnessed perceptible recovery and reduced volatility since March 2009, with intermittent corrections. Both Dow Jones and NASDAQ equity indices recorded around 16 per cent rise during Q3 of 2009 over the preceding quarter.
- ⇒ Both sovereign and corporate (financial and non-financial) credit spreads narrowed further, indicating significant drop in risk and liquidity premiums; lower risk spread and improved market liquidity helped in lifting the pace of domestic as well as international bond issuances by the corporates.
- ⇒ Between end-March 2009 and October 20, 2009, the US dollar depreciated by 11.1 per cent against the euro, 12.6 per cent against the pound sterling and 7.8 per cent against the Japanese yen. The US dollar also depreciated against Indian rupee, Korean won and Thai Baht. The US dollar registered significant depreciation against South African Rand, Brazilian real, Mexican peso, Turkish lira and Russian ruble.
- ⇒ The EME currencies witnessed appreciating trend in Q3 of 2009, reflecting in part their relative attractiveness to foreign investors for higher yields.

Indian Economy

Growth

- ⇒ India's **GDP growth** during the first quarter of 2009-10 at 6.1 per cent represents a modest recovery from the 5.8 per cent growth registered during the preceding two quarters.
- ⇒ The **industrial sector** has started exhibiting recovery, with 10.4 per cent growth in August 2009 and 5.8 per cent growth during April-August 2009, as against 1.7 per cent and 4.8 per cent during the corresponding periods of the previous year, respectively, driven by Basic, Intermediate and Consumer durable goods. Growth in core infrastructure witnessed notable acceleration in August 2009, and the growth over April-August 2009 was higher at 4.8 per cent as against 3.3 per cent during the corresponding period of the previous year, mainly driven by Mining & Electricity output.
- ⇒ The deficient monsoon coupled with recent floods in some States and their expected adverse impact on the kharif **agricultural production**, however, entail downside risk for the overall growth prospects.
- ⇒ Lead indicators of **services sector** activities also suggest some pick up in growth momentum for services relating to construction and telecommunications.

Demand

- ⇒ The 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, compared to 4.5 per cent a year ago.

- ⇒ **Government consumption**, which had increased sharply in Q3 and Q4 of 2008-09 due to the fiscal stimulus measures and the Sixth Pay Commission payouts, also decelerated in Q1 of 2009-10.
- ⇒ Gross fixed capital formation (**GFCF**) which had peaked to 12.5 per cent in the second quarter of 2008-09, witnessed sharp deceleration in growth to 4.2 per cent.
- ⇒ Combined finances of the Central and State Governments budgeted for 2009-10 indicates that the **key deficit indicators** as per cent of GDP would remain at the elevated levels as in 2008-09; the combined revenue deficit and fiscal deficit as percent of GDP in 2009-10 would increase by 1.1 and 1.3 percentage points to 5.5 per cent and 10.2 per cent, respectively, while the Central Government's Fiscal deficit is estimated at 6.8 per cent as against 6.0 per cent in the previous year.
- ⇒ An analysis of the performance of select non-financial non-government companies showed that the **sales growth**, that had been substantial in the first and second quarters of 2008-09, witnessed sharp deceleration post-September 2008 on account of falling demand and confidence; sales growth, turned negative in the first quarter of 2009-10, to almost -1 per cent compared to 29.3 per cent in the corresponding quarter last year, while growth in **PAT** was at 5.5 per cent in the first quarter of 2009-10 compared to 7 per cent.
- ⇒ Merchandise trade deficit during April-August 2009 stood at US \$ 38.2 billion, which was lower by 37.1 per cent than US \$ 60.7 billion in April-August 2008, due to relatively larger year-on-year decline in imports than exports during the period.

Monetary Conditions

- ⇒ **M₃ growth** was 18.9 per cent as on October 9, 2009 as compared with 20.9 per cent a year ago, mainly reflecting the sustained expansion in aggregate deposits during this period, particularly Time deposits.
- ⇒ Much of the financial year expansion in broad money (M₃) during 2009-10 (up to October 9, 2009) (which was 8.0 per cent as compared with 7.7 per cent during the corresponding period of the previous year) resulted from the increase in commercial banks' credit to the Government.
- ⇒ Scheduled commercial banks' **investment in SLR securities** expanded by 40.9 per cent (y-o-y) as on October 9, 2009, as compared with 3.2 per cent a year ago, driven by the higher market borrowing by the Government.
- ⇒ **Bank Credit to the Commercial Sector** during 2009-10 (up to October 9, 2009) grew at 4.8 per cent as compared with 9.1 per cent growth shown during the corresponding period of the previous year, while total flow of resources from non-bank sources has recorded an increase.
- ⇒ Consistent with its accommodative monetary stance, the Reserve Bank expanded its domestic assets through open market operations (OMO) and unwinding of market stabilisation scheme (MSS) securities to provide primary liquidity to support the required monetary expansion. Several measures taken by the Reserve Bank since mid-September 2008 have augmented actual/potential **liquidity** in the system on the aggregate by Rs.5,85,000 crore.
- ⇒ The effectiveness of the growth-supportive accommodative monetary policy stance was evident from sustained high growth in broad money and the daily absorption of **excess liquidity** (in excess of Rs.1,00,000 crore on average) throughout the second quarter of 2009-10.

Financial Markets

- ⇒ Financial markets in India, which functioned well even at the height of the crisis, showed 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.
- ⇒ The gradual increase in **secondary market yield** across the maturity spectrum was evident during Q2 of 2009-10. Between end-June 2009 and end-September 2009, the yield on 1-30 year maturity increased between 16-70 basis points. The yield curve continued to reveal moderation in rates towards the short end on account of prevalence of abundant liquidity in the financial system. However, the medium to long-term yields hardened on concerns of large fiscal deficit.
- ⇒ **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.
- ⇒ The weighted average **BPLRs** of public sector and private sector banks exhibited a decline after September 2008, falling from about 16.4 per cent to 15.3 per cent for Private sector banks and from about 14 per cent to 12 per cent for PSU banks.
- ⇒ 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 (mainly by PSUs, while private sector mobilisation almost halved) 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

- ⇒ The **WPI inflation**, which had turned negative by the first week of June 2009, remained so for 13 consecutive weeks before moving up to above zero in September 2009. Unlike the volatile pattern in WPI inflation, CPI inflation continues to remain high in the range of 11.7 per cent to 13.2 per cent during August/September 2009. (The greater divergence between WPI and CPI inflation could be attributed to the higher weight in CPIs of food articles, which have displayed higher inflation in recent months.)
- ⇒ Amongst the major groups, primary articles inflation, y-o-y, was higher at 8.6 per cent as on October 10, 2009 from 5.2 per cent at end-March 2009, mainly on account of **food articles** which registered double-digit inflation. Vegetable prices recorded an increase of around 59.3 per cent over end-March 2009.

Growth Outlook

- ⇒ 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

- ⇒ Developments that could **neutralise inflationary** pressures include sluggish aggregate demand and negative output-gap, stabilisation of oil prices, 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 baseline **projection for WPI** inflation at end-March 2010 is placed at 6.5 per cent with an upside bias.

Monetary Policy Measures

Reserve Bank has decided to keep

- ✓ the policy **repo rate** unchanged at 4.75 per cent,
- ✓ the **reverse repo rate** unchanged at 3.25 per cent and
- ✓ the **CRR** of banks unchanged at 5 per cent of their NDTL.

The following measures constitute the first phase of 'exit':

- ✗ The statutory liquidity ratio (**SLR**), which was reduced from 25 per cent of demand and time liabilities to 24 per cent, is being restored to 25 per cent.

- ✗ The limit for **export credit refinance** facility, which was raised to 50 per cent of eligible outstanding export credit, is being returned to the pre-crisis level of 15 per cent.

- ✗ The two unconventional **refinance facilities**: (i) special refinance facility for scheduled commercial banks; and (ii) special term repo facility for scheduled commercial banks [for funding to mutual funds (MFs), non-banking financial companies (NBFCs), and housing finance companies (HFCs)] are being discontinued with immediate effect.

- ✗ Further, the liabilities of scheduled banks arising from transactions in collateralised borrowing and lending obligations (**CBLO**) with Clearing Corporation of India Ltd. (CCIL) would now be subject to the maintenance of the cash reserve ratio (**CRR**).

- ✗ Increasing the provisioning requirement for advances to the **commercial real estate** sector classified as 'standard assets' from 0.4 per cent to 1.0 per cent.

Read the entire report at <http://rbi.org.in/scripts/NotificationUser.aspx?Id=5326&Mode=0>

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