Y V Reddy: The outlook for Indian economy - an update

Speech by Dr Y V Reddy, Governor of the Reserve Bank of India, at the 76th Annual General Meeting of the Federation of Indian Chambers of Commerce & Industry (FICCI), New Delhi, 7 January 2004.

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Friends, I am thankful to President Mr. Muthiah for giving me the opportunity to address the 76th General Meeting of FICCI. I had the privilege of addressing FICCI in New Delhi about a year ago (October 24, 2002), at the invitation of Mr. Lodha and the subject was, if I recall right, "World Economic Outlook and Financial Market Developments – Implications for India". Today, I will share with you Reserve Bank of India's latest assessment of outlook for Indian economy for the rest of the current fiscal year, while no doubt also capturing some global developments.

You may recall that on November 3, 2003, we set out the Mid-Term Review of Monetary and Credit Policy for the year 2003-04. The first part of the Statement, as in the past, provided a mid-year Review of the macroeconomic and monetary developments of the economy with a focus on the outlook for 2003-04. In that light, the stance of the monetary policy set out in April 2003 was left unchanged. Today, I propose to place before you an update on the outlook for the Indian economy in the light of developments since November 3, 2003. The structural reforms mentioned in Part-III of the Mid-Term Review will not be part of the presentation today, though they remain important in achieving the progress that we anticipate.

It may be recalled that at the time of the Mid-Term Review, there was reasonable expectation of an overall GDP growth of 6.5 per cent to 7.0 per cent, with an upward bias, for the year 2003-04. This projection was actually an upward revision from the earlier projections of around 6.0 per cent made in the April Policy Statement. At the time of the Mid-Term Review, Central Statistical Organisation (CSO) estimates of GDP growth were available for the first quarter of 2003-04. These estimates placed the first quarter growth at 5.7 per cent over the GDP in the corresponding quarter of the preceding year. We made an upward revision in our growth assessment as several other indicators that pointed to acceleration in real economic activity were available. The second quarter estimates that have recently been released by the CSO validate our view of high growth in 2003-04. The impressive real GDP growth of 8.4 per cent in the second quarter places us firmly amongst the fastest growing economies in the world during the current year. More importantly, the second quarter estimates show that buoyancy has been spread across most sectors of the economy and is not confined merely to agriculture, which still accounts for most of the rebound. The manufacturing sector has recorded a significant growth of 7.3 per cent in the second quarter of 2003-04, continuing the sustained acceleration from the low of 2.9 per cent growth registered in first quarter of 2001. The improved prospects for real activity globally should add strength to the upward momentum in growth. On balance, therefore, there is room at this juncture for greater optimism in growth prospects than before. It is reasonable to expect that unless there are unforeseen circumstances, the overall GDP growth for the year 2003-04 as a whole, which was estimated at 6.0 per cent at the beginning of the year and 6.5-7.0 per cent in November is, on latest assessment, likely to be higher and around 7.0 per cent with a continued upward bias.

Inflation is the other key parameter that is taken into account in monetary policy formulation and it is measured primarily in terms of variation in the wholesale price index (on a point to point basis). The Mid-Term Review had placed the inflation projections for policy purposes in the range of 4.0 per cent to 4.5 per cent with a possible downward bias. It was also mentioned that the RBI would continue to closely monitor the price behaviour leaving no room for complacency on the inflation front. As you are aware, the annual rate of inflation was 6.7 per cent at the time the April policy projections were made and it continued in the range of 6.3-6.9 per cent for nearly two months thereafter. It, however, declined to around 4.0 per cent in August, before climbing back to 5.0 per cent or more since September 20, 2003. Inflation rate has risen further since the Mid-Term Policy on November 3, 2003 and as on December 20, 2003, the point-to-point inflation rate was 5.6 per cent. The inflation trends in the last two months have not been unexpected but, the magnitude of price rise has been above the original expectations.

The increase in inflation in the last two months appears to be mainly on account of fruits, vegetables, mineral oils, fuels, and cotton textiles. Two important international factors have contributed to more than the unanticipated upward pressure on prices. First, international oil prices have remained firm.

The average price of OPEC basket had reached US$29.5 a barrel at the end of 2003, while US prices are hovering around US$32 a barrel. The global oil prices today are thus about 10 per cent higher than they were at the time of the Mid-Term policy Statement. The outlook for oil prices in the near term appear highly uncertain. Secondly, world primary commodity prices have also increased in 2003. These trends, along with revival of growth and falling excess capacities in several advanced economies have brought about a noticeable shift in the outlook for prices. The fear of deflation in advanced economies has been replaced by a possible upward pressure, led by increases in commodity prices. No doubt, these international developments enhance the probability of international transmission of inflation. At the same time, there are three favourable factors to counter these recent adverse global developments. First, in the normal course, it is expected that the inflation rate would fall in the period mid-January to March 2004. Secondly, there are cushions in terms of food stocks and ample forex reserves. Thirdly, our economy has, in recent years, shown remarkable resilience in absorbing shocks including on the oil front. In view of all these factors, it is possible that the downward bias may not be attainable but it appears that the range of 4.0 per cent to 4.5 per cent for inflation indicated in the Mid-term Review continues to be relevant for policy purposes unless there are unanticipated severe shocks. It may be noticed that the policy assumption in April 2003 was 5.0-5.5 per cent and the latest assessment placing it in the range of 4.0-4.5 per cent demonstrates that, overall, inflationary situation continues to be benign for 2003-04.

There has been a marginal improvement in central government finances since the Mid-Term policy Statement. The gross fiscal deficit of the Central Government as at the time of Mid-term Review which was higher by 40.3 per cent (based on fiscal data available up to September 2003) is now higher by 12.3 per cent (based on fiscal data available up to November 2003) over the corresponding periods of last year. Similar improvement is also seen on the revenue account, which was higher by 37.4 per cent, is now higher by 13.0 per cent over the same periods under reference. The gross fiscal deficit of the Central Government may get relief by virtue of the debt swaps of the State Governments but a clearer picture would be evident in the next few months. At this juncture, it is necessary to reiterate the importance of pursuing promptly, and with resolve, fiscal consolidation for the medium term.

There are some signs of pick up in credit off-take in recent months. scheduled commercial banks' non-food credit, in the current financial year, increased by 8.1 per cent by mid-December [upto Dec. 12, 2003], as compared with an increase of only 2.7 per cent upto mid-September [upto Sept. 19, 2003]. While credit expansion till Mid-September this year was clearly lower than in the corresponding period of last year, the credit expansion in three months since then, i.e. between mid-September and mid-December has been nearly 50 per cent more than in the corresponding period of last year. The total resource flows to the commercial sector in 2003 so far, i.e., up to end-November 2003 has been higher than last year by Rs.3,058 crore. There are continued indications of a shift in corporate financing pattern in recent years with increased reliance on internal finance and on external borrowing.

Consistent with these developments, in the current financial year up to December 26, 2003, money supply (M3) remained with an increase of 10.1 per cent as compared with 10.1 per cent in the corresponding period of the previous year. Reserve money increased by 6.9 per cent this year so far as against an increase of 1.5 per cent in the corresponding period of the previous year, mainly reflecting the large capital inflows and consequent increase in RBI's net foreign currency assets.

The financial markets continue to remain generally stable. While the average daily absorption in the repo transactions under the Liquidity Adjustment Facility (LAF) during the year continue to be in the same range during the last two months as it was in previous months, the average call money rate moved down by a little over 20 basis points. The yield on treasury bills of different maturities has declined, while the yield on Government securities with 10-year residual maturity has marginally firmed up since November 2003. In fact, a slight steepening of the yield curve is noticeable with shifts in yield at the very long-end. By and large, the behaviour of the fixed income market has been in consonance with the monetary policy stance.

In the light of expectations in the monetary policy about a reduction in the lending rates, there is some evidence of a commitment by banks to reduce the Prime Lending Rates (PLRs) in January, 2004. Following the introduction of the benchmark PLR (BPLR) concept, 11 public sector banks have already announced their BPLR while the rest have assured the Indian Banks Association (IBA) that they will similarly announce their rates. As a result, the new BPLRs are now lower by 25-50 basis points. The progress in regard to movement of interest rates by the banking system has been largely in consonance with policy expectations. While no direct link can be established between lending rates and credit off-take, simultaneous and intensive efforts will have to be undertaken by the banking system to remove the procedural and transactional rigidities in the delivery of credit, particularly to agriculture and small industries. A noteworthy feature of credit off-take has been the impressive increase in priority sector lending in the current financial year and this has posted the highest growth in recent years. There is scope for further improvement in regard to both credit pricing and credit delivery. Efforts by RBI, with close co-operation from banks, will have to be intensified.

Now, let me turn to external developments. Since the Mid-term Review, the prospects for the world economy have improved further, while at the same time, the uncertainties relating to the currency movements of major currencies have increased. Whereas the monetary policy in many countries has moved to mild tightening in some countries, in others there is a neutral bias with expectations of tightening, particularly in the U.S., with no firm indication on the timing. These uncertainties would necessarily have an impact on global liquidity as well as the flow of resources to emerging countries including India. As far as India is concerned, the relative weight of the fundamentals and confidence in the economy appears to be more than the global liquidity factors that govern the capital flows. As such, on current reckoning, for us there could be some moderation, but no dramatic deceleration, in capital inflows.

The Indian forex market generally continued to witness orderly conditions during recent months. At the time of the mid-term policy, the exchange rate of the rupee, over the end-March 2003 levels, had appreciated by 4.8 per cent *vis-à-vis* the US dollar but depreciated by 2.3 per cent against the Euro, 2.5 per cent against the Pound Sterling and 4.2 per cent against the Japanese Yen. During November-December 2003, the US dollar has depreciated by 7.9 per cent against the Euro, 4.7 per cent against the Pound Sterling and 3.0 per cent against the Yen. During November-December, 2003, the rupee has depreciated against all these currencies; by 8.5 per cent against the Euro, 5.3 per cent against the Pound Sterling and 3.6 per cent against the Yen and by only 0.6 per cent against the US dollar. It is, therefore, clear that the phenomenon in the last few months should appropriately be described as a significant depreciation of the US dollar. In general, the adjustment in the US dollar, which was considered to be essential, seems to have taken place in large measure in a non-disruptive manner so far. There are, however, emerging pressures on the distribution of the burden of adjustment mainly between US, Euro area, and Asia, especially Japan and China.

Under these circumstances, there appears to be considerable merit in continuing with our policy of exchange rate management of the rupee addressing essentially the volatility issues without a fixed target. As a result of this policy of exchange rate management, in the context of maintaining orderly conditions in the forex markets, the foreign exchange reserves increased by US $8.0 billion during November-December 2003. As mentioned in my recent address at the Bank Economists Conference, considering the state of markets and the capabilities of the market participants in our country, non-volatility in financial markets has to be treated as a public good and perhaps it is worthwhile reiterating this today.

The growth rate in our exports in the current financial year continue to be around half of what it was in the corresponding period of last year. Though half, the export growth of 8.8 per cent during April-November 2003 is on top of an increase of 18.0 per cent in the corresponding period of last year. In November 2003, export growth accelerated to 13.7 per cent, which was higher than 10.8 per cent growth in November 2002. On current reckoning, the prospects for exports appear to be as anticipated two months ago.

Imports have accelerated this year on the back of revival of domestic economy [22.0 per cent in US dollar terms during April-November 2003]. Oil imports in US dollar terms are higher by 12.4 per cent. Non-oil imports have increased at a high rate of 26.5 per cent. Detailed commodity data available till August shows that during the first five months of the current financial year, non-oil, non-gold import increased by 23.1 per cent as compared with an increase of 11.9 per cent in the corresponding period last year. The trade deficit in the current financial year so far has widened, in fact is double of last year. The current account, however, remains in surplus on account of robust invisible earnings.

It will be useful to conclude this presentation with an overall assessment. The macroeconomic environment has continued to improve during the year. It has reinforced the positive outlook on the domestic economy, though some uncertainties prevail in regard to global environment. Furthermore, comfort can be drawn from the fact that the Indian economy has demonstrated considerable resilience to exogenous shocks in recent years. The optimism reflected in business confidence surveys at the time of Mid-Term Policy Review seems to have been further enhanced and the credit rating agencies have taken positive note of recent developments. The inflation outlook by and large remains benign, though careful monitoring and management would have to continue with a view to cushion supply shocks and better manage supply bottlenecks for individual commodities so that price volatilities are evened out. The money, government securities and forex markets remain stable. The foreign exchange reserves are at a more comfortable level than ever before and there is adequate liquidity in the system. The yield curve has slightly steepened. These gains can be, however, consolidated with further progress in regard to credit delivery and credit pricing. Moreover, investment activity, both in the public and private sectors has to pick up to enable sustained acceleration in growth.

In brief, I would like to submit that the monetary policy stance set out earlier in April 2003, has served us well so far. In fact, growth in GDP for 2003-04 which was estimated at 6 to 6.5 per cent at the beginning of the year, now appears to be around 7.0 per cent with an upward bias; while inflation which then was assumed to be in the range of 5.0 to 5.5 per cent may now be in the range of 4.0 to 4.5 per cent. Assuming that there are no unexpected adverse developments, there is merit in maintaining the *status quo* as far as the monetary and credit policy measures are concerned, while pursuing with the reform process. Hence, unless unforeseen circumstances emerge, the current measures should in the normal course remain till the next Monetary and Credit Policy in April 2004. Against this backdrop, the Reserve Bank expects the growth momentum to be reinforced, inflation to be contained as indicated, financial stability continued to be maintained and external sector to perform well. In conclusion, may I say that the overall developments in the economy are favourable and provide the main springs for a strong revival of investment by industry?

Thank you.