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Economic Weekly



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Indian Economy

PMEAC Puts 2010-11 Forecast At 8.5%

The Prime Minister's Economic Advisory Council (PMEAC), headed by former Reserve Bank governor C Rangarajan, released its outlook for 2010-11. It revised the growth outlook upwards from 8.2% in February 2010 to 8.5% now. For 2011-12, the outlook was kept unchanged at 9%. The PMEAC observes that as global prospects are still weak, India needs to promote business confidence and facilitate investments, in order to return to the 9% growth path. Hence, the outlook depends on two critical factors -- confidence and investments.

The highlights of the report are:

Sectoral Growth

- **Agriculture:** The PMEAC expects this sector to grow 4.5%. For agriculture, projections depend on the southwest monsoons. As the Met department has been saying that rains have been normal so far, a strong rebound in kharif and rabi crops is expected. The other factors that should push growth are better seed and fertiliser availability and construction of a large number of water harvesting structures through the NREGA programme. A low base effect should also help generate a growth of around 4.5% in 2010-11.
- **Industry:** The council expects industrial growth to ease as the base-effect wears off from June 2010 onwards. It expects industry to grow 9.7% in 2010-11.
- **Services:** The services sector is expected to pick up thanks to growth in the construction, trade and hotels sub-sectors. It expects services to grow 8.9% in 2010-11, higher than the 8.5% of 2009-10.

Inflation

The PMEAC says inflation has been a major concern for the economy in the past year. WPI inflation has moved from just food price-driven to manufactured products. CPI inflation has remained in double digits for a long time. However, the council expects inflation to come down because of better monsoon, which will lower food prices. This, combined with the base-effect, will let inflation fall to around 6.5% by March 2011. The PMEAC also said that RBI policies will be biased towards tightening inflation.

Government Finances

In the past, PMEAC has been critical of the way the government has managed its finances. According to the council, this year the actual fiscal and revenue deficits could be lower than government projections. This is because of higher-than-expected collections from 3G and Broadband Wireless Access auctions.

For 2010-11, the PMEAC projects consolidated fiscal deficit at 8.4%, much lower than the 10.2% figure in 2009-10. Revenue deficit is also expected to decline from 6.3% in 2009-10 to 4.6% in 2010-11. It highlighted two main challenges for policymakers ahead. First, proceeds from alternative sources such as 3G auctions will not be available next year and stringent curbs need to be taken to contain expenditure. Second, only strong fiscal discipline can lead to fiscal targets set by the 13th Financial Commission.

External Sector

The PMEAC expects exports to grow from \$182.2 billion in 2009-10 to \$216.1 billion in 2010-11. Imports are expected to grow from \$299.5 billion in 2009-10 to \$353.9 billion in 2010-11. As a result, trade deficit is expected to widen from \$117.3 billion to \$137.8 billion. Earnings from invisibles had declined from \$89.9 billion in 2008-09 to \$78.9 billion in 2009-10. This is expected to rebound and increase to \$96 billion.

Despite a surge in invisibles, current account deficit has widened because of increase in imports. The current account deficit will widen to \$41.8 billion from \$38.4 billion in 2009-10. Capital account is expected to increase to \$72.8 billion because of expected increase in FDI. FII inflows are expected to moderate in 2010-11.

This implies that the balance of payment surplus is expected at \$30.9 billion in 2009-10. However, the PMEAC does not see the surplus capital flows as a concern. It says balance capital flows can readily be absorbed by the financing needs of the Indian economy. It does not pose serious problem to exchange rate management. It also expects that RBI will continue to manage the exchange rate environment to reduce excessive volatility.

Others

The PMEAC also highlighted two areas that need immediate policy action – raising farm productivity and completing shortfalls in infrastructure projects. Within infrastructure, creating additional capacity in power is highly critical.

For further details visit: http://eac.gov.in/reports/ecoout_1011.pdf

RBI Q1 FY10 Monetary Policy Review

The Reserve Bank of India (RBI) will release the Q1 review of the monetary policy and macro-economy on July 27, 2010. Market participants expect RBI to increase both the repo and reverse repo rates by 25 basis points (bps) each to 5.75% and 4.25% respectively.

The markets expect RBI to maintain the cash reserve ratio (CRR) at 6%, given the persistent deficit liquidity conditions.

RBI has been increasing interest rates for three reasons:

1. Inflation and inflationary expectations are building up;
2. Growth numbers (such as IIP and GDP) have been robust;
3. To normalise interest rates. RBI lowered its policy rates aggressively during the global financial crisis two years ago. As the conditions steadily improved, RBI began to raise interest rates. Real interest rates (nominal rate minus inflation) are still negative, implying that more rate hikes may be needed. But, as the global economy still faces huge uncertainties, RBI has adopted a gradual pace towards normalising interest rates.

We had done a recap of the Indian and global economies when RBI raised policy rates on July 2, 2010 (see edition dated July 5, 2010). Since then there have been two main data releases – WPI monthly inflation and IIP. Both were lower than market expectations, yet fairly high.

Again, the challenge for RBI will be to lower high inflation and inflationary expectations, amid global uncertainty. Let us review the conditions against which RBI decides to tweak or not tweak its monetary policy.

Domestic Economy

- IIP data for May 2010 stood at 11.5% -- significantly lower than market expectations of 16%. Market players now expect IIP growth to slow down as companies take a break from the record production levels. The index levels still remain high.
- WPI inflation has continued to surge and stood at 10.55% in June 2010. It was also lower than market expectations of around 10.8%. The inflation figure continues to be revised upwards. For April 2010, it was revised upwards from 9.59% to 11.23% and the March 2010 numbers were revised upwards from 9.9% to 11.04%. Chances are that the June numbers too will be revised upwards to around 11.5%. Hence, overall inflation is much higher than what the provisional figures show. Core inflation has surged from -0.8% in November 2009 to 7.3% in May 2010. Core inflation itself is higher than RBI's projected March-end 2010 inflation rate of 5.5%.
- CPI inflation has declined, but still remains in the 13.6-14.5% range. Moreover, the decline is on account of the base effect, as indices continue to rise. Overall, significant inflation pressures remain.
- However, there is a positive news on the monsoon front. Rainfall, till now, has been better than last year. The cumulative seasonal rainfall for the whole country up to July 21, 2010, has so far been 14% below the long period average (LPA). Of the 36 meteorological subdivisions, rainfall has been excess in over 50, normal in over 21 and deficient in 10. Although it has been below normal for the whole country, areas such as Punjab have got excess rainfall. Hence, expectations are that supply-side pressures on food and food prices will be lower.
- High growth, coupled with high inflation, is a strong factor for RBI to hike interest rates. There were two points that made the RBI move uncertain – liquidity position and global economic outlook (explained later). Money markets have been facing deficit liquidity since June. The situation worsened because of money outflows due to payments for the 3G and broadband wireless access spectrum auctions and tax outflows. Since then, the deficit in liquidity has hovered around Rs 50,000-70,000 crore. Money market rates have moved up because of this. Hence, markets were not sure whether RBI would increase its policy rates.

The deficit was expected to be temporary and liquidity was expected to come back in the system from mid-July 2010 onwards. However, the deficit in liquidity persists.

RBI extended the second liquidity adjustment facility till July 30, 2010. But as the liquidity deficit continues, it is expected that the second LAF facility will be further extended. There is an interesting point made by some market participants: why should RBI increase the repo rate under this deficit liquidity situation and make it further costlier for banks? They suggest that RBI should only be increasing its reverse repo rate and not tax the banking system further.

- Growth in non-food credit has surged and touched 22.1% in the fortnight ended July 2, 2010. This is much higher than RBI's projected growth of 20% for March 2011. Much of this growth is because of payments made for 3G auctions and BWA spectrum.

	RBI Projection for end of March 2011 (YoY, in %)	Growth as on July 2, 2010 (YoY, in %)
Money supply	17	16
Non-food credit	20	22.1
Deposits	18	15

Source: RBI

On the other hand bank deposits have grown by 16%, lower than the growth of credit. That figure is also lower than RBI projections of 18%. Time deposits form around 87% of the total deposits and have been growing at around 13.6%. As bank deposits form the bulk of money supply (M3), it is also assumed to be growing at around 16%.

Global Economy

The global economy is at a critical juncture. The European Union released the results of a stress test conducted on 91 select banks. Only seven banks failed the test – five in Spain and one each in Germany and Greece. As the results were released on late Friday, analysis and comments are still pouring in.

European policymakers say the tests prove that things are not as bad with European banks as it was made out to be. So, markets should improve now and not be so pessimistic over Europe. However, some have called the stress tests 'soft' and even alleged that there is a lot of window dressing of balance sheets. Hence, a more refined analysis will be made only after markets open on Monday.

Economic data from the US have again worsened since June. US Fed chairman Ben Bernanke recently termed the US economic outlook as highly uncertain. Some economies — such as those of the US, UK and the Euro area countries — are still hurting and an increase in interest rates looks like a remote possibility. However, growth has picked up in some economies and their central banks raised rates recently. New Zealand, Canada, Sweden and Chile are examples.

The question being debated currently is whether economies should impose fiscal austerity plans or not. Proponents say, given the high debt levels austerity will infuse confidence in markets. However, naysayers point that there is huge stress in economies and fiscal austerity will backfire, given the similar experiences in Japan and during the Great Depression. Given this background, RBI is expected to continue to increase its interest rates. But with global uncertainty still very high and economies recovering mainly because of stimulus packages, the outlook is still hazy.

Sub-Group Inflation Trends

- **Primary articles:** The primary articles index for the week ended July 10, 2010, increased sharply from 306.2 to 307.5 (WoW). The primary articles' inflation increased to 16.48% (YoY). Primary articles is broadly divided into two sub-sectors -- food and non-food articles:

WPI Sub-group Inflation At A Glance				
	Index (week ended, in units)		Rate of Inflation (YoY, in %)	
	Jul 3, 2010	Jul 10, 2010	Jul 3, 2010	Jul 10, 2010
Primary Articles	306.2	307.5	16.25	16.48
◆ Food Articles	295.8	297.6	12.81	12.47
◆ Non-Food Articles	288.2	288.1	18.85	20.75
Fuel Group	386.7	386.7	14.27	14.27

Source: Commerce Ministry

- ◆ **Food articles:** The food articles index for week ended July 10 increased from 295.8 to 297.6 (WoW). The food articles' inflation stood at 12.47% (YoY). Inflation declined because of a slight base-effect.

The food articles index increased because of rise in prices of meat items like chicken and fish. Prices of spices, milk, gram and fruits & vegetables also increased. However, prices of *moong*, maize and *arhar* declined.

- ◆ **Non-food articles:** The non-food articles index decreased from 288.2 to 288.1 (WoW). The non-food articles' inflation stood at 20.75%. The index decreased on account of lower prices of cotton. However, prices of silk and rubber rose.
- **Fuel Group:** The fuel group index for the week ended July 10, 2010, remained unchanged at 386.7 (WoW). The fuel group inflation also remained unchanged at 14.27%.

Agriculture: Fourth Advance Estimates For 2009-10

As per the fourth advance estimates of crop production released on Saturday, July 24, total foodgrain production in 2009-10 is likely to be 218.2 million tones (mt), slightly up from the third advance estimates issued in May.

The estimates cover the 2009 kharif crop that was heavily impacted by a severe drought. The impact was especially severe in the case of rice, groundnut and coarse cereals.

In the subsequent rabi season, some ground was regained but overall production was still about 16mt lower than the 234.47mt achieved in 2008-09. Incidentally, 2008-09 was a year of record foodgrains production, following years of good weather conditions.

As per the latest estimates, wheat production has reached a record 80.71mt, marginally higher than the earlier best of 80.68mt achieved in 2008-09. Similarly, pulses production reached a record 14.59mt achieved in the last six years (2008-09: 14.57mt).

Production of rice in 2009-10 stood at 89.13mt and wheat at 80.71mt. There has been minor upward revision in most crops as compared to the third estimates:

Foodgrain Production (in million tones)					
	season	2008-09 final estimates	3rd advance estimates FY11	4th advance estimates FY10	
Total foodgrains	kharif	118.14	102.34	103.84	
	rabi	116.33	115.85	114.36	
	total	234.47	218.19	218.20	
Rice	kharif	84.91	74.78	75.91	
	rabi	14.27	14.53	13.22	
	total	99.18	89.31	89.13	
Wheat	rabi	80.68	80.98	80.71	
	Jowar	kharif	3.05	2.85	2.82
		rabi	4.19	3.99	4.16
	total	7.24	6.84	6.98	
Bajra	kharif	8.89	6.46	6.50	
Maize	kharif	14.12	11.64	12.00	
	rabi	5.61	4.68	4.68	
	total	19.73	16.32	16.68	
Total pulses	kharif	4.69	4.36	4.30	
	rabi	9.88	10.41	10.29	
	total	14.57	14.77	14.59	
Tur	kharif	2.27	2.56	2.55	
Gram	rabi	7.06	7.38	7.35	
Urad	kharif	0.84	0.86	0.85	
	rabi	0.33	0.43	0.40	
	total	1.17	1.29	1.25	
Moong	kharif	0.78	0.44	0.44	
	rabi	0.26	0.29	0.29	
	total	1.04	0.73	0.73	

RBI Watch

Draft Guideline On OTC Forex Derivatives, Overseas Hedging Of Commodity Price And Freight s On Risk

RBI placed the initial draft guidelines on November 12, 2009, for feedback from market participants. However, due to developments in domestic and international financial markets, guidelines on over-the-counter foreign exchange derivatives were reviewed. Some stakeholders, particularly corporates with global businesses, had concerns over the initial guidelines as it will seriously impede their forex risk management operations and global competitiveness. Hence, RBI has placed the revised guidelines.

For details visit: <http://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/ANE128230710.pdf>

Working Group To Address Issues In International Financial Reporting Standards

RBI constituted a working group to address implementation issues and facilitate formulation of operational guidelines in the context of International Financial Reporting Standards (IFRS) convergence for the Indian banking system. The working group is under the chairmanship of P R Ravi Mohan, Chief GM, department of banking operations & development, in the Reserve Bank of India.

Six sub-groups have been formed to deal with the following issues:

1. Classification and measurement of financial assets.
2. Classification and measurement of financial liabilities and hedge accounting. This group will also look into balance sheet issues of corporates and their implications.
3. Amortised cost and impairment.
4. Fair value measurement.
5. Presentation, disclosures and balance sheet formats.
6. De-recognition, consolidation and residuary issues.

In the context of convergence of Indian accounting standards with IFRS, a separate road map for the banking industry and non-banking finance companies (NBFCs) was prepared in March 2010. As per the road map, all scheduled commercial banks will convert their opening balance sheet by April 1, 2013, in compliance with the IFRS-converged Indian Accounting Standards. A gradualistic approach is proposed for NBFCs and urban cooperative banks.

Global Central Bank Watch

Bank Of Canada Raises Rates

At its meeting held on July 19, 2010, Bank of Canada decided to raise its policy rate by 25 bps to 0.75%.

Politics

An Armchair, A Road-Builder And Their Broadside

It is not very often that senior government officials spar publicly over performance targets, especially when they relate to infrastructure projects. But when they do, even if that means some embarrassment for the ruling dispensation, it perhaps shows that somewhere, in the labyrinth of Indian politics, things are moving ahead.

After the very public locking of horns between senior Congress leader Digvijay Singh and home minister P Chidambaram over the right way to resolve the on-going Naxal problem, it was the turn of roads minister Kamal Nath to launch an open tirade against the Planning Commission earlier this month. This flare-up came as a surprise to everyone (except, it seems, to Planning Commission deputy chairman Montek Singh Ahluwalia, who was present at the event). The primary reason behind Nath's outburst is the Commission's role in paring down the road ministry's targets.

"Producing a book is one thing, while building a road is something different. You collect something from here and there and then produce a book. It's very well when you are an armchair adviser," Nath reportedly said at a conclave on private participation in state highways, organised by the Planning Commission.

As if this was not enough, he added, *"Montek, I have observed the Planning Commission over the past 30 years of my professional life. I need to be candid and I think (the Commission should) get realistic. The builders of the T3 airport terminal told me it was possible because Planning Commission was not involved in it."*

Though Montek, a seasoned player himself, downplayed Nath's observations as "constructive criticism" at that time, he later came out with a rebuff saying that the country cannot be run merely by road builders.

Observers say that the root of the tussle lies in the fact that after years of languishing as merely an ornamental arm of the government, the Planning Commission has lately seen a revival, particularly under Montek. Nath's ire stems from the Commission's refusal to endorse his targets of building 20km a day of roads.

Montek countered the road minister's allegation, saying that plans and targets of individual ministries need to take into account the funding available. A primary role of the Planning Commission, Montek asserted, is to ensure that such target are scaled down according to the finances. Typically, he said, ministries' targets are 100% more than the money available.

Government insiders say that the tussle began sometime in May when the cabinet secretariat asked all infrastructure ministries to fix quarterly targets. The directive said the plan panel would play an advisory role and assist the ministries in fixing these targets. However, the Commission drafted a cabinet note itself, setting quarterly targets for all ministries without consulting them. This move did not go down with several ministries.

Last heard, the two veterans — Nath and Montek — were ironing out the wrinkles. Hopefully, the outcome leads to better performance.

Mamata In A Hurry, Leaves Signal Green

Technically speaking, the Uttarbanga Express accident, which killed nearly 70 people, was the result of a faulty system. The green signal did not turn red although according to the 'absolute block system', an approaching train should have received a red signal if there is another train on the same line.

But the mishap is merely one in a series — 14th in as many months, some say — that has wrecked the reputation of Indian Railways. Critics say the reason is that railway minister Mamata Banerjee is determined to root out colour red from West Bengal.

Coming under severe criticism for the amount of time she spends in her home state, Banerjee seems to be losing the mileage she had gained in recent times by posing the first real threat to the Left Front government there, which has been in power since the late 1970s.

No amount of fiddling with a sabotage theory seems to have garnered any sympathy for the minister, who virtually sees herself waltzing into Kolkata's Writer's Building (the seat of the West Bengal government) in a few months. What has irked Mamata-baiters all the more is the candour with which she reportedly claimed that the West Bengal CM's post was more important to her than the railway ministry, which, she asserted, did not reflect her true identity.

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