CHALLENGES AND OUTLOOK

4.94 The domestic economy is currently witnessing the contagion effects of the global economic slowdown. It is necessary to ensure the continued health of the economy and the productive sectors through adequate liquidity and credit from the financial sector. The objective is to restore the economy to a high growth path consistent with price and financial stability.

4.95 In the first half of the fiscal year 2008-09, the inflationary pressure was on account of the momentum in the international commodity prices and the domestic prices of food items like cereals and pulses. The Government has been alert and responsive to situation as it unfolded and took the required administrative and fiscal measures in tandem with the monetary policy initiatives of the RBI, which bore fruit. Though agricultural imports by India are limited, the constraints in the global agricultural production might exacerbate the supply side concerns in India. There is need to address these concerns, particularly in the medium term through productivity gains and efficient supply management. The continued food inflation though moderating of late, could undermine inclusive growth, in particular, the efforts to combat poverty.

4.96 While risks from the uncertainties in the global financial markets continue to persist, there are some concerns on the domestic front as well. In respect of the monetary policy, the effort to maintain ample liquidity in the system, as some would argue, might be sowing the seeds of the next inflationary cycle. It would be important, therefore, to ensure that once economic growth picks up sufficient momentum, the excess liquidity is rolled back in an orderly manner. There is also the concern related to transmission channels, the lags and the impact of monetary policy changes on the financial and real sectors of the economy.

4.97 In India, monetary transmission has had a differential impact across various segments of financial market. In general, the transmission has been more efficient in the money and bond markets and somewhat sluggish in the credit market with its implications for the real side of the economy. The credit market suffers from structural rigidities which may have been reinforced in the recent years due to a high credit demand encouraging the banks to raise deposits at higher rates for maintaining long term liquidity. These high rates have now come in the way of cutting lending rates at a pace which is consistent with the current outlook on inflation and the need for stimulating investment demand.

4.98 The focus in the coming months will continue to be on having a calibrated approach to using monetary policy measures for an early return to the high growth path. At the same time, efforts to build and preserve financial stability in the economy have to be high on the agenda. It would require strengthening the resilience of the banking sector, ensuring well functioning financial markets, proactive liquidity management and institutional reforms to make regulatory oversight systems more effective.