

RESERVE BANK OF INDIA

**Macroeconomic and
Monetary Developments
First Quarter Review 2012-13**

**Issued with the First Quarter Review of
Monetary Policy 2012-13**



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Macroeconomic and
Monetary Developments
First Quarter Review 2012-13

Reserve Bank of India
Mumbai

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MACROECONOMIC AND MONETARY DEVELOPMENTS FIRST QUARTER REVIEW 2012-13

Overview

1. *Monetary and liquidity conditions have eased during 2012-13 as cuts in cash reserve ratio (CRR) and policy rates worked through the system. The Reserve Bank cut CRR by 125 basis points (bps) and front-loaded the policy rate reduction by cutting the repo rate by 50 bps in April 2012. It, however, paused at its Mid-Quarter Review in June 2012 factoring in inflation persistence and macro-economic risks that emanated from lack of momentum in fiscal consolidation. Significantly, while there is slack in the economy, inflation remains persistent. Going forward, monetary policy space needs to be created through fiscal adjustment and structural measures to improve supply conditions and boost the investment climate, so that the revival is supported in a non-inflationary manner.*

2. *Growth in Q1 of 2012-13 is likely to have stayed low after having dropped to a 29-quarter low in the sequentially preceding quarter. While the slowdown has been primarily driven by investment, more recently and to a lesser extent, consumption has also slowed. Global growth prospects have worsened during Q1 of 2012-13, thus putting domestic recovery at greater risk. Inflation, after falling in Q4 of 2011-12 has turned sticky. Price pressures remain with significant suppressed inflation in domestic energy prices and rupee depreciation, which have partly off-set the gains from lower global commodity prices.*

Global Economic Conditions

Global growth prospects worsen with growth also slowing in EDEs

3. *Debt overhang and persistent euro area problems coupled with still incomplete*

adjustment of the US economy from the 2008 financial crisis are keeping growth in Advanced Economies (AEs) low. Deceleration in growth in BRICS economies, which have so far been the drivers of growth in Emerging and Developing Economies (EDEs), has worsened global growth prospects further.

Financial market stress accentuates

4. *Global financial market stress eased significantly during Q1 of 2012 after ECB made a large liquidity injection, but was accentuated again by the deepening crisis in the euro area, especially in Greece and Spain. The recent Libor fixing case has also added to the uncertainty by drawing attention to how a few large global financial institutions allegedly manipulated one of the most commonly used market rates. Meanwhile, falling commodity prices and subdued inflation in large economies provided additional space for monetary easing. This fresh round of monetary easing has, however, increased the risks of inflation in EDEs even while inflation is likely to remain subdued in most AEs.*

Indian Economy: Developments and Outlook

Output

Growth risks accentuate, negative output gap likely to persist during 2012-13

5. *Economic activity slowed down considerably during Q4 of 2011-12 and has likely stayed weak during Q1 of 2012-13. Growth in 2012-13 is likely to remain below potential. Newer risks to growth have arisen from slowing global trade, domestic supply*

bottlenecks of industrial inputs, coal and electricity and less-than-satisfactory monsoon so far. Services growth is also showing signs of slowing in line with slowing industrial growth and weak global economy.

Aggregate Demand

Need for curtailing subsidies and propelling a government investment stimulus to address investment slack

6. *Aggregate demand weakened further during Q4 of 2011-12. The investment slowdown seen since H2 of 2010-11 has extended to Q4 of 2011-12. Apart from the sharp fall in investment, private consumption moderated during Q4 of 2011-12. Fiscal and monetary space to stimulate the economy remain limited in the presence of an already large fiscal deficit and persistent inflation. The fiscal deficit target for 2012-13 is at a risk of being breached due to likely overshooting of subsidies and shortfall in receipts. To address this risk, fiscal space needs to be created by curtailing subsidies and significantly boosting government capital expenditures to provide an investment stimulus to the economy, which would help crowd-in private investment.*

External Sector

CAD risks and concerns about sustainability persist

7. *Softening of global crude oil prices and moderation of gold imports may bring some relief to the balance of payments, but Current Account Deficit (CAD) risks remain significant for 2012-13. Slowing global growth and trade are likely to keep expansion in exports of goods and services low. Services exports net of services imports have declined notably in Q1 of 2012-13. With lower growth, the sustainable level of CAD has also come down to around 2.5 per cent of GDP. Financing a large CAD may pose difficulties in face of slowing foreign investment flows. External debt is likely to rise*

as increased debt flows bridge financing gap. As a result, external vulnerability indicators may deteriorate and would make economy susceptible to external shocks unless trade balance is compressed and FDI flows improve.

Monetary and Liquidity Conditions

Monetary and liquidity conditions ease during 2012-13

8. *A 50 basis points (bps) rate cut, following a 125 bps CRR reduction, coupled with active open market operation purchases have significantly eased monetary and liquidity conditions during 2012-13 so far. While these measures are supportive of growth, the rate of deposit expansion has slowed which could adversely affect liquidity. Credit growth has picked up in the current financial year and is in line with the indicative projections. The flow of resources from non-bank sources has also been good. In spite of a relative improvement in monetary and liquidity conditions during Q1 of 2012-13, the Reserve Bank would need to closely monitor the liquidity and monetary conditions ahead so that they remain consistent with the evolving growth-inflation mix.*

Financial Markets

Currency and equity markets remained under pressure

9. *Spillovers from global financial market uncertainties and waning investor confidence amidst deteriorating macroeconomic conditions, kept domestic currency and equity markets under pressure. The rupee depreciated by nearly 10 per cent during Q1 of 2012-13, before staging some recovery in July 2012. Equity markets remained range bound, with sharp gains in May 2012 being nullified during June 2012. Money market rates and G-sec yields eased reflecting improved liquidity and falling global commodity prices. However, going forward, financial stress is likely to remain with falling earnings and high leverage for non-financial firms.*

Price Situation

Inflation pressures persist despite weakening growth momentum

10. *Headline WPI inflation persisted above 7 per cent, while consumer price inflation, as per the new CPI, remains in double-digits. Inflationary pressures have persisted, with significant contribution from food and energy segments. Going forward, the decline in global commodity prices will provide some relief, but the gains have been partly offset by rupee depreciation. While core inflationary pressures are currently muted, a continued rise in real wages could spill over to core inflation. Persistence of inflation, even as growth is slowing, has emerged as a major challenge for monetary policy.*

Macroeconomic Outlook

Outlook remains weak, need to support recovery in a non-inflationary manner

11. *Growth risks in 2012-13 have been amplified by decelerating global trade and domestic supply constraints. At the same time, inflation risks remain significant due to suppressed inflation, poor supply responses and deficit monsoon conditions. Various surveys suggest that business and consumer confidence remain low. Revival of investor confidence would, therefore, need to be supported by addressing concerns over policy stasis, while putting in place complimentary actions that address macro-economic weaknesses.*

I. OUTPUT

The Indian economy grew at a slower pace than its potential in 2011-12. Growth slowed down in all three sectors of the economy through the course of the year. Moderation in industrial growth persisted in the midst of domestic supply constraints, a clouded domestic policy environment and a deteriorating external outlook. The services sector also under-performed given its inter-linkages with the industrial sector. The available information suggests that slowdown has extended into Q1 of 2012-13, and output expansion in 2012-13 is likely to stay below the potential.

Persistent euro area problems and weakening growth in EDEs may drag global growth in 2012

I.1 Global growth, which was better than expected during Q1 of 2012, weakened sharply during Q2 mainly due to increased uncertainties in the euro area and dampened demand conditions in emerging and developing economies (EDEs). Global growth projection for the year 2012 by the IMF (World Economic Outlook Update, July 2012) is 3.5 per cent. The growth projection for the EDEs has been revised downward (by 0.1 per cent from the earlier projection in WEO, April 2012) to 5.6 per cent.

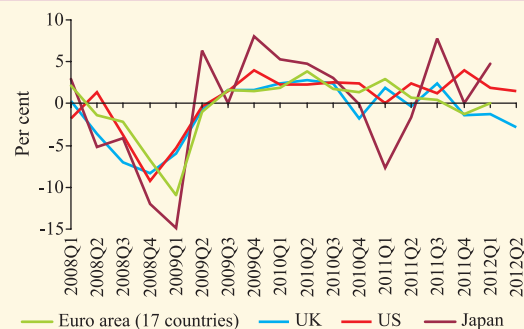
I.2 The deceleration in growth in the BRICS nations, which have so far been drivers of EDEs' growth, has added a new dimension to the global slowdown, making near-term recovery difficult. Growth in China, India, Brazil and South Africa has decelerated since 2011, while that in Russia has been low since 2008.

I.3 The euro area crisis has strongly affected the global economic outlook through effects on confidence as well as trade and capital flows. While economic activity in the euro area diminished or stagnated in Q4 of 2011 and Q1 of 2012, the US economy grew at a modest pace (Chart I.1). As per advance estimates, US growth decelerated to 1.5 per cent in Q2 of 2012. Even though the Japanese economy expanded at an annualised rate of 4.7 per cent in Q1 of 2012, it may slow down ahead as the impact of reconstruction spending wears off.

I.4 The Institute for Supply Management (ISM) report on US manufacturing suggests a contraction in economic activity in the manufacturing sector in June 2012 (PMI of 49.7), the first time since July 2009. The uncertainty over the path of fiscal policy, which is set to tighten abruptly at the beginning of 2013 or what is termed the 'fiscal cliff', could further weaken the US growth later this year. Even though Germany recorded 0.5 per cent q-o-q growth in Q1 of 2012 (as against a contraction in Q4 of 2011), business sentiment fell for the second consecutive month in June to a two-year low. The UK economy witnessed its third consecutive quarterly contraction as the preliminary estimates indicate 0.7 per cent q-o-q decline in GDP in Q2 of 2012.

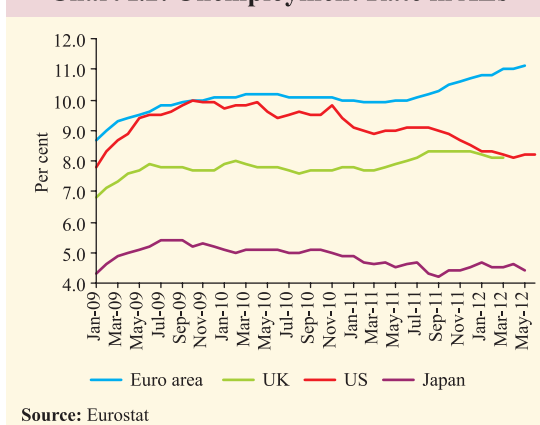
I.5 In the US, the uptick in the unemployment rate to 8.2 per cent since May 2012 has compounded the sense that the economy is

Chart I.1: Growth in AEs (q-o-q)



Note: The q-o-q growth rates have been annualised.

Source: Eurostat, Office of National Statistics (UK) and Bureau of Economic Analysis (US).

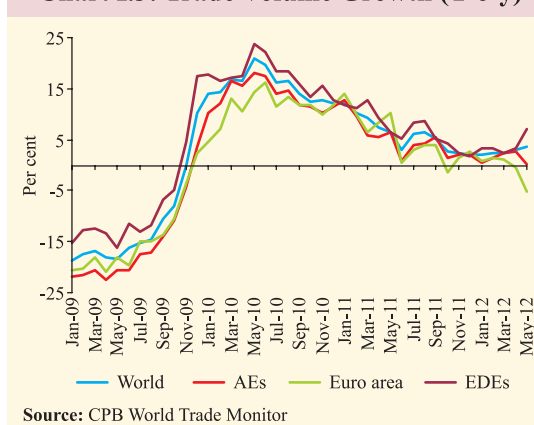
Chart I.2: Unemployment Rate in AEs

going through a sluggish patch. The unemployment rate across the euro area rose to a new high of 11.1 per cent in May 2012, the highest level since records began in January 1995 (Chart I.2). The unemployment rate for people below the age of 25 was even higher at 22.6 per cent. According to the OECD, the unemployment rate in the advanced economies (AEs) will stay high till the end of 2013.

I.6 The weak economic activity in the AEs is impacting the EDEs. The reduced demand for exports and weak capital flows combined with their own domestic policy shortcomings has resulted in subdued economic performance in the EDEs, especially in the case of India and Brazil. China's growth in Q2 of 2012 fell to a three-year low of 7.6 per cent.

Dampening trade volume growth is affecting EDEs exports

I.7 The slowing growth of the AEs and EDEs has resulted in significant cooling of international trade in Q2 of 2012 after a modest rebound in Q1 of 2012. World trade growth decelerated from its peak of 20 per cent (CPB World Trade Monitor Index) in May 2010 to as low as 2.3 per cent in April 2012 (Chart I.3). The downturn in Europe and resultant fall in import demand has adversely affected the EDEs as the EU constitutes their single largest market. There was a sharp deceleration in both China's exports and imports during H1 of 2012 to 9.2 per cent

Chart I.3: Trade Volume Growth (Y-o-y)

and 6.6 per cent, respectively (23.9 per cent and 27.9 per cent in H1 of 2011). Continued deceleration of imports into China does not augur well for other EDEs.

Growth slowdown persists during Q4 of 2011-12 in India

I.8 The sequential slowdown in growth witnessed in the first three quarters of 2011-12 persisted with the fourth quarter registering growth of 5.3 per cent (Table I.1). This was the lowest y-o-y growth in any quarter of the previous seven years, including the crisis year of 2008-09. The sharp slowdown in growth in Q4 of 2011-12 is largely attributable to the contraction in value added in the manufacturing sub-sector and deceleration in most services sub-sectors. The downturn reflects the continued high inflation as well as the impact of other adverse global and domestic macro-economic factors. For 2011-12 as a whole, growth decelerated sharply to 6.5 per cent from 8.4 per cent in the previous two years.

I.9 The potential growth rate, which is the maximum rate of growth that the economy can sustain without creating macroeconomic imbalances, moderated during 2009-10 to 2011-12 from around 8.0 per cent to around 7.5 per cent (Chart I.4). The output gap was positive during 2009-10 and 2010-11. With the growth rate declining by nearly 2 percentage points in 2011-12, reflecting the impact of both cyclical

Table 1.1: Sectoral Growth Rates of GDP (2004-05 prices)

Item	(Per cent)									
	2010-11*	2011-12#	2010-11				2011-12			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture & allied activities	7.0	2.8	3.1	4.9	11.0	7.5	3.7	3.1	2.8	1.7
2. Industry	6.8	2.6	8.2	5.6	7.2	6.3	6.5	2.7	0.9	0.7
2.1 Mining & quarrying	5.0	-0.9	6.9	7.3	6.1	0.6	-0.2	-5.4	-2.8	4.3
2.2 Manufacturing	7.6	2.5	9.1	6.1	7.8	7.3	7.3	2.9	0.6	-0.3
2.3 Electricity, gas & water supply	3.0	7.9	2.9	0.3	3.8	5.1	7.9	9.8	9.0	4.9
3. Services	9.2	8.5	9.8	8.7	7.8	10.4	9.3	8.5	8.7	7.5
3.1 Trade, hotels, transport, storage & communication <i>etc.</i>	11.1	9.9	12.6	10.6	9.7	11.6	13.8	9.5	10.0	7.0
3.2 Financing, insurance, real estate & business services	10.4	9.6	10.0	10.4	11.2	10.0	9.4	9.9	9.1	10.0
3.3 Community, social & personal services	4.5	5.8	4.4	4.5	-0.8	9.5	3.2	6.1	6.4	7.1
3.4 Construction	8.0	5.3	8.4	6.0	8.7	8.9	3.5	6.3	6.6	4.8
4. GDP at factor cost (Total 1 to 3)	8.4	6.5	8.5	7.6	8.2	9.2	8.0	6.7	6.1	5.3

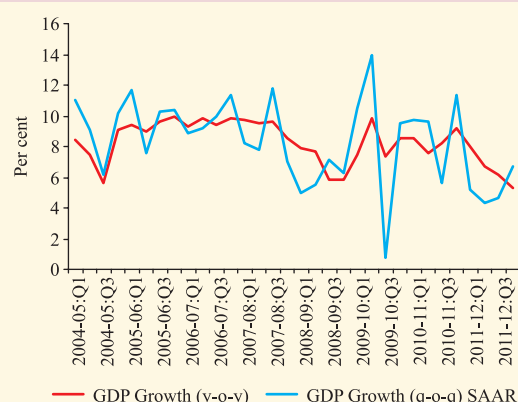
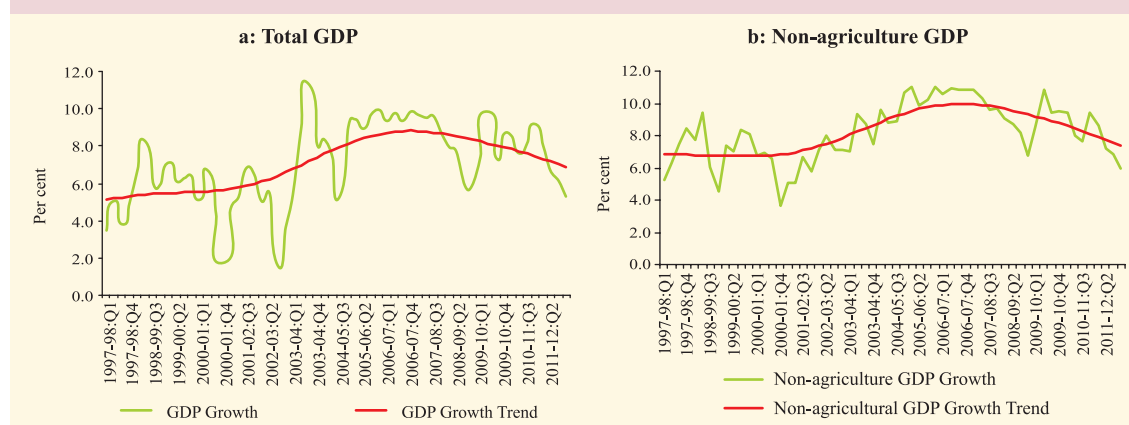
*: Quick Estimates. #: Revised Estimates.

Source: Central Statistics Office.

as well as structural factors, the output gap turned negative during 2011-12. Growth momentum remains weak as is evident from low q-o-q SAAR numbers (Chart I.5).

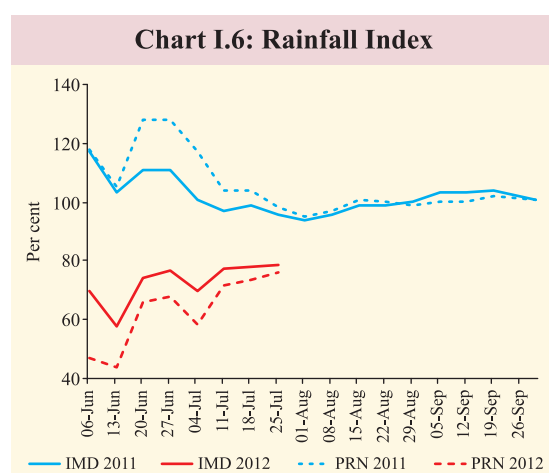
Deficient monsoon likely to impact kharif crops

I.10 Foodgrain production in 2011-12 rose by 5.2 per cent from the previous year to an all-time high of 257.4 million tonnes. As per the fourth advance estimates of foodgrain production, there was record output of rice, wheat, cotton and sugarcane. In 2012-13, even though the

Chart I.5: Momentum Indicator of Growth**Chart I.4: GDP Growth**

south-west monsoon arrived on time along the coast of Kerala during the first week of June 2012, its progress to the rest of the country has been slow and uneven. In view of this, the India Meteorological Department (IMD) revised its forecast of rainfall for the period (June-September 2012) from 99 per cent of the long period average (LPA) in May 2012 to 96 per cent of LPA in June 2012 and further down to 92 per cent of LPA in July 2012. The latest information (till July 26, 2012) shows that the south-west monsoon has now covered the entire country but the cumulative rainfall is still 21 per cent below the LPA as against 3 per cent below LPA during the corresponding period in the previous year.

I.11 Spatially, rainfall across the four main regions of the country is in deficit with the highest deficiency observed in north-west India (38 per cent below LPA). Overall, rainfall has been deficient/scanty across 63 per cent of the total geographical area of the country covering 22 of the 36 sub-divisions and normal/excess across the rest. In contrast, during the corresponding period last year, rainfall was excess/normal across 85 per cent of the geographical area covering 30 sub-divisions. The deficiency in monsoon as gauged from the Reserve Bank's production-weighted rainfall index (PRN) is higher with the PRN on July 27, 2012 being 76 compared with a reading of 79 for the IMD index (Chart I.6).

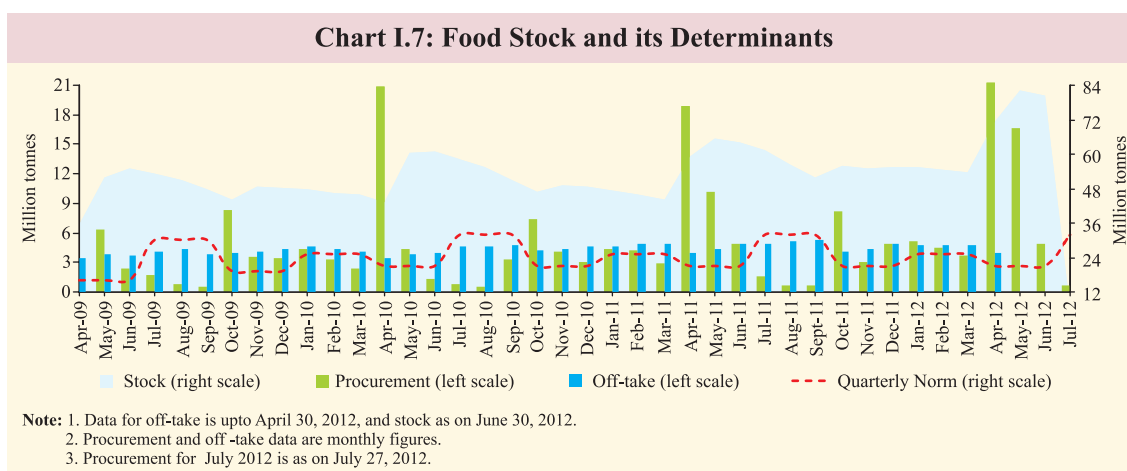


I.12 The unsatisfactory performance of the south-west monsoon so far in terms of quantum and spatial/temporal distribution resulted in the slow progress in sowing of *kharif* crops during June 2012. However, there has been significant improvement in sowing during July 2012 for most crops. Notwithstanding this improvement, area sown under pulses and coarse cereals declined sharply (Table I.2). The crop situation is likely to worsen further if *El Nino* conditions emerge during the later part of the season. Deficit rainfall has also affected the level of water in the 84 reservoirs under the Central Water Commission (CWC). The storage was 24 per cent of capacity on July 26, 2012 as against 43 per cent during the corresponding period last year.

Table I.2: *Kharif* Sowing: 2012-13

(Million hectares)					
Crop	Normal area as on date	Area sown		Percentage variations	
		July 27, 2012	July 29, 2011	over 2011	over normal as on date
1	2	3	4	5	6
Rice	20.0	19.1	21.0	-9.0	-4.5
Coarse Cereals	16.1	11.7	15.2	-23.0	-27.3
Pulses	8.0	6.3	7.4	-14.9	-21.3
Oilseeds	13.4	13.8	15.0	-8.0	3.0
Sugarcane	4.7	5.3	5.2	1.9	12.8
Cotton	9.4	9.7	10.6	-8.5	3.2
Jute and mesta	0.8	0.8	0.9	-10.1	0.0
All Crops	72.4	66.7	75.2	-11.3	-7.9

Source: Ministry of Agriculture, GoI.



Contingency measures are required should monsoon fail

I.13 Indian agriculture's dependence on the monsoon has come down over the years and in recent episodes of deficient monsoons the output impact has been limited. The current level of stock of foodgrains is comfortable should foodgrains output be adversely impacted. At around 80.6 million tonnes in June 2012 (82 million tonnes in May 2012), stocks continue to remain one of the highest ever (Chart I.7). In fact, record stocks necessitate augmentation of storage capacity to avoid wastage of foodgrains. A short-term strategy to protect open stocks is being put in place. The government has also prepared contingency plans in the event of monsoon failure. This entails ensuring sufficient availability of all seeds, fodder, power and diesel, additional wage allocation under MGNREGA and sufficient funds under the National Disaster Relief Fund. An Inter-Ministerial Group has been constituted to review the situation on a weekly basis. On current assessment, rainfall during this year's monsoon season has been slightly better than that during the drought year of 2009.

I.14 Frequent price shocks with respect to high-value food items such as meat, fish, eggs, milk, and fruit and vegetables in the recent period reflect the persistence of supply-demand imbalances. To secure food and nutritional

security, apart from increased production of these food items, an increased efficiency in post-harvest handling is essential. The development of vegetable clusters, terminal market complexes, cold chains, and warehouses under the public-private partnership model and operationalising warehouse receipts system are significant steps that hold immense potential for better post-harvest management and price discovery.

I.15 To improve efficiency and develop a nation-wide agricultural market, 18 states/union territories have amended their Agriculture Produce Market Committee (APMC) Acts so far. Further reforms such as a single-point market fee system that facilitates the free movement of produce, reduction in price differences between the producer and the consumer market segments and popularising the practice of cleaning, grading, and packaging of the produce are expected to facilitate better market access by farmers, reduce transportation costs and increase the income of farmers.

Industrial slowdown intensifies

I.16 Growth in the index of industrial production (IIP) moderated sharply to 0.8 per cent during April-May 2012 as compared with 5.7 per cent during April-May 2011 (Table I.3). The slowdown in growth is reflected across all sectors. The mining sector continued to decline mainly due to regulatory and environmental

Table I.3: Index of Industrial Production: Sectoral and Use-Based Classification of Industries

(Per cent)							
Industry Group	Weight in the IIP	Growth Rate			Weighted Contribution#		
		Apr-Mar 2011-12	April-May		Apr-Mar 2011-12	April-May	
			2011-12	2012-13 P		2011-12	2012-13 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	14.2	-1.9	1.6	-2.0	-7.8	3.3	-29.8
Manufacturing	75.5	3.0	6.0	0.6	83.2	83.3	66.5
Electricity	10.3	8.2	8.5	5.2	24.6	13.3	64.8
Use-Based							
Basic Goods	45.7	5.5	7.3	3.1	75.0	50.9	166.3
Capital Goods	8.8	-4.0	6.4	-13.8	-20.7	15.2	-250.6
Intermediate Goods	15.7	-0.8	2.0	0.6	-3.7	4.8	10.0
Consumer Goods (a+b)	29.8	4.4	5.2	4.0	49.2	29.2	171.7
a) Consumer Durables	8.5	2.6	3.3	7.2	13.3	8.5	140.1
b) Consumer Non-durables	21.3	5.9	6.8	1.3	35.8	20.7	31.6
General	100	2.9	5.7	0.8	100	100	100

P : Provisional # : Figures may not add up to 100 due to rounding off.

Source: Central Statistics Office.

issues affecting coal mining and the low output of natural gas from the Krishna-Godavari (KG) basin.

I.17 The recent contraction in mining is constraining the growth in the manufacturing sector. Mining output has been contracting since Q2 of 2011-12 impacting manufacturing output adversely, despite increasing imports of industrial inputs such as coal and steel substituting for domestic supply of industrial inputs. An empirical analysis of monthly data from April 2010 onwards reveals that a one per cent increase in mining output, on an average, results in a 0.6 per cent increase in manufacturing output two periods ahead. Robust performance of the domestic mining sector which provides critical industrial inputs such as coal, natural gas and iron ore is, therefore, necessary for sustaining manufacturing growth.

I.18 There has been a sharp moderation in manufacturing which was affected by sluggish investment activity, waning global demand and high input costs. While the industrial slowdown has been pervasive, it is compounded by the volatility in capital goods output (Chart I.8).

Excluding the volatile items, the truncated IIP (96 per cent of IIP) growth in April-May 2012 is 3.0 per cent compared with 0.8 per cent growth in the general IIP (Chart I.9). Also, the growth pattern is skewed, with eight of the 22 industry groups showing negative growth during April-May 2012.

I.19 By the use-based classification, moderation in growth is seen in all categories except consumer durables. The output of consumer non-durables has been declining since January 2012. The production of capital goods

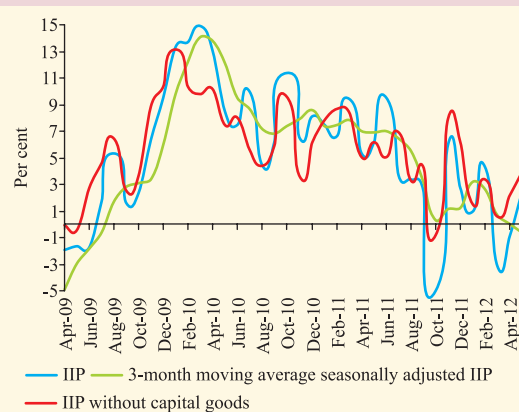
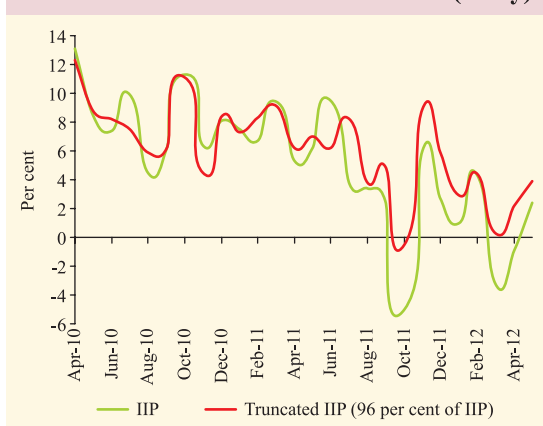
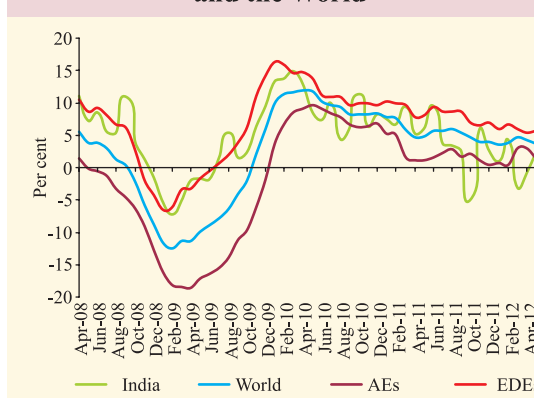
Chart I.8: Industrial Growth (Y-o-y)

Chart I.9: IIP vis-a-vis truncated IIP (Y-o-y)**Chart I.10: Industrial Growth - India and the World**

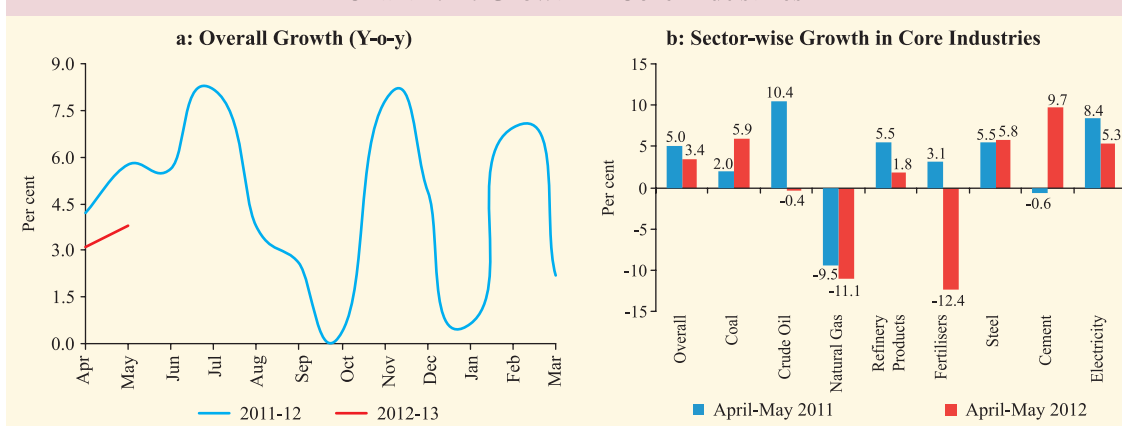
declined in April-May 2012. The declining domestic production of capital goods has been partly substituted by increase in capital goods imports. However, domestic production of capital goods has also suffered in the backdrop of weak investment environment. As these conditions persist, investment activity is likely to remain subdued. The modest performance of basic and intermediate goods has also added to the overall moderation in industrial activity.

I.20 Revival of global growth is significant for industrial recovery. Domestic industrial growth has a strong correlation with global industrial growth. The correlation coefficient between domestic and global IIP during April 2008 to May 2012 is 0.75 (Chart I.10).

Input bottlenecks and capacity constraints impacting core industries

I.21 Growth of eight core industries decelerated to 3.4 per cent during April-May 2012 compared to 5.0 per cent during the corresponding period in the previous year. Output of crude oil, natural gas and fertilisers contracted while that of refinery products and electricity decelerated during April-May 2012. Deficit rainfall during the period also affected the generation of hydro power. The output of coal, cement and steel, however, showed improvement during the period (Chart 1.11).

I.22 The government has initiated several measures to augment the production potential of core industries, in particular, mining, in the

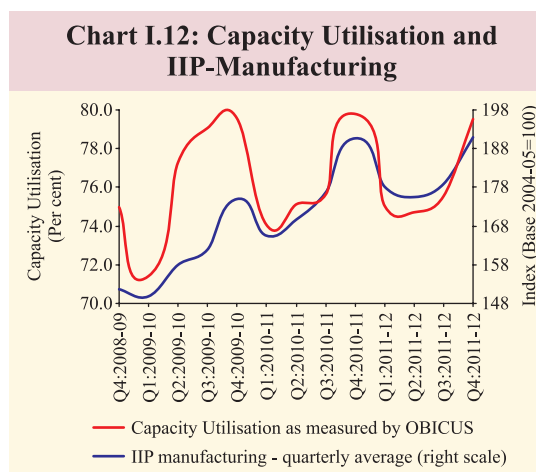
Chart 1.11: Growth in Core Industries

recent period. The improved performance of the coal industry could be partly attributed to this. However, several bottlenecks still afflict the mining sector output and a lot more needs to be done to remove structural constraints that have brought mining activity to a near standstill.

I.23 The 17th round of the Order Books, Inventories and Capacity Utilisation Survey (<http://www.rbi.org.in/OBICUS17>) of the Reserve Bank for Q4 of 2011-12 indicates an improvement in the growth of new orders over the previous quarter, though the y-o-y growth was lower than in Q4 of the previous two years. Capacity utilisation level also improved in Q4 of 2011-12. The improvement is partly on account of seasonality but the level of capacity utilisation in the fourth quarter is fairly close to the peak level observed in the corresponding quarter of the previous year (Chart I.12). As expected, capacity utilisation has a strong co-movement with IIP-manufacturing.

Employment growth slows down

I.24 The quarterly quick survey of employment conducted by the Labour Bureau in select sectors of the economy indicates that employment growth slowed considerably during Q4 of 2011-12 compared to the previous quarter and the corresponding quarter of the previous year. The quarter recorded the lowest rate of employment creation in two years, with



all sectors barring IT/BPO and transport witnessing a decline in employment during the quarter. However, the employment of direct workers increased while that of contract workers declined during the quarter. Overall, employment generation in eight major industries during 2011-12 was lower than in the previous year by 14.3 per cent (Table I.4).

Services sector likely to moderate

I.25 The slowdown in the industrial sector and the muted demand conditions have impacted the growth of the services sector. Various lead indicators of the services sector point towards deceleration in growth (Table I.5). Addition to the wireless subscriber base is moderating. This could be partly on account of

Table I.4: Changes in Estimated Employment

Industry/Group	(in millions)				
	2010-11	2011-12	2010-11 Q4	2011-12 Q3	2011-12 Q4
1	2	3	4	5	6
1. Textiles including apparels	0.100	0.090	-0.120	0.080	0.000
2. Leather	0.030	-0.020	-0.010	-0.010	-0.003
3. Metals	0.090	0.080	0.020	0.000	-0.007
4. Automobiles	0.110	0.030	0.010	-0.010	-0.001
5. Gems and jewellery	-0.004	0.030	-0.002	0.010	-0.003
6. Transport	-0.003	0.040	0.010	0.030	0.016
7. IT/BPO	0.670	0.580	0.290	0.110	0.104
8. Handloom / Powerloom	-0.010	-0.003	-0.020	0.010	-0.026
Overall	0.980	0.840	0.170	0.220	0.080

Source: 14th Quarterly Quick Employment Survey, January-March 2012, Labour Bureau.

Table I.5: Indicators of Services Sector Activity

(Growth in Per cent)					
Services Sector Indicators	2009-10	2010-11	2011-12	April-June 2011-12	April-June 2012-13
1	2	3	4	5	6
Tourist arrivals	5.8	9.5	8.6	10.7	4.2
Cement	10.5	4.5	6.7	-0.6#	9.7#
Steel	6.0	13.2	7.0	5.5#	5.8#
Cell phone connections (in millions)\$	192.5	227.3	107.6	15.3*	6.1*
Automobile sales	24.4	16.8	11.2	10.7	10.0
Railway revenue-earning freight traffic	6.6	3.8	5.2	7.0	4.8
Cargo handled at major ports	5.8	1.6	-1.7	5.2	-5.5
Civil aviation					
Domestic cargo traffic	24.3	23.8	-4.8	0.5*	2.0*
International cargo traffic	10.5	17.7	-1.9	10.3*	-6.0*
Domestic passenger traffic	15.6	18.1	15.1	14.1*	8.3*
International passenger traffic	8.8	10.3	7.6	14.0*	5.6*

*: Data pertains to April 2012.

#: Data refers to April-May 2012.

\$: Refers to wireless subscriber additions in actual numbers.

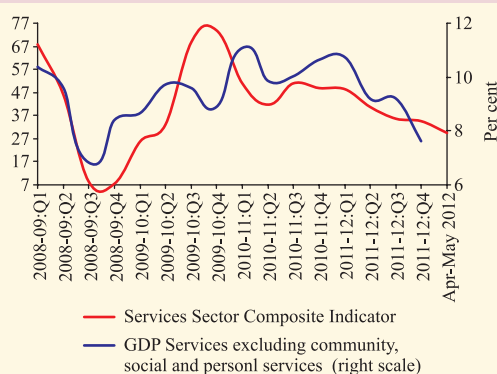
Source: Ministry of Statistics and Programme Implementation, Ministry of Tourism and CMIE.

mobile number portability reducing the need for multiple connections. A services sector composite indicator based on growth in indicators of construction, trade and transport, and finance, developed by the Reserve Bank shows continuation of slowdown in services in Q1 of 2012-13 (Chart I.13). The outlook for the services sector depends to a large extent on

the revival in industrial growth and an improvement in the global economic conditions.

Growth in 2012-13 likely to be below potential

I.26 Going forward, the outlook for growth looks weak and substantially affected by global headwinds, inflation and policy uncertainty. Although the south-west monsoon has been forecasted to be normal during 2012-13, its weak progress so far is a concern. The services sector is also showing signs of slowing down. Growth in communication services is likely to be low. The industrial sector, though improved in May, does not seem to be on course for sustained recovery. With growth slowing down, inflation is expected to moderate but demand-supply imbalances in respect of a number of items are limiting the price adjustment. Rupee depreciation in the recent period, however, is expected to support industrial and services sector activity through improved export competitiveness.

Chart I.13: Services Sector Composite Indicator

II. AGGREGATE DEMAND*

Reflecting the slowdown in the domestic economy, growth in aggregate demand weakened further during Q4 of 2011-12. The decline in investment, particularly private corporate investment, has emerged as a major drag on demand. From a long-term perspective, the sustained fall in investment so far has impacted India's growth potential. Some moderation in private consumption is also taking place, partly due to the impact of inflation on purchasing power. Corporate sales decelerated along with continued decline in profits and could adversely impact investments ahead. In this situation, crowding-in of private investment demand by public investment spending stimulus while aggressively cutting expenditure on subsidies hold the key to growth revival.

Expenditure side of GDP continued to show weak demand

II.1 The expenditure side aggregates, based on the revised estimates of national income released by the CSO in end-May 2012, are indicative of slackening demand conditions in

the economy (Table II.1). This assessment however, is strongly influenced by the 'statistical discrepancy' in the data. For example, the sum of the contribution-weighted growth rates of the different expenditure components in Q4 of 2011-12 works out to 9 per cent, which is much

Table II.1: Expenditure Side GDP (2004-05 prices)

Item	2010-2011*	2011-12#	(Per cent)							
			2010-11				2011-12			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
Growth Rates (y-o-y)										
I. GDP at market prices	9.6	6.9	9.5	8.9	10.0	9.7	9.0	6.9	6.2	5.6
II. Total Consumption Expenditure	8.1	5.4	9.4	8.8	6.9	7.4	4.9	4.9	6.1	5.8
(i) Private	8.1	5.5	9.1	8.6	7.3	7.6	4.9	4.6	6.4	6.1
(ii) Government	7.8	5.1	11.1	10.5	4.7	6.7	4.9	7.2	4.7	4.1
III. Gross Fixed Capital Formation	7.5	5.5	8.8	6.9	11.1	3.7	14.7	5.0	-0.3	3.6
IV. Change in Stocks	37.4	2.4	39.4	35.5	37.7	37.1	7.1	2.8	0.4	-0.4
V. Net Exports	5.5	-30.7	-35.4	-14.6	29.5	33.4	-23.2	-46.7	-117.9	117.8
VI. Discrepancies	38.9	-112.7	-1.0	11.1	91.1	7.3	-51.8	-119.6	-152.0	-124.0
Relative shares										
I. Total Consumption Expenditure	70.1	69.1	72.8	72.1	72.7	63.5	70.1	70.8	72.7	63.6
(i) Private	58.7	57.9	61.9	61.7	60.3	51.9	59.5	60.3	60.4	52.2
(ii) Government	11.4	11.2	11.0	10.5	12.5	11.6	10.6	10.5	12.3	11.4
II. Gross Fixed Capital Formation	32.5	32	32.2	34.0	32.3	31.4	33.9	33.4	30.3	30.9
III. Change in Stocks	3.7	3.5	3.7	3.8	3.5	3.6	3.7	3.6	3.4	3.4
IV. Net Exports	-6.0	-7.4	-7.6	-8.2	-5.4	-3.4	-8.6	-11.3	-11.1	0.6
V. Discrepancies	-2.5	0.3	-3.8	-4.3	-5.4	2.7	-1.7	0.8	2.6	-0.6
Memo:										(₹ Billion)
Real GDP at market prices	52368	56277	12087	12265	13533	14484	13174	13111	14377	15296

* : Quick Estimates. # : Revised Estimates.

Note: As only major items are included in the table, data will not add up to 100.

Source: Central Statistics Office.

* Despite its well-known limitations, expenditure-side GDP data are being used as proxies for components of aggregate demand. However, in view of these limitations, which are amply reflected in the data for Q4 of 2011-12, supplementary information, including anecdotal data and judgements have been used to draw inferences.

Table II.2: Contribution-Weighted Growth Rates of Expenditure-Side GDP (2004-05 Prices)*

Item	(Per cent)							
	2010-11				2011-12			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9
1. Private final consumption expenditure	5.6	5.3	4.5	4.0	3.0	2.8	3.9	3.2
2. Government final consumption expenditure	1.2	1.1	0.6	0.8	0.5	0.8	0.6	0.5
3. Gross fixed capital formation	2.9	2.4	3.6	1.2	4.7	1.7	-0.1	1.1
4. Changes in stocks	1.2	1.1	1.1	1.1	0.3	0.1	0.0	0.0
5. Valuables	0.8	0.7	0.6	0.5	0.3	0.2	0.1	0.2
6. Net Export (i-ii)	-2.2	-1.1	2.5	1.9	-1.8	-3.8	-6.4	4.0
(i) Exports	2.6	3.7	6.0	6.3	3.9	4.4	1.5	4.6
(ii) Less Imports	4.8	4.8	3.5	4.4	5.7	8.2	7.9	0.6
7. Sum 1 to 6	9.5	9.3	12.9	9.5	7.0	1.8	-2.0	9.0
8. Discrepancies	0.0	-0.5	-2.8	0.2	2.0	5.1	8.2	-3.4
9. GDP at market prices (7+8)	9.5	8.9	10.0	9.7	9.0	6.9	6.2	5.6

*: Contribution-weighted growth rate of a component of expenditure side GDP is obtained as follows:
 (Year-on-Year change in the component ÷ Year-on-Year change in GDP at constant market prices) × Year-on-Year growth rate of GDP at constant market prices.

Source: Central Statistics Office

higher than the growth rate of 5.6 per cent derived from the supply side after adjusting for net indirect taxes (Table II.2). Such ‘statistical discrepancy’ is also reflected in the incorrect manifestation of external demand through positive net exports in Q4 of 2011-12 in contrast to the record current account deficit posted in the data that were released by the Reserve Bank in end-June 2012.

II.2 Keeping aside the apparent statistical weaknesses in the data, the moderation in expenditure persisted in Q4 of 2011-12, which was reflected across private and government final consumption expenditure and subdued growth in capital formation.

Growth slowdown is reflected in weaker growth in private consumption and investment

II.3 The growth in private final consumption expenditure, which accounts for around 60 per cent of GDP, decreased in Q4 of 2011-12. The subdued levels of gross fixed capital formation (GFCF), which accounts for around 30 per cent of GDP, can be partly attributed to high interest rates but non-monetary factors have also played

a significant role. In this context, it may be mentioned that real interest rates in the recent period are lower than their levels in the pre-crisis years when investment rates were much higher. The moderation of investment in the recent period, therefore, suggests that there are factors other than interest rate at play. Empirical estimates in a recent Reserve Bank Working Paper show that the real interest (lending) rates explain only around one-third of real GDP growth. In the post crisis period, the slackening of investment is mainly related to the private corporate sector. In addition, the share of public investment in GDP has declined. Apart from the erosion in corporate profit margins and already high leverage, other domestic and global factors have contributed to weakening investment activity.

Investment outlook remained insipid in Q4 of 2011-12

II.4 Corporate investment intentions remained depressed. The aggregate project cost envisaged from the new projects sanctioned financial assistance by banks/FIs, have continued to moderate through 2011-12 aggregating ₹2.1

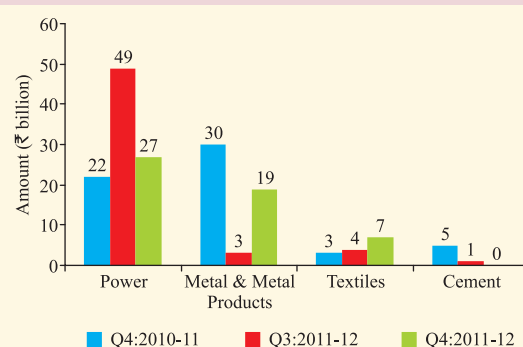
Table II.3: Institutionally Assisted Projects and Their Envisaged Cost (Quarter-wise)

Period		Number of Projects	Project Cost (₹ billion)
1		2	3
2009-10	Q1	146	908
	Q2	189	1,327
	Q3	175	1,194
	Q4	231	827
2010-11	Q1	181	1,250
	Q2	202	1,067
	Q3	160	787
	Q4	167	821
2011-12	Q1	154	787
	Q2	194	572
	Q3	151	506
	Q4	169	255

Note: Based on data reported by 39 banks/FIs.

trillion in 2011-12, down from ₹3.9 trillion in the previous year (Table II.3). Industry-wise analysis revealed that the share of the power sector in the total envisaged project cost remained the highest in Q4 of 2011-12 followed by metal & metal products and textiles (Chart II.1).

II.5 The time-phasing details of projects that have been sanctioned institutional assistance for various years up to 2011-12 indicate that total intended capital expenditure by private corporate (non-financial) firms declined in 2011-12 and can be expected to decline further during 2012-13 as planned investment in new projects

Chart II.1: Investment Intentions of Institutionally Assisted Projects: Major Industries

is likely to remain low (Table II.4). Overall, declining trend in investment demand from the private corporate sector has emerged as the major drag on overall investment.

Moderation in sales growth coupled with high input cost pressures led to declining corporate profits

II.6 Sales growth for select Non-Government, Non-Financial (NGNF) listed companies by and large held up during 2011-12, though there was a perceptible drop in the last quarter (Table II.5, II.6). However, persistent pressure from input costs and rising interest outgo, led to decline in net profits (PAT). Operating and net profit margins declined during 2011-12 indicating a weakening pricing power for Indian corporates.

Table II.4: Phasing of Capital Expenditure of Projects Sanctioned Assistance by Banks/FIs

(₹ billion)								
Capital Expenditure in the Year	Up to 2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Beyond 2013-14	Grand Total
1	2	3	4	5	6	7	8	9
Year of Sanction								
Up to 2007-08	1,826	1,317	583	376	98	47	-	4,247
2008-09	265	1,029	864	568	366	84	46	3,223
2009-10	2	444	1,359	1,216	804	320	111	4,255
2010-11	-	3	320	1,101	1,095	823	584	3,926
2011-12	-	-	39	254	746	638	443	2,120
Grand Total #	2,093	2,793	3,165	3,515	3,109	1,912	1,184	-

#: The estimates are *ex ante*, incorporating only the envisaged investment, and thus are different from those actually realised/ utilised.

Table II.5: Corporate Sector- Financial Performance

										per cent
Item	Annual: 2010-11	Annual: 2011-12	2010-11				2011-12			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
No. of Companies	2273									
Growth Rates (y-o-y)										
Sales	20.0	18.6	25.1	19.2	17.1	20.7	22.6	19.1	19.5	15.5
Change in stock	80.4	-23.0	391.7	-55.5	108.5	124.0	-41.7	3.4	99.2	-55.9
Expenditure, of which	22.3	20.9	29.6	20.3	19.0	22.9	23.0	22.7	25.4	16.5
Raw Material	26.3	22.7	37.8	22.3	20.3	25.2	27.6	23.1	26.1	17.0
Staff Cost	19.3	17.6	16.5	20.5	21.2	19.5	19.9	17.4	18.8	14.4
Power & fuel	18.1	27.2	17.5	12.8	19.6	26.6	27.2	26.2	30.4	25.3
Operating Profits (PBDIT)	12.3	1.7	15.2	7.3	11.0	16.5	12.5	-1.1	-6.0	-1.4
Other Income*	2.0	41.4	-26.2	55.1	6.1	-14.6	45.4	28.3	70.6	47.6
Depreciation	16.2	10.5	20.2	17.6	14.7	14.6	9.7	9.7	10.3	11.2
Gross Profits (PBIT)	10.0	4.2	8.1	9.0	9.5	11.9	16.5	-0.4	-3.2	2.5
Interest	20.5	35.8	27.0	6.3	24.1	30.6	22.3	46.2	41.9	34.4
Tax Provision	11.3	11.3	5.2	8.3	4.8	2.7	22.1	4.3	-3.1	4.5
Net Profits (PAT)	9.0	-11.8	5.5	9.6	8.9	13.2	6.9	-15.6	-32.2	-7.7
Select Ratios										
Change in stock [#] to Sales	1.8	1.3	2.6	0.7	1.3	2.4	1.2	0.5	2.3	1.1
Interest Burden	19.7	27.9	20.9	19.5	19.8	19.0	22.0	28.8	28.9	27.3
Interest Coverage	5.1	3.6	4.8	5.1	5.1	5.3	4.6	3.5	3.5	3.7
PBDIT to Sales	15.8	13.6	16.3	15.6	16.1	15.4	15.0	13.0	12.6	13.1
PBIT to Sales	13.6	12.1	13.6	13.5	13.6	13.4	13.0	11.3	11.0	12.2
PAT to Sales	8.5	6.3	8.6	8.6	8.4	8.6	7.5	6.1	4.8	6.9

*: Other income excludes extraordinary income/expenditure if reported explicitly. #: For companies reporting this item explicitly.

Note: Growth rates are percentage changes in the level for the period under reference over the corresponding period of the previous year for common set of companies.

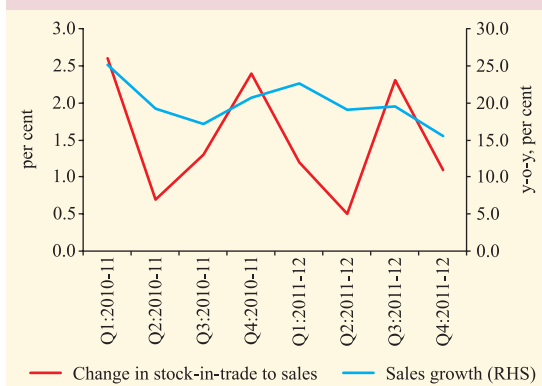
II.7 Growth in sales (y-o-y) remained strong in the first three quarters of 2011-12 before moderating in Q4 of 2011-12. On a sequential basis, however, sales picked up in the latter half of the year. During Q4 of 2011-12, there was also some decline in the rate of growth of input

Table II.6: Corporate Sector- Financial Performance (Sequential Growth)

									Q-on-Q, per cent
Indicator	Number of Companies 2273								
	2010-11 Q1	2010-11 Q2	2010-11 Q3	2010-11 Q4	2011-12 Q1	2011-12 Q2	2011-12 Q3	2011-12 Q4	
1	2	3	4	5	6	7	8	9	
Sales	-3.6	5.7	5.1	12.4	-1.8	2.7	5.5	8.6	
Change in Stock	89.0	-70.6	98.5	137.8	-58.0	-47.9	282.5	-47.3	
Expenditure, of which	-2.9	4.7	5.2	15.0	-2.9	4.5	7.5	6.8	
Raw Material	-3.6	4.9	6.0	18.9	-3.5	1.2	8.5	10.4	
Staff Cost	3.5	7.3	2.8	4.9	3.6	5.0	4.1	1.0	
Power & Fuel	11.9	0.6	4.5	9.4	10.6	-0.2	8.0	5.1	
Operating Profits (PBDIT)	-1.1	1.2	8.2	7.3	-4.2	-11.1	2.9	12.6	
Other Income*	-47.1	43.5	-22.9	74.2	-24.6	26.6	2.6	50.7	
Depreciation	1.2	2.1	3.0	7.7	-3.1	2.1	3.6	8.5	
Gross Profits (PBIT)	-9.2	4.9	5.7	13.5	-7.4	-10.3	2.6	20.2	
Interest	16.5	-1.4	5.8	20.0	-2.3	17.9	2.7	13.6	
Tax Provision	-9.6	3.5	2.8	7.3	7.0	-11.5	-4.6	15.7	
Net Profits (PAT)	-9.9	5.6	3.8	14.1	-14.6	-16.5	-16.7	55.4	

*: Other income excludes extraordinary income/expenditure if reported explicitly

Note: Growth rates are percentage changes in the level for the period under reference over the previous quarter for common set of companies.

Chart II.2: Movement in Sales Growth and Stock-in-Trade to Sales

costs as well as interest outgo on a year-on-year basis. The build-up in inventory, however, was lower in Q4 of 2011-12 partly neutralising the higher built-up observed during the previous quarter.

II.8 Along with the decline in sales growth, the stock-in-trade to sales ratio has also declined in Q4 of 2011-12 (Chart II.2). This decline points towards a pessimistic corporate outlook for demand conditions ahead.

High deficits limit fiscal space for reviving private investment

II.9 The centre's gross fiscal deficit (GFD) rose sharply to 5.8 per cent in 2011-12 from 4.9 per cent in 2010-11, with revenue deficit constituting over three-fourths of GFD as against 67.5 per cent a year ago. The widening of revenue deficit in 2011-12 reflected the impact of the economic slowdown on tax revenues with the revenue receipts-GDP ratio in 2011-12 turning out to be lower than even the crisis years of 2008-09 and 2009-10. Although the revenue expenditure-GDP ratio declined in 2011-12, this was at the cost of development revenue expenditure. Notably, subsidies increased to 2.5 per cent of GDP. With the large and growing revenue deficit constraining the fiscal space for investment expenditure, the capital outlay to GDP ratio declined to 1.6 per cent, well below the pre-crisis level of over 2 per cent.

Table II.7: Key Fiscal Indicators

(As per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal deficit	Outstanding Liabilities@
1	2	3	4	5
Centre				
2010-11	1.8	3.3	4.9	52.8
2011-12 RE	2.8	4.5	5.9	51.9
	(2.7)	(4.3)	(5.8)	
2012-13 BE	1.9	3.4	5.1	—
States*				
2010-11	0.5	-0.0	2.1	23.3
2011-12 RE	0.8	-0.1	2.3	22.3
2012-13 BE	0.6	-0.4	2.1	21.0
Combined*				
2010-11	2.4	3.2	6.9	65.8
2011-12 RE	3.6	4.4	8.2	65.4
2012-13 BE	2.6	3.1	7.1	—

RE: Revised Estimates. BE: Budget Estimates.

@: Includes external debt at current exchange rates.

*: Data in respect of States pertains to 26 State Governments.

Note: Figures in parentheses are provisional accounts.**Source:** Budget documents of the Central and State Governments.

II.10 Preliminary data indicates that the combined revenue and fiscal deficits of the centre and states as a proportion of GDP increased by 1.2 percentage points and 1.3 percentage points, respectively, in 2011-12 over the previous year, with over 80 per cent of the increase contributed by the centre (Table II.7). Combined development expenditure-GDP ratio increased in 2011-12 on account of the states (Table II.8).

Table II.8: Combined Finances of Central and State Governments

Item	Per cent to GDP		
	2010-11	2011-12	2012-13
		(RE)	BE
1	2	3	4
1. Total expenditure	27.8	28.3	27.8
2. Revenue Expenditure	23.7	24.0	23.3
3. Capital Expenditure	4.1	4.3	4.5
Of which: Capital Outlay	3.7	3.7	4.1
4. Non-Developmental Expenditure	11.1	11.1	11.1
5. Development expenditure	16.4	16.8	16.3
6. Revenue Receipts	20.5	19.6	20.2
i) Tax Revenue (net)	16.3	16.4	16.9
ii) Non Tax Revenue	4.2	3.2	3.4

RE: Revised Estimates. BE: Budget Estimates.

Note: Data in respect of States pertains to 26 State Governments.**Source:** Budget documents of the Central and State Governments.

Likely overshooting of subsidies pose fiscal risks during 2012-13

II.11 Achieving fiscal consolidation as envisaged in the budget for 2012-13 would hinge on the realisation of budgeted tax buoyancies and capping of subsidies to below 2 per cent of GDP. The compensation to oil marketing companies for under-recoveries budgeted at ₹400 billion for 2012-13, however, appears inadequate, given the spillover in compensation of ₹385 billion in Q4 of 2011-12 and under-recoveries of ₹478 billion reported by oil marketing companies for Q1 of 2012-13, in spite of some softening of global crude oil prices. Capping the subsidies within the budgeted limits would necessitate steps to allow the pass-through of international crude oil prices to domestic prices, failing which it would be difficult to achieve the overall deficit targets.

II.12 Besides the fiscal slippage on account of fuel subsidies, moderation in growth from the assumed 7.6 per cent for 2011-12 in the Union budget could be another risk factor for revenue receipts.

II.13 Available data show that during April-May 2012 key deficits in terms of percentages to budget estimates improved over the corresponding period of the previous year mainly on account of higher tax revenue, particularly under income and services tax collections. Direct taxes continued to exhibit buoyant growth in Q1 of 2012-13, although the increase partly reflects the lower tax refunds compared with the previous year. Indirect tax collections under Union excise and customs duties during Q1 of 2012-13 shows marked slippage from budgeted growth.

II.14 Aggregate expenditure growth in the first two months of 2012-13 was higher than a year ago, attributable to higher non-plan revenue expenditure, with interest payments accounting for over 29 per cent of the increase.

State finances budgeted to improve further in 2012-13

II.15 In contrast to the centre, the consolidated revenue account of the states (excluding Mizoram and Manipur) showed a marginal surplus in 2011-12 as compared with the revenue balance in 2010-11. Although there was an increase in the GFD-GDP ratio, this was used to fund higher capital outlays. On the revenue front, despite the economic slowdown, the tax-GDP ratio of the states increased over the previous year, aided in large part by higher VAT/sales tax collections on petroleum products. In fact, for the first time tax collections of state governments on petroleum products in 2011-12 were higher than those of the centre. The quality of expenditure also improved in 2011-12, with increases in development and social sector expenditures as well as capital outlay in proportion to GDP.

II.16 The key deficit indicators of the states are budgeted to improve further in 2012-13. The consolidated revenue surplus of the state governments is budgeted to increase in 2012-13, mainly on account of an increase in the revenue receipts-GDP ratio, which is to be supplemented by reduction in the revenue expenditure-GDP ratio. The budgeted increase in revenue surplus would enable a higher capital outlay-GDP ratio for the states in 2012-13, even while reducing their consolidated GFD-GDP ratio.

II.17 The majority of the states have budgeted to meet the targets set by the Thirteenth Finance Commission (ThFC) for deficit/debt indicating their commitment to the fiscal consolidation process. The challenge for the states is to refrain from sacrificing the quality of fiscal adjustment in their endeavour to meet the incentivised quantitative targets.

Need to create fiscal space, spur investment to revive growth

II.18 Recovery of investment is critical in reviving growth but depends on fiscal consolidation and improvement in overall

macroeconomic scenario. The major challenges to growth recovery at the current juncture emanate from the weak investment demand. Even a modest recovery in economic growth during 2012-13 is contingent on the recovery of investment. However, the capacity of investment to respond to monetary policy actions to stimulate growth is conditional on an improvement in non-monetary factors that have impacted investment in the current cycle. On the other hand, persistent inflation, limits the space for monetary policy to revive growth.

II.19 The slowdown in consumption demand also points towards the impact of high and persistent inflation on purchasing power. This also indicates the need for keeping inflation under check to maintain consumption demand at levels consistent with the overall growth

objective. Therefore, monetary policy has to continue to remain guarded against a build-up of inflationary risks as well as to sustain the growth potential.

II.20 Given the deterioration in the fiscal situation, the option of using fiscal policy to stimulate aggregate demand remains unavailable unlike in 2008-09 when the previous period of fiscal consolidation helped to provide the necessary fiscal space. As higher deficits could lead to pressures on yields, affecting the already weak private investment demand, it is critical to return to a credible and durable fiscal consolidation path. As such, fiscal space would need to be created by controlling revenue expenditure to provide more resources for capital expenditure which could crowd-in private investment.

III. THE EXTERNAL SECTOR

The weakness in the external sector observed in 2011-12 continued during the first quarter of 2012-13, mainly reflecting uncertainty in global economic and financial conditions coupled with weak domestic macroeconomic conditions. The rupee witnessed renewed pressures and depreciated against the US dollar in Q1 of 2012-13, in line with the trend registered by major EDE currencies. Capital flows have remained subdued and volatile. Notwithstanding various policy measures initiated by the Reserve Bank, significant depreciation of the rupee, softening commodity prices and moderation in gold imports, improvement in the trade deficit will continue to hinge upon global macroeconomic conditions and therefore, upside risks remain. With services exports likely to decelerate during 2012-13, the risks of CAD going above its sustainable rate, and difficulties in financing it, persist.

Global factors continue to weigh on India's exports

III.1 India's merchandise exports, which had decelerated in 2011-12, contracted in Q1 of 2012-13 mainly reflecting subdued demand conditions in key global markets, particularly the EU and the US (Table III.1). In particular, exports of engineering goods, petroleum products, gems and jewellery and readymade garments have been affected. Evidently the significant depreciation in the rupee since H2 of 2011-12 could not sufficiently offset the impact of the slowdown in global demand. In

recent years, due to export diversification efforts, the share of developing economies in India's total exports witnessed a gradual increase. However, as the sluggish economic conditions in advanced economies (AEs) slowly spilled over to other emerging and developing economies (EDEs), diversification did not yield results similar to those seen in previous years. Going forward, economic conditions especially in EU are likely to remain muted for some time. As a result, growth in global trade volume, including exports from EDEs, is likely to be lower in 2012. Indian exports are likely to reflect this general trend.

Table III.1: India's Merchandise Trade

Item	(US\$ billion)							
	April-March				April-June			
	2010-11 R		2011-12 P		2011-12 R		2012-13 P	
	Value	Growth (%)	Value	Growth (%)	Value	Growth (%)	Value	Growth (%)
1	2	3	4	5	6	7	8	9
Exports	251.1	40.5	304.6	21.3	76.5	36.4	75.2	-1.7
Of which: Oil	41.5	47.1	55.6	34.0	15.3	76.2	12.9	-15.6
Non-oil	209.7	39.3	249.0	18.8	61.2	29.1	62.3	1.8
Imports	369.8	28.2	489.4	32.4	122.7	36.3	115.3	-6.1
Of which : Oil	106.0	21.6	154.9	46.2	39.4	52.5	41.5	5.3
Non-oil	263.8	31.1	334.5	26.8	83.3	29.7	73.8	-11.5
Gold	40.5	41.6	56.2	38.8	16.1	109.1	8.5	-47.5
Non-Oil Non-Gold	223.3	29.3	278.3	24.6	67.2	18.9	65.3	-2.9
Trade Deficit	-118.6		-184.8		-46.2		-40.1	
Of which: Oil	-64.5		-99.3		-24.1		-28.6	
Non-oil	-54.1		-85.5		-22.1		-11.5	

R: Revised. P: Provisional.

Source: DGCI&S.

Softening of international commodity prices narrowed the trade deficit

III.2 The weakness in India's external position in 2011-12 stemmed partly from the import-induced surge in the current account deficit (CAD). Given the inelastic nature of India's imports of petroleum, oil and lubricants (POL) and gold, the rise in international prices of these commodities led to overall high imports. This trend, however, reversed in Q1 of 2012-13. The decline in imports in the quarter was sharper than that in exports (Chart III.1a). Import moderation was mainly on account of a modest contraction in POL imports and a significant contraction in gold and silver imports. The lower growth in POL reflects the softening of international crude oil prices, while the decline in gold and silver imports appears to reflect the impact of policy measures taken in January and March 2012 (Chart III.1b). Growth moderation in non-oil imports in recent months appears to be on account of confluence of various factors, viz., domestic slowdown, global uncertainty, moderation in global commodity prices and the possible impact of rupee depreciation in some sectors. As a result, the trade deficit narrowed somewhat in Q1 of 2012-13 compared with the corresponding period of the previous year.

Upside risks to trade deficit persist

III.3 Recent trend of faster deceleration in imports than exports has given rise to the

possibility that CAD could improve in 2012-13. However, current assessment suggests that such improvement could be insufficient to ensure CAD sustainability. The upside risk to CAD remain significant. The response of exports to depreciation of rupee has so far remained muted due to subdued global demand. Downside risks to export growth are large in view of worsening global conditions. Exchange rate sensitivity of India's import is also limited.

Slowdown in global IT spending may dampen growth in software exports

III.4 Despite the challenges in global market conditions, services exports, in general and software exports in particular sustained the growth momentum in 2011-12 (Table III.2). However, net services exports earnings at US\$14 billion in Q1 of 2012-13, have declined by about 12 per cent y-o-y, suggesting loss of momentum. Services exports in gross terms expanded by 3 per cent, while imports increased by 19 per cent in this quarter. Going forward, NASSCOM projection of 11-14 per cent growth in software exports in 2012-13, suggests deceleration. Current indications, borne out by dollar revenue guidance of IT majors, suggest that software export earnings may even be lower than projected by NASSCOM. The risk of lower software exports may arise from reduced spending on technology by US corporations, continued uncertainty in the euro area countries and likely euro depreciation. As

Chart III.1: India's Merchandise Trade and Gold Imports

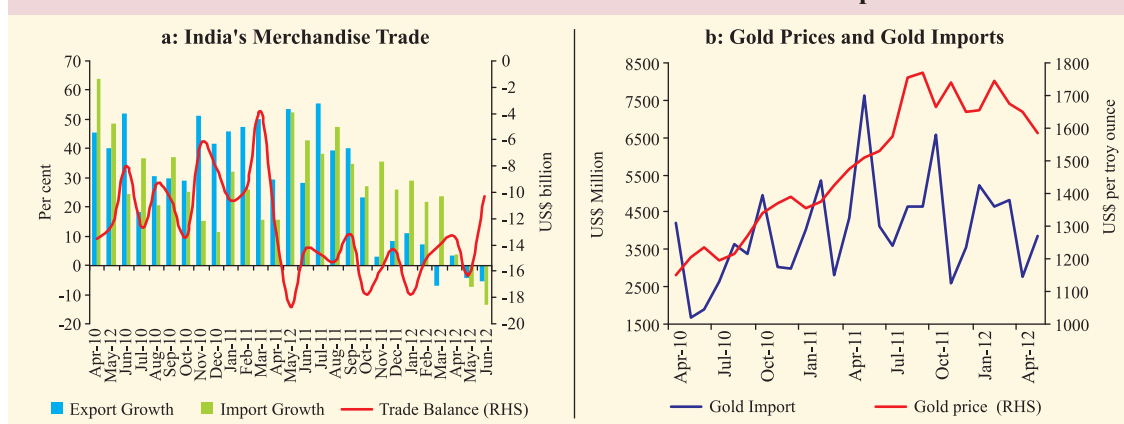


Table III.2: Major Items of India's Balance of Payments

(US\$ billion)							
	2010-11 (PR)	2011-12 (P)	2011-12				2010-11
			Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (P)	Q4 (PR)
1	2	3	4	5	6	7	8
1. Goods Exports	250.6	309.8	78.8	79.6	71.5	80.0	77.4
2. Goods Imports	381.1	499.5	123.7	124.1	120.1	131.7	107.4
3. Trade Balance (1-2)	-130.5	-189.7	-44.9	-44.5	-48.6	-51.7	-30.0
4. Services Exports	131.7	140.9	33.7	32.3	37.3	37.7	35.3
5. Services Imports	83.0	76.9	17.4	18.3	21.1	20.0	20.7
6. Net Services (4-5)	48.7	64.0	16.3	14.0	16.2	17.7	14.6
7. Goods & Services Balances (3+6)	-81.8	-125.7	-28.6	-30.5	-32.4	-34.0	-15.4
8. Primary Income (Net)	-17.3	-16.0	-3.6	-4.0	-3.8	-4.6	-4.5
9. Secondary Income (Net)	53.1	63.5	14.8	15.6	16.2	16.9	13.6
10. Net Income (8+9)	35.8	47.5	11.2	11.6	12.4	12.3	9.1
11. Current Account Balance (7+10)	-46.0	-78.2	-17.4	-18.9	-20.2	-21.7	-6.3
12. Capital Account Balance	0.04	-0.1	-0.3	0.2	0.1	-0.2	-0.02
13. Financial Account Balance	48.9	80.7	18.7	19.0	20.6	22.4	7.1
of which: Change in Reserves (increase-/decrease+)	-13.1	12.8	-5.4	-0.3	12.8	5.7	-2.0
14. Errors & Omissions (-) (11+12+13)	-3.0	-2.4	-0.9	-0.4	-0.5	-0.6	-0.8
<i>Memo: As ratio to GDP</i>							
15. Trade Balance	-7.7	-10.3	-9.8	-9.9	-10.7	-10.6	-6.2
16. Net Services	2.9	3.5	3.6	3.1	3.5	3.6	3.0
17. Net Income	2.1	2.6	2.4	2.6	2.7	2.5	1.9
18. Current Account Balance	-2.7	-4.2	-3.8	-4.2	-4.4	-4.5	-1.3
19. Capital and Financial Account, Net (Excl. changes in reserves)	3.7	3.7	5.2	4.4	1.7	3.4	1.9
P: Preliminary; PR: Partially Revised							
Note: Total of subcomponents may not tally with aggregate due to rounding off.							

software exports account for nearly 63 per cent of net receipts of invisibles, any deceleration in these exports may aggravate the already high CAD recorded in recent quarters.

Capital flows may remain volatile due to global uncertainties

III.5 The exacerbation in CAD during 2011-12 led to depletion of reserves notwithstanding improved capital flows (Table III.3). Since Q1 of 2012-13, concerns about the growth and financial health of euro area countries have further intensified. In addition, signs of weakness in the US and China have also made investors more cautious and driven up global financial market volatility. These factors, combined with weakening domestic macroeconomic conditions, led to a net FII outflow of US\$ 1.7 billion in Q1 of 2012-13.

Concerns about the domestic business environment appear to be weighing on FDI inflows as well. NRI deposits, however, have picked up in recent months (Table III.4). Since concerns about the growth outlook for AEs seem to have prompted investors to reconsider the resilience of emerging market growth as well, the outlook for capital flows to EDEs including India remains subdued.

Rupee gains in Q4 of 2011-12 dissipated in Q1 of 2012-13

III.6 The rupee gained by 4.1 per cent in Q4 of 2011-12, partly reflecting the favourable impact of policy measures by the Reserve Bank to improve capital flows and curb speculative pressure in foreign exchange market. The intervention in the foreign exchange market also helped in containing the depreciation. However,

Table III.3: Disaggregated Items of Financial Account

(US\$ billion)							
	2010-11 (PR)	2011-12 (P)	2011-12				2010-11 Q4 (PR)
			Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (P)	
1	2	3	4	5	6	7	8
1. Direct Investment (net)	9.4	22.1	9.3	6.5	5.0	1.4	1.1
1.a Direct Investment to India	25.9	33.0	12.4	9.5	6.9	4.2	5.5
1.b Direct Investment by India	-16.5	-10.9	-3.1	-3.0	-1.9	-2.9	-4.4
2. Portfolio Investment	28.2	16.6	2.3	-1.4	1.8	13.9	-0.01
2.a Portfolio Investment in India	29.4	16.8	2.5	-1.6	1.9	14.1	-0.03
2.b Portfolio Investment by India	-1.2	-0.2	-0.2	0.2	-0.04	-0.2	0.02
3. Other investment	24.4	29.2	12.6	14.2	1.0	1.4	8.1
3.a Other equity (ADRs/GDRs)	2.0	0.6	0.3	0.2	0.1	0.03	0.2
3.b Currency and deposits	3.8	12.1	1.2	3.1	3.2	4.6	2.0
Deposit-taking corporations, except the central bank: (NRI Deposits)	3.2	11.9	1.2	2.8	3.3	4.7	0.9
3.c Loans*	18.6	16.8	14.9	9.5	-7.7	-0.03	1.0
3.c.i Loans to India	18.3	15.7	14.9	8.9	-8.1	-0.02	0.7
Deposit-taking corporations, except the central bank	1.2	4.1	11.5	3.9	-8.7	-2.6	-2.7
General government (External Assistance)	5.0	2.5	0.4	0.3	1.4	0.3	0.8
Other sectors (ECBs)	12.2	9.1	3.0	4.7	-0.8	2.3	2.7
3.c.ii Loans by India	0.3	1.0	-0.02	0.6	0.5	-0.01	0.3
General government (External Assistance)	-0.03	-0.2	-0.04	-0.04	-0.04	-0.04	-0.01
Other sectors (ECBs)	0.3	1.2	0.02	0.6	0.5	0.03	0.3
3.d Trade credit and advances	11.0	6.7	3.1	2.9	0.6	0.2	2.7
3.e Other accounts receivable/payable - other	-11.1	-6.9	-6.8	-1.5	4.9	-3.3	2.2
4. Reserve assets (increase-/decrease+)	-13.1	12.8	-5.4	-0.3	12.8	5.7	-2.0
Financial Account (1+2+3+4)	48.9	80.7	18.7	19.0	20.6	22.4	7.1

P: Preliminary; PR: Partially Revised

*: Includes External Assistance, ECBs, non-NRI Banking Capital and short term trade credit.

Note: Total of subcomponents may not tally with aggregate due to rounding off.**Table III.4: Capital Flows in 2011-12 and 2012-13 So Far**

(US\$ billion)					
Component	2011-12				2012-13
	Apr.- Jun.	Jul.- Sep.	Oct.- Dec.	Jan.- Mar.	Apr.- Jun.
	Average of the monthly flows				
1	2	3	4	5	6
FDI in India	4.1	3.1	2.3	1.5	2.2*
FDI by India	1.0	1.0	0.6	1.0	0.5
FIIIs (Net)	0.8	-0.5	0.6	4.7	-0.6
ADRs/GDRs	0.1	0.1	0.03	0.01	0.01
ECB Inflows	1.0	1.6	0.9	0.8	-0.4
NRI Deposits (Net)	0.4	0.9	1.1	1.6	2.4*

*April-May.

the rupee started weakening from the first week of April 2012 as portfolio capital inflows dried up. The large trade deficit, domestic policy uncertainty and growing apprehensions about the euro area affected the overall investment sentiment. As a result, the rupee reached a low of 57.2 on June 27, 2012 and the real effective exchange rate (*i.e.*, the REER based on 6, 30 and 36 currency baskets) recorded a depreciation (Table III.5).

Increasing external debt is a concern

III.7 Since equity flows dwindled, various measures were taken to encourage other capital flows into the country. These include an increase

Table III.5: Nominal and Real Effective Exchange Rates-Trade Based
(Base: 2004-05=100)

(Per cent, appreciation+/depreciation-)						
	Index July 20, 2012 P	Year-on-Year Variation (Average)			2011-12 (March 2012 over January 2012)	2012-13 (July 20, 2012 over March 2012)
		2009-10 P	2010-11P	2011-12		
1	2	3	4	5	6	7
36-REER	91.4	-3.2	8.0	-3.2	2.3	-7.2
36-NEER	78.6	-2.6	3.1	-6.4	1.2	-9.7
30-REER	83.5	-4.6	4.8	-2.9	2.3	-7.2
30-NEER	80.3	-2.2	1.1	-5.4	1.0	-9.6
6-REER	104.6	-0.3	13.0	-6.8	2.5	-7.1
6-NEER	76.4	-3.7	5.7	-7.9	1.4	-9.9
₹/US\$ (Average)	54.5#	-3.2	4.0	-4.9	2.0	-7.7#
₹/US\$ (end-March)	55.9*	12.9	1.1	-12.7	-2.9	-8.6*

P: Provisional. NEER: Nominal Effective Exchange Rate.

REER: Real Effective Exchange Rate.

*: As on July 26, 2012. #: April-July 26, 2012 over March 2012.

Note: Rise in indices indicates appreciation of the rupee and *vice versa*.

in FII investment in debt securities (both government and corporate debt), enhancing all-in-cost ceiling for ECBs and trade credit and the deregulation of interest rates on rupee-denominated NRI deposits, *i.e.*, NRE and NRO accounts. On account of the greater recourse to such debt creating flows in financing CAD, India's external debt increased significantly during Q4 of 2011-12 (Table III.6). Further, the repayment of commercial borrowings of about US\$ 15 billion (including FCCBs of about US\$ 4.7 billion) is due during 2012-13. Thus, there

is a pressing need to improve the equity flows to finance CAD and maintain the external debt at a manageable level.

Sustainability of CAD and its financing remain concerns

III.8 External sector vulnerability indicators showed mixed trend in Q4 of 2011-12 (Table III.7). There has been a marginal improvement in the ratio of short-term debt to total debt. While debt GDP ratio and debt service ratio remained same, other indicators such as ratio

Table III.6: India's External Debt

(US \$ billion)							
Item	End-Mar 2011 PR	End-Jun 2011 PR	End-Sep 2011 PR	End-Dec 2011 PR	End-Mar 2012 QE	Variation (End-Mar 2012 over End-Dec 2011)	
						Amount	Per cent
1	3	4	5	6	7	8	9
1. Multilateral	48.5	49.4	49.1	49.9	50.5	0.5	1.1
2. Bilateral	25.7	26.2	27.1	27.1	26.8	-0.3	-1.1
3. International Monetary Fund	6.3	6.4	6.2	6.1	6.1	0.1	0.9
4. Trade Credit (above 1 year)	18.6	18.7	19.5	19.8	19.9	0.1	0.6
5. External Commercial Borrowings	88.6	92.9	96.3	98.7	104.4	5.7	5.8
6. NRI Deposits	51.7	52.9	52.3	52.5	58.6	6.1	11.6
7. Rupee Debt	1.6	1.6	1.4	1.3	1.3	0.0	0.0
8. Long-term (1 to 7)	240.9	247.9	252.0	255.4	267.6	12.3	4.8
9. Short-term	65.0	68.5	71.5	76.0	78.2	2.2	2.9
Total (8+9)	305.9	316.4	323.5	331.4	345.8	14.5	4.4

PR: Partially Revised. QE: Quick Estimates.

Table III.7: External Sector Vulnerability Indicators

(Per cent)							
Indicator	End-Mar 2010	End-Jun 2010	End-Mar 2011	End-Jun 2011	End-Sep 2011	End-Dec 2011	End-Mar 2012
1	2	3	4	5	6	7	8
1. Ratio of Total Debt to GDP	18.0	-	17.8	15.9	17.8	20.0	20.0
2. Ratio of Short-term to Total Debt (Original Maturity)	20.0	20.9	21.2	21.6	22.1	22.9	22.6
3. Ratio of Short-term to Total Debt (Residual Maturity)	41.2	42.5	42.2	43.3	43.4#	43.5#	42.6
4. Ratio of Concessional Debt to Total Debt	16.8	15.9	15.5	15.1	14.8	14.4	13.9
5. Ratio of Reserves to Total Debt	106.9	98.0	99.6	99.8	96.3	89.5	85.1
6. Ratio of Short-term Debt to Reserves	18.8	21.0	21.3	21.7	23.0	25.6	26.6
7. Reserves Cover of Imports (in months)	11.1	10.7	9.6	9.2	8.5	7.7	7.1
8. Reserves Cover of Imports and Debt Service Payments (in months)	10.5	10.1	9.1	8.8	8.0	7.3	6.8
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	5.8	4.1	4.3	4.8	4.7	5.6	5.6
10. External Debt (US\$ billion)	260.9	270.3	305.9	316.4	323.5	331.4	345.8
-: Not available. #: RBI Estimate.							

of foreign exchange reserves to total debt and the short-term debt to foreign exchange reserves, deteriorated as at end-March 2012 compared with end-December 2011. India's Net International Investment Position (NIIP) also weakened (Table III.8).

Rising vulnerability to external shocks

III.9 The CAD-GDP ratio was high at 4.5 per cent in Q4 of 2011-12, taking the full year

Table III.8: Overall International Investment Position of India

(US\$ billion)					
Period	Mar-11 (PR)	Jun-11 (PR)	Sep-11 (PR)	Dec-11 (P)	Mar-12 (P)
1	2	3	4	5	6
NIIP	-203.6	-216.5	-196.6	-204.8	-244.8
Assets	439.8	450.0	453.9	431.6	437.1
Liabilities	643.4	666.5	650.5	636.5	682.0
NIIP-GDP Ratio*	-12.1	-11.9	-11.0	-11.3	-13.2

PR: Partially Revised P: Preliminary.

* Based on annualised GDP.

ratio to an all time high of 4.2 per cent. Such high level of CAD, especially against the backdrop of volatile global macroeconomic conditions and volatile capital flows, raise grave concerns about its sustainability. A recent analysis shows that with GDP growth of 7 per cent, CAD-GDP ratio of around 2.5 per cent is sustainable. The estimate is based on analysis of threshold level of India's net external liability to GDP ratio to work out sustainable CAD-GDP ratio in various growth scenarios. With an increase in deficit beyond this level, financing could be a constraint and the external sector vulnerability may rise further. High external debt, along with a deterioration in the net international investment position and a moderate decline in forex reserves also weakened the resilience of India's external sector in Q4 of 2011-12. Going forward, the trend in CAD will largely depend on the global macroeconomic and trade environment. The trend in capital flows will depend on global liquidity conditions, as well as the domestic investment and policy environment.

IV. MONETARY AND LIQUIDITY CONDITIONS

While continuing to manage the growth-inflation trade-off, the Reserve Bank reduced the repo rate by 50 basis points in April 2012. Monetary conditions have gradually eased in 2012-13 so far as a result of the two-stage reduction in the cash reserve ratio in Q4 of 2011-12, the repo rate cut and significant depreciation of the exchange rate. Active liquidity management by the Reserve Bank by way of sizeable open market purchases and other policy measures has helped correct the excessively tight liquidity that prevailed during the latter part of 2011-12. Besides the gradual pick-up in growth in monetary aggregates in 2012-13 so far, there has been a pick-up in non-food credit which as of mid-July 2012 was growing marginally above the indicative projection for 2012-13.

Reserve Bank front-loads rate cut using the available monetary policy space

IV.1 In April 2012, the Reserve Bank reduced the repo rate for the first time in three years. Even as inflation remained the main concern, the policy rate was reduced by 50 basis points on account of moderation in growth below its post-crisis trend (Table IV.1). While it was recognised that the deviation in growth from its trend was modest, the slowdown, nevertheless, was expected to contribute to some moderation in core inflation. The cumulative impact of past monetary tightening was expected to moderate inflation further through slower growth.

IV.2 Inflation has, however, persisted above the level consistent with sustainable growth.

When the Reserve Bank undertook the front-loaded rate cut action in April 2012, it clearly enunciated that upside risks to inflation persisted and space for further reduction in policy rates was limited. This space was further constrained by lack of credible action to curtail subsidies and related expenditure by the government. Also, there were a number of factors other than monetary policy actions behind the growth slowdown in 2011-12.

IV.3 Apart from the rate cut, monetary conditions eased as a result of softening impact on interest rates of the 125 basis points reduction in the cash reserve ratio (CRR) during Q4 of 2011-12 and the significant exchange rate depreciation (about 10 per cent in Q1 of 2012-13 and about 20 per cent cumulative since August 2011). The monetary easing during Q1 of 2012-13 has significantly corrected the tightness in monetary and liquidity conditions witnessed during Q4 of 2011-12. M₃ expansion during 2011-12 at 13.1 per cent was below the indicative projection of 15.5 per cent. Low reserve money expansion at 9.6 per cent (adjusted for CRR changes) contributed to lower expansion of money supply. Reserve money creation has improved during 2012-13 so far, and deposit creation and consequently, monetary expansion is within sight of indicative projections for the year (Table IV.2).

Table IV.1: Movements in Key Policy Variables

(Per cent)		
Effective since	Repo Rate	Cash Reserve Ratio
1	2	3
May 3, 2011	7.25 (+0.50)	6.00
June 16, 2011	7.50 (+0.25)	6.00
July 26, 2011	8.00 (+0.50)	6.00
September 16, 2011	8.25 (+0.25)	6.00
October 25, 2011	8.50 (+0.25)	6.00
January 28, 2012	8.50	5.50 (-0.50)
March 10, 2012	8.50	4.75 (-0.75)
April 17, 2012	8.00 (-0.50)	4.75

Note: Figures in parentheses indicate change in percentage points.

Table IV.2: Monetary Indicators

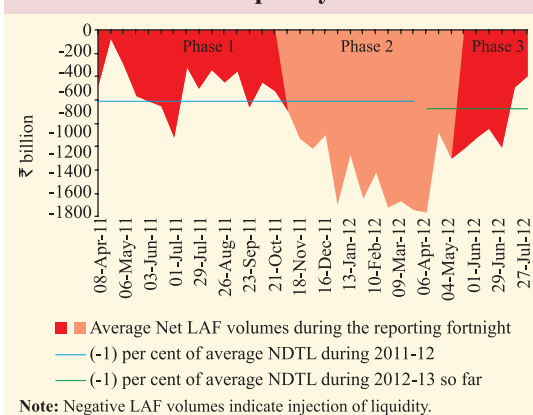
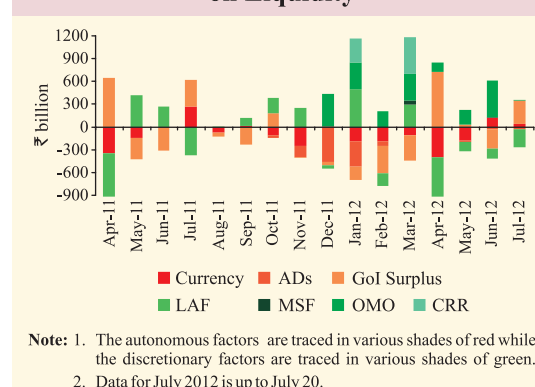
Item	Outstanding Amount (₹ billion) July 13, 2012	Financial year to date variations (Per cent)		Y-o-y variations (Per cent)	
		2011-12	2012-13	July 15, 2011	July 13, 2012
1	2	3	4	5	6
Reserve Money (M_0)*	14,810.1	-1.8	3.8	13.3	9.5
Reserve Money (Adjusted)		-1.8	3.6	13.5	15.7
Broad Money (M_3)	77,301.2	4.0	5.0	16.9	14.3
Main Components of M_3					
Currency with the Public	10,798.0	4.5	5.2	14.9	13.4
Aggregate Deposits	66,463.9	4.0	5.0	17.3	14.4
of which: Demand Deposits	6,603.5	-13.7	-6.3	-5.2	5.8
Time Deposits	59,860.4	6.6	6.4	20.7	15.4
Main Sources of M_3					
Net Bank Credit to Government	25,558.2	7.7	7.9	22.3	19.6
Bank Credit to Commercial Sector	50,751.6	2.0	2.3	19.3	17.4
Net Foreign Assets of the Banking Sector	16,377.6	1.2	6.1	5.8	16.2
<i>Memo:</i>					
Net Non-monetary Liabilities of the Banking Sector	15,531.7	-0.3	1.7	20.8	38.8

Note: 1. Data are provisional.
2. *: Data pertain to July 20, 2012.

Liquidity deficit eases in response to active management and measures taken by the Reserve Bank

IV.4 There was a significant easing of liquidity deficit in Q1 of 2012-13, and the extent of deficit returned to the Reserve Bank's comfort level of one per cent of net demand and time liabilities (NDTL) in July 2012 (Chart IV.1). This was primarily on account of large scale open market purchases by the Reserve Bank as also measures such as enhancing of the limit of export credit refinance (ECR).

IV.5 There was a distinct period of liquidity tightness that prevailed from November 2011 to early April 2012. The liquidity squeeze started in November 2011 on account of large scale forex intervention by the Reserve Bank as well as the usual high currency demand during the festive season. The squeeze on liquidity persisted into Q4 of 2011-12 as the government built up large balances with the Reserve Bank. There was continued intervention in the forex market while the drain on account of currency persisted due to seasonal factors as well as elections in a few states (Chart IV.2). Moreover,

Chart IV.1: Liquidity Conditions**Chart IV.2: Impact of Various Factors on Liquidity**

the spread between the pace of credit growth and deposit growth, which had narrowed in the first three quarters of 2011-12 and had in fact turned negative in December 2011, widened again during the fourth quarter. This added a structural dimension to the liquidity deficit (Chart IV.3). The Reserve Bank responded by injecting liquidity through outright open market operations of ₹1.3 trillion between November 2011 and March 2012 as also CRR cuts that released about ₹0.8 trillion into the system. Despite the active management, the liquidity deficit persisted at a high level.

IV.6 Since April 2012, however, there has been an easing of the liquidity stress in the system. The significant easing was brought about by the Reserve Bank actively managing liquidity through the liquidity adjustment facility (LAF) and open market operations (OMO). The Reserve Bank injected liquidity through outright OMO purchases of ₹0.8 trillion in the financial year so far, of which ₹0.6 trillion was through auction route. Also, there was some narrowing of the wedge between the pace of growth of deposit and credit in Q1 of 2012-13.

IV.7 In order to provide greater liquidity cushion to banks, the borrowing limit of scheduled commercial banks (SCBs) under the Marginal Standing Facility (MSF) has been raised from one per cent of their NDTL to two per cent since April 17, 2012. This has further

helped in steering the monetary policy operating target, the weighted average overnight call money rate, within the formal corridor (Chart IV.4). The movements in the operating target of monetary policy mostly mirror the liquidity position in the system. As noted above, there was a systemic liquidity deficit from November 2011 to early April 2012. This period coincided with the call rate mainly staying above the mid-point of the corridor (*i.e.*, the repo rate) and at times hovering close to the ceiling set by the MSF rate. As liquidity eased in Q1 of 2012-13, the call rate gradually eased back to the mid-point of the corridor.

IV.8 To further augment liquidity and encourage banks to increase credit flow to the export sector, the Reserve Bank increased the limit of ECR from 15 per cent of outstanding export credit to 50 per cent with effect from the fortnight beginning June 30, 2012. This amounted to release of additional liquidity support of over ₹300 billion, equivalent to about 50 basis points reduction in the CRR. The daily average amount of ECR availed increased from ₹70 billion in June 2012 to ₹177 billion in July 2012 (up to July 26).

IV.9 As regards the autonomous factors that drive liquidity – currency with the public, intervention in the foreign exchange market and government's cash position – the first two were largely adverse during the Q1 of 2012-13. There

Chart IV.3: Spread between credit and deposit growth of scheduled commercial banks

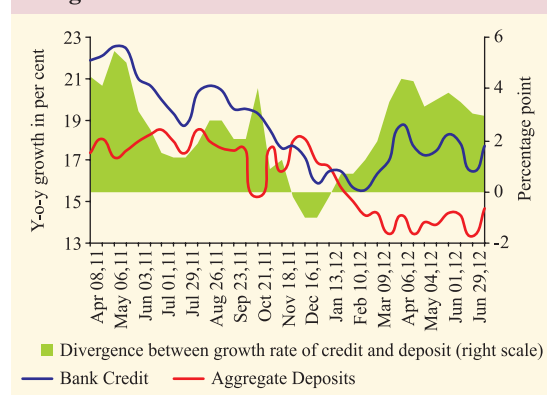
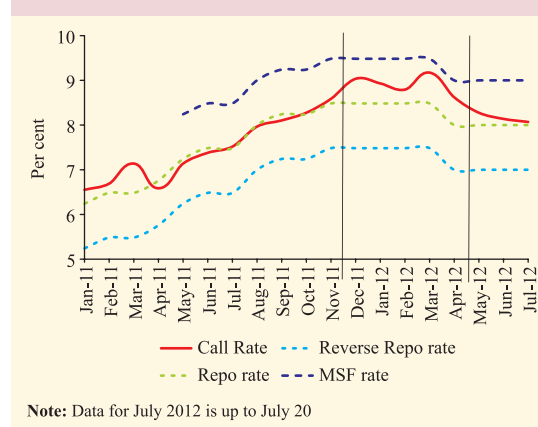


Chart IV.4: LAF Corridor and Call Rate



is typically strong demand for currency in April and May coinciding with the *rabi* marketing season. Also, as there was extreme volatility in the exchange rate, the Reserve Bank sold foreign exchange to authorised dealers in May and June. However, as a large part of the intervention was also in the forward/swap market, drain on rupee liquidity was not very significant. The liquidity stress from the above two autonomous factors was partly addressed by the net drawdown of balances by the government. As noted earlier, the large build-up in the government balance with the Reserve Bank in Q4 of 2011-12 had compounded the liquidity deficit in that quarter. As government spending increased significantly in the first quarter of 2012-13, there was concomitant easing of liquidity. The net effect of government spending during the quarter (June 30, 2012 over March 31, 2012) was release of ₹549 billion into the system.

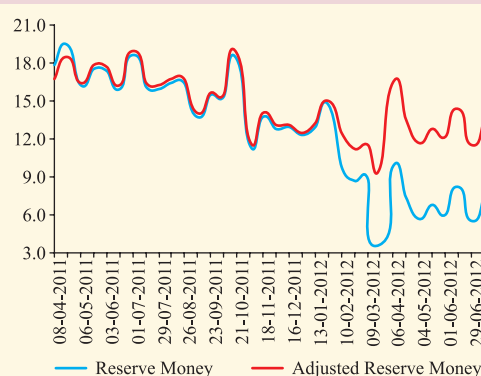
Reserve money expansion improves in Q1 of 2012-13

IV.10 There was a sharp deceleration in the pace of expansion of reserve money during Q4 of 2011-12. While this was predominantly on account of the CRR cuts, even adjusting for the first-round impact of CRR cut, the adjusted reserve money growth showed a deceleration. As seen earlier, active management of liquidity through OMO, LAF and MSF transactions led to a gradual rise in the rate of reserve money expansion in Q1 of 2012-13 as against the steady deceleration observed in the previous quarters (Chart IV.5). On the liabilities side of the Reserve Bank balance sheet, the growth is explained by the increased demand for currency.

Deceleration in broad money growth arrested in Q1 of 2012-13

IV.11 Given the significant primary liquidity injection through OMO purchases and CRR cuts, there has been a pick-up in growth rates

Chart IV.5: Growth in Reserve Money (Y-o-y, per cent)



of monetary aggregates in 2012-13 so far as against the steady deceleration observed in the fourth quarter of 2011-12 (Chart IV.6). On a y-o-y basis, the growth rate as on July 13, 2012 was lower than the previous year.

IV.12 There was a pick-up in demand for currency during the first quarter of 2012-13 as is usually observed in Q1. The y-o-y growth rate was lower than that of the previous year on account of the base effect (Chart IV.7).

IV.13 The mobilisation of deposits during the first quarter of 2012-13 was higher than in comparable period of recent years. The y-o-y deposit growth of SCBs at 14.7 per cent on July 13, 2012 is below the indicative projection of 16 per cent for 2012-13 (Chart IV.8). The

Chart IV.6: Broad Money Growth (Y-o-y, per cent)

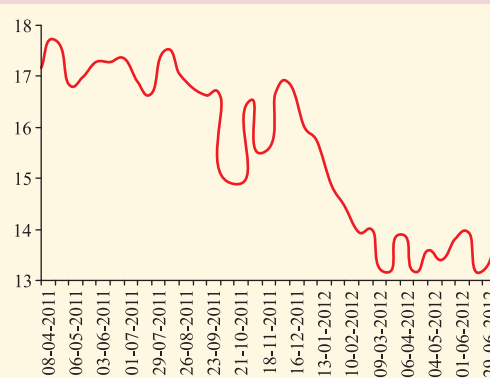
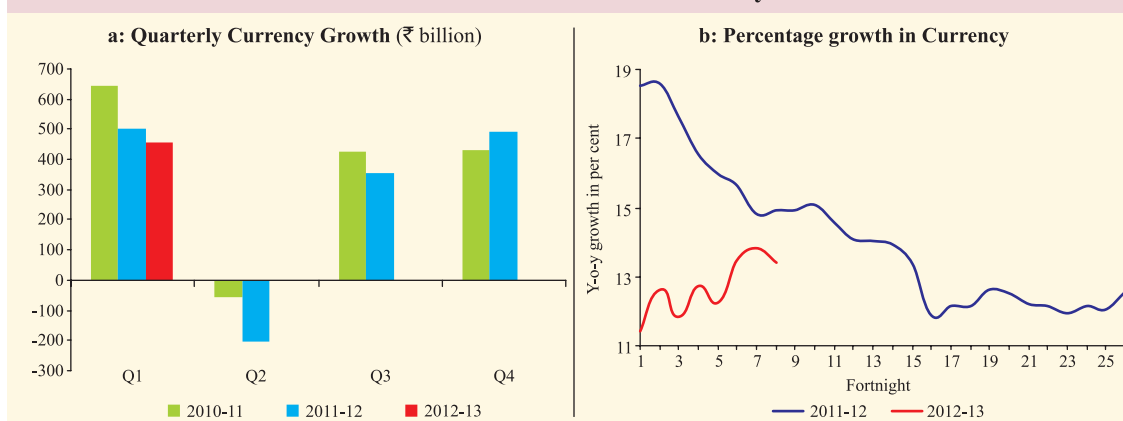


Chart IV.7: Growth in Currency


increase in deposit across the bank groups has, however, been skewed (Table IV.3).

Monetary expansion improves with rise in money multiplier

IV.14 With the CRR cuts effected in January 2012 and March 2012, there has been a reduction in the ratio of bankers' deposits with the Reserve Bank to aggregate deposits in the banking system (the reserves deposit ratio). However, monetary expansion remained subdued during Q4 of 2011-12 as increase in money multiplier was not commensurate to the CRR cut as currency demand was high. The relatively higher pace of deposit mobilisation in 2012-13 so far has resulted in lowering both the behavioural ratios. Thus, with the rise in the

Table IV.3: Aggregate Deposits of Scheduled Commercial Banks

(Amount in ₹ billion)					
Bank Group	Out-standing as on July 13, 2012	Y-o-y variation as on			
		July 15, 2011		July 13, 2012	
		Amount	Per cent	Amount	Per cent
1. Public Sector Banks*	46,453.6	6,458.6	18.9	5,897.2	14.5
of which: SBI and Associates	14,076.4	1,650.9	15.7	1,898.6	15.6
Nationalised Banks	32,377.1	4,807.8	20.4	3,998.6	14.1
2. Foreign Banks	2,697.6	114.7	5.0	276.8	11.4
3. Private Banks	11,294.3	1,485.1	18.2	1,645.6	17.1
4. All Scheduled Commercial Banks	62,217.5	8,259.0	18.0	7,991.3	14.7

Note: 1) Data as on July 13, 2012 are provisional.
2) * Excluding Regional Rural Banks.

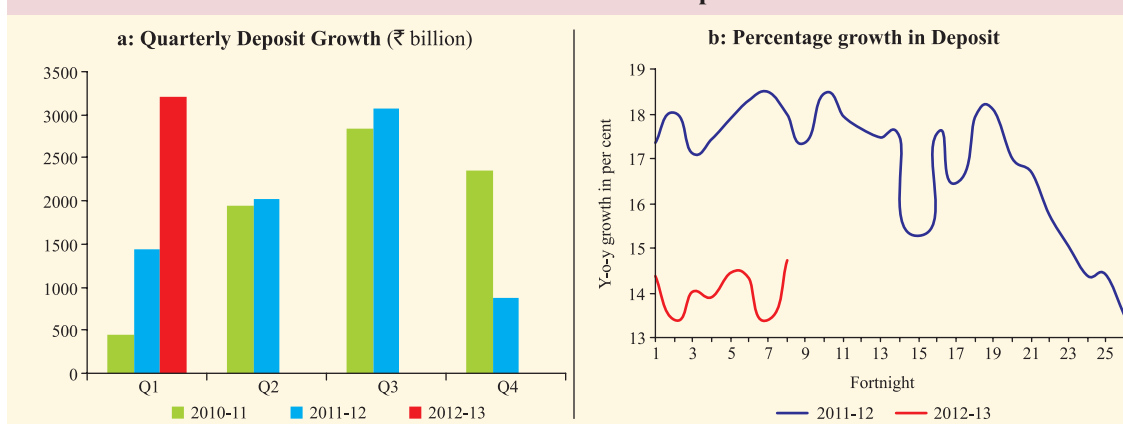
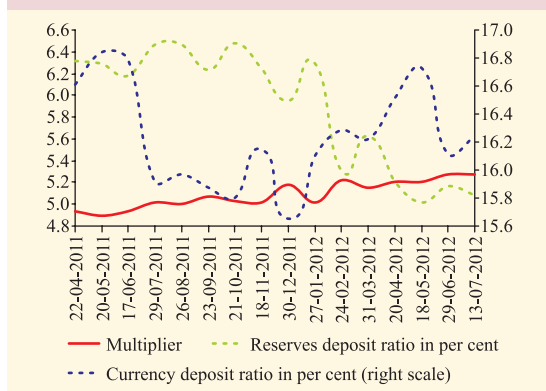
Chart IV.8: Growth in Deposit


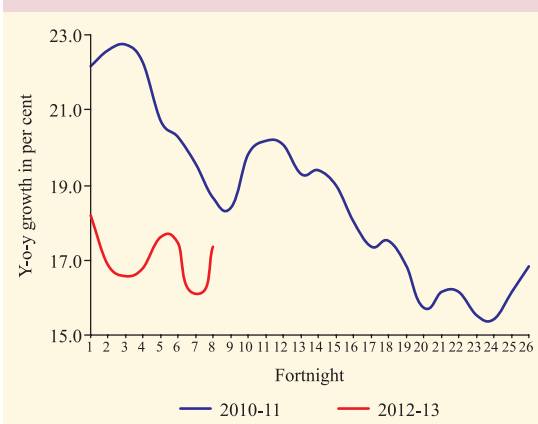
Chart IV.9: Money Multiplier and the Behavioural Ratios

money multiplier, there has been a gradual pick-up in money supply in 2012-13 so far (Chart IV.9).

Credit growth in line with the indicative trajectory for 2012-13

IV.15 The y-o-y growth rate in non-food credit increased to 17.4 per cent in mid-July 2012 from 16.8 per cent at end-March 2012 (Chart IV.10). Hence, credit growth is in line with the indicative trajectory of 17 per cent for the year. Anecdotal evidence from bankers suggests that there may be some deceleration ahead.

IV.16 Analysis of the sectoral deployment of credit (based on data from select banks which cover 95 per cent of total non-food credit

Chart IV.10: Growth in non-food credit

extended by all SCBs) for Q1 of 2012-13 reveals that industries, services and personal loans accounted for 36.1 per cent, 28.6 per cent and 28.6 per cent, respectively, of the incremental credit flow during the quarter. Within industries, nearly two-thirds of the credit flow was to mining and quarrying, rubber, plastic and their products, beverage and tobacco, vehicle, vehicle parts and transport equipment and wood and wood products.

Increase in the flow of resources to the commercial sector

IV.17 There has been a 41 per cent increase in the total flow of financial resources to the commercial sector during 2012-13 so far, compared to the corresponding period of previous year (data on banks is available till July 13, 2012 while that for most non-bank sources is for up to June only). Unlike the previous year, banks as well as non-banks had a near equal contribution to funding in the economy during the period (Table IV.4). There was about two-fold increase in funding from non-bank domestic sources. The marked increase was on account of higher issuances of commercial papers (CPs), accommodation from all Indian financial institutions (AIFIs), net credit by housing finance companies and LIC's net investment. Foreign sources of funding, however, declined compared to the corresponding period of the previous year. This is consistent with the slowdown in capital flows during the year so far.

Monetary and liquidity conditions are not significantly impinging on growth

IV.18 While there has been some rise in nominal and real interest rates during 2011-12, computation of real weighted average lending rates (WALR) suggest that they are currently much lower than the pre-crisis period of 2003-04 to 2007-08 when the investment boom took place. In nominal terms, the WALR averaged 12.4 per cent in the pre-crisis period,

Table IV.4: Flow of Financial Resources to the Commercial Sector

Item	(₹ billion)			
	April-March		April-July 13	
	2010-11	2011-12	2011-12	2012-13
1	2	3	4	5
A. Adjusted Non-food Bank Credit (NFC)	7,110.3	6,764.4	526.3	984.7
i) Non-Food Credit	6,815.0	6,525.2	601.5	911.3
<i>of which:</i> petroleum and fertiliser credit	-243.2	171.4	41.8	-28.7 #
ii) Non-SLR Investment by SCBs	295.3	239.2	-75.2	73.4
B. Flow from Non-banks (B1+B2)	5,341.1	5,745.8	846.3	944.8
B1. Domestic Sources	3,010.9	3,441.8	255.9	556.4
1. Public issues by non-financial entities	285.2	74.0	7.5	5.1 #
2. Gross private placements by non-financial entities	674.4	558.1	-	-
3. Net issuance of CPs subscribed to by non-banks	67.9	100.2	234.3	355.0 #
4. Net credit by housing finance companies	427.9	530.1	19.8	68.5 \$
5. Total gross accommodation by the four RBI regulated AIFs - NABARD, NHB, SIDBI & EXIM Bank	400.1	469.2	-66.8	37.6 #
6. Systemically important non-deposit taking NBFCs (net of bank credit)	794.7	1,290.8 P	-	-
7. LIC's gross investment in corporate debt, infrastructure and social sector	360.8	419.4	61.1	90.2 #
B2. Foreign Sources	2,330.3	2,304.0	590.4	388.4
1. External Commercial Borrowings / FCCBs	555.0	421.0	136.0	102 #
2. ADR/GDR Issues excluding banks and financial institutions	92.5	27.0	12.4	2.4 #
3. Short-term credit from abroad	501.8	306.0	-	-
4. FDI to India	1,181.0	1,550.0	442.0	284.0 \$
C. Total Flow of Resources (A+B)	12,451.5	12,510.2	1,372.6	1,929.5
<i>Memo Item:</i>				
<i>Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes</i>	-367.1	185.2	101.9	210.2 #
\$: Up to May 2012. #: Up to June 2012. P: Provisional. -: Data not Available.				

but fell to 10.5 per cent in 2009-10. After marginal hardening for two years, the nominal rate stood at 12.7 per cent for 2011-12. The real WALR calculated as nominal rate less WPI inflation fell from an average of 7.0 per cent in the pre-crisis period to 4.0 per cent in the post-crisis period, and was as low as 3.8 per cent in 2011-12 (Table IV.5). The fall is less sharp if GDP deflator is used to calculate inflation instead of WPI.

IV.19 A negative relationship between real output growth and real interest rates does exist, and as such real interest rate matters for growth and investment. In spite of the rate hikes, real interest rates are lower than in the pre-crisis period. In this context, there is a need to look at non-monetary factors that are constraining growth as current monetary and liquidity

Table IV.5: Real Lending Rate based on Weighted Average Lending Rate (WALR)

Year (March-end)	WALR	Real Lending Rate calculated using	
		WPI	GDP-deflator
1	2	3	4
2003-08*	12.4	7.0	7.3
2008-09	11.5	3.4	3.0
2009-10	10.5	6.7	4.6
2010-11	11.4	1.8	3.0
2011-12^	12.7	3.8	4.7

WALR: Weighted average nominal lending rate, estimated based on Basic Statistical Returns of Scheduled Commercial Banks.

* Average of the years 2003-04, 2004-05, 2005-06, 2006-07 and 2007-08.

^ WALR for 2011-12 is based on data for 21,452 branches of 16 banks.

conditions are not impinging upon growth significantly.

V. FINANCIAL MARKETS

Global financial conditions deteriorated further during Q1 of 2012-13 as Greece and Spain came near flashpoint, requiring further bailouts to contain the contagion. The LIBOR-fixing case further demonstrated the fragilities in the banking and financial market space. Subdued global growth is increasing spillover risks, even as fresh rounds of austerity measures have been put in place to tackle the sovereign debt crisis. The financial markets in India also remained under pressure with increased volatility in the currency and equity markets, in line with the other emerging economies. The Reserve Bank undertook a slew of measures to boost capital flows and also to ensure adequate liquidity in the domestic money markets.

Optimism for euro area recovery fades as uncertainties re-emerge

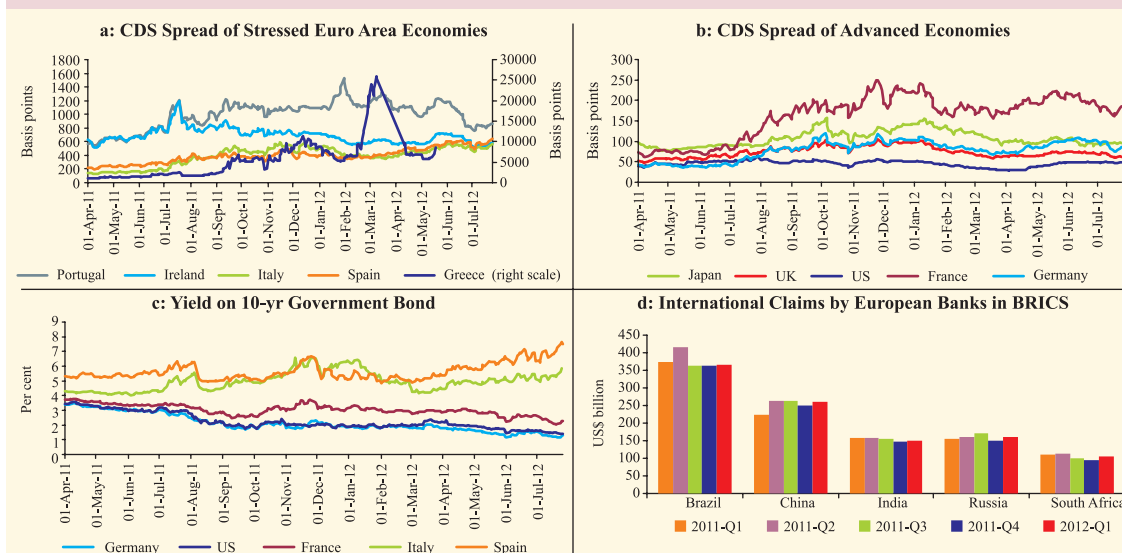
V.1 Euro area difficulties increased sharply in Q1 of 2012-13, first as political parties in Greece failed to form a new government necessitating re-elections, and later with the deepening banking crisis in Spain. Prior to the re-elections in Greece, markets viewed Greece's exit from the euro area as imminent. Even after the pro-euro coalition of parties came to power in the Greece re-elections, market uncertainty prevails on how long Greece may stay as part of the euro area. A heightened Spanish banking problem has increased the risks to euro area financial stability. The risks associated with

sovereign debt indicated by spreads of credit default swaps (CDS) has, in general, increased over end-March 2012 levels (Chart V.1 a, b).

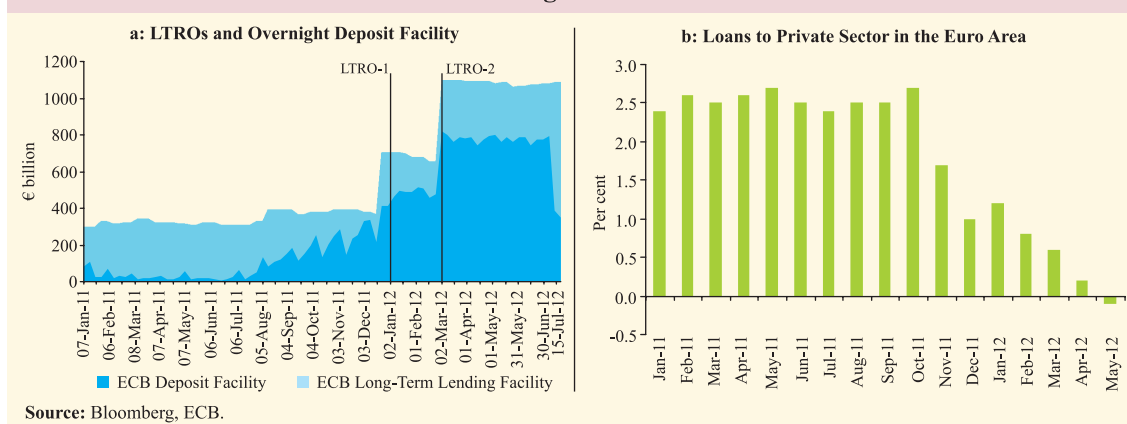
V.2 The subdued economic outlook and increased risk aversion drove investors to safe assets such as US and German sovereign bonds leading to lower yields. On the other hand, the G-sec yields of countries perceived as riskier rose significantly (Chart V.1 c).

V.3 Increased funding pressures and regulatory requirements, compounded by the uncertainties in the euro area, have intensified deleveraging by European banks since H2 of 2011-12. The impact of deleveraging was also evident as international claims by European

Chart V.1: Movements in Global Financial Markets



Source: Bloomberg, BIS.

Chart V.2: LTROs and Lending to Private Sector in the Euro Area

banks in BRICS countries declined in the second half of 2011 (Chart V.1d). Going forward, the pace of deleveraging may slow down. However, the ongoing regulatory reforms and proposed implementation of Basel III recommendations in 2013 may lead to continued tightening of lending conditions.

V.4 Since Q3 of 2011-12, the euro area economy has either contracted or remained stagnant. The difficulties in the euro area have triggered an austerity *versus* growth debate, reflecting the perception that austerity-focused policies have contributed to economic hardship while failing to eliminate the existential threat to the euro. Despite the two Long-Term Refinancing Operations (LTROs) conducted by the ECB that infused more than €1 trillion into the system, credit off-take has remained subdued. Much of the liquidity found its way back to the ECB's overnight deposit facility, while the growth in private sector lending turned negative in May 2012 (Chart V.2).

Policy Response to Slowing Growth and Sovereign Debt Concerns

V.5 Significant headwinds from the euro area have compounded the global slowdown, prompting widespread growth-enabling policy measures towards the end of Q1 of 2012-13. Recent initiatives by the European Council to alleviate economic and financial pressures in the euro area include proposals to establish a single supervisory mechanism

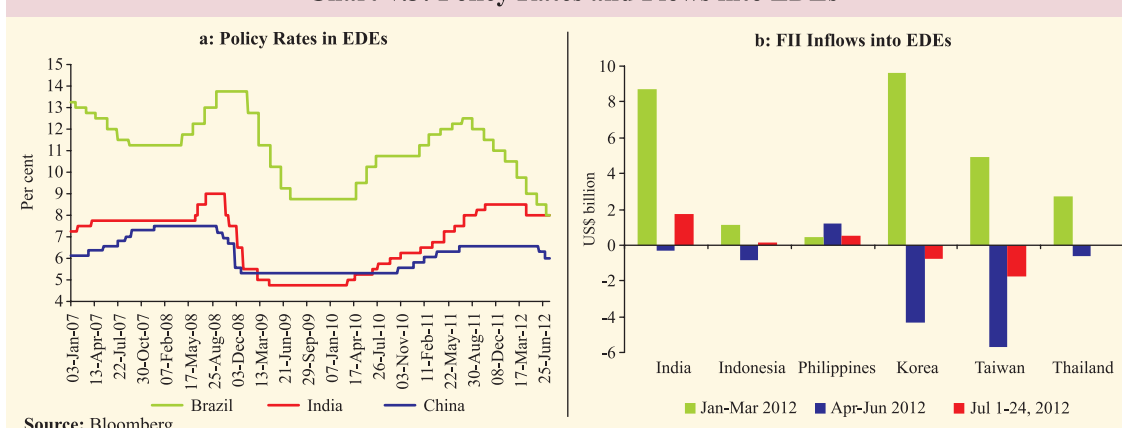
involving the ECB, the European Stability Mechanism (ESM) and plausible direct recapitalisation of banks. However, a robust long term solution is pending. This is highlighted by the return of stress in the financial markets following Moody's decision to attach a negative outlook on the Aaa sovereign rating of Germany, Netherlands and Luxembourg and the debt rollover difficulties being faced by Spain and Italy. Thereafter, the Spanish yields firmed up.

Capital inflows into emerging markets decline as growth moderates

V.6 Subdued growth in the advanced economies (AEs) and euro area concerns coupled with moderation in domestic growth conditioned the financial markets of emerging and developing economies (EDEs), with FII inflows turning negative for most EDEs (Chart V.3). However, following the slew of monetary easing measures in most AEs towards the end of Q1 and early Q2 of 2012-13, the trend is expected to reverse moderately. Declining equity market trends as well as the depreciation of EDE currencies against the US dollar underscore the damp investor sentiments.

Indian financial markets impacted by lower growth, decline in capital inflows and euro area uncertainty

V.7 Lower growth, persistent inflation and concerns over fiscal and current account deficits, in addition to the global economic weakness and the re-emergence of the euro area crisis,

Chart V.3: Policy Rates and Flows into EDEs

conditioned the Indian financial markets in Q1 of 2012-13. Money market rates declined during 2012-13 so far, reflecting improved liquidity conditions in the system and the 50 bps reduction in the repo rate announced in the Monetary Policy Statement 2012-13. The G-sec yields declined reflecting the lower growth expectations, global risk aversion driven flight to safe-haven government securities and purchase of securities through OMO. Funding strains kept deposit rates sticky, nevertheless, the base rate of banks showed a slight moderation. In line with other Asian countries, the Indian rupee depreciated, but by a higher magnitude on account of exacerbated concerns on current account and fiscal deficits. Equity markets declined led by a weak investment climate, muted domestic growth and FII outflows in Q1 of 2012-13.

Call rate eased reflecting improved liquidity conditions

V.8 With liquidity conditions remaining significantly tight in March 2012 on account of quarterly advance tax outflows and rise in currency in circulation, all segments of the money market witnessed an increase in rates. However, during Q1 of 2012-13, the liquidity conditions eased with the average daily LAF injection showing a declining trend (Table V.1). Supported by the cut in policy rate and improved liquidity conditions (partly due to the OMOs by the Reserve Bank), the call rate declined subsequently (Chart V.4).

V.9 The rates in the collateralised segments moved in tandem with the call rate, but have generally remained below it during 2012-13 so far. Banks and primary dealers remain the major

Table V.1: Average Daily Volume in Domestic Financial Markets

(₹ billion)										
	Money Market						Bond Market		Forex Market	Stock Market ##
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificates of Deposit*	G-Sec**	Corporate Bond #	Inter-bank (US\$ mn)	
1	2	3	4	5	6	7	8	9	10	11
Mar-12	-1574.3	175.1	111.8	379.8	911.9	4195.3	98.6	26.1	20.6	151.9
Apr-12	-1028.6	249.5	143.2	376.8	1310.0	4447.5	141.1	20.0	23.1	120.1
May-12	-985.5	184.5	151.3	339.1	1498.0	4394.1	151.8	17.5	20.9	117.3
Jun-12	-913.0	151.8	180.4	375.9	1258.1	4251.7	257.6	29.5	18.4	117.1
Jul-12(P)	-476.5^	149.9^	172.1^	411.6^	-	-	-	28.8@	-	112.8@

*: Outstanding position.

** : Average daily outright trading volume in central government dated securities.

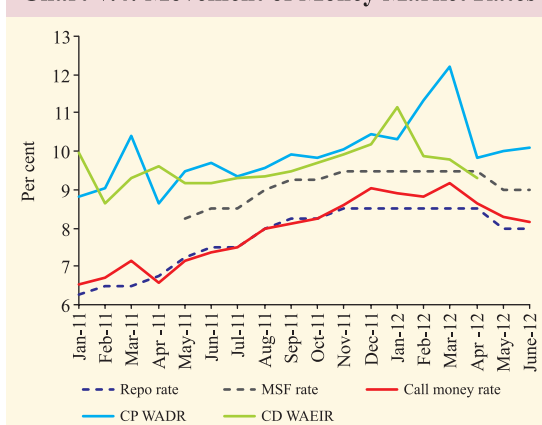
: Average daily trading in corporate bonds.

: Average daily turnover in BSE and NSE. P: Provisional

^ : Average daily data up to July 26, 2012.

@ : Up to July 24, 2012.

Note: In col. 2, (-) ve sign indicates injection of liquidity while (+) ve sign indicates absorption of liquidity.

Chart V.4: Movement of Money Market Rates

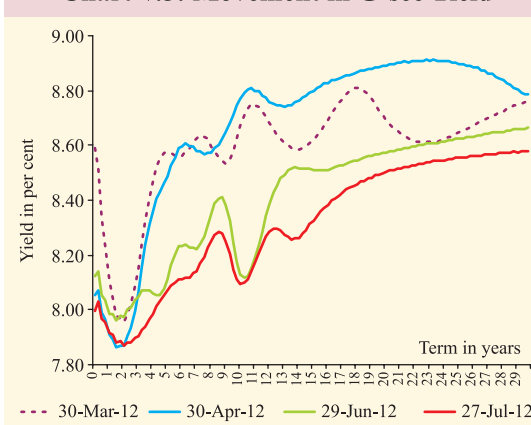
groups of borrowers in the collateralised segments, while mutual funds (MFs) continue as the major group of lenders.

V.10 CD rates spiked during March 2012, reflecting overall tight liquidity conditions in the money markets and the reluctance of MFs to rollover bank CDs after asset management companies were made accountable for fair valuations on a mark-to-market basis. CP rates firmed up similarly. However, since then the weighted average effective interest rates (WAEIR) on CDs and the weighted average discount rate (WADR) of commercial paper (CP) declined, following improved liquidity conditions.

G-sec yields declined, reflecting the domestic economic situation, declining crude oil prices

V.11 Driven by expectations of a rate cut in the Annual Policy of the Reserve Bank, and also by concerns of weakening industrial and export growth, G-sec yields softened at the beginning of Q1 of 2012-13. However, S&P's revision of India's long term rating outlook to negative led yields to temporarily firm up towards the end of April 2012. The declining trend in crude oil prices, general risk aversion and purchase of securities through OMO caused the yields to ease thereafter (Chart V.5).

V.12 Yields continued to soften during the first half of June 2012 following the disappointing

Chart V.5: Movement in G-sec Yield

growth figure for Q4 of 2011-12 at 5.30 per cent. On the whole, in Q2 of 2012-13 so far, the yields exhibited a softening bias. According to SEBI data, FIIs made investments in debt worth ₹51.5 billion in 2012-13 so far (up to July 23, 2012). MFs also bought debt worth ₹1,535.5 billion during the same period.

V.13 The markets remain cautious about the reduction in fiscal deficit. Gross market borrowings of the government through dated securities during 2012-13 were ₹2.3 trillion (net borrowings ₹1.6 trillion) up to July 23, 2012 compared with ₹1.6 trillion (net borrowings ₹1.1 trillion) during the corresponding period of the previous year (Table V.2). During 2012-13 (up to July 23, 2012), 20 states raised ₹420 billion on a gross basis (net ₹370 billion) compared with ₹370 billion on a gross basis (net ₹303 billion) raised by 14 states during the

Table V.2: Issuances of Central and State Government Dated Securities

Item	2011-12	2012-13*
1	2	3
Central government		
Gross amount raised (₹ billion)	5,100.0	2,340.0
Devolvement on primary dealers (₹ billion)	121.1	12.0
Bid-cover ratio (range)	1.4-5.1	1.5-3.6
Weighted average maturity (years)	12.7	13.6
Weighted average yield (per cent)	8.5	8.5
State government		
Gross amount raised (₹ billion)	1,586.3	419.8
Cut-off yield range (per cent)	8.4-9.5	8.7-9.3
Weighted average yield (per cent)	8.8	9.0

*Up to July 23, 2012.

Table V.3: Deposit and Lending Rates of Banks

(Per cent)						
Items	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
1	2	3	4	5	6	7
1. Domestic Deposit Rate (1 - 3 year tenor)						
i) Public Sector Banks	8.00-9.75	8.25-9.75	8.55-9.75	8.55-9.75	9.00-9.75	8.75-9.50
ii) Private Sector Banks	7.75-10.10	8.00-10.50	8.00-10.50	8.00-10.50	8.00-10.50	8.00-10.00
iii) Foreign Banks	3.50-9.10	3.50-10.00	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.75
Modal Deposit Rate (all tenors)	6.65	7.08	7.44	7.46	7.42	7.40
2. Base Rate						
i) Public Sector Banks	8.25-9.50	9.25-10.00	10.00-10.75	10.00-10.75	10.00-10.75	10.00-10.50
ii) Private Sector Banks	8.25-10.00	8.50-10.50	9.70-11.00	10.00-11.25	10.00-11.25	9.75-11.25
iii) Foreign Banks	6.25-9.50	6.25-9.50	6.25-10.75	6.25-10.75	7.38-11.85	7.38-11.85
Modal Base Rate	9.50	10.00	10.75	10.75	10.75	10.50
3. Median Lending Rate*						
i) Public Sector Banks	8.88-14.00	9.50-14.50	10.50-15.25	10.25-15.25	10.60-15.35	-
ii) Private Sector Banks	9.00-14.50	9.25-15.00	9.00-15.25	10.00-15.50	10.50-15.50	-
iii) Foreign Banks	7.70-14.05	7.70-14.50	9.13-14.75	9.50-14.38	10.00-14.50	-

* : Median range of interest rate at which at least 60 per cent business has been contracted. - : Not available.

corresponding period of 2011-12. The weighted average yield firmed up to 9.0 per cent up to July 23, 2012 from 8.6 per cent for the same period in the previous year.

Deposit rates of banks stay sticky, reflecting higher costs and inflation

V.14 The modal deposit rates for scheduled commercial banks (SCBs) declined marginally by 2 bps to 7.40 per cent across all maturities during Q1 of 2012-13, while the modal base rate of SCBs declined by 25 bps to 10.50 per cent (Table V.3). Banks' response on deposit rates remain rather muted so far, reflecting the interplay of factors such as tight liquidity conditions in Q1 of 2012-13 and high inflation.

Rupee depreciated sharply amid concerns of widening current account and fiscal deficit and global uncertainty

V.15 In Q4 of 2011-12, the Indian rupee reversed its falling streak exhibited during most of the year and recorded some gains. Owing to the interplay of a mix of domestic and global factors (see para III.6 page 19), the rupee started weakening from April 2012. Subsequently however, the rupee gained due to improved FII flows coupled with the lower trade deficit partly aided by policy initiatives. The distinct phases

and primary drivers of the rupee movement over the course of the year have been mapped in Chart V.6.

V.16 The depreciation of the exchange rate in Q1 of 2012-13 is not specific to India; most EDE currencies have also depreciated. However, the depreciation of Indian rupee is large reflecting growing current account deficit unlike other major Asian economies who have current account surpluses (Table V.4).

Equity markets turned cautious on concerns about the investment climate

V.17 The slow recovery in Q4 of 2011-12 reversed for most part of Q1 of 2012-13, on the

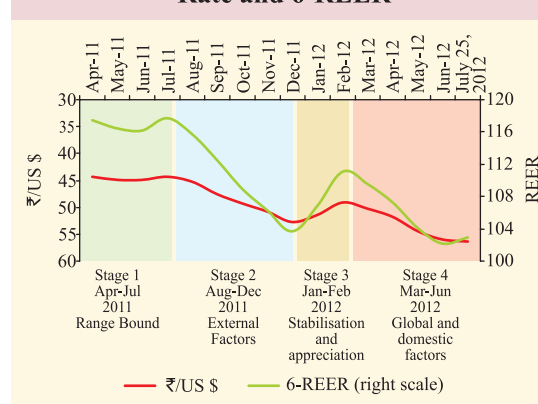
Chart V.6: Trend in Exchange Rate and 6-REER

Table V.4: Movements in Select EDE Currencies against the US Dollar

Appreciation (+)/Depreciation (-) in per cent (y-o-y)			
Currency	2010-11	2011-12	Apr-Jul 26, 2012
1	2	3	4
Current Account Deficit Countries			
1. Brazil	9.7	-10.8	-10.1
2. India	1.1	-12.7	-8.6
3. Mexico	4.3	-7.0	-4.6
4. South Africa	8.0	-11.5	-7.5
5. Turkey	-4.8	-10.5	-1.7
Current Account Surplus Countries			
1. Argentina*	-4.3	-7.5	-4.2
2. China	4.1	4.2	-0.7
3. Indonesia	4.7	-5.1	-3.3
4. Malaysia	8.2	-1.4	-3.2
5. Russia	3.4	-2.8	-10.1
6. South Korea	2.2	-2.7	-1.1
7. Thailand	6.7	-1.8	-2.6

*: Current account balance turned into deficit from 2011.

backdrop of deceleration in IIP growth, weak revenue outlook for major Indian IT companies and concerns over the implementation of retrospective tax and general anti-avoidance rules (GAAR). Euro area crisis, the downgrade of India's long term rating outlook to negative from stable and the rupee slide also affected the market sentiment. However, the later part of June 2012 saw the market turnaround from low levels on account of a pick-up in FII investment in the equity market, clarifications by the government on retrospective tax, GAAR and the government decision to boost investments in infrastructure, and, on the global front, the European Council's decision to support stressed

euro area sovereigns and banks. SEBI data indicate that FIIs sold shares worth ₹9.8 billion in Q1 of 2012-13, while MFs sold shares worth ₹6.4 billion during the same period (Chart V.7).

V.18 In Q2 of 2012-13 so far (up to July 23, 2012), the equity market recovered aided by FII investments (₹78.7 billion), moderation in the depreciation of the rupee and the easy monetary policy pursued globally.

The primary market remained subdued

V.19 The low risk appetite of investors coupled with a weak secondary market and negative returns on IPOs led to low resource mobilisation

Table V.5: Resource Mobilisation from Capital Market

(₹ billion)			
Category	2011-12	2011-12 (Apr-Jun)	2012-13 (Apr-Jun)
1	2	3	4
A. Prospectus and Rights Issues*	129	70	5
1. Private Sector (a+b)	83	24	5
a) Financial	9	17	0
b) Non-financial	74	7	5
2. Public Sector	46	46	0
B. Euro Issues	27	12	2
C. Mutual Fund Mobilisation(net)@	-220	730	-4,995
1. Private Sector	-154	644	-3,985
2. Public Sector #	-66	86	-1,010

* Excluding offer for sale.

@: Net of redemptions.

#: Including UTI MF.

Source: Mutual Fund data are sourced from SEBI and exclude funds mobilised under Fund of Funds Schemes.

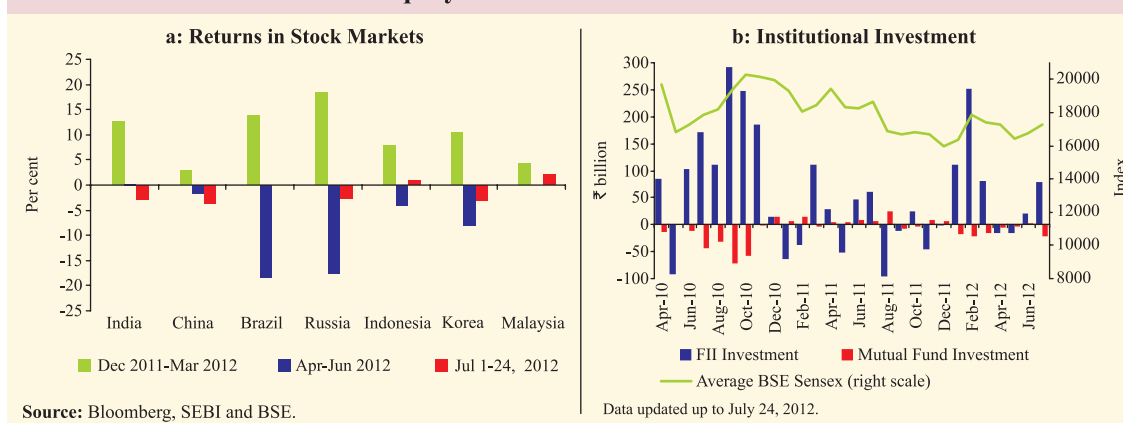
Chart V.7: Equity Market and Institutional Investment

Table V.6: House Price and Transactions Volume Indices (Base Q4:2008-09 = 100)

Quarter	Mumbai	Delhi	Bengaluru	Ahmedabad	Lucknow	Kolkata	Chennai*	Jaipur	Kanpur	All India
1	2	3	4	5	6	7	8	9	10	11
House Price Index										
Q4: 2010-11	172.3	135.2	113.6	128.7	140.3	171.9	106.8	155.3	135.7	141.7
Q1:2011-12	191.6	152.8	116.9	152.3	149.3	157.0	106.3	161.1	135.4	152.0
Q2:2011-12	206.1	153.0	116.0	162.8	159.2	159.0	113.9	165.1	138.3	157.8
Q3:2011-12	191.7	168.6	146.1	171.8	172.3	155.0	120.3	163.5	140.0	164.1
Q4:2011-12	224.7	195.3	140.6	177.2	169.7	158.4	117.0	164.4	148.7	176.9
Growth in per cent										
Y-o-Y	30.4	44.4	23.7	37.7	21.0	-7.9	9.5	5.9	9.5	24.8
Q-o-Q	17.2	15.8	-3.8	3.1	-1.5	2.2	-2.7	0.5	6.2	7.8
House Transactions Volume Index										
Q4: 2010-11	111.9	151.5	102.2	153.8	108.4	91.1	81.6	218.7	156.2	126.3
Q1:2011-12	89.5	149.4	100.8	134.3	93.9	107.9	80.3	243.1	208.4	123.2
Q2:2011-12	79.0	165.5	123.5	154.1	106.7	139.2	85.5	239.1	131.1	129.1
Q3:2011-12	75.9	195.9	84.6	131.2	165.1	108.9	130.9	222.0	120.6	128.9
Q4:2011-12	108.6	149.8	70.8	122.2	153.0	128.5	99.0	247.5	172.1	126.5
Growth in per cent										
Y-o-Y	-2.9	-1.1	-30.7	-20.5	41.1	41.1	21.3	13.2	10.2	0.2
Q-o-Q	43.1	-23.5	-16.3	-6.9	-7.3	18.0	-24.4	11.5	42.7	-1.9

Note: * Chennai index is based on both residential and commercial properties.

All India index is a weighted average of city indices, weights based on population proportion.

in the primary segment in 2011-12. During 2012-13 so far (up to end-June 2012), the primary market continued to remain muted, with only ₹5 billion mobilised through six public issues (four IPO and two rights issues) (Table V.5).

Housing prices increased in most cities despite lower volumes

V.20 According to the Reserve Bank's quarterly House Price Index (HPI) during Q4 of 2011-12 housing prices in all cities, except Kolkata, showed an increase on a y-o-y basis. Compared to the previous quarter, housing prices show a moderation for Bengaluru, Lucknow and Chennai (Table V.6). The number of housing transactions on an annual basis shows mixed trends, with the average all-India Index remaining almost unchanged. While Mumbai, Delhi, Ahmedabad and Bengaluru report a decline in transaction volumes on an annual basis, the quarterly decline in five out of nine cities has led to a decline in the all-India transaction volume index growth. Despite transaction volumes moderating in the later part of 2011-12, housing prices seem to have firmed up.

Stressed financial conditions likely to persist

V.21 Financial conditions are likely to remain uncertain in the near-term with the stress likely to persist for some time, given both global and domestic conditions. The recent LIBOR fixing controversy has also added to the uncertainty by drawing attention to how a few large global financial institutions allegedly manipulated one of the most commonly used market rates. The episode has also reduced market confidence in key benchmark rates. Cases of inattention to money laundering have also dented market confidence. These events add to the already existing pressures arising from euro area fragilities.

V.22 On the domestic front, falling corporate earnings at a time when corporate positions are already leveraged, could keep equity markets under pressure. As such, there is a need to improve the investment climate to drive the economy out of its slowdown and improve market sentiments. While currency pressures have currently abated, uncertainty remains ahead with global risk aversion being high and the external sector weakening.

VI. PRICE SITUATION

Headline inflation persisted above 7 per cent during Q1 of 2012-13 due to a rebound in food inflation as well as high fuel inflation even as non-food manufactured products inflation declined to below 5 per cent. The softening impact of growth moderation on inflation was partly offset by structural rigidities in the supply of food as well as the exchange rate depreciation. The benefits from the decline in global commodity prices were also partly offset by the falling rupee. The near-term inflation trajectory could remain sticky and conditioned by a number of risks that emanate from the unsatisfactory progress and distribution of the south-west monsoon, higher MSPs announced for kharif crops and the impact of the exchange rate pass-through. The path of inflation could also be impacted by the timing and magnitude of administered price revisions even though such adjustments have become necessary to reduce pressure on the medium-term inflation from expansionary fiscal policy. Continued pressure from wages and the structural nature of protein-food inflation could also keep inflation high even with moderation in overall growth.

Added monetary easing by major economies as falling inflation provides space

VI.1 Continuing uncertainty about how the sovereign debt crisis might play out along with newer indications of weakening growth, both in Advanced Economies (AEs) as well as Emerging and Developing Economies (EDEs) resulted in a decline in global commodity prices and moderation of global inflation. Demand pressures in the AEs are likely to remain muted for an extended period of time due to negative output gaps and subdued wages in the face of continued high unemployment in most economies. Inflation is also edging lower in most EDEs, largely helped by lower international primary commodity prices, given the higher share of primary commodities in their overall consumption. However, the ultimate impact of falling commodity prices on the EDEs is also conditioned by the exchange rate movements of their currencies. Volatility in commodity prices and exchange rate movements are likely to impart greater volatility in inflation for EDEs as compared with AEs.

VI.2 In view of the amplified risks to growth and weakening inflationary pressures, many central banks undertook further monetary policy easing, although most of them remained wary

of additional quantitative easing. The US Fed decided to extend “Operation Twist” till December 2012. The European Central Bank in June 2012 broadened the collateral acceptable at its window and in July 2012 reduced its policy rate. However, the Bank of England decided to increase its quantitative easing asset purchase programme. The People’s Bank of China reduced the reserve requirements ratio in May 2012 and further cut its policy rate in June and July 2012. CPI inflation in all these countries has fallen and is currently below 3 per cent, thus providing monetary space to address growth risks (Table VI.1).

Global commodity prices declined on amplified risks to global growth and improved supply prospects

VI.3 International prices of most commodities weakened during Q1 of 2011-12 due to growing economic uncertainties and weakening growth (Chart VI.1). Though the benefit from lower global commodity prices to India was partly offset by the depreciation of the rupee, as in the case of many EDEs, overall it has had a softening impact on global inflation. Global crude oil prices moderated on sovereign debt fears and the continued rise in production and build-up of inventories. Brent crude prices

Table VI.1: Global Inflation Indicators

Country/ Region	Key Policy Rate	Policy Rate (as on July 27, 2012)	Changes in Policy Rates (basis points)		CPI Inflation (y-o-y, Per cent)	
			Sep. 2009 to Dec. 2011	Jan. 2012 to Jul. 2012 (as on 27 th)	Jun-11	Jun-12
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	3.50 (Jun. 6, 2012)	125	(-) 75	3.6#	1.2#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	75	0	3.1	1.5
Euro area	Interest Rate on Main Refinancing Operations	0.75 (Jul. 6, 2012)	0	(-) 25	2.7	2.4
Israel	Key Rate	2.25 (Jul. 1, 2012)	225	(-) 50	4.2	1.0
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10* (Oct. 5, 2010)	(-) 10	0	-0.4\$	0.2\$
Korea	Base Rate	3.00 (Jul. 12, 2012)	125	(-) 25	4.2	2.2
UK	Official Bank Rate	0.50 (Mar. 5, 2009)	0	0	4.2	2.4
US	Federal Funds Rate	0.0 to 0.25* (Dec. 16, 2008)	0	0	3.6	1.7
Emerging and Developing Economies						
Brazil	Selic Rate	8.00 (Jul. 7, 2012)	225	(-)300	6.7	4.9
China	Benchmark 1-year Deposit Rate	3.00 (Jul. 6, 2012)	125	(-)50	6.4	2.2
	Benchmark 1-year Lending Rate	6.00 (Jul. 6, 2012)	125	(-)56		
India	Repo Rate	8.00 (Apr. 17, 2012)	(600)	(-150)		
			375	(-) 50	8.7\$	10.2\$
Indonesia	BI Rate	5.75 (Feb. 9, 2012)	(-) 50	(-) 25	5.5	4.5
Philippines	Reverse Repurchase Rate	3.75 (Jul. 26, 2012)	50	(-) 75	5.2	2.8
	Repurchase Rate	5.75 (Jul. 26, 2012)	50	(-) 75		
Russia	Refinancing Rate	8.00 (Dec. 26 2011)	(-) 275	0	9.4	4.3
South Africa	Repo Rate	5.00 (Jul. 20, 2012)	(-) 150	(-) 50	5.0	5.5
Thailand	1-day Repurchase Rate	3.00 (Jan. 25, 2012)	200	(-) 25	4.1	2.6

*: Change is worked out from the minimum point of target range.

#: Q2 (April-June).

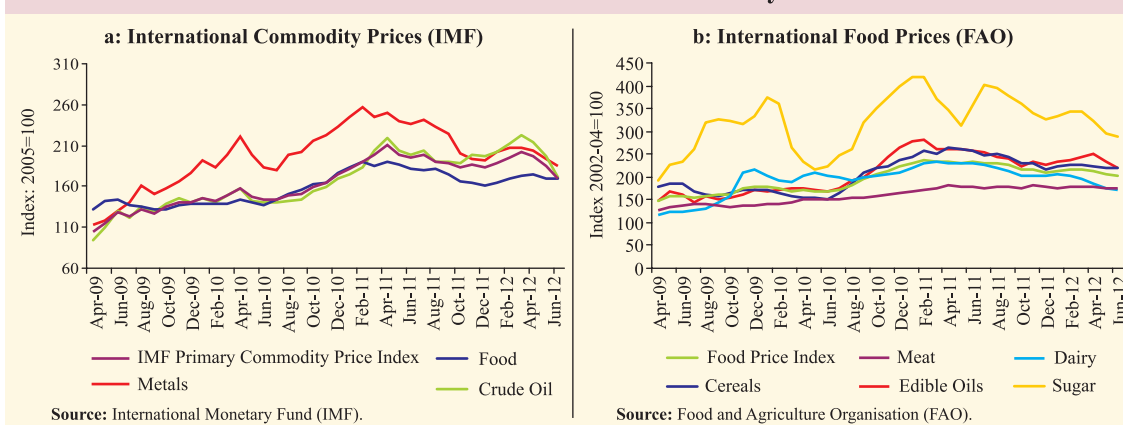
\$: May.

Note: Figures in parentheses in column (3) indicate the effective dates when the policy rates were last revised. Figures in parentheses in columns (4), (5) and (6) indicate the variation in the cash reserve ratio during the period. For India, data on inflation pertain to CPI for Industrial Workers (CPI-IW).

Source: Websites of respective central banks/statistical agencies.

fell by about 25 per cent during Q1 of 2012-13. Compared with the average price of US\$ 111.9

per barrel during 2011-12, the average Indian basket crude oil prices moderated to US\$ 106.9

Chart VI.1: Trends in Global Commodity Prices

per barrel during Q1 of 2012-13. Prices declined to US\$92 per barrel during the second fortnight of June 2012 before recovering to US\$102.3 per barrel as on July 26, 2012. The recent increase has been both on account of aggravated geo-political tensions and monetary policy stimulus to revive growth by a number of central banks.

VI.4 Metal prices declined on concerns about moderation in global demand with the focus on Europe and China. Global food prices also moderated in recent months as is evident from the decline of the Food and Agricultural Organisation (FAO) food price index by about 7 per cent during Q1 of 2012-13. However, drought in the US and unfavourable weather conditions in Europe and other major crop producing countries are likely to impact food production negatively during 2012-13, which could put upward pressure on global food prices. Moreover, global commodity prices could come under further pressure if demand in the EDEs recover or excess global liquidity spills over to the commodity markets.

Inflation pressures persist in India despite weakening of growth momentum

VI.5 Headline wholesale price index (WPI) inflation declined from a high of 10 per cent in September 2011 to 7.2 per cent in January 2012. During Q1 of 2012-13, the average headline inflation was at 7.4 per cent (7.3 per cent, provisional, for June 2012) (Chart VI.2). The current headline inflation, though lower than the average inflation of above 9 per cent during the past two years, is much higher than the decadal average of 5.4 per cent during the 2000s. The WPI increased on a sustained basis and the 3-month moving average seasonally adjusted month-over-month changes since January 2012 indicate sustained price pressures with some moderation in April-May 2012 (Chart VI.2 d).

VI.6 In terms of contribution to overall inflation, the share of food picked up sharply from February 2012. However, the contribution of manufactured non-food products recorded a consistent decline which was largely on account of deceleration in growth momentum in Q4 of

Chart VI.2: Trends in Wholesale Price Inflation

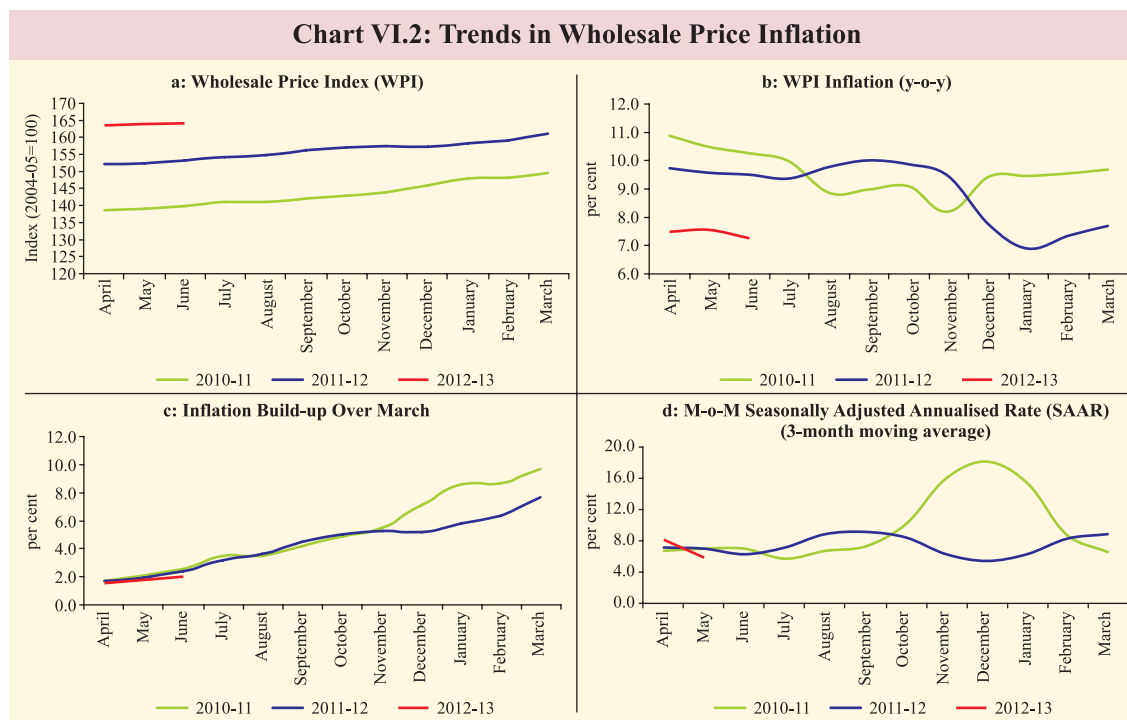
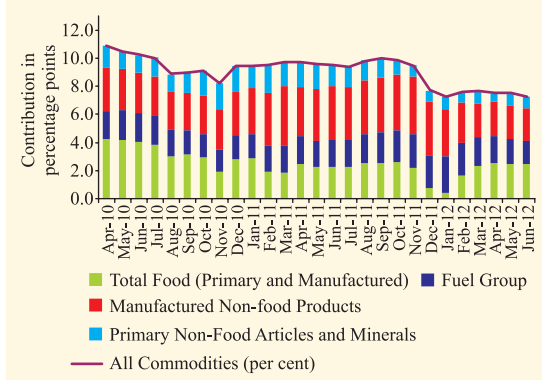


Chart VI.3: Contribution to Inflation: Major Groups

2011-12. The contribution of the fuel group remained high (Chart VI.3).

Food inflation persists at high levels

VI.7 Food inflation increased significantly in recent months, driven largely by the increase in vegetable prices following the seasonal decline. Apart from vegetables, inflation was also high in pulses and edible oils in recent months. Advance estimates of production show shortfalls in the production of pulses as well as oilseeds during 2011-12. While cereals inflation remained moderate in the recent past (3.6 per cent on average during October 2010-March 2012), it increased to 6.4 per cent in Q1 of 2012-13 despite record foodgrains production in the previous year. Also, inflation in protein-rich items like milk, eggs, fish and

meat continued to be in the double digits since August 2011, reflecting both structural demand-supply imbalances and input cost pressures (Chart VI.4). While the volatility in food inflation was largely on account of the seasonal movements in the prices of vegetables, the sustained increase in the prices of protein-rich items imparted a structural character to food inflation.

Uncertainty over monsoon and high MSP could put further pressure on food inflation

VI.8 There could be a further build-up of food inflationary pressures during 2012-13. The slow progress of the south-west monsoon so far and the uncertainty about its quantum as well as spatial and temporal distribution has emerged as a major risk to food inflation in the near-term. For the marketing year 2012-13, the government has announced increase in the minimum support price (MSP) for various crops in the range of 15 to 53 per cent. The commodities for which MSP has been raised have a combined weight of 3.4 per cent in overall WPI and the average increase (using WPI weights) work out to 25.6 per cent. The impact of MSP on market prices could vary across different commodities. However, the price pressures from the MSP continue to remain a major risk to inflation as the increases in MSP tend to translate into increases in market prices for most commodities.

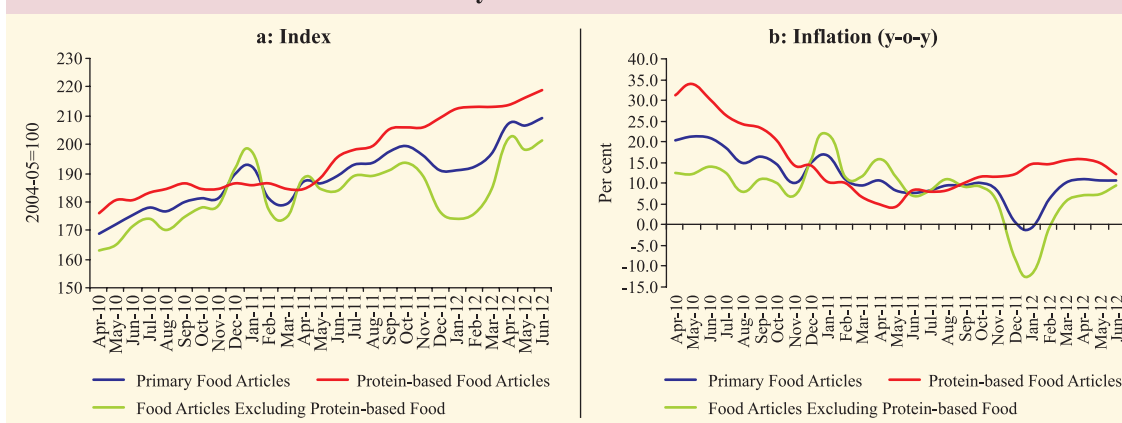
Chart VI.4: Primary Food Articles: Index and Inflation

Table VI.2: Comparative Movement of Oil Price and Exchange Rate since July 2011

	July 2011	March 2012	July 26, 2012	Change in per cent	
				July, 2011 to March, 2012	Since March, 2012
1	2	3	4	5	6
Crude Oil Indian Basket (US\$/barrel)	112.5	123.61	102.3	9.9	-17.2
Exchange Rate (₹/US\$)	44.4	50.3	56.0	11.7*	10.1*
Crude Oil Indian Basket (₹/barrel)	4995.8	6220.1	5724.8	24.5	-8.0

* Indicates the depreciation of the rupee against dollar.

Note: The composition of Indian Basket of Crude Oil represents average of Oman & Dubai for sour grades and Brent (Dated) for sweet grade in the ratio of 67.6:32.4.

Source: Petroleum Planning and Analysis Cell.

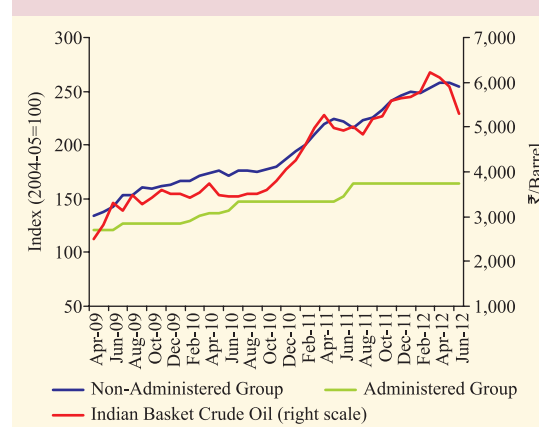
High fuel inflation continued as rupee depreciation partly offset lower crude prices

VI.9 Fuel inflation remained in double digits, reflecting the increase in international crude oil prices over the past two years. Though global crude oil prices have declined since March 2012, lagged pass-through of past increases has led to further increase in fuel prices. The Oil Marketing Companies (OMC) raised petrol prices by ₹7.5 per litre on May 24, 2012 and subsequently adjusted the prices in line with changes in international prices. Also, the OMCs decided to implement the revised structure of 'state specific cost' with effect from July 24/25, 2012 to adjust for irrecoverable state taxes. This has led to changes in prices of petrol, diesel, kerosene and LPG across different states. While prices increased in some states, it declined in some other states reflecting the state specific tax structure. Since March 2012, the extent of crude oil prices decline in dollar terms has been substantial enough to reduce the price in Indian rupee terms despite depreciation of the rupee (Table VI.2). However, administered prices have not been revised for more than a year and therefore, risks to fuel inflation continue to remain significant (Chart VI.5).

VI.10 Currently, the estimated under-recovery by domestic OMCs for diesel is ₹9.95 per litre, for PDS kerosene ₹27.20 per litre and ₹319.00 per cylinder for domestic LPG. Not adjusting

administered prices in line with trends in international prices will further expand under-recoveries, which will lead to considerable fiscal strain. Though price adjustments will exert inflationary pressures in the near term, the risk to medium-term price stability from a widening fiscal deficit will be addressed by adjustment of prices in line with market conditions

VI.11 Coal prices were increased in January 2012, with non-coking coal prices being hiked by 32.7 per cent. Increase in coal prices could lead to significant input cost pressures, particularly for electricity generation. Electricity price increases in the recent period have been much less than the increase in input costs. Therefore, State Electricity Boards (SEBs) need to catch up by the large hikes in prices at which they sell electricity to Discoms. Revision in power tariffs could become inevitable under such a scenario, which would add pressure to fuel inflation.

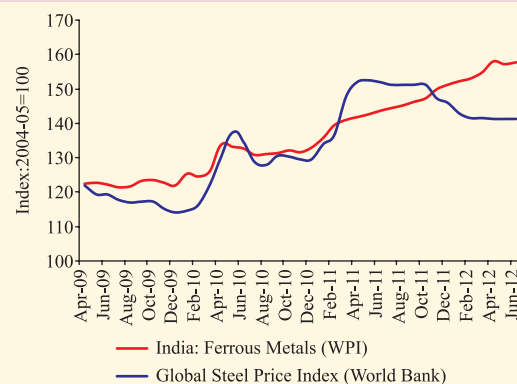
Chart VI.5: Global and Domestic Fuel Prices

Inflation in non-food manufactured products muted by decline in growth

VI.12 Manufactured non-food products inflation, an indicator of generalised inflationary pressures, moderated to below 5 per cent by March 2012 after two years. Since then, manufactured non-food products inflation remained subdued (4.8 per cent, provisional, June 2012), though price pressures are still visible in some manufactured commodities such as metals, fertilisers, pesticides and paints. Even though non-food manufactured products inflation declined in recent months, it still remains higher than the decadal average of 4.0 per cent during the 2000s. Also, core inflation in India in the recent period has been much higher than in AEs and EDEs.

VI.13 The month-over-month seasonally adjusted annualised changes (3-month moving average) showed moderation of price pressures, notwithstanding a marginal pick-up in the latest month (Chart VI.6). Within non-food manufactured products, the ‘basic metals and metals products’ group, which has a substantial weight (10.7 per cent) in overall WPI, continued to have double digit inflation. Domestic metal prices have largely been following the global trends and therefore, the inflation in this category remained high as exchange rate depreciation partly offset the impact of moderating global prices (Chart VI.7). Apart

Chart VI.7: Global and Domestic Steel Prices



from the pressure from global price trends and exchange rate movements, domestic constraints on supplies of key inputs like minerals and coal could also be a source of pressure on prices. These trends also indicate that the supply-side pressures do translate to generalised inflation through the input cost channel. These partly explain the lower than expected pace of moderation in non-food manufactured products inflation in the wake of significant slowdown in growth.

VI.14 Input cost pressures continued to remain persistent as seen from the HSBC Markit Purchasing Managers Index (PMI) which indicates that the pace of expansion of input costs was much higher than increases in output prices (Chart VI.8). In an environment of

Chart VI.6: Manufactured Non-food Products Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes

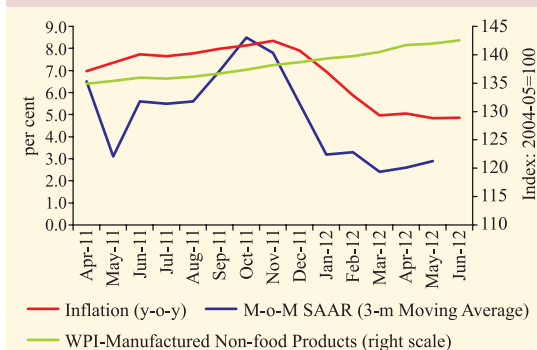
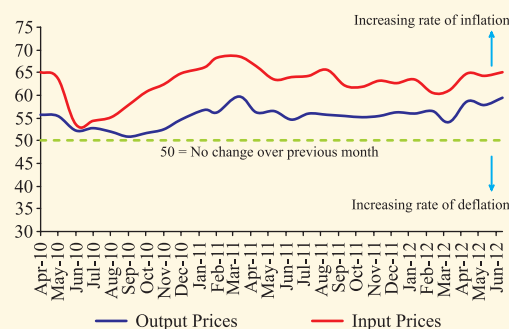


Chart VI.8: Purchasing Managers Index (PMI) Output and Input Prices (Seasonally Adjusted)

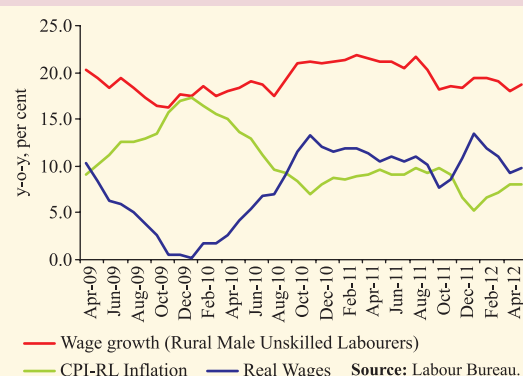


significant decline in profit margins (see Chapter II for details) this could force manufacturers to pass on prices even when demand remains moderate. This is corroborated by the output price index in PMI picking up significantly in recent months.

Wage pressures remain significant and may constrain the moderation in core inflation

VI.15 The persistence of inflation can also partly be attributed to labour market conditions. The increase in wages in rural areas continued to be much sharper than compared to the comparable rate of inflation (Chart VI.9). The divergent pattern of this relationship between wage growth and inflation across major states also points out to region specific factors that influenced the wage-price dynamics (Chart VI.10). Similarly, in the formal sector, analysis of company finance data suggests that growth in staff costs, despite a moderate decline in the recent period, remained elevated (Chart VI.11). Rising real wages during the period of high inflation do protect the working population from the adverse impacts of inflation. However, rising real wages in excess of the productivity growth may not be sustainable in the medium-term and run the risk of a wage-price spiral.

Chart VI.9: Increase in Rural Wages Relative to Inflation



New CPIs exhibit higher inflation

VI.16 Inflation as per the newly introduced Consumer Price Index (CPI) remained significantly higher than the WPI inflation (Table VI.3). There was also substantial divergence in inflation in certain product groups such as condiments and spices and vegetables. Notably, the divergence in the new CPI and the WPI inflation after excluding the volatile items (food and fuel) continued to be high. A comparison of similar items under the WPI and the new CPI indicate that there is divergence even among common product group inflation (Chart VI.12). This divergence between the new CPI inflation and the headline WPI inflation has

Chart VI.10: Increase in CPI for Rural Labourers (CP-RL) and Rural Wages*

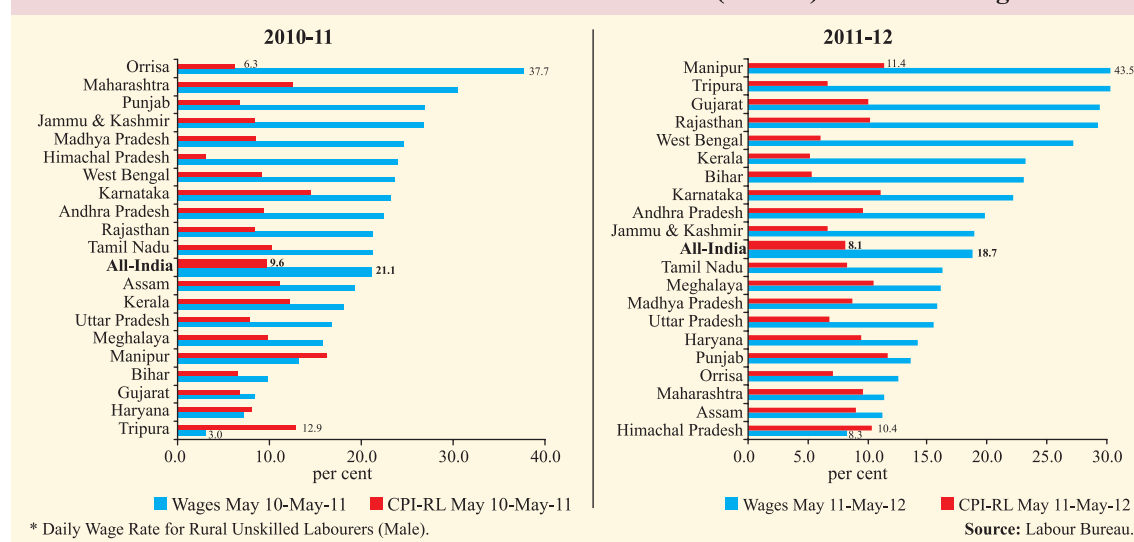
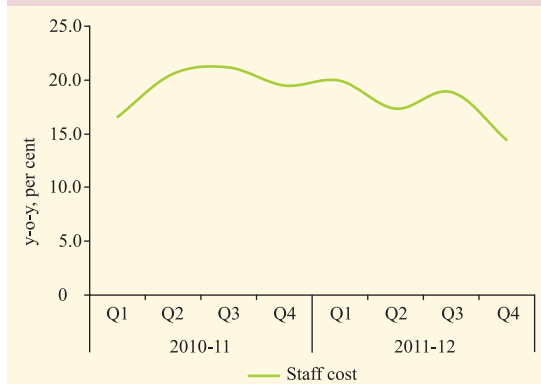
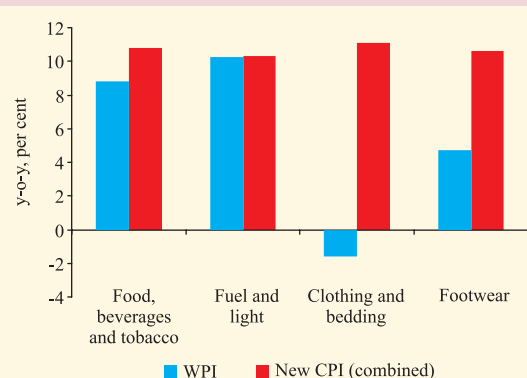


Chart VI.11: Staff Cost Growth in the Corporate Sector**Chart VI.12: Inflation in Comparable Items in WPI and New CPI (June 2012)**

raised concerns about the extent of the transmission of recent moderation in headline inflation to the consumers.

VI.17 The difference in weighting pattern and coverage could also explain the divergence between inflation based on the CPI and the WPI. While food has a relatively larger weight in the new CPI, the WPI has more weight for manufactured products with items like metals and chemicals that do not enter the CPI directly. The new CPI includes housing and many services which are not covered under WPI. Comparable data for a relatively longer period of time is necessary to make a realistic assessment of the divergence between the new CPI and existing inflation measures. The new comprehensive CPI does not have adequate history to support data analysis and to be used as the sole headline measure of inflation.

Table VI.3: WPI and New-CPI (Combined) Inflation

	Food		Fuel		Excluding Food and Fuel		Overall	
	WPI	New CPI	WPI	New CPI	WPI	New CPI	WPI	New CPI
1	2	3	4	5	6	7	8	9
Weight	24.3	47.6	14.9	9.5	60.8	42.9	100	100
Jan-12	1.5	3.9	17.0	13.0	7.5	10.6	7.2	7.5
Feb-12	5.9	6.7	15.1	12.8	6.3	10.4	7.6	8.8
Mar-12	8.7	8.1	12.8	11.8	5.8	10.2	7.7	9.4
Apr-12	9.3	10.1	12.1	11.2	5.4	10.2	7.5	10.3
May-12	9.0	10.5	11.5	10.7	5.7	10.1	7.5	10.4
June-12	9.0	10.8	10.3	10.3	5.6	9.1	7.3	10.0

Risks to inflation remain even as growth slowdown eases demand pressures

VI.18 Even though inflation declined during the latter part of 2011-12, the persistence of inflation in recent months above the 7 per cent mark points to the sticky nature of inflation, even as growth has slowed. Inflation in the non-food manufactured products category came down to below 5 per cent, partly reflecting the demand moderating impact of past monetary tightening and weakening of pricing power. However, high food inflation, especially in protein-rich items, and persistent fuel inflation kept headline inflation high. The near-term inflation outlook is conditioned on the spatial and temporal distribution of the south-west monsoon, the impact of exchange rate pass-through and likely trends in global commodity prices. While moderation in global commodity prices could ease the pressure from imported inflation, pass-through of rupee depreciation will partly offset the impact. The increases in MSP and sustained increases in wage levels could further exert pressure on overall inflation. The administered prices of fuel do not reflect the trends in global market prices and revision of these would be necessary to reduce the extent of suppressed inflation. The persistence of inflation in an environment of slowing growth is a major challenge for monetary policy.

VII. MACROECONOMIC OUTLOOK

The outlook for the Indian economy remains weak. In an uncertain global economic environment, the interplay between growth slowdown, high inflation, wide current account, fiscal gaps and falling investment has weakened the economy. Surveys of business expectations confirm that confidence levels are low. On the other hand, inflation expectations remain sticky. The economy has reached a critical point, at which economic activity can spin up or down depending on how the policy uncertainty is addressed and supporting measures put in place. Leading indicators, especially credit growth and PMIs, suggest that a recovery is still possible with appropriate policy action.

Growth prospects for 2012-13 stay weak

VII.1 The Indian economy slowed significantly during 2011-12, with growth decelerating to 6.5 per cent. The growth prospects for 2012-13 remain weak due to a combination of global and domestic macro-economic factors. Global growth is turning weaker than anticipated. Along with the sovereign debt overhang and financial market uncertainties, it is impacting global trade.

VII.2 The IMF in its July update of the World Economic Outlook has made significant downward revisions in its current year growth estimates for India, UK, Brazil and China. As fiscal adjustments take shape in advanced economies (AEs), shrinking deficits could keep AEs growth slow for an extended period. This could result in a significant drag on growth in India.

VII.3 Recent indications suggest that global trade flows have ebbed again after some pick-up in Q4 of 2011-12. This trend could persist because of tight credit conditions, the adverse impact of deleveraging on trade finance and, more importantly, growth slowdown in emerging and developing economies (EDEs), including China. If global trade loses steam, it can have ramifications for recovery in India.

VII.4 Growth in India has decelerated faster than envisaged. Some slowdown was inevitable

as growth sacrifice was needed to combat the high inflation of the past two years. However, the lack of a quick policy response to address structural bottlenecks and encourage investment, has exacerbated the slowdown. In view of the growth moderation, the Reserve Bank in its Monetary Policy Statement 2012-13 on April 17, 2012 frontloaded the policy rate reduction with a repo rate cut of 50 basis points on the premise that the process of fiscal consolidation critical for inflation management, would get under way along with other supply-side initiatives. However, the absence of movement on fiscal correction, along with other persistent risks to inflation during 2012-13, limit the space for monetary easing and the Reserve Bank decided to hold the policy rate in its Mid Quarter Policy Review on June 18, 2012.

VII.5 On the domestic front, the macro-economic and structural factors that are impeding growth still remain to be addressed. At the current juncture, some uncertainty is arising from the temporal and spatial deficiency in the monsoon. Despite the recent revival, cumulative rainfall up to July 27, 2012 was 21 per cent deficient. The Reserve Bank's production weighted rainfall index (PRN) showed a 39 per cent drop from the normal during June 2012. However, there has been some improvement since then and the PRN deficiency is now 24 per cent. The impact of the monsoon will emerge more clearly in the coming weeks.

VII.6 Monsoon risks to overall growth could turn out to be limited due to the declining share of rainfed agriculture with improved irrigation, as also the small share of total agriculture output in GDP. However, from a welfare standpoint, the impact may be significant because it affects the poor through inflation as well as income. This also has fiscal implications through drought relief, MGNREGA and other government welfare schemes.

VII.7 The slowdown in industrial activity continues. Mining activity remains at a near standstill in the face of a lack of adequate regulatory environment to support good business. Manufacturing activity also remains sluggish in the face of a rise in input costs and slack domestic demand. High inflation has impacted consumption, at a time when investment activity is already weak, making the immediate revival of growth difficult. Subdued global demand amid weakening consumer confidence has weighed down on services growth, which may continue to experience some spillover from the slow industrial growth. While construction growth remains subdued, the 'trade, hotels, transport and communications' segment has also slowed down.

VII.8 Taking into account the increased risks, the growth outlook in 2012-13 may turn out to be lower than anticipated. However, a recovery, even if modest, still appears possible if appropriate policy correctives are quickly put in place. Credit expansion in Q1 of 2012-13 has picked-up and PMIs for manufacturing and services remain in expansion mode. This suggests that while growth has decelerated, a sharp dip can still be averted.

Inflation risks remain significant

VII.9 Headline inflation has moderated from near double-digit levels and remained in the range of 7-8 per cent for the past seven months. The extent of moderation, in spite of the negative output gap, has been constrained by a number of off-setting factors such as rupee

depreciation and sustained pressures from input costs and wages. Typically, episodes of high inflation have been marked by inflation persisting for 2-3 years and have required sustained efforts to lower inflation expectations and inflation.

VII.10 The near-term outlook on inflation continues to be marked by a number of upside risks, despite the significant slowdown in growth. Both persistent headline WPI inflation and retail inflation, even as the core inflation remains moderate, indicate continued supply-side pressures on overall inflation. These are unlikely to be mitigated in the near term. The progress of the monsoon so far has been unsatisfactory. Some price pressures could emerge in coarse cereals, pulses and edible oils. The short-term trajectory of food inflation could shift upwards impacted by the adverse monsoon, large increases in the Minimum Support Prices (MSP) and structural pressures on protein inflation that can further be reinforced if feed costs increase due to poor rainfall. The impact of the rupee depreciation against the US dollar will limit the favourable impact from a fall in global crude oil and metal prices. The suppressed inflation of the past is likely to show up in electricity, coal and fuels during 2012-13. On the whole, in spite of core inflation pressures moderating and some deceleration in wage inflation, upside risks to inflation projections for 2012-13 remain significant.

Business expectations indices suggest subdued business confidence

VII.11 Various surveys portray weakening optimism about business prospects. The NCAER Business Confidence Index, which registered an improvement in business environment during April 2012, slid back during July 2012. Private sector firms appear apprehensive about the investment climate and their financial positions, even though capacity utilisation levels remain relatively high.

Table VII.1: Business Expectations Surveys

Period Index	NCAER- Business Confidence Index July 2012	FICCI Overall Business Confidence Index Q2:2011-12	Dun & Bradstreet Business Optimism Index Q3: 2012	CII Business Confidence Index Q1: 2012-13
1	2	3	4	5
Current level of the Index	126.6	51.5	136.1	55.0
Index as per previous survey	134.9	51.6	150.0	52.9
Index levels one year back	145.2	76.2	143.6	62.5
% change (q-on-q) sequential	-6.2	-0.2	-9.2	4.0
% change (y-on-y)	-12.8	-32.3	-5.2	-12.0

VII.12 The latest Dun & Bradstreet Business Optimism Index for July–September 2012, conducted in June 2012 amid renewed domestic and global economic pressures, indicates increased pessimism, with a q-o-q decline in volume of sales, net profits, new orders, inventory and employee levels. Weak demand conditions are observed across sectors, especially in the intermediate and capital goods sectors. The demand for finished goods also shows a significant moderation, pointing to a further slowdown in capital expenditure by firms.

VII.13 The CII business confidence index, however, registered moderate recovery, with almost three-fourth of the respondents expecting a 7 or higher per cent growth in 2012-13, with the primary concern being stagnancy in reforms. The survey indicates optimism about overall sales, new orders and pre-tax profits in Q1 of 2012-13, as results indicate a corresponding rise in the last quarter as well.

VII.14 Across surveys, higher input costs seem to be the major deterrent to business confidence (Table VII.1). The seasonally adjusted HSBC Markit Purchasing Managers' Indices (PMI) for both manufacturing and services (June 2012) suggest improved business conditions and rising output. Despite the increasing input costs, higher employment levels and rising output prices point to some optimism about growth revival. Business expectations remain positive.

Industrial Outlook Survey points to moderation in both demand and financial conditions

VII.15 The Reserve Bank's 58th round of the Industrial Outlook Survey (<http://www.rbi.org.in/IOS58>), conducted during Q1 of 2012-13 with a sample of 1,404 manufacturing companies, showed a deterioration in business sentiments both in the assessment quarter Q1 and the expectations quarter Q2 of 2012-13.

VII.16 The Business Expectation Index (BEI), a composite indicator based on several business parameters, shows moderation for assessment (Q1 of 2012-13) as well as expectation (Q2 of 2012-13) quarters (Chart VII.1). The fall in assessment index has been much sharper than the expectation index, indicating that the perceived plateauing was not realised. However, these indices remained in the positive growth zone (*i.e.*, above 100, which is the threshold separating contraction from expansion).

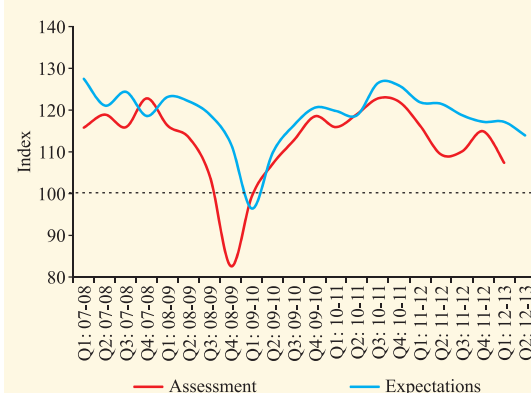
Chart VII.1: Business Expectation Index

Table VII.2: Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response*								
		2011						2012		
		Jul-Sep		Oct-Dec		Jan-Mar		Apr-Jun		Jul-Sep
		E	A	E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9	10	11
1. Overall Business Situation	Better	39.8	18.7	35.2	17.7	33.6	26.5	34.9	18.3	30.6
2. Overall Financial Situation	Better	30.6	11.7	26.3	11.2	25.2	18.5	27.7	14.2	23.6
3. Availability of Finance	Improve	24.2	12.1	20.2	10.4	19.0	15.8	22.9	15.0	20.4
4. Cost of External Finance	Decrease	-39.7	-50.2	-41.0	-50.6	-38.8	-37.4	-22.7	-30.5	-24.0
5. Production	Increase	40.6	22.6	39.9	25.3	40.4	33.1	34.7	20.3	33.6
6. Order Books	Increase	35.9	20.3	33.4	18.4	31.3	24.8	29.5	16.9	29.9
7. Capacity Utilisation	Increase	25.0	9.9	22.2	10.8	24.3	16.7	19.9	8.6	18.4
8. Cost of Raw Material	Decrease	-51.7	-58.1	-49.7	-61.2	-50.1	-59.4	-49.0	-63.1	-51.4
9. Employment in the Company	Increase	19.4	15.6	16.5	11.3	13.6	12.9	14.6	10.0	12.3
10. Exports	Increase	25.8	13.1	22.1	11.5	18.6	14.2	20.7	10.8	20.5
11. Imports	Increase	19.0	15.7	16.9	11.6	15.5	14.4	15.7	11.6	15.5
12. Selling Price	Increase	18.3	10.7	16.0	8.9	14.7	13.5	19.0	17.5	18.8
13. Profit Margin	Increase	2.5	-17.1	-1.6	-17.3	-2.9	-11.3	-1.2	-17.9	-3.6

* Net response is measured as the percentage share differential between the companies reporting optimistic (positive) and pessimistic (negative) responses; responses indicating status quo (no change) are not reckoned. Higher 'net response' indicates higher level of optimism and vice versa.

E: Expectation. A: Assessment.

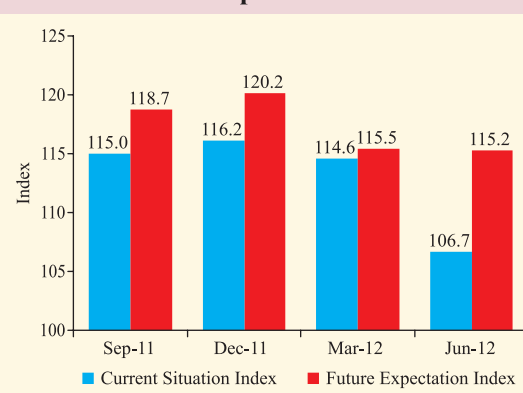
VII.17 Net response of major demand side parameters, viz., production, order books, capacity utilisation, exports and imports for Q1 of 2012-13, remained positive, *albeit*, lower when compared on a y-o-y as well as a q-o-q basis. The outlook response shows similar results.

VII.18 The results also point to lower optimism in the overall financial situation through H1 of 2012-13. The net response for availability of finance was positive, although marginally lower than the previous quarter. 'Cost of external finance' is perceived to rise further, but by a lower percentage of respondents. The majority still expect the cost of raw material to rise further in Q2 of 2012-13. While a higher percentage of respondents (on a net basis) assessed that the profit margin declined over the last quarter, the outlook for Q2 of 2012-13 remains more or less balanced (Table VII.2).

Consumer Confidence Survey indicates static future expectations

VII.19 The Reserve Bank's 9th round of the Consumer Confidence Survey (<http://www.rbi.org.in/CCS9>), conducted in June 2012,

indicates that although the majority of respondents perceive current household circumstances to have improved, there has been a rise in the proportion of respondents reporting otherwise. This led to a fall in consumer confidence for the current period. However, the future expectations of households remained almost constant at the level observed in the last round (Chart VII.2).

Chart VII.2: Current Situation Index and Future Expectation Index

External agencies see moderation in growth ahead

VII.20 The revised GDP growth estimate for 2011-12 at 6.5 per cent came in sharply lower than the conservative estimates by external agencies (7.0-7.6 per cent). Stuttering global growth coupled with domestic concerns on multiple fronts, viz., weak IIP growth momentum, persistent inflation, and high fiscal and current account deficits, without much being done on the reform front, have led to further downward revisions in the growth outlook for 2012-13 by 0.2-0.8 percentage points. At this juncture, however, the consensus forecasts on growth seem to be placed lower than the 7.3 per cent projected by the Reserve Bank in its Monetary Policy Statement 2012-13 (Table VII.3).

Table VII.3: Agencies' Projections for 2012-13

Agency	Latest Projection		Earlier Projection	
	GDP Growth (Per cent)	Month	GDP Growth (Per cent)	Month
1	2	3	4	5
Economic Advisory Council to the PM	7.6	Feb-12	-	-
Finance Ministry	7.6 (+/0.25)	Feb-12	-	-
IMF* (calendar year)	6.1	July-12	6.9	Apr-12
World Bank	6.9	Jun-12	7.5	Mar-12
OECD*	7.3	May-12	7.5	Nov-11
ADB	6.5	Jul-12	7.0	Apr-12
NCAER	7.3	Apr-12	-	-

* GDP at market rates.

Survey of professional forecasters¹

VII.21 The results of the 20th round of the 'Survey of Professional Forecasters' (<http://www.rbi.org.in/SPF20>) conducted by the

Table VII.4: Median Forecasts of Select Macroeconomic Indicators by Professional Forecasters 2012-13 and 2013-14

	Actual 2011-12	Annual Forecast				Quarterly Forecast																	
		2012-13		2013-14		2012-13								2013-14									
						Q1				Q2				Q3				Q4				Q1	
		E	L	E	L	E	L	E	L	E	L	E	L	E	L	E	L	E	L				
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16								
1. Real GDP growth rate at factor cost (in per cent)	6.5#	7.2	6.5	-	7.0	6.6	5.5	7.1	6.3	7.4	6.6	7.5	7.0	-	7.1								
a. Agriculture & Allied Activities	2.8#	3.0	3.0	-	3.0	3.0	2.7	3.2	3.0	3.1	2.7	3.0	2.9	-	2.8								
b. Industry	2.6#	6.0	4.0	-	5.7	4.6	1.5	5.5	3.7	6.3	5.0	6.2	5.5	-	6.0								
c. Services	8.5#	8.8	8.0	-	8.6	8.4	7.5	8.5	7.8	8.8	8.1	8.6	8.4	-	8.4								
2. Gross Domestic Saving (per cent of GDP at current market price)	-	32.8	31.3	-	32.2	-	-	-	-	-	-	-	-	-	-								
3. Average WPI-Inflation	8.9	6.9	7.3	-	6.8	6.6	7.4*	6.9	7.6	6.7	7.4	6.7	7.2	-	6.5								
4. Exchange Rate (INR/USD end period)	51.2	48.3	53.0	-	51.0	49.5	56.3*	48.8	55.0	48.0	54.5	47.8	53.0	-	52.5								
5. T-Bill 91 days Yield (per cent-end period)	8.7	7.9	8.0	-	7.5	-	-	-	-	-	-	-	-	-	-								
6. 10-year Govt. Securities Yield (per cent-end period)	8.6	8.2	8.1	-	7.8	-	-	-	-	-	-	-	-	-	-								
7. Export (growth rate in per cent)@	23.7*	13.2	12.0	-	17.0	-	-	-	-	-	-	-	-	-	-								
8. Import (growth rate in per cent)@	31.1*	15.0	8.3	-	14.3	-	-	-	-	-	-	-	-	-	-								
9. Trade Balance (US\$ billion)	-189.8*	-	-	-	-	-50.2	-46.0	-47.7	-45.5	-44.8	-46.2	-48.0	-47.3	-	-45.6								
E: Previous Round Projection. - : Not Available.	L: Latest Round Projection. &: Actual.	#: Revised Estimate. @: US\$ on BoP basis.						*: Preliminary.															
Note : The latest round refers to Twentieth round for the quarter ended June 2012, while previous round refers to Nineteenth round for the quarter ended March 2012.																							
Source : Survey of Professional Forecasters, First Quarter 2012-13.																							

E: Previous Round Projection.

L: Latest Round Projection.

#: Revised Estimate.

*: Preliminary.

- : Not Available.

&: Actual.

@: US\$ on BoP basis.

Note : The latest round refers to Twentieth round for the quarter ended June 2012, while previous round refers to Nineteenth round for the quarter ended March 2012.

Source : Survey of Professional Forecasters, First Quarter 2012-13.

¹ The forecasts reflect the views of professional forecasters and not of the Reserve Bank.

Reserve Bank shows a downward revision in the median growth forecast for 2012-13 to 6.5 per cent. The industry and service sector median growth forecasts have turned low, but are expected to pick-up beginning Q2 of 2012-13. The average inflation outlook has been revised upward to 7.3 per cent for 2012-13 and moderation is expected from Q3 of 2012-13 onwards (Table VII.4).

Inflation expectations stay sticky

VII.22 The Inflation Expectations Survey of Households (IESH) (<http://www.rbi.org.in/IESH28>), conducted among 4,000 households across 12 cities and 7 occupational categories in June 2012, indicates that the median inflation perception for the current quarter (*i.e.*, April-June 2012) as well as the median inflation expectations going forward remained at the same level. However, the mean perception and expectation of inflation moved up marginally compared with the previous round. The percentage of respondents expecting higher inflation in next quarter/year has also increased compared with the last round.

Inflation and macro risks to condition growth-enabling policy actions

VII.23 Domestic growth declined to its lowest in 29 quarters during Q4 of 2011-12. Early indications for Q1 of 2012-13 suggest that growth is likely to remain subdued. While growth risks are significant, policy choices have been complicated as inflation remains above the comfort level. Further, inflation risks have increased and continue to constitute significant risk to growth sustainability, thus making it imperative to not allow monetary conditions to aggravate these risks. Also, the wide CAD and high fiscal deficit continue to limit the monetary space and pose major challenges for macroeconomic policy. Though adjustments in the exchange rate could contribute to bridging

the current account deficit, excessive volatility, particularly the risks of a downward spiral in the rupee, needs monitoring. Going forward, improved liquidity and monetary conditions suggest the possibility of a slow recovery in industrial growth.

VII.24 Additional rounds of accommodative monetary policy across the globe, if sustained through 2012-13, can reverse the trend of falling commodity prices at some stage. Global food inflation is also likely in the face of widespread drought in US and elsewhere. Besides, monsoon shortfall also weigh heavily on the inflation outlook in India. Rising input costs have fed into output prices, though further pass-through may be limited. On the other hand, corporates are likely to raise prices to protect themselves against margin pressures in sectors where competitive structures are not in place and mark-ups can be protected.

VII.25 The economy is now at a critical juncture where revival can be supported by restoring confidence through policy actions to encourage investment. Removing constraints on FDI and improving the investment climate by moving quickly to address bottlenecks in infrastructure space are important. Also, speeding up fiscal consolidation by putting in place an investment stimulus through large capital spending by the government but offsetting it by curtailing revenue spending by revamping the subsidy schemes could go a long way in reviving growth. Reviving infrastructure investment while addressing increased risks to lending to this sector is critical in this context.

VII.26 In short, decisive policy action backed by credible commitment to a long-term strategy for correcting macroeconomic imbalances and stimulating investment is crucial at this stage to revive confidence as well as provide space for monetary policy to help sustain growth while keeping inflation under control.