RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments Third Quarter Review 2012-13

Issued with the Third Quarter Review of Monetary Policy 2012-13

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Reserve Bank of India
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MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2012-13

Overview

1. Growth since Q4 of 2012-13 is expected to stage a gradual recovery aided by some revival in investment demand and the favourable effect of some moderation in inflation on consumption. Inflation in Q3 of 2012-13 has trended down, though upside risks remain from suppressed inflation which could impart stickiness to inflation trajectory in 2013-14. Core inflation pressures have receded markedly and are unlikely to re-emerge quickly on demand considerations. However, high food and fuel inflation still remain a concern and this in part is reflected in high CPI inflation.

2. Since the beginning of 2012, the Reserve Bank has worked towards easing monetary and liquidity conditions in a calibrated manner so as to not jeopardise the trend of moderating inflation. The strategy yielded dividends, as headline and core inflation moderated during Q3 of 2012-13. However, monetary policy needs to continue to be calibrated in addressing growth risks as inflation remains above the Reserve Bank's comfort level and macroeconomic risks from twin deficits persists.

Global Economic Conditions

Fiscal adjustments likely to keep global recovery muted in 2013

3. Though the US registered high growth in Q3 of 2012 and the pace of economic contraction moderated in the euro area, growth prospects for advanced economies (AEs) in 2013 remain subdued. While the immediate risk of the fiscal cliff in the US has been averted due to a hurried deal on tax rate hikes, the debt ceiling limit and the sequester issue pertaining to expenditure reduction are still unsettled. Growth in emerging market and developing economies (EMDEs) may have bottomed out, but an enduring recovery hinges on global headwinds.

Global commodity price inflation likely to remain soft, although with some risks from QE

4. Inflation in AEs is likely to remain moderate as demand remains weak, leaving the global inflation scenario benign in the near term. As a baseline case, improved supply prospects in key commodities such as oil and food are also likely to restrain commodity price pressures. However, upside risks persist, especially on the back of some recovery in EMDEs and large quantitative easing (QE) by AE central banks. In the presence of significant excess global liquidity, triggers for supply disruptions or incremental news flow on reduced slack could exacerbate price volatility and become a source of inflationary pressure.

Unconventional monetary policies reduce global financial stress in the interim, but risks remain ahead

5. International financial market stress moderated greatly following aggressive monetary easing measures by the central banks of AEs, as also recent policy initiatives on fiscal consolidation in the euro area *economies, encouraging capital flows into EMDEs. However, in the absence of credible long-term fiscal consolidation in the US, and generally reduced fiscal space in AEs, the efficacy of monetary policy actions may get subdued. Risks to the global financial sector, although moderating, are likely to persist.*

Indian Economy: Developments and Outlook

Output

Growth remains below trend, recovery likely in 2013-14

6. The Indian economy further decelerated in the first half (H1) of 2012-13, with moderation in all three sectors of the economy. The weak monsoon dented agricultural performance. Policy constraints, supply and infrastructure bottlenecks and lack of sufficient demand continued to keep industrial growth below trend. Subdued growth in other sectors and weak external demand pulled down the growth of services as well. Though a modest recovery may set in from Q4 of 2012-13 as reforms get implemented, sustaining recovery through 2013-14 would require all-round efforts in removing impediments to business activity.

Aggregate Demand

Improvement in investment climate is a pre-requisite for economic recovery

7. Demand weakened in H1 of 2012-13. There was significant moderation in consumption as private consumption decelerated even as government expenditure accelerated. On the fiscal side, near-term risks have diminished due to the government's repeated avowal of commitment to the revised fiscal deficit target of 5.3 per cent of gross domestic product (GDP) for the year. However, sustainable fiscal consolidation would require bringing current spending, especially on subsidies, under control and protecting, if not enhancing capital expenditure. Going forward, the key to demand revival lies in improving the investment climate as well as investor sentiments through sustained reforms.

External sector

Widening of CAD and its financing remains a key policy challenge

8. The current account deficit (CAD) to GDP ratio reached a historically high level of 5.4 per cent in Q2 of 2012-13. Low growth and uncertainty in AEs as well as EMDEs continued to adversely impact exports in Q3 of 2012-13. This, combined with continuing large imports of oil and gold, resulted in a deterioration of the trade balance. For the time being, strong capital flows have enabled financing of CAD without a significant drawdown of foreign exchange reserves. However, the possibility of volatility in these flows, which may put further pressure on the external sector, cannot be ruled out. A two-pronged approach, of lowering CAD in the medium term while ensuring prudent financing of CAD in the interim, is necessary from the policy perspective.

Monetary and Liquidity Conditions

With tightening cycle gradually impacting inflation, the Reserve Bank takes measures to combat tight liquidity conditions

9. Monetary policy in India has sought to balance the growth-inflation dynamics that included a frontloaded policy rate cut of 50 basis points (bps) in April 2012 and several liquidity enhancing measures. These included lowering of the cash reserve ratio (CRR) by 50 bps on top of a 125 bps reduction in Q4 of 2011-12 and the statutory liquidity ratio (SLR) by 100 bps in a bid to improve credit flows. The Reserve Bank also infused liquidity of over ₹1.3 trillion through outright open market operation (OMO) purchases during 2012-13 so *far. However, growth in monetary aggregates remains below the indicative trajectory.*

Financial Markets

Domestic reform initiatives and surging capital flows improve market sentiment and revive the IPO market

10. Improved global sentiments along with recent policy reforms by the government beginning September 2012, and market expectations of a cut in the policy rate in the face of moderation in inflation, aided FII flows into the domestic market. The equity markets showed significant turnaround, while the rupee remained range-bound. In addition, revival is witnessed in the IPO segment. Although Indian financial market sentiments improved significantly in Q3 of 2012-13, some macroeconomic concerns persist, as witnessed in the inverted yield curve. Sustained commitment to curtail twin deficits and nurture growth without fuelling inflation is critical to support investor confidence.

Price Situation

Headline and core inflation moderated, but suppressed inflation poses risks

11. Headline inflation moderated in Q3 of 2012-13 with significant moderation in non-food manufactured products inflation. Both weakening domestic demand and lower global commodity prices contributed to the softening of headline inflation. Though the recent hike in diesel prices will put some pressure on the overall price level, the near-term inflation outlook indicates that the moderation may continue through Q4 of 2012-13. While the pressure from generalised inflation remains muted at the current juncture, risks from suppressed inflation, pressure on food prices and high inflation expectations getting entrenched into the wage-price spiral need to be reckoned with. The inflation path for 2013-14 could face downward rigidity as some of the risks from suppressed inflation materialise.

Macroeconomic Outlook

Balance of macroeconomic risks suggest continuation of calibrated stance

12. Reforms since September 2012 have reduced immediate risks, but there is a long road ahead to bring about a sustainable turnaround for the Indian economy. Business sentiments remain weak despite reform initiatives and consumer confidence is edging down. The Reserve Bank's survey of professional forecasters anticipates a slow recovery in 2013-14 with inflation remaining sticky. Fiscal risks have somewhat moderated in 2012-13, but a sustained commitment to fiscal consolidation is needed to generate monetary space. Widening CAD, which is at historically high level, remains a constraint on monetary easing. Against this backdrop, while growth can be supported by monetary policy if inflation risks recede, credible fiscal correction with improved execution in infrastructure space to boost investment would be needed for a sustained revival. The balance of macroeconomic risks suggest continuation of the calibrated stance while increasingly focussing on growth risks.

I. OUTPUT

India's growth slipped to 5.3 per cent in Q2 of 2012-13 from 5.5 per cent in Q1. Agricultural growth in 2012-13 is likely to be below trend as the rabi crop is unlikely to fully compensate for the kharif deficiency. Industrial growth is expected to stay below its trend due to supply and infrastructure bottlenecks and slack in external demand. Growth in the services sector has decelerated due to lackadaisical conditions in commodity-producing sectors and some of its own drivers faltering. Consequent to these factors, growth in 2012-13 may fall below the Reserve Bank's October 2012 projection of 5.8 per cent. Even though a modest recovery may set in from Q4 of 2012-13 as reforms and efforts to remove structural constraints get underway, sustaining this recovery through 2013-14 would require all-round efforts in removing impediments for business activity. With global recovery likely to stay muted in the near term, closing the output gap in India would be challenging.

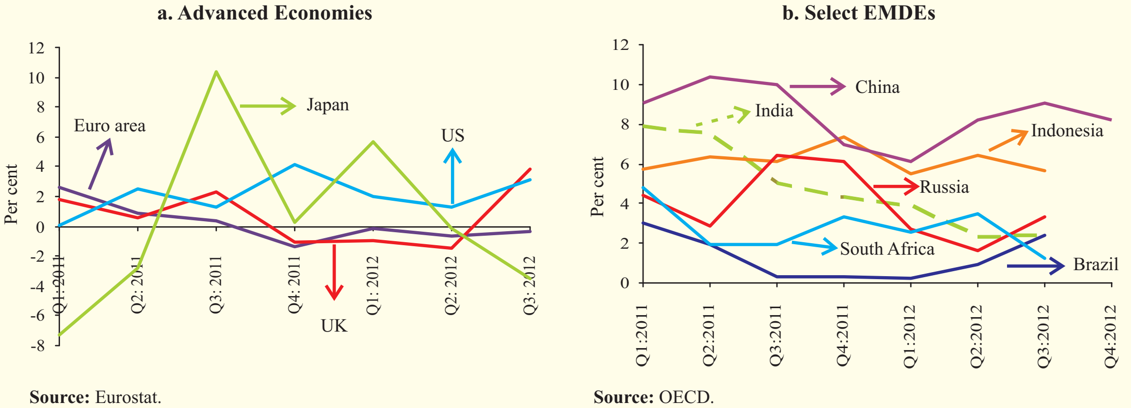
Fiscal adjustments likely to keep global recovery muted in 2013

I.1 There was a mild improvement in macroeconomic conditions in advanced economies (AEs) in Q3 of 2012. However, the sustainability of this improvement through 2013 remains uncertain in view of the fiscal adjustment agenda facing most AEs.

I.2 While the US economy expanded significantly by 3.1 per cent (q-o-q annualised) in Q3 of 2012, growth in Q4 is expected to be lower than in Q3. The pace of contraction in the euro area slowed from 0.7 per cent in Q2 to 0.3 per cent in Q3 of 2012 (Chart I.1). Spain, Italy and Portugal continued to be in recession, while GDP contracted in the Netherlands. The euro area's composite Purchasing Managers Index (PMI) for December 2012 suggests that recession continues in the region. German economy, the largest in the region, is estimated to have contracted in Q4 of 2012.

I.3 Labour markets in AEs exhibited a mixed picture in Q4 of 2012. The unemployment rate in the US remained steady at about 7.8 per cent in December 2012 after improvements seen in the preceding quarter. In the UK, the unemployment rate fell by 0.1 percentage points to 7.7 per cent for the period September-November 2012. However, in the euro area the unemployment rate reached a new high of 11.8

Chart I.1: Growth (Q-o-q, SAAR)



Source: Eurostat. **Source:** OECD.

per cent in November 2012. The unemployment rate in Spain and Greece exceeds 26 per cent, with youth unemployment rates of about 57 per cent. Such levels clearly impart a socio-economic constraint to fiscal consolidation programmes to support adjustment and stabilisation in the euro area. As such, risks to global growth emanating from euro area remain significant.

I.4 Growth in emerging market and developing economies (EMDEs) turned weaker during Q3 of 2012. However, there are signs of a modest improvement in Q4. China registered its first acceleration in growth in two years in y-o-y terms in Q4 of 2012. Brazil's PMI also showed a marked improvement in November and December 2012. The readings indicate that growth may have bottomed out.

I.5 Despite signs of improvement in activity in recent months, prospects for recovery in 2013 remain highly uncertain. International agencies have sequentially scaled down their forecasts for growth in 2013 (Chart I.2).

I.6 The patchy deal on fiscal cliff in the US, through enactment of the American Taxpayer Relief Act of 2012, has lowered the immediate risks. However, the deal is still likely to have some adverse effect on the US recovery in 2013. Under 'no deal' scenario, the fiscal cliff was estimated to hike revenues close to 20 per cent and also lower spending a little. The deal has substantially reduced the tax side of the cliff but not eliminated it. The budget sequestration on the spending side will still have an impact if not negotiated before the automatic spending cuts take effect on March 1, 2013. Overall, the deal may still result in a deficit reduction of about a third of the original estimate. Also, even though the US is on its way to temporarily suspend the requirement for the Congress to approve a higher debt ceiling as the US$16.4 trillion borrowing limit is reached, concerns about long term debt sustainability remain.

I.7 Concerns remain heightened about economic fundamentals and policy adjustment in the euro area. In Japan, though the government has announced further fiscal stimulus of US$116 billion to ride the economy out of recession, concerns remain about the level of public debt.

I.8 In the EMDEs, the short-term growth recovery hinges upon the extent to which the external risks relating to escalation of uncertainties in the euro area crisis and the possibility of bumpy fiscal adjustment in the US are averted. Against the backdrop of uncertain growth prospects and generally low and stable inflation, central banks in many EMDEs held or reduced policy rates to low levels in 2012. The need and scope for monetary policy action, however, differs across economies, mainly reflecting varying growth and inflation risks, and risks to financial stability from past stimuli.

Growth slowdown in India continues, revival may take some more time

I.9 Growth in India continued to be subdued at 5.3 per cent in Q2 of 2012-13 and is likely to remain low in Q3 as well. The slowdown reflects the uncertain global macro-economic environment as well as domestic factors such as low growth in real investment (gross fixed capital formation) and a weak south-west monsoon. Consequently, growth in the first half (H1) of 2012-13 was 5.4 per cent and

Chart I.2: Global Growth Forecasts for 2013

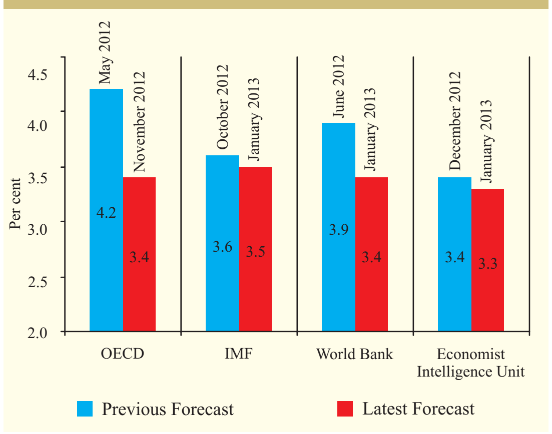
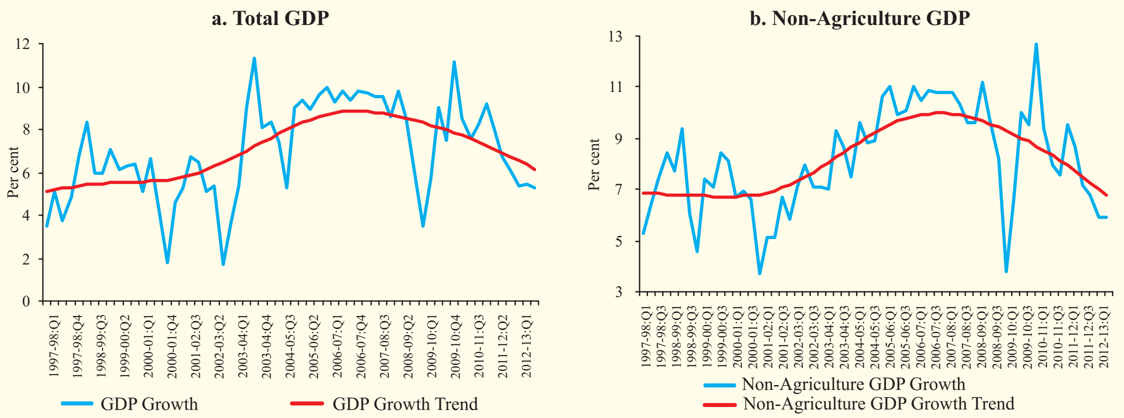


Chart I.3: GDP Growth



below trend, compared with growth of 7.3 per cent in H1 of 2011-12 (Chart I.3).

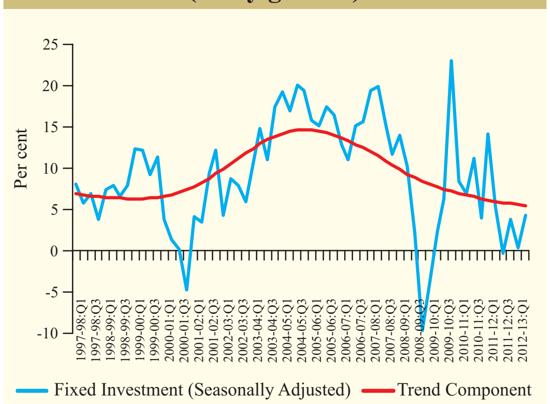
I.10 Looking ahead, even as inflation is moderating and growth is likely to have bottomed out, the Reserve Bank's growth projection of 5.8 per cent for 2012-13 could face downside risks. This is largely because the positive impact of the various policy measures announced by the government is yet to show up fully or definitively in the various data releases, partly reflecting inherent gestation lags of the policy initiatives and partly the persistence of structural supply bottlenecks. Moreover, real fixed investment has been trending down since peaking in Q1 of 2005-06 (Chart I.4).

Agriculture and industry further drag down growth in Q2 of 2012-13

I.11 The deceleration in growth in H1 of 2012-13 was seen across all the major sectors. The agriculture sector was adversely impacted due to the weak south-west monsoon. Industrial slowdown was on account of moderation in manufacturing and 'electricity, gas and water supply'. The dip in services sector growth was mainly on account of 'trade, hotels, transport, storage and communication', even as the other sub-sectors showed improvement (Table I.1).

I.12 Against the backdrop of the moderation in the performance of industry and services sectors, the Planning Commission has scaled down the average annual growth target of the economy to 8.0 per cent (8.2 per cent earlier) during the Twelfth Five Year Plan. Growth during the previous Plan period was 7.9 per cent. Overall, the growth rate is projected to progressively increase to 9.0 per cent by 2016-17, the terminal year of the Twelfth Plan. This is arduous as a quick revival appears difficult with slack in global demand and serious structural issues that need to be addressed. Total investment in the infrastructure sector during the period is estimated at ₹56.3 trillion (about US$1 trillion). The attainment of this target is contingent on increasing the share of private investment in total investment in infrastructure from 38 per cent in the previous Plan to about 48 per cent during the Twelfth Plan.

Chart I.4: Real Fixed Investment (Y-o-y growth)



Rabi crop expected to be normal despite deficient rains

I.13 The recovery of rainfall during August-September helped maintain soil moisture. Even though the north-east monsoon continued to be below normal (by 21 per cent as on December 31, 2012) sowing of *rabi* crops has not been affected as the water level in major reservoirs is satisfactory. Sowing under major *rabi* crops so far in the year is comparable with the level in the previous year (Table I.2).

I.14 The high stock of foodgrains indicates that the country is currently self-sufficient in wheat and rice (Chart I.5). In recent months, however, cereal prices, particularly of wheat and rice, have remained elevated.

Table I.2: Progress of *Rabi* Sowing

(Million hectares)

Crops	Normal as on Date	2011-12*	2012-13*	Percentage change from previous year	Percentage deviation from Normal
1	2	3	4	5	6
Foodgrains	49.3	50.8	50.7	-0.2	2.8
Wheat	28.2	29.6	29.5	-0.3	4.6
Rice	1.3	1.0	0.9	-10.0	-30.8
Coarse Cereals	6.3	5.8	6.1	5.2	-3.2
Cereals	35.8	36.5	36.4	-0.3	1.7
Pulses	13.5	14.3	14.2	-0.7	5.2
Oilseeds	8.7	8.4	8.5	1.2	-2.3
All Crops	**58.0**	**59.2**	**59.2**	**0.0**	**2.1**

*: January 18.
Source: Ministry of Agriculture, GoI.

Weakness in industrial performance likely to persist

I.15 Industrial growth has remained subdued since July 2011 due to weak global demand, weak supply linkages, high input costs and sluggish investment activity. During 2012-13 (April-November) industrial growth slowed to 1.0 per cent. Barring a spike in October 2012 due to a favorable base effect and festival-related pick-up in production, growth has been disappointing across sectors. The industrial sector was mainly affected by the contraction in the output of capital goods and the mining sector (Table I.3). Subdued investment activity has led to the decline of capital goods production, while regulatory and environmental issues have affected the output of the mining sector. Excluding capital goods, the growth rate of overall IIP during April-November 2012 was 3.0 per cent

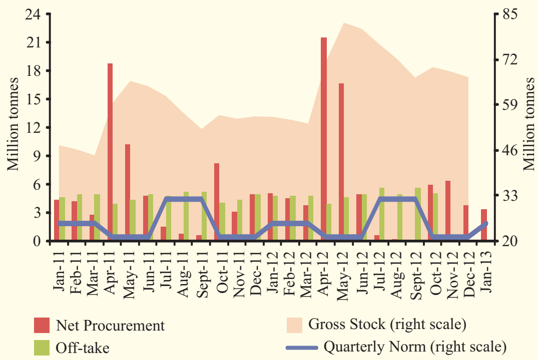
Table I.1: Sectoral Growth Rates of GDP (2004-05 prices)

(Per cent)

Item	2010-11*	2011-12#	2011-12 Q1	2011-12 Q2	2011-12 Q3	2011-12 Q4	2012-13 Q1	2012-13 Q2	2011-12 H1	2012-13 H1
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture & allied activities	7.0	2.8	3.7	3.1	2.8	1.7	2.9	1.2	3.4	2.1
2. Industry	6.8	2.6	6.5	2.7	0.9	0.7	0.8	1.2	4.6	1.0
2.1 Mining & quarrying	5.0	-0.9	-0.2	-5.4	-2.8	4.3	0.1	1.9	-2.8	0.9
2.2 Manufacturing	7.6	2.5	7.3	2.9	0.6	-0.3	0.2	0.8	5.1	0.5
2.3 Electricity, gas & water supply	3.0	7.9	7.9	9.8	9.0	4.9	6.3	3.4	8.9	4.8
3. Services	9.2	8.5	9.3	8.5	8.7	7.5	7.4	7.1	8.9	7.2
3.1 Trade, hotels, transport, storage & communication	11.1	9.9	13.8	9.5	10.0	7.0	4.0	5.5	11.6	4.7
3.2 Financing, insurance, real estate and business services	10.4	9.6	9.4	9.9	9.1	10.0	10.8	9.4	9.6	10.1
3.3 Community, social & personal services	4.5	5.8	3.2	6.1	6.4	7.1	7.9	7.5	4.6	7.7
3.4 Construction	8.0	5.3	3.5	6.3	6.6	4.8	10.9	6.7	4.9	8.8
4. GDP at factor cost (total 1 to 3)	8.4	6.5	8.0	6.7	6.1	5.3	5.5	5.3	7.3	5.4

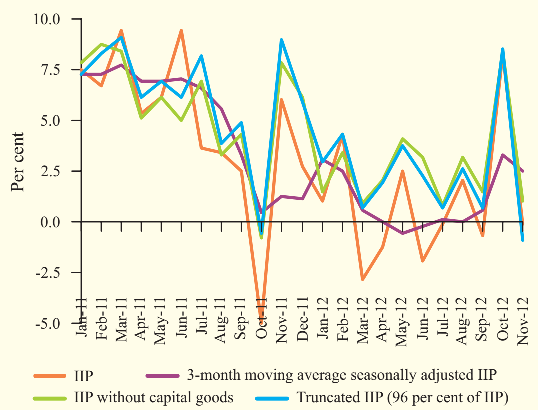
*: Quick Estimates. #: Revised Estimates.
Source: Central Statistics Office.

Chart I.5: Food Stock and its Determinants



Note: 1. Data for off-take is up to October 2012 and stock up to December 2012.
2. Data for procurement is up to January 13, 2013.

Chart I.6: Industrial Growth (Y-o-y)



(Chart I.6). Truncated IIP (96 per cent of the IIP), calculated by the Reserve Bank by excluding the volatile items, shows higher growth than the overall IIP for the same period.

I.16 The manufacturing sector witnessed sharp moderation in growth during April-November 2012. Within the manufacturing sector, capital goods industries such as machinery and equipment, electrical machinery and computing machinery registered a contraction in output. The slowdown in consumption demand has affected the growth of motor vehicles, food products and apparel industries.

I.17 Lack of reliable power supply has emerged as a challenge in capacity utilisation of small- and medium-scale industries. Electricity generation decelerated sharply during April-November 2012 due to a weak monsoon and shortages in coal supply. Capacity utilisation or plant load factor (PLF) of thermal power plants was 69.6 per cent during April-December 2012, compared with 71.9 per cent during the same period in the previous year. Shortage of coal is one of the main reasons for lower PLF in the current year. As on January 7, 2013, 36 of the 90 thermal power stations had coal stocks for less than 7 days (critical), of which 22 power stations had stocks for less than 4 days (super-

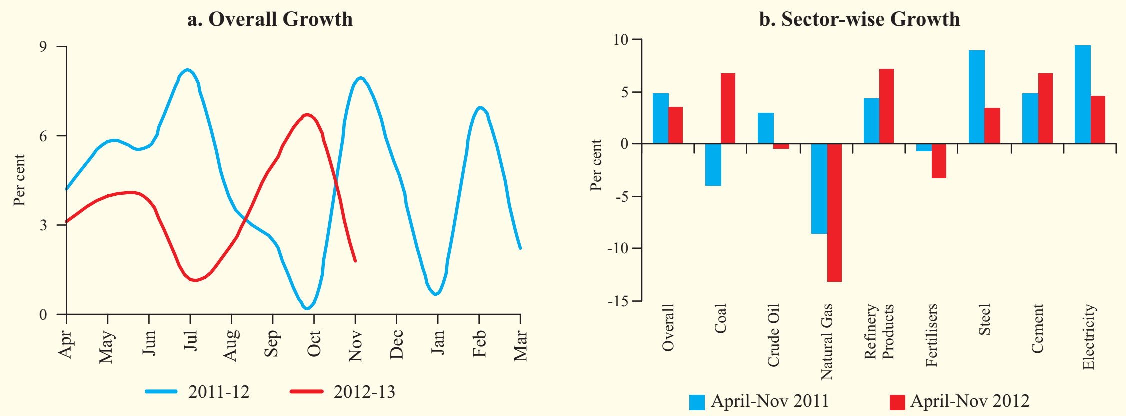
Table I.3: Index of Industrial Production: Sectoral and Use-based Classification of Industries

(Per cent)

Industry Group	Weight in the IIP	Growth Rate			Weighted Contribution#		
		Apr-Mar	Apr-Nov		Apr-Mar	Apr-Nov	
		2011-12	2011	2012 P	2011-12	2011	2012 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	14.2	-2.0	-2.4	-1.5	-7.6	-7.1	-15.9
Manufacturing	75.5	3.0	4.2	1.0	83.2	85.7	76.1
Electricity	10.3	8.2	9.5	4.4	24.3	21.6	40.1
Use-based							
Basic Goods	45.7	5.5	6.3	2.8	74.5	64.8	110.5
Capital Goods	8.8	-4.0	-1.0	-11.1	-20.4	-3.8	-152.0
Intermediate Goods	15.7	-0.6	-0.6	1.8	-3.0	-2.0	24.1
Consumer Goods (a+b)	29.8	4.4	5.0	3.8	48.6	41.2	117.3
a) Consumer Durables	8.5	2.6	5.2	5.2	13.2	19.7	76.3
b) Consumer Non-durables	21.3	5.9	4.9	2.5	35.3	21.5	40.7
General	100	2.9	3.8	1.0	100	100	100

P : Provisional. #: Figures may not add up to 100 due to rounding off.
Source: Central Statistics Office.

Chart I.7: Growth in Core Industries (Y-o-y)



critical), while the normative stock required is for 22 days.

I.18 With investment activity remaining subdued, the prospects of a recovery in industrial growth appear weak. The export channel also plays an important role. The revival of global growth is, therefore, crucial for industrial recovery in India. There is strong co-movement between domestic and global IIP, the correlation coefficient between the two during April 2008 to November 2012 was 0.7.

Recovery of core industries yet to pick up momentum

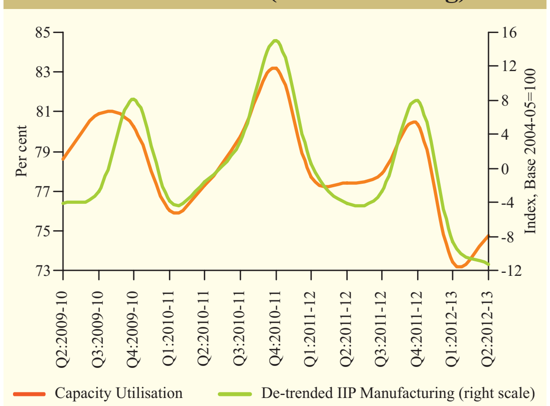
I.19 Growth in eight core infrastructure industries decelerated to 3.5 per cent during April-November 2012 compared to 4.8 per cent during the corresponding period of the previous year. While the production of coal, cement and petroleum refinery products accelerated during the period, it was offset by the deceleration in the production of electricity and steel (Chart I.7).

I.20 The subdued growth of the core industries has remained a drag on industrial production. Policy uncertainties in areas such as iron ore and coal mining have adversely affected the output of the steel and power industries. The recent initiatives taken by the government for the allocation of new coal blocks and commencement of production from CIL's new coalfields are expected to boost coal output going forward. However, in the interim, constraints in infrastructure sector remain (see Chapter 2).

Marginal increase in capacity utilisation

I.21 Capacity utilisation as measured by the 19th round of the Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank increased marginally in Q2 of 2012-13 after bottoming out during the previous quarter (http://www.rbi.org.in/OBICUS19). There is a broad co-movement between capacity utilisation and de-trended IIP manufacturing (Chart I.8). On a sequential quarterly basis, new orders

Chart I.8: Capacity Utilisation and De-trended IIP (Manufacturing)



moderated in Q2 of 2012-13 and finished goods inventory increased faster than raw material inventory.

Lead indicators of services sector signal moderation

I.22 The moderation of services sector growth in H1 of 2012-13 was largely due to the sharp deceleration in the growth of the 'trade, hotels, transport, storage and communication'. Slowdown in services associated with trading activity reflects the sluggish domestic industrial scenario.

I.23 The telecom industry in India has witnessed significant moderation in growth in the recent period due to increased saturation and regulatory uncertainties. Heightened competition has led to aggressive pricing which has reduced the average revenue per user to one of the lowest in the world. Stagnating revenues from voice services imply that business would now be largely driven by wireless data services. At the same time, for continued growth of the telecom sector it is critical to establish appropriate mechanisms to achieve a balance between competition and consolidation to benefit both the users and the providers of telecommunication services.

Table I.4: Indicators of Services Sector Activity

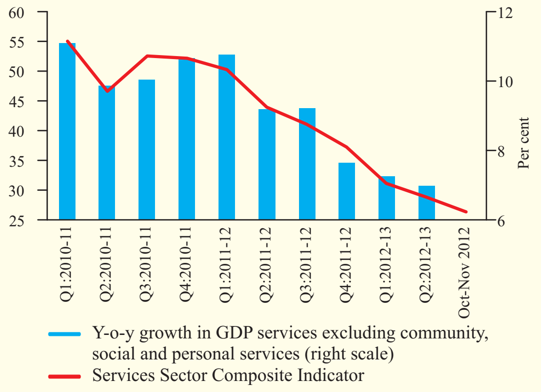
(Growth in per cent)

Services Sector Indicators	2011-12	Apr-Dec 2011-12	Apr-Dec 2012-13
1	2	3	4
Tourist arrivals	8.6	9.4	3.0
Cement	6.7	4.8#	6.7#
Steel	7.0	8.9#	3.4#
Automobile sales	11.2	11.0	4.6
Railway revenue earning freight traffic	5.2	4.5	4.5
Cargo handled at major ports	-1.7	0.4	-3.1
Civil aviation			
Domestic cargo traffic	-4.8	-6.0*	-1.1*
Domestic passenger traffic	15.1	19.0*	-5.3*
International cargo traffic	-1.9	0.1*	-4.5*
International passenger traffic	7.6	7.8*	1.9*
Financial Services Indicator			
Aggregate Deposit	13.5	12.0	9.6
Non-food Credit	16.8	10.4	8.6

*: Data refers to Apr-Oct. #: Data refers to Apr-Nov.

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

Chart I.9: Services Sector Composite Indicator



I.24 Going forward, various indicators of the services sector activity as also the Reserve Bank's services sector composite indicator point towards weakening of growth (Table I.4 and Chart I.9). There has been significant deceleration in automobile sales and railway freight earnings during November-December 2012. The pace of foreign tourist arrivals has been slack through 2012-13 and cargo handled at ports contracted significantly during November-December 2012. Services exports too are likely to remain low given the uncertain outlook for global growth.

Employment situation weakens in Q1 of 2012-13

I.25 As per the 15th quarterly Quick Employment Survey conducted by the Labour Bureau in select sectors of the economy, employment growth moderated during Q1 of 2012-13 compared with the previous quarter. However, there were gains in employment in recent years. As per the latest Annual Survey of Industries, organised industrial sector employment increased by 7.8 per cent in 2010-11 while wage per worker rose by 14.8 per cent. There was a significant increase in both employment and wages in the second half of the decade 2001-10 (Table I.5).

Table I.5: Employment and Wage Statistics

	Rural	Urban	Total
1	2	3	4
Growth in employment (Per cent)			
2000s	6.3	4.1	4.9
First half	4.8	1.1	2.5
Second half	7.8	7.2	7.2
Growth in wage per worker (Per cent)			
2000s	7.1	5.9	6.2
First half	2.6	2.0	2.0
Second half	11.5	9.8	10.4

Source: Annual Survey of Industries, MOSPI, GoI

Below-trend growth likely to persist through the second half of 2012-13

I.26 In spite of the shortfall in *kharif*, overall growth in agricultural and allied activities during 2012-13 may remain positive. Foodgrain and non-foodgrain crops account for about a third of this output, with horticulture and livestock accounting for about half and forestry and fishing the rest.

I.27 With industrial performance still remaining sluggish, growth is likely to remain below trend during H2 of 2012-13. Weak industrial growth and unfavourable global economic conditions pull down the momentum in the services sector, which accounts for about two-third of GDP. However, the construction sub-sector has generally been robust thus far, and is likely to improve further with the ending of the monsoon season.

I.28 A slow recovery is likely to shape up in 2013-14 with progressive implementation of some of the reforms announced since mid-September 2012. These include, *inter alia*, liberalisation of FDI in multi-brand retail, amendment of the Banking Regulation Act and the setting up of the Cabinet Committee on Investments chaired by the Prime Minister to expedite decisions on approvals/clearances for implementation of mega projects. The setting up of debt funds to provide long-term resources for infrastructure projects would help in reducing financing constraints currently facing the sector. Financing is also expected to improve with the government accepting the major recommendations of the Expert Committee on General Anti-Avoidance Rules (GAAR) that will bring about greater clarity on taxation aspects.

I.29 Global risks may have temporarily reduced in terms of part resolution of the US 'fiscal cliff' issues and financial fragility issues in the euro area. However, going forward the euro area risks remain significant, as key economies in the region are contracting. In this milieu, it is imperative that reform measures continue to be executed efficiently and domestic inflation recedes further, to support sustainable recovery in India.

II. AGGREGATE DEMAND*

Demand conditions in the economy remained tepid during Q2 of 2012-13. Private consumption, the mainstay of aggregate demand, continued to decelerate, reflecting the impact of high inflation. However, government consumption accelerated during the first half of the year. The envisaged fiscal correction now underway is expected to improve demand management. Steps to contain subsidies need to be persisted with and expedited so that fiscal imbalance is reduced and resources are freed to step up capital expenditure next year. There was a marginal sequential rise in investment in Q2 of 2012-13, as reflected in a modest increase in gross fixed capital formation as also the sanctioned project assistance during the quarter. A turnaround in the investment cycle, which has been in downturn for two years, crucially hinges on increased public investment to crowd in private investment and resolution of power and road sector bottlenecks.

Expenditure side of GDP continued to show weak demand

II.1 Growth in GDP at market prices decelerated sharply to 2.8 per cent in Q2 of 2012-13 from 6.9 per cent in the corresponding period of 2011-12, the lowest in the previous 13 quarters (Table II.1). Though private final consumption expenditure (PFCE) continues to be the major driver of growth, its contribution to growth has declined since Q4 of 2011-12 (Table II.2).

II.2 During H1 of 2012-13, growth in GDP at market prices was significantly lower than that at factor cost due to lower growth in net indirect taxes. The deceleration was reflected in all components except government final consumption expenditure (GFCE). Growth in private consumption moderated due to high inflation coupled with lower income growth during 2012-13 so far. Net exports growth continued to be negative partly due to weak external demand. This is in line with the record current account deficit observed during Q2 of 2012-13.

II.3 Going forward, possible moderation in inflation would support private final consumption. The announced efforts towards fiscal consolidation could also restrain government final consumption somewhat. More definitive indication of a pick-up in gross fixed capital formation is yet to be seen. On the whole, the growth process during 2012-13 would be largely driven by private consumption.

Problems facing infrastructure sector still constraining investment

II.4 As on November 1, 2012, out of 563 central sector projects (of ₹1.5 billion and above), largely concentrated in five sectors, *viz.*, road transport and highways, power, petroleum, railways and coal, nearly half were reported to be delayed. As a result, there were significant cost overruns in many of these projects. The major factors reported for the time overruns were delays in land acquisitions/ environmental clearances/tie-up of project financing/finalising of engineering designs, lack of infrastructure support and linkages, change in scope and other contractual issues. The maximum number of delays was reported for two key infrastructure sectors – power, and road transport and highways.

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* Despite their well-known limitations, expenditure-side GDP data are being used as proxies for components of aggregate demand.

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

(Per cent)

Item	2010-11*	2011-12#	2011-12				2012-13		2011-12	2012-13
			Q1	Q2	Q3	Q4	Q1	Q2	HI	HI
1	2	3	4	5	6	7	8	9	10	11
Growth Rates										
Real GDP at market prices	**9.6**	**6.9**	**9.0**	**6.9**	**6.2**	**5.6**	**3.9**	**2.8**	**7.9**	**3.4**
Total Consumption Expenditure	8.1	5.4	4.9	4.9	6.1	5.8	4.7	4.4	4.9	4.6
(i) Private	8.1	5.5	4.9	4.6	6.4	6.1	4.0	3.7	4.7	3.8
(ii) Government	7.8	5.1	4.9	7.2	4.7	4.1	9.0	8.7	6.0	8.8
Gross Fixed Capital Formation	7.5	5.5	14.7	5.0	-0.3	3.6	0.7	4.1	9.7	2.3
Change in Stocks	37.4	2.4	7.1	2.8	0.4	-0.4	-1.2	-0.1	5.0	-0.7
Valuables	32.4	7.9	9.8	9.4	2.9	9.3	-55.4	-27.9	9.6	-41.5
Net Exports	5.5	-30.7	-23.2	-46.7	-117.9	117.8	-2.1	-11.6	-35.5	-7.5
Discrepancies	38.9	-112.7	-51.8	-119.6	-152.0	-124.0	-123.7	51.1	-88.0	-276.3
Relative Shares										
Total Consumption Expenditure	70.1	69.1	70.1	70.8	72.7	63.6	70.6	71.9	70.4	71.3
(i) Private	58.7	57.9	59.5	60.3	60.4	52.2	59.5	60.8	59.9	60.2
(ii) Government	11.4	11.2	10.6	10.5	12.3	11.4	11.1	11.1	10.5	11.1
Gross Fixed Capital Formation	32.5	32.0	33.9	33.4	30.3	30.9	32.8	33.8	33.6	33.3
Change in Stocks	3.7	3.5	3.7	3.6	3.4	3.4	3.5	3.5	3.7	3.5
Valuables	2.4	2.4	2.6	2.7	2.1	2.2	1.1	1.9	2.7	1.5
Net Exports	-6.0	-7.3	-8.6	-11.3	-11.1	0.6	-8.5	-12.3	-10.0	-10.4
Discrepancies	-2.5	0.3	-1.7	0.8	2.6	-0.6	0.4	1.2	-0.4	0.8
Memo:										
Real GDP at market prices (₹ billion)	52,368	55,959	13,174	13,111	14,377	15,296	13,693	13,480	26,285	27,173

*: Quick Estimates. #: Revised Estimates.

Source: Central Statistics Office.

II.5 The problems in the power sector are yet to be fully resolved despite concerted efforts by the government. On the coal linkage issue, while power producers have started signing new fuel supply agreement with Coal India Limited that commits supply of 65 per cent of the assured coal quantity through domestic sources and another 15 per cent in the form of imported coal, the key issue of price pooling remains unresolved. Given the large price differential between domestic and imported coal, the understanding on price pooling is

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

(Per cent)

	2011-12				2012-13	
	Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7
1. Private Final Consumption Expenditure (PFCE)	3.0	2.8	3.9	3.2	2.4	2.2
2. Government Final Consumption Expenditure (GFCE)	0.5	0.8	0.6	0.5	1.0	0.9
3. Gross Fixed Capital Formation (GFCF)	4.7	1.7	-0.1	1.1	0.2	1.4
4. Change in Stocks (CIS)	0.3	0.1	0.0	0.0	0.0	0.0
5. Valuables	0.3	0.2	0.1	0.2	-1.5	-0.8
6. Net Exports (i + ii)	-1.8	-3.8	-6.4	4.0	-0.2	-1.3
(i) Exports	3.9	4.4	1.5	4.6	2.4	1.1
(ii) Imports	5.7	8.2	7.9	0.6	2.6	2.4
7. Sum (1 to 6)	7.0	1.8	-2.0	9.0	1.9	2.4
8. Discrepancies	2.0	5.1	8.2	-3.4	2.1	0.4
9. GDP at Market Prices (7+8)	9.0	6.9	6.2	5.6	3.9	2.8

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

Source: Central Statistics Office.

essential to bridge the demand-supply gap through imports. Also, adequate response from state governments on the discom restructuring package is not forthcoming. The state governments and their state electricity boards need to quickly commit themselves to the restructuring of their debt with all attendant requirements.

II.6 In the road sector, the record tendering by the National Highways Authority of India awarding 6,491 kilometres of road projects in 2011-12 has not helped in reversing the declining investment in this sector as a very large number of these projects have not achieved environmental clearances. Some projects are also stuck due to land acquisition issues. In addition, firms engaged in these projects are finding it difficult to achieve financial closure. Investment in road sector has collapsed in 2012-13, with scant interest in new projects, large delays and poor execution in existing projects. Even the projects being awarded on engineering, procurement and construction (EPC) basis, where the state bears the cost, are making little headway. This is because the new legal framework necessitates upfront environmental clearances for even small stretches of land, before private contractors execute the project.

Sales growth moderates further, indicating slack demand

II.7 Sales growth for listed non-government non-financial (NGNF) companies moderated and reached its lowest level in three years in Q2 of 2012-13 (Table II.3). The deceleration in sales was spread across manufacturing, IT and non-IT services sectors, all size groups and all use-based groups, except intermediate groups, with sharper deceleration in motor vehicles, iron and steel, and textiles. However, net profits recorded a growth of more than 25 per cent in Q2 of 2012-13 reversing the declining trend of the previous four quarters. The growth in profits was on a low base and reflected support from other income and lower rate of growth in interest payments. Resultantly, profit margins also improved during the quarter (Table II.4). Inventory accumulation, reflected in the

Table II.3: Corporate Sector- Financial Performance

Indicator	Q2:2011-12	Q3:2011-12	Q4:2011-12	Q1:2012-13	Q2:2012-13
1	2	3	4	5	6
No. of Companies			**2,241**		
			Growth Rates (Y-o-y growth in per cent)		
Sales	18.8	19.7	15.5	13.2	11.1
Expenditure, *of which*	21.9	25.3	16.7	15.5	11.9
Raw Material	23.0	25.4	16.6	13.2	14.1
Staff Cost	16.5	18.7	14.4	17.6	14.8
Power and fuel	31.4	30.5	25.4	17.7	13.9
Operating Profits (EBITDA)	0.2	-5.1	-1.0	-4.0	10.9
Other Income*	41.9	67.1	51.4	29.0	50.9
Depreciation	11.7	10.5	11.0	9.9	9.4
Gross Profits (EBIT)	2.8	-2.0	3.7	-3.0	19.0
Interest	58.5	44.4	36.9	37.0	11.4
Tax Provision	5.1	-1.6	2.5	-4.5	10.4
Net Profit	-14.2	-29.7	-5.8	-10.3	25.8
			Select Ratios (in per cent)		
Change in stock # to Sales	0.6	2.2	0.9	1.0	1.5
Interest Burden	29.1	28.1	26.3	32.3	27.2
EBITDA to Sales	13.1	12.6	13.1	12.8	13.1
EBIT to Sales	11.9	11.2	12.5	11.5	12.7
Net Profit to Sales	6.3	5.0	7.0	6.1	7.1

#: For companies reporting this item explicitly.

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

Table II.4: Corporate Sector Financial Performance (Q-o-q growth in per cent)

Indicator	2011-12			2012-13	
	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6
No. of Companies			**2,241**		
Sales	2.8	6.4	8.6	-4.7	0.9
Expenditure, *of which*	4.1	8.5	6.7	-4.1	0.9
Raw Material	0.9	8.3	9.5	-5.4	1.7
Staff Cost	5.6	4.3	1.2	5.6	3.1
Power and fuel	0.9	3.7	5.5	6.6	-2.3
Operating Profits (EBITDA)	-10.3	2.3	13.0	-7.4	3.7
Other Income	21.5	-7.8	50.0	-23.3	42.2
Depreciation	2.3	2.2	8.3	-3.0	1.8
Gross Profits (EBIT)	-9.1	0.4	20.8	-12.1	11.5
Interest*	15.5	-3.1	13.3	8.1	-6.0
Tax Provision	-10.8	-4.8	14.6	-1.9	3.2
Net Profit	-16.0	-15.4	52.7	-17.4	17.8

*: Some companies report interest on net basis.

change in stock-to-sales ratio, went up during the quarter but remained below the recent peak observed in Q3 of 2011-12 (Chart II.1).

II.8 Early results of 166 companies for Q3 of 2012-13 indicate continued moderation in sales. Expenditure growth also decelerated further and profit margins remained almost intact. However, the early results are from a small set of companies which are not representative of the overall corporate sector.

Marginal increase in envisaged project expenditure

II.9 Based on data received from 39 banks/ financial institutions as also on financing from external commercial borrowings (ECB) and foreign currency convertible bonds (FCCB), there was a small increase in the total cost of projects sanctioned in Q2 of 2012-13. However, the amount of sanctioned assistance was much lower than during the corresponding quarter of the previous year (Chart II.2).

Fresh policy measures helping fiscal consolidation

II.10 In October 2012, the government announced a revised fiscal roadmap following the recommendations of the Report of the Committee on Roadmap for Fiscal Consolidation (Chairman: Dr. Vijay L. Kelkar). As per the revised roadmap, the gross fiscal deficit (GFD) for 2012-13 is estimated at 5.3

Chart II.1: Movement in Change in Stock to Sales Growth

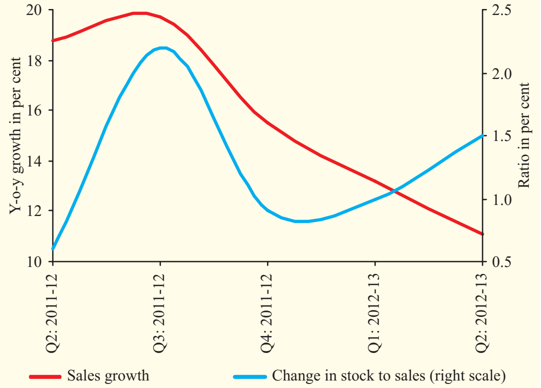
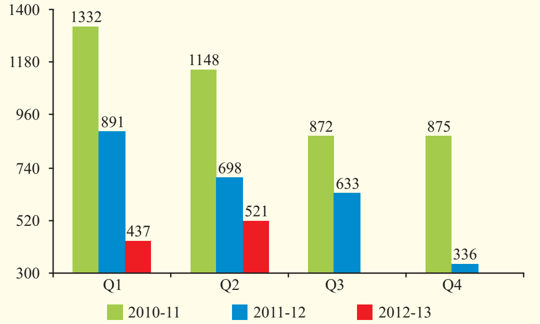


Chart II.2: Total Envisaged Cost of Sanctioned Projects (₹ billion)



Note: Capex figures include data reported by 39 banks and financial institutions. It also includes ECB/FCCB financing. Data for Q2 of 2012-13 is provisional and based on reported data from 33 banks and financial institutions.

per cent of GDP compared with the budget estimate of 5.1 per cent. The government's fiscal consolidation plan envisages fiscal deficit to decline to 4.8 per cent of GDP in 2013-14 and by 0.6 percentage points every year thereafter to reach 3.0 per cent of GDP in 2016-17.

II.11 The government has taken several steps to curtail deficit and put government finances on a more sustainable path. In a significant move, in January 2013, the government partially deregulated the prices of diesel, allowing full adjustment of prices for bulk consumers and a staggered increase for others. On the other hand, the annual supply of subsidised LPG cylinders per household has been increased to nine, from the cap of six announced in September 2012. These measures on the whole constitute an important signal to address fiscal imbalances, though its impact in the current fiscal year is expected to be negligible.

II.12 Renewed thrust to disinvestment of public sector undertakings so as to meet the budgetary target, cut-back in both plan and non-plan expenditure and increased reliance on direct cash transfers to cut leakages in subsidies also constitute important steps in reducing fiscal deficit. The government has, however, committed to retaining allocations to all flagship schemes to protect the poor. On tax reforms, it has committed to introducing the goods and services tax (GST) and reviewing the Direct Tax Code (DTC). More recently, the government has reiterated its stance of restricting expenditure in the last quarter of the financial year to 33 per cent of the budget estimates, and that during March to 15 per cent, to curb the bunching of expenditure towards the close of the financial year.

II.13 Further fiscal consolidation measures would be necessary in near term. The Kelkar committee has recommended several steps in this direction. For instance, over the next two to three years, resources could be raised by monetising government's unutilised and under-utilised land resources. These resources could be used to finance infrastructure needs particularly in urban areas. Such innovative measures would need to be examined though, as such asset sales do not support a structural correction in the fiscal position

Fiscal deficit remains high as slowdown impacts revenues

II.14 During the first eight months of the current year, the fiscal deficit amounted to 4.1 per cent of GDP or 80.4 per cent of the budget estimates (Table II.5). Revenue deficit, at 3.1 per cent of GDP, was marginally lower than in the corresponding period of the previous year. Given the current trends, significant shortfall in tax revenues and some shortfall in budgeted spectrum receipts is likely. Realisation of budgeted disinvestment proceeds crucially hinges on market conditions. However, the government is working to achieve the revised fiscal deficit target of 5.3 per cent with containment of both plan and non-plan expenditure during the last quarter of the year.

Growth slowdown remains a drag on revenue collections

II.15 Revenue collections remained sluggish at 47.6 per cent of budget estimates during April-November 2012 (49.7 per cent in the previous year). The growth in collection of corporation tax and excise duties remained modest due to continued growth moderation, while customs duty collections were adversely impacted, reflecting the deceleration in imports. Collections under personal income tax, however, remained buoyant partly due to lower refunds compared to previous year. Non-tax revenue receipts, at 46.3 per cent of budget estimates, were also significantly lower than the receipts of 57.7 per cent during the corresponding period of the previous year due to the poor response to spectrum

Table II.5: Central Government Finances during April-November 2012

(₹ billion)

Item	2012-13 Budget Estimates	April-November		Percentage to Budget Estimates		Growth Rate (Per cent)	
		2011-12	2012-13	2011-12	2012-13	2011-12	2012-13
1	2	3	4	5	6	7	8
1. Revenue Receipts (i+ii)	**9356.9**	**3928.1**	**4458.2**	**49.7**	**47.6**	**-17.6**	**13.5**
i) Tax Revenue (Net)	7710.7	3204.7	3696.0	48.2	47.9	8.0	15.3
ii) Non-Tax Revenue	1646.1	723.4	762.2	57.7	46.3	-59.8	5.4
2. Non-Debt Capital Receipts	416.5	145.1	89.0	26.4	21.4	-47.1	-38.7
3. Non-Plan Expenditure	9699.0	5394.2	6242.6	66.1	64.4	12.4	15.7
of which							
i) Interest Payments	3197.6	1659.1	1828.6	61.9	57.2	23.3	10.2
ii) Food Subsidies	750.0	440.7	620.0	72.8	82.7	-12.3	40.7
iii) Fertiliser Subsidies	609.7	450.4	552.9	90.1	90.7	17.7	22.8
iv) Petroleum Subsidies	435.8	233.0*	403.0	98.4	92.5	49.1	72.9
4. Plan Expenditure	5210.3	2212.8	2433.9	50.1	46.7	4.9	10.0
5. Revenue Expenditure	12861.1	6732.7	7653.2	61.4	59.5	9.1	13.7
6. Capital Expenditure	2048.2	874.2	1023.3	54.4	50.0	18.4	17.0
7. Total Expenditure	**14909.3**	**7606.9**	**8676.5**	**60.5**	**58.2**	**10.1**	**14.1**
8. Revenue Deficit	**3504.2**	**2804.6**	**3195.0**	**91.3**	**91.2**	**100.1**	**13.9**
9. Gross Fiscal Deficit	**5135.9**	**3533.7**	**4129.3**	**85.6**	**80.4**	**89.5**	**16.9**
10. Gross Primary Deficit	**1938.3**	**1874.6**	**2300.7**	**129.4**	**118.7**	**260.7**	**22.7**

*: Refers to non-plan expenditure in respect of Ministry of Petroleum and Natural Gas which primarily includes post-APM subsidies and compensation made to oil marketing companies for under-recoveries on account of sale of sensitive petroleum products, apart from marginal amount for other non-plan expenditure.

Source: Controller General of Accounts, Ministry of Finance.

auction and the reported staggering of auction receipts.

Non-plan expenditure continues to exert pressure despite a moderation in total expenditure

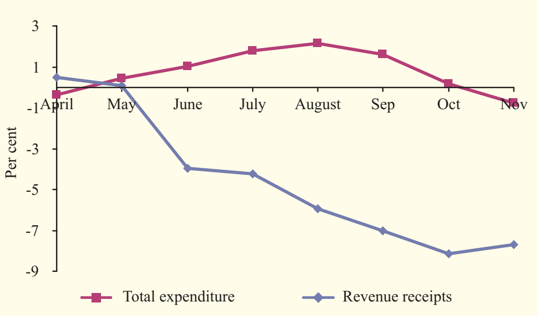
II.16 During April-November 2012, the total expenditure of the government was lower at 58.2 per cent of the budget estimates (60.5 per cent in the previous year). The deceleration in expenditure has been more pronounced since September 2012, with a narrowing down in the differential between the current year's expenditure (as per cent of budget estimate) and the respective three-year average (as per cent to actual), indicating the government's efforts to rein in expenditure (Chart II.3).

II.17 The total expenditure of the government during 2012-13, however, is likely to exceed budget estimates mainly on account of non-plan revenue expenditure. At 16.7 per cent, the growth in non-plan revenue expenditure during April-November 2012 was significantly higher than the budgeted growth of 6.1 per cent.

Quality of fiscal adjustment remains a concern

II.18 Significant cut-backs in plan and capital expenditure and reliance on non-durable receipts such as disinvestment proceeds could

Chart II.3: Central Government Revenue Receipts and Total Expenditure*



*: Difference between the current year's revenue receipts/total expendiure (as per cent of budget estimate) and the respective previous 3-year average (as per cent of actuals).

compromise the quality of fiscal adjustment. During April-November 2012, plan expenditure and capital expenditure as percentages to budget estimates were significantly lower than those in the preceding year. Plan expenditure as a percentage of budget estimate was lower for major departments/ministries such as power, road transport and highways, rural development and women and child development. Lower public investment in crucial infrastructure would have implications for growth. While the quality of expenditure remains an area of concern, fiscal augmentation through increased recourse to disinvestment proceeds and one-off receipts such as spectrum auctions may not be sustainable.

Additional market borrowing likely to be averted this year, but further steps needed

II.19 The government announced the first supplementary demand for grant, which entails a net cash outgo of ₹308 billion mainly to provide part compensation for estimated under-recoveries to oil marketing companies (₹285 billion) and infusion of equity in Air India (₹20 billion). This additional expenditure may not entail any additional market borrowings. However, the subsidy provision made so far appears inadequate.

Reviving investment demand is the key to economic turnaround

II.20 The government has made a commitment to bring down the level of the fiscal deficit. However, if the compression in government expenditure is mainly from plan/capital heads, it raises concerns relating to quality of the fiscal consolidation. As the reforms announced by the government take effect, the improvement in investment climate would help in reviving growth. Increased public investment to crowd-in private investment along with removal of structural impediments slowing private investment is needed to pull the economy out of the current slowdown.

III. THE EXTERNAL SECTOR

The CAD–GDP ratio reached a historic high of 5.4 per cent in Q2 of 2012-13, heightening concerns about the sustainability and financing of CAD. Worsening trade deficit and slower growth in services exports were the major factors behind the sharp rise in CAD. Weak external demand, which affected merchandise exports adversely, combined with continuing high imports of POL and gold, resulted in deterioration of the trade balance in Q3 of 2012-13. Despite the policy initiatives taken by the government, export revival is contingent on economic recovery in advanced economies as well as EMDEs. Even though capital flows have been sufficient to finance CAD for the time being, the volatility therein can put pressure on the external sector. Clearly, it is imperative to lower the CAD, while ensuring in the interim its prudent financing.

Weak external demand continues to affect merchandise exports adversely

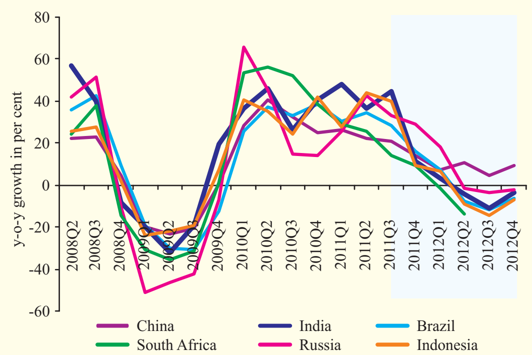
III.1 India's export performance continued to show the adverse impact of low growth and uncertainty in the advanced as well as major Emerging Market and Developing Economies (EMDEs). The downturn in the global manufacturing cycle in both advanced economies and EMDEs has impacted the overall world trade volume, which is also reflected in negative export growth of major EMDEs, including India, Brazil, Russia, South Africa and Indonesia (Chart III.1). Even though the export growth of China remains positive, it has also decelerated in the recent period.

Despite policy actions, revival of export growth remains uncertain

III.2 India's subdued exports performance, which began in H2 of 2011-12, showed further deterioration during 2012-13 so far. Since the outlook for global growth remains weak, it is unlikely that exports will reach even the previous year's level. Commodity-wise data show that growth in exports of engineering goods, petroleum products, textile products, gems & jewellery and chemicals & related products was severely affected because demand conditions in key markets such as the US and Europe continued to remain sluggish. Demand from new export destinations explored under diversification efforts also weakened. For instance, apart from export growth to developed countries, export growth to developing countries has also either decelerated or declined in recent quarters (Chart III.2). During April-November 2012, EU accounted for 27.4 per cent of total decline in merchandise exports, followed by Singapore (21.0 per cent), China (20.7 per cent), Hong Kong (4.8 per cent) and Indonesia (4.6 per cent). Lower growth in export-oriented Asian economies caused by setbacks to global recovery has clearly weighed on India's external demand from these economies.

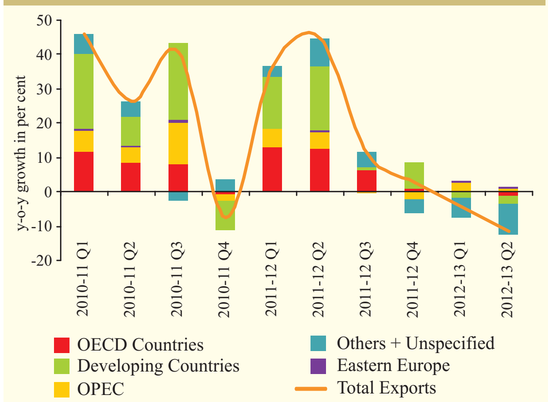
III.3 In view of the lacklustre performance of the exports sector, the government announced export promotion measures on December 26, 2012. These include (i) the extension of the interest subvention scheme for select

Chart III.1: Export Growth in Select EMDEs



Sources: DGCI&S, GoI and Direction of Trade Statistics, IMF and preliminary estimates from country sources.

Chart III.2: Region-wise Share in India's Export Growth



employment-oriented sectors up to end-March 2014, (ii) the introduction of a pilot scheme of 2 per cent interest subvention for project exports through EXIM Bank for countries of the SAARC region, Africa and Myanmar, (iii) broadening the scope of the Focus Market Scheme, Special Focus Market Scheme and Market-Linked Focus Product Scheme and (iv) incentives for incremental exports to the US, EU and countries of Asia during the period January–March 2013 over the base period. To enhance the flow of credit to the export sector, the Reserve Bank introduced a US dollar-rupee swap facility for scheduled banks to support incremental Pre-shipment Export Credit in Foreign Currency (PCFC) by banks on January 14, 2013. Despite these measures, quick recovery in exports to major trading partners may not take place unless economic activity in both advanced economies and EMDEs picks up significantly.

Continued high imports of POL and gold may widen India's trade deficit further

III.4 Import growth has surged since September 2012, mainly due to a pick-up in the quantum of POL (Chart III.3). With the uptrend in the international price of gold in recent months, gold imports stayed at an elevated level in recent months. On the other hand, non-oil non-gold imports registered a decline, reflecting a slowdown in domestic economic activity.

III.5 With imports growth turning positive from September 2012 and exports growth remaining subdued, concerns regarding a deteriorating trade deficit have been reinforced. During April–December 2012, the trade deficit was 7.2 per cent higher than that in April–December 2011 (Table III.1). Going forward, apart from global and domestic growth conditions, the trend in POL and gold imports will be critical determinants of India's overall trade deficit.

III.6 Policy attempt so far has been to deftly balance the genuine interests of the gold business, as also the need of the savers to hedge against inflation, against the overwhelming need to dampen gold imports with a view to preserving current account and macro-financial

Chart III.3: India's Merchandise Trade

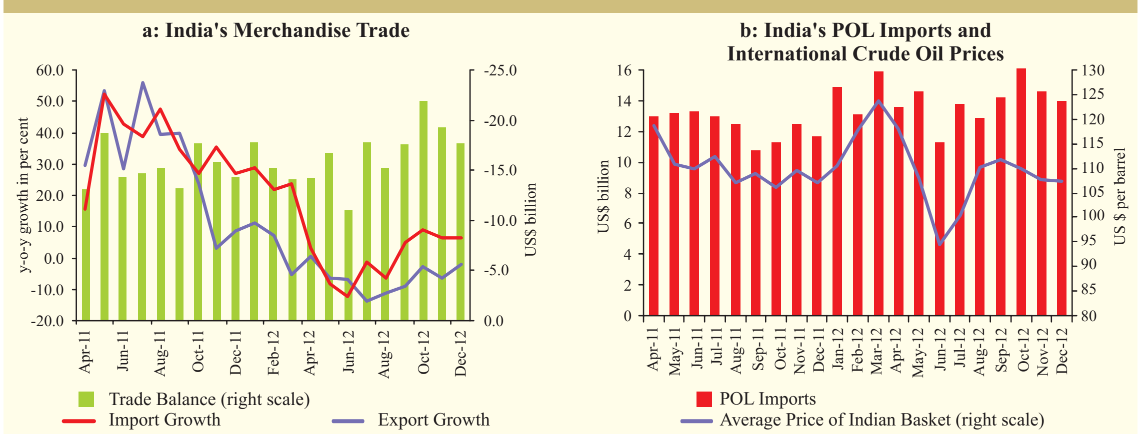


Table III.1: India's Merchandise Trade

(US$ billion)

Item	April–March				April–December			
	2010-11 (R)		2011-12 (R)		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	306.0	21.8	226.6	29.6	214.1	-5.5
of which: Oil	41.5	47.1	56.0	35.1	42.3	49.5	40.0	-5.4
Non-oil	209.7	39.3	249.9	19.2	184.3	25.8	174.1	-5.5
Gold	6.1	39.6	6.7	10.8	5.0	31.6	4.7	-6.0
Non-Oil Non-Gold	203.6	39.2	243.2	19.5	179.3	25.6	169.4	-5.5
Imports	369.8	28.2	489.3	32.3	363.9	35.2	361.3	-0.7
of which: Oil	106.0	21.6	155.0	46.2	111.0	47.6	125.4	13.0
Non-oil	263.8	31.1	334.4	26.7	252.9	30.4	235.9	-6.7
Gold	40.5	41.6	56.3	38.9	41.7	46.3	37.8	-9.4
Non-Oil Non-Gold	223.3	29.4	278.0	24.5	211.2	27.6	198.1	-6.2
Trade Deficit	-118.6		-183.4		-137.3		-147.2	
of which: Oil	-64.5		-98.9		-68.7		-85.4	
Non-oil	-54.1		-84.4		-68.6		-61.8	
Non-Oil Non-Gold	-19.7		-34.8		-31.9		-28.7	
Memo :								
Trade Deficit/GDP (in per cent)		*-7.0*		*-10.0*		*-10.1*		*-11.7*

R : Revised P : Provisional

stability. The gold demand in recent years has also picked up for speculative purposes. Against this backdrop, the Reserve Bank had constituted a Working Group to Study the Issues Related to Gold and Gold Loans by NBFCs in India (Chairman: Shri K.U.B. Rao). The Group, in its report, noted that high gold imports have implications for external sector vulnerability. The Group has recommended measures to contain gold demand like introduction of new gold-backed financial products, supply management measures such as channelising the existing supply of scrap gold, and the introduction of tax incentives on gold-related instruments as well as steps to increase the monetisation of gold. The Reserve Bank placed the report of the Group on its website on January 2, 2013 for comments from stakeholders and the public.

III.7 Besides enhancing the customs duty from 4 per cent to 6 per cent on gold imports, the government has proposed to unfreeze or release a part of the gold physically held by mutual funds under Gold ETFs and enable them to deposit the gold with banks under the Gold Deposit Scheme. The minimum quantity as well as minimum tenure of gold deposits (from 3 years to 6 months) have been reduced.

Concerns about sustainability of CAD heighten as the CAD–GDP ratio reaches a historic high in Q2 of 2012-13

III.8 India's current account deficit (CAD) increased further in Q2 of 2012-13 mainly due to the worsening trade deficit, decelerated growth in net export of services and higher outflows under primary income (Table III.2). The CAD–GDP ratio at 5.4 per cent is not only unsustainable, but is also the highest-ever peak level. Early indications are that in Q3 of 2012-13, CAD as a percentage of GDP may increase further from this peak. Subdued growth conditions in major advanced economies seem to have impacted growth in India's export of software services in recent quarters. However, results of major IT firms for Q3 of 2012-13 suggest some improvement in their dollar revenues. Even though global IT spending is projected to increase by 4.2 per cent in 2013,

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

(US $ billion)

		2011-12				2012-13	
	2011-12 (PR)	Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (PR)	Q1 (PR)	Q2 (P)
1	2	3	4	5	6	7	8
1. Goods Exports	309.8	78.8	79.6	71.5	80.0	76.7	69.8
2. Goods Imports	499.5	123.7	124.1	120.1	131.7	119.0	118.2
3. Trade Balance (1–2)	-189.7	-44.9	-44.5	-48.6	-51.7	-42.3	-48.3
4. Services Exports	140.9	33.7	32.3	37.3	37.7	34.8	34.8
5. Services Imports	76.9	17.4	18.3	21.1	20.0	20.8	19.2
6. Net Services (4–5)	64.0	16.3	14.0	16.1	17.7	14.0	15.7
7. Goods & Services Balance (3+6)	-125.7	-28.6	-30.5	-32.5	-34.0	-28.3	-32.8
8. Primary Income (Net)	-16.0	-3.6	-4.0	-3.8	-4.6	-4.9	-5.6
9. Secondary Income (Net)	63.5	14.8	15.6	16.2	16.9	16.8	16.1
10. Net Income (8+9)	47.5	11.2	11.6	12.4	12.3	11.9	10.5
11. Current Account Balance (7+10)	-78.2	-17.4	-18.9	-20.2	-21.7	-16.4	-22.3
12. Capital Account Balance	-0.1	-0.3	0.2	0.1	-0.2	-0.2	-0.3
13. Financial Account Balance	80.7	18.7	19.0	20.6	22.4	15.7	24.2
of which: Change in Reserves	12.8	-5.4	-0.3	12.8	5.7	-0.5	0.2
14. Errors & Omissions (11+12–13)	-2.4	-0.9	-0.4	-0.5	-0.6	1.0	-1.6
Memo: As a ratio to GDP (in per cent)							
15. Trade Balance	-10.3	-9.8	-9.9	-10.7	-10.6	-10.0	-11.7
16. Net Services	3.5	3.6	3.1	3.5	3.6	3.3	3.8
17. Net Income	2.6	2.4	2.6	2.7	2.5	2.8	2.5
18. Current Account Balance	-4.2	-3.8	-4.2	-4.4	-4.5	-3.9	-5.4
19. Capital and Financial Account, Net (Excl. changes in reserves)	3.7	5.2	4.4	1.7	3.4	3.8	5.7

Note: Total of sub-components may not tally with aggregate due to rounding off.
PR: PartiallyRevised. P: Preliminary.

uncertainty regarding global recovery continues to be one of the downward risks for India's software exports. Unless global economic and trade conditions improve significantly and boost India's export of goods and services, the high CAD may continue to be challenging.

Strong capital flows facilitate financing of CAD

III.9 BoP statistics shows that improved capital flows were about adequate to finance an expanding CAD during Q2 of 2012-13, as evident from only a marginal drawdown of foreign exchange reserves (Table III.3).

III.10 While net inflows under FDI moderated somewhat during April-November 2012, net inflows by foreign institutional investors (FII) have shown a significant uptrend. Net FII inflows during 2012-13 (up to January 18) at US$ 18.8 billion were significantly higher than during the corresponding period of the previous year (US$ 7.6 billion), thus providing temporary comfort for financing of CAD (Table III.4).

III.11 Besides improved global liquidity and sentiment, robust FII inflows were largely the outcome of improved perception about the domestic economy, driven by recent reforms announced by the government since September 2012. These reforms include, *inter alia*, liberalised FDI norms for the retail, insurance and pension sectors, a roadmap for fiscal consolidation and an increase in FII limits in the corporate and government debt markets. The FII investment limits in government securities and corporate bonds were raised by US$ 5 billion each, taking the total investment limit in domestic debt (including corporate debt for infrastructure) to US$ 75 billion. While the increased limit may enhance debt inflows, they do not provide a solution to CAD financing on a sustainable basis.

III.12 Much of the recent FII investment under the G-sec limits has flown into short term T-bills, enhancing the refinancing

Table III.3: Disaggregated Items of Financial Account

(US$ billion)

	2011-12	2011-12				2012-13	
	(PR)	Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (PR)	Q1 (PR)	Q2 (P)
1	2	3	4	5	6	7	8
1. Direct Investment (net)	**22.1**	**9.3**	**6.5**	**5.0**	**1.4**	**3.9**	**8.9**
1.a Direct Investment to India	33.0	12.4	9.5	6.9	4.2	5.9	10.3
1.b Direct Investment by India	-10.9	-3.1	-3.0	-1.9	-2.9	-2.0	-1.4
2. Portfolio Investment (net)	**16.6**	**2.3**	**-1.4**	**1.8**	**13.9**	**-2.0**	**7.6**
2.a Portfolio Investment in India	16.8	2.5	-1.6	1.9	14.1	-1.7	7.9
2.b Portfolio Investment by India	-0.2	-0.2	0.2	-0.05	-0.2	-0.3	-0.3
3. Financial Derivatives & Employee Stock Options	–	–	–	–	–	**-0.5**	**-0.3**
4. Other Investment (net)	**29.2**	**12.6**	**14.2**	**1.0**	**1.4**	**14.8**	**7.9**
4.a Other equity (ADRs/GDRs)	0.6	0.3	0.2	0.1	0.03	0.1	0.1
4.b Currency and deposits	12.1	1.2	3.1	3.2	4.6	6.4	3.5
Deposit-taking corporations, except the central bank: (NRI Deposits)	11.9	1.2	2.8	3.3	4.7	6.6	2.8
4.c Loans*	16.8	14.9	9.5	-7.7	-0.03	3.5	3.3
4.c.i Loans to India	15.7	14.9	8.9	-8.1	-0.02	3.4	3.6
Deposit-taking corporations, except the central bank	4.1	11.5	3.9	-8.7	-2.6	3.0	2.0
General government (External Assistance)	2.5	0.4	0.3	1.4	0.3	0.02	0.1
Other sectors (ECBs)	9.1	3.0	4.7	-0.8	2.3	0.4	1.4
4.c.ii Loans by India	1.0	-0.02	0.6	0.5	-0.01	0.1	-0.3
General government (External Assistance)	-0.2	-0.04	-0.04	-0.04	-0.04	-0.1	-0.1
Other sectors (ECBs)	1.2	0.02	0.6	0.5	0.03	0.1	-0.3
4.d Trade credit and advances	6.7	3.1	2.9	0.6	0.2	5.4	4.1
4.e Other accounts receivable/payable	-6.9	-6.8	-1.5	4.8	-3.3	-0.6	-3.0
5. Reserve Assets (increase –/ decrease+)	**12.8**	**-5.4**	**-0.3**	**12.8**	**5.7**	**-0.5**	**0.2**
Financial Account (1+2+3+4+5)	**80.7**	**18.7**	**19.0**	**20.6**	**22.4**	**15.7**	**24.2**

Note: Total of sub-components may not tally with aggregate due to rounding off.
P: Preliminary. PR: Partially Revised – : Not available
*: Includes External Assistance, ECBs, non-NRI Banking Capital and short-term trade credit.

risks to external debt. On the other hand, a range-bound currency after a bout of depreciation has made the Indian equity market attractive for FIIs. Going forward, the implementation and acceleration in domestic reforms would be critical for sustained equity flows to the economy. Though the risk aversion in global markets declined during the previous quarter, the flows could be volatile given the euro area risks.

Table III.4: Capital Flows

(US$ billion)

Component	2011-12				2012-13		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
	Average of monthly flows						
1	2	3	4	5	6	7	8
FDI in India	4.1	3.1	2.3	1.5	2.0	3.4	1.9*
FDI by India	1.0	1.0	0.6	1.0	0.7	0.5	0.9*
FIIs	0.8	-0.5	0.6	4.7	-0.6	2.6	3.3
ADRs/GDRs	0.1	0.1	0.03	0.01	0.03	0.03	0.0
ECB	1.0	1.6	-0.3	0.8	0.1	0.5	1.3
NRI	0.4	0.9	1.1	1.6	2.2	0.9	0.9*

*: October–November.

III.13 Benefitting from higher interest rates and a weakening rupee, non-resident Indians (NRIs) nearly doubled their deposits with banks in India during April–November 2012 compared with the corresponding period of 2011-12. Net flow through external commercial borrowings (ECBs) was higher during Q3 of 2012-13 compared to previous quarter, despite high principal repayments made by the Indian corporate sector. ECBs were mainly raised for the import of capital goods, new projects and the redemption of FCCBs.

After depreciating in October and November, the rupee exchange rate was range bound in December 2012

III.14 The rupee had recovered in September 2012 due to the announcement of various reform measures by the government and increasing global risk appetite. However, challenged by concerns relating to high CAD and uncertainty regarding domestic growth, the rupee again showed a downtrend during October and November 2012 and subsequently remained range bound (₹54.2–55.1 per US dollar) in December 2012. Reflecting the trend in the rupee in nominal terms, the REER based on 6-currency and 36-currency as on January 18, 2013 showed a depreciation of 3.5 per cent and 3.9 per cent, respectively, over end-March 2012 (Table III.5).

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

	Index Jan 18, 2013 (P)	y-o-y Variation (Average) 2011-12	FY Variation (Jan 18, 2013 over end-Mar 2012)
1	2	3	4
36- REER	91.7	-3.2	-3.9
36-NEER	78.9	-6.4	-4.9
6-REER	105.7	-6.8	-3.5
6-NEER	75.8	-7.9	-5.2
₹/US$ (end-March)	53.9*	-12.7	-5.0*

NEER: Nominal Effective Exchange Rate.
REER: Real Effective Exchange Rate.
P: Provisional. *: As on January 24, 2013.
Note: Rise in indices indicates appreciation of the rupee and *vice versa*.

External debt witnessed steep rise in Q2 of 2012-13

III.15 India's external debt as at end-September 2012 was significantly higher than in the preceding quarter, with a rise in both long-term as well as short-term components of debt (Table III.6). In particular, there was a surge in non-resident external rupee-denominated deposits (NRE), reflecting the continued interest shown by non-residents due to better returns and rupee depreciation.

Composition of external debt changes with greater share of short-term debt

III.16 The share of short-term debt in the composition of external debt has been rising in recent years, except for a dip in the immediate aftermath of the financial crisis (Chart III.4). The dip in share of short-term debt immediately after the financial crisis was mainly due to a deceleration in short-term trade credit. The reversal in this trend has been on account of rising short-term trade credit and FII investment in government T-bills and some other instruments.

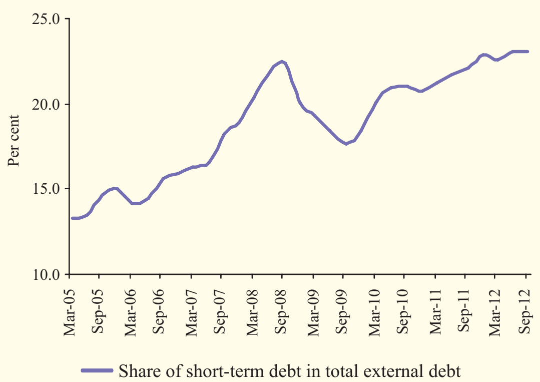
Table III.6: India's External Debt

(US$ billion)

Item	End-Mar 2011 (PR)	End-Mar 2012 (PR)	End-Jun 2012 (PR)	End-Sep 2012 (QE)	Variation (end-Sep 2012 over end-Jun 2012)
	Amount				Per cent
1	2	3	4	5	6
1. Multilateral	48.5	50.5	49.7	50.7	2.0
2. Bilateral	25.7	26.7	27.1	27.6	1.7
3. IMF	6.3	6.2	6.0	6.1	1.6
4. Trade Credit (above 1 year)	18.6	19.0	19.0	19.0	–0.3
5. ECBs	88.5	104.9	104.3	109.0	4.6
6. NRI Deposits	51.7	58.6	60.9	67.0	10.1
7. Rupee Debt	1.6	1.4	1.2	1.3	6.8
8. Long-term (1 to 7)	240.9	267.2	268.3	280.8	4.7
9. Short-tem (Original Maturity)	65.0	78.2	80.5	84.5	5.0
10. Short-term (Residual Maturity)#	129.1	147.4	150.0	159.6	6.4
Total (8+9)	**305.9**	**345.4**	**348.8**	**365.3**	**4.7**

PR: Partially Revised QE: Quick Estimates #: RBI estimates

Chart III.4: Changing Composition of External Debt



External vulnerability indicators showed mixed trend in Q2 of 2012-13

III.17 The trends in the external vulnerability indicators were mixed in Q2. While the ratio of external debt (measured in terms of the rupee) to GDP showed marginal improvement, the ratio of short-term debt (original maturity) to external debt stayed at the same level as in the preceding quarter. However, the ratio of foreign exchange reserves to external debt deteriorated (Table III.7).

III.18 India's net international investment position (NIIP), as represented by net international liabilities, increased to US$ 271.5 billion at end-September 2012 from US$ 223.8 billion at end-June 2012. The rise in net liabilities occurred mainly due to a significant increase in liabilities and the valuation changes emanating from exchange rate movements. Accordingly, the NIIP-GDP ratio at end-September 2012 deteriorated compared with that at end-June 2012 (Table III.8). India's NIIP has shown gradual deterioration during the post-crisis period, as net international liabilities as a per cent of GDP increased from 5.5 per cent as at end-March 2008 to 15.3 per cent as at end-September 2012 due to the widening current account deficit.

Table III.7: External Sector Vulnerability Indicators

(Per cent)

Indicator	End-Mar 2012	End-Jun 2012	End-Sep 2012
1	2	3	4
Ratio of Total Debt to GDP*	19.9	21.6	20.7
Ratio of Short-term to Total Debt (Original Maturity)	22.6	23.1	23.1
Ratio of Short-term to Total Debt (Residual Maturity)	42.6	42.9	43.7
Ratio of Concessional Debt to Total Debt	13.9	13.5	13.2
Ratio of Reserves to Total Debt	85.2	82.9	80.7
Ratio of Short-term Debt to Reserves	26.6	27.8	28.7
Ratio of Short-term debt (Residual Maturity) to Total Debt#	42.7	42.9	43.7
Ratio of Short-term Debt (Residual Maturity) to Reserves#	50.1	51.8	54.1
Reserves Cover of Imports (in months)	7.1	7.0	7.2
Reserves Cover of Imports and Debt Service Payments (in months)	6.8	6.6	6.8
Debt Service Ratio (Debt Service Payments to Current Receipts)	6.0	5.8	5.8
External Debt (US$ billion)	345.4	348.8	365.3

*: Annualised GDP at current market prices. #: RBI Estimates.

Table III.8: Overall International Investment Position of India

(US$ billion)

	Mar-11	Mar-12	Jun-12	Sep-12
1	2	3	4	5
NIIP	-203.6	-248.4	-223.8	-271.5
Assets	439.8	437.8	433.7	441.7
Liabilities	643.4	686.2	657.6	713.2
NIIP–GDP Ratio*	-12.1	-13.5	-12.3	-15.3

* Based on annualised GDP.
'-' implies net international liabilities.

III.19 In sum, concerns about the sustainability of India's external sector have increased. Despite the second round of export promotion measures announced by the government, uncertainty relating to recovery in global economic and trade conditions may continue to weigh on India's exports. In order to bring the CAD on a sustainable path, the trends in India's imports, particularly POL and gold imports, need close monitoring. Even though the recent policy announcements in advanced economies have eased the global financial stress, re-acceleration of economic activity which is critical for recovery in global trade prospects may take time. Growth prospects for EMDEs also needs to improve in order to strengthen external demand for India. Even though abundant global liquidity augurs well for capital flows to economies like India, lowering CAD is important even as a sound domestic economic and business environment would continue to be critical to facilitate sustained capital flows and financing of CAD without stress.

IV. MONETARY AND LIQUIDITY CONDITIONS

Monetary policy in this financial year so far has sought to balance the growth–inflation dynamics through a combination of measured steps for liquidity easing and policy rate cut. While reserve money growth adjusted for CRR has maintained reasonable pace during Q3, broad money growth remained below the indicative trajectory. Aggregate deposit growth lagged behind credit growth, even as credit expansion remains moderate due to slack in activity and deterioration in the asset quality of banks. Despite considerable primary liquidity infusion by the Reserve Bank through CRR cuts and open market purchases of government securities, liquidity conditions tightened in Q3 of 2012-13. This was mainly because of an increase in government cash balances with the Reserve Bank. Going forward, contingent on further moderation in inflation, monetary policy could increasingly shift focus and respond to growth, giving due cognizance to the evolving macro-financial factors.

Tightening cycle gradually impacted inflation

IV.1 During the current financial year, growth has slowed markedly, even as inflation remained above the Reserve Bank's comfort level. Monetary Policy has responded to this evolving growth-inflation dynamics through calibrated easing. After lowering the cash reserve ratio (CRR) by 125 basis points (bps) during Q4 of 2011-12, the Reserve Bank frontloaded a reduction in its repo rate by 50 bps in April 2012. Even as elevated inflation and the twin deficits have severely restricted the space for further easing of the policy rate since April 2012, subsequent measures were directed towards ensuring adequate liquidity to facilitate a turnaround in credit deployment to productive sectors for supporting growth. As part of liquidity management measures, the CRR was reduced in two stages by a further 50 bps in a pre-emptive manner to ease monetary and liquidity conditions. Also, the statutory liquidity ratio (SLR) of scheduled commercial banks (SCBs) was reduced to improve the credit conditions facing the private sector (Table IV.1).

Table IV.1:Movements in Key Policy Variables

(Per cent)

Effective since	Reverse Repo Rate		Repo Rate		Cash Reserve Ratio*		Statutory Liquidity Ratio*	
1	2		3		4		5	
May 3, 2011	6.25	(+0.50)	7.25	(+0.50)	6.00		24	
June 16, 2011	6.50	(+0.25)	7.50	(+0.25)	6.00		24	
July 26, 2011	7.00	(+0.50)	8.00	(+0.50)	6.00		24	
September 16, 2011	7.25	(+0.25)	8.25	(+0.25)	6.00		24	
October 25, 2011	7.50	(+0.25)	8.50	(+0.25)	6.00		24	
January 28, 2012	7.50		8.50		5.50	(-0.50)	24	
February 13, 2012	7.50		8.50		5.50		24	
March 10, 2012	7.50		8.50		4.75	(-0.75)	24	
April 17, 2012	7.00	(-0.50)	8.00	(-0.50)	4.75		24	
June 18, 2012	7.00		8.00		4.75		24	
August 11, 2012	7.00		8.00		4.75		23	(-1.00)
September 22, 2012	7.00		8.00		4.50	(-0.25)	23	
November 3, 2012	7.00		8.00		4.25	(-0.25)	23	

Figures in parentheses indicate changes in policy rates/ratios.

* : Per cent of Net Demand and Time Liabilities.

IV.2 Furthermore, apart from supplying liquidity through daily liquidity adjustment facility (LAF), the Reserve Bank made active use of the auctions under outright open market operations (OMOs) and injected primary liquidity of about ₹1.1 trillion coupled with liquidity injection of around ₹229 billion through anonymous trading platform (NDS-OM) in 2012-13 so far. The judicious use of the two sets of instruments, *i.e.*, keeping the policy rate unchanged since April and pro-active liquidity easing measures conferred dual benefits that were evident as inflation gradually declined from its peak and credit off-take showed signs of improvements during most of November and December 2012. Inflation, however, continues to remain above the Reserve Bank's comfort level (Chart IV.1).

Reserve Bank takes measures to combat tight liquidity conditions

IV.3 Liquidity conditions since April 2012 can be broadly classified into three phases. The financial year started with the spillover of the tight liquidity condition from the previous year, which was beyond the Reserve Bank's comfort zone. The deficit was managed through a combination of primary liquidity injection through OMOs and LAF as well as an enhancement of the export credit refinance limit. The second phase commenced in July 2012 when, consequent upon these policy measures, the liquidity deficit declined and returned to the Reserve Bank's comfort level and remained mostly there until the beginning of November 2012. To pre-empt any prospective tightening of liquidity conditions arising out of frictional factors such as advance tax outflows, festive season currency demand and increase in the wedge between the growth rates of credit and deposit, the Reserve Bank reduced the CRR by 25 bps in September 2012 in addition to the 100 bps SLR cut effective from August 2012 (Table IV.1). Since November 2012, the inter-bank market has witnessed a tightening of liquidity conditions mainly due to the build-up of government cash balances and rise in currency in circulation with the liquidity deficit crossing the Reserve Bank's comfort level of (-1) per cent of net demand and time liabilities (NDTL) (Chart IV.2).

IV.4 To address the tightness, the Reserve Bank, after considering the prevailing macroeconomic situation, again reduced the CRR of scheduled banks by 25 basis points to 4.25 per cent of their NDTL effective November 3, 2012. Consequently, about ₹175 billion of primary liquidity was injected into the banking system. Liquidity deficit worsened due to an unprecedented increase in currency demand during the first half of November 2012. The quarterly advance tax outflows in December 2012 further increased the liquidity deficit (Chart IV.3).

Chart IV.1: Repo Rate and Inflation

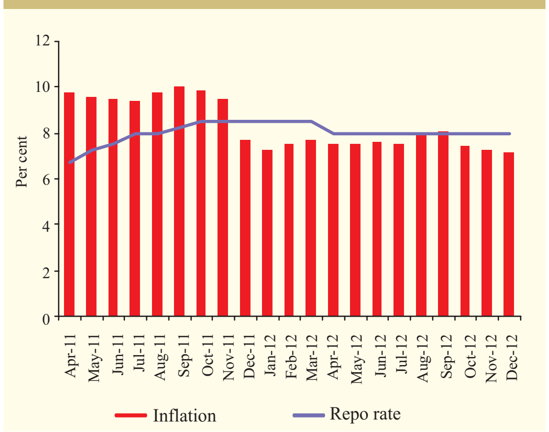


Chart IV.2: Liquidity Conditions

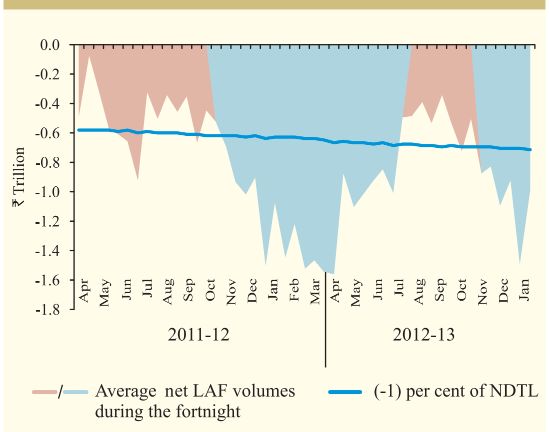
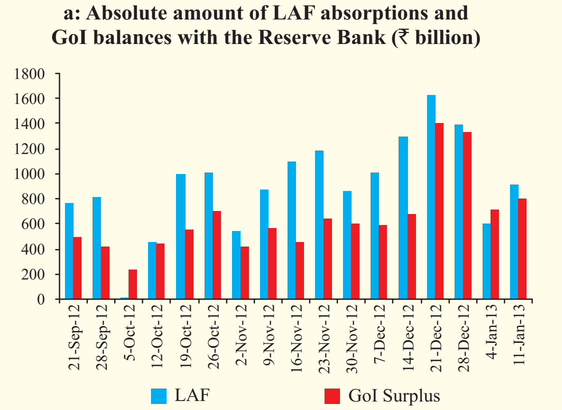
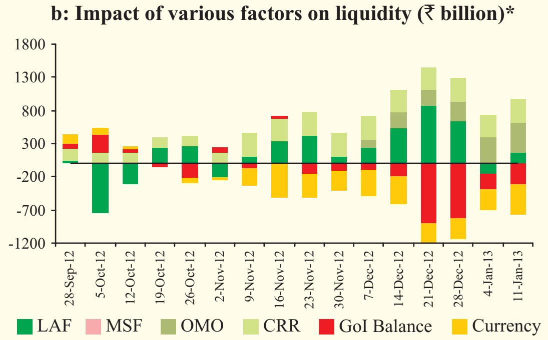


Chart IV.3: Determinants of Liquidity in Q3 of 2012-13





*: (+) indicate injection while (-) indicate absorption of liquidity from the banking system. Impacts are calculated relative to end-September fortnight. For instance, impact of GoI balance on a fortnight is computed as a difference in the GoI balance from that of fortnight ending September 21, 2012. Similarly for LAF, MSF, CRR, OMO *etc.*

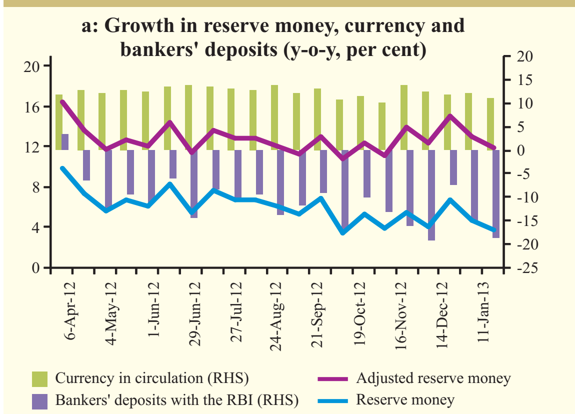
IV.5 Given the significant squeeze on liquidity creation and large build-up of government cash balances, the Reserve Bank resumed open market purchase auctions of government securities on December 4, 2012 after a gap of nearly five months. The Reserve Bank injected primary liquidity through open market purchases to the tune of ₹391 billion during the month in addition to the liquidity injection through its LAF operations averaging about ₹1.2 trillion during the month.

IV.6 In January 2013, with an increase in government spending, the recourse to LAF declined compared with the previous month. However, it continues to mostly remain higher than the Reserve Bank's comfort level. The Reserve Bank remains committed to actively manage the liquidity conditions. Despite the large liquidity shortage since November 2012, there has been only one instance of recourse to Marginal Standing Facility (MSF) during November-December 2012. The call rate generally hovered around the repo rate, without significant spike, indicating the depth and resilience of the inter-bank market. This reflects the favourable effect of the new monetary policy operating procedure.

Reserve money adjusted for CRR expanded at reasonable pace in Q3 of 2012-13

IV.7 Reserve money growth generally decelerated during Q3 of 2012-13, despite large injection of primary liquidity by the Reserve Bank through OMO and LAF (Chart IV.4). On the sources side, high government cash balances since end-September dampened the increase in the net Reserve Bank credit to

Chart IV.4: Movements in Reserve Money



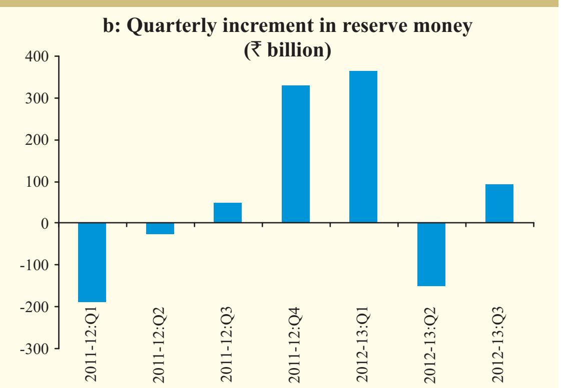


Table IV.2: Monetary Indicators

Item	Outstanding Amount (₹ billion)	FY variations (per cent)		Y-o-y variations (per cent)	
	January 11, 2013	2011-12	2012-13	Jan 13, 2012	Jan 11, 2013
1	2	3	4	5	6
Reserve Money (M_0)*	**14,795.4**	**5.4**	**3.7**	**12.7**	**2.0**
Reserve Money (Adjusted)*		**5.5**	**5.9**	**12.9**	**10.0**
Broad Money (M_3)	**81,115.7**	**10.5**	**10.2**	**15.7**	**12.9**
Main Components of M_3					
Currency with the Public	11,097.7	9.6	8.2	12.1	11.0
Aggregate Deposits	70,003.5	10.6	10.6	16.3	13.2
of which: Demand Deposits	6,886.1	–6.5	–2.3	4.9	1.9
Time Deposits	63,117.4	13.2	12.2	17.9	14.6
Main Sources of M_3					
Net Bank Credit to Govt.	26,529.4	14.6	11.9	24.5	16.7
Bank Credit to Commercial Sector	54,282.0	10.3	9.4	16.7	16.1
Net Foreign Assets of the Banking Sector	16,293.4	9.5	5.5	12.0	6.8

Note: Data are provisional.
* : Data pertain to January 18, 2013.

the centre (Chart IV.3). On the components side, the decline in bankers' deposits with the Reserve Bank due to CRR cuts eroded the effect of the increasing trend in the currency in circulation that was observed during the quarter. The quantum of reserve money, adjusted for the first-round impact of the CRR cuts, however, increased during the quarter compared to a decline in previous quarter. The release of impounded liquidity through CRR cuts was expected to stimulate credit creation and positively impact the broad money growth through the multiplier mechanism.

Broad money growth remains below indicative trajectory

IV.8 Broad money growth decelerated in Q3 and fell below the indicative trajectory of the Reserve Bank, mainly due to deceleration in the growth of aggregate deposits (Table IV.2). On the sources side, both the global and domestic macroeconomic situation had some dampening impact on credit growth, which also muted the multiplier expansion that was expected to boost broad money growth (Chart IV.5).

IV.9 Data on sectoral deployment of credit from select 47 banks accounting for about 95

Chart IV.5: Broad Money and Aggregate Deposit Growth

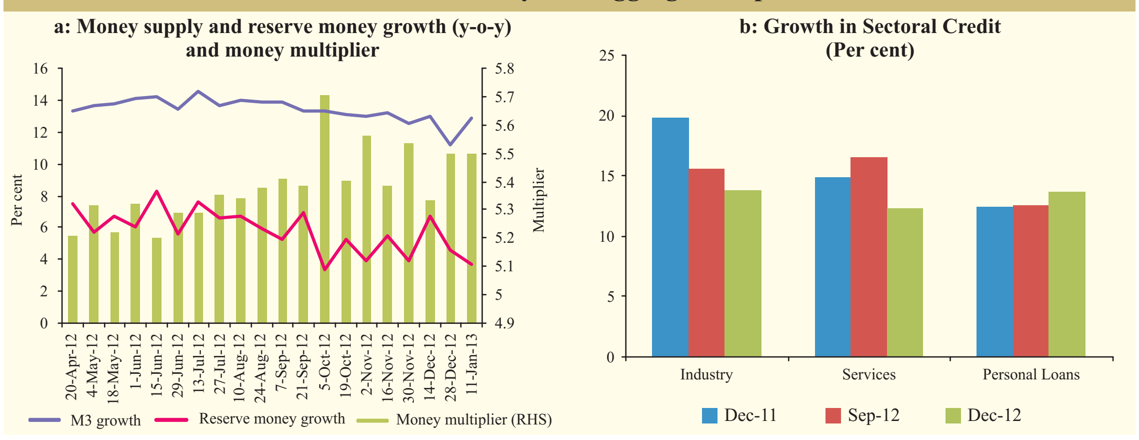
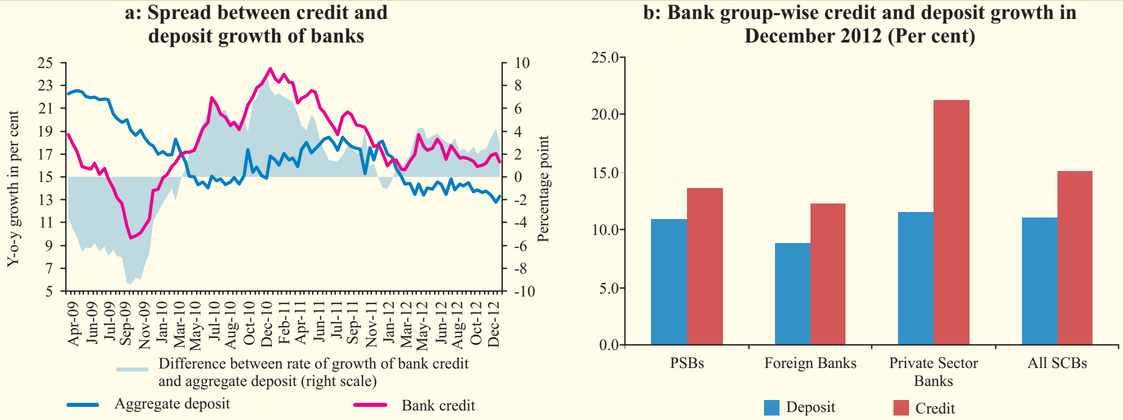


Chart IV.6: Spread between Credit and Deposit Growth of Bank



per cent of the total non-food credit deployed by all the SCBs generally indicated a decrease in y-o-y growth in industrial credit as well as credit to the services sector in December 2012 compared with corresponding period previous year, and also compared with September 2012 (Chart IV.5b).

Increased wedge between credit and deposit growth remains a concern

IV.10 In 2012-13, the lack of commensurate growth in aggregate deposit to fund the credit growth has given rise to an asset-liability gap, which is also indicated by the increase in the credit-deposit ratio (Chart IV.6). The deceleration in the term deposits, which constitutes the major component of aggregate deposit, could be largely attributed to the low and declining real interest rates on time deposits. Moreover, with an increase in the wedge between credit and deposit growth, banks are likely to tap the inter-bank market to fund this gap. With already tight liquidity conditions, the widening wedge poses a concern as it is likely to worsen the tight liquidity condition.

Risk aversion impacting credit as asset quality concerns accentuate

IV.11 Besides sluggish demand, a major factor that could have led to the low credit growth of the PSBs over the past quarters is the deterioration in their asset quality (Table IV.3). Asset quality indicators of the banking sector, which had deteriorated significantly during 2011-12, have further deteriorated in the financial year so far (Table IV.4). The worsening asset quality during Q2 of 2012-13 continued to be led by public sector banks, which account for the major portion of bank advances. Deterioration in asset quality and

Table IV.3: Credit Flow from Scheduled Commercial Banks

(₹ billion)

Bank Credit	As on Jan 11, 2013* Outstanding Amount	Variation (Y-o-y)			
		As on Jan 13, 2012		As on Jan 11, 2013*	
		Amount	Percent	Amount	Percent
1	2	3	4	5	6
1. Public Sector Banks*	36,624.8	4,462.6	16.2	4,630.8	14.5
2. Foreign Banks	2,536.0	364.2	19.1	260.4	11.4
3. Private Sector Banks	9,928.6	1,148.0	16.8	1,930.5	24.1
4. All Scheduled Commercial Banks@	50,427.9	6,139.2	16.5	7,081.1	16.3

*: Excluding RRBs in public sector banks.
@: Including RRBs.
Note: Data as on Jan 11, 2013 are provisional.

Table IV.4: Bank Group-wise NPA Ratios

Bank Group	Jun-12					Sep-12				
	Gross NPAs to Gross Advances (%)	Net NPAs to Net Advances (%)	Slippage Ratio #	Restructured Standard Asset to Gross Advances (%)	CRAR (%)	Gross NPAs to Gross Advances (%)	Net NPAs to Net Advances (%)	Slippage Ratio #	Restructured Standard Asset to Gross Advances (%)	CRAR (%)
1	2	3	4	5	6	7	8	9	10	11
Public Sector Banks	3.57	1.75	3.49	6.67	12.78	4.02	2.02	2.89	7.34	12.33
Foreign Banks	2.90	0.83	2.43	0.08	15.72	2.90	0.76	1.38	0.16	17.07
New Private Sector Banks	2.19	0.45	1.31	1.06	16.11	2.1	0.45	1.12	1.05	16.34
Old Private Sector Banks	1.92	0.61	0.02	3.83	13.82	2.16	0.81	1.61	3.85	13.78
All Banks *	3.25	1.45	3.04	5.37	13.74	3.59	1.66	2.50	5.86	13.60

Source: Latest updated OSMOS database. * Includes LABs.

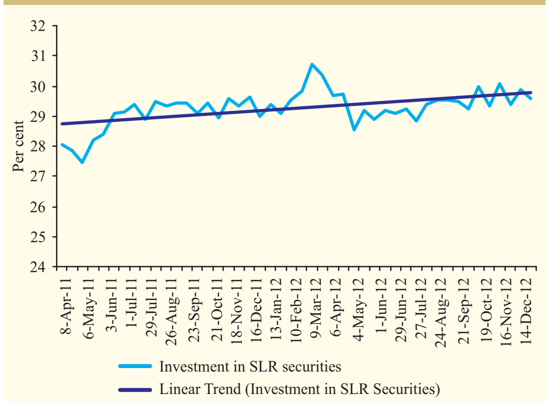
Based on the data collected from banks for special analysis. Sep-12 figures of slippage ratio are annualised.

in macroeconomic conditions resulted in increased risk aversion in the banking sector. This, in turn, led to a portfolio switch from credit creation to investment in SLR securities on the back of large government market borrowings (Chart IV.7).

Lagged monetary policy transmission to lending rate also indicates structural rigidities in the credit market

IV.12 Taking a cue from the reduction in the policy rate (repo rate) by 50 bps in April 2012 and the subsequent reduction in the SLR by 100 bps in August 2012 and the CRR by 175 bps during January-November 2012, several banks have reduced their deposit and base rates during 2012-13 (up to January 15, 2013). Accordingly, the modal deposit rate and modal base rate of banks declined during the financial year so far. Though the impact of these policy measures is still unfolding, available data suggest that the transmission of the policy rate to deposit and lending rates of banks is relatively less pronounced than money market rates, reflecting the presence of structural rigidities in the credit market.

Chart IV.7: SLR Investment by Scheduled Commercial Banks



Non-bank domestic sources augmented flow of resources to the commercial sector

IV.13 The total flow of financial resources to the commercial sector for the financial year so far (up to January 11, 2013) was higher compared with the corresponding period of the previous year (Table IV.5). The increase in flow has been accounted for by both bank and non-bank sources, though the latter played a dominant role. Among the domestic sources, non-food credit and non-SLR investment by SCBs, net issuance of commercial paper, net credit by housing finance companies, systemically important non-deposit taking NBFCs, witnessed large increase compared to corresponding period previous year. Foreign sources of funding (up to December 2012), also recorded marginal increase compared with the previous year, mainly on account of a higher external commercial borrowings/ foreign currency convertible bonds and short-term credit from abroad. However, FDI, which is considered to be the most stable source of

Table IV.5: Resource Flow to the Commercial Sector

(₹ billion)

	April-March			April 1 to Jan 11	
	2009-10	2010-11	2011-12	2011-12	2012-13
1	2	3	4	5	6
A. Adjusted Non-Food Bank Credit (NFC)	**4,786**	**7,110**	**6,764**	**3,953**	**4,397**
i) Non-Food Credit	4,670	6,815	6,525	3,705	4,058
of which: petroleum and fertiliser credit	*100*	*-243*	*171*	*7*	*0* ^
ii) Non-SLR Investment by SCBs	117	295	239	248	338
B. Flow from Non-banks (B1+B2)	**5,850**	**5,341**	**5,338**	**4,154**	**5,232**
B1. Domestic Sources	***3,652***	***3,011***	***3,034***	***1,913***	***2,951***
1. Public issues by non-financial entities	320	285	45	40	103 *
2. Gross private placements by non-financial entities	1,420	674	558	328	442 P+
3. Net issuance of CPs subscribed to by non-banks	261	68	100	393	778 *
4. Net Credit by housing finance companies	285	428	530	248	387 ^
5. Total gross accommodation by 4 RBI regulated AIFIs - NABARD, NHB, SIDBI & EXIM Bank	338	400	469	215	184 *
6. Systemically important non-deposit taking NBFCs (net of bank credit)	607	795	912	480	716 +
7. LIC's net investment in corporate debt, infrastructure and Social Sector	422	361	419	210	341 *
B2. Foreign Sources	***2,198***	***2,330***	***2,304***	***2,241***	***2,281***
1. External Commercial Borrowings / FCCB	120	555	421	309	406 *
2. ADR/GDR Issues excluding banks and financial institutions	151	92	27	26	10 ^
3. Short-term Credit from abroad	349	502	306	269	519 +
4. Foreign Direct Investment to India	1,578	1,181	1,550	1,637	1,346 ^
C. Total Flow of Resources (A+B)	**10,636**	**12,451**	**12,102**	**8,107**	**9,629**
Memo:					
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	966	-367	-185	-54	699 *

Note: ^: Up to November 30, 2012. + : Up to September 30, 2012. * : Up to December 2012. P: Provisional.

capital inflows, witnessed a decline during the period.

Monetary conditions may evolve with shifting growth-inflation dynamics

IV.14 Since January 2012, monetary policy has sought to balance the growth–inflation dynamics through a combination of liquidity easing measures and policy rate cut. It has reduced the CRR and the SLR and infused primary liquidity through open market purchases. After front-loading a 50 bps repo rate cut in April 2012, the Reserve Bank has maintained a pause on policy rate so far because of inflation remaining above its comfort level and the lack of requisite adjustments to fiscal and current account imbalances. Going forward, if inflation continues to trend down, monetary policy could increasingly shift focus and respond to growth moderation. However, the exact policy path would be contingent upon the evolving dynamics of inflation and growth, the trajectory of monetary and credit aggregates and other macroeconomic and financial parameters.

V. FINANCIAL MARKETS

Policy actions, both domestic and global, augured well for the Indian financial markets in Q3 of 2012-13. With aggressive monetary-easing measures by central banks of advanced economies and some policy initiatives in distressed euro area economies, capital flows surged into emerging economies. The Indian rupee and equity markets greatly benefitted from the improved investor optimism. Despite the domestic macroeconomic stress, expectations of a turnaround in the economy drove the rally in the Indian markets. Improved investor confidence was also visible from the pick-up in the IPO market after a subdued year.

Global financial markets improve on euro area policy action and fiscal cliff agreement

V.1 International financial market conditions improved in Q3 of 2012-13 despite a fragile global economic outlook. Recent financial market developments indicate a perceived reduction in some major downside risks to the world economy. The easing of stress can be seen in the positive streak shown by Bloomberg's Composite Financial Conditions Index (BFCIUS Index) that tracks the overall stress in money, bond, and equity markets, thereby enabling assessment of the availability and cost of credit (Chart V.1a).

V.2 The possibility of a near-term worsening of the euro area crisis also appears to have declined following new policy announcements and the extension of financial help to troubled periphery economies. In December 2012, the euro area finance ministers empowered the European Central Bank (ECB) as the common bank supervisor from 2014. They also approved €39.5 billion aid to Spanish banks. International leaders also agreed upon a deal to again restructure Greece's debt, with further large hair cuts that paved the way for the release of €34.4 billion in aid payment. Following these developments, credit default swap (CDS) spreads for European economies have reduced.

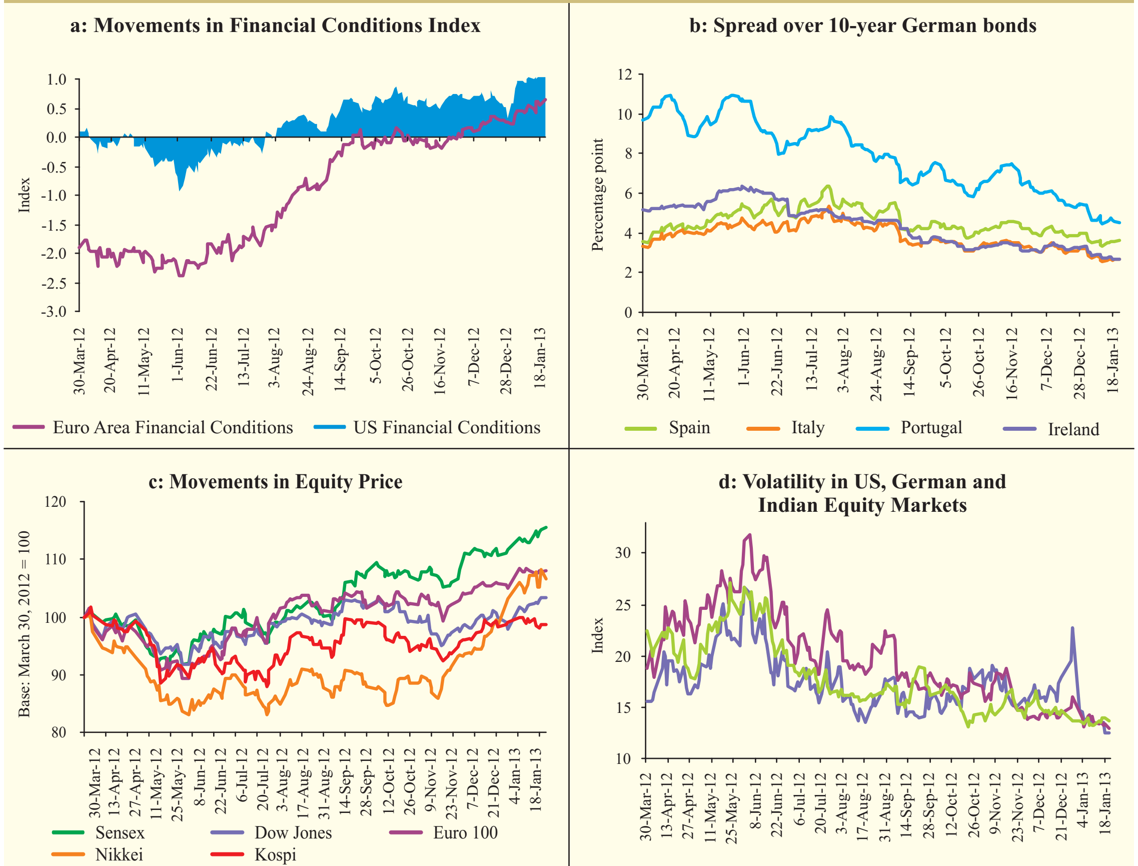
V.3 With the improvement in borrowing conditions in the financial markets, the 10-year G-sec interest rate spread between distressed euro area countries such as Spain, Italy, Ireland and Portugal, and Germany declined (Chart V.1b). The Italian and Spanish governments were also able to raise longer-maturity debt from the markets with improvements in funding conditions.

V.4 Global equity prices showed major gains in 2012, as investor preference to hold risky assets increased following quantitative stimuli announced by major central banks, despite weak corporate earnings. The mini-fiscal deal clinched by the US also aided the rally in global markets in 2013 so far (Chart V.1 c). Stock market uncertainty, as measured by implied volatility, also decreased during the period under review (Chart V.1d).

AE central banks' unconventional policy stimuli boost market sentiments

V.5 Unprecedented monetary stimuli by central banks of advanced economies (AEs), which include QE3 and recently announced additional purchase of long-term treasury securities to the tune of US$ 45 billion per month by the US Federal Reserve (Fed), the outright monetary transactions (OMT) programme by the ECB and the asset purchase programme by the Bank of Japan (BoJ), as well as measures taken by the European Union to contain the

Chart V.1: Movements in International Financial Markets

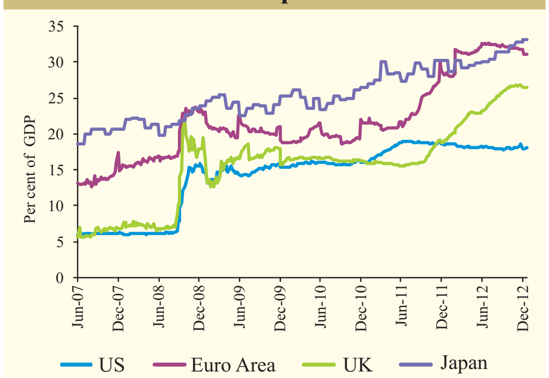


Source: Bloomberg, Datastream.

euro area debt crisis, have helped revive global financial market sentiments. Concomitantly, the balance sheets of these central banks have expanded significantly (Chart V.2).

V.6 Despite the positive impact of central banks' unconventional monetary policy actions, the future impact of such policy is of concern as latter rounds of QE had a subdued effect (Chart V.3a). Monetary policy stimuli in Q4 of 2012 did not necessarily have a dampening effect on the long-term treasury yield in the US (Chart V.3b). This could be because, in the absence of a credible long-term fiscal consolidation plan, yields may have become less responsive to central bank actions. On the whole, the evaluation of the success of QE would require further research.

Chart V.2: Central Bank Balance Sheet Expansion

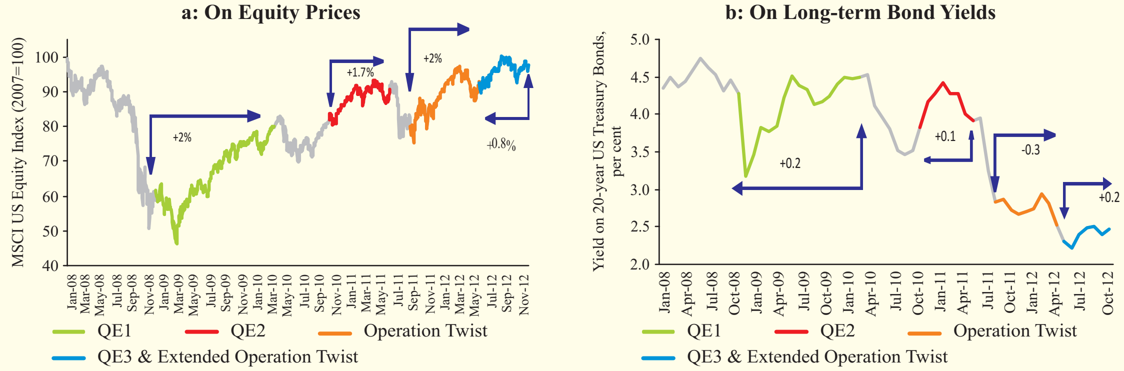


Source: Datastream.

Buoyant capital flows drive asset prices in EMDEs

V.7 Excessive global liquidity arising from the easy monetary policy pursued by central banks in AEs, along with the lack of investment opportunities, channelled funds into the emerging market and developing economies

Chart V.3: Impact of US Federal Reserve Actions



Note: Figures denote average monthly percentage change.
Source: Datastream.

Note: Figures denote yield change in percentage points.
Source: Datastream.

(EMDEs) in search of higher returns. India and other Asian countries, such as South Korea, Philippines and Thailand, received higher FII inflows in 2012 than in 2011 (Chart V.4).

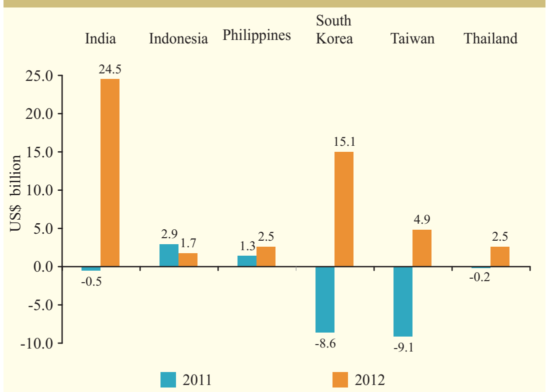
V.8 Apart from the push factors discussed above, various pull factors emanating from domestic factors, such as the continued dependence of the Indian economy on domestic consumption unlike other export-driven economies and the relatively stable earnings of listed companies, aided the surge in flows into India. The domestic reform measures announced by the government since mid-September 2012 also boosted investor sentiments. Indian equity markets showed significant turnaround, while the rupee remained range-bound.

Money markets remained stable despite liquidity deficit

V.9 Notwithstanding tight liquidity conditions due to advance tax payments, high government cash balances and rise in currency in circulation, the weighted average call money rate generally remained around the repo rate in Q3 of 2012-13. The rates in the collateralised segments *i.e.,* CBLO and market repo, which constitute the predominant share (around 80 per cent) of the overnight money market, moved in tandem with the call money rate (Chart V.5).

V.10 The amount of outstanding certificates of deposits (CDs) witnessed a fall during 2012-13. The weighted average effective interest rate

Chart V.4: FII flows into EMDEs



Source: Bloomberg.

Chart V.5: Movement in Money Market Rates

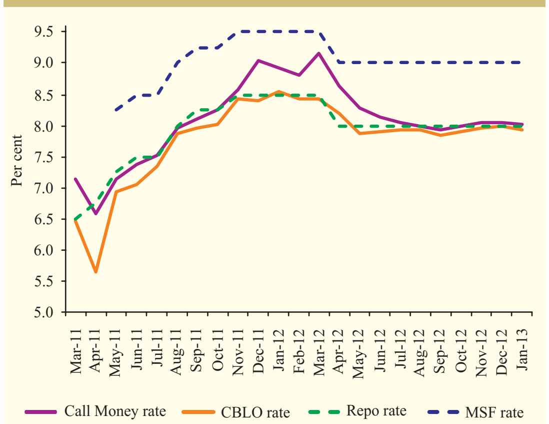


Table V.1: Average Daily Volume in Domestic Financial Markets

(in ₹ billion)

Month	Money Market: LAF	Money Market: Call Money	Money Market: Market Repo	Money Market: CBLO	Money Market: Commercial Paper*	Money Market: Certificates of Deposits*	Bond Market: G-Sec**	Bond Market: Corporate Bond#	Forex Market inter-bank (US$ bn)	Stock Market ##
1	2	3	4	5	6	7	8	9	10	11
Mar-12	–1574	175	112	380	912	4195	99	26	21	152
Jun-12	–913	152	180	376	1258	4252	258	30	19	117
Sep-12	–517	143	185	502	1706	3572	260	36	21	143
Oct-12	–671	150	218	436	1941	3531	230	39	20	139
Nov-12	–941	141	207	368	1994	3066	157	25	18	128
Dec-12	–1231	142	147	398	1818	3328	197	28	19	145

*: Outstanding position. ** : Average daily outright volume traded in central government dated securities.
: Average daily trading in corporate bonds. ## : Average daily turnover in BSE and NSE.
Note: (–) ve figure under LAF indicates injection of liquidity into the system.

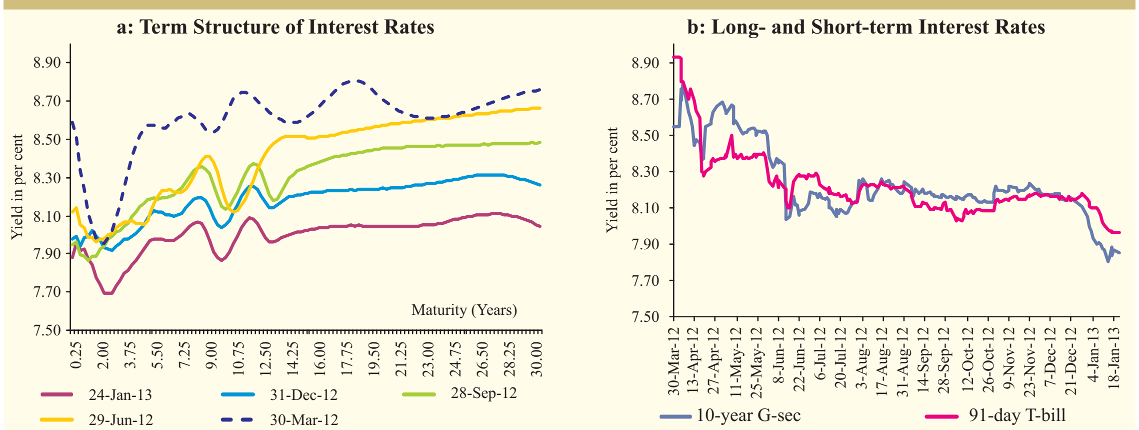
(WAEIR) of aggregate CD issuances decreased to 8.7 per cent at end-December 2012 from 11.1 per cent at end-March 2012 (Table V.1).

V.11 Increased risk aversion by banks to lend to the corporate sector, as evident from the moderation in credit off-take, also manifested in a significant uptick in the size of fortnightly issuance of commercial paper (CP). The weighted average discount rate (WADR) of aggregate CP issuances decreased to 9.0 per cent at end-December 2012 from 12.2 per cent at end-March 2012.

Yield curve gets inverted on economic slack and as borrowing programme stays on track

V.12 During Q3 of 2012-13, G-sec yields firmed up in October, but declined markedly since December, with bonds rallying in response to four major factors. First, the market assessed that the year may pass without additional market borrowing. Second, expectations of a rate cut were built on moderating inflation. Third, resumption of OMO purchases by the Reserve Bank also led to a rally in G-sec market. Fourth, on review of the government's cash position, the auction of dated securities scheduled for January 4, 2013 got postponed to late February 2013, which also caused the yields to soften. The 10-year generic yield declined from 8.63 per cent at end-March 2012 to 7.99 per cent on January 1, 2013 and further to 7.88 per cent as on January 24, 2013 (Chart V.6).

Chart V.6: Movements in G-sec Yield



V.13 However, during Q3, the fall in short term yields was not as significant, largely on account of persistent tightness in liquidity and the government's decision to increase the quantity of T-bill issuances during the last quarter of the fiscal. With the spread between the yield on the 10-year G-sec and 91-day T-bill turning negative, the G-sec market showed an inverted yield curve. During the financial year, up to January 21, 2013, the weighted average maturity of the dated securities issued has increased to 13.5 years from 12.5 years during the corresponding period last year. The bid-cover ratio stood in the range of 1.36-4.10 as against 1.39-5.12 in the previous year (Table V.2).

V.14 In the same period, 27 states have raised ₹1.3 trillion on a gross basis compared with around ₹1.1 trillion raised during the corresponding period of the previous year.

Rupee exchange rate remained range bound in Q3 of 2012-13

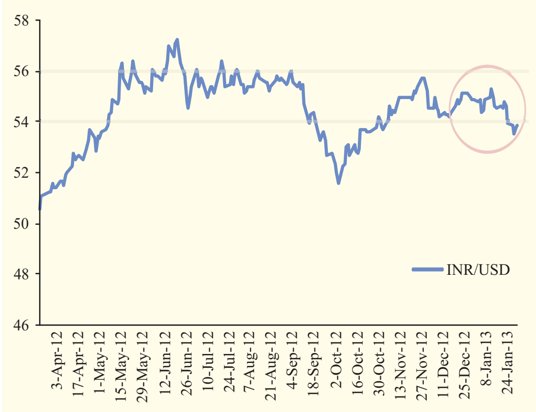
V.15 Various reform measures, including liberalised FDI limits for certain sectors and the announcement of a fiscal consolidation path, enhanced global investor confidence in the Indian economy. This, along with announcements of quantitative easing by the US Fed and the BOJ, boosted capital inflows to India and aided the recovery of the rupee.

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	5,220.0
Devolvement on primary dealer (₹ billion)	121.1	18.3
Bid-cover ratio (range)	1.39-5.12	1.36-4.10
Weighted average maturity (years)	12.66	13.48
Weighted average yield (per cent)	8.52	8.39
State government		
Gross amount raised (₹ billion)	1,586.3	1,312.3
Cut-off yield range (per cent)	8.36-9.49	8.58-9.31
Weighted average yield (per cent)	8.79	8.92

* Up to January 21, 2013.

Chart V.7: Nominal Exchange Rate of the Rupee



Following the significant appreciation in September 2012, the rupee movement turned range bound with a weakening bias, reflecting the wide trade deficit (Chart V.7).

V.16 As on January 23, 2013, the rupee showed lower depreciation over end-March 2012 compared to other major EMDEs like Brazil, South Africa and Argentina (Table V.3).

Table V.3: Movement in Exchange Rates of Select EMDEs against the US dollar

Appreciation (+)/Depreciation (-) in per cent

Currency	2010-11	2011-12	Jan 23, 2013 over end-March 2012
1	2	3	4
Current Account Deficit Countries			
1. Brazilian Real	9.7	-10.8	-10.4
2. Indian Rupee	1.1	-12.7	-4.9
3. Mexican Peso	4.3	-7.0	1.2
4. South African Rand	8.0	-11.5	-14.3
5. Turkish Lira	-4.8	-10.5	0.6
Current Account Surplus Countries			
1. Argentina	-4.3	-7.5	-11.7
2. Indonesian Rupiah*	4.7	-5.1	-4.7
3. Malaysian Ringgit	8.2	-1.4	1.0
4. South Korea Won	2.2	-2.7	6.9
5. Thai Baht	6.7	-1.8	3.6
6. Russian Rouble	3.4	-2.8	-3.0
7. Euro	5.4	-6.0	-0.2
8. China	4.1	4.2	0.3

*: Since Q4 of 2011 Indonesia has turned into a current account deficit country.

Domestic equity markets firmed up as market liquidity improved with FII flows

V.17 As on January 24, 2013, the domestic equity markets witnessed a y-o-y gain of 17.2 per cent with a 6.2 per cent gain over end-September 2012. Following the global equity market rally driven by a spate of generally better international economic data and policy actions, the Indian bourses also picked up. The BSE Sensex and S&P CNX Nifty crossed the 20,000 and 6,000 mark, respectively after two years. The BSE Sensex closed at 19,924 on January 24, 2013.

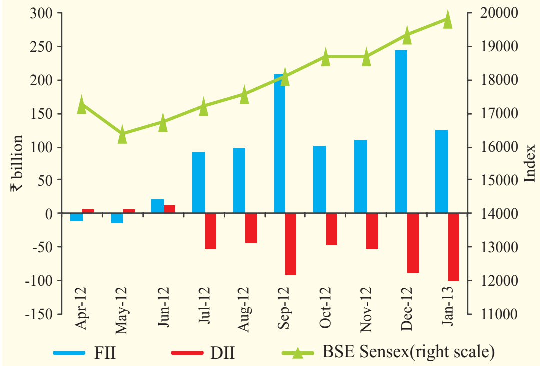
V.18 Various factors, including recent reform measures such as the diesel price hike, cap on subsidised LPG, permission for FDI in retail and aviation and the passing of the Banking Laws (Amendment) Bill, 2011 in Parliament, along with hopes of a cut in the policy rate by the Reserve Bank in January 2013, and sustained FII inflows helped revive the domestic equity market.

V.19 Market indicators, such as market capitalisation and daily turnover, have shown an increasing trend in 2012, reflecting the positive sentiment in the Indian stock market. Further, the PE ratio of the BSE Sensex increased in 2012, indicating a rise in the valuation of Indian stock over the year.

V.20 During 2012-13 (up to January 23, 2013), FIIs made net investments of ₹1,190 billion in the capital market (both equity and debt) compared with that of ₹520 billion during the corresponding period in the previous year. FIIs made net investments of ₹1,011 billion in the equity markets compared with ₹27 billion last year.

V.21 Domestic institutional investors (DIIs) (comprising banks, domestic financial institutions, insurance companies, new pension fund and mutual funds) made net sales during 2012-13 (up to January 23, 2013) (Chart V.8).

Chart V.8: FII and DII Investments in Equity Market

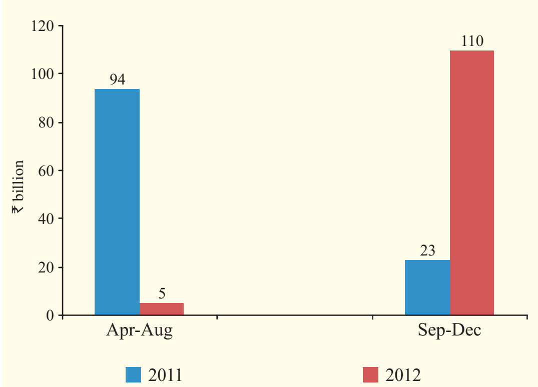


Source: SEBI and BSE.

Bankex outperformed Sensex

V.22 As at end-December 2012, the BSE Bankex, which represents major banks in India, recorded much higher y-o-y gains of 57 per cent than the BSE Sensex (26 per cent), despite concerns about modest loan growth, deterioration in asset quality and alleviated risks. The factors that influenced the BSE Bankex favourably are the strong balance sheet performance by some private sector banks, stable net interest margin owing to a reduction in the CRR by 175 basis points of NDTL and expectation of treasury profit as bonds rallied. The Bankex also benefitted from the positive sentiments in the overall Indian equity markets.

Chart V.9: Trends in Public Issues Mobilisation



Source: SEBI.

Table V.4: House Price and Transaction 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										
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
Q1:2012-13	231.8	217.3	140.2	176.6	179.4	204.2	133.9	171.9	144.9	188.6
Q2:2012-13	232.4	225.2	143.0	183.4	208.9	226.9	129.5	177.7	135.8	194.3
Growth in per cent										
y-o-y	12.8	47.2	23.2	12.7	31.3	42.7	13.7	7.6	–1.8	23.1
q-o-q	0.3	3.6	2.0	3.9	16.4	11.1	–3.3	3.4	–6.3	3.0
House Transactions Volume Index										
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
Q1:2012-13	153.2	133.6	81.6	140.1	151.9	98.2	80.9	296.7	154.9	134.6
Q2:2012-13	100.4	142.6	112.6	130.5	233.7	96.9	68.2	322.6	409.2	145.4
Growth in per cent										
y-o-y	27.1	–13.8	–8.8	–15.3	119.1	–30.4	–20.2	34.9	212.1	12.6
q-o-q	–34.5	6.7	38.0	–6.9	53.9	–1.3	–15.7	8.7	164.1	8.0

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.

Signs of IPO market revival in December 2012 after a subdued period

V.23 During September–December 2012, ₹110 billion was mobilised through 18 issues compared to ₹23 billion mobilised through 11 issues during the corresponding period last year (Chart V.9). Various measures taken by SEBI, such as allowing qualified foreign investors (QFIs) to invest in the primary as well as secondary markets, electronic initial public offers (e-IPOs), requiring companies to attain the minimum public shareholding of 25 per cent by June 2013, introduction of the Rajiv Gandhi Equity Savings Scheme, 2012 and the disinvestment programme by the government may also enhance primary market activity.

House prices show slight moderation, but with increasing volumes

V.24 The annual growth in the Reserve Bank's quarterly House Price Index at the all-India level remains strong at 23 per cent in Q2 of 2012-13. The q-o-q increase, however, moderated to 3 per cent, the lowest in the past seven quarters. Transaction volumes have picked up and showed an annual growth of over 12 per cent in Q2 (Table V.4).

Markets improve, but uncertainty still significant for 2013

V.25 Reduced fiscal space in several AEs and limited scope for monetary policy actions due to the enlarged balance sheets of central banks are expected to keep sentiments and markets range bound. The stress in the global financial markets has eased in view of reduced uncertainties in the euro area and the temporary resolution of the fiscal cliff in the U.S. However, a credible fiscal consolidation by the US can generate a more significant impact. Quantitative easing by the AEs has translated into higher capital flows to EMDEs, including India, which may witness some moderation going forward, but is nevertheless, likely to remain positive in the near term.

V.26 Looking at domestic factors, commitment to reforms and efforts for sustainable fiscal consolidation would provide a positive impetus to the markets. Stronger signs of global and domestic recovery are crucial to support investor optimism.

VI. PRICE SITUATION

Headline inflation moderated from over 8 per cent in September 2012 to 7.2 per cent in December 2012. The significant slowdown in growth below trend led to a decline in non-food manufactured products inflation. Food inflation, however, continued to persist at elevated levels as new drivers emerged, which was also reflected in double-digit consumer price inflation. Inflation is expected to moderate gradually, supported by softer global commodity prices and weak domestic demand even though some pressure could be felt from the staggered increases in diesel prices. Also, there are continued risks from persistent price pressures from food, high inflation expectations and wage-price spiral, leading to further pressure on generalised inflation.

Global inflation conditions remain benign, albeit with some pressure in EMDEs

VI.1 Subdued global inflation environment in AEs continued into Q3 of 2012-13, as weaker global growth dampened demand conditions and commodity prices remained range bound. The average inflation in OECD countries was 1.9 per cent in November 2012, with core inflation (excluding food and fuel) being lower at 1.6 per cent. Among the major EMDEs, China recorded inflation of 2.5 per cent in December 2012, while inflation in Russia, Brazil and South Africa ruled above 5 per cent.

Fresh round of quantitative easing (QE) enhances global liquidity

VI.2 Continued weakness in the global economy has forced the central banks in most AEs to continue with extremely easy monetary policy of near zero nominal interest rates and quantitative easing (Table VI.1).

VI.3 The US Federal Reserve (US Fed) expanded its QE from the start of 2013 with the expiry of Operation Twist. The Bank of Japan expanded the size of its QE further and in January 2013 adopted a revised inflation target of 2 per cent. The US Fed also tweaked its September 2012 forward guidance of keeping the target range for the federal funds rate at exceptionally low levels of 0 to 0.25 per cent until at least mid-2015 with an indication to do so till: (i) the unemployment rate remained above 6.5 percent, (ii) inflation between 1–2 years ahead was projected at no more than a 0.5 percentage point above its 2 per cent longer-run goal, and (iii) longer-term inflation expectations continued to be well-anchored. However, in January 2013 it indicated the possible end of QE before the end of the year on concerns over the sustainability of such large-scale asset purchases in view of risks associated with financial stability and the size of its balance sheet.

VI.4 As the recovery prospects for the global economy remain weak (see Chapter 1) amidst high unemployment, spare capacity and subdued wage pressures, the monetary policy stance of AEs is likely to continue to remain accommodative. Following significant slowdown in growth in the recent period, more and more central banks in EMDEs have reduced their policy rates to address growth concerns.

Muted global growth indicates range-bound global commodity prices in the near term

VI.5 International commodity prices gradually moderated during Q3 of 2012-13 after exhibiting some uptick in Q2 (Chart VI.1).

Table VI.1: Global Inflation Indicators

Country/ Region	Key Policy Rate	Policy Rate (as on January 24, 2013)	Changes in Policy Rates (basis points)		CPI Inflation (Y-o-y, per cent)	
			Sep 2009 to Dec 2011	Jan 2012 to Jan 2013 (as on 24th Jan)	Dec-11	Dec-12
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	3.00 (Dec 5, 2012)	125	(-) 125	3.0#	2.2#
Canada	Overnight Rate	1.00 (Sep 8, 2010)	75	0	2.9$	0.8$
Euro area	Interest Rate on Main Refinancing Operations	0.75 (Jul 11, 2012)	0	(-) 25	2.7	2.2
Israel	Key Rate	1.75 (Jan 1, 2013)	225	(-) 100	2.2	1.6
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10* (Oct. 5, 2010)	(-) 10	0	-0.5$	-0.2$
Korea	Base Rate	2.75 (Oct 11, 2012)	125	(-) 50	4.2	1.4
UK	Official Bank Rate	0.50 (Mar 5, 2009)	0	0	4.2	2.7
US	Federal Funds Rate	0.0 to 0.25* (Dec 16, 2008)	0	0	3.0	1.7
Emerging and Developing Economies						
Brazil	Selic Rate	7.25 (Oct 11, 2012)	225	(-) 375	6.5	5.8
China	Benchmark 1-year Deposit Rate	3.00 (Jul 6, 2012)	125	(-) 50	4.1$	2.5
	Benchmark 1-year Lending Rate	6.00 (Jul 6, 2012)	125	(-) 56		
			(600)	(-150)		
India	Repo Rate	8.00 (Apr 17, 2012)	375	(-) 50	9.3$	9.5$
			(100)	(-175)		
Indonesia	BI Rate	5.75 (Feb 9, 2012)	(-) 50	(-) 25	3.8	4.3
Philippines	Reverse Repurchase Rate	3.50 (Oct 25, 2012)	50	(-) 100	4.2	2.9
	Repurchase Rate	5.50 (Oct 25, 2012)	50	(-) 100		
Russia	Refinancing Rate	8.25 (Sep 14, 2012)	(-) 275	25	6.8$	6.5$
South Africa	Repo Rate	5.00 (Jul 20, 2012)	(-) 150	(-) 50	6.1	5.7
Thailand	1-day Repurchase Rate	2.75 (Oct 17, 2012)	200	(-) 50	3.5	3.6

*: Change is worked out from the minimum point of target range. #: Q4 (Oct–Dec). $: November.

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

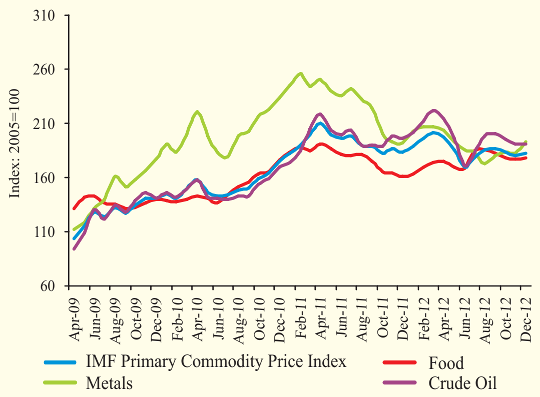
Source: Websites of respective central banks/statistical agencies.

Crude oil prices moderated as supply prospects improved and geo-political tensions eased in the Middle East. Moreover, the prospects of a weaker global economy also played a role in keeping oil prices range-bound. Metal prices continued to show signs of weakening as demand has slowed significantly, especially from China.

VI.6 The near-term outlook on global crude oil prices indicates a softening bias as many of the factors that led to lower crude prices in 2012 continue to play out. While continued slow growth of AEs and EMDEs is expected to keep demand subdued, the prospects of improved production from a number of oil-producing economies along with a possible step-up in shale oil and gas production could keep overall demand-supply conditions in favour of lower price levels. However, a major decline in oil prices seems unlikely given the tight demand-supply balance, offsetting pressure from QE and the risks of geo-political tensions further feeding into oil prices.

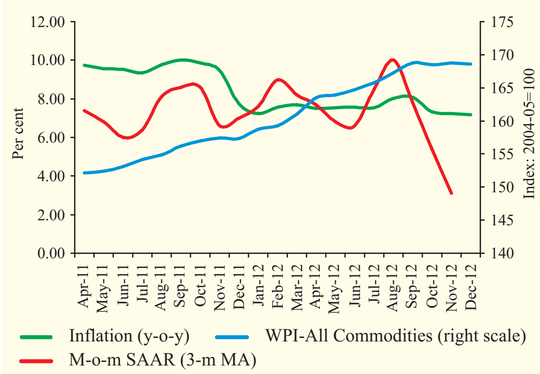
VI.7 International food prices moderated in recent months from the sudden spike witnessed in Q2 of 2012-13 following severe droughts this year in the US, a large part of Europe, central Asia and Australia. According to the Food and Agricultural Organization (FAO), the shortfall in global production of cereals, especially for wheat and coarse cereals could be met by drawdown of stocks. Despite some moderation, the current level of food prices remain significantly high compared to historical levels and food prices remain extremely vulnerable to shocks induced by weather-related disturbances, which have increased in the recent period.

Chart VI.1: Trends in Global Commodity Prices



Source: International Monetary Fund.

Chart VI.2: Wholesale Price Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes



Headline inflation moderated, but consumer price inflation remained high

VI.8 Headline Wholesale Price Index (WPI) inflation (y-o-y) in India moderated from 8.1 per cent in September 2012 to 7.2 per cent (provisional) in December 2012. The moderation in inflation during Q3 of 2012-13 was faster than expected during the second quarter review. Vegetable and fruit prices declined as the south-west monsoon revived in the latter half. The moderation was also driven by a decline in the prices of freely-priced fuel products and metals in line with some moderation in their global prices. A range-bound exchange rate further helped this course. Moreover, the indirect impact of the diesel price hike in September 2012 remained contained, indicating that firms did not pass on rising input costs to output prices on account of weak demand conditions.

VI.9 The build-up in price pressures seems to have tapered off in recent months, as the headline WPI remained almost flat (Chart VI.2). The momentum of price changes, as indicated by the 3-month moving average seasonally adjusted month-over-month changes, also indicate significant moderation. The financial year build-up of inflation during 2012-13 (up to December 2012) indicates that the price pressures that were building up in the initial months have eased significantly since September 2012, as prices remained range-bound in all the three major groups of the WPI (Chart VI.3).

VI.10 Though headline inflation moderated somewhat, price increases for items under administered prices have been much higher than those for freely-priced products in the recent period (Chart VI.4). Moderation in inflation, commensurate with slowdown in growth, is getting constrained by suppressed inflation coming into the open with administered price revisions, especially on fuel products such as diesel and electricity. Though such revisions add to near-term price pressures, they are desirable from a medium-term price stability objective, as suppressed inflation could lead to fiscal costs in terms of mounting subsidies that could turn inflationary.

Chart VI.3: Financial Year Build-up of Inflation

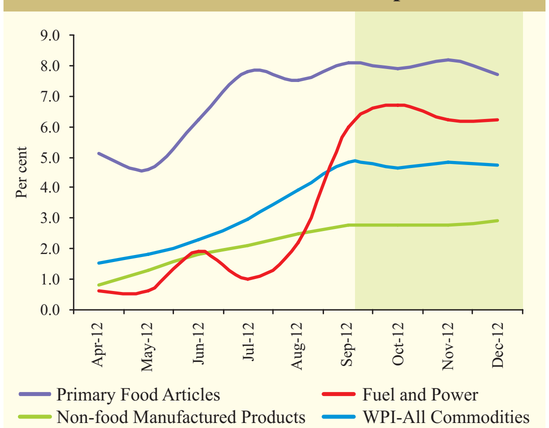
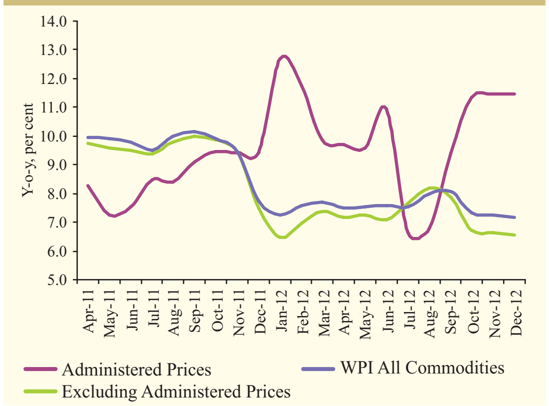


Chart VI.4: Administered and Non-Administered Price Inflation in India



Food inflation remains persistent as new drivers emerge

VI.11 Food inflation continued to remain high as new drivers of food inflation emerged (Chart VI.5). With the late revival of the monsoon, prices cooled off, especially for vegetables and fruits. Price pressures, however, continued to remain significant for cereals and pulses, with financial year build-up of cereals inflation at 16 per cent and pulses at 19 per cent (up to December 2012). It may be noted that the impact of the delayed and skewed south-west monsoon was significant on the production of cereals and pulses. Inflation in protein-rich food items remained elevated, notwithstanding some moderation in recent months.

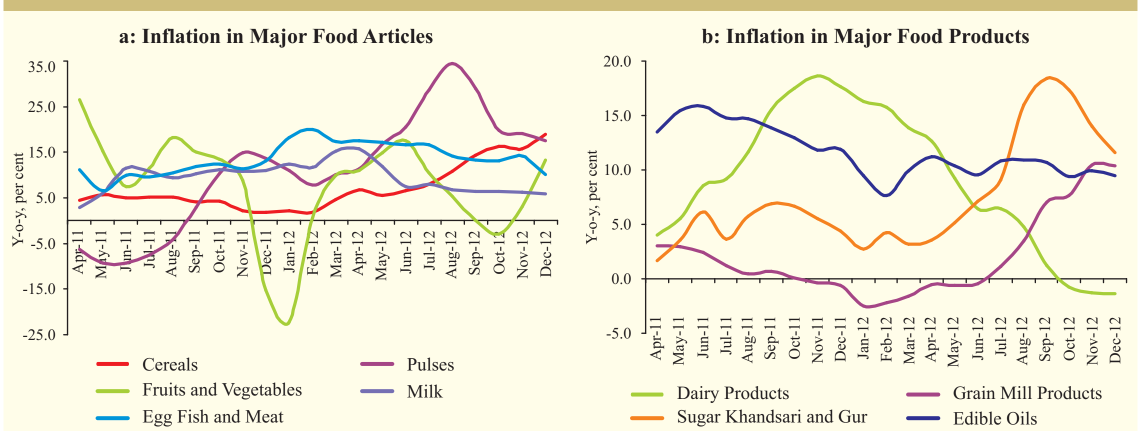
VI.12 Manufactured food products inflation also remained near double digits, as price increases were significant in sugar, grain mill products, edible oils and oil cakes. The increase in edible oil and oil cake prices could be attributed to significant increases in oilseeds prices in the recent period. Though there has been some moderation in December 2012, y-o-y price increases in oilseeds remain high at 29 per cent. The increase in the price of oil cake, used as a fodder, could spill over to milk prices.

VI.13 Persistent high food inflation has emerged as a major challenge for inflation management. There has been a significant increase in the cost of production in agriculture, driven largely by the increase in wage costs, which has also resulted in higher minimum support prices. Also, the changing pattern of consumption in favour of protein-rich items has not been matched by supply elasticities, which add to price pressures in these products. Augmenting supply capacities and integrating the supply chain by removing inefficiencies could be critical in achieving the goal of stable food prices.

Moderate decline in fuel inflation aided by rupee appreciation, but suppressed inflation persists

VI.14 The revision in diesel prices by ₹5 per litre in September 2012 led to fuel inflation reverting to double digits. However, in October and November 2012, prices of freely-priced fuel products declined aided by a stronger

Chart VI.5: Food Inflation Trends



rupee and some decline in international crude oil prices. In December 2012, there was a marginal increase owing to higher bitumen prices.

VI.15 The revision in administered fuel prices and some decline in freely-priced fuel product prices led to partial closing of the gap between the two price levels (Chart VI.6). Despite this, the magnitude continues to remain large, which has resulted in the build-up of under-recoveries of the oil marketing companies (OMCs) to the tune of ₹1.25 trillion during April-December 2012, of which 59 per cent was on account of diesel.

VI.16 Given this unsustainable level of under-recoveries, the government on January 17, 2013 allowed the OMCs to raise the retail price of diesel in a staggered manner and to charge bulk consumers of diesel taking supplies directly from the installations of the OMCs at non-subsidised prices. Accordingly, the retail price of diesel was increased by ₹0.45 per litre (excluding VAT) and the price of diesel for bulk consumers was increased by ₹9.25 per litre (excluding VAT) from January 18, 2013. The government also decided to raise the number of subsidised LPG cylinders per customer from 6 to 9 in a financial year. While the increase in diesel prices could lead to higher price levels in the near-term, the reduction in fiscal burden as prices get adjusted would help in medium-term inflation management.

VI.17 High domestic fuel inflation at a time when global fuel prices remained range-bound reflects the role that administered prices play in shaping the inflation trajectory. For most periods, inflation in administered fuel products remained well below the freely-priced products under the fuel group, contributing to suppressed inflation. Now, revisions of administered prices are driving up fuel inflation at a time when freely-priced products show a significant decline in inflation, thereby making fuel inflation more persistent (Chart VI.7).

VI.18 Though global crude price (Indian basket) declined by about 2 per cent in dollar terms during April-December 2012 compared to the corresponding period in the previous year, in rupee terms it increased by about 13 per cent, owing to the depreciation of the rupee. Administered price revisions were much lower than the increase in global prices, which further increased the subsidy burden. This had also limited the demand adjustments to price and exchange rate signals, thereby leading to a widening of the current account deficit (see Chapter III for details). The recent revision in diesel prices could be expected to correct some of these imbalances.

Core inflation pressure has eased and is likely to remain subdued amidst the slowdown

VI.19 Non-food manufactured products inflation, the indicator of generalised

Table VI.6: Global and Domestic Fuel Prices

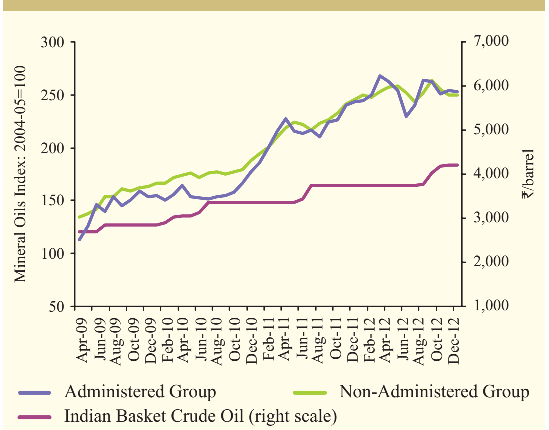
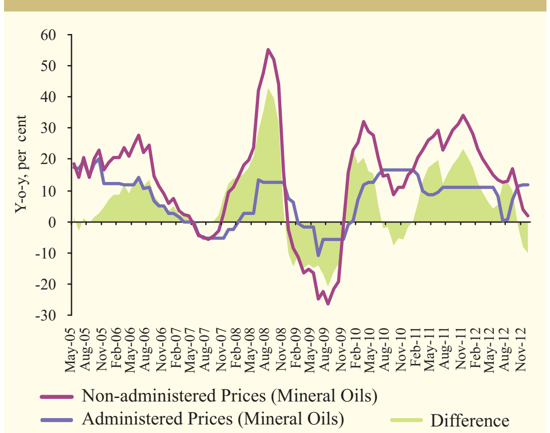


Chart VI.7: Fiscal Control on Fuel Inflation



inflationary pressures, declined considerably to 4.2 per cent (provisional) in December 2012 from 5.8 per cent in August 2012. The month-over-month seasonally adjusted annualised changes (3-month moving average) also indicate significant moderation in price pressures in recent months.

VI.20 The decline in inflation in this segment reflects both the impact of the growth slowdown, which has impacted the pricing power, as well as the pass-through of lower commodity prices, especially that of metals, as the exchange rate volatility has reduced. This also indicates the moderating impact of tight monetary policy on inflation, which is now becoming increasingly visible, *albeit* with a lag.

VI.21 Within non-food manufactured products, 'basic metals and metals products' has been the major driver of the recent decline in inflation. It is also seen that the contribution of metals and chemicals to inflation in non-food manufacturing has been significantly high in the recent period (Chart VI.8). Month-over-month price changes in most commodity groups remained marginal, indicating that the pressure on generalised inflation has ebbed significantly in the recent period.

Depreciation of the rupee offset the impact of softer global commodity prices on domestic inflation

VI.22 The impact of softer global commodity prices during 2012 compared to the previous year was expected to provide some comfort on generalised inflation, especially in items such as metals and chemicals, that have a significant weight in the non-food manufactured products component of the WPI. However, the depreciation of the rupee offset this favourable impact for most of this period, thereby leading to the persistence of inflation (Chart VI.9).

Risks to inflation persist from high fiscal deficit, if not contained

VI.23 The high level of fiscal deficit and higher revenue expenditure by the government may add to the inflationary process. Incomplete pass-through of energy prices may result in higher subsidies, which are also inflationary. While in the present macroeconomic scenario of below-trend growth the risks to inflation from the fiscal deficit may not be visible in the near term, the medium-term inflationary impact cannot be overlooked. Empirical estimates indicate that the fiscal deficit significantly contributes to inflation in the long run. There is, therefore, a need to move towards further fiscal consolidation.

Persistent wage inflation pressures may constrain inflation moderation

VI.24 Recent trends in rural wages indicate that the pace of increase in rural wages moderated from a peak of about 22 per cent (y-o-y) in August 2011 to about 18 per cent in

Chart VI.8: Contributors to Non-food Manufactured Products (NFMP) Inflation

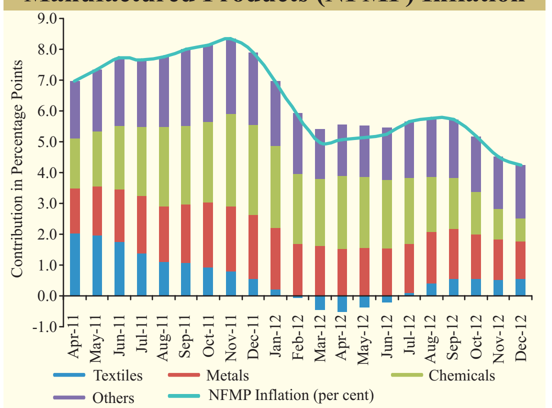
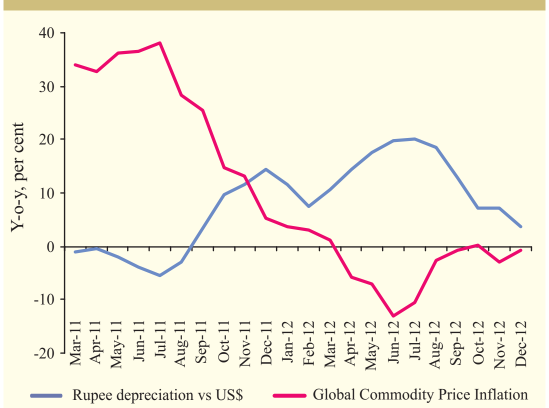


Chart VI.9: Exchange Rate and Commodity Price Movements



November 2012. This, along with an increase in inflation in rural areas in recent months, led to a decline in real wage growth to about 6.5 per cent in November 2012. Though a rapid increase in wages (both nominal and real) has been a common phenomenon during the current high inflation period, a comparison with the previous period (2002-07) reveals that a significant increase in real wages occurred only in the recent period (Chart VI.10). Empirical estimates of causality between wages and inflation in rural areas show that in the recent period causality ran from wages to prices, indicating that increase in real wages has been feeding into the cost of production and also sustaining demand, thereby leading to higher prices. State-specific factors also play a major role in wage-price dynamics as is evident from the large variation in inflation and wage growth in rural areas across major states (Chart VI.11).

VI.25 There is also evidence that increasing wage costs are a source of concern even in the organised sector. Private sector surveys indicate that wage increases in India are much higher than in other EMDEs. In the private corporate sector, the increase in staff costs remained at double digits, indicating persistent pressure from wage costs (see Chapter II).

Divergence between CPI and WPI inflation persists

VI.26 Even as WPI inflation moderated, inflation, as per the all-India new Consumer Price Index (CPI-combined: rural+urban), remained elevated, with inflation for December 2012 at 10.6 per cent. Double-digit food inflation in the new CPI, which has a higher weight for food than the WPI, continues to keep CPI inflation above the WPI. Also, in the new-CPI, excluding the food and fuel component, inflation remains much higher than the WPI (Table VI.2). This could be partly because the WPI does not cover services and rent, whereas both are covered in the new CPI. In terms of contribution to inflation, the pattern remained consistent in the recent period with the food and beverage group being the major driver. The persistence of high CPI inflation compared to the headline inflation moderation is a source of concern.

Chart VI.10: Wages and Inflation in Rural Areas

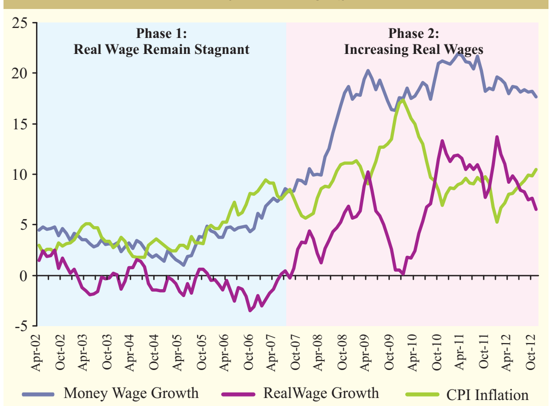
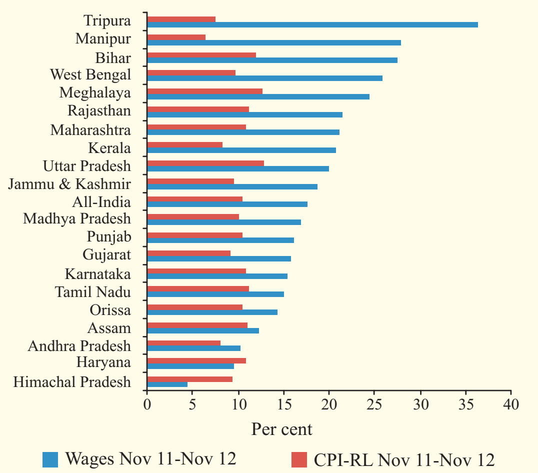


Chart VI.11: State-wise Rural Labourers Inflation and Wage growth: November 2012



Source: Labour Bureau.

Inflation remains divergent between rural and urban areas across product groups

VI.27 Though the overall inflation in rural and urban areas remains close (at 10.7 and 10.4 per cent, respectively, in December 2012), there is wide variation in inflation across various commodity groups (Chart VI.12). In the case of vegetables, condiments & spices and milk, inflation is higher in rural areas than in urban areas, even though rural areas are the producers of these products. In urban areas,

Table VI.2: WPI and New CPI (Combined) Inflation

	Food		Fuel		Excl. 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*	*100.0*	*100.0*
Apr-12	9.3	10.1	12.1	11.2	5.4	10.2	7.5	10.3
May-12	8.9	10.5	11.5	10.7	5.8	10.1	7.5	10.4
Jun-12	9.1	10.8	12.1	10.3	5.6	8.9	7.6	9.9
Jul-12	9.0	11.6	8.4	7.3	6.5	8.5	7.5	9.9
Aug-12	9.3	12.1	8.7	7.5	7.1	8.3	8.0	10.0
Sep-12	8.8	11.7	12.0	7.2	6.6	8.1	8.1	9.7
Oct-12	7.8	11.5	11.6	7.6	5.8	8.4	7.3	9.8
Nov-12	9.0	11.8	10.0	7.4	5.6	8.4	7.2	9.9
Dec-12	10.4	13.1	9.4	8.2	5.0	8.4	7.2	10.6

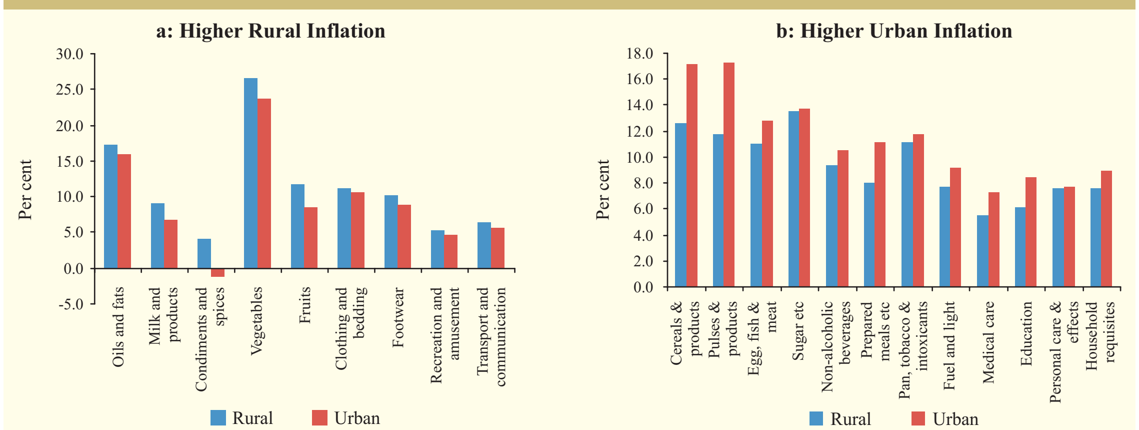
cereals, pulses, prepared meals, sugar and some miscellaneous goods and services report higher inflation. It is also observed that food prices are more volatile in urban areas than in rural areas. The role of supply-chain inefficiencies merits closer analysis in this context.

Inflation moderation may be constrained by persistent risks during 2013-14

VI.28 The current moderation in both headline and core inflation reflects the impact of a significant slowdown in growth and past monetary policy measures. While the supply-side pressure from high food prices persists, suppressed inflation in the fuel group needs to be passed on even at the cost of a higher inflation reading in the short term.

VI.29 Going forward, while the likely persistence of a high consumer price inflation remains a concern, expected moderation in headline WPI inflation in Q4 of 2012-13 could improve the overall inflation scenario. Softer global commodity prices could keep pressure from imported inflation benign, though risks from global commodity price volatility and exchange rate changes cannot be ruled out. Further moderation in food inflation would be conditional on easing of supply pressures, as well as improving the efficiency of the supply chain. The revision in diesel prices announced on January 17, 2013 and the proposed staggered increases in the coming months will result in higher inflation numbers in the near-term. Price pressures can also arise from possible adjustments in prices of coal and electricity. Nevertheless, these steps are desirable from a medium-term inflation management point of view. The pressure on generalised inflation, however, can be expected to remain muted given the weak pricing power of firms. Pressures from industrial raw material prices, which had been a significant source of inflation in non-food manufactured products in the recent past, are also abating. However, the risks of entrenchment of higher food inflation into higher inflation expectations and a wage-price spiral remain. Given these risks, the moderation in inflation is expected to be gradual.

Chart VI.12: Commodity Group-wise Rural and Urban Inflation: December 2012



VII. MACROECONOMIC OUTLOOK

Growth remains subdued due to a combination of external and domestic factors. Various surveys show that business and consumer confidence remain subdued. Government's commitment to reforms is expected to instill confidence among investors and support gradual recovery. Inflation has moderated but remains high. The decline has not been commensurate with the slowdown in growth and upside risks remain from suppressed inflation. While government has embarked on a fiscal adjustment path, staying on this course over the medium-term is necessary for providing sufficient space for monetary policy to stimulate growth. The widening current account deficit also remains a major source of concern. While domestic and global conditions are expected to improve slowly, calibration of the policy stance is important due to prevailing uncertainties.

Reforms reduce immediate risks, but long road ahead

VII.1 The fresh round of reforms that were initiated in September 2012, after a hiatus, has reduced the immediate risks facing the Indian economy. The recent measures taken, especially in January 2013 have further reinforced this momentum. There are signs that growth may have bottomed out, though recovery may take some more time and is likely to be paced gradually. However, on an immediate footing, the recent reforms and measures to debottleneck infrastructure and other sectors have reduced the macroeconomic and financial risks facing the Indian economy. These measures need to be carried forward as certain key constraints continue to impede investments in road and power sectors. As the envisaged measures are implemented to remove the impediments, the economy can start turning around in 2013-14. However, weak global economic conditions, domestic business constraints and low confidence levels may keep the recovery modest next year, while the near-term risks to the economy emanating from fiscal and external imbalances remain.

VII.2 Clearly, there is a long road ahead to regain the pre-crisis potential growth. Traversing this requires tough economic and political decisions that do not fritter away the recent modest gains, as the compulsions of political cycles mount in the run-up to the 2014 general elections.

Business sentiments stay weak, further action needed to restore confidence

VII.3 Latest rounds of business confidence surveys portray a mixed picture. On the whole, it appears that the reform measures taken so far have not decisively lifted business sentiments and further action may be needed to restore confidence.

Table VII.1: Business Expectations Surveys

Period Index	NCAER- Business Confidence Index Jan 2013	FICCI Overall Business Confidence Index Q2:2012-13	Dun & Bradstreet Business Optimism Index Q1:2013	CII Business Confidence Index Q3: 2012-13
1	2	3	4	5
Current level of the Index	119.7	62.4	146.8	49.9
Index as per previous survey	125.4	51.8	140.8	51.3
Index levels one year back	125.2	51.6	156.2	48.6
% change (q-o-q) sequential	-4.5	20.5	4.3	-2.7
% change (y-o-y)	-4.4	20.9	-6.0	2.7

VII.4 The NCAER survey shows a further drop in business confidence, due mainly to perceptions on investment climate deteriorating (Table VII.1). The CII's Business Confidence Index showed a marginal fall in business confidence during Q3 of 2012-13. Domestic economic developments, high interest rates, infrastructure bottlenecks and institutional issues emerged as key concerns in the survey.

VII.5 However, FICCI's overall business confidence index suggests a significant improvement in business confidence. Reform measures, including opening up of FDI in multi-brand retail appear to have lifted sentiments, though inadequate infrastructure and rising costs of manpower and raw materials were cited as constraints. The Dun & Bradstreet Business Optimism Index rose moderately as compared to the previous quarter. Optimism indices of volume of sales, net profits, new orders and employment improved relative to the previous quarter.

VII.6 The seasonally adjusted HSBC Markit Purchasing Managers' Index for manufacturing indicated a pick up in manufacturing activity during October-December 2012 driven by new orders. The HSBC Markit PMI for services in December 2012 recorded the fastest growth in three months.

Industrial Outlook Survey reflects marginal improvement

VII.7 The Reserve Bank's 60th round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS60) conducted during Q3 of 2012-13 showed marginal improvement in the business sentiments of the manufacturing sector.

VII.8 The Business Expectation Index (BEI), a composite indicator based on several business parameters, signals marginal improvement for Q3 of 2012-13. However, the index remained broadly at the same level for Q4 (Chart VII.1). These indices have persisted in the growth terrain (*i.e.* above 100, which is the threshold separating contraction from expansion).

VII.9 Analysis of the net responses among various components of demand conditions shows that the assessment on production remained flat in Q3 of 2012-13. The declining trend in the net response on order books in the previous two quarters was reversed in Q3 of 2012-13. While the respondent companies had lower optimism on capacity utilisation, exports and imports during Q3 of 2012-13, their outlook for Q4 of 2012-13 shows improvement (Table VII.2).

VII.10 There was continued optimism on the availability of finance. The cost of external finance is perceived to rise, but by a lower percentage of respondents. The cost of raw

Chart VII.1: Business Expectation Index

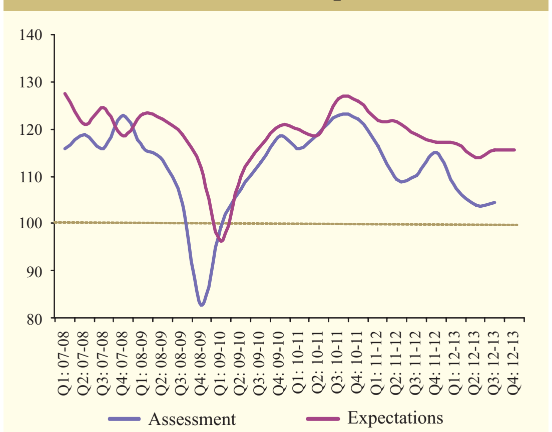


Chart VII.2: Current Situation Index and Future Expectation Index

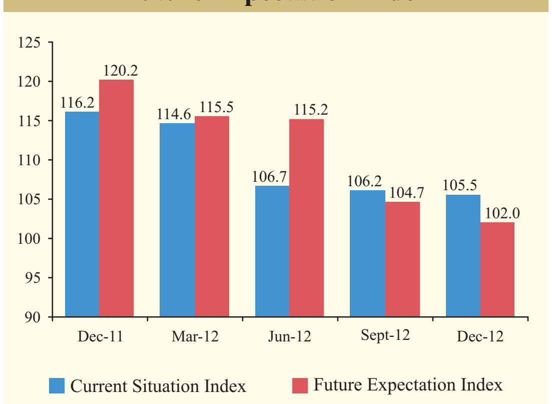


Table VII.2: Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response[1]								
		Jan -Mar 2012		Apr-Jun 2012		Jul-Sep 2012		Oct -Dec 2012		Jan-Mar 2013
		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	33.6	26.5	34.9	18.3	30.6	16.1	32.2	17.2	37.5
2. Overall Financial Situation	Better	25.2	18.5	27.7	14.2	23.6	12.2	25.8	12.7	27.0
3. Production	Increase	40.4	33.1	34.7	20.3	33.6	18.8	35.7	18.6	37.1
4. Order Books	Increase	31.3	24.8	29.5	16.9	29.9	12.0	30.3	12.9	29.8
5. Capacity Utilisation	Increase	24.3	16.7	19.9	8.6	18.4	6.3	20.0	5.7	21.7
6. Exports	Increase	18.6	14.2	20.7	10.8	20.5	10.0	18.0	9.3	18.4
7. Imports	Increase	15.5	14.4	15.7	11.6	15.5	9.8	14.0	8.8	13.5
8. Employment in the Company	Increase	13.6	12.9	14.6	10.0	12.3	8.3	13.3	6.7	10.3
9. Availability of Finance	Improve	19.0	15.8	22.9	15.0	20.4	13.8	21.3	10.0	19.5
10. Cost of External Finance	Decrease	-38.8	-37.4	-22.7	-30.5	-24.0	-27.4	-20.6	-24.4	-18.1
11. Cost of Raw Material	Decrease	-50.1	-59.4	-49.0	-63.1	-51.4	-59.6	-48.6	-50.7	-45.0
12. Selling Price	Increase	14.7	13.5	19.0	17.5	18.8	18.5	17.3	10.2	15.8
13. Profit Margin	Increase	-2.9	-11.3	-1.2	-17.9	-3.6	-15.1	-1.3	-16.7	-2.0

[1] *Net response* is the percentage difference between the *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: Responses for Expectation quarter and A: Responses for Assessment quarter.

material is also expected to rise at a marginally lower rate in the next quarter. The perception on profit margins remained nearly unaltered for Q4 of 2012-13.

Consumer confidence remains subdued

VII.11 The Reserve Bank's 11th round of Consumer Confidence Survey (http://www.rbi.org.in/CCS11), conducted in December 2012 continued to show a decline in the index in the latest quarter. There was deterioration in the perceptions on current economic conditions, current household circumstances and current spending. The Future Expectations Index also indicates a decline in consumers' perceptions of the future (Chart VII.2).

External agencies lower India's growth projections further

VII.12 Various agencies have further revised downwards their growth projections for the year 2012-13. The recent projections for growth in GDP at factor cost now range from 5.4 to 5.9 per cent (Table VII.3).

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

	Latest Projection		Earlier Projection	
	Real GDP Growth (Per cent)	Month	Real GDP Growth (Per cent)	Month
1	2	3	4	5
PMEAC	6.7	Aug-12	7.6	Feb-12
Ministry of Finance	5.7 to 5.9	Dec-12	7.6 (+/-0.25)	Mar-12
IMF*	5.4	Jan-13	5.6	Oct-12
World Bank	5.4	Jan-13	6.0	Oct-12
OECD**	4.4	Nov-12	7.3	Jun-12
ADB	5.4	Dec-12	5.6	Oct-12
NCAER	5.9	Nov-12	6.4	Jul-12

*: Corresponds to the World Economic Outlook update of January 2013 projection of 4.5 per cent for GDP at market prices for the calendar year 2012, The growth for 2013-14 is projected at 6.0 per cent, both at factor cost and market prices.
**: GDP at market prices.

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

	Actual	Annual forecasts				Quarterly Forecast									
	2011-12	2012-13		2013-14		2012-13				2013-14					
						Q3		Q4		Q1		Q2		Q3	
		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 (%)	6.5#	5.7	5.5	6.6	6.5	5.6	5.5	6.2	6.0	6.4	6.1	6.7	6.5	-	6.6
a. Agriculture & Allied Activities	2.8#	1.4	1.5	3.0	3.0	-0.3	0.5	1.5	1.9	2.4	2.5	2.5	3.0	-	3.2
b. Industry	2.6#	3.0	2.8	5.3	4.7	3.2	3.5	3.9	4.0	4.6	4.4	5.1	4.6	-	5.5
c. Services	8.5#	7.8	7.4	8.0	7.8	8.0	7.6	8.2	7.8	8.0	7.6	7.9	7.7	-	7.9
2. Gross Domestic Saving (% of GDP at current market price)	-	30.3	30.5	31.6	31.2	-	-	-	-	-	-	-	-	-	-
3. Average WPI-Inflation	8.9	7.7	7.5	6.7	7.0	7.3*	7.4	7.7	7.0	7.0	6.8	7.0	6.6	-	7.0
4. Exchange Rate (INR/1USD end period)	51.2	52.0	54.0	50.8	52.0	54.8&	55.0	51.5	54.0	51.5	53.0	51.3	52.5	-	51.5
5. 10-year G-sec Yield (%-end period)	8.6	8.0	7.9	7.8	7.8	-	-	-	-	-	-	-	-	-	-
6. Export (growth rate in %)!	20.9*	0.0	-3.5	12.0	11.2	-	-	-	-	-	-	-	-	-	-
7. Import (growth rate in %)!	30.3*	-0.9	-1.4	12.7	8.6	-	-	-	-	-	-	-	-	-	-
8. Trade Balance (US$ billion)	-189.8*	-	-	-	-	-46.5	-55.9	-47.6	-48.1	-45.2	-46.5	-47.0	-50.8	-	-53.0
9. CAD (% of GDP)	4.2*	3.5	4.2	2.7	3.5	-	-	-	-		-	-	-	-	-
10. Central Government Fiscal Deficit (% of GDP)	5.1^	5.7	5.7	5.3	5.3	-	-	-	-	-	-	-	-	-	-

E: Previous Round Projection. L: Latest Round Projection. #: Revised Estimate *: Preliminary

- : Not Available. !: US$ on BoP basis. &: Actual ^: Budget Estimate

Note: Latest round refers to the 22nd round for quarter ended Dec-12, while previous round refers to the 21st round for quarter ended Sep -12.

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

Survey of professional forecasters anticipates slow recovery[1]

VII.13 The 22nd round of the Survey of Professional Forecasters (http://www.rbi.org.in/SPF22) conducted by the Reserve Bank, forecasts slower growth in 2012-13 revising its median growth projection downwards to 5.5 per cent. Forecasts suggest gradual recovery with higher projected GDP growth in 2013-14 while the average WPI inflation is projected to gradually moderate in the coming year. The twin deficits are expected to improve in 2013-14 with the CAD as a percentage of GDP projected to moderate to 3.5 per cent and the central government fiscal deficit as a percentage of GDP projected to fall to 5.3 per cent (Table VII.4).

Inflation expectations see marginal increase

VII.14 The latest round of Inflation Expectations Survey of Households (IESH) (http://www.rbi.org.in/IESH30) conducted among 5,000 households across 16 cities (of which 4 cities are covered for the first time in this round) and 7 occupational categories during November 30 to December 7, 2012, indicates that the perception of current inflation as well as the expectations on future inflation have increased marginally (q-o-q) in Q3 of 2012-13. However, the percentage of respondents expecting a higher rise in prices in Q4 of 2012-13 as well as in Q3 of 2013-14 has decreased as compared with the last round of the survey.

Output gap may start closing in 2013-14, although at a slow pace

VII.15 On current assessment, growth in 2012-13 is likely to fall below the Reserve Bank's baseline projection of 5.8 per cent set out in the Second Quarter Review (October 2012). The IIP recorded a dismal growth of 1.0 per cent during April-November 2012. The full year growth may fall even below last year's

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

disappointing 2.9 per cent growth. With a generalised slowdown in consumption as well as investment, a turnaround looks difficult this year.

VII.16 However, the output gap could start closing in 2013-14 on the back of some revival in investment demand. The improvement would, *inter alia*, hinge on inflation receding which will support higher consumption. Current slack demand has not been associated with a build-up of finished goods inventories as firms have cut down supplies in response to falling demand. This raises hopes that the inventory cycle may be supportive of recovery when it shapes up. External demand has already shrunk and as a baseline case, is also unlikely to dampen growth ahead. As such, it is important to quickly move to resolve the problems that are still impeding investments particularly in the infrastructure and mining sector.

Inflation risks may remain in 2013-14

VII.17 Although, inflation is likely to moderate to below the baseline projection of 7.5 per cent for March 2013 set in the October policy, the direct and indirect impact of the recent increase in diesel prices would exert some upward pressure on overall price level. Suppressed inflation continues to pose a significant risk to the inflation trajectory in 2013-14 and as some of this risks materializes, inflation path may turn sticky. Amidst the large current account deficit (CAD), the possibility of currency depreciation and its pass-through to domestic prices constitutes an additional risk that cannot be glossed over. On the other hand, as fundamentals improve, it could impart strength to the rupee. This can have a favourable impact on inflation.

VII.18 An important element in the inflation mathematics is that core inflation pressures have markedly receded and are unlikely to re-emerge quickly on demand considerations. However, a close vigil on cost-push inflation and wage-inflation spiral would need to be maintained.

Fiscal risks moderate in 2012-13, but sustained commitment to fiscal consolidation is needed to generate monetary space

VII.19 Fiscal risks have declined in recent months as the government re-dedicated itself to the goals of fiscal consolidation. However, a sustainable path to fiscal consolidation hinges on fundamental fiscal reforms that cut subsidies and augment revenues. Measures to contain subsidies have been initiated and would need to be persisted with. Front-loaded fiscal consolidation would generate sufficient space for monetary policy to act without stoking inflationary pressures.

Wide CAD remains a constraint on monetary policy easing

VII.20 At the present juncture, the widening CAD has become a major constraint on easing monetary policy. Even if inflation recedes further, the wide CAD may slow the pace and extent to which monetary policy can be eased. With the likelihood that the CAD may exceed 4 per cent of GDP for the second successive year in 2012-13, prudence is necessary while stimulating aggregate demand.

VII.21 Given, India's growth potential and liberalised capital account there may be a case that India can run a wider CAD/GDP ratio than was possible in the 1980s and 1990s. In inter-temporal terms, it can import more today, if it can export more in future. While it can build up liabilities to the rest of world that are financed by inflows in the financial account, it is important to ensure that the borrowed capital is productively used for real investments that yield marginal product in excess of the interest rate the country has to pay on the foreign liabilities. Secondly, even if CAD is inter-temporally solvent, a view is necessary whether the size of the CAD is easily financeable given the shocks that can emerge from volatile capital flows, which include surges and sudden stops or reversals.

VII.22 The forward-looking assessment provided in the previous Macroeconomic and Monetary Developments clearly pointed to a widening of the CAD in Q2 of 2012-13. It had emphasised the need to stay on the path of fiscal consolidation, as also keeping a tab on private consumption and supplementing it with the selective use of expenditure-switching policies to lower the CAD. This was one of the key considerations while setting the monetary policy in October and December 2012. With the CAD turning out to be a record high of 5.4 per cent of GDP in Q2 of 2012-13, further caution is warranted while framing monetary and fiscal policies.

VII.23 While making the overall interest rate environment more conducive to investments and with some improvement in consumption, it is necessary to ensure that fiscal and monetary policies do not lose control over government or private consumption spending, even if it means a more gradual recovery of the Indian economy. Given India's low trade elasticities, especially at this point of time when world demand is low, there is little alternative but to use expenditure-reducing policies in addition to expenditure-switching policies to bring CAD down to a more sustainable level of around 2.5 per cent of GDP. At the same time, reducing dependence on debt-creating capital inflows is needed. This is particularly important as the export prospects remain impacted by global slowdown. On the other side, India's energy security position is likely to keep imports high. As a result, the balance of payments position is likely to remain vulnerable to global growth cycles and oil price fluctuations.

Balance of macroeconomic risks suggests continuation of calibrated stance

VII.24 In view of all the considerations discussed above, the balance of macro-economic risks suggests continuation of a calibrated stance. In Q3 of 2012-13 headline inflation has receded somewhat faster-than-anticipated. Core inflationary pressures have also turned subdued. However, headline inflation has not declined at a pace commensurate with the negative output gap that has now prevailed for the fifth successive quarter. The size of the negative output gap now exceeds one per cent of GDP. While growth remains low, inflation concerns have not dissipated. Consumer inflation remains high and even the headline remains above the comfort level.

VII.25 The emerging slack in investment needs to be addressed. This slack has emerged from a combination of domestic and global factors. While global growth may remain slow for some more years as significant fiscal adjustment is needed to overcome the debt overhang in the advanced economies, the domestic growth could respond to the policy action that has now begun. Given the preponderance of non-monetary factors behind the current slowdown in an environment where risks from high inflation, current account and fiscal deficits still remain, the scope for supportive monetary policy action is constrained. However, as reform actions get executed, monetary policy could increasingly focus on growth revival.

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