

VII. MACROECONOMIC OUTLOOK

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

Growth prospects for 2012-13 stay weak

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

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

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

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

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

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

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

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

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

Inflation risks remain significant

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

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

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

Business expectations indices suggest subdued business confidence

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

Table VII.1: Business Expectations Surveys

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

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

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

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

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

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

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

Chart VII.1: Business Expectation Index

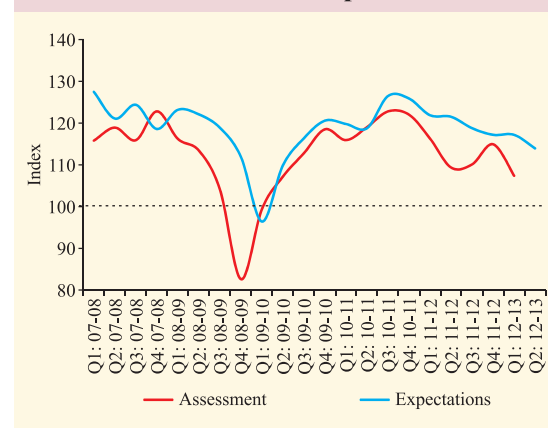


Table VII.2: Reserve Bank's Industrial Outlook Survey

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

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

E: Expectation. A: Assessment.

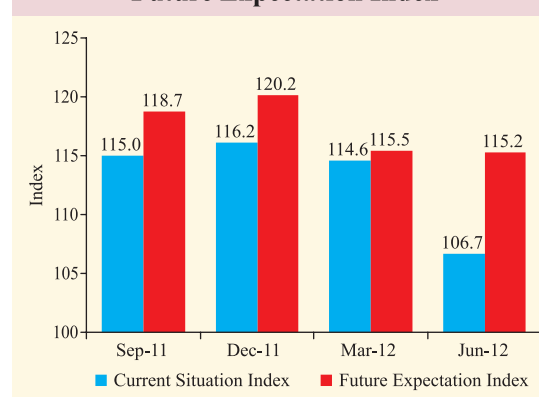
VII.17 Net response of major demand side parameters, viz., production, order books, capacity utilisation, exports and imports for Q1 of 2012-13, remained positive, albeit, lower when compared on a y-o-y as well as a q-o-q basis. The outlook response shows similar results.

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

Consumer Confidence Survey indicates static future expectations

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

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

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


External agencies see moderation in growth ahead

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

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

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

* GDP at market rates.

Survey of professional forecasters¹

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

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

	Actual 2011-12	Annual Forecast				Quarterly Forecast									
		2012-13		2013-14		2012-13								2013-14	
						Q1		Q2		Q3		Q4		Q1	
		E	L	E	L	E	L	E	L	E	L	E	L	E	L
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. Real GDP growth rate at factor cost (in per cent)	6.5#	7.2	6.5	-	7.0	6.6	5.5	7.1	6.3	7.4	6.6	7.5	7.0	-	7.1
a. Agriculture & Allied Activities	2.8#	3.0	3.0	-	3.0	3.0	2.7	3.2	3.0	3.1	2.7	3.0	2.9	-	2.8
b. Industry	2.6#	6.0	4.0	-	5.7	4.6	1.5	5.5	3.7	6.3	5.0	6.2	5.5	-	6.0
c. Services	8.5#	8.8	8.0	-	8.6	8.4	7.5	8.5	7.8	8.8	8.1	8.6	8.4	-	8.4
2. Gross Domestic Saving (per cent of GDP at current market price)	-	32.8	31.3	-	32.2	-	-	-	-	-	-	-	-	-	-
3. Average WPI-Inflation	8.9	6.9	7.3	-	6.8	6.6	7.4*	6.9	7.6	6.7	7.4	6.7	7.2	-	6.5
4. Exchange Rate (INR/1USD end period)	51.2	48.3	53.0	-	51.0	49.5	56.3*	48.8	55.0	48.0	54.5	47.8	53.0	-	52.5
5. T-Bill 91 days Yield (per cent-end period)	8.7	7.9	8.0	-	7.5	-	-	-	-	-	-	-	-	-	-
6. 10-year Govt. Securities Yield (per cent-end period)	8.6	8.2	8.1	-	7.8	-	-	-	-	-	-	-	-	-	-
7. Export (growth rate in per cent)@	23.7*	13.2	12.0	-	17.0	-	-	-	-	-	-	-	-	-	-
8. Import (growth rate in per cent)@	31.1*	15.0	8.3	-	14.3	-	-	-	-	-	-	-	-	-	-
9. Trade Balance (US\$ billion)	-189.8*	-	-	-	-	-50.2	-46.0	-47.7	-45.5	-44.8	-46.2	-48.0	-47.3	-	-45.6

E: Previous Round Projection. L: Latest Round Projection. #: Revised Estimate. *: Preliminary.
 -: Not Available. &: Actual. @: US\$ on BoP basis.
Note: The latest round refers to Twentieth round for the quarter ended June 2012, while previous round refers to Nineteenth round for the quarter ended March 2012.
Source: Survey of Professional Forecasters, First Quarter 2012-13.

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

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

Inflation expectations stay sticky

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

Inflation and macro risks to condition growth-enabling policy actions

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

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

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

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

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