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

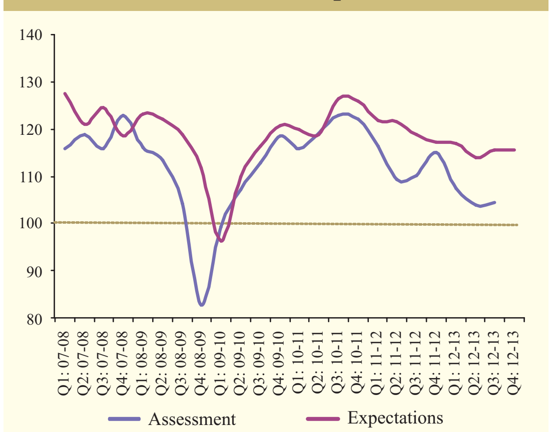

Chart VII.2: Current Situation Index and Future Expectation Index

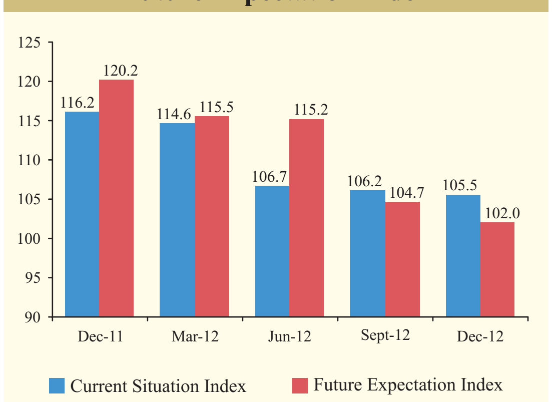

Table VII.2: Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response[1] Jan-Mar 2012 E	Jan-Mar 2012 A	Apr-Jun 2012 E	Apr-Jun 2012 A	Jul-Sep 2012 E	Jul-Sep 2012 A	Oct-Dec 2012 E	Oct-Dec 2012 A	Jan-Mar 2013 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: Real GDP Growth (Per cent)	Latest Projection: Month	Earlier Projection: Real GDP Growth (Per cent)	Earlier Projection: 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.