Macroeconomic and Monetary Developments Second Quarter Review 2012-13

Reserve Bank of India
Mumbai

Contents

MACROECONOMIC AND MONETARY DEVELOPMENTS SECOND QUARTER REVIEW 2012-13

Overview

1. *Since the beginning of 2012, monetary policy has been aimed at maintaining monetary conditions in line with the objective of containing inflation, while ensuring that liquidity conditions remain supportive of recovery. In this direction, the Reserve Bank used the available space to support growth by lowering the cash reserve ratio (CRR) by 150 basis points on a cumulative basis, the statutory liquidity ratio (SLR) by 100 bps, the repo rate by 50 basis points and infusing over ₹1.7 trillion of liquidity through outright open market purchases. As a result, liquidity in 2012-13 so far has stayed in line with policy objective. Going forward, there is a need to calibrate monetary policy factoring in the evolving growth-inflation dynamics as also the progress that may be made in containing the twin deficits.*

2. *Growth in Q2 of 2012-13 is likely to have stayed low with no perceptible signs of improvement from the preceding quarter. Saving and investment rates have declined in recent years, pushing the economy's potential growth rate down to about 7 per cent. The reform measures announced since mid-September 2012 can help improve growth subject to quick implementation. As the policy environment, pace of clearances for projects and input supplies improve, the drag of stalled infrastructure investment on growth would decline.*

3. *Inflation has stayed sticky at around 7.5 per cent in 2012-13 so far. Non-food manufacturing inflation has not softened in spite of the negative output gap that has emerged as a result of slowing growth. Fiscal imbalances, past exchange rate depreciation and feeble supply response have impacted inflation. Going forward, inflation is likely to remain sticky in near months, but some relief may follow as demand-side inflationary pressures ebb after a period of high wage and cost push inflation.*

Global Economic Conditions

Global growth prospects weaken

4. *Growth prospects, both in advanced economies (AEs) and emerging and developing economies (EDEs) have weakened in Q2 of 2012. In October 2012, the International Monetary Fund (IMF) revised its global growth projections for both these groups downwards. Weaker growth prospects largely reflect the impact of sovereign debt overhang and banking fragilities in the euro area coupled with fiscal multipliers impacting growth with on-going fiscal consolidation. Euro area risks have affected business confidence and caused world trade to decelerate. Consequently, several EDEs face weaker external demand on top of an already slowing domestic demand. Further downside risks to global growth stem from a possible "fiscal cliff" leading to sudden and sharp fiscal consolidation in the US.*

Global inflation likely to stay benign

5. *With the slack in output and employment in AEs and falling growth in many large EDEs, global inflation pressures are likely to stay muted during rest of 2012. Global commodity prices are expected to remain range bound, but event risks can disturb the current stability. The renewed quantitative easing in some AEs poses*

some upside risks through liquidity and exchange rate channels.

Contagion risks persist in global financial markets

6. *Risks of spillovers in global financial markets remain large despite of credible policy actions by major central banks. Unconventional monetary policies hinging on exceptional liquidity support and easy money have transitorily moderated uncertainties in the financial markets keeping them in a risk-on, risk-off mode. However, the underlying stress has not diminished with incomplete deleveraging and unfinished financial sector reforms. This has kept the financial systems fragile and markets impacted by risk aversion.*

Indian Economy: Developments and Outlook

Output

Growth remains sluggish, reforms may arrest downturn

7. *Economic indicators suggest that the slowdown has continued in Q2 of 2012-13 with slack industrial activity and sub-par services sector performance. However, recent policy reforms should help, albeit with some lag, in contributing to arresting the downturn. They may support the recovery later upon successful implementation. The improved prospects for Rabi, following the reduction in monsoon deficit with late rains are also expected to contribute to improving growth and inflation outlook, even though the recovery may take some time to set in.*

Aggregate Demand

Fiscal consolidation and removal of impediments to infrastructure investments hold the key to growth revival

8. *Aggregate demand is weakening in 2012-13 led by investment slowdown. Corporate sales growth has also moderated significantly. In spite of recent measures aimed at lowering fiscal deficits, fiscal slippage is likely in 2012-13 reinforcing the need for further measures for fiscal consolidation to crowd-in private investment. Rebalancing of aggregate demand towards investment holds the key to growth revival. It is, therefore, necessary to remove the pending constraints in the power, coal and road sectors at the earliest.*

External sector

CAD wider than comfortable in spite of BoP improvement

9. *External sector risks remain in spite of the improved balance of payments (BoP) during Q1 of 2012-13. Though the merchandise trade deficit in 2012-13 so far has been lower, it largely reflects contraction in import demand on the back of growth deceleration. Services trade surplus is lower, leaving the current account deficit (CAD) wide enough for re-emergence of financing pressures should global risk aversion increase or domestic recovery falter. Recent measures, including those to augment FDI, should help in CAD financing. However, external sector vulnerability and sustainable level of CAD would need to be considered, while framing medium-term trade and capital account policies.*

Monetary and Liquidity Conditions

Reserve Bank infuses liquidity, calibrates monetary policy with evolving growth-inflation dynamics

10. *Active liquidity management through reductions in the CRR, and the SLR backed by OMOs has kept liquidity largely in line with the policy objective, factoring in inflation persistence and the need to ensure credit supply to support growth. Liquidity conditions remained comfortable during Q2 of 2012-13. Monetary and credit aggregates, however, remained below the indicative trajectory. The current credit slowdown largely reflects tepid demand*

conditions and distinctively lower credit expansion in case of public sector banks, reflecting mainly their risk aversion engendered by deteriorating asset quality. Looking ahead, monetary policy will need to factor in output and inflation gaps, keeping in view the current trajectory of liquidity, monetary and credit aggregates.

Financial Markets

Markets respond to reform measures, but more needed to revive primary capital markets

11. *Policy reform measures have shifted market sentiments, strengthening the equity prices and the rupee exchange rate. Gains for the bond markets have been limited despite of the G-sec auction calendar for the second half of the year remaining in line with the budgeted numbers. This may be due to markets factoring in the inadequate fiscal adjustment in the current year. There is need for steps to revive the primary capital markets so that financing constraints for corporate investments are reduced.*

Price Situation

Inflation remains on a sticky path warranting caution for some more time

12. *Inflation has stayed sticky at around 7.5 per cent. Persistent non-food manufactured products inflation, despite the growth slowdown, has emerged as a concern. While the near-term inflation risks are on the upside, inflation should start moderating from Q4 of 2012-13. These expectations factor in the late revival of the monsoon that can have a salutary effect on current food inflation. With global inflation likely to remain benign and suppressed inflation pressures starting to recede, inflation could soften further in H1 of 2013-14. However, improved supply-responses and moderation of wage inflation is vital for bringing down inflation to comfort levels.*

Macroeconomic Outlook

Policy calibration needed as inflation risks persist, while growth remains weak

13. *Business sentiments remain weak at the moment and global growth projections, including that for India, are getting revised downwards. Domestic constraints, especially in infrastructure space, have continued to impede investments. However, the falling growth cycle appears to have reached its trough. Recent policy measures have reduced macroeconomic risks, but speedy implementation and sustained reforms are important for turning the economy around. Meanwhile, inflation risks persist, warranting a cautious policy calibration. If macro-risks from inflation and twin deficits recede further, that could yield space down the line for monetary policy to respond to growth concerns.*

I. OUTPUT

With both domestic and global factors that had impacted India's growth during 2011-12 remaining unresolved, growth remained sluggish during Q1 of 2012-13. Indicators suggest that the slowdown continued into Q2 of 2012-13 with slack industrial activity and sub-par services sector performance. Despite unconventional monetary easing by several advanced economies, global growth prospects have weakened since the previous quarter thus adversely impacting the near-term growth outlook for India. However, recent policy reforms by the government, albeit with some lag, should contribute towards arresting the downturn by easing some domestic constraints. Measures to remove constraints facing the infrastructure sector would be crucial for growth revival.

Global growth prospects weaken over the previous quarter

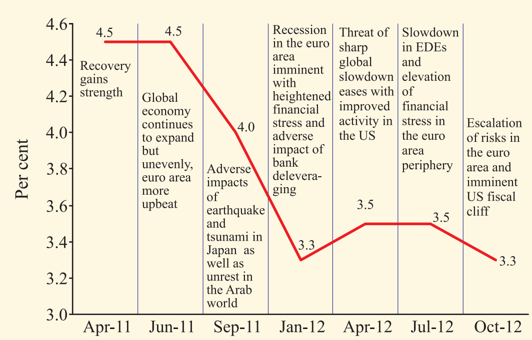
I.1 The global growth outlook has deteriorated further as the sovereign debt overhang, fiscal adjustments, banking fragilities and financial market uncertainties, especially in the euro area, weighed on growth prospects. Sequentially, growth decelerated in Q2 of 2012 in the US, Japan and China while euro area and UK failed to register positive growth. Though there have been signs of a mild recovery in the US housing markets, the possibility of the occurrence of a US fiscal cliff poses a significant risk to the US and global recovery, despite the "open-ended" quantitative easing announced by the Federal Reserve. The fiscal cliff refers to a possible large reduction in the federal budget deficit between 2012 and 2013 on account of certain tax hikes and spending cuts becoming effective from January 2013.

I.2 The IMF's World Economic Outlook (WEO) released earlier this month, further marked down its global growth forecast for 2012 to 3.3 per cent from the July 2012 estimate of 3.5 per cent. This is mainly due to a downward revision in growth projection for EDEs to 5.3 per cent from 5.6 per cent in July 2012. The growth forecast for advanced economies (AEs) has been reduced by 0.1 percentage point to 1.3 per cent. The latest revision in global growth forecast for 2012 means a cumulative downward revision of 1.2 percentage points since April 2011, when global recovery had gained strength (Chart I.1).

I.3 The US economy expanded by 2.0 per cent (annualised) in Q3 of 2012, faster than 1.3 per cent in Q1 of 2012. Euro area output contracted at a rate of 0.7 per cent (annualised) in Q2. The employment scenario in the AEs also continues to be grim. The unemployment rate in the US, however, declined to 7.8 per cent in September 2012 from 8.1 per cent in August 2012.

I.4 Spillovers from AEs and domestic constraints have affected economic activity in EDEs as well. The BRICS economies continued to slow. China's growth decelerated for the seventh consecutive quarter to 7.6 per cent (y-o-y) in Q3 of 2012. Only Q2 data is available for the other countries. Russia's growth

Chart I.1: IMF Projections for Global Growth in 2012



Source: World Economic Outlook and Updates (various issues).

weakened further to 4.1 per cent in Q2 of 2012, decelerating continuously for three successive quarters. Brazil's growth fell for the tenth successive quarter to 0.5 per cent. South Africa's growth improved marginally, but has stayed below 3.0 per cent in the preceding four quarters. With risks to global growth and trade, near-term improvement in growth prospects for EDEs seems unlikely.

I.5 Global industrial production grew at the rate of 1.7 per cent in August 2012, its slowest pace since zero growth in November 2009 (Chart I.2). Lead indicators such as Purchasing Managers Index (PMI) suggest no significant improvement in Q3. The volume of world trade fell in July 2012 (Chart I.3). Slowdown in global industrial activity and trade could adversely impact India's growth prospects, given the inter-linkages.

Risks from the impending US 'fiscal cliff' remain significant

I.6 A major downside risk to global growth is now looming from the US fiscal cliff. The US Congressional Budget Office forecasts that the US fiscal deficit will decline by 3.3 percentage points to 4 per cent of GDP in 2013. Such a sharp fiscal consolidation may have a deleterious impact on global growth (Table I.1). There could be an adverse impact of the US fiscal cliff on India's growth. If global growth slumps, there would be spillover impact on current account as well, though some offset may be available if global commodity prices fall.

Table I.1: Global Implications of the US 'Fiscal Cliff'

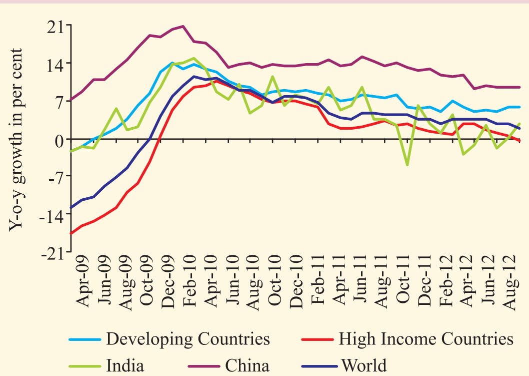
	Percentage point change from the baseline		
	GDP	Current Account Balance*	Fiscal Balance*
1	2	3	4
World	-1.0	–	0.4
US	-2.2	1.2	2.9
High Income Countries	-1.1	0.1	0.8
Euro Area	-0.4	-0.3	-0.1
Developing Countries	-0.6	-0.4	-0.3
South Asia	-0.2	0.1	0.1

Source: World Bank Estimates.
* as per cent of GDP.

Growth in India was sluggish in Q1 of 2012-13

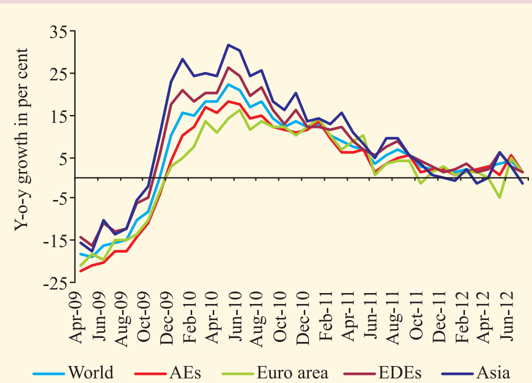
I.7 Growth during Q1 of 2012-13, at 5.5 per cent, was marginally higher than in the previous quarter, but much lower than the 8.0 per cent growth registered in the corresponding quarter of 2011-12. The deceleration was seen across all the three major sectors, particularly the industrial and services sectors (Table I.2). The slowdown in manufacturing has been particularly severe. The services sector moderated for the second successive quarter in tandem with a sharp deceleration in the growth of 'trade,

Chart I.2: Growth in Industrial Production



Source: World Bank.

Chart I.3: Growth in Exports Volume



Source: CPB World Trade Monitor.

Table 1.2: Sectoral Growth Rates of GDP (at 2004-05 prices)

(Per cent)

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

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

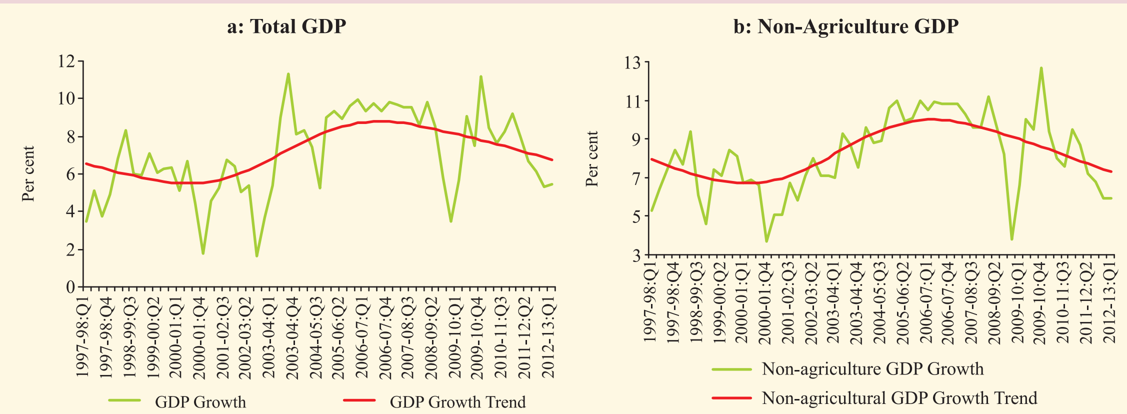
hotels, transport, storage and communication', even as construction picked-up.

I.8 Since the second week of September 2012, the government has announced a number of policy measures towards fiscal consolidation by reducing fuel subsidies and clearing stake sales in public enterprises. It has also taken several other reform measures (see Table VII.1 on reform measures). While these measures have helped improve sentiments, their impact on growth will be felt with a lag, particularly after the substantive implementation of the initiatives relating to FDI and infrastructure.

Negative output gap likely to persist in 2012-13

I.9 The potential growth rate of the Indian economy peaked around the middle of 2007-08, and has since continued its downward slide into Q1 of 2012-13 (Chart I.4). There are many methodological issues surrounding the estimation of potential output and the range of empirical estimates leaves considerable uncertainty. Nevertheless, what is clear is that potential output has been impaired as a result of the fall in savings and investment, high inflation and domestic structural impediments

Chart I.4: GDP Growth

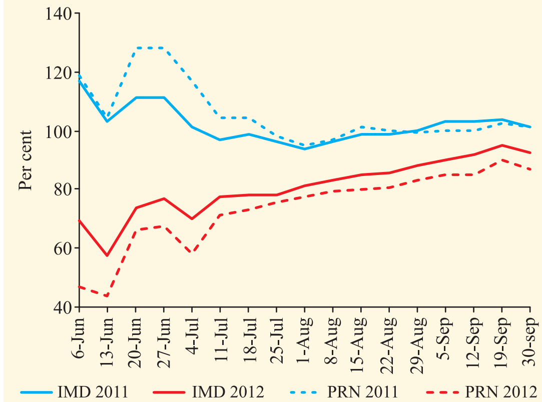


compounded by cyclical global slowdown. Current estimates suggest that potential growth may have now dropped to around 7.0 per cent. The output gap has been negative for four consecutive quarters.

Delayed and uneven monsoon has impacted kharif production though rabi prospects seem better

I.10 In 2012, not only was there a delay in the onset of the south-west monsoon, but its progress and distribution was uneven, especially during the crucial *kharif* sowing period of June and July. This resulted in delayed sowing of most crops. Although rainfall improved during August and September, the cumulative rainfall for the country as a whole (up to September 30) was 8 per cent below the LPA. The production-weighted rainfall index (PRN) constructed by the Reserve Bank indicated a deficiency of 13 per cent for the season as a whole (Chart I.5).

Chart I.5: Rainfall Index



I.11 Deficient rainfall resulted in shortfall in area sown for several crops, notably coarse cereals and pulses (Table I.3). The delay in sowing, particularly in July 2012 adversely impacted the production of *kharif* crops in 2012 as indicated by the First Advance Estimates. Revival of monsoon during the latter half of the season and the governments contingency plans to tackle the drought-like situation, to an extent, helped in moderating the adverse impact of deficiency of monsoon during June and July 2012. The late recovery of rainfall, especially during September has improved soil moisture content and reservoir levels, thus improving the prospects for winter and *rabi* crops which could help in compensating for the loss of *kharif* crops.

I.12 The current stock of around 67 million tonnes (September 2012) of rice and wheat is more than sufficient to meet the requirements of buffer norms (Chart I.6). However, food and

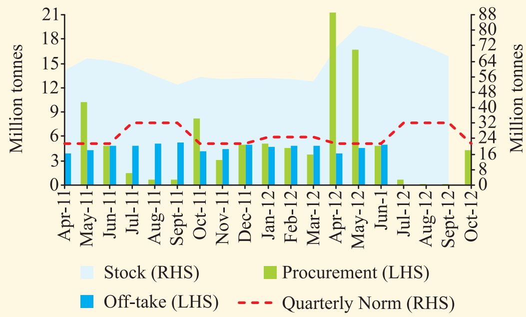
Table I.3: *Kharif* Sowing and Production

(Area in million hectares; Production in million tonnes)

Crop	Normal	Sowing*		*Kharif* Production		Percentage change over 2011	
		2011	2012	2011 4th Advance Estimate	2012 1st Advance Estimate	Sowing (4) over (3)	Production (6) over (5)
1	2	3	4	5	6	7	8
Foodgrains	71.9	72.1	66.5	129.9	117.2	-7.8	-9.8
Rice	39.1	40.1	39.2	91.5	85.6	-2.2	-6.4
Coarse Cereals	21.9	20.7	17.8	32.3	26.3	-14.0	-18.6
Pulses	11	11.3	9.5	6.2	5.3	-15.9	-14.5
Oilseed	17.9	18.5	17.5	20.8	18.8	-5.4	-9.6
Sugarcane	4.7	5.1	5.1	357.7	335.3	0.0	-6.3
Cotton#	9.9	12.2	11.6	35.2	33.4	-4.9	-5.1
Jute and mesta ##	0.8	0.8	0.8	11.6	11.3	0.0	-2.6
All- Crops	105.2	108.7	101.5	–	–	-6.6	–

*: Full Season. #: Million bales of 170 kgs each. ##: Million bales of 180 kgs each.
Source: Ministry of Agriculture, Government of India.

Chart I.6: Food Stock and its Determinants



Note: 1. Data for off-take is for April-June 2012 and stock as on September 30, 2012.
2. Procurement and off -take data are monthly figures.
3. Procurement for October 2012 is as on October 19, 2012.

nutrition security at stable prices remains a concern as food prices experienced significant upward pressures with the deficiency in monsoon (for details see Chapter VI. Price situation). There was also a spurt in futures prices of some agricultural commodities during June-July owing to concerns about a weak monsoon.

Recovery of investment essential for industrial growth

I.13 The growth in index of industrial production (IIP) decelerated sharply during April-August 2012 compared with the corresponding period of the previous year. This was mainly due to a decline in capital goods production highlighting the slowdown in investment activity (Table I.4). The contraction of the mining sector also contributed to the slowdown in industrial production. Excluding capital goods, the growth rate of overall IIP during April-August 2012 was 2.7 per cent (Chart I.7).

I.14 The slowdown in industrial activity is reflected across all sectors. Manufacturing sector output did not grow during April-August 2012, reflecting subdued investment activity and moderation in external demand. Major sub-sectors of manufacturing, such as electrical machinery and apparatus, motor vehicles, food products and apparel contributed significantly to the overall decline in growth of manufacturing output. The mining sector continued to contract due to regulatory and environmental issues. Policy uncertainties with respect to coal and iron ore mining may act as a deterrent for this key sector. Power generation moderated sharply during April-August 2012, both on account of shortages in coal supply and uneven monsoon conditions.

I.15 As per the use-based classification, moderation in growth was seen in all categories

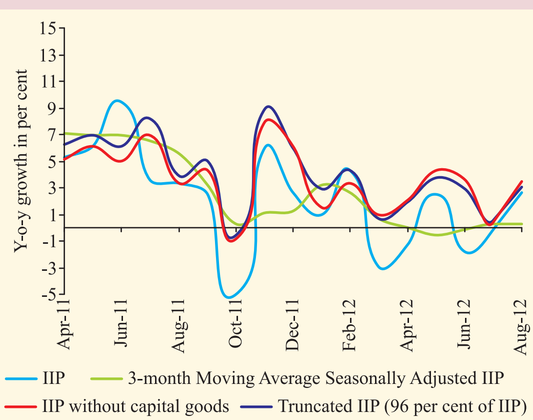
Table I.4: Index of Industrial Production: Sectoral and Use-Based Classification of Industries

(Per cent)

Industry Group	Weight in the IIP	Growth Rate		
		Apr-Mar 2011-12	April-August	
			2011	2012P
1	2	3	4	5
Sectoral				
Mining	14.2	-2.0	-0.5	-0.6
Manufacturing	75.5	3.0	6.0	0.0
Electricity	10.3	8.2	9.5	4.8
Use-Based				
Basic Goods	45.7	5.5	7.6	2.8
Capital Goods	8.8	-4.0	7.3	-13.8
Intermediate Goods	15.7	-0.6	0.8	0.6
Consumer Goods (a+b)	29.8	4.4	4.4	3.5
a) Consumer Durables	8.5	2.6	4.5	5.7
b) Consumer Non-durables	21.3	5.9	4.3	1.6
General	**100**	**2.9**	**5.6**	**0.4**

P : Provisional.
Source: Central Statistics Office.

Chart I.7: Industrial Growth



except consumer durables. The contraction in capital goods production during April-August 2012 mainly reflects weak investment demand. There has, however, been partial substitution by increase in capital goods imports, which increased significantly during this period.

I.16 An analysis of the relationship between production and imports of manufacturing goods industries during April 2010 to March 2012 confirms that there is a statistically significant and negative relation between domestic production and imports in the case of textiles and electrical machinery. The negative association implies that textiles and electrical machinery industries have been subject to some loss of competitiveness, resulting in the substitution of domestic output by imports (Chart I.8).

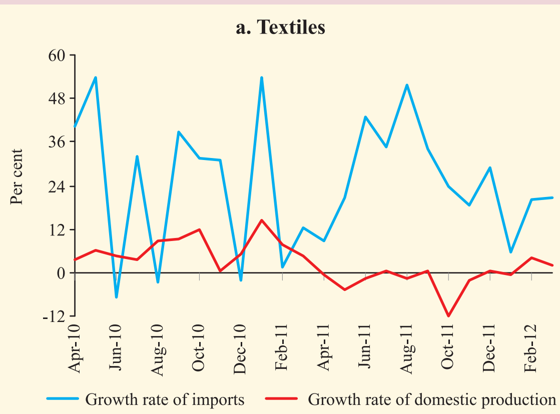
I.17 To support revival in industrial growth, there is a need to take expeditious decisions to accelerate investments, especially by easing policy constraints and removing major supply bottlenecks. The recent proposal to set up a National Investment Board (NIB) is intended to improved co-ordination and expedite investment clearances of large projects thus helping to improve investment climate. However, since a large number of project clearances are also required at sub-national levels, it is important to improve coordination amongst all concerned agencies, including those which may be beyond the ambit of NIB.

I.18 Recovery in domestic industrial production could also be contingent on a revival in global growth. A strong co-movement between domestic and global IIP is observed; the correlation coefficient of which during the period April 2008 to August 2012 was as high as 0.7 (see Chart I.2).

Revival of investment cycle hinges on resolution of policy uncertainties facing power and coal industries

I.19 The growth of eight core infrastructure industries decelerated to 2.8 per cent during April-August 2012 compared to 5.5 per cent during the corresponding period of the previous year (Chart I.9). Going forward, a reversal of downturn facing these industries essentially depends on revival of investment activity. This, in turn, hinges on resolution of policy uncertainties facing the power and coal industries. Despite large new power capacities reaching gestation stage during the Eleventh Five Year Plan, these capacities have not yielded the desired results due to input supply constraints. Though about 55 GW of new capacity creation was achieved, a large part of new capacity in thermal power was affected by coal shortages. The coal requirement for thermal power generation during 2012-13 is estimated at 476 million tones, but indigenous supplies may be only 407 million tonnes, requiring the balance to be met through imports. This demand-supply

Chart I.8: Domestic Production *vis-à-vis* Imports of Manufactured Goods



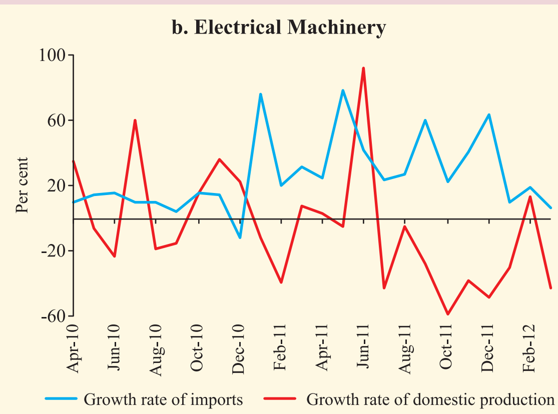
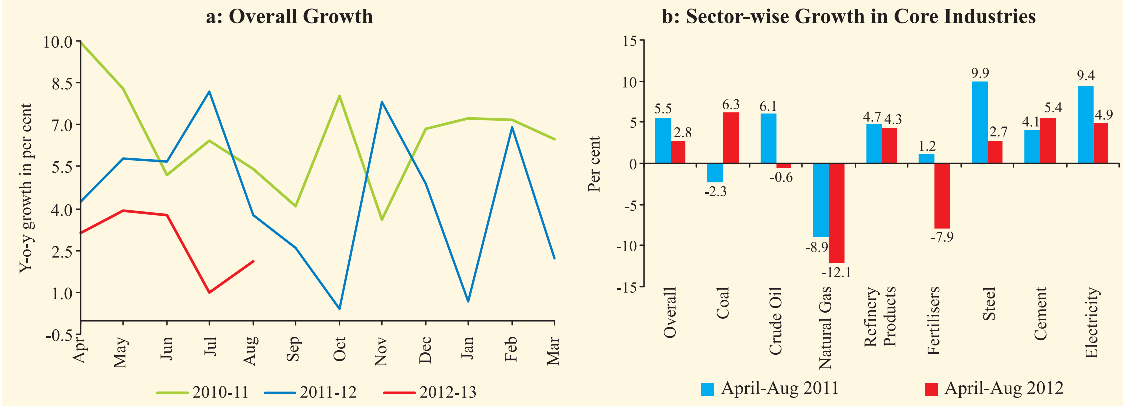


Chart I.9: Growth in Core Industries



gap is projected to rise further during the Twelfth Plan. New plants that have been commissioned on the basis of coal linkage are facing severe constraints in the absence of committed Fuel Supply Agreements (FSAs). Besides, power projects are held up for want for various clearances. Also, distribution of power has come under financial stress, with state power distribution companies (discoms) sitting on an accumulated debt of ₹1.9 trillion as on March 2011. A large amount of bank finance is stuck in bad loans to these discoms.

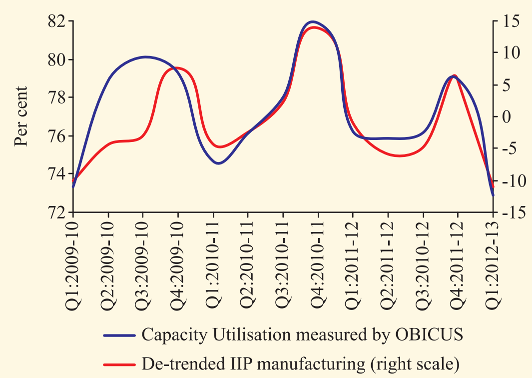
I.20 However, over the past two months substantive progress has been made towards resolving outstanding issues confronting the sector. New FSAs that provide reasonable graded penalty clauses at pre-agreed disincentive triggers of 80 per cent of the Assured Coal Quantity (ACQ) are now approved by the Coal India Limited (CIL) and are expected to be signed shortly. A scheme of financial restructuring of discoms has now been put in place, which will aim at bringing about a financial turnaround of discoms (see para II.16). However, a comprehensive solution to the coal supply issue lies in addressing supply shortages through imports in the interim backed by appropriate price pooling or effective alternative mechanisms, as also getting the coal blocks auctions going so that issue does not linger beyond the Twelfth Plan period. So, while existing measures are steps in the right direction, rest of the issues would need to be resolved expeditiously to kick start the investment cycle in the infrastructure sector once again.

I.21 Other decisions in the recent period such as revoking the ban on certain categories of projects by allowing government land alienation and permission for clearance of up to 40 hectare of forest land at the regional level, are significant steps towards mitigating policy uncertainties. It has been decided that both forest and environment clearances would be processed simultaneously to avoid delays. Further, the recent policy initiatives such as permitting FDI in retail trade, civil aviation and power trading exchanges and rationalisation of diesel prices will help improve the investment climate.

Capacity utilisation at its lowest level in thirteen quarters

I.22 On account of the slowdown in economic growth, capacity utilisation measured by the 18th round of the Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank was at a three-year low in Q1 of 2012-13 (http://www.rbi.org.in/OBICUS18). There is a strong co-movement between capacity utilisation and de-trended IIP manufacturing (Chart I.10). The survey further shows that there was higher growth in new orders, both q-o-q and y-o-y, the latter partly

Chart I.10: Capacity Utilisation and Industrial Growth



due to a lower base. There was an increase in pending orders due to inability to fully meet the new orders.

Lead indicators of services sector signals moderation

I.23 At 7.4 per cent, the services sector registered its lowest growth in thirteen quarters during Q1 of 2012-13. This was largely due to the weak performance of 'trade, hotels, transport, storage and communication' sector. The contraction of the industrial sector and weak demand conditions have constrained the growth of the services sector. Leading indicators of the services sector point towards further moderation in growth going forward (Table I.5). This is also corroborated by the Reserve Bank services sector composite indicator (Chart 1.11).

Table I.5: Indicators of Services Sector Activity

(Growth in per cent)

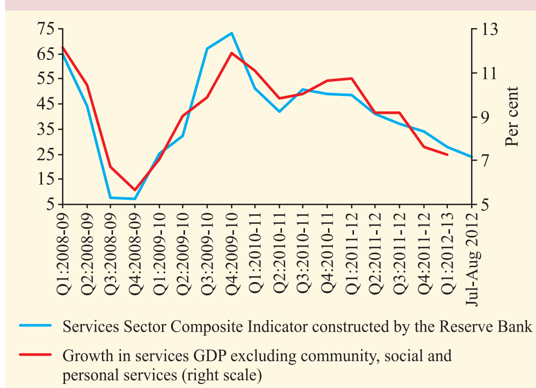
Services Sector Indicators	2010-11	2011-12	Apr-Sep 2011-12	Apr-Sep 2012-13
1	2	3	4	5
Tourist arrivals	9.5	8.6	9.3	3.4
Cement	4.5	6.7	4.1#	5.4#
Steel	13.2	7.0	9.9#	2.7#
Cell phone connections (in million)$	227.3	107.6	46.8*	-5.7*
Automobile sales	16.8	11.2	12.0	3.6
Railway revenue-earning freight traffic	3.8	5.2	4.8	4.8
Cargo handled at major ports	1.6	-1.7	3.1	-3.3
Civil aviation				
Domestic cargo traffic	23.8	-4.8	-5.1*	3.8*
International cargo traffic	17.7	-1.9	3.9*	-4.3*
International passenger traffic	10.3	7.6	8.8*	3.3*
Domestic passenger traffic	18.1	15.1	18.0*	-0.5*

#: Data pertains to April-August.
*: Data pertains to April-July 2012.
$: Refers to wireless subscriber additions in actual numbers.
Source: Ministry of Statistics and Programme Implementation, Ministry of Tourism, SIAM and CMIE.

Recent reform initiatives may help in turning the tide

I.24 The slowdown in the Indian economy has been due to both domestic as well as external factors. The crucial domestic factor impinging on growth was policy uncertainties and lack of reforms. Since September 2012, a number of reforms have been announced that should improve the investment climate and help attract more investment, domestic as well as foreign. The announcement of these reform measures in themselves are not sufficient to ensure recovery as their impact would critically hinge on successful implementation.

Chart I.11: Services Sector Composite Indicator



II. AGGREGATE DEMAND*

Aggregate demand weakened further in Q1 of 2012-13, led by patchy investment demand. Corporate sales have moderated significantly. On the fiscal front, the deficit indicators have considerably widened. While the slowdown has had an impact on indirect taxes, both excise and customs, public expenditure remained high, particularly on subsidies. Recent initiatives taken by the government, especially those related to its expenditure on fuel subsidies are welcome but are less than adequate to avert fiscal slippage in 2012-13. Further steps will need to be taken soon.

Protracted slowdown in private consumption and investment

II.1 Expenditure side GDP growth moderated sharply to 3.9 per cent in Q1 of 2012-13 from 9.0 per cent in the corresponding quarter of previous year (Table II.1). Private final consumption expenditure and gross fixed capital formation, which account for around 60 per cent and 30 per cent, respectively, of GDP and which had both decelerated in the previous year, slackened further in Q1 of 2012-13.

II.2 The downturn in investment, as explained in previous reports, was led by non-monetary factors, though interest rates also had a material

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

(Per cent)

Item	2010-11	2011-12	2011-12				2012-13
			Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7	8
			Growth Rates				
Real GDP at market prices	9.6	6.9	9.0	6.9	6.2	5.6	3.9
Total Consumption Expenditure	8.1	5.4	4.9	4.9	6.1	5.8	4.7
(i) Private	8.1	5.5	4.9	4.6	6.4	6.1	4.0
(ii) Government	7.8	5.1	4.9	7.2	4.7	4.1	9.0
Gross Fixed Capital Formation	7.5	5.5	14.7	5.0	-0.3	3.6	0.7
Change in Stocks	37.4	2.4	7.1	2.8	0.4	-0.4	-1.2
Valuables	32.4	7.9	9.8	9.4	2.9	9.3	-55.4
Net Exports	5.5	-30.7	-23.2	-46.7	-117.9	117.8	-2.1
Discrepancies	38.9	-112.7	-51.8	-119.6	-152.0	-124.0	-123.7
			Relative shares				
Total Consumption Expenditure	70.1	69.1	70.1	70.8	72.7	63.6	70.6
(i) Private	58.7	57.9	59.5	60.3	60.4	52.2	59.5
(ii) Government	11.4	11.2	10.6	10.5	12.5	11.4	11.1
Gross Fixed Capital Formation	32.5	32.0	33.9	33.4	30.3	30.9	32.8
Change in Stocks	3.7	3.5	3.7	3.6	3.4	3.4	3.5
Valuables	2.4	2.4	2.6	2.7	2.1	2.2	1.1
Net Exports	-6.0	-7.4	-8.6	-11.3	-11.1	0.6	-8.5
Discrepancies	-2.5	0.3	-1.7	0.8	2.6	-0.6	0.4
Memo:							
Real GDP at market prices (₹ billion)	52368	55959	13174	13111	14377	15296	13693

* : Quick Estimates. # : Revised Estimates.
Note: As only major items are included in the table, data will not add up to 100.
Source: Central Statistics Office.

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

effect. At the same time, government final consumption expenditure (which excludes transfer payments such as subsidies), which accounts for around 11 per cent of GDP, picked up sharply in Q1 of 2012-13, partly reflecting a base effect.

II.3 The decline in the weighted contribution of net exports and valuables in Q1 of 2012-13 is in line with the balance of payments, in contrast to the data for the previous quarter (Table II.2). Significantly, discrepancies continue to vitiate expenditure data. The table shows that the sum of the contribution-weighted growth rates of the different expenditure components works out to only 1.9 per cent in Q1 of 2012-13, which is much lower than the growth rate of 3.9 per cent derived from the production approach GDP ('supply side') after adjusting for net indirect taxes. Since the production-approach GDP is considered as the firmer estimate in the National Accounts Statistics, the difference between the expenditure side GDP derived from the supply side and that obtained from the different components of expenditure is reported as a statistical discrepancy. The discrepancy largely arises due to the lack of firm data on the expenditure components and the consequent use of indicator based approach by the CSO. Such large discrepancy complicates the assessment of aggregate demand in the economy for monetary policy.

Moderation in sales growth coupled with decline in profits and contraction in margins reflect slack demand

II.4 The subdued demand is reflected in the dampened sales of non-government non-financial (NGNF) listed companies. Sales growth decelerated to a 10-quarter low of 13 per cent in Q1 of 2012-13 (Table II.3). Further, due to a higher rate of growth in expenditure compared to sales, net profits declined by 10.7 per cent. The decline in net profits on a q-o-q basis was even sharper at 18 per cent (Table II.4).

II.5 Lower growth in profits (EBITDA/EBIT/net profits) relative to sales led to a decline in profit margins (EBITDA/EBIT/net profits as

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

(Per cent)

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

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

Source: Central Statistics Office.

Table II.3: Corporate Sector- Financial Performance

Item	2011-12	2011-12				2012-13
		Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7
No. of Companies			2308			
			Growth Rates[1] (in Per cent)			
Sales	18.8	22.3	19.3	19.3	15.3	13.0
Expenditure, of which	21.4	22.8	22.7	24.9	16.4	15.3
Raw Material	22.6	28.0	23.1	25.0	16.1	13.0
Staff Cost	17.4	19.0	18.0	18.6	14.4	17.5
Power & fuel	28.2	31.1	26.2	30.4	25.4	17.7
Operating Profits (EBITDA)	1.1	12.6	-0.8	-5.5	-0.8	-4.1
Other Income*	49.3	63.5	25.6	69.9	47.5	29.4
Depreciation	10.6	11.4	9.8	10.3	10.7	9.5
Gross Profits (EBIT)	4.5	18.2	-0.1	-2.2	3.3	-3.0
Interest	40.3	34.1	47.4	43.6	36.7	36.3
Tax Provision	6.3	22.0	4.0	-2.6	2.9	-5.5
Net Profits	-11.9	7.1	-15.3	-30.5	-7.9	-10.7
			Select Ratios			
Change in stock # to Sales	1.3	1.4	0.5	2.3	1.0	0.8
Interest Burden	26.7	23.4	28.5	28.5	26.8	32.9
Interest Coverage	3.7	4.3	3.5	3.5	3.7	3.0
EBITDA to Sales	13.4	15.0	12.9	12.6	13.1	12.7
EBIT to Sales	12.1	13.3	11.4	11.2	12.4	11.4
Net Profits to Sales	6.4	7.6	6.1	4.9	6.9	6.0

#: For companies reporting this item explicitly.
*: Other income excludes extraordinary income/expenditure if reported explicitly.
1. Growth rates are percentage changes in the level for the period under reference over the corresponding period of the previous year for common set of companies.

percentage of sales). A decline in change in stock-in-trade to sales ratio is in line with lower capacity utilisation as observed from OBICUS and indicates a possible moderation in expectation on demand conditions, going forward (Chart II.1).

Table II.4: Corporate Sector Financial Performance (Sequential Growth)

Indicator	Common Companies (Q-o-Q Growth in Per cent)				
	2011-12				2012-13
	Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6
No. of Companies			2308		
Sales	-2.9	3.4	5.6	8.7	-4.8
Expenditure, of which	-3.6	4.9	7.7	6.8	-4.5
Raw Material	-3.3	1.1	8.3	9.7	-5.9
Staff Cost	2.7	6.7	3.1	1.3	5.4
Power & fuel	13.5	-3.0	7.9	5.5	6.6
Operating Profits (EBITDA)	-4.9	-10.8	3.0	13.5	-8.1
Other Income	-9.6	7.7	4.8	44.5	-20.7
Depreciation	-1.9	0.6	3.7	8.2	-3.0
Gross Profits (EBIT)	-6.3	-11.2	3.1	20.5	-12.1
Interest*	8.4	8.0	3.1	13.3	8.0
Tax Provision	5.0	-11.3	-4.5	15.6	-3.6
Net Profits	-15.1	-16.3	-15.1	52.5	-17.7

*: Some companies report interest on net basis.

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

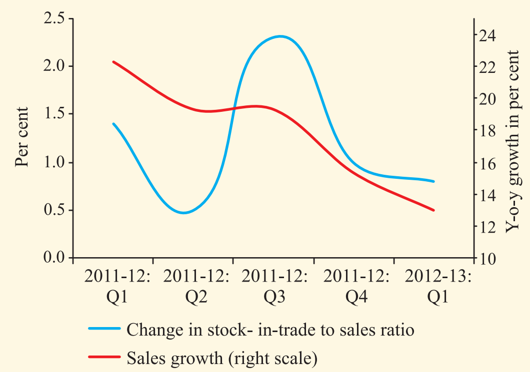


Table II.6: Institutionally-Assisted Projects and their Envisaged Cost (Quarter-wise)

Financial Year		No. of Projects	Project Expenditure # (₹ billion)
1		2	3
2011-12	Q1	154 (131)	787 (677)
	Q2	194	572
	Q3	151	506
	Q4	169 (153)	255 (226)
2012-13	Q1*	80	268

#: Based on data reported by 39 banks/FIs.
*: Data for Q1:2012-13 is provisional and is based on reported data from 32 banks/FIs. Corresponding data for Q1:2011-12 and Q4:2011-12 are given in parentheses.

II.6 Early results of 190 companies for Q2 of 2012-13 indicate that the sales growth continued to slowdown for these companies (Table II.5). There was a marked improvement in growth of net profits. However, the early results are from a small set of companies which are not representative of the overall corporate sector.

Table II.5: Corporate Sector- Early Results Q2 of 2012-13

Growth Rates[1] (in Per cent)			
Item	2011-12	2012-13	
	Q2	Q1	Q2
1	2	3	4
Number of Companies		190	
Sales	28.9	16.1	13.5
Expenditure, of which	32.6	19.8	15.7
Raw Material	39.6	20.7	15.8
Staff Cost	22.0	23.1	23.0
Power & fuel	21.9	8.1	12.5
Operating Profits (EBITDA)	11.7	2.0	8.4
Other Income*	77.6	37.5	30.7
Depreciation	5.8	-2.6	-3.4
Gross Profits (EBIT)	21.6	8.6	15.4
Interest	57.6	33.0	-5.2
Tax Provision	24.7	6.8	12.0
Net Profits	15.9	7.9	21.6
Select ratios			
Change in stock # to Sales	1.2	1.2	2.3
Interest Burden	9.8	10.0	8.1
Interest Coverage	10.2	10.0	12.4
EBITDA to Sales	15.8	14.4	15.0
EBIT to Sales	15.1	14.2	15.4
Net Profits to Sales	10.3	9.8	11.0

#: For companies reporting this item explicitly.
*: Other income excludes extraordinary income/expenditure if reported explicitly.
1. Growth rates are percentage changes in the level for the period under reference over the corresponding period of the previous for common set of companies.

Investment remained subdued in Q1 of 2012-13

II.7 Moderation in the cost of projects sanctioned by major banks/FIs for new corporate investment persisted during Q1 of 2012-13 (Table II.6). While the number of approvals declined sharply, there was a marginal increase in the envisaged cost of projects during the quarter. Industry-wise analysis of investment intentions reveals that the share of the power sector in the total planned investment was the highest (Chart II.2).

Chart II.2: Share of Industries in Planned Investment

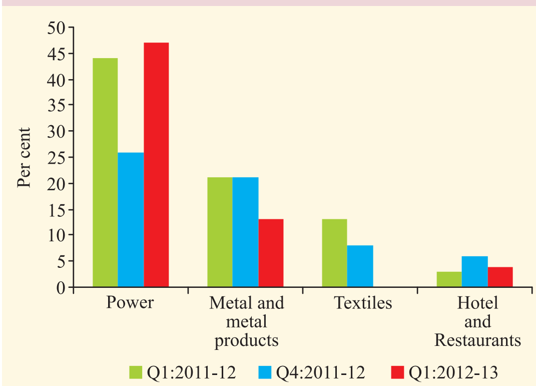


Table II.7: Central Government Finances during April-August 2012

(₹ billion)

Item	2011-12 (RE)	2012-13 (BE)	April-August Amount		Percentage to Budget Estimates		Growth Rate (Per cent)	
	(Amount)		2011-12	2012-13	2011-12	2012-13	2011-12	2012-13
1	2	3	4	5	6	7	8	9
1. Revenue Receipts (i+ii)	**7669.9**	**9356.9**	**1885.5**	**2227.3**	**23.9**	**23.8**	**-35.2**	**18.1**
i) Tax Revenue (Net)	6422.5	7710.7	1449.0	1750.6	21.8	22.7	4.6	20.8
ii) Non-Tax Revenue	1247.4	1646.1	436.6	476.7	34.8	29.0	-71.3	9.2
2. Non-Debt Capital Receipts	297.5	416.5	101.4	50.8	18.4	12.2	85.1	-49.9
3. Non-Plan Expenditure	8921.2	9699.0	3402.2	4174.0	41.7	43.0	9.3	22.7
of which								
i) Interest Payments	2756.2	3197.6	1002.4	1137.7	37.4	35.6	17.1	13.5
ii) Food Subsidies	728.2	750.0	282.2	451.0	46.6	60.1	-11.7	59.8
iii) Fertiliser Subsidies	672.0	609.7	263.1	377.1	52.6	61.8	20.0	43.3
iv) Petroleum Subsidies	684.8	435.8	10.3	396.1	4.4	90.9	20.5	-
4. Plan Expenditure	4266.0	5210.3	1320.0	1479.5	29.9	28.4	-3.3	12.1
5. Revenue Expenditure	11619.4	12861.1	4185.5	5001.7	38.1	38.9	7.0	19.5
6. Capital Expenditure	1567.8	2048.2	536.7	651.9	33.4	31.8	-5.1	21.5
7. Total Expenditure	**13187.2**	**14909.3**	**4722.2**	**5653.5**	**37.5**	**37.9**	**5.5**	**19.7**
8. Revenue Deficit	**3949.5**	**3504.2**	**2300.0**	**2774.4**	**74.9**	**79.2**	**129.2**	**20.6**
9. Gross Fiscal Deficit	**5219.8**	**5135.9**	**2735.2**	**3375.4**	**66.3**	**65.7**	**80.6**	**23.4**
10. Gross Primary Deficit	**2463.6**	**1938.3**	**1732.8**	**2237.7**	**119.6**	**115.4**	**163.3**	**29.1**

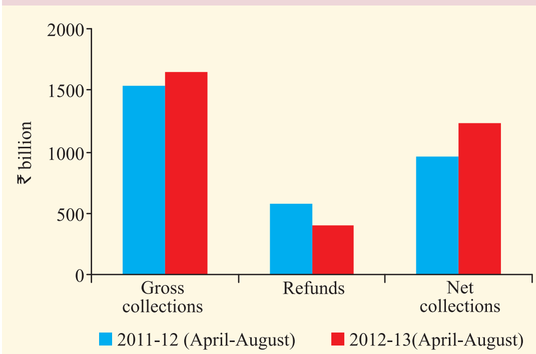
Source : Controller General of Accounts, Ministry of Finance.

Fiscal slippage likely in 2012-13, in spite of recent measures

II.8 The deficit indicators of the central government widened during 2012-13 (April-August) compared with the corresponding period of the previous year (Table II.7). There is a deviation from the projected fiscal consolidation path as the fiscal deficit during the first five months of 2012-13 comprised nearly two-thirds of the budget estimate for the year as a whole. On the current reckoning, the centre's gross fiscal deficit (GFD/GDP) ratio in 2012-13 is unlikely to see a significant improvement from that in the previous year. This underscores the need for taking further steps soon, in addition to the measures taken since mid-September 2012.

II.9 On the revenue side, the net collections under direct taxes improved during April-August 2012, with a growth rate higher than budgeted for the year, mainly reflecting lower refunds than a year ago (Chart II.3). The growth in indirect tax collections, however, has moderated during the period. Deceleration in industrial growth and foreign trade has affected collections under union excise duties and customs duties, respectively. Service tax revenue increased sharply over the period due to an increase in the service tax rates as well as the widening of the services tax base since

Chart II.3: Direct Tax Collections of Central Government



Source: Central Board of Direct Taxes, Ministry of Finance

July 2012. For the year as a whole, the gross tax-GDP ratio, is likely to be much lower than the budget estimates, reflecting the impact of slowdown in economic growth on tax collections.

II.10 Overall, there could be some shortfall in centre's revenue receipts. With regard to non-debt capital receipts, the government recently approved partial disinvestment of its equity holding in four public sector enterprises. Given the recent buoyancy witnessed in the stock markets, it may be possible to meet the budgetary target for disinvestment proceeds.

II.11 Total expenditure growth during 2012-13 (April-August) was higher than in the corresponding period of 2011-12 and the budgeted growth for 2012-13. The expenditure on subsidies was more than two-thirds of the budget estimates. For the year as a whole, a significant slippage in all three major subsidies – food, fertilisers and petroleum – is likely, resulting in higher than budgeted non-plan expenditure. Consequently, a cut-back in plan expenditure is envisaged to restrict the fiscal slippage.

II.12 The recent measures such as upward revision in diesel prices, restriction on subsidised LPG and levy of service tax on railway freight and passenger fares are steps in the right direction but further corrective measures are required to contain the fiscal deficit within sustainable limit. In this regard, the Committee on Roadmap for Fiscal Consolidation (Chairman: Dr. Vijay Kelkar) has made recommendations for policy interventions. The report set out the targets as well as the steps for course correction that need to be adhered to. In accordance with the stipulations of the amended Fiscal Responsibility and Budget Management Act, 2003, the government has placed before the Parliament in September 2012, the Medium Term Expenditure Framework Statement which sets out a three-year rolling target for the expenditure indicators, specifying the underlying assumptions and risks involved.

Subsidies remain high and likely to overshoot budget estimates

II.13 Notwithstanding the recent price revisions and quantitative restrictions in administered petroleum products, the required compensation for under-recoveries of OMCs is estimated to be higher than budget estimates. Though the government had budgeted for an absolute decline in the amount of fertiliser subsidy in 2012-13, these have already crossed the budget estimate for the year as a whole. The food subsidy in 2012-13, as per official sources, is estimated to be ₹924.9 billion, an increase of around 24 per cent over the budget estimates.

II.14 Rationalisation and reprioritisation of government expenditure is imperative for fiscal consolidation. Strategically, overall expenditure on subsidies needs to be restricted, and complemented with better targeting and distribution in accordance with policy priorities. Direct cash transfer of subsidies in food, fertilisers and petroleum will help towards subsidy reduction.

Financial restructuring of state distribution companies may have medium to long-term implications for state finances

II.15 The consolidated key deficit indicators of states are budgeted to improve in 2012-13 over 2011-12 (RE), reflecting the intent to carry forward fiscal consolidation in line with the recommendations of the Thirteenth Finance Commission (Table II.8). The consolidated revenue surplus for states is budgeted to increase in 2012-13, primarily through an increase in revenue receipts. The improvement in the revenue account is expected to reduce the fiscal deficit and primary deficit by 0.2 percentages points of GDP each and would also provide resources for higher capital outlay. The

Table II.8: Key deficit Indicators

(As per cent of GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal deficit	Outstanding Liabilities
1	2	3	4	5
		Centre		
2010-11	1.8	3.3	4.9	52.8
2011-12 RE	2.8 (2.7)	4.5 (4.3)	5.9 (5.8)	51.9
2012-13 BE	1.9	3.4	5.1	-
		States		
2010-11	0.5	-0.1	2.1	23.4
2011-12 RE	0.8	-0.1	2.3	22.5
2012-13 BE	0.6	-0.4	2.1	21.8
		Combined		
2010-11	2.4	3.2	6.9	66.0
2011-12 RE	3.6	4.4	8.2	65.6
2012-13 BE	2.6	3.0	7.1	-

RE: Revised Estimates. BE: Budget Estimates.

Note: 1. Minus (-) sign indicates surplus.
2. Outstanding liabilities of centre and combined includes external liabilities of the centre calculated at current exchange rates.
3. Figures in parentheses are provisional accounts.

Source: Budget documents of the Central and State governments.

revenue expenditure-GDP ratio is expected to decline by 0.1 percentage point in 2012-13. This will, however, be on account of lower growth in the development component, both social and economic services.

II.16 The recently announced scheme for financial restructuring of state distribution companies (discoms) proposes a strategy for their financial turnaround. As per the announced scheme, 50 per cent of the outstanding short-term liabilities of the discoms to lending institutions would be converted into bonds issued by the former, backed by state government guarantees. These bonds are to be taken over within 2-5 years and converted into special securities by the state governments. The restructuring/ rescheduling will be subject to state governments and discoms taking certain prior steps to improve the operational performance of the discoms. The financial restructuring plan will hence not have any immediate implications for state finances as there is a moratorium on repayment of the principal for three to five years and even the interest payment would be due only in the next fiscal. This will, however, have a medium- to long-term impact on the state finances.

Fiscal consolidation and boost to investment is key to growth revival

II.17 High fiscal deficit has impacted the macroeconomic climate and contributed to the investment downturn. A credible fiscal consolidation strategy is now on the anvil but needs to be backed by further measures. Overall demand conditions during 2012-13 have stayed depressed, due mainly to slack in investment. With a number of initiatives to address structural impediments and augment FDI, the investment climate should start improving. As the structural constraints facing investment get removed, there could be some revival in investment demand going forward.

III. THE EXTERNAL SECTOR

India's balance of payments (BoP), which had deteriorated sharply in 2011-12, showed some improvement in Q1 of 2012-13. The merchandise trade deficit in H1 of 2012-13 has remained at the same level compared to H1 of 2011-12, as fall in exports due to sluggish global demand was almost equally matched by import contraction mainly reflecting slowdown in domestic economic activity. This, coupled with the trend of falling surplus in services trade over the medium term, is likely to leave the current account deficit (CAD) too wide for comfort. CAD financing pressures can re-emerge in the face of event risks, although the recent policy measures announced by the government have helped boost portfolio inflows for now. The rupee strengthened on the back of these flows. Though external vulnerability indicators generally deteriorated in Q1 of 2012-13, India's net international investment position (NIIP) improved, largely due to valuation effects.

Global growth uncertainties continue to impinge on export growth

III.1 India's export growth, which had lost momentum in the second half of 2011-12, mainly owing to a slowdown in external demand, has shown further deterioration in 2012-13 so far (Table III.1). Exports contracted by 6.8 per cent in H1 of 2012-13, with the pace of decline turning more pronounced in Q2. This also shows that the expected positive effects of exchange rate depreciation on exports were muted by weak global demand in the more uncertain macroeconomic environment. Destination-wise data available up to August 2012 suggest that this uncertainty was particularly reflected in the considerable decline in exports to the euro area. Recently, growth in exports to China has also turned negative. Demand from other important export destinations, *viz.*, the US and the OPEC countries however, remained somewhat intact. Export demand from most other regional and

Table III.1: India's Merchandise Trade

(US$ billion)

Item		April–March				April-September			
		2010-11 (R)		2011-12 (P)		2011-12 (R)		2012-13 (P)	
		Value	Growth (%)	Value	Growth (%)	Value	Growth (%)	Value	Growth (%)
1		2	3	4	5	6	7	8	9
Exports		**251.1**	**40.5**	**304.6**	**21.3**	**154.1**	**40.4**	**143.7**	**-6.8**
Of which:	Oil	41.5	47.1	55.6	34.0	29.2	65.2	25.6	-12.3
	Non-oil	209.7	39.3	249.0	18.8	125.0	35.7	118.1	-5.5
	Gold	6.1	41.9	7.0	14.8	3.6	42.3	3.1	-13.8
	Non-Oil Non-Gold	203.5	39.1	242.0	18.9	121.4	35.5	115.0	-5.3
Imports		**369.8**	**28.2**	**489.4**	**32.4**	**243.5**	**38.1**	**232.9**	**-4.4**
Of which :	Oil	106.0	21.6	154.9	46.2	75.7	51.8	80.8	6.8
	Non-oil	263.8	31.1	334.5	26.8	167.9	32.7	152.1	-9.4
	Gold	40.5	41.6	56.2	38.8	28.4	62.7	19.1	-32.9
	Non-Oil Non-Gold	223.3	29.3	278.3	24.6	139.5	27.9	133.1	-4.6
Trade Deficit		**-118.6**		**-184.8**		**-89.4**		**-89.3**	
Of which:	Oil	-64.5		-99.3		-46.5		-55.2	
	Non-oil	-54.1		-85.5		-42.9		-34.0	
	Non-Oil Non-Gold	-19.8		-36.3		-18.1		-18.0	

R: Revised P: Provisional.
Source: DGCI&S.

non-traditional markets, in particular from Southeast Asia and Latin America, has moderated.

III.2 Major exporting sectors that have been significantly affected due to weak external demand include engineering goods, gems and jewellery, textile and textile products and petroleum products. Apart from sluggish external demand, the softening of international commodity prices, particularly metal prices, might also have contributed to the reduced value of exports from some of these sectors. Despite the measures taken to ease economic and financial conditions in the US and the euro area, the risk of a further worsening of global trade prospects continues. Against the backdrop of these uncertainties, achieving the export target of US$ 360 billion during 2012-13 looks challenging.

Import contraction, mainly due to slowdown in domestic growth

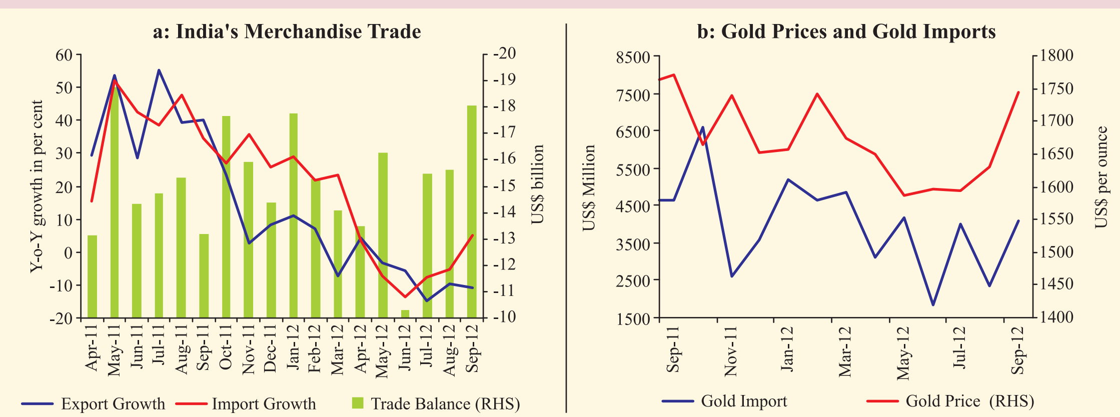
III.3 Imports contracted by 4.4 per cent during H1 of 2012-13, mainly reflecting subdued domestic economic growth coupled with depressed export prospects (Chart III.1). While the significant deceleration in economic activity helped keep the growth in petroleum, oil and lubricants (POL) imports at a moderate 6.8 per cent in H1 of 2012-13, non-oil imports declined by 9.4 per cent, largely led by significantly lower imports of gold. This possibly reflected the impact of a rise in customs duty, the policy to restrain gold loans by NBFCs and rupee depreciation. A decline in imports of export-related items and capital goods possibly indicates slowdown in export-oriented sectors and concerns relating to a slowdown in domestic investment.

III.4 With fall in exports being almost equally matched with fall in imports in value terms, India's merchandise trade deficit at about US$ 89 billion in H1 of 2012-13 was at the same level as in H1 2011-12. Going forward, with global oil prices for the Indian basket remaining firm, a reduction in the total oil import bill may be difficult. Further, export demand is likely to be constrained by deteriorating global growth prospects and decelerating global trade.

Low import and export elasticities prevent improvement of trade balance despite significant depreciation

III.5 Estimates show that the elasticity of India's non-oil exports to REER is around 0.4 with a lag of one year. This is essentially because of sizeable import content of exports and slower supply responses to price changes. Similarly, price elasticity of non-oil imports is estimated to be statistically insignificant as it includes price insensitive components like gold and also fertilisers which does not have full pass-through. Furthermore, price elasticity of net POL imports is only 0.1. Even though these estimates are sensitive to the estimation

Chart III.1: India's Merchandise Trade



methods, the time period used and the choice of variables, they indicate that the impact of depreciation of the exchange rate on India's exports and imports is low. Estimates assessing existence of 'J' curve effect show that changes in both overall trade balance (ratio of exports to imports) as also in the non-oil trade balance are statistically insignificant to REER movements.

Fall in trade deficit and higher secondary income led to lower CAD in Q1 of 2012-13

III.6 The impact of moderation in the trade deficit and improved net receipts on account of secondary income compared to Q1 of 2011-12, was discernible in a lower current account deficit in Q1 of 2012-13. Offsetting the impact of lower net receipts in services exports on CAD in Q1, secondary income, mainly representing private transfers, remained buoyant, perhaps encouraged by depreciation of the rupee. Nonetheless, the CAD-GDP ratio was marginally higher at 3.9 per cent in Q1 of 2012-13 compared with Q1 of 2011-12, mainly on account of lower nominal GDP in dollar terms partly due to depreciation of the rupee (Table III.2). Going forward, the trend in various components of services exports, particularly business services, and private transfers would largely depend on economic activities in trading partner countries and movement in the rupee exchange rate. Current indications are that CAD could widen again in Q2 of 2012-13.

Turnaround in FII flows may improve financing of CAD

III.7 Q2 of 2012-13 witnessed a turnaround in FII flows. While in Q1 of 2012-13, FIIs disinvested in the equity segment that were partially offset by their net investments in the

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

(US$ billion)

	2010-11 (PR)	2011-12 (P)	2011-12				2012-13
			Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (P)	Q1 (P)
1	2	3	4	5	6	7	8
1. Goods Exports	250.6	309.8	78.8	79.6	71.5	80.0	76.7
2. Goods Imports	381.1	499.5	123.7	124.1	120.1	131.7	119.2
3. Trade Balance (1–2)	-130.5	-189.7	-44.9	-44.5	-48.6	-51.7	-42.5
4. Services Exports	131.7	140.9	33.7	32.3	37.3	37.7	34.4
5. Services Imports	83.0	76.9	17.4	18.3	21.1	20.0	20.2
6. Net Services (4–5)	48.7	64.0	16.3	14.0	16.1	17.7	14.2
7. Goods & Services Balances (3+6)	-81.8	-125.7	-28.6	-30.5	-32.4	-34.0	-28.3
8. Primary Income (Net)	-17.3	-16.0	-3.6	-4.0	-3.8	-4.6	-4.9
9. Secondary Income (Net)	53.1	63.5	14.8	15.6	16.2	16.9	16.8
10.Net Income (8+9)	35.8	47.5	11.2	11.6	12.4	12.3	11.9
11.Current Account Balance (7+10)	-46.0	-78.2	-17.4	-18.9	-20.2	-21.7	-16.4
12.Capital Account Balance	0.04	-0.1	-0.3	0.2	0.1	-0.2	-0.2
13. Financial Account Balance	48.9	80.7	18.7	19.0	20.6	22.4	16.5
of which: Change in Reserves [(-) increase/ (+) decrease]	-13.1	12.8	-5.4	-0.3	12.8	5.7	-0.5
14. Errors & Omissions (11+12–13)	-3.0	-2.4	-0.9	-0.4	-0.5	-0.6	0.1
Memo : As a ratio to GDP							
15. Trade Balance	-7.7	-10.3	-9.8	-9.9	-10.7	-10.6	-10.0
16. Net Services	2.9	3.5	3.6	3.1	3.5	3.6	3.3
17. Net Income	2.1	2.6	2.4	2.6	2.7	2.5	2.8
18. Current Account Balance	-2.7	-4.2	-3.8	-4.2	-4.4	-4.5	-3.9
19. Capital and Financial Account, Net (Excl. changes in reserves)	3.7	3.7	5.2	4.4	1.7	3.4	4.0

Note: Total of subcomponents may not tally with aggregate due to rounding off.
PR: Partially Revised. P: Preliminary.

debt segment, FII investments in Q2 improved distinctly in both segments. There was a surge in portfolio inflows after the reform measures were initiated in mid-September 2012, with net FII investment of over US$ 5.5 billion in a month and a half. FDI flows to India moderated to US$ 10.7 billion during April-August 2012 compared with US$ 19.6 billion during April-August 2011 (Table III.3).

III.8 The strong FII inflows since mid-September 2012 are mainly the outcome of a perception change among foreign investors following policy measures announced by the government (refer to Table VII.1 for details).

III.9 Balance of payment (BoP) statistics for Q1 of 2012-13 show that, overall, capital flows were sufficient to finance the CAD as evident in the marginal accretion to India's foreign exchange reserves.

III.10 Among debt-creating flows, external commercial borrowings (ECBs) witnessed some recovery in Q2 of 2012-13 over the preceding quarter, but they remained substantially lower than Q2 of 2011-12. Despite the easing of policy measures with regard to ECBs in recent months, the Indian corporate sector seems to have shied away from raising ECBs, reflecting the rising risk aversion, as also the more limited demand for such funds given the rise in corporate leverage, and slack in investment demand. Given the exchange risk or hedging cost due to economic uncertainty, ECBs involve higher debt service cost in rupee terms for corporate borrowers. Flows under trade credit and NRI deposits have been robust so far. While rupee depreciation and deregulation/increase in interest rates accelerated the momentum in flows of NRI deposits in Q1, the pace of flows has moderated in recent months (Table III.4)

III.11 Going forward, capital inflows will depend on credible implementation of reform policies, including fiscal consolidation, and global economic conditions. The recent announcement of QE3 by the US Federal Reserve is likely to be positive for capital flows to emerging economies like India. Nevertheless, the weak global and domestic growth outlook coupled with euro area risks may create uncertainty that can heighten global risk aversion.

Table III.3: Capital Flows

(US$ billion)

Component	2011-12				2012-13	
	Q1	Q2	Q3	Q4	Q1	Q2
	Average of the monthly flows					
1	2	3	4	5	6	7
FDI in India	4.1	3.1	2.3	1.5	2.0	2.4*
FDI by India	1.0	1.0	0.6	1.0	0.7	0.3*
FIIs	0.8	-0.5	0.6	4.7	-0.6	2.6
ADRs/GDRs	0.1	0.1	0.03	0.01	0.01	0.03
ECB	1.0	1.6	1.1	0.6	0.2	0.3
NRI	0.4	0.9	1.1	1.6	2.2	0.2*

*: July–August.

Rupee exhibit strengthening bias on the back of FII inflows and QE

III.12 Subsequent to a depreciation of 7.1 per cent in Q1 of 2012-13 over Q4 of 2011-12 (on average basis), the rupee remained relatively weak against the dollar in July-August 2012, largely guided by external developments. Nevertheless, net FII inflows of over US$ 3.7 billion during this period helped the rupee move in a narrow range of ₹54.6 to 56.4 per dollar. However, since the second week of September 2012, the rupee has shown recovery against the US dollar. This followed the announcement of QE3 by the US Federal Reserve that has since weakened the US dollar in the global currency markets, as also the surge in capital inflows to India following its reforms measures. Since October 8, 2012 however, rupee has weakened mainly due to demand for dollar by oil importing firms. Reflecting the trend in rupee in nominal terms, the REER based on 6-currency and 36-currency as on October 19, 2012 showed a depreciation of 4.1 per cent and 3.2 per cent, respectively, over end-March 2012 (Table III.5).

Table III.4: Disaggregated Items of Financial Account

(US$ billion)

	2010-11 (PR)	2011-12 (P)	2011-12 Q1 (PR)	2011-12 Q2 (PR)	2011-12 Q3 (PR)	2011-12 Q4 (P)	2012-13 Q1 (P)
1	2	3	4	5	6	7	8
1. Direct Investment (net)	**9.4**	**22.1**	**9.3**	**6.5**	**5.0**	**1.4**	**4.2**
1.a Direct Investment to India	25.9	33.0	12.4	9.5	6.9	4.2	6.2
1.b Direct Investment by India	-16.5	-10.9	-3.1	-3.0	-1.9	-2.9	-2.0
2. Portfolio Investment	**28.2**	**16.6**	**2.3**	**-1.4**	**1.8**	**13.9**	**-2.0**
2.a Portfolio Investment in India	29.4	16.8	2.5	-1.6	1.9	14.1	-1.7
2.b Portfolio Investment by India	-1.2	-0.2	-0.2	0.2	-0.04	-0.2	-0.3
3. Financial Derivatives & Employee Stock Options	–	–	–	–	–	–	**-0.5**
4. Other Investment	**24.4**	**29.2**	**12.6**	**14.2**	**1.0**	**1.4**	**15.3**
4.a Other equity (ADRs/GDRs)	2.0	0.6	0.3	0.2	0.1	0.03	0.1
4.b Currency and deposits	3.8	12.1	1.2	3.1	3.2	4.6	6.5
Deposit-taking corporations, except the central bank: (NRI Deposits)	3.2	11.9	1.2	2.8	3.3	4.7	6.6
4.c Loans*	18.6	16.8	14.9	9.5	-7.7	-0.03	3.8
4.c.i Loans to India	18.3	15.7	14.9	8.9	-8.1	-0.02	3.7
Deposit-taking corporations, except the central bank	1.2	4.1	11.5	3.9	-8.7	-2.6	3.0
General government (External Assistance)	5.0	2.5	0.4	0.3	1.4	0.3	-0.1
Other sectors (ECBs)	12.2	9.1	3.0	4.7	-0.8	2.3	0.8
4.c.ii Loans by India	0.3	1.0	-0.02	0.6	0.5	-0.01	0.1
General government (External Assistance)	-0.03	-0.2	-0.04	-0.04	-0.04	-0.04	-0.1
Other sectors (ECBs)	0.3	1.2	0.02	0.6	0.5	0.03	0.1
4.d Trade credit and advances	11.0	6.7	3.1	2.9	0.6	0.2	5.4
4.e Other accounts receivable/payable - other	-11.1	-6.9	-6.8	-1.5	4.9	-3.3	-0.4
5. Reserve Assets	**-13.1**	**12.8**	**-5.4**	**-0.3**	**12.8**	**5.7**	**-0.5**
Financial Account (1+2+3+4+5)	**48.9**	**80.7**	**18.7**	**19.0**	**20.6**	**22.4**	**16.5**

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

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

(Variations in Per cent, appreciation+/depreciation-)

	Index Oct 19, 2012 (P)	Y-o-Y Variation (Average) 2011-12	2012-13 (Oct 19, 2012 over end-Mar 2012)
1	2	3	4
36-REER	92.3	-3.2	-3.2
36-NEER	79.4	-6.4	-4.3
30-REER	84.7	-2.9	-2.4
30-NEER	81.5	-5.4	-4.4
6-REER	105.1	-6.8	-4.1
6-NEER	76.3	-7.9	-4.5
₹/US$ (Average)	54.5	-4.9	-12.0#
₹/US$ (end-March)	53.7*	-12.7	-4.8*

NEER: Nominal Effective Exchange Rate.
REER: Real Effective Exchange Rate.
P: Provisional. *: As on October 19, 2012.
#: April-October 19, 2012 over April 2011-March 2012.
Note: Rise in indices indicates appreciation of the rupee and *vice versa*.

External debt increased moderately due to valuation gains

III.13 India's external debt registered an increase of 1.1 per cent on a q-o-q basis as at end-June 2012, primarily on account of a rise in non-resident external rupee-denominated deposits (NRE), reflecting the impact of deregulation of interest rates of these deposits in December 2011. Short-term trade credit witnessed a significant increase, due to higher utilisation of credit by oil companies because of the rise in international oil prices during the quarter. A noticeable aspect of the composition of external debt was that the stock of external commercial borrowings recorded a marginal decline due to higher repayments during the quarter (Table III.6).

Table III.6: India's External Debt

(US$ billion)

Item	End-Mar 2011 (PR)	End-Jun 2011 (PR)	End-Mar 2012 (PR)	End-Jun 2012 (QE)	Per cent Variation (5) over (4)
1	2	3	4	5	6
1. Multilateral	48.5	49.4	50.5	49.8	-1.4
2. Bilateral	25.7	26.2	26.7	27.2	1.9
3. IMF	6.3	6.4	6.2	6.0	-3.2
4. Trade Credit (above 1 year)	18.6	18.7	19.0	19.1	0.6
5. ECBs	88.6	92.7	105.2	104.8	–0.4
6. NRI Deposits	51.7	52.9	58.6	60.9	3.9
7. Rupee Debt	1.6	1.6	1.4	1.2	-14.3
8. Long-term (1 to 7)	240.9	247.7	267.5	269.1	0.6
9. Short-term	65.0	68.5	78.2	80.5	2.9
Total (8+9)	**305.9**	**316.2**	**345.7**	**349.5**	**1.1**

PR: Partially Revised. QE: Quick Estimates.

III.14 The CAD during Q1 of 2012-13 was largely financed through debt flows, with continued uncertainty in the global economy affecting the quantum of equity flows. However, the magnitude of increase in external debt was lower than that of the preceding quarter largely due to valuation gains of US$ 7.9 billion during Q1 resulting from appreciation of the US dollar against the Indian rupee and other international currencies. Thus, excluding the valuation gains, the stock of external debt as at end-June 2012 would have increased by 11.8 billion.

External vulnerability indicators witnessed deterioration, but remain comparable with peers

III.15 There was some deterioration in the major indicators considered for assessing the vulnerability of the external sector in Q1 of 2012-13 (Table III.7). Key indicators of external sector vulnerability, such as debt-GDP ratio, short-term debt as per cent to total debt as well as to foreign exchange reserves and import cover, deteriorated as at end-June 2012 compared to end-March 2012.

III.16 India's NIIP as represented by net international liabilities, improved to US$ 220.3 billion at end-June 2012 from US$ 244.2 billion at end-March 2012. Accordingly, the NIIP/GDP ratio at end-June 2012 declined compared with that at end-March 2012. The improvement in NIIP was essentially on account of the valuation changes emanating from exchange rate movements (Table III.8).

Table III.7: External Sector Vulnerability Indicators

(Ratios in per cent)

Indicator	End-Mar 2011	End-Mar 2012	End-Jun 2012
1	2	3	4
Ratio of Total Debt to GDP	17.8	20.0	21.7
Ratio of Short-term to Total Debt (Original Maturity)	21.2	22.6	23.0
Ratio of Short-term to Total Debt (Residual Maturity)	42.2	42.6	42.9
Ratio of Concessional Debt to Total Debt	15.5	13.9	13.5
Ratio of Reserves to Total Debt	99.6	85.2	82.9
Ratio of Short-term Debt to Reserves	21.3	26.6	27.8
Reserves Cover of Imports (in months)	9.6	7.1	7.0
Reserves Cover of Imports and Debt Service Payments (in months)	9.1	6.8	6.6
Debt-Service Ratio (Debt Service Payments to Current Receipts)	4.3	6.0	5.9
External Debt (US$ billion)	305.9	345.7	349.5

III.17 Historical data suggests some improvement in the major indicators of external vulnerability, such as foreign exchange reserves to total debt ratio, short-term debt to foreign exchange reserves and external debt to GDP ratio over the past two decades (Chart III.2). However, more recently, there has been some deterioration in these indicators. Short-term debt to total debt ratio has risen since 2004-05. Moreover, in the recent years, while the ratio of foreign exchange reserves to total debt has declined, the ratio of short-term debt to foreign exchange reserves has increased. These trends are a matter of concern although foreign exchange reserves provide a cushion.

III.18 A cross-country analysis highlights the relatively robust position of India compared with

Chart III.2: External Vulnerability Indicators: India

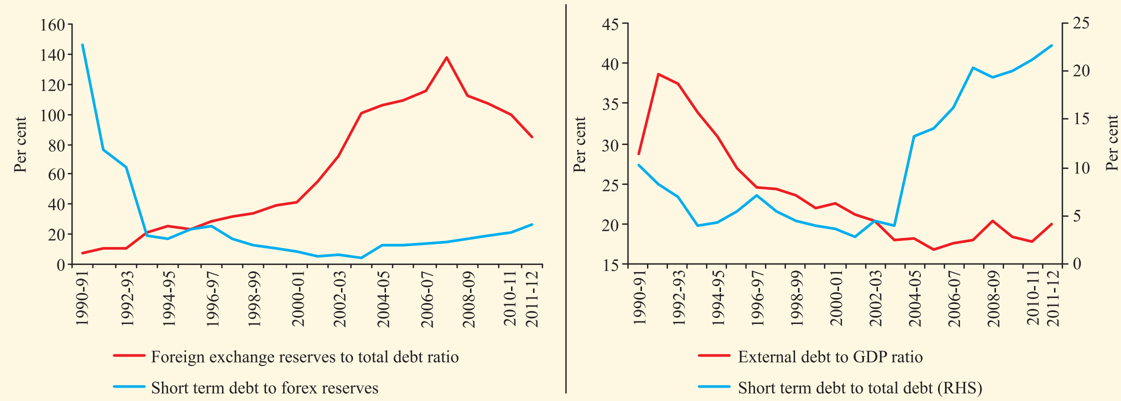


Table III.8: Overall International Investment Position of India

(US$ billion)

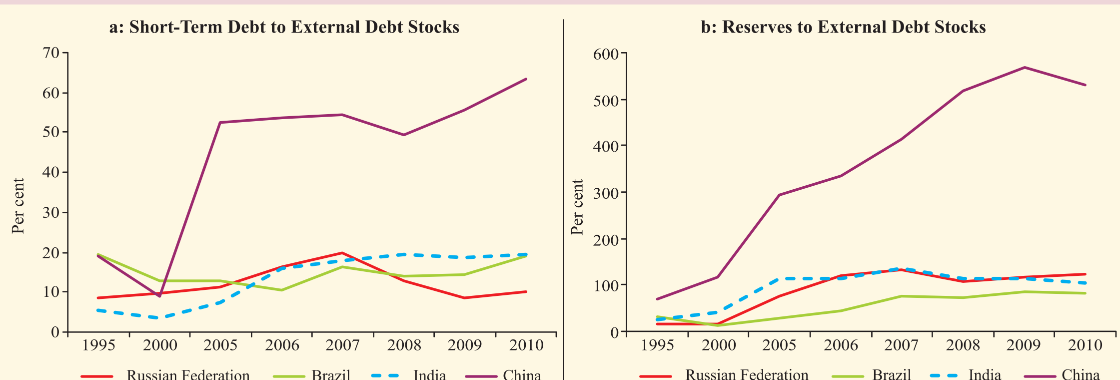
Period	Mar-11 (PR)	Jun-11 (PR)	Sep-11 (PR)	Dec-11 (PR)	Mar-12 (PR)	Jun-12 (P)
1	2	3	4	5	6	7
Net IIP	-203.6	-216.1	-196.0	-204.7	-244.2	-220.3
Assets	439.8	450.0	453.9	431.6	437.1	433.5
Liabilities	643.4	666.1	649.8	636.2	681.3	653.9
Net IIP-GDP Ratio*	-12.1	-12.2	-10.7	-11.1	-13.2	-12.2

* Based on annualised GDP. PR: Partially Revised.
P: Preliminary.

other indebted developing countries. According to the Global Development Finance Report, 2012, in terms of ratio of external debt to GNI at end-2010, India's position was the fifth lowest among the top 20 developing debtor countries. In terms of short-term to total external debt stock, as also foreign exchange reserves to external debt stocks, India's position is comparable to other BRIC countries, except China. Even though China's short-term debt to total external debt ratio is very high, its foreign exchange reserves are also high, thus providing adequate cover (Chart III.3).

III.19 In sum, India's external sector faces some sustainability issues that emanate from large current account imbalances. Although reserves coverage and manageable external debt provide some comfort, macro-financial policies aimed at lowering inflation, containing demand by more restrained fiscal spending, improving trade competitiveness through structural and other policies and the direct use of trade policy measures would be needed for medium-term sustainability.

Chart III.3: External Vulnerability Indicators: BRIC Countries



Source : Global Development Finance, World Bank, 2012

IV. MONETARY AND LIQUIDITY CONDITIONS

Liquidity conditions have eased during 2012-13, as a result of calibrated and pre-emptive measures, which include OMO purchases and reduction in both the SLR and the CRR. The Reserve Bank also front loaded a reduction in its repo rate by 50 basis points in April 2012. However, with inflation remaining high, it has kept the policy rate unchanged since then. While the reserve money growth decelerated and broad money growth remained steady in Q2 of 2012-13, the aggregate deposit and non-food credit growth have been below the indicative trajectory. Going forward, the secondary impact of the CRR cut, appropriate liquidity conditions and seasonal pick-up in credit demand are expected to influence the monetary aggregates, while the trajectory of the monetary cycle will be shaped by evolving growth-inflation dynamics.

Reserve Bank injects liquidity to support credit flow, while calibrating monetary policy on growth-inflation dynamics

IV.1 The Reserve Bank has calibrated monetary policy in line with evolving growth-inflation dynamics. Without fundamentally changing its policy stance that has primarily sought to contain inflation and inflation expectations over the past two years, it has been ensuring that liquidity conditions do not tighten excessively. As a result of the infusion of liquidity through CRR cuts of 125 bps in Q4 of 2011-12 and again by 25 bps in September 2012 (Table IV.1), coupled with over ₹800 billion of liquidity infusion through outright open market purchases during 2012-13 so far, liquidity conditions have remained easier in 2012-13 as compared with 2011-12. Besides, the Reserve Bank lowered the Statutory Liquidity Ratio (SLR) by 100 bps with effect from August 11, 2012 – a measure that was expected to support private credit. It also front-loaded a 50 bps policy rate cut in April, in anticipation of measures supportive of fiscal consolidation that have been partly taken in September 2012 (Chart IV.1).

Table IV.1: Movements in Key Policy Variables

(Per cent)

Effective	Repo Rate	Cash Reserve Ratio	Statutory Liquidity Ratio
1	2	3	4
May 3, 2011	7.25 (+0.50)	6.00	24.0
June 16, 2011	7.50 (+0.25)	6.00	24.0
July 26, 2011	8.00 (+0.50)	6.00	24.0
September 16, 2011	8.25 (+0.25)	6.00	24.0
October 25, 2011	8.50 (+0.25)	6.00	24.0
January 28, 2012	8.50	5.50 (-0.50)	24.0
March 10, 2012	8.50	4.75 (-0.75)	24.0
April 17, 2012	8.00 (-0.50)	4.75	24.0
August 11, 2012	8.00	4.75	23.0 (-1.00)
September 22, 2012	8.00	4.50 (-0.25)	23.0

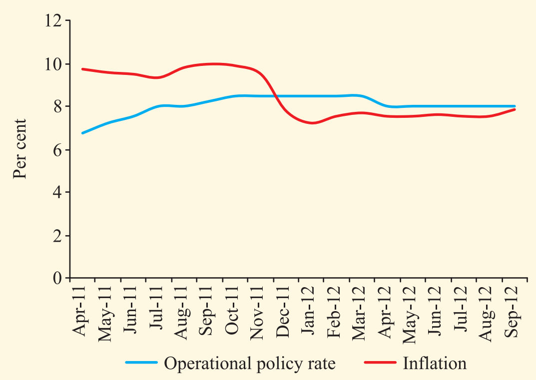
Note : 1. Repo indicates injection of liquidity.
2. Figures in parentheses indicate change in the key rates in percentage points.

IV.2 Active liquidity management through CRR, OMO and SLR has kept liquidity largely in line with the policy objective that factored in the persistence of inflation at a substantially higher than the Reserve Bank's comfort level as well as the need to ensure that supply of credit is not a constraining factor for productive needs.

Conditions transit back to a phase of comfortable liquidity

IV.3 Since 2011-12, the liquidity conditions can be broadly divided into three distinct phases. After remaining within the Reserve Bank's comfort zone during the first phase from April 2011 to October 2011, the liquidity deficit crossed the one per cent of NDTL level (Chart IV.2). This large liquidity deficit was mainly caused by forex intervention and increased divergence between credit and deposit growth. The deficit conditions were further

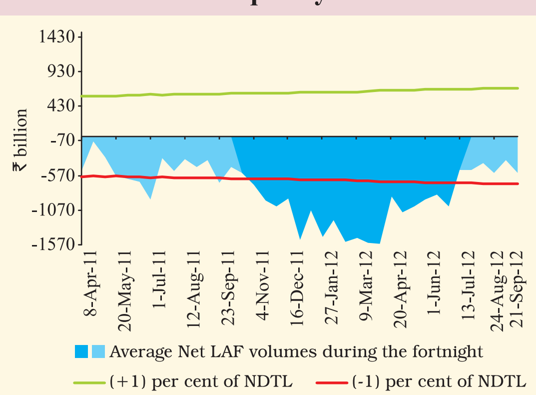
Chart IV.1: Operational Policy Rate and Inflation



aggravated by frictional factors like the build-up of government cash balances with the Reserve Bank that persisted longer than anticipated and the increase in currency in circulation.

IV.4 The Reserve Bank had to actively manage liquidity to provide greater liquidity cushion to the financial system, while at the same time guarding against the risk of resurgence of inflationary pressure. Consequently, liquidity conditions eased significantly in Q1 of 2012-13 and the extent of the deficit mostly returned to the Reserve Bank's comfort level from July 2012, marking the onset of the third phase. Three major factors that contributed to this turnaround in Q2 of 2012-13 were the injection of liquidity by way of open market operations (OMOs), decline in currency in circulation and a decline in government cash balances with the Reserve Bank. The increased use of the export credit refinance facility by banks after the increase in its limit announced in the Mid-Quarter review of June 2012 and the one per cent reduction in the SLR announced on July 31, 2012 also helped in improving liquidity conditions.

Chart IV.2: Liquidity Conditions

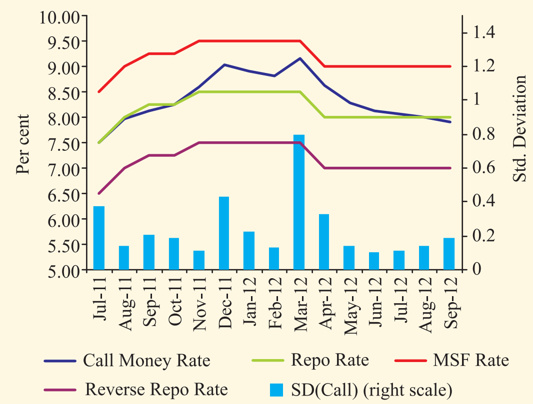


Note: Negative LAF Volumes indicate injection of liquidity.

IV.5 Liquidity conditions improved significantly in July 2012 compared with June 2012, with average daily net liquidity injection under LAF declining to around ₹480 billion, which further declined marginally in August 2012. The first half of September saw a significant decline in liquidity injection, mainly on account of a decline in the government's cash balances. Anticipating possible pressure on liquidity in the subsequent period on account of advance tax payment, seasonal pickup in the credit demand and transitional pressure arising from the currency demand during the festive season, the Reserve Bank, in September 2012 reduced the CRR by 25 basis points, which resulted in around ₹170 billion of primary liquidity injection into the banking system. With advance tax outflows from the banking system, the average daily net liquidity injection increased to more than ₹700 billion in the second half of September 2012, which was less than the quarterly spikes generally associated with advance tax collections. There was no auction purchase under outright open market operation (OMO) in Q2 of 2012-13, although there were purchases of government securities through the NDS-OM trading platform.

IV.6 The liquidity deficit eased in the first week of October 2012, but it has increased once again from the second week of the month. With less than usual front loading by the banks, the spike was mainly on account of banks' demand for reserve requirements coupled with the rise in government's surplus with the Reserve Bank. The average daily net liquidity injection under the LAF was around ₹580 billion during October 1-24, 2012.

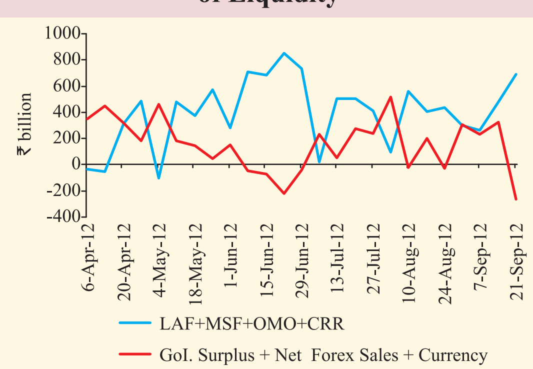
Chart IV.3: LAF Corridor and Call Rate



IV.7 Overall, the liquidity stress in the banking system declined in Q2 of 2012-13. This was evident from the lower recourse to the marginal standing facility (MSF) by banks during this period. Despite the advance tax outflows and the increase in borrowing limit under MSF from April 2012, the SCBs did not avail of MSF in September 2012. Moreover, the monthly average call rate, which hovered between the repo rate and the MSF rate during November 2011-July 2012, declined subsequently and has mostly hovered below the repo rate since August 2012. Further, there was a sharp decline in volatility in the call rate in this financial year so far, as measured by the standard deviation of the rate movements in a month (Chart IV.3).

IV.8 In general, the calibrated liquidity management of the Reserve Bank (Chart IV.4) has addressed three crucial contemporaneous challenges, which include facilitating credit flows, ensuring smooth policy transmission and smoothing operational rate. Appropriate liquidity management provided a liquidity cushion to facilitate credit flows to the productive sectors of the economy. It, on the other hand, ensured that the drawls under the Liquidity Adjustment Facility (LAF) broadly remained within the indicative target of (+/–) 1 per cent of NDTL, thereby facilitating monetary policy transmission; and finally, the decline in volatility in the money market rate captured the central banks' tendency to smooth operational interest rate in line with an optimal monetary policy framework.

Chart IV.4: Drivers and Management of Liquidity



Note: (+) injection, (-) absorption.

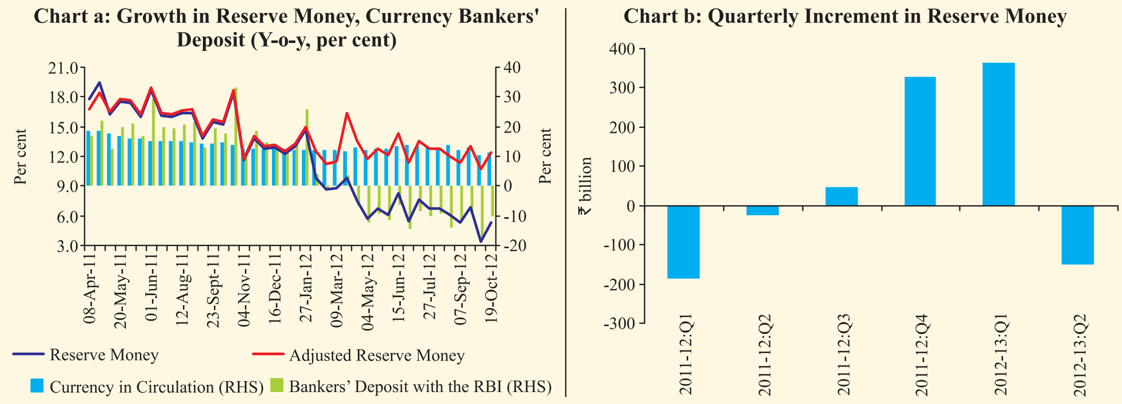
Reserve money decelerated in Q2 of 2012-13

IV.9 There was marked deceleration in reserve money during Q2 of 2012-13. On the component side, while the currency in circulation growth (y-o-y) decelerated, the growth in banker's deposit (y-o-y) with the Reserve Bank declined and remained negative in the financial year so far. This decline in bankers' deposits mainly reflects the reduction in impounded liquidity and, thus, the easing of liquidity conditions as envisaged by the 150 basis point CRR reductions since January 2012. The CRR adjusted reserve money (y-o-y) growth remained relatively stable and hovered around 12.5 in the financial year so far, although it remained below the 16.5 per cent level recorded during the comparable period in 2011-12 (Chart IV.5 and Table IV.2).

Broad money grew steadily in Q2 of 2012-13 but remained below the indicative trajectory

IV.10 During this financial year so far, the money supply (y-o-y) growth hovered around 13.6 per cent. While the deceleration in reserve money contributed to the lower broad money growth, the countervailing increase in the money multiplier, especially in Q2 of 2012-13, has contributed to steadying the monetary

Chart IV.5: Deceleration in Reserve Money



expansion. In Q2 of 2012-13, the increase in money multiplier has been driven by reductions in the currency-deposit ratio and the aggregate deposit to bankers' deposit ratio. With a CRR cut effective from the fortnight beginning September 22, 2012, there was a further reduction in the banker's deposit to aggregate deposit ratio, which lead to an increase in the money multiplier (Chart IV.6).

Aggregate deposit and credit growth decelerated

IV.11 On the component side, the year-on-year aggregate deposit growth has decelerated. It mainly reflected the underlying trend in time deposits, which constitute around 90 per cent of the aggregate deposit. The moderation in the net financial saving rate of the household sector during 2011-12 partially reflected the slower growth in households' holding of bank deposits. Moreover, low real interest rates in time deposits and relatively high rate of returns in alternate assets (*e.g.,* gold) might explain some part of the deceleration in time deposits (Chart IV.7). The sharp decline in aggregate deposits at end-Q2 could be due to the decline in deposit rates announced by various banks from September 7, 2012 as well as the advance tax

Table IV.2: Monetary Indicators

Item	Outstanding Amount (₹ billion) October 05, 2012	FY variations (per cent)		Y-o-Y Variations (per cent)	
		2011-12	2012-13	October 07, 2011	October 05, 2012
1	2	3	4	5	6
Reserve Money (M_0)*	**14,627.4**	**0.9**	**2.5**	**18.4**	**5.3**
Reserve Money (Adjusted)*		**0.9**	**3.5**	**18.7**	**12.4**
Broad Money (M_3)	**79,118.8**	**7.4**	**7.5**	**16.6**	**13.3**
Main Components of M_3					
Currency with the Public	10,545.0	4.2	2.7	13.9	11.0
Aggregate Deposits	68,554.8	7.9	8.3	17.1	13.7
of which: Demand Deposits	6,926.5	–9.1	–1.7	–2.8	5.4
Time Deposits	61,628.2	10.4	9.6	20.1	14.7
Main Sources of M_3					
Net Bank Credit to Govt.	25,795.8	9.5	8.9	23.7	18.8
Bank Credit to Commercial Sector	51,696.0	5.6	4.2	19.4	15.6
Net Foreign Assets of the Banking Sector	15,462.2	11.0	0.2	14.9	0.0

Note: 1. Data are provisional.
2. *: Data pertain to October 19, 2012.

Chart IV.6: Money Supply and the Reserve Money Growth (Y-o-y) and Money Multiplier

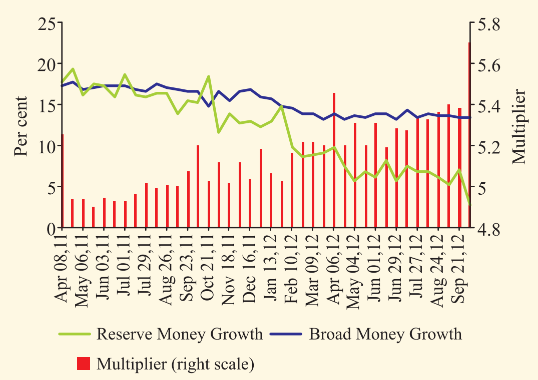
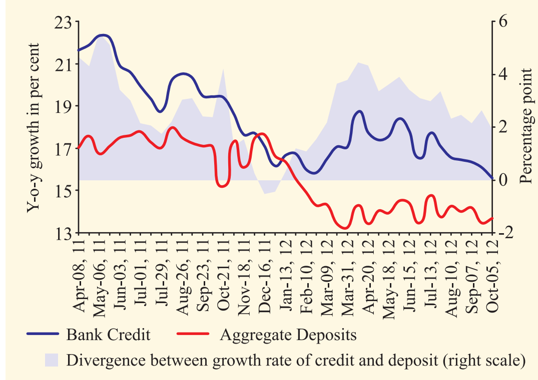


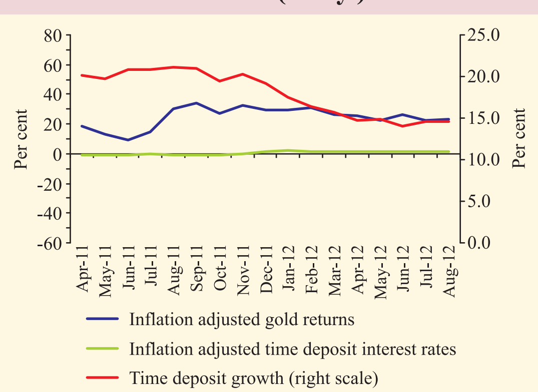
Chart IV.8: Wedge between Bank Credit and Aggregate Deposit



outflow from the banking system. Following the seasonal pattern, the currency with the public also declined in Q2 of 2012-13.

IV.12 Non-food credit growth, which had generally increased during Q1 of 2012-13, has decelerated in Q2. This has been mainly due to the slack investment demand and slowdown in the credit-intensive manufacturing sector. The increased risk perception of banks could also have played a role in the low bank credit disbursement. Despite the positive wedge between the y-o-y growth in credit and aggregate deposit, the wedge between the two narrowed in Q2 compared to Q1 of 2012-13. The decline in the divergence between these growth rates helped contain one of the structural factors causing deficit liquidity in the banking system during Q2 of 2012-13 (Chart IV.8).

Chart IV.7: Real Return and Time Deposit Growth (Y-o-y)



IV.13 There was a deceleration in credit growth (y-o-y) for all SCBs at end-September 2012. At the bank-group level, the deceleration was particularly sharp for the public sector banks (PSBs). As PSBs are the largest lenders in terms of outstanding credit, deceleration in their credit growth pulls down the overall credit expansion of all SCBs taken together. The credit growth of the foreign banks registered an even sharper deceleration. Private sector banks, which registered strong credit growth in the comparable period last year, continued to witness a robust credit growth (Table IV.3).

IV.14 The deceleration in the credit growth reflected the slack investment demand, slowing economic activity and more importantly, deteriorating credit quality, especially in the case of PSBs. The ratio of gross non-performing assets (NPAs) to gross advances and the net NPA to net advances that had increased significantly during 2011-12, rose further in Q1 of 2012-13 across the bank groups (Table IV.4). The increases in these ratios were maximum for the PSBs, which account for the major part of the bank advances. The slippage ratio that indicates the fresh NPAs increased across the sectors signalling additional stress in the banking sector. Restructuring of standard assets also increased significantly for PSBs during Q1 of 2012-13. Deterioration in the assets quality and in the macroeconomic conditions resulted

Table IV.3: Credit Flow from Scheduled Commercial Banks

Item	Outstanding As on Oct. 05,2012* Amount (₹ billion)	Variation (y-on-y)			
		As on Oct. 07, 2011		As on Oct. 05, 2012*	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1. Public Sector Banks*	34,994.5	4,695.7	18.3	4,616.0	15.2
2. Foreign Banks	2,351.4	459.0	26.2	137.1	6.2
3. Private Sector Banks	9,490.4	1,456.4	22.7	1,622.7	20.6
4. All Scheduled Comm. Banks@	48,093.9	6,766.1	19.5	6,597.2	15.9

*Excluding RRBs in public sector banks. @ Includes RRBs.

in added risk aversion in the banking sector. This led to a portfolio switch from credit creation to investments in G-secs on the back of large government market borrowing. The SCBs were holding around 28 per cent of their NDTL in SLR investments at end-September 2012.

IV.15 An analysis of sectoral deployment of credit based on data from select banks (which cover 95 per cent of total non-food credit extended by all SCBs) for September 2012 reveals that the non-food bank credit growth (y-o-y) to industries, services and personal loans decelerated compared with the previous year. The year-on-year bank credit growth to industry at 15.6 per cent in September 2012 decelerated considerably, from 22.9 per cent in September 2011. Deceleration in credit growth to industry was observed in all the major sub-sectors, barring chemical and chemical products, cement and cement products, and paper and paper products.

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

IV.16 The total flow of financial resources to the commercial sector during 2012-13 (up to October 5, 2012) has marginally declined when compared to the corresponding period in the previous year. Though the decline in flow has been accounted for by both bank and non-bank sources, the flow from non-banks has remained an important source of financing to the commercial sector (Table IV.5). Among the non-bank sources, funds from domestic sources have witnessed an increase this financial year so far, mainly due to the higher issuance of commercial papers and increase in net credit by housing finance companies (HFCs). Foreign sources of funding (up to September 2012), however, declined compared with the previous

Table IV.4: Bank Group-wise NPA Ratios

Bank Group	March 2012					June 2012				
	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	3.17	1.47	2.95	5.74	13.23	3.57	1.75	3.49	6.67	12.78
Foreign Banks	2.68	0.61	2.35	0.10	16.74	2.90	0.83	2.43	0.08	15.72
New Private Sector Banks	2.18	0.44	1.17	1.06	16.66	2.19	0.45	1.31	1.06	16.11
Old Private Sector Banks	1.80	0.59	0.01	3.42	14.12	1.92	0.61	0.02	3.83	13.82
All Banks *	2.94	1.24	2.60	4.69	14.24	3.25	1.45	3.04	5.37	13.74

Source: Latest updated OSMOS database. * Includes LABs.
Based on the data collected from banks for special analysis. Jun-12 figures of slippage ratio are annualised.

Table IV.5: Flow of Financial Resources to the Commercial Sector

(₹ billion)

Item	April-March		April 1 to Oct. 5	
	2010-11	2011-12	2011-12	2012-13
1	2	3	4	5
A. Adjusted Non-food Bank Credit (NFC)	**7,110**	**6,764**	**2,296**	**2,138**
i) Non-Food Credit	6,815	6,525	2,086	1,871
of which: petroleum and fertiliser credit	*-243*	*171*	*16*	*-94* ^
ii) Non-SLR Investment by SCBs	295	239	210	268
B. Flow from Non-banks (B1+B2)	**5,341**	**5,717**	**2,714**	**2,586**
B1. Domestic Sources	***3,011***	***3,413***	***1,066***	***1,351***
1. Public issues by non-financial entities	285	45	40	63
2. Gross private placements by non-financial entities	674	558	-	-
3. Net issuance of CPs subscribed to by non-banks	68	100	705	894 +
4. Net credit by housing finance companies	428	530	111	182 *
5. Total gross accommodation by the four RBI regulated AIFIs - NABARD, NHB, SIDBI & EXIM Bank	400	469	86	71 &
6. Systemically important non-deposit taking NBFCs (net of bank credit)	795	1291P	-	-
7. LIC's gross investment in corporate debt, infrastructure and social sector	361	419	125	141 ^
B2. Foreign Sources	***2,330***	***2,304***	***1,648***	***1,235***
1. External Commercial Borrowings / FCCBs	555	421	351	217 &
2. ADR/GDR Issues excluding banks and financial institutions	92	27	13	9 ^
3. Short-term credit from abroad	502	306	137	291 #
4. Foreign Direct Investment to India	1,181	1,550	1,147	718 ^
C. Total Flow of Resources (A+B)	**12,451**	**12,481**	**5,010**	**4,724**
Memo Item:				
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	-367	-185	34	500 &

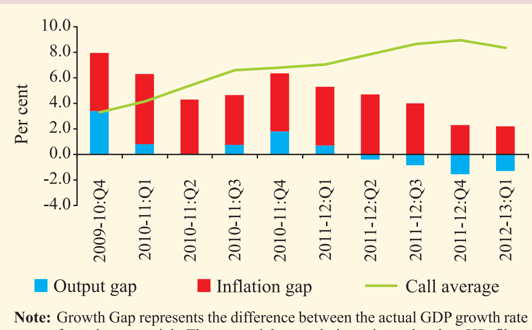
P : Provisional. &: Up to end September 2012. ^: Up to August 2012. #: Up to June 2012.
+: September 24, 2012. *: Up to July 2012. -: Not Available.

year, mainly on account of a decline in external commercial borrowings/ FCCBs and decline in foreign direct investment in India.

Monetary and liquidity conditions evolving with growth-inflation dynamics

IV.17 The movement of operational target (weighted average call rate) that tracks the policy rate has evolved in line with output and inflation gaps (Chart IV.9). Though the monetary policy was tightened due to large inflation gap, the economic slowdown could be attributed to several other factors apart from monetary tightening (see Chapter I). Despite appropriate liquidity conditions prevailing over most of Q2 2012-13, the deceleration in non-food credit growth partly suggests exogenous or non-monetary factors like slack global demand and increased risk aversion.

Chart IV.9: Call Rate, Output Gap and Inflation Gap



Note: Growth Gap represents the difference between the actual GDP growth rate from its potential. The potential growth is estimated using HP filter. Inflation gap represents the difference between the quarterly inflation from comfort level of five per cent.

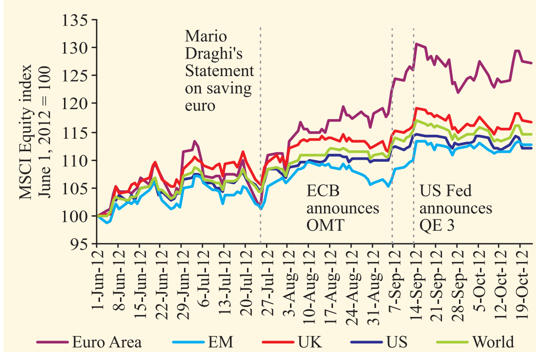
V. FINANCIAL MARKETS

The sovereign debt overhang continued to cause strains in global financial markets. Significant monetary easing measures in the advanced economies ameliorated conditions temporarily, but credit and liquidity risks are still high. On the domestic front, the recently announced policy reform measures have induced investor optimism and led to enhanced market activity. The rupee witnessed a short spell of appreciation following the policy initiatives, though it somewhat weakened in recent weeks. However, the primary capital market, which still remains subdued, is unable to provide capital-raising options, and bring down the leverage ratios for firms to revive investments.

Central banks' actions revive sentiments, but risks remain

V.1 Global financial markets, which had undergone renewed turmoil for most part of Q1 of 2012-13, witnessed reduced stress since end-July. This followed the ECB President's statement on July 26, 2012 - that within its mandate, the ECB is ready to do whatever it takes to preserve the euro. Later, equity markets rallied in the financial markets following the September 2012 announcements of "sterilised" outright monetary transactions (OMT) by the ECB and an "open-ended" quantitative easing (QE-3) by the Fed (Chart V.1). The €500 billion permanent bailout fund, the European Stability Mechanism (ESM), launched on October 8, 2012, further boosted market sentiments.

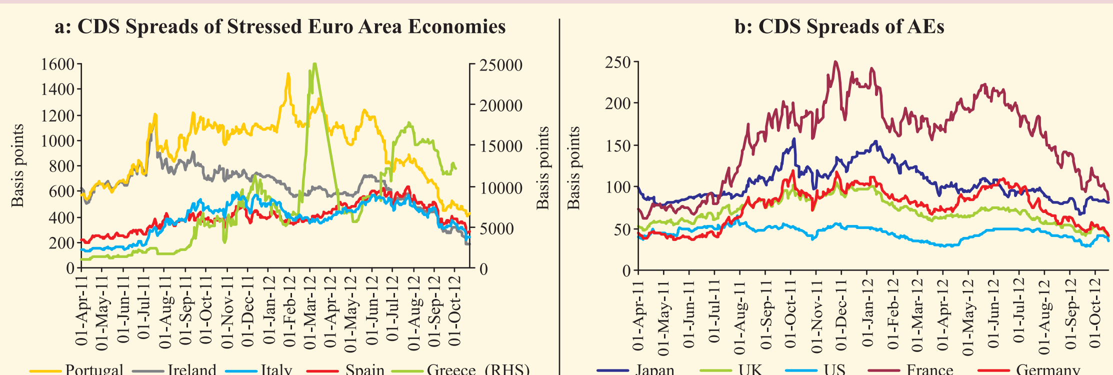
Chart V.I: Movement in Equity Prices since June 2012



Source: MSCI, Datastream.

V.2 Global risk-aversion among investors appeared to have eased since September with the credit default swap (CDS) spreads declining after the announcement of the policy measures (Chart V.2). Borrowing costs for euro area

Chart V.2: Trends in Global Financial Markets



Source: Bloomberg.

countries, especially Spain and Italy, have also fallen.

V.3 Even after improvements in financial market conditions, elevated bond yields in the euro area periphery compared to core euro area yields, signal continued concerns about risks in the euro area.

Domestic money market rates eased reflecting improved liquidity conditions

V.4 In India, the financial market witnessed some stress during Q1 of 2012-13 with the equity markets underperforming and the rupee depreciating amid moderation in capital inflows. However, financial market conditions improved significantly during Q2. Amidst comfortable liquidity conditions, the call money rate remained in line with the policy repo rate, even during the period of advance tax collections in September *(see Chart IV.3)*.

V.5 The rates in the collateralised segments (*i.e.,* CBLO and market repo) moved in tandem with the call rate, but generally remained below it during Q2 of 2012-13. There was a shift in market volume in favour of CBLO and away from the call money in the overnight money market during Q2 (Table V.1).

V.6 Banks and primary dealers continued to be the major borrowers in the collateralised segment during Q2. While mutual funds (MFs) continued to be the major lenders in the CBLO segment, their share in total lending declined in the market repo segment. Nationalised banks emerging as the major lenders in the latter segment during the quarter.

V.7 With lower demand for funds amidst credit slowdown, there has been a near 55 per cent q-o-q decline in the average fortnightly issuance of certificates of deposits (CDs) to around ₹185 billion in Q2, and the weighted average effective interest rate (WAEIR) on CDs declined to 8.4 per cent in September 2012 from 9.3 per cent in June 2012.

V.8 The corporate sector increased its average fortnightly issuance of commercial papers (CPs) by around 22 per cent (q-o-q) to ₹330 billion during Q2. The weighted average discount rate (WADR) on CPs declined to 9.0 per cent in September 2012 from 10.1 per cent in June 2012. 'Leasing and finance' and 'manufacturing companies' remained the major issuers of CPs. The yields on auction Treasury Bills (TBs) eased till October 23, 2012 in line with the declining short-term interest rates.

G-sec yields decline marginally reflecting improved liquidity conditions

V.9 Yield movements during Q2 of 2012-13 were range bound, though with a softer bias.

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

(₹ billion)

	Money Market						Bond Market		Forex Market inter-bank (US$ mn)	Stock Market ##
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificates of Deposits*	G-Sec**	Corporate Bond#		
1	2	3	4	5	6	7	8	9	10	11
Mar-12	-1574.3	175.1	111.8	379.8	911.9	4195.3	98.6	26.1	20.6	152.3
Jun-12	-913.0	151.8	180.4	375.9	1258.1	4251.7	257.6	29.5	18.4	117.3
Jul-12	-481.1	146.4	173.3	381.9	1732.3	4155.3	220.1	28.2	18.9	115.8
Aug-12	-462.2	129.5	183.3	459.4	1878.9	4029.8	178.4	27.8	19.0	117.9
Sep-12	-517.1	142.8	185.1	502.4	1705.8	3571.9	260.1	36.4	20.2	142.8

*: 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: In column 2, (-) sign indicates injection of liquidity.

Yields softened significantly in July 2012 mainly due to improved liquidity conditions and expectations that the monetary policy may be eased following market perceptions of abating inflationary pressures on the domestic front, and global cues of further slowdown in world economy. However, yields rose sharply on July 31, 2012, reacting to the Reserve Bank's policy announcement of a one percentage point cut in the SLR to 23 per cent while leaving the policy rate unchanged (Chart V.3).

V.10 After some intermittent softening, the yields again hardened in mid-August following worse-than-expected inflation outcome, but the movement was checked by expectations of weak growth numbers for Q1 of 2012-13. Better-than-expected growth numbers, however, caused yields to temporarily firm up, but adherence to the budgetary numbers in the auction calendar for H2 of 2012-13 softened opening yields on September 28, 2012. However, profit booking eroded the gains. Concerns about fiscal slippage have kept yields largely flat during October 2012.

V.11 Around 72 per cent of the budgeted borrowing programme of the central government through dated securities amounting to ₹4,090 billion has been accomplished so far. The weighted average maturity of dated securities issued up to October 23, 2012, increased to 13.6 years. There has been a general downward movement in the primary market yield during the financial year so far. The weighted average yield of primary auctions stood at 8.43 per cent (Table V.2). Investor sentiment, however, was largely sustained. The bid-cover ratio stood in the range of 1.4 to 4.1.

V.12 During 2012-13 so far, 25 states have raised ₹905.3 billion on a gross basis. The weighted average yield firmed up to 8.94 per cent as the yield spreads for 10-year state development loans issuances over the corresponding Government of India security, increased to 42-84 bps compared to a spread of 25-42 bps for the corresponding period of the previous year.

Deposit and lending rates exhibit stickiness

V.13 Following the reduction in the CRR in two steps by 125 bps during January-March 2012 and the reduction in the repo rate by 50 bps effective April 17, 2012, the modal deposit rate for scheduled commercial banks (SCBs) declined by 11 bps to 7.29 per cent during Q2 of 2012-13 while the modal base rate of SCBs continued to remain at 10.50 per cent (Table V.3).

V.14 In general, there has been a convergence in average deposit and lending rates across public and private sector banks. The reduction

Chart V.3: Movement in G-sec Yield

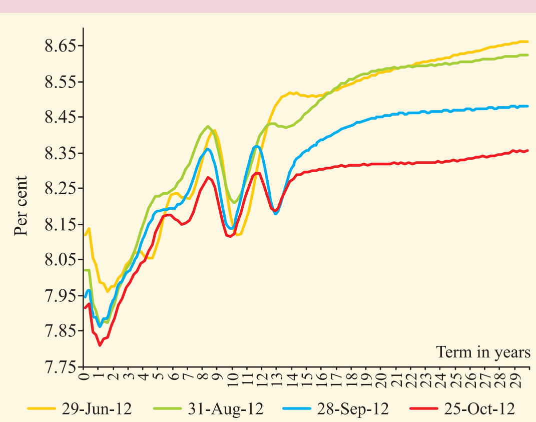


Table V.2 : Issuances of Central and State Government Dated Securities

Item	2011-12	2012-13*
1	2	3
Central government		
Gross amount raised (₹ billion)	5,100.0	4,090.0
Devolvement on primary dealers (₹ billion)	121.1	18.3
Bid-cover ratio (range)	1.4-5.1	1.4-4.1
Weighted average maturity (years)	12.7	13.6
Weighted average yield (per cent)	8.5	8.4
State government		
Gross amount raised (₹ billion)	1,586.3	905.3
Cut-off yield range (per cent)	8.4-9.5	8.7-9.3
Weighted average yield (per cent)	8.8	8.9

* Up to October 23, 2012.

Table V.3: Deposit and Lending Rates of Banks

(Per cent)

Items	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sept-12
1	2	3	4	5	6	7
1. Domestic Deposit Rate (1 - 3 year tenor)						
i) Public Sector Banks	8.25-9.75	8.55-9.75	8.55-9.75	9.00-9.75	8.75-9.50	8.50-9.30
ii) Private Sector Banks	8.00-10.50	8.00-10.50	8.00-10.50	8.00-10.50	8.00-10.00	8.00-9.75
iii) Foreign Banks	3.50-10.00	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.75
Modal Deposit Rate (all tenors)	***7.08***	***7.44***	***7.46***	***7.42***	***7.40***	***7.29***
2. Base Rate						
i) Public Sector Banks	9.25-10.00	10.00-10.75	10.00-10.75	10.00-10.75	10.00-10.50	9.75-10.50
ii) Private Sector Banks	8.50-10.50	9.70-11.00	10.00-11.25	10.00-11.25	9.75-11.25	9.75-11.25
iii) Foreign Banks	6.25-9.50	6.25-10.75	6.25-10.75	7.38-11.85	7.38-11.85	7.25-11.75
Modal Base Rate	***10.00***	***10.75***	***10.75***	***10.75***	***10.50***	***10.50***
3. Median Lending Rate*						
i) Public Sector Banks	9.50-14.50	10.50-15.25	10.25-15.25	10.60-15.35	10.50-15.50	-
ii) Private Sector Banks	9.25-15.00	9.00-15.25	10.00-15.50	10.50-15.50	10.63-15.38	-
iii) Foreign Banks	7.70-14.50	9.13-14.75	9.50-14.38	10.00-14.50	10.00-14.50	-

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

in the CRR by 25 bps with effect from September 22, 2012, may also help in softening deposit and lending rates further. A few banks, mostly public sector banks, have already reduced their base rates.

Reform measures announced by the government boost investor sentiments and lead to appreciation of the Rupee

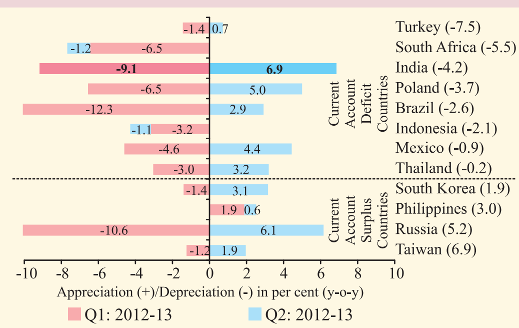
V.15 The rupee appreciated by 6.9 per cent in Q2 of 2012-13 (5.2 per cent in the month of September 2012 alone), driven by both global developments and domestic policy measures *(See Table VII.1* and Chart V.4*)*. However, since the second week of October 2012 the rupee has weakened. It stood at 53.63 on October 25, 2012.

V.16 The Reserve Bank also undertook additional policy measures in September 2012 to facilitate capital inflows. These include enhancing the maximum permissible ECB for repayment of rupee loans and fresh rupee capital expenditure under the US$ 10 billion scheme from 50 to 75 per cent of average foreign exchange earnings realised during the previous three years; permitting infrastructure companies to avail of trade credit up to a maximum period of five years for import of capital goods; and rationalising overseas direct investment by Indian entities in respect of annual performance returns.

Secondary equity markets improved with reform measures and FII inflows

V.17 In the recent period (up to October 25, 2012), the Indian equity market witnessed gains on a y-o-y basis. At a level of 18,758, the BSE Sensex is 8.7 per cent higher than it was at the same time last year. Market sentiments, turned positive due to improved global liquidity conditions, FII inflows and the recent policy measures announced by the government.

Chart V.4: Select EDE Currency Movements against the US$



Note: Figures in parentheses represent WEO's estimated/projected CAD for the year 2012, except in case of India, where actual data point for the period of 2012 (Jan-Jun) is given.

However, governance issues and mixed Q2 results of some major companies pared some of the gains recorded earlier. During 2012-13 so far (up to October 23, 2012), FIIs made net investments of about ₹497 billion in the Indian equity market (Chart V.5).

IPO market continued to be sluggish

V.18 The primary market, on the other hand, showed mixed trends. Private placement and MFs witnessed substantial pick up during 2012-13 so far, while the IPO market remained sluggish. During April-August 2012, the total resources mobilised through private placement grew by about 73 per cent (y-o-y), while the net inflow of funds into MFs schemes grew by around 41 per cent on account of the base effect. The MF inflows to the liquid and income schemes were higher, on the back of improved liquidity conditions while they were net sellers in the equity segment.

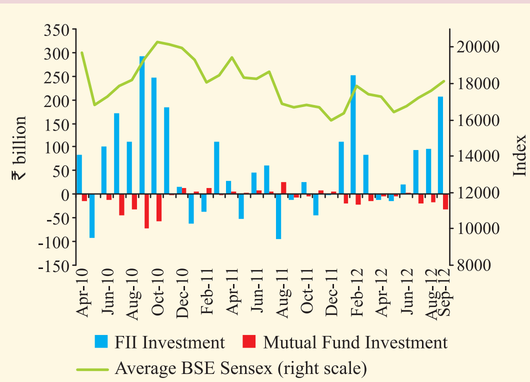
V.19 Both the number of issues and the amount raised through IPO issues are very low in comparison to the peak resource mobilisation achieved in 2007-08 (Chart V.6). Even the offer document *i.e.*, Draft Red Herring Prospectus, filed with SEBI during April-September 2012 declined by 90 per cent over the corresponding period in 2011-12. Many companies which had filed their offer document to raise funds have withdrawn their proposals and two IPOs have not been fully subscribed in 2012-13 so far.

V.20 The IPO market remained subdued due to weak investment demand arising from the slowdown in overall economic growth, persistent inflation and high fiscal and current account deficits. The IPO activity mirrored the trends in the secondary market, in line with cautious investor sentiments in the recent past. Second, many of the IPOs listed during 2011-12 are currently trading below their issue price. As on October 25, 2012, of the 34 IPOs listed in the equity market in 2011-12, 20 were trading below their issue price. Negative returns on IPO investments have adversely affected investor sentiments. Third, global IPO activities have also been subdued since 2011. During Q2 of 2012-13, the resources raised through global IPO markets were 48 per cent lower than in the previous quarter, even though the secondary equity market posted huge gains during this period.

Policy changes contemplated to support the capital market

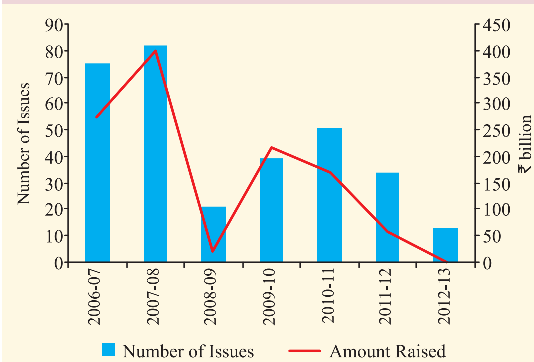
V.21 Apart from the policy reform measures mentioned earlier, the Kelkar Committee on ‘Roadmap for Fiscal Consolidation’ has made suggestions to revive the disinvestment programme. The Deepak Parekh Committee has

Chart V.5: Institutional Investment



Source: SEBI and BSE.

Chart V.6: Trends in the IPO market



Note: 2012-13 pertains to April-September 2012 only.
Source : SEBI

Table V.4: House Price and Transactions Volume Indices (Base Q4:2008-09 = 100)

Quarter	Mumbai	Delhi	Bengaluru	Ahmedabad	Lucknow	Kolkata	Chennai*	Jaipur	Kanpur	All India
1	2	3	4	5	6	7	8	9	10	11
House Price Index										
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
Growth in per cent										
Y-o-Y	21.0	42.2	19.9	15.9	20.2	30.1	25.9	6.7	7.1	24.1
Q-o-Q	3.1	11.3	-0.3	-0.3	5.7	28.9	14.5	4.6	-2.5	6.7
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
Growth in per cent										
Y-o-Y	71.2	-10.6	-19.0	4.3	61.8	-9.0	0.7	22.0	-25.7	9.3
Q-o-Q	41.1	-10.8	15.3	14.6	-0.7	-23.6	-18.3	19.9	-10.0	6.4

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.

suggested setting up infrastructure debt funds to boost infrastructure financing.

V.22 The SEBI has also taken various measures to revive mutual fund investments and IPO activity. MF companies will now have to shift to the 'one plan per scheme' model. Also, a proposal has been made for a mandatory 'safety net' to protect the interests of small investors. Further, substantial QE programmes of AEs along with low interest rates will boost global liquidity and revive FII inflows to the IPO market. FII inflows and reform measures that are fuelling the uptrend in the secondary market, may also have a positive impact on the IPO market.

Housing prices remain firm with rising volumes

V.23 The Reserve Bank's quarterly House Price Index, based on data for 9 cities, indicates a q-o-q increase of 6.7 per cent at the all-India level. The annual increase in house prices show a marginal moderation in Q1, while the transaction volume grew by 9.3 per cent (Table V.4).

Investor confidence picks up, but further macro-financial improvement is necessary

V.24 With the continued slowdown in global growth, global investor sentiments remain muted, despite the recent bout of activity aided by policy measures, both global and domestic. Pending long-term solutions for the euro area crisis, global uncertainties continue to dominate. Nevertheless, the excess global liquidity in the wake of monetary easing measures by AEs, is expected to flow into emerging and developing economies (EDEs) in search of higher returns.

V.25 By pushing through a series of much awaited reform measures, the government has signalled a break in policy stasis. With the promise of more measures to follow, investor scepticism seems to have abated. However, further improvement in macro-financial conditions would be necessary.

VI. PRICE SITUATION

WPI inflation has stayed around 7.5 per cent during 2012-13 so far. This reflects a combination of factors: the spillover impact from fiscal imbalances, some pass-through from earlier exchange rate depreciation and feeble supply response. Persistence in the non-food manufactured products inflation, even as growth has slowed, has emerged as a concern. While the late revival of monsoon has helped cool the price pressure from commodities like vegetables, the projected shortfall in the kharif crop is likely to exert pressure on food prices, especially cereals, pulses and oilseeds. Though the administered price revisions effected in September 2012 will raise inflation in the near-term, they will also help in reducing the medium-term inflationary pressures by containing the fiscal deficit. The pressures on fuel inflation could soften if crude prices remain range-bound and rupee maintains a strengthening bias. Overall, the inflation path is expected to remain sticky in the near-term, barring major supply shocks.

As global inflation conditions ease, India remains an outlier

VI.1 Tepid growth, high unemployment and negative output gap along with weak demand have eased the inflation environment in the Advanced Economies (AEs). The average inflation for OECD countries declined to 2.0 per cent in August 2012 from 2.8 per cent in January 2012. India remains an outlier, with higher inflation than most Emerging and Developing Economies (EDEs), which reflects the role of structural as well as country-specific factors.

Further quantitative easing by AE central banks adds to global liquidity

VI.2 The monetary policy stance in most AEs remains accommodative of growth recovery (Table VI.1). The recent round of monetary easing by some central banks of AEs, notably the European Central Bank (ECB), US Federal Reserve (US Fed) and the Bank of Japan (BoJ) during September 2012 temporarily reduced financial market stress and contributed to asset price build-up, particularly in equity markets as sentiments improved (for details see Chapter V). The exceptionally easy monetary policy of the US Fed and the BoJ is expected to weaken the dollar and yen and trigger gains in EDE currencies. This could feed into lower inflation in EDEs through exchange rate pass-through effects. However, the liquidity glut in AEs could get transmitted to EDEs given the interest rate differential, which may push up demand and lead to higher commodity prices.

VI.3 Given the spare capacity in the US and the global economy, subdued wage pressures and limited impact of commodity prices on core inflation in AEs, pressures on inflation in the near-term may remain low. However, the medium-term impact of easing of liquidity on inflation and inflationary expectations cannot be overlooked. The impact of quantitative easing on commodity prices through the financialisation of commodity markets is also likely to be a source of risk to inflation.

Global commodity prices remain volatile with uncertain outlook

VI.4 International commodity prices increased markedly in Q2 of 2012-13, reverting from the moderation observed during Q1 (Chart VI.1a). The uptick in commodity prices in recent months has been driven by crude oil and food prices. However, metal prices have continued to decelerate since February 2012, except for the recent period, due to weak demand conditions in both AEs as well as EDEs. Taking into account the relatively subdued demand, given the growth slowdown and possible increases in oil production in OPEC countries, Brazil, Kazakhstan, and the Russian Federation and the

Table VI.1: Global Inflation Indicators

Country/ Region	Key Policy Rate	Policy Rate (as on October 25, 2012)	Changes in Policy Rates (basis points)		CPI Inflation (y-o-y, Per cent)	
			Sep, 2009 to Dec. 2011	Jan 2012 to Oct 2012 (as on 25th Oct.)	Sep-11	Sep-12
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	3.25 (Oct. 3, 2012)	125	(-) 100	3.4#	2.0#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	75	0	3.2	1.2
Euro area	Interest Rate on Main Refinancing Operations	0.75 (Jul. 11, 2012)	0	(-) 25	3.0	2.6
Israel	Key Rate	2.25 (Jul. 1, 2012)	225	(-) 50	2.9	2.1
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10* (Oct. 5, 2010)	(-) 10	0	0.2$	-0.4$
Korea	Base Rate	2.75 (Oct. 11, 2012)	125	(-) 50	3.8	2.0
UK	Official Bank Rate	0.50 (Mar. 5, 2009)	0	0	5.2	2.2
US	Federal Funds Rate	0.0 to 0.25* (Dec. 16, 2008)	0	0	3.9	2.0
Emerging and Developing Economies						
Brazil	Selic Rate	7.25 (Oct. 11, 2012)	225	(-) 375	7.3	5.3
China	Benchmark 1-year Deposit Rate	3.00 (Jul. 6, 2012)	125	(-) 50	6.1	1.9
	Benchmark 1-year Lending Rate	6.00 (Jul. 6, 2012)	125 (600)	(-) 56 (-) 150		
India	Repo Rate	8.00 (Apr. 17, 2012)	375 (100)	(-) 50 (-150)	9.0$	10.3$
Indonesia	BI Rate	5.75 (Feb. 9, 2012)	(-) 50	(-) 25	4.6	4.3
Philippines	Reverse Repurchase Rate	3.75 (Jul. 26, 2012)	50	(-) 75	4.7	3.6
	Repurchase Rate	5.75 (Jul. 26, 2012)	50	(-) 75		
Russia	Refinancing Rate	8.25 (Sep. 14, 2012)	(-) 275	25	7.2	6.6
South Africa	Repo Rate	5.00 (Jul. 20, 2012)	(-) 150	(-) 50	5.7	5.5
Thailand	1-day Repurchase Rate	2.75 (Oct. 17, 2012)	200	(-) 50	4.0	3.4

*: Change is worked out from the minimum point of target range. #: Q3 (Jul-Sep). $: August.

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.

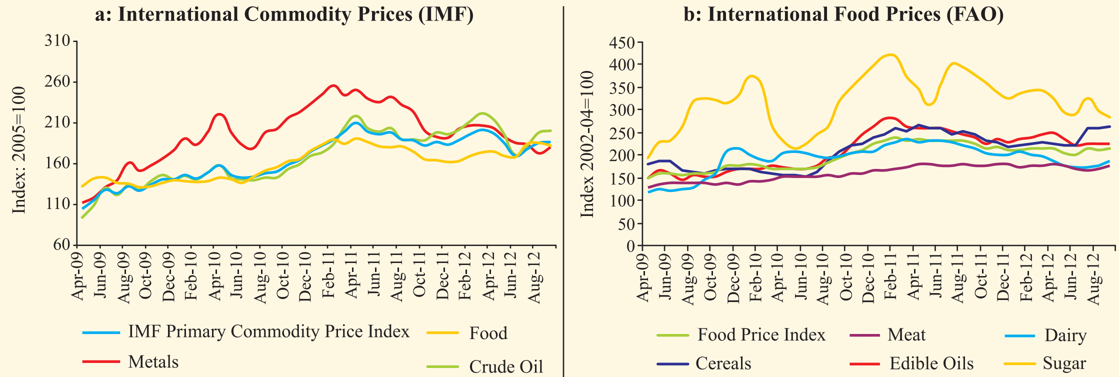
impact of shale gas on energy supplies in the US, crude oil prices are expected to remain range-bound. However, the near-term path of energy prices could be conditioned by the Middle East geopolitics.

VI.5 Food prices, especially of wheat and coarse cereals, increased in recent months following supply disruptions in a number of countries (Chart VI.1b). The Food and Agriculture Organisation (FAO) estimates that world cereal production in 2012 will be 2.6 per cent down from the previous year's record crop, but suggests that fears of serious global supply shortages are now behind us. Notwithstanding the early indications of improved crop conditions in 2013, the near-term price pressures on global food continue to remain significant and could turn out to be a source of inflation especially for countries that are net importers.

Inflation pressures persist in India despite weakening of growth momentum

VI.6 Headline WPI inflation (y-o-y) has remained sticky at around 7.5 per cent throughout the current financial year (7.8 per cent, provisional in September 2012). The build-up in price pressures continues to remain persistent as seen from the secular upward trend in the index (Chart VI.2). The momentum of price changes, as indicated by the 3-month moving average seasonally adjusted month-over-month changes in WPI, also indicates some uptick in the recent months (Chart VI.2d).

Chart VI.1: Trends in Global Commodity Prices



Source: International Monetary Fund (IMF).

Source: Food and Agriculture Organisation (FAO).

VI.7 In the recent period, changes in administered prices have been a major driver of inflation (Chart VI.3). Revisions in coal prices in January 2012 and electricity prices in June 2012 led to higher inflation. The revision in diesel and LPG prices would add to inflation during the course of the year though it will help moderate inflationary pressures in the medium-term, by way of fiscal consolidation

Food inflation remains elevated reflecting poor supply elasticities

VI.8 Food inflation concerns persist. Although there has been some moderation in the inflation in fruits and vegetables in recent months following the late revival of the monsoon, a number of items within the primary food articles group witnessed significant price pressures (Chart VI.4a). Inflation in cereals has reached double digits after more than two years, while pulses inflation has remained above 20 per cent since June 2012. Apart from the trends in primary food articles, there has been significant pressure on some manufactured food products like sugar and edible oils (Chart VI.4b). The deficiency of the monsoon during June and July 2012 impacted the crop prospects of key food products, which has translated into an increase in prices (Chart VI.5).

Chart VI.2: Trends in Wholesale Price Inflation

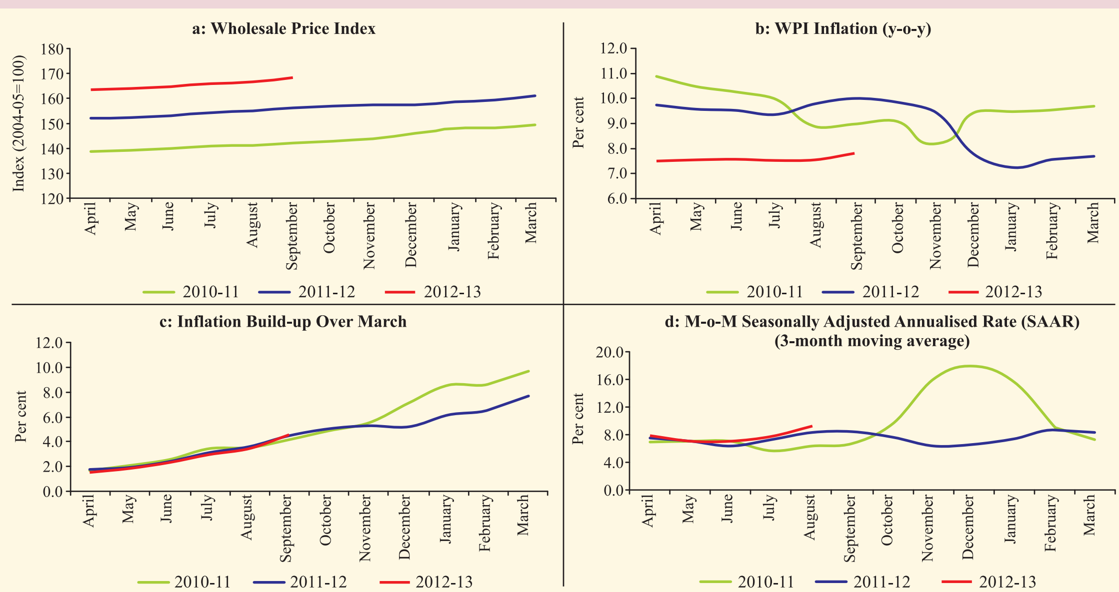
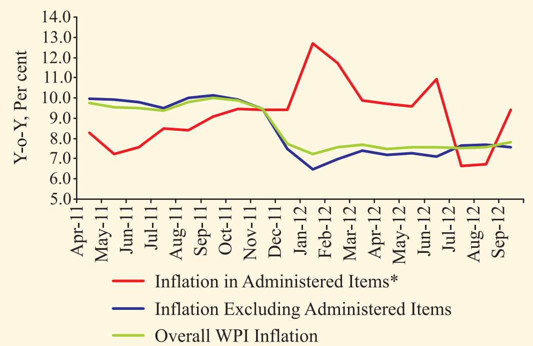


Chart VI.3: Administered and Non-Administered Price Inflation in India



* includes coal, diesel, domestic LPG, electricity and urea.

VI.9 Since 2008-09 the average food inflation at 10.3 per cent has been much above the overall headline inflation of 7.6 per cent. Both supply and demand side factors could have played a role in keeping food inflation high. Significant increases in rural wages in recent years have contributed substantially to the increase in cost of production as productivity growth remains low. This has also led to a significant increase in the Minimum Support Prices for most crops. At the same time, increases in wages, both in rural and urban areas, could have pushed up demand for food, given that the share of food in total consumption basket is higher for wage earners than for other segments of the population.

VI.10 The recently released key results of the NSSO 68th round survey (2011-12) on household consumption expenditure indicate that real per capita consumption expenditure in rural and urban areas grew at an average rate of 8.7 per cent and 6.7 per cent per annum, respectively, during the period 2009-10 to 2011-12, compared with a growth of 1.4 per cent and 2.4 per cent per annum, respectively, during 2004-05 to 2009-10. Although these results could have been influenced by the fact that 2009-10 was a drought year, which could have led to underestimation of consumption, thereby giving a low base, the fact that real consumption expenditure expanded during a period of high food inflation indicates that the demand remains strong, feeding into higher price levels as supply elasticities remain low.

Fuel inflation reflects lagged pass-through; under-recoveries remain high

VI.11 Inflation in the fuel and power group remained in double digits since February 2010, except for July and August 2012. The uptick in fuel inflation to double digits in September 2012 was driven by revision in price of diesel and increase in prices of a number of freely priced fuel products. Electricity price increase since June 2012 also contributed to the pick-up in inflation in this segment.

VI.12 Freely priced product prices moved in line with the changes in international prices, while administered fuel prices were not changed during June 2011- August 2012 (Chart VI.6). This has led to substantial build-up of under-recoveries to the tune of ₹856 billion during

Chart VI.4: Food Inflation Trends

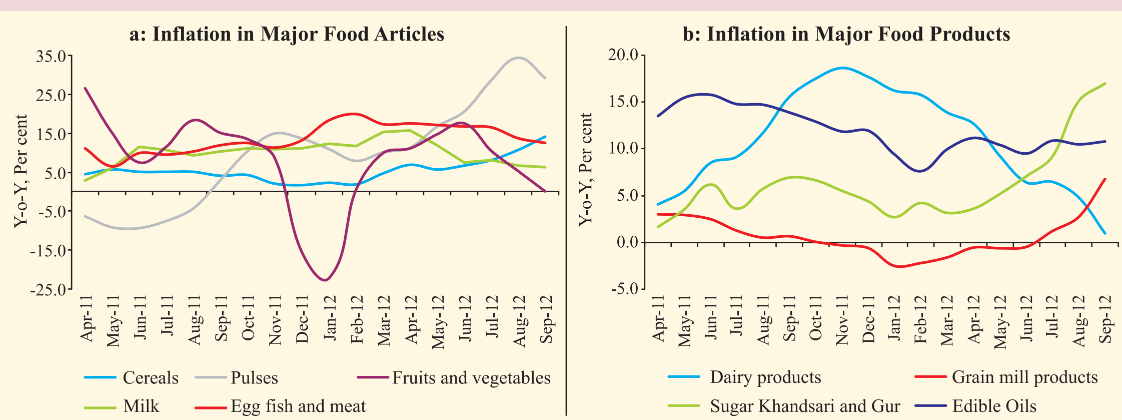
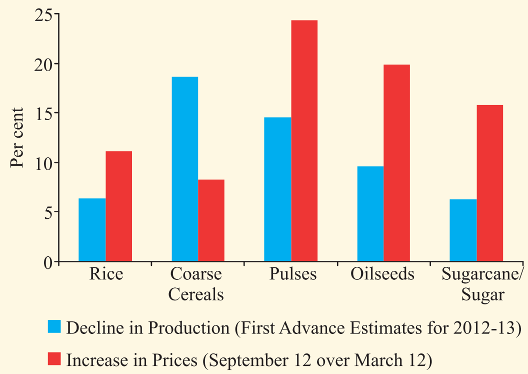


Chart VI.5: Output and Price Trends in Key Food Articles

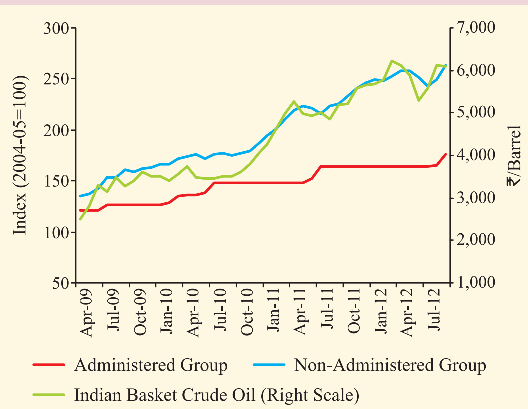


April-September 2012, with about 62 per cent of the under-recoveries coming from diesel.

VI.13 Against this background, in September 2012 the government revised diesel prices by ₹5 per litre (excluding VAT) and capped the supply of subsidised LPG cylinders (of 14.2 kg) to each consumer to six cylinders per annum. Although the revision could put upward pressures on fuel inflation in the coming months, it will help in price stability over the medium term through fiscal consolidation.

VI.14 However, even after the recent revision in oil prices, pass-through, which remains incomplete, has impacted the subsidies and the fiscal deficit (for details, see Chapter II). Currently (effective October 16, 2012), the estimated under-recovery by domestic oil marketing companies (OMCs) is ₹9.8 per litre for diesel, ₹33.9 per litre for PDS kerosene and ₹468.5 per cylinder for subsidised domestic LPG.

Table VI.6: Global and Domestic Fuel Prices



VI.15 Trends in global prices and exchange rates significantly impact domestic fuel prices, as more than 85 per cent of India's oil consumption is met through imports. Global crude oil prices (Indian Basket), which averaged US$112 per barrel during 2011-12 declined by 4.3 per cent to US$107 per barrel during 2012-13 (up to September). Though crude prices have moderated from the levels witnessed in March 2012, the depreciation of the rupee, partly offset the favourable impact (Table VI.2).

VI.16 A stable rupee since the second half of September 2012 resulted in some moderation in the prices of freely priced fuel products in October 2012, as crude oil prices continued to remain range-bound. Pressure on fuel inflation could soften if crude prices remain range-bound and rupee maintain a strengthening bias.

VI.17 The increase in electricity prices could further add to input cost pressures. The uncertainty regarding coal supply prospects following the de-allocations of many coal blocks by the government could also be a source of price pressures, if they are not compensated by imports. One positive impact of the revision in electricity prices is the improvement in the financial conditions of the State Electricity Boards (SEBs). With more grid power forthcoming as a result of financial improvement in the SEBs, there will be less dependence on genset power, thereby possibly reducing overall energy costs for producers.

Generalised inflationary pressures persist

VI.18 Non-food manufactured products inflation, the indicator of generalised inflationary pressures, remained above 5 per cent during 2011-12 so far (5.6 per cent in September 2012). The month-over-month seasonally adjusted annualised changes (3-month moving average) in WPI non-food manufacturing, though showed some moderation in the latest month, remain strong.

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

	Sep-11	Mar-12	Sep-12	Change in per cent	
				Y-o-Y	Since Mar, 2012
1	2	3	4	5	6
Crude oil Indian Basket (US$/barrel)	108.8	123.6	111.8	2.7	-9.6
Exchange Rate (₹/$)	47.6	50.3	54.6	-12.8*	-7.9*
Crude Indian Basket (₹/barrel)	5181.9	6220.1	6104.3	17.8	-1.9

* Indicates the depreciation of the rupee against dollar.
Source: Petroleum Planning and Analysis Cell (PPAC).

VI.19 Within non-food manufactured products, the 'basic metals and metals products' and chemicals groups have been the major drivers of inflation (Chart VI.7). It is seen that the contribution of these product groups to inflation in non-food manufacturing has been significantly high compared to their weights. The recent pick-up in inflation in this segment has also been driven by the increase in the contribution of the textiles group, which had declined significantly and turned negative during the period of decline in non-food manufactured products inflation.

Inflation in certain items contributes hugely to core inflation

VI.20 The contribution of individual commodities to the increase in non-food manufactured products prices has also been asymmetric. A few items, most notably gold and ornaments, ammonium phosphate and grey cement, have been contributing disproportionately to the inflation in non-food manufactured products inflation. While assessing the generalised price pressures from the movements in non-food manufactured products index, such disproportionate influences need to be taken into account.

Price adjustments have remained sticky downwards

VI.21 Manufactured non-food products inflation has remained persistent during 2012-13 so far. The number of items showing a price increase significantly outnumbered the number of items showing a price decline during the period where non-food manufactured products inflation remained elevated. Such a trend amidst the economic slowdown reflects the rigidities in relative price adjustments, which could keep core inflation high even when demand pressures remain muted. However, the reported price changes within non-food manufactured products in recent months indicate that the number of items reporting price increases has declined, while the number of items reporting price decreases has increased. This has not translated into a decline in overall inflation, as large positive changes in a few discrete items drive the overall change (Chart VI.8)

VI.22 Although the growth slowdown has been significant, the input cost pressures continued to remain persistent as seen from the HSBC Markit Purchasing Managers Index (PMI). Firms would be forced to pass on increase in input costs to output prices as the absorbing capacity has declined with significant decline in the profit margins of corporates. This could also translate to persistence of non-food manufactured products inflation even with growth slowdown.

Wage pressures remain persistent and could constrain inflation moderation

VI.23 A major factor in high food prices and overall inflation is increase in rural wages; both in nominal and real terms. However, indications are that the pace of increase in rural wages

Chart VI.7: Non-food Manufactured Products Inflation: Major Contributors

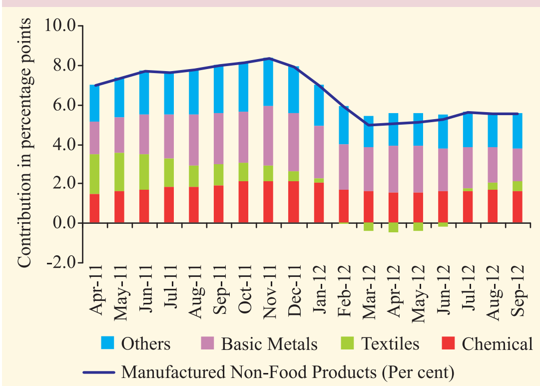


Chart VI.8: Price Changes Within Non-food Manufactured Products

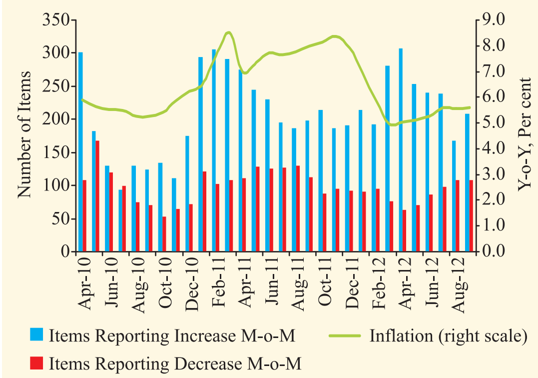
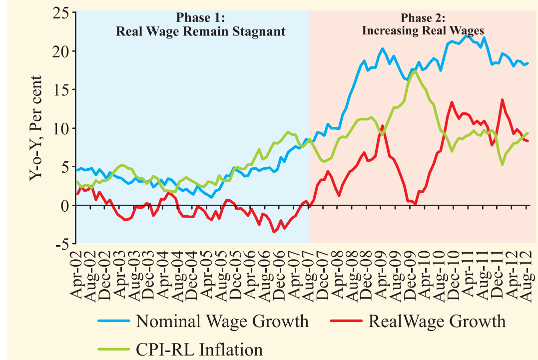


Chart VI.9: Wages* and Inflation in Rural Areas



* Daily Wage Rate for Rural Unskilled Labourers (Male).

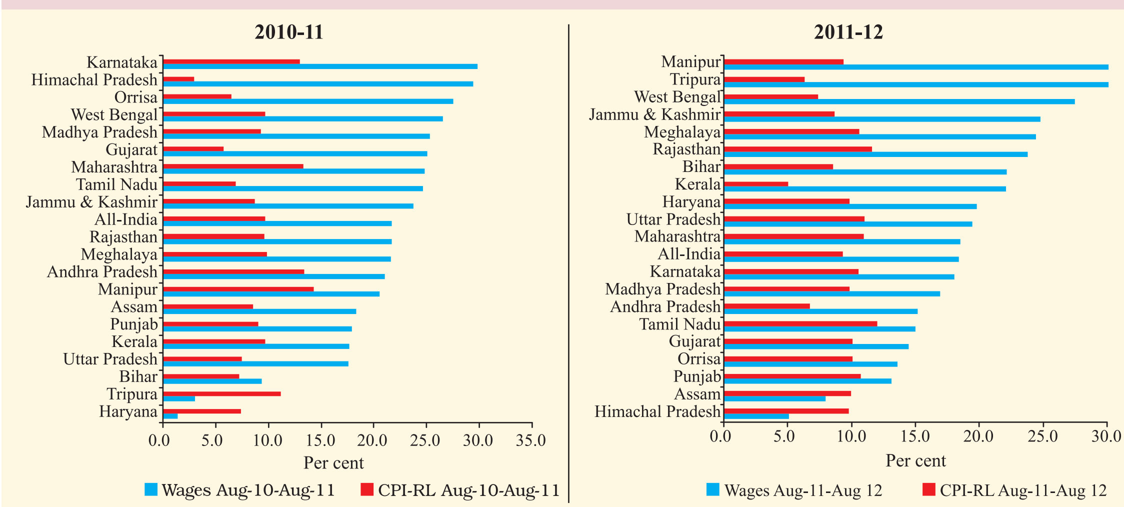
moderated from a peak of about 22 per cent (y-o-y) in August 2011 to about 18 per cent in August 2012. This, along with an increase in inflation in rural areas in recent months, led to a moderation in real wage growth to about 8 per cent in August 2012 from 11 per cent in August 2011(Chart VI.9). There is a large variation in inflation and wage growth in rural areas across the major states, pointing to the presence of state specific factors in conditioning the wage-price dynamics (Chart VI.10).

VI.24 It is observed that even in the organised sector, the growth in staff costs grew at the rate of about 17 per cent during 2011-12 indicating persistent pressure from wage costs. After some moderation in the preceding quarters, the growth in staff costs again picked up in the recent quarter (Table II.3).

CPI inflation continues to be above WPI

VI.25 Inflation, as per the all-India new Consumer Price Index (CPI-combined (rural+urban)) remained elevated, with inflation for September 2012 at 9.7 per cent. The new CPI shows some moderation in recent months when the food and fuel components are excluded (Table VI.3). However, new CPI inflation excluding food and fuel component continues to remain higher than the comparable component of WPI. The contribution of the food and beverage group to overall inflation has

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



* Daily Wage Rate for Rural Unskilled Labourers (Male).

Source: Labour Bureau.

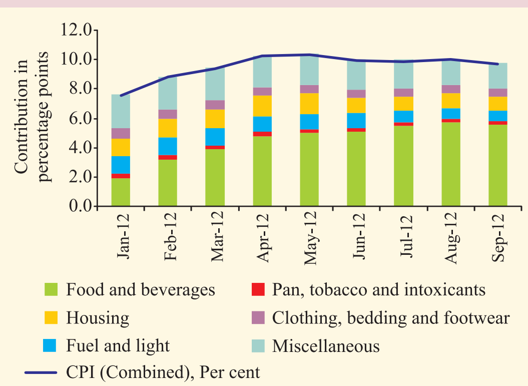
Table VI.3: WPI and New-CPI (Combined) Inflation

	Food		Fuel		Excluding Food and Fuel		Overall	
	WPI	New CPI	WPI	New CPI	WPI	New CPI	WPI	New CPI
1	2	3	4	5	6	7	8	9
Weight	*24.3*	*47.6*	*14.9*	*9.5*	*60.8*	*42.9*	*100*	*100*
Jan-12	1.5	3.9	17.0	13.0	7.5	10.6	7.2	7.5
Feb-12	5.9	6.7	15.1	12.8	6.3	10.4	7.6	8.8
Mar-12	8.7	8.1	12.8	11.8	5.8	10.2	7.7	9.4
Apr-12	9.3	10.1	12.1	11.2	5.4	10.2	7.5	10.3
May-12	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	9.1	12.1	8.3	7.5	6.6	8.3	7.6	10.0
Sep-12	8.5	11.7	11.9	7.3	6.3	8.2	7.8	9.7

increased in recent months, *albeit* marginally declining in September 2012. This has kept the overall inflation high even with a decline in inflation in the core component (Chart VI.11). The contribution of fuel & power and miscellaneous items (which includes services) in CPI inflation has declined in recent months.

VI.26 Notably, significant divergences in inflation as measured by the WPI and the new CPI were observed in certain product groups such as condiments & spices, fruits & vegetables and clothing & bedding. A comparison of similar item groups under the two inflation measures indicates that except for fuel and power, CPI inflation is much higher than WPI

Chart VI.11: Contribution to new CPI (combined) inflation



inflation in most of the product groups. Differences in the weighting pattern, area coverage and coverage of markets could explain part of the divergence. This could also indicate that inflation is generally higher at the retail level than at the wholesale level, which could be due to factors such as higher transport and labour costs and rigidities within the supply chain.

Inflation path remains sticky; better supply response and enhancing productivity are critical for medium-term price stability.

VI.27 Persistent inflation, even when growth has slowed significantly, has turned India into an outlier in a benign global inflation environment. From the supply side, high inflation in India reflects the lagged adjustments in prices of fuel as well as the role of structural factors. From the demand side, growth of real wages in excess of increase in productivity and high fiscal deficit have added to inflationary pressures. A sustained moderation in inflation, therefore, can be achieved through policy initiatives to address the structural constraints. Also there is a need to reduce unit labour costs by improving productivity levels in the economy so as to enable growth in real wages in a non-inflationary manner.

VI.28 Going forward, the deficient and uneven monsoon and spikes in global food prices have added to concerns on food inflation. The revision in administered prices of oil could add to near-term price pressures, but could help improve the macroeconomic fundamentals. Although manufactured products inflation moderated during last quarter of 2011-12, it has remained sticky, as sustained input cost pressures, pass-through effects and significant wage pressures offset the impact of the slowdown in growth. Inflation could remain around the current level in the near term and any significant moderation in inflation is conditional on improvements in structural factors. The inflation path for the current year in the face of moderation in growth and the negative output gap continues to be a concern.

VII. MACROECONOMIC OUTLOOK

The dampened investment climate may revive gradually following the demonstrated intent for fiscal policy reforms and commitment to much-awaited active policy to propel the economy forward. This will help improve business sentiments which remained cautious driven by uncertainties in the global and domestic economies. External agencies and professional forecasters have significantly revised their growth projections for India downwards. If the announced domestic reform measures are well-implemented and complemented by further reforms, the economy would turn around, despite the current expectations and sluggish global growth. In the interim, cautious calibration is needed so that macroeconomic risks are contained.

Recent actions by the government reduce macroeconomic risks, but implementation is important

VII.1 Domestic growth has averaged 5.4 per cent over the previous two quarters. This is lower than the 6.5 per cent in 2011-12 and the crisis-affected growth of 6.7 per cent in 2008-09. With an amalgamation of weaker economic indicators including falling savings and investment, rising twin deficits and inflation, potential growth also dropped by one percentage point in a little over a year.

VII.2 Part of the slowdown was due to weak global growth amidst debt and financial crises that has slowed down growth and trade across geographies. However, domestic factors have magnified the growth slowdown in India. High and persistent inflation which necessitated monetary policy action to contain inflation and anchor inflation expectations, partly contributed to this. Monetary tightening was needed to consolidate macroeconomic stability and foster growth in the medium run. But, beyond this, inadequate movement on the policy and implementation fronts worsened the investment climate that had already suffered due to global uncertainties and the cyclical downturn in the Indian economy.

VII.3 The slew of policy measures announced by the government, since mid-September 2012, have started addressing these concerns (Table VII.1). These reforms measures by themselves are not sufficient to address the macro and structural problems constraining growth and delivering the needed reduction in twin deficits. Yet, they mark a significant directional change. Speedy implementation of the proposed measures and further progress to contain twin deficits would be needed for sustainable recovery to set in.

Economic downturn is getting arrested

VII.4 By reducing the macro-financial risks, the reforms should help arrest falling growth. Although, growth in Q2 of 2012-13 is unlikely to be significantly different, gradual recovery could follow later in the year.

VII.5 Growth in 2012-13 has slowed more than anticipated due to multiple factors. The *kharif* crop has been adversely impacted following deficient monsoon. Good rainfall in August and September has improved the soil moisture content and reservoir levels, thus raising the prospects for a good *rabi* crop. However, agriculture is likely to pull the overall growth down as *kharif* crop shortfall may not be entirely recovered.

VII.6 Contraction in mining sector continues following a clamp-down on illegal mining activity. Manufacturing output has stagnated as external demand as well as domestic investment and private final consumption expenditure have decelerated. Services sector growth has also slowed as activity in trade, transport, hotels and

Table VII.1: Key Reform Measures Since Mid-September 2012

Date of announcement	Reform measure and key features	Expected outcome	Whether approval pending
1	2	3	4
Sep. 13, 2012	Fuel price hike: • Diesel price hike by ₹5/litre • Capping subsidised LPG cylinders at 6 p.a./household	Would reduce under-recoveries on sale of diesel by about ₹150 billion in 2012-13, making a small but significant contribution to fiscal consolidation. Would also lower suppressed inflation in the system, bringing medium-term benefits, even though inflation may rise in the near term.	No
Sep. 14, 2012	FDI liberalisation • Up to 51% FDI in multi-brand and single brand retail subject to conditions • Up to 74% FDI in teleports, mobile TV and sky-broadcasting services. • Up to 49% FDI in aviation by foreign airlines.	Moderate FDI inflows likely over next 1–3 years in retail. This will improve organised retail penetration, but its market share may still remain less than 10 per cent. Supply-chain management over the years should improve, helping to lower prices and improve consumer welfare. MSMEs would also benefit. Both exports and imports could rise. FDI in aviation would depend on restructuring and M&A. FDI in broadcasting may support digitisation through the cable and Direct-to-Home (DTH) segments over time.	No
Sep. 14, 2012	Disinvestment in PSUs Oil India Limited (10%), MMTC (9.33%), NALCO (12.15%) & Hindustan Copper (9.59%)	Raise ₹150 billion out of ₹300 billion budgeted for disinvestment in the Union Budget 2012-13. Also improve efficiency and market discipline and bring in greater shareholder accountability and better corporate governance in these PSUs.	No
Sep. 21, 2012	Reduction in withholding tax Reduced tax on overseas borrowings by domestic companies during July 2012–June 2015 to 5 % from 20%, Subject to conditions	Reduced cost for corporate borrowing abroad. This may increase debt inflows in the capital account.	No
Sep. 24, 2012	Financial restructuring of state distribution companies (Discoms)	Accumulated losses of discoms are estimated at ₹1.9 trillion as at the end of 2010-11. The restructuring package may face several difficulties in implementation, but it is a significant step towards containing the financial problems in the power sector.	No
Sep. 29, 2012	Proposal for National Investment Board (NIB) headed by the PM to clear infrastructure projects above a certain threshold.	Faster clearances of infrastructure investment would provide greater clarity and reduce uncertainty. It would also avoid delays in the implementation of projects.	Cabinet approval pending
Oct. 1, 2012	Package for insurance sector	Would help in capital infusion in insurance sector and also encourage domestic savings.	IRDA, CBDT and CEBC notifications pending
Oct. 4, 2012	Further FDI liberalisation (in insurance & pension) Foreign investment ceiling in the pension sector at 26% or such percentage as may be approved for the insurance sector, whichever is higher.	Would help tap a large pool of global savings to improve long-term growth in India. Such FDI would bring more stable capital inflows and bring about greater exchange rate stability.	Parliamentary approval necessary
Oct. 4, 2012	Twelfth Five-Year Plan Approved by cabinet for placing it before the National Development Council (NDC)	Would set the growth agenda for the next five years with plans covering large infrastructure investments.	NDC approval pending
Oct. 5, 2012	Pushing economic legislations: CCEA approval of amendments to the Companies Bill, 2011, the Forward Contracts (Regulation) Amendment Bill, 2010 and the Competition Act, 2002.	Diverse benefits from an improved legal framework	Parliamentary approval necessary

communication has been impacted given its linkages with the rest of the economy.

VII.7 While a modest recovery can be expected later in the year as the investment climate improves, growth in 2012-13 will fall short of the earlier projection.

Inflation risks persist, warranting cautious policy calibration

VII.8 Notwithstanding the growth deceleration, inflation remains significantly above comfort levels. This partly reflects the impact of past suppressed inflation that is now being reflected in current inflation numbers as administered prices are adjusted upwards. This has kept core inflation elevated in relation to the falling growth as cost-push pressures are getting reflected in prices. In addition, some latent demand-side pressures still persist, as there have been large wage inflation pressures in the economy in recent years.

VII.9 Despite the recent moderation in the price of crude oil, liquidity impact of QE and geopolitical uncertainties constitute upward risks to commodity prices. On the domestic front, the reform measures-induced hike in administered prices would cause inflation to rise in the near-term but ease fiscal pressures in the medium-term, which will help soften inflation. Supply-side rigidities and less competitive market structures continue to put pressure on prices. For several commodities, the input cost pressures are significant. As a result inflation has now persisted for the third year, inspite of negative output gap, supported by the wage-price spiral that poses significant risk to medium-term inflation. In the short-run inflation may turn out to be slightly higher than anticipated. However, it is likely to soften from Q4 of 2012-13.

Business sentiments are weak, but recent policy actions may improve confidence

VII.10 Various business confidence surveys portray weak sentiment about business prospects in Q1 and Q2 of 2012-13. NCAER's Business Confidence Index shows a declined in overall confidence over Q1 of 2012-13, but no change over a year. FICCI's business confidence survey, likewise, reveals a fall in the overall business confidence index in Q1 of 2012-13. According to FICCI, weak demand, high cost of credit and worsening employment prospects emerged as constraints. The CII Business Confidence Index fell during Q2 of 2012-13, reflecting low business sentiments. Stagnation in reforms and credit availability constraint emerged as important (Table VII.2).

VII.11 Most of the responses for these surveys were received before the announcement of the reform measures. Those received later indicate improved business sentiments. The Dun & Bradstreet Business Optimism Index for Q3 of 2012-13 shows an improvement over the previous quarter, reflecting the improved sentiments.

VII.12 The seasonally adjusted HSBC Markit Purchasing Managers' Index for manufacturing remained flat during September 2012, while that for services recorded the fastest expansion in business activity in the past seven months. However, input prices continue to rise in both sectors, while business expectations fell to a six-month low in the services sector.

Table VII.2: Business Expectations Surveys

Period Index	NCAER-Business Confi-dence Index Oct 2012	FICCI Overall Business Confi-dence Index Q1:2012-13	Dun & Brad-street Business Opti-mism Index Q4: 2012	CII Busi-ness Confi-dence Index Q2: 2012-13
1	2	3	4	5
Current level of the Index	125.4	51.8	140.8	51.3
Index as per previous survey	126.6	60.3	136.1	55.0
Index levels one year back	125.4	51.6	143.7	53.6
% change (q-o-q) sequential	–0.9	–14.1	3.5	–6.7
% change (y-o-y)	0.0	0.4	–2.0	–4.3

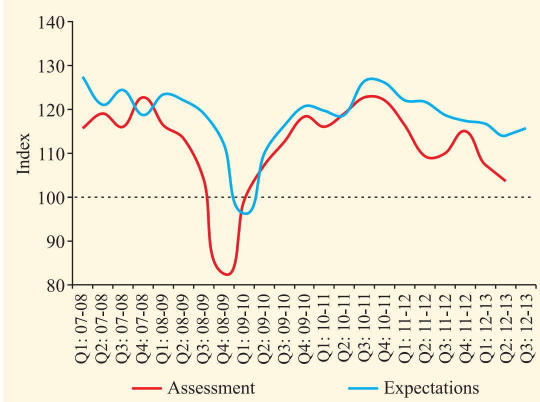
But there is a shift, however small, to a better outlook

VII.13 The Reserve Bank's 59th round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS59) conducted during Q2 of 2012-13 showed further weakening in the business sentiments of the manufacturing sector during the quarter.

VII.14 The Business Expectation Index (BEI), a composite indicator based on several business parameters, declined to levels seen at the onset of the financial crisis in Q3 of 2008-09. However, the survey also revealed that the outlook for the ensuing Q3 of 2012-13 had improved marginally (Chart VII.1).

VII.15 Demand conditions, as reflected in the net responses for production, order books, capacity utilisation, exports and imports, appear to have further weakened in Q2. However, the outlook for Q3 showed marginal improvement, except for exports and imports (Table VII.3).

Chart VII.1: Business Expectation Index



VII.16 The results also pointed to deterioration in the overall financial situation in Q2 of 2012-13, but showed a marginally improved outlook for the ensuing Q3. The cost of external finance is perceived to rise, but by a lower percentage of respondents. The cost of raw material is also expected to rise at a lower rate in the next quarter. The profit margin, which has been declining for the past few quarters, is expected to remain at the same level in Q3 of 2012-13.

Table VII.3: Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response								
		2011-12				2012-13				
		Oct-Dec		Jan-Mar		Apr-Jun		Jul-Sep		Oct-Dec
		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	35.2	17.7	33.6	26.5	34.9	18.3	30.6	16.1	32.2
2. Overall Financial Situation	Better	26.3	11.2	25.2	18.5	27.7	14.2	23.6	12.2	25.8
3. Production	Increase	39.9	25.3	40.4	33.1	34.7	20.3	33.6	18.8	35.7
4. Order Books	Increase	33.4	18.4	31.3	24.8	29.5	16.9	29.9	12.0	30.3
5. Capacity Utilisation	Increase	22.2	10.8	24.3	16.7	19.9	8.6	18.4	6.3	20.0
6. Exports	Increase	22.1	11.5	18.6	14.2	20.7	10.8	20.5	10.0	18.0
7. Imports	Increase	16.9	11.6	15.5	14.4	15.7	11.6	15.5	9.8	14.0
8. Employment in the Company	Increase	16.5	11.3	13.6	12.9	14.6	10.0	12.3	8.3	13.3
9. Availability of Finance	Improve	20.2	10.4	19.0	15.8	22.9	15.0	20.4	13.8	21.3
10. Cost of External Finance	Decrease	–41.0	–50.6	–38.8	–37.4	–22.7	–30.5	–24.0	–27.4	–20.6
11. Cost of Raw Material	Decrease	–49.7	–61.2	–50.1	–59.4	–49.0	–63.1	–51.4	–59.6	–48.6
12. Selling Price	Increase	16.0	8.9	14.7	13.5	19.0	17.5	18.8	18.5	17.3
13. Profit Margin	Increase	–1.6	–17.3	–2.9	–11.3	–1.2	–17.9	–3.6	–15.1	–1.3

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. A: Responses for assessment quarter.

Consumer confidence yet to revive

VII.17 The Reserve Bank's 10th round of the Consumer Confidence Survey (http://www.rbi.org.in/CCS10), conducted in September 2012 indicates a decline in the index for the fourth quarter in succession, though the decline turned marginal in the latest quarter.

VII.18 The Current Situation Index, based on current perceptions of economic conditions, household circumstances, income, spending and price level, was estimated to be 106.2 compared with 106.7 in the preceding quarter. However, the Future Expectations Index, based on expectations of economic conditions, income, spending, price level, and employment prospects, declined substantially in this quarter (Chart VII.2).

External agencies revise India's growth projections downwards

VII.19 The latest forecasts of GDP growth by various agencies are in the range of 5.6 to 6.7 per cent (Table VII.4). These mark significant downward revision from their earlier estimates. The Asian Development Bank has lowered its growth forecast for India to 5.6 per cent from 6.5 per cent, citing delayed reforms contributing to falling investment and consumption, particularly in real estate and infrastructure.

VII.20 The IMF also revised its growth projection for India downwards to 5.6 per cent in October 2012. In its World Economic Outlook, it noted that India's growth has suffered from waning business confidence amid slow approvals for new projects, sluggish structural reforms, policy rate hikes designed to rein in inflation, and flagging external demand. It added that given the high inflation, India cannot afford to loosen its monetary policy unless it slows down domestic demand with more fiscal adjustments.

Survey of professional forecasters[1]

VII.21 Growth slowdown is also corroborated by the results of the 21st round of the 'Survey of Professional Forecasters' (http://www.rbi.org.in/SPF21) conducted by the Reserve Bank. The median growth forecast for 2012-13 has been revised downward to 5.7 per cent from the earlier 6.5 per cent. Overall, the GDP growth is expected to pick up from Q4 of 2012-13. Although, WPI inflation is expected to moderate from Q4 of 2012-13, it is expected to remain above 7 per cent till Q2 of 2013-14. The median

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

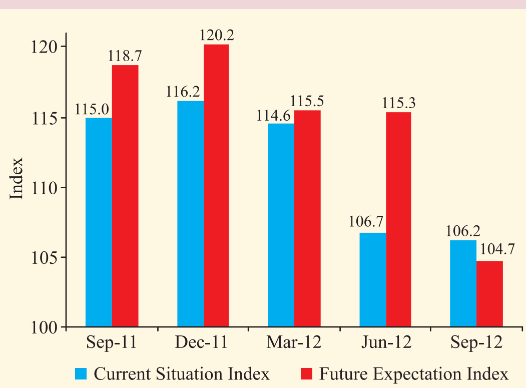


Table VII.4: Agencies' Projections for 2012-13

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	6.7	Aug-12	7.6	Feb-12
Finance Ministry	7.6 (+/–0.25)	Mar-12	-	-
ADB	5.6	Oct-12	6.5	Jul-12
IMF*	5.6	Oct-12	6.4	Jul-12
NCAER	6.4	Jul-12	7.3	Apr-12
OECD (at market prices)	7.3	May-12	7.5	Nov-11
World Bank	6.0	Oct-12	6.9	Jun-12

*: Corresponds to the latest World Economic Outlook projection of 4.9 per cent for GDP at market prices for calendar year 2012, revised downwards from 6.1 per cent in July 2012.

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

forecasters also suggest some moderation in current account deficit (CAD), but a marked fiscal slippage in 2012-13 (Table VII.5).

Inflation expectations of households decline

VII.22 The latest round of the Inflation Expectations Survey of Households (http://www.rbi.org.in/IESH29), indicates that the perception of the current quarter inflation (*i.e.,* July–September 2012), as well as the expectations on future inflation have decreased (q-o-q). The percentage of respondents expecting price rise 'more than current rate' in the next quarter has decreased. However, it has marginally increase in the case of expectation for the next year as compared with the last round. The survey was conducted before the diesel price hike.

Credible policy co-ordination key to push the economy into growth gear

VII.23 The policy actions announced by the government since September 2012 should be seen as major initiatives to reverse the course of the falling growth. As these measures are implemented and feed through the system, they will facilitate the recovery of India's realised as well as potential growth. Whether the recovery will be quick or slow-paced would depend on several factors, including global conditions, which at the moment are not very conducive despite some positive news on labour and housing markets in the US. However, the key to recovery lies in policy co-ordination among

Table VII.5: 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			
						Q2		Q3		Q4		Q1		Q2	
		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#	6.5	5.7	7.0	6.6	6.3	5.5	6.6	5.6	7.0	6.2	7.1	6.4	–	6.7
a. Agriculture & Allied Activities	2.8#	3.0	1.4	3.0	3.0	3.0	1.2	2.7	-0.3	2.9	1.5	2.8	2.4	–	2.5
b. Industry	2.6#	4.0	3.0	5.7	5.3	3.7	1.9	5.0	3.2	5.5	3.9	6.0	4.6	–	5.1
c. Services	8.5#	8.0	7.8	8.6	8.0	7.8	7.5	8.1	8.0	8.4	8.2	8.4	8.0	–	7.9
2. Gross Domestic Saving (per cent of GDP at current market price)	–	31.3	30.3	32.2	31.6	–	–	–	–	–	–	–	–	–	–
3. Average WPI-Inflation	8.9	7.3	7.7	6.8	6.7	7.6	7.6&	7.4	8.0	7.2	7.7	6.5	7.0	–	7.0
4. Exchange Rate (INR/1USD end period)	51.2	53.0	52.0	51.0	50.8	55.0	52.7&	54.5	52.5	53.0	51.5	52.5	51.5	–	51.3
5. 10-year Govt. Securities Yield (per cent-end period)	8.6	8.1	8.0	7.8	7.8	–	–	–	–	–	–	–	–	–	–
6. Export (growth rate in per cent)@	23.7*	12.0	0.0	17.0	12.0	–	–	–	–	–	–	–	–	–	–
7. Import (growth rate in per cent)@	31.1*	8.3	-0.9	14.3	12.7	–	–	–	–	–	–	–	–	–	–
8. Trade Balance (US$ billion)	-189.8*	–	–	–	–	-45.5	-46.6	-46.2	-46.5	-47.3	-47.6	-45.6	-45.2	–	-47.0
9. Current Account Deficit (per cent of GDP)	4.2*	3.6	3.5	2.8	2.7	–	–	–	–	–	–	–	–	–	–
10. Central Government Fiscal Deficit (per cent of GDP)	5.1^	5.5	5.7	5.1	5.3	–	–	–	–	–	–	–	–	–	–

E: Previous Round Projection. L: Latest Round Projection. #: Revised Estimate. *: Preliminary.
- : Not Available. &: Actual. @: US$ on BoP basis. ^: Budget Estimate.

Note : The latest round refers to Twenty First round for the quarter ended September 2012, while previous round refers to Twentieth round for the quarter ended June 2012.

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

different government agencies and the removal of structural bottlenecks in infrastructure projects.

VII.24 It is also necessary to retain focus on further improvement in macroeconomic conditions by lowering the twin deficits. This requires staying on the path of fiscal consolidation, keeping a tab on private consumption demand and supplementing it with selective use of expenditure-switching policies to lower the CAD. It is also important to ensure that inflation stays below the threshold beyond which high growth cannot be sustained.

VII.25 The exchange rate is not a foolproof tool for addressing the challenges of structural inflation that we face today. Ultimately, fiscal policy needs to work towards expediting supply-side responses and keeping private consumption demand under reasonable control.

VII.26 Monetary policy needs to be cautious in the interim, focussing on inflation while using the available space to support growth to the degree it can. Lowering inflation is important from consumer welfare and equity considerations, as also for sustainable growth over the medium-term. If risks to macroeconomy from inflation and twin deficit recede further, that could yield space down the line for monetary policy to respond to growth concerns.