Macroeconomic and Monetary Developments Second Quarter Review 2010-11

Reserve Bank of India
Mumbai

Contents

MACROECONOMIC AND MONETARY DEVELOPMENTS SECOND QUARTER REVIEW 2010-11

Overview

Global Economic Conditions

1. The momentum of global recovery, which exceeded expectations in the first half of 2010, has slowed down in the last few months. The IMF revised its projection of global growth for 2010 to 4.8 per cent, up from its earlier projection of 4.6 per cent, on the strength of performance in the first half. However, the IMF projects global growth to decelerate to 4.2 per cent in 2011.

2. In advanced economies, the weakening of recovery has raised concerns about both unemployment and deflation. With capacity for fiscal stimulus already stretched and given the concerns about sovereign debt, further quantitative easing seems the preferred option to address the weakness in growth. The persisting output gap could tempt advanced economies to resort to protectionist measures along with preference for undervalued exchange rates, and that could pose downside risks to global recovery.

3. EMEs, which had led the global recovery, continue to exhibit strong growth momentum. Notwithstanding some likely moderation in the momentum in the second half of the year, the growth imbalance relative to advanced economies is expected to persist. The widening asymmetry in monetary exit points to the possibility of larger capital inflows into EMEs, exerting potential pressures on their asset prices and exchange rates. Furthermore, given the visible pressure on capacity in certain EMEs relative to buoyant domestic demand, as well as rising global commodity and food prices since the mid-year, risks to inflation in EMEs have increased.

4. While corporate profits and stock prices have generally recovered globally, the dampening effects of unfinished deleveraging and depressed bank lending in advanced economies continue to hinder global recovery. The growing uncertainty in the global markets impacted Indian financial markets through two different channels, viz., pressure on the Indian Rupee to appreciate and rise in equity prices due to sharp increase in portfolio flows.

Indian Economy-Trends and the Outlook

Output

5. The sharp and broad-based recovery of the Indian economy, which started in the second half of 2009-10 continued through Q_1 of 2010-11, leading to further consolidation of growth around the trend. A normal monsoon, following a severely deficient monsoon last year, is expected to lift the agriculture sector growth to above the trend rate of growth in 2010-11. Industrial production showed robust growth though with wide volatility around the trend. The core infrastructure sector continues to lag behind the pace of growth in industrial production. Lead indicators of services activities, however, suggest *continuation of the momentum. The current data and indicators of economic performance remain consistent with the 8.5 per cent growth projected in the July 2010 Monetary Policy Statement.*

Aggregate Demand

6. Given the weakening external demand conditions and the need for fiscal consolidation, sustained growth will hinge increasingly on private consumption and investment demand. Trends in production of capital goods, capital expenditure plans of corporates, non-oil imports and growth in credit as well as financing from non-banking sources during 2010-11 so far suggest strong conditions for investment activities. Private consumption expenditure data for the first quarter of 2010-11, and the trends in corporate sales as well as production of consumer durables point to a pick up. The contribution of government demand to growth in 2010-11 is expected to weaken given the policy emphasis on fiscal consolidation. While both revenue deficit and fiscal deficit, as percentage of GDP, have been lower so far in the current year relative to the corresponding period of last year, there has been higher growth in both revenue and capital expenditure this year, thereby providing demand support to the growth process. The contribution of net exports to growth on the expenditure side of GDP was negative in the first quarter of 2010-11, a trend expected to continue during the rest of the year. Overall aggregate expenditure trends point to persistence of momentum.

External Sector

7. The current account deficit in the balance of payments widened in the first quarter of 2010-11 due to a higher trade deficit and moderation of the surplus in the invisibles account. Capital flows, led by FII flows in recent months, have met the financing needs of the current account deficit. Despite the appreciation of the Indian rupee on the basis of 6-currency real effective exchange rate (REER) during the year so far, over and above the significant appreciation last year, the 36 currency REER remains largely stable. The higher inflation differential between India and its major trading partners, however, is a source of pressure on the competitiveness of Indian exports. The current account deficit, as percentage of GDP, could be expected to be higher in 2010-11 than the 2.9 per cent recorded in 2009-10. While capital inflows into EMEs including India are expected to remain buoyant, a higher level of current account deficit is a concern. While the deficit may be fully financed by capital inflows, the potential volatility in such flows poses some risk. The exchange rate of the Indian rupee remained flexible moving both ways, as net intervention in the foreign exchange market since 2009-10 has remained negligible. As on October 22, 2010, the foreign exchange reserves stood at US$ 295.4 billion.

Monetary and Liquidity Conditions

8. Liquidity conditions became tight in the month of May 2010 consequent to the transfer of liquidity from the markets to the government in the wake of the 3G/BWA auctions. Since then, liquidity conditions have generally remained in the deficit mode, which is consistent with the monetary policy stance of the Reserve Bank. Policy interest rates have been raised five times since the beginning of March 2010, raising *the repo rate by 125 basis points and the reverse repo rate by 175 basis points. This asymmetric tightening narrowed the policy corridor from 150 basis points to 100 basis points. With repo replacing reverse repo as the operative rate in the LAF, the effective policy interest rate has increased by 275 basis points since March 2010. Broad money (M_3) continues to exhibit subdued growth reflecting the pattern in the growth of aggregate deposits. With non-food credit growth converging to the 20 per cent growth trajectory indicated in the First Quarter Review of Monetary Policy, banks have scaled up their deposit mobilisation efforts as evident from the higher deposit rates being offered since July 2010. Non-bank financing has emerged as a major source of financing for investment, and in the first half of 2010-11, financing from external sources in particular increased.*

Financial Markets

9. In the global financial markets, concerns about sovereign defaults eased, but they were replaced by concerns about risks stemming from the slowdown in global recovery. The multi-speed recovery across the world and the consequent differential exit from the accommodative monetary stance has strengthened both the push and pull factors underlying the significant pick up in private capital flows to EMEs. In the Indian financial markets, the impact of this trend has been visible in the appreciation of the exchange rate of the rupee against the US dollar and the bullish spikes in equity prices. The transmission of higher policy interest rates and deficit liquidity conditions strengthened across different segments of the financial markets, ranging from CPs, CDs, CBLO, Treasury Bills, government securities and bank deposits. The transmission to bank lending rates is evident with a lag. Some banks have recently announced increase in their Base Rates. Since the introduction of the Base Rate, activities in the CPs market have picked up, as corporates explored alternative financing. Banks also resorted to CDs for raising bulk deposits. Housing prices in major cities generally increased.

Inflation

10. The headline inflation data since August 2010 are based on the new series, reflecting the altered consumption pattern and the price trends at a disaggregated level and hence capture the current structure of the economy better. As per the new series, the headline inflation after remaining in double digits for five successive months up to July 2010, has begun to moderate. Inflation in non-food manufactured products, which could be seen as most sensitive to monetary policy measures, has shown some moderation. But food inflation remains disconcertingly high despite a normal monsoon. This can be partly attributed to a change in the consumption pattern in favour of protein-rich items such as eggs, milk, fish and meat where price increases have been high. Different measures of CPI inflation have edged below the double digits levels after more than a year. Despite moderation in recent months, elevated WPI and CPI inflation remain a challenge for monetary policy.

Overall Assessment

11. As the growth outlook continues to be robust, the objective of non-disruptive normalisation of the policy rate seems to *have been generally met. While non-food manufacturing inflation, which could be seen as most responsive to monetary policy, has shown some moderation, elevated food price inflation is a cause for concern. The monetary policy measures introduced since January 2010 could be expected to help in moderating the headline inflation by March 2011. The possibility of rigidity in food inflation, however, cannot be ruled out, unless the supply situation is improved with structural measures to match the growing demand for non-staple food products. This is particularly so because such downward rigidity in inflation at an elevated level has resulted despite a normal monsoon and range-bound international oil prices for most part of the year. Anchoring inflation expectations in such an environment is a difficult challenge for monetary policy. While moderating momentum of the non-food manufactured inflation suggests that recent monetary actions are having an impact, inflation still remains above the comfort level. Going forward, the growth-inflation outlook will dominate the policy response, and the nature and timing of monetary policy actions would have to be conditioned by their expected effectiveness in attaining the intended goal.*

I. OUTPUT

The Indian economy, which had exhibited a sharp recovery in the second half of 2009-10, witnessed further consolidation of growth in the first quarter of 2010-11. With a normal monsoon, lead data on the kharif sowing and production estimates suggest an above trend rate of growth in the agriculture sector in 2010-11. Industrial growth remains robust, albeit, with greater volatility. Lead indicators of services activities point to a continuation of the momentum. Going forward, while the growth rates in the services sector and agriculture are likely to remain elevated, sustainability of the recent buoyancy in the industrial sector would require alleviation of supply constraints, particularly in the infrastructure sector and sustained momentum in private demand.

I.1 As per the estimates released by the CSO, real GDP growth was placed at 8.8 per cent during the first quarter of 2010-11, which is the highest quarterly growth recorded so far since the third quarter of 2007-08. Although part of the increase in growth during the first quarter of 2010-11 is due to a favourable base effect, it largely reflects consolidation of the recovery. Real GDP growth was broad based, with robust performance in all the major sectors (Table I.1). Agriculture and allied activities witnessed a strong pick-up over the previous four quarters, led by higher growth in allied activities. The growth in the industrial sector, though lower than in the previous two quarters, continued to be in double digits, primarily reflecting robust capital goods and consumer durables production. The services sector growth gathered further momentum during the first quarter of 2010-11.

Agricultural Situation

I.2 The cumulative actual area weighted rainfall during the South-West monsoon season (June to September 30,

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

(Per cent)

Item	2008-09 *	2009-10 #	2009-10				2010-11
			Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7	8
1. Agriculture & allied activities	1.6	0.2	1.9	0.9	-1.8	0.7	2.8
2. Industry	**3.1**	**10.4**	**4.6**	**9.0**	**12.3**	**15.1**	**11.4**
2.1 Mining & quarrying	1.6	10.6	8.2	10.1	9.6	14.0	8.9
2.2 Manufacturing	3.2	10.8	3.8	9.1	13.8	16.3	12.4
2.3 Electricity, gas & water supply	3.9	6.5	6.6	7.7	4.7	7.1	6.6
3. Services	**9.3**	**8.3**	**7.5**	**10.0**	**7.3**	**8.5**	**9.4**
3.1 Trade, hotels, restaurants, transport, storage & communication, *etc.*	7.6	9.3	5.5	8.5	10.2	12.4	12.2
3.2 Financing, insurance, real estate & business services	10.1	9.7	11.8	11.5	7.9	7.9	8.0
3.3 Community, social & personal services	13.9	5.6	7.6	14.0	0.8	1.6	6.7
3.4 Construction	5.9	6.5	4.6	4.7	8.1	8.7	7.5
4. GDP at factor cost	**6.7**	**7.4**	**6.0**	**8.6**	**6.5**	**8.6**	**8.8**

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

2010) was 2 per cent above Long Period Average (LPA), as against 22 per cent below LPA during the previous year. Of the 36 meteorological subdivisions, the cumulative rainfall was excess/normal in 31 sub-divisions (13 sub-divisions last year). The rainfall, however, was deficient in North-East India (Chart I.1). As on October 21, 2010, the total live water storage in 81 major reservoirs of the country was 74 per cent of the Full Reservoir Level (64 per cent during the corresponding period last year).

I.3 Following a normal monsoon, the area sown during *kharif* 2010-11 (as on October 22) turned out to be higher than in the corresponding period of the previous year for all crop categories, except soyabean and sesamum (Table I.2). The increase in area coverage during 2010-11 *kharif* season relative to 2008-09, however, turns out to be marginal. Since 2009-10 had witnessed a significant deficiency in rainfall, a comparison of 2010-11 performance with 2008-09 provides a better picture of growth in the agriculture sector. Acreage under pulses, cotton, sugarcane and soyabean during *kharif* 2010-11, has been more than the normal area sown.

I.4 The increase in total area sown is manifested in the First Advance Estimates of *kharif* production, which show increase in production across all crops, barring jute, sesamum and soyabean. The total *kharif* foodgrains production during 2010-11 is estimated to increase by 10.4 per cent over the previous year. The increase, however, is on a lower base of last year, which happened to be a drought year. The estimated *kharif* foodgrains production during 2010-11 (114.6 million tonnes), still remains lower than the level attained in 2007-08 (120.9 million tonnes) and 2008-09 (118.1 million tonnes).

I.5 Owing to drought in some States, particularly Jharkhand, Bihar and West Bengal, *kharif* rice production during 2010-11, though estimated higher than the preceding year, would fall short of the record level achieved in 2008-09. Floods in Punjab and Haryana and delayed replanting of paddy could also have affected the rice productivity. Total cereals production, hence, may lag behind the levels attained in 2007-08 and 2008-09. Notwithstanding the likely increase in *kharif* production, the demand supply gap in the case of oilseeds and pulses is likely to remain. Among

Chart I.1: South-West Monsoon Pattern

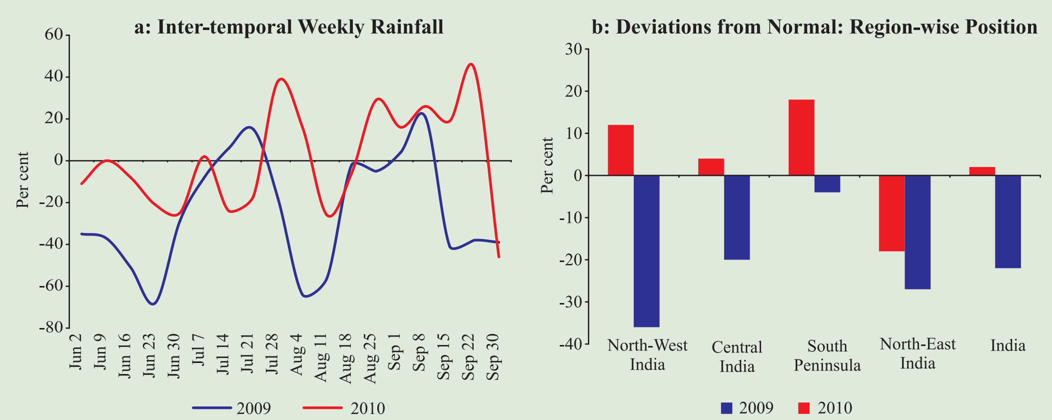


Table I.2: Area Sown and Production under *Kharif* Crops

(Area in lakh hectares and production in million tonnes)

Crop	Sowing				Production			
	Normal	2008-09	2009-10	2010-11*	2007-08	2008-09	2009-10$	2010-11@
1	2	3	4	5	6	7	8	9
Rice	395.10	386.18	332.87	355.12	82.66	84.91	75.91	80.41
			(-13.8)	(6.7)		(2.7)	(-10.6)	(5.9)
Total coarse cereals	222.23	199.85	206.16	212.16	31.89	28.54	23.63	28.23
			(3.2)	(2.9)		(-10.5)	(-17.2)	(19.5)
Total cereals	617.33	586.03	539.03	567.28	114.55	113.45	99.54	108.64
Total pulses	107.94	104.78	104.97	125.32	6.40	4.69	4.30	6.00
of which			(0.2)	(19.4)		(-26.8)	(-8.2)	(39.5)
Tur	35.53	34.58	36.48	44.86	3.08	2.27	2.55	3.27
Urad	22.82	21.97	22.92	25.54	1.12	0.84	0.85	1.08
Moong	26.14	24.12	24.79	29.80	1.25	0.78	0.44	0.88
Total foodgrains	725.27	690.81	644.00	692.60	120.95	118.14	103.84	114.63
			(-6.8)	(7.5)		(-2.3)	(-12.1)	(10.4)
Total nine oilseeds	175.72	184.02	174.43	175.49	20.71	17.81	15.66	17.27
of which			(-5.2)	(0.6)		(-14.0)	(-12.0)	(10.3)
Groundnut	53.81	52.87	44.65	49.84	7.36	5.62	3.66	5.64
Sesamum	17.76	15.55	17.62	17.06	0.76	0.64	0.66	0.62
Soyabean	84.00	96.42	95.82	93.35	10.97	9.91	10.05	9.81
Cotton #	90.86	90.92	100.09	108.47	25.88	22.28	23.94	33.50
			(10.1)	(8.4)		(-13.9)	(7.4)	(40.0)
Jute # #	7.85	7.37	6.92	7.59	10.22	9.63	10.70	9.69
			(-6.1)	(9.7)		(-5.7)	(11.1)	(-9.5)
Sugarcane	44.97	44.15	42.02	50.60	348.19	285.03	277.75	324.91
			(-4.8)	(20.4)		(-18.1)	(-2.6)	(17.0)
All Crops	1044.67	1017.27	967.46	1034.75				
			(-4.9)	(7.0)				

* : As on October 22, 2010. $: Fourth Advance Estimates. @ : First Advance Estimates.

: Million bales of 170 kgs. each. ## : Million bales of 180 kgs. each.

Note: Figures in parentheses are percentage change over previous year.

Source: Ministry of Agriculture, Government of India.

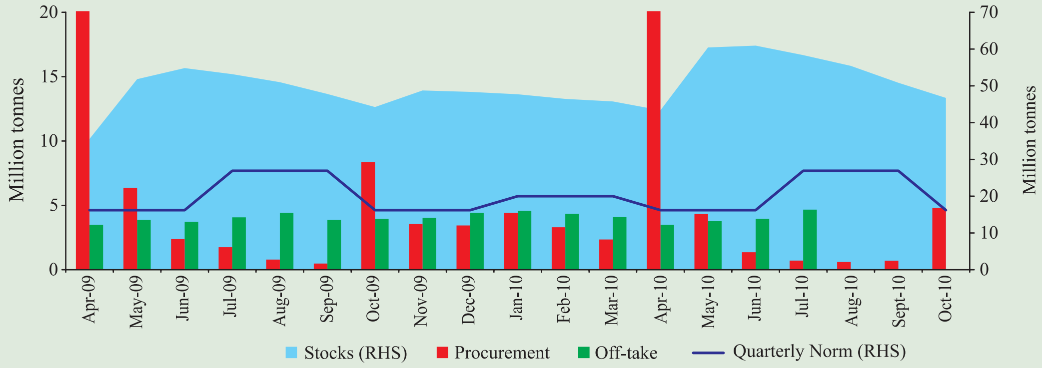
commercial crops, only cotton has posted an all-time high production. This has not helped in moderating domestic prices since international cotton prices have spiked after floods in Pakistan, which is a major producer and exporter of cotton**.**

I.6 The demand supply gap in the case of important food items like fruits and vegetables and protein based products continue to persist due to near stagnant supply, owing to lower yields and increase in demand due to factors like increase in population and income levels and changing food habits of the people. This exerts pressure on the prices. Moreover, increase in input costs has also led to spurt in prices in the case of protein items like milk, eggs and meat.

Food Management

I.7 The procurement of foodgrains (rice and wheat) during 2010-11 (up to October 23) was lower than that in the corresponding period of the previous year. Average monthly procurement during April-September 2010 was 4.8 million tonnes as against 5.4 million tonnes during the corresponding period of last year. The average monthly off-take during the period April-July 2010 (up to which data are available), was 4.0 million

Chart I.2: Food Stock and its Determinants



Note: 1. Data for off-take is available only up to July 2010.
2. Procurement and off -take data are monthly figures

tonnes as against 3.8 million tonnes during the corresponding period of last year. This had been reflected in declining stocks in recent months. The total stock of foodgrains with the Food Corporation of India (FCI) and other Government agencies, which stood at 60.9 million tonnes as on June 1, 2010 came down to 46.7 million tonnes as on October 1, 2010. The stocks of rice and wheat, at 18.4 million tonnes and 27.8 million tonnes, respectively, were higher than their buffer stock norms (Chart I.2). Keeping in view the disproportionately large adverse welfare effects of high food inflation and the scope for significant increase in food prices in response to supply shocks, the policy on food management has to focus on both adequate buffer stocks and better supply management.

Industrial Performance

I.8 Growth in industrial output has exhibited volatility in the recent period, notwithstanding double-digit growth during October 2009 to July 2010 (except June 2010) (Chart I.3). Index of Industrial Production (IIP) recorded a lower growth of 5.6 per cent in August 2010 compared with 10.6 per cent in August 2009, mainly on account of negative growth in capital goods and consumer non-durables. The volatility in capital goods as measured by coefficient of variation during April 1994 to August 2010 was placed at 1.1, the highest recorded among the use-based industries. The volatile IIP growth can also be partly attributed to a base effect.

I.9 During April-August 2010, consumer non-durables growth remained subdued at 1.6 per cent compared with (-) 1.1 per cent during the same period last year. Improved *kharif* production (particularly sugar) is expected to have a favourable

Chart I.3: Growth in Index of Industrial Production (y-o-y)

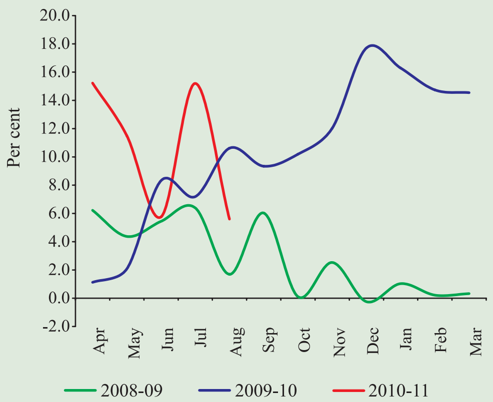
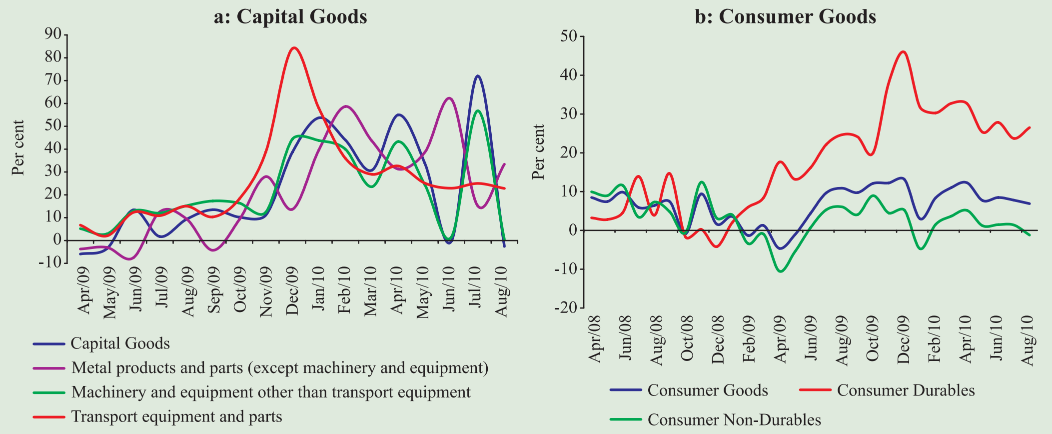


Chart I.4: Drivers of Manufacturing Growth



impact on the production of consumer non-durable goods in the coming months.

I.10 Despite some moderation in recent months, IIP grew by 10.6 per cent during April-August 2010, as compared to 5.9 per cent during the corresponding period of last year. The manufacturing sector which accounts for 79.4 per cent of weight in IIP, still recorded double digit growth. The manufacturing sector growth was propelled by high growth in capital goods and consumer durables segments (Chart I.4 a and b and Table I.3). The capital goods sector has recorded high double digit growth since December 2009, except in June and August 2010 when it turned negative. The growth

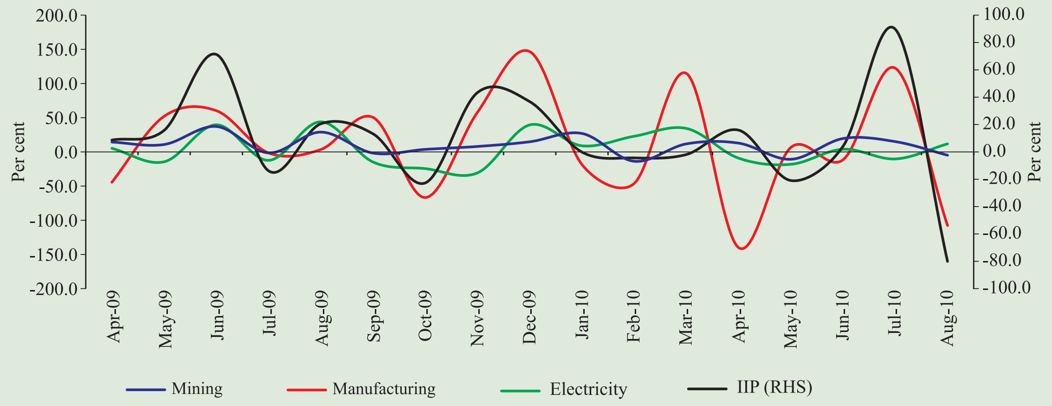
Table I.3: Index of Industrial Production: Sectoral and Use-Based Classification of Industries

(Per cent)

Industry Group	Weight in the IIP	Growth Rate			Weighted Contribution #		
		April-March 2009-10	April-August		April-March 2009-10	April-August	
			2009-10	2010-11 P		2009-10	2010-11 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	10.5	9.9	8.0	9.4	6.3	8.8	5.9
Manufacturing	79.4	10.9	5.6	11.3	88.8	81.8	90.8
Electricity	10.2	6.0	6.5	4.3	4.8	9.3	3.4
Use-Based							
Basic Goods	35.6	7.2	6.2	5.9	20.4	31.7	16.5
Capital Goods	9.3	19.2	3.4	29.0	24.7	7.2	33.1
Intermediate Goods	26.5	13.6	9.3	9.8	32.5	41.5	25.1
Consumer Goods (a+b)	28.7	7.3	3.6	8.6	22.4	19.7	25.4
a) Consumer Durables	5.4	26.2	18.8	27.0	19.3	24.5	21.9
b) Consumer Non-durables	23.3	1.3	-1.1	1.6	3.1	-4.9	3.5
General	**100.0**	**10.5**	**5.9**	**10.6**	**100.0**	**100.0**	**100.0**

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

Chart I.5: Month-over-Month Annualised Seasonally Adjusted Sectoral IIP Growth Rates

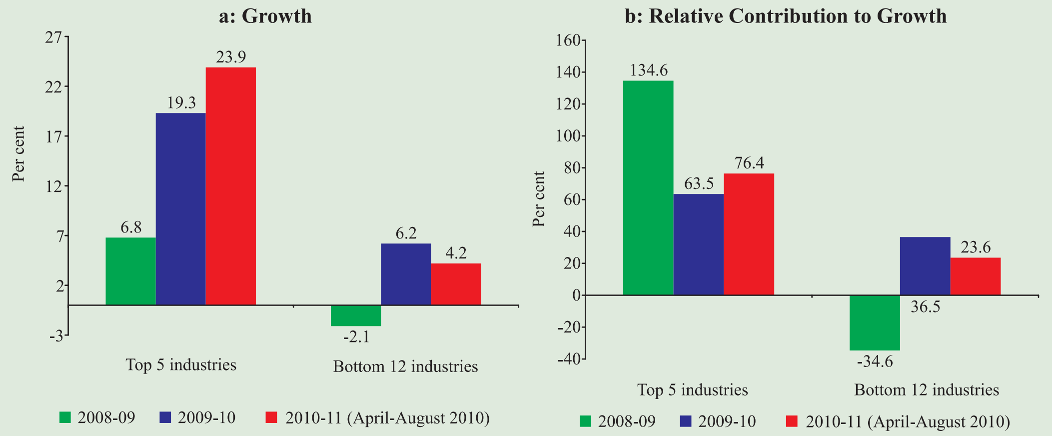


pattern, however, has been volatile, with a sharp acceleration at 72 per cent in July 2010 as compared with a decline of 2.6 per cent in August 2010. The high volatility in the data relating to the industrial sector in general and capital goods sector in particular, has raised issues about how effectively the data reflect the underlying momentum in the industrial sector.

I.11 The month-over-month seasonally adjusted annualised growth rates show deceleration in all sectors of the IIP during August 2010 (Chart I.5).

I.12 Growth in the manufacturing sector is yet to become broad-based although eleven out of seventeen industries, accounting for about 51 per cent of the weight in the IIP, recorded higher growth during April-August 2010 than corresponding period of last year. The top five manufacturing industries, with a combined weight of 24.6 per cent in the IIP, grew at around 24 per cent, contributing about 76 per cent to the overall growth during this period, slightly higher than last year (Chart 1.6 a and b).

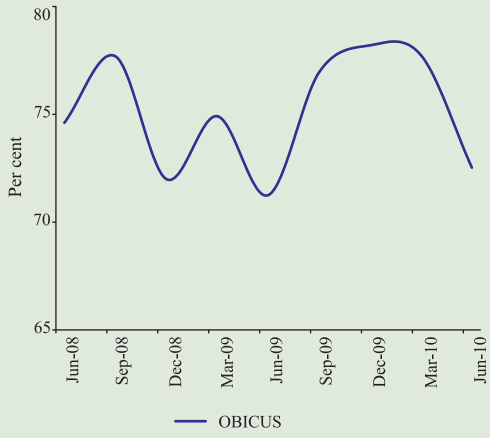
Chart I.6: Growth Concentration in Manufacturing Sector



I.13 During the period April-August 2010, capacity utilisation levels in the infrastructure sector showed a mixed trend. While fertiliser and petroleum refinery production sectors recorded slightly higher utilisation, finished steel and cement witnessed lower utilisation as compared to the same period last year (Table I.4).

I.14 The Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank indicates that capacity utilisation, which had remained range-bound since Q2 of 2009-10, declined during Q1 of 2010-11 (Chart I.7).

Chart I.7: Capacity Utilisation



Infrastructure

I.15 The infrastructure sector comprising six core industries (accounting for 26.6 per cent of the total weight in IIP) recorded a growth of 4.0 per cent during April-September 2010-11, which represents some moderation as compared to the corresponding period of the preceding year (4.5 per cent) (Chart I.8 a and b). The growth in the infrastructure sector during the period was led by crude oil, petroleum refinery and finished steel, while there was lower growth in cement, electricity and coal production as compared to April-September 2009-10. Core infrastructure growth continued to lag behind the pace of industrial growth. Preliminary evidence suggests that this break-down of relationship between core infrastructure industries and IIP capital goods is partly due to increase in imports of crude oil, steel and coal. The current level of growth momentum in infrastructure industries, especially electricity generation, needs to improve substantially in order to sustain a robust growth in industry.

Table I.4: Capacity Utilisation in Infrastructure Sector

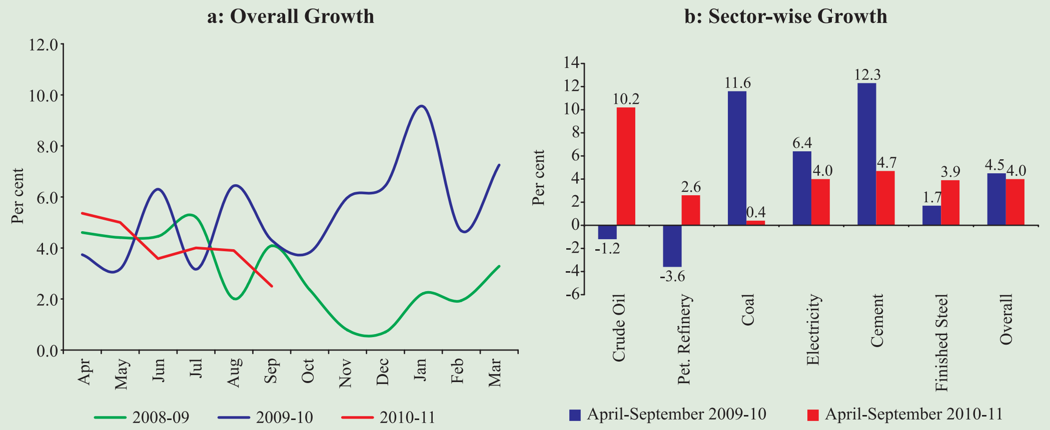
(Per cent)

Sector	April-August	
	2009-10	2010-11
1	2	3
Finished Steel (SAIL+VSP+ Tata Steel)	88.9	87.0
Cement	84.0	77.0
Fertiliser	92.3	92.9
Petroleum Refinery Production	103.2	104.1

Source: Capsule Report on Infrastructure Sector Performance (April 2009-August 2010), Ministry of Statistics and Programme Implementation, GoI.

I.16 The electricity generation during April–September 2010 has recorded a growth of 4.0 per cent as compared with 6.4 per cent during the same period last year. Thermal generation achieved a growth of 2.7 per cent, mainly due to higher growth in gas based generation (8.5 per cent). Growth in thermal generation was constrained by shortage of coal. Natural gas production, which is not reflected in the core infrastructure index, increased by 25.2 per cent during April-September 2010 as against 28.2 per cent growth in the same period last year on account of higher production from D6 block in the Krishna-Godavari (KG) basin.

Chart I.8: Growth in Infrastructure Industries



Services Sector

I.17 The services sector growth recorded further acceleration in Q1 2010-11 relative to both the previous quarter and the corresponding quarter of last year (Chart I.9). Growth in the 'trade, hotels, restaurants, transport, storage and communication' segment has been robust in recent quarters.

I.18 Lead indicators of services sector like commercial vehicles production, cell phone connections, air cargo, and passengers handled at domestic and international terminals have increased at a robust pace during the year so far (Table I.5). Cement production, a lead indicator of construction activities, seemed to be weaker than last year.

I.19 To sum up, on the supply side, although agricultural production during *kharif* season 2010-11 is estimated to post a stronger positive growth over the previous year, it may still trail behind the levels attained in 2008-09 and 2007-08, while the demand continues to grow. The

Chart I.9: Trends in Quarterly Growth of Services Sector

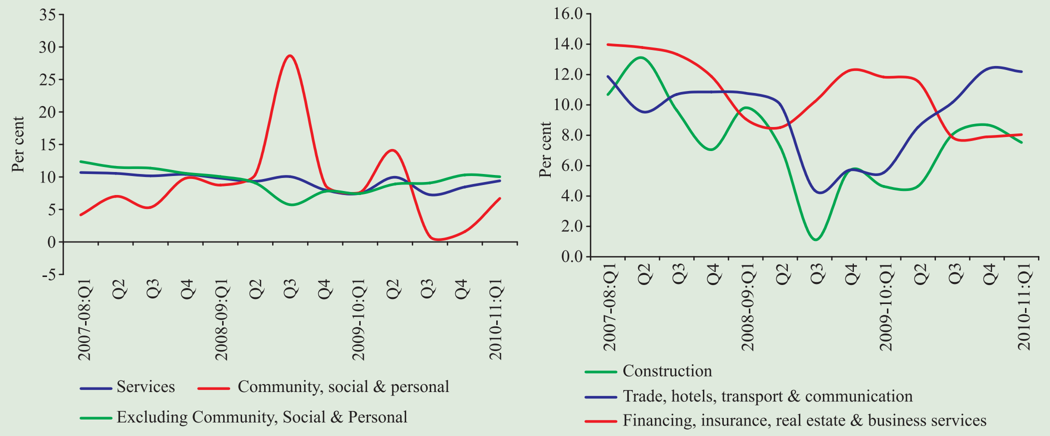


Table I.5: Indicators of Services Sector Activity

(Growth in per cent)

Indicators	2007-08	2008-09	2009-10	April-August 2009-10	April-August 2010-11
1	2	3	4	5	6
Tourist arrivals $	12.2	-3.3	3.5	-2.9	8.5
Commercial vehicles production $	4.8	-24.0	35.9	-7.4	46.8
Cement	8.1	7.2	10.5	13.4	4.6
Steel	6.2	1.6	4.9	1.9	3.5
Railway revenue earning freight traffic $	9.0	4.9	6.6	6.6	2.3
Cell phone connections	38.3	80.9	47.3	95.3	32.8
Cargo handled at major ports	12.0	2.2	5.7	1.8	0.6
Civil aviation					
Export cargo handled	7.5	3.4	10.4	4.0	21.3
Import cargo handled	19.7	-5.7	7.9	-9.0	28.2
Passengers handled at international terminals	11.9	3.8	5.7	1.8	13.0
Passengers handled at domestic terminals	20.6	-12.1	14.5	2.4	17.9

$: Data pertain to April-September.

Source: Ministry of Tourism; Ministry of Statistics and Programme Implementation and Society of Indian Automobile Manufacturers (SIAM).

increase in overall demand and also shifts in the consumption pattern would require higher production of protein-based food items as well as manufactured food items to contain inflation. With growing demand supply mismatches, the expected dampening impact of a normal monsoon on food inflation may not materialise, unless the *rabi* production improves substantially and the policy on food management focuses on better supply management. To contain high inflation emanating from key food items like milk, meat, fish and eggs, the livestock and allied sector would have to show sustained improvement The industrial sector shows volatile trends in growth rates, which raises questions about sustainability of the double digit trend. Trends in capacity utilisation also show some moderation. Going forward, the sustainability of current buoyancy in industrial sector would require significant boost to infrastructure industries, particularly, electricity, coal, oil and gas. Cheaper imports, given the current external environment, could also compete with domestic manufacturing activities. Services sector continued to show acceleration and the lead indicators remain supportive of further momentum.

II. AGGREGATE DEMAND

Drivers of growth from the expenditure side in the first quarter of 2010-11 suggest continued predominance of both private consumption and investment expenditures. Recent trends in capital goods production, capital expenditure plans of corporates, non-oil imports, growth in credit and financing from non-banking sources point to strengthening of drivers of investment expenditure. Expenditure side GDP data as well as trends in corporate sales and production of consumer durables indicate pick-up in private consumption expenditure. Despite the policy emphasis on fiscal consolidation and the observed improvement in revenue deficit, Government's expenditures have shown stronger growth than last year. The turnaround in agricultural production during kharif 2010-11 is expected to stimulate private expenditure.

Domestic Demand

II.1 India's growth drivers continue to be domestic. This has helped not only in limiting the impact of global recession on domestic growth but also in ensuring a fast and durable recovery. The key factors driving growth and their sustainability over the medium-term could be seen from the expenditure side of GDP. Real GDP at market prices grew by 10 per cent in the first quarter of 2010-11, higher than 8.8 per cent growth recorded in respect of real GDP at factor cost. The higher growth in real GDP at market prices is a reflection of higher net indirect taxes.

II.2 At a disaggregated level, the growth of private final consumption expenditure (PFCE) picked up moderately during the first quarter of 2010-11. With turnaround in agriculture production during the *kharif* season 2010-11, it is expected that rural demand and private consumption expenditure could gather momentum, going forward. The Government final consumption expenditure (GFCE) after remaining subdued for two quarters, accelerated sharply during the first quarter of 2010-11. The acceleration in GFCE during the first quarter of 2010-11 is in tandem with the growth in revenue expenditure of the Central Government (Chart II.1 and Table II.1).

Chart II.1: Growth in Major Components of Expenditure Side GDP

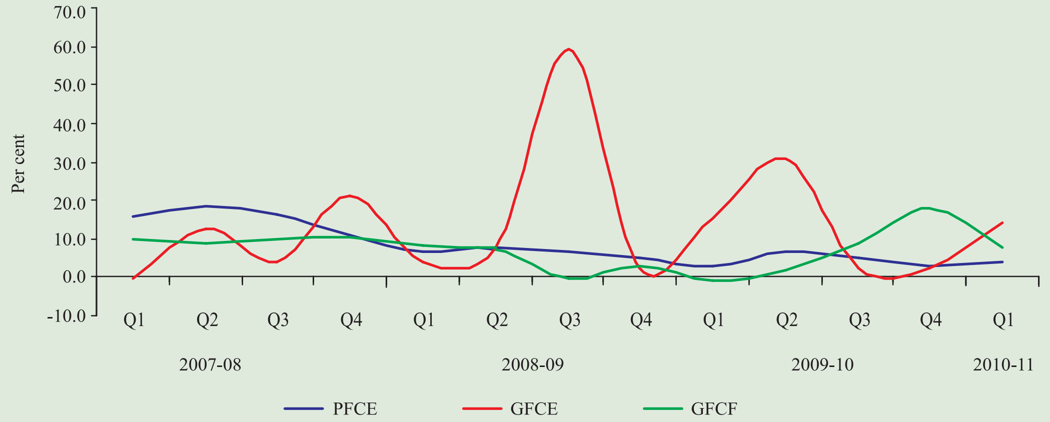


Table II.1: Expenditure Side GDP (2004-05 Prices)

(Per cent)

Item	2008-09 *	2009-10 #	2009-10 Q1	2009-10 Q2	2009-10 Q3	2009-10 Q4	2010-11 Q1
1	2	3	4	5	6	7	8
			Growth Rates				
Real GDP at market prices	5.1	7.7	5.2	6.4	7.3	11.2	10.0
Total Consumption Expenditure	8.3	5.3	4.7	9.6	4.8	2.6	5.5
(i) Private	6.8	4.3	2.9	6.4	5.3	2.6	3.8
(ii) Government	16.7	10.5	15.3	30.5	2.5	2.1	14.2
Gross Fixed Capital Formation	4.0	7.2	-0.7	1.6	8.8	17.7	7.6
Change in Stocks	-61.2	5.9	-0.9	4.2	8.7	11.1	7.0
Net Exports	40.2	-9.7	-27.4	6.1	-0.3	-113.4	20.5
			Relative shares				
Total Consumption Expenditure	70.9	69.4	71.4	71.5	73.4	62.3	68.4
(i) Private	59.5	57.6	59.9	60.1	60.4	51.1	56.5
(ii) Government	11.5	11.8	11.5	11.3	13.1	11.2	11.9
Gross Fixed Capital Formation	32.9	32.8	31.2	33.2	31.9	34.6	30.5
Change in Stocks	1.3	1.3	1.3	1.4	1.3	1.3	1.3
Net Exports	-6.1	-5.1	-4.8	-8.7	-6.7	0.4	-5.2
Memo:							(₹ crore)
Real GDP at market prices	4,465,360	4,807,222	1,099,653	1,125,257	1,242,858	1,339,454	1,209,888

* : 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.

II.3 Investment growth in the form of gross fixed capital formation (GFCF), which had picked up in the third quarter of 2009-10 and then accelerated sharply in the last quarter, witnessed moderation during the first quarter of 2010-11. Reflecting this, the share of gross fixed capital formation in GDP declined, with an offsetting increase in the share of private consumption expenditure. Private consumption expenditure and gross fixed capital formation, nevertheless, were the major drivers of growth in real GDP at market prices (Chart II.2).

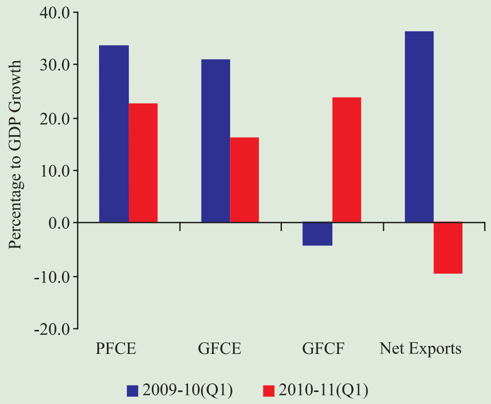
II.4 The slack in gross fixed capital formation during the first quarter of 2010-11, however, appears to be somewhat contrary to the buoyant trends witnessed in respect of capital goods segment in the IIP.

Demand Management through Fiscal Policy

Central Government Finances

II.5 Reflecting the impact of economic recovery, partial rollback of fiscal stimulus

Chart II.2: Weighted Contribution to GDP Growth from Expenditure Side



measures and receipts from 3G spectrum and broadband wireless access (BWA) auctions, the position of Central Government finances improved significantly with revenue deficit (RD) and gross fiscal deficit (GFD) during April-August 2010-11 turning out to be substantially lower, both in absolute terms and as a proportion of budget estimates, over the corresponding period of the previous year (Chart II.3 and Table II.2).

II.6 Improvement in finances of the Central Government during 2010-11 so far (April-August) was evident from substantial increase in revenue receipts (85.0 per cent), supported by tax and non-tax revenues. The gross tax revenue increased significantly (27.3 per cent) in contrast to the sharp decline (11.6 per cent) recorded during 2009-10 (April-August), mirroring the underlying economic recovery and the partial rollback of indirect tax cuts.

II.7 Direct tax collections showed significant improvement during April-August 2010-11, recording a growth of 13.8 per cent over April-August 2009-10. While corporate tax collections grew by 18.4 per cent, collections under personal income tax increased by 14.0 per cent. In addition, the mobilisation of revenues from 3G/BWA spectrum auctions in June 2010 helped to ease the pressure on Government finances.

II.8 During April-August 2010-11, growth in revenue as well as capital expenditure was higher than in the corresponding period of 2009-10. The escalation in aggregate expenditure emanated from accelerated growth (39.2 per cent) in plan expenditure. During 2010-11 so far (April-August), Centre has already incurred 40.4 per cent of aggregate expenditure budgeted for 2010-11 (Chart II.4).

II.9 The fiscal stimulus measures initiated by the Government achieved the objective of containing the duration and extent of economic slowdown in India. Taking cognisance of the improved growth prospects and the need for fiscal consolidation for sustaining the growth momentum, Central government has

Chart II.3: Key Deficit Indicators

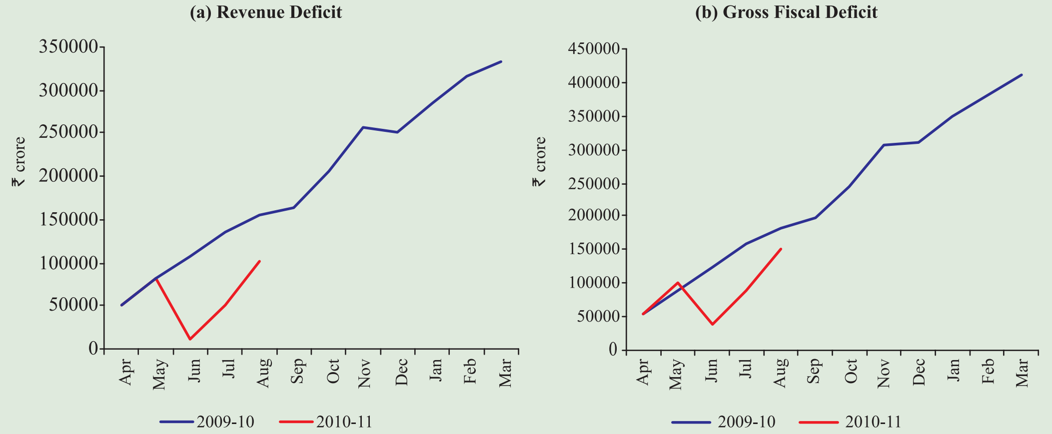


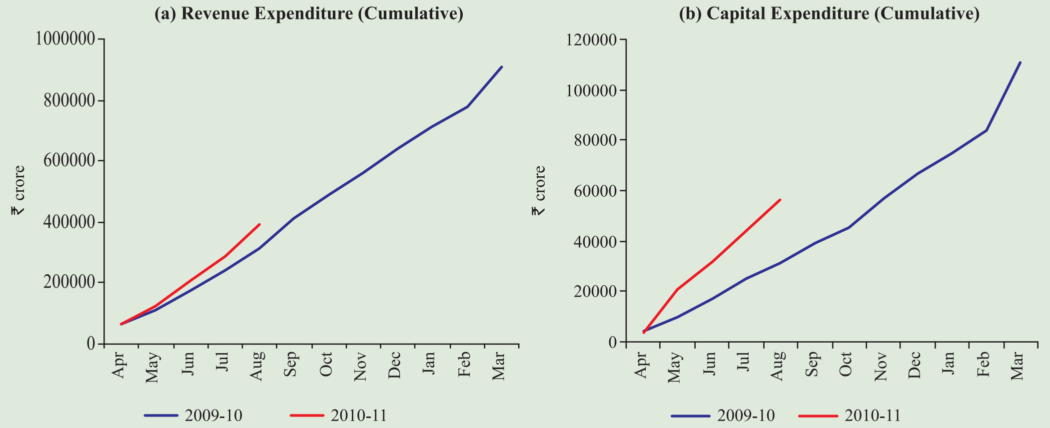
Table II.2 : Central Government Finances: April-August 2010-11

Item	April-August (₹ crore)		Percentage to Budget Estimates for		Growth Rate (Per cent)	
	2009	2010	2009-10	2010-11	2009-10	2010-11
1	2	3	4	5	6	7
1. Revenue receipts	1,57,198	2,90,799	25.6	42.6	-2.7	85.0
i) Tax revenue (Net)	1,06,837	1,38,500	22.5	25.9	-14.8	29.6
ii) Non-tax revenue	50,361	1,52,299	35.9	102.8	39.6	202.4
2. Non-debt capital receipts	3,835	5,479	71.7	12.1	218.8	42.9
3. Non-plan expenditure	2,45,275	3,11,249	35.3	42.3	27.1	26.9
of which:						
i) Interest payments	72,133	85,621	32.0	34.4	9.6	18.7
ii) Defence	41,129	45,395	29.0	30.8	65.8	10.4
iii) Major subsidies	54,193	54,738	51.1	50.2	4.7	1.0
4. Plan expenditure	98,048	1,36,454	30.2	36.6	13.2	39.2
5. Revenue expenditure	3,12,283	3,91,151	34.8	40.8	20.4	25.3
6. Capital expenditure	31,040	56,552	25.1	37.7	53.6	82.2
7. Total expenditure	3,43,323	4,47,703	33.6	40.4	22.8	30.4
8. Revenue deficit	1,55,085	1,00,352	54.9	36.3	58.4	-35.3
9. Gross fiscal deficit	1,82,290	1,51,425	45.5	39.7	56.0	-16.9
10. Gross primary deficit	1,10,157	65,804	62.8	49.6	115.8	-40.3

Source: Controller General of Accounts, Ministry of Finance.

embarked on gradual fiscal exit plan as announced in the Budget 2010-11. The robust growth in revenue receipts in 2010-11 is premised on partial rollback of indirect tax rate reduction and revenue from 3G/BWA spectrum auctions. Given the one-off nature of auction proceeds, the priority of consolidation should continue in terms of quantity and quality. In order to achieve a sustainable progress on fiscal consolidation path, it would be desirable to adopt measures designed to augment revenue collection on a sustainable basis and rationalisation of recurring expenditure, with a focus, particularly on curtailing non-plan revenue expenditure.

Chart II.4: Trends in Central Government Expenditure



State Finances

II.10 State Governments undertook various measures in terms of additional spending and tax cuts in 2009-10 with a view to boost domestic economic activities. As a result, revenue deficit re-emerged in 2009-10, after a gap of three years. Recognising the need for fiscal discipline, States have embarked upon the process of fiscal consolidation in 2010-11. Revenue expenditure, as a ratio to GDP, is budgeted to be lower at 13.4 per cent in 2010-11 (BE) as against 13.6 per cent in 2009-10 (RE). States expect to witness higher revenue buoyancy in 2010-11 (BE) on account of higher own tax revenue and share in Central taxes. Accordingly, revenue deficit and gross fiscal deficit of State governments are budgeted to be lower in 2010-11.

Combined Fiscal Position

II.11 An overview of the combined finances of the Central and State Governments budgeted for 2010-11 indicates that the key deficit indicators as per cent of GDP would moderate compared to the elevated levels in 2009-10 (Table II.3). The envisaged fiscal consolidation is to be driven by significant increase in revenue receipts, while curtailing the growth of expenditure. Total expenditure in terms of both growth and as a percentage of GDP would moderate somewhat from the previous year. Growth in tax collections is expected to improve on account of reversal of tax cuts and the acceleration in economic growth.

Corporate Performance

II.12 The turnaround in overall economic activity was reflected in the corporate sector performance. Sales of private corporate business sector witnessed significant improvement, recording a growth of 24.2 per cent (y-o-y) during the first quarter of 2010-11 (Table II.4).

Table II.3: Key Fiscal Indicators

(Per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal Deficit	Outstanding Liabilities*
1	2	3	4	5
		Centre		
2008-09	2.6	4.5	6.0	56.7
2009-10 RE	3.2	5.3	6.7	56.4
2010-11 BE	1.9	4.0	5.5	56.9
		States #		
2008-09	0.6	-0.2	2.4	26.2
2009-10 RE	1.6	0.8	3.4	26.2
2010-11 BE	1.0	0.4	2.9	26.1
		Combined		
2008-09	3.4	4.3	8.5	72.0
2009-10 RE	4.8	6.0	10.0	72.5
2010-11 BE	3.0	4.4	8.3	73.6

RE : Revised Estimates. BE : Budget Estimates.
* : Includes external liabilities at historical exchange rates.
# : Data pertain to 27 State Governments.
Note: Negative sign indicates surplus.

Table II.4: Corporate Sector Financial Performance

(Growth rates/ratios in per cent)

Item	2008-09				2009-10				2010-11
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7	8	9	10
No. of companies	2500	2386	2486	2561	2530	2531	2562	2565	2546
Sales	29.3	31.8	9.5	1.9	-0.9	0.1	22.5	29.1	24.2
Other income*	-8.4	-0.6	-4.8	39.4	50.2	6.0	7.4	10.3	-21.2
Expenditure	33.5	37.5	12.6	-0.5	-4.4	-2.5	20.6	30.7	29.0
Depreciation provision	15.3	16.5	16.8	19.6	21.5	20.7	21.6	20.1	19.9
Gross profits	11.9	8.7	-26.7	-8.8	5.8	10.9	60.0	36.7	8.2
Interest payments	58.1	85.3	62.9	36.5	3.7	-1.0	-12.3	-2.9	26.9
Profits after tax	6.9	-2.6	-53.4	-19.9	5.5	12.0	99.3	44.0	2.4
Select Ratios									
Change in stock-in-trade to sales #	2.9	2.2	-1.7	-1.8	0.6	2.3	0.8	1.1	2.9
Gross profits to sales	14.5	13.5	11.0	13.7	15.7	14.9	14.3	14.6	13.9
Profits after tax to sales	9.7	8.6	5.3	8.1	10.2	9.4	8.8	9.0	8.6
Interest to sales	2.4	2.9	3.8	3.2	2.8	3.1	2.7	2.4	2.9
Interest to gross profits	16.8	21.5	34.6	23.3	18.0	20.5	19.1	16.6	21.1
Interest coverage (times)	6.0	4.6	2.9	4.3	5.6	4.9	5.2	6.0	4.7

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

\# : For companies reporting change in stock-in-trade explicitly.

Note: 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.

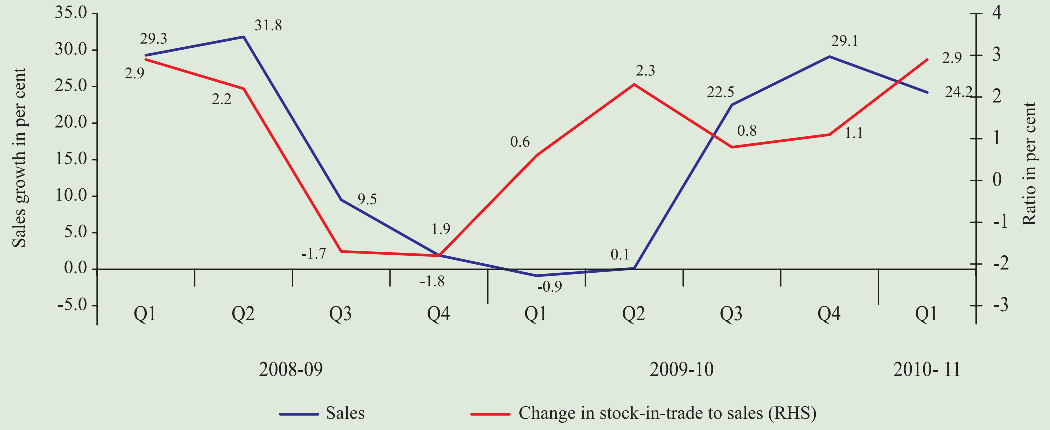
2. The quarterly data may not add up to annual data due to differences in the number and composition of companies covered, in each period.

The high growth in sales partly reflects the low base effect, as the economic activity in the first quarter of the previous year had remained subdued with an almost flat sales and moderate profit growth. Sequentially, sales growth during the first quarter of 2010-11 witnessed moderation over the fourth quarter of 2009-10, though seasonally adjusted sales increased by 1.9 per cent over the fourth quarter of 2009-10.

II.13 Change in stock-in-trade, which remains generally around the peak in the first quarter of each financial year, formed 2.9 per cent of sales during the first quarter of 2010-11 (Chart II.5). A rise in change in stock-in-trade to sales ratio suggests that corporates are building up their inventories in anticipation of higher demand. Accumulation of stocks increased to 3.3 per cent of sales excluding sugar industry during the quarter. Given the strong growth in sales, increase in change in stock to sales ratio suggests significant addition to stocks during the quarter, which could have been a factor to support the robust overall GDP and industrial growth in that quarter.

II.14 Strong investment intentions were evident as reflected in higher envisaged capital expenditure of companies, which approached banks/FIs for financial assistance during April-June 2010. In the first quarter of 2010-11, 87 projects were sanctioned assistance by banks/FIs of ₹99,998 crore as against 35 projects of ₹30,116 crore sanctioned during corresponding period of the previous year.

Chart II.5: Movement in Sales Growth & Change in Stock-in-Trade to Sales Ratio



External Demand

II.15 Unlike in the fourth quarter of 2009-10, when net exports had contributed positively to real GDP growth on the expenditure side, the contribution of net exports during the first quarter of 2010-11 became negative, as growth in imports remained ahead of growth in exports. (see Chart II.2). While the growth in exports was impacted by the weak and uncertain global economic environment, that of imports reflected the increasing momentum of domestic economic activity.

II.16 To sum up, private consumption expenditure has picked up, but needs to gain further momentum to support a self-sustaining robust growth in GDP. Notwithstanding the process of fiscal consolidation that is underway, Government spending continues to support growth, reflecting higher growth in both revenue and capital expenditures. Available data relating to production of capital goods, notwithstanding volatility, and capital expenditure plans of the corporates point to a strong momentum in investment expenditure during the current fiscal year. Reflecting the high growth in India relative to hesitant recovery in the advanced economies, the contribution of net exports to aggregate demand could be expected to remain negative during the year. Overall, although aggregate demand trends point to continuation of the momentum, investment demand needs to emerge as the key driver for sustainable robust growth.

III. THE EXTERNAL ECONOMY

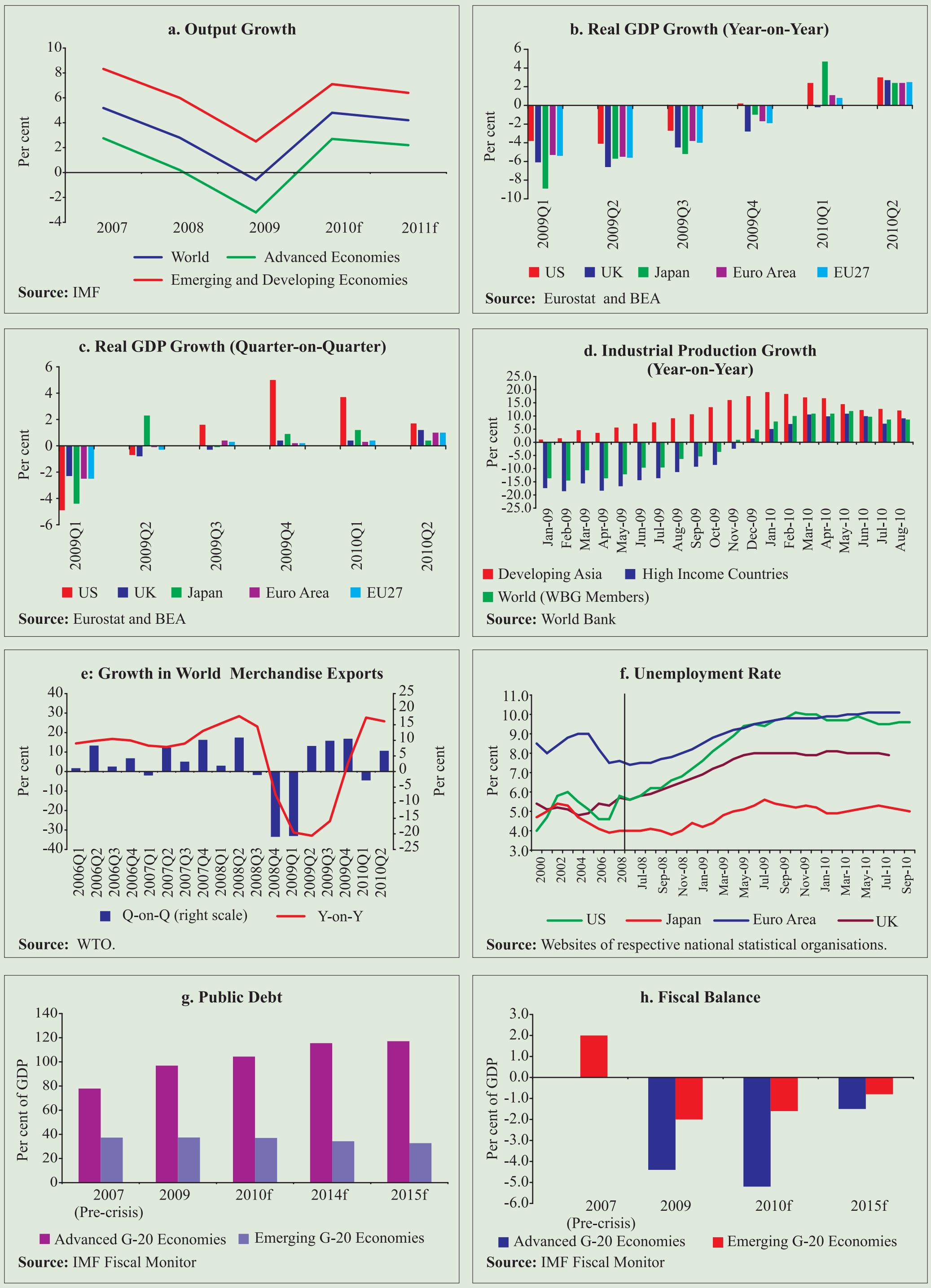
As renewed concerns about the strength of the global recovery started to dampen the external demand conditions, the impact of robust domestic growth was visible in the form of a higher current account deficit in the first quarter of 2010-11. While better absorption of foreign capital through a higher current account deficit contained the impact of surplus capital flows on the exchange rate, persistent positive inflation differential remained a source of pressure on external competitiveness of exports. Moreover, despite stronger absorption of capital inflows, the nominal exchange rate of the rupee appreciated against the US dollar.

International Developments

III.1 The global economy is projected to recover from -0.6 per cent growth recorded in 2009 to 4.8 per cent in 2010. This overall outlook, however, masks large divergence in the pace and nature of the recovery, both across countries and between the two halves of 2010. According to the IMF, in the advanced economies, growth is expected to halve from 3.50 per cent in the first half of the year to 1.75 per cent in the second half. Emerging and developing economies too are expected to witness a moderation in the pace of growth from 8 per cent in the first half to 6.25 per cent in the second half. The temporary slowdown is also believed to extend up to the first half of 2011.

III.2 The global recovery lost momentum in the second quarter of the year, with the pace of recovery starting to slow down significantly in the advanced economies, particularly in the US and Japan (Chart III.1b & c). Growth in world industrial production also exhibited signs of deceleration after attaining peaks in March 2010 (Chart III.1d). Emerging Market Economies (EMEs), however, sustained the strong growth, and as a result, the asymmetry in growth widened further. While another short phase of contraction in economic activities in advanced economies, *i.e.,* the fear of a double dip has receded, the feeble growth has reinforced concerns over deflation and high unemployment rates (Chart III.1f). With scope for fiscal stimulus already stretched to the point where sovereign risk concerns could be detrimental to recovery in growth, several central banks of advanced economies have signaled possible use of additional accommodative monetary policy stance (Chart III.1g & h). Unlike output, trade activities have recovered strongly, and the momentum has also been sustained (Chart.III.1e). Reflecting this, the WTO revised upwards its estimates for growth in merchandise trade volume to 13.5 per cent for 2010 from the previous estimates of 10.0 per cent, which will be the fastest ever year-on-year expansion in trade so far. This high growth, however, needs to be seen against the low base that resulted from sharp 12.2 per cent contraction experienced in 2009. Moreover, even though the value of merchandise trade expanded by 25 per cent in the first half of 2010, the level of activity still remains below the pre-crisis level. With deficient domestic demand, there have been signs of resorting to protectionism and undervalued exchange rates in some countries, which would hinder

Chart III.1: Key Global Indicators



overall global recovery. The unemployment situation in general continues to be grim, and employment intensive recovery remains a major global policy challenge. According to the ILO's August 2010 assessment of global employment trends for the youth, the global unemployment among youth (in the age group of 15 to 24) has increased from 11.9 per cent in 2007 to 13.0 per cent in 2009, which is expected to edge up further to 13.1 per cent in 2010. According to the IMF, unemployment has increased by 30 million since 2007, three fourth of which has been in advanced economies.

III.3 Developing Asia, according to the September 2010 assessment of the ADB, has sustained the momentum after witnessing a robust recovery, and is expected to grow at 8.2 per cent in 2010, as against 5.4 per cent in 2009. Recovery in both domestic demand and exports has contributed to this performance. End of the benefit of low base, fading policy stimulus and weaker growth in advanced economies in the second half of the year will be the major downside risks to growth. Risks to inflation could stem from buoyant domestic demand and rising commodity prices. The IIF revised upwards in October 2010 its assessment of private capital flows to EMEs for 2010 by US$ 116 billion from its April projections. Projected capital flows to EMEs in 2010 at US$ 825 billion will be significantly higher than US$ 581 billion in 2009. The Global Financial Stability Report, October 2010 notes that higher growth prospects and sounder fundamentals in EMEs point to a structural asset reallocation from advanced economies, which may increase volatility in portfolio capital flows and strain local market valuations in emerging market economies.

III.4 The recent volatile external developments suggest that for the purpose of policy, their direct and indirect impact on the Indian economy and the financial system would have to be constantly assessed, and appropriate corrective policy response may have to be taken to deal with any visible signs of vulnerability. The asymmetry in growth relative to advanced economies would imply higher trade imbalance in India, which also has to recognise the risks from protectionism and exchange rate policies of other countries. The overall upbeat outlook for capital flows to EMEs suggests that given the robust domestic growth outlook and the increasing interest rate differentials after the calibrated normalisation of monetary policy, gross capital inflows in 2010-11 would be higher than what were expected a few months back.

Merchandise Trade

Exports

III.5 India's merchandise exports, which exhibited a robust recovery in the last quarter of 2009-10, continued to record high growth during the current financial year (Chart III.2). After recording a growth

Chart III.2: India's Merchandise Trade

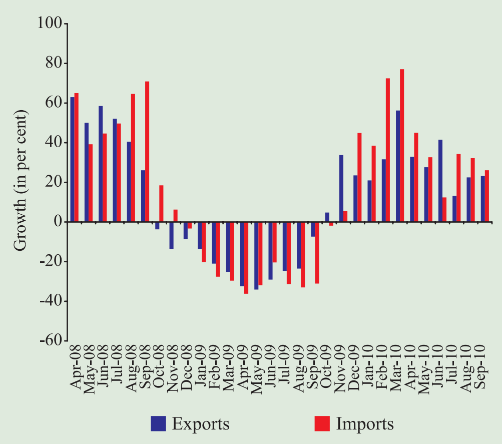
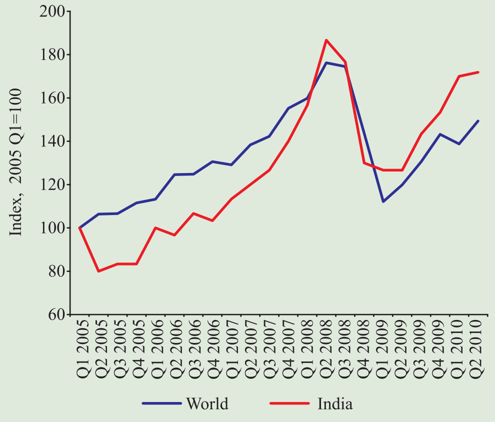


Chart III.3: Merchandise Exports of India Vs. World



of 36.4 per cent during the fourth quarter of 2009-10, export growth has witnessed some moderation to 27.6 per cent this year during April-September. India's export performance, however, remains better than the overall global trends (Chart III.3).

Imports

III.6 Reflecting the demand associated with robust domestic growth, imports increased at a higher pace, though with some volatility during the year so far. Oil imports registered a growth of 54.8 per cent during the first quarter of 2010-11 on account of the combined effect of increase in volume along with higher international crude oil prices relative to the corresponding quarter of the previous year (Chart III.4). Non-oil imports increased by 33.7 per cent during April-August 2010, reflecting strong domestic demand conditions.

III.7 Stronger growth in both oil and non-oil imports relative to exports resulted in a wider merchandise trade deficit during April-September 2010 at US$ 63.2 billion as compared with US$ 46.9 billion during the corresponding period of the previous year (Table III.3).

Balance of Payments (BoP)

Current Account

III.8 The impact of the continuing asymmetry between robust growth in India and fragile recovery in the advanced economies was visible in the current account deficit, which expanded in the first

Chart III.4: India's POL Imports and International Crude Oil Prices

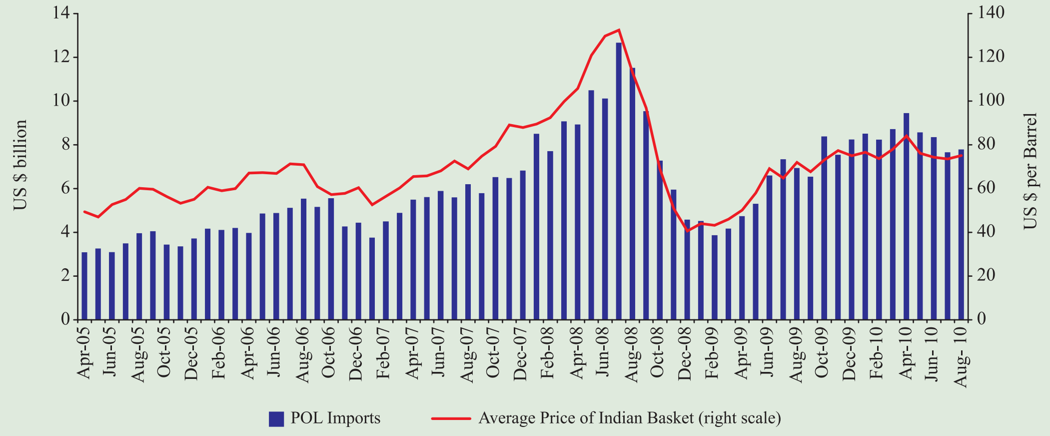


Table III.3: India's Merchandise Trade

(US$ billion)

	April-March		April-September			
	2009-10 P		2009-10 R		2010-11 P	
	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth (%)
1	2	3	4	5	6	7
Exports	178.7	-3.6	80.9	-25.7	103.3	27.6
Oil	28.1	2.1	10.8	-42.5	..	..
Non-oil	150.5	-4.6	70.2	-22.2	..	..
Imports	286.8	-5.6	127.8	-30.9	166.5	29.9
Oil	87.1	-7.0	37.5	-40.8	40.7*	31.7*
Non-oil	199.7	-4.9	90.4	-25.8	101.2*	33.7*
Trade Balance	**-108.2**	**-8.6**	**-46.9**	**-38.4**	**-63.2**	**34.8**
Non-Oil Trade Balance	**-49.2**	**-5.9**	**-20.2**	**-36.0**	**..**	**..**

R: Revised. P: Provisional. .. Not Available. *: Figures pertain to April-August.
Source: Directorate General of Commercial Intelligence and Statistics (DGCI&S).

quarter of 2010-11, relative to both previous quarter and corresponding quarter of the previous year (Table III.4). The trade deficit, on a BoP basis, was higher at US$ 34.2 billion in the first quarter of 2010-11 as compared with US$ 25.6 billion during corresponding period of 2009-10.

Table III.4: India's Balance of Payments

(US$ billion)

	2008-09 Apr-Mar PR	2009-10 Apr-Mar P	2009-10 Apr-Jun PR	2009-10 Jul-Sep PR	2009-10 Oct-Dec PR	2009-10 Jan-Mar P	2010-11 Apr-Jun P
1	2	3	4	5	6	7	8
1. Exports	189.0	182.2	39.2	43.5	47.1	52.4	53.7
2. Imports	307.7	299.5	64.8	72.6	78.1	83.9	87.9
3. Trade Balance (1-2)	-118.7	-117.3	-25.6	-29.1	-31.1	-31.5	-34.2
4. Net Invisibles	89.9	78.9	21.2	20.4	18.9	18.5	20.5
5. Current Account Balance (3+4)	-28.7	-38.4	-4.5	-8.8	-12.2	-13.0	-13.7
6. Gross Capital Inflows	312.4	344.0	77.1	95.4	81.3	90.2	95.3
7. Gross Capital Outflows	305.2	290.4	73.1	76.6	66.6	74.1	76.9
8. Net Capital Account (6-7)	7.2	53.6	4.0	18.8	14.7	16.1	18.4
9. Overall Balance (5+8)#	-20.1	13.4	0.1	9.4	1.8	2.1	3.7
Memo:							
i. Export growth (%)	13.7	-3.6	-31.8	-18.9	19.3	36.2	37.2
ii. Import growth (%)	19.4	-2.7	-21.7	-21.7	6.3	43.0	35.7
iii. Net service exports growth (%)	27.7	-31.1	-3.1	-47.4	-40.8	-24.5	-3.0
iv. Net Invisibles growth (%)	18.7	-12.2	-3.7	-23.3	-15.6	-2.6	-3.4
v. Foreign Exchange Reserves (as at end Period)	252.0	279.1	265.1	281.3	283.5	279.1	275.7

P: Preliminary. PR: Partially Revised.
: also includes errors & omissions.

Invisibles

III.9 India's net surplus in the invisibles account (comprising services, income and transfers) declined during the first quarter of 2010-11 as compared to last year, mainly because of strong growth in services payments and decline in investment income receipts. The increase in services exports (by 22.5 per cent) during April-June 2010 was mainly due to a rise in services related to travel, and transportation as well as miscellaneous services such as software, business and financial services, which was largely offset by substantial expansion in services payments, particularly transportation, business and financial services. As a result, there was a net decline of 3.0 per cent in the services account. The invisibles surplus financed about 60.0 per cent of the trade deficit during the quarter as against about 83.0 per cent during the corresponding quarter of the previous year (Table III.5).

Capital Account

III.10 The net surplus in the capital account in the first quarter of 2010-11 exceeded the levels of the previous two quarters, as well as the financing need in the current account (Table III.6). There was a compositional shift across different components of capital flows during recent months. Foreign investment, which used to be a major constituent of the capital account, showed some moderation, mainly due to the slowdown in Foreign Direct Investment (FDI) inflows. Net inflows by FIIs were also lower during the quarter.

Table III.5: Invisibles Gross Receipts and Payments

(US$ billion)

	Invisibles Receipts				Invisibles Payments			
	April-March		April-June		April-March		Apr-June	
	2008-09 PR	2009-10 P	2009-10 PR	2010-11 P	2008-09 PR	2009-10 P	2009-10 PR	2010-11 P
1	2	3	4	5	6	7	8	9
1. Travel	10.9	11.9	2.3	3.0	9.4	9.3	2.0	2.3
2. Transportation	11.3	11.1	2.5	3.1	12.8	11.9	2.8	3.1
3. Insurance	1.4	1.6	0.4	0.4	1.1	1.3	0.3	0.3
4. Govt. not included elsewhere	0.4	0.4	0.1	0.1	0.8	0.5	0.1	0.1
5. Miscellaneous	77.7	68.7	16.0	19.6	27.9	36.5	5.7	10.2
Of which:								
Software	46.3	49.7	11.0	12.7	2.8	1.5	0.4	0.6
Non-Software	31.4	19.0	5.0	6.9	25.1	35.0	5.3	9.6
6. Transfers	47.5	54.4	13.3	13.8	2.7	2.3	0.5	0.7
Of which:								
Private Transfers	46.9	53.9	13.3	13.7	2.3	1.8	0.4	0.6
7. Income	14.3	13.0	3.0	2.9	18.8	20.4	5.0	5.5
Investment Income	13.5	12.1	2.7	2.6	17.5	18.7	4.7	5.0
Compensation of Employees	0.8	0.9	0.2	0.2	1.3	1.7	0.4	0.5
Total (1 to 7)	**163.5**	**161.2**	**37.6**	**42.7**	**73.6**	**82.3**	**16.4**	**22.3**

P: Preliminary. PR: Partially Revised.

Table III.6: Net Capital Flows

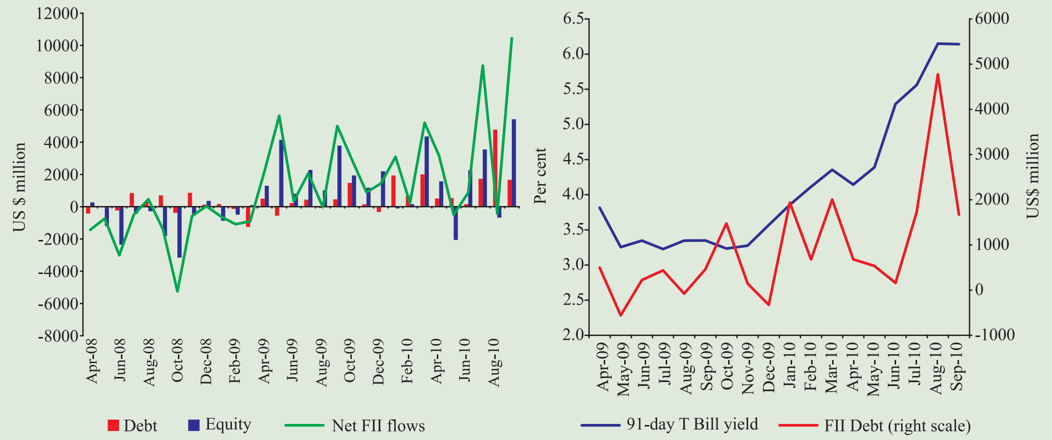
(US$ billion)

	2008-09 Apr-Mar PR	2009-10 Apr-Mar P	2009-10 Apr-Jun PR	2009-10 Jul-Sep PR	2009-10 Oct-Dec PR	2009-10 Jan-Mar PR	2010-11 Apr-Jun P
1	2	3	4	5	6	7	8
1. Foreign Direct Investment (FDI)	17.5	19.7	6.1	6.5	3.9	3.2	3.2
Inward FDI	35.0	31.7	8.7	10.7	7.1	5.1	6.0
Outward FDI	17.5	12.0	2.6	4.2	3.2	1.9	2.8
2. Portfolio Investment	-14.0	32.4	8.3	9.7	5.7	8.8	4.6
Of which:							
FIIs	-15.0	29.0	8.2	7.0	5.3	8.5	3.5
ADR/GDRs	1.2	3.3	0.04	2.7	0.5	0.1	1.1
3. External Assistance	2.6	2.0	0.1	0.5	0.6	0.8	2.3
4. External Commercial Borrowings	7.9	2.5	-0.5	1.2	1.7	0.1	2.7
5. NRI Deposits	4.3	2.9	1.8	1.0	0.6	-0.6	1.1
6. Banking Capital excluding NRI Deposits	-7.5	-0.8	-5.2	3.4	1.3	-0.4	2.9
7. Short-term Trade Credit	-1.9	7.7	-1.5	0.8	3.3	5.0	5.6
8. Rupee Debt Service	-0.1	-0.1	-0.02	-	-	-0.1	-0.02
9. Other Capital	-1.5	-12.7	-5.2	-4.3	-2.4	-0.9	-3.9
Total (1 to 9)	**7.2**	**53.6**	**4.0**	**18.8**	**14.7**	**16.1**	**18.4**

P: Preliminary. PR: Partially Revised. – : Negligible.

FIIs, which were traditionally investing in equity market, started diversifying towards debt markets (Chart III.5). The attraction of the debt market could be attributed to the rising interest rate environment in India and the near zero interest rate conditions in advanced countries over an extended period. In order to support the development of vital infrastructure, to facilitate the transfer of power from energy surplus regions to underserved areas and to improve the quality of public services, India received

Chart III.5: Recent Trends in Net FIIs' Investments



large foreign capital in the form of external assistance during the quarter. Strong domestic demand along with the rising interest rate differentials also led to higher net inflows of External Commercial Borrowings (ECBs) during the quarter. Short-term trade credit to India recorded a large net inflow of US$ 5.6 billion in the first quarter of 2010-11 (as against a net outflow of US$ 1.5 billion during the corresponding quarter of 2009-10) in line with the increase in imports associated with strong domestic economic activity and improved conditions in the global financial markets. Banking capital recorded inflows of US$ 4.0 billion during the quarter, mainly due to overseas foreign currency borrowings of banks and net inflows under NRI deposits. Debt flows during the quarter at about US$12 billion accounted for almost 64 per cent of total net capital flows.

III.11 Available information on certain lead indicators of capital flows for the period 2010-11 so far shows some moderation in inflows in the form of FDI and NRI deposits, but larger net inflows under FIIs and ECBs (Table III.7). Debt flows, particularly ECBs, which are sensitive to interest rate differential, have been higher. FII flows have remained volatile during the year so far. They recorded net outflows in May 2010 but revived strongly in July recording net inflows of US$ 8.8 billion. Again, there were net outflows in August 2010, followed by net inflows in September 2010 at US$ 10.5 billion. Inflows in October increased to a record level of US$ 28.7 billion (up to October 22, 2010), which also reflected the over subscription of IPOs floated in the capital market. In this context, it may be noted that although many other Asian EMEs have also seen large capital inflows recently, India runs a current account deficit as opposed to current account surpluses in many other Asian economies.

Table III.7: Capital Flows in 2010-11 so far

(US$ billion)

Component	Period	2009-10	2010-11
1	2	3	4
FDI to India	April-September	17.8	13.5
FIIs (net)	April-October 22	18.9	51.0
ADRs/GDRs	April-September	2.7	1.6
ECB Approvals	April-September	7.2	10.6
NRI Deposits (net)	April-September	2.9	2.2

FDI : Foreign Direct Investment.
FII : Foreign Institutional Investors.
ECB : External Commercial Borrowings.
NRI : Non Resident Indians.
ADR : American Depository Receipts.
GDR : Global Depository Receipts.

Foreign Exchange Reserves

III.12 As net capital flows were higher than the current account deficit, India's foreign exchange reserves (excluding valuation effects) increased by US$ 3.7 billion during the first quarter of 2010-11 as compared to only a marginal increase of US$ 0.1 billion during the corresponding period of the previous year. Since the valuation loss on account of the appreciation of the US dollar against major international currencies amounted to about US$ 7 billion during April-June 2010, there was a net decline in the outstanding level of foreign exchange reserves by US$ 3.3 billion. India's foreign exchange reserves stood at US$ 295.4 billion as on October 22, 2010 (Table III.8).

Real Effective Exchange Rate of the Rupee

III.13 The real effective exchange rate (REER) indices for both 6-currency and 36

Table III.8: Composition of Foreign Exchange Reserves

(US$ million)

Month	Gold	SDR	Foreign Currency Assets	Reserve Tranche Position in the IMF	Total (2+3+4+5)
1	2	3	4	5	6
Mar-09	9,577	1	241,426	981	251,985
Mar-10	17,986	5,006	254,685	1,380	279,057
Apr-10	18,537	4,982	254,773	1,341	279,633
May-10	19,423	4,861	247,951	1,309	273,544
Jun-10	19,894	4,875	249,628	1,313	275,710
Jul 10	19,278	5,006	258,551	1,348	284,183
Aug 10	20,008	4,974	256,227	1,932	283,142
Sept 10	20,516	5,130	265,231	1,993	292,870
Oct 10#	20,516	5,178	267,694	2,012	295,399

: As on October 22, 2010.

currency baskets had exhibited significant appreciation in 2009-10. During 2010-11 so far (April-October 22, 2010), the 6-currency REER has recorded higher appreciation as compared with 36-currency REER (Chart III.6 and Table III.9). The 36-currency REER covers around 90 per cent of India's foreign trade. If the positive inflation differentials persist, and the tendency among some countries to use undervalued exchange rates to boost their exports amplifies further, then the competitiveness

Table III.9: Nominal and Real Effective Exchange Rates of the Indian Rupee (Trade Based Weights, Base: 1993-94=100)

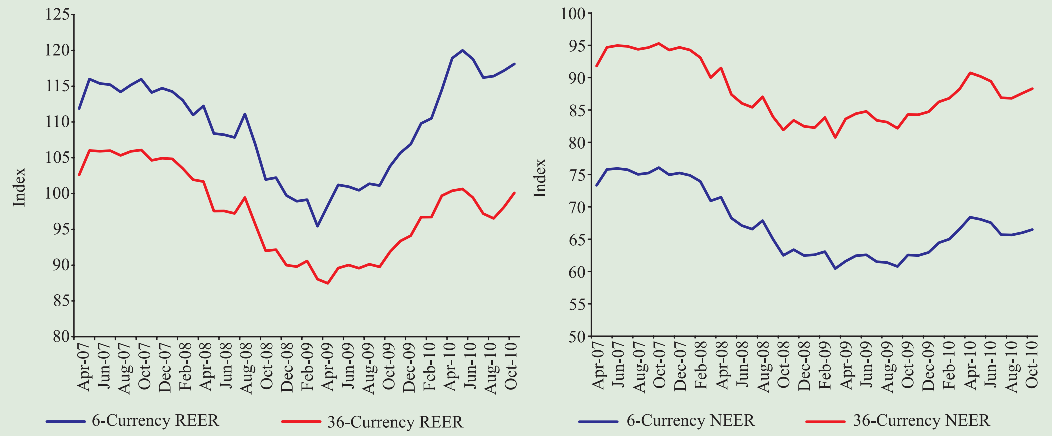
(Per cent, appreciation + /depreciation -)

	Index October 22, 2010 P	2008-09	2009-10	2009-10 (Apr-Oct)	2010-11 (Apr-Oct 22) P
1	2	3	4	5	6
36-REER	100.1	-13.6	13.2	4.4	0.4
36-NEER	88.3	-10.3	9.3	4.5	0.0
30-REER	92.7	-6.9	4.1	1.3	-0.6
30-NEER	108.2	-2.6	2.7	1.2	0.3
6-REER	118.1	-14.0	20.0	8.8	3.1
6-NEER	66.5	-14.8	10.2	3.5	-0.1
Memo:					
Rs/US$	44.47	-21.5	12.9	8.5	1.5

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

of Indian exports may face pressures. The reason for the divergence between 6-currency REER and 36-currency REER indices could be seen from the movement in the 30-currency REER index, which excludes 6 currencies (covered in the 6-currency REER). India's inflation differentials with respect to 6 major

Chart III.6: REER & NEER



countries included in the 6-currency REER have been higher than that with respect to other EMEs in the 30-currency index.

External Debt

III.14 India's external debt stock at US$ 273.1 billion at end-June 2010 recorded an increase of US$ 10.8 billion over its level at end-March 2010, mainly on account of significant increase in short-term trade credits, ECBs and multilateral borrowings of the Government. Excluding valuation effects resulting from the appreciation of the US dollar against major international currencies, India's external debt increased by US$ 12.1 billion. As at end-June 2010, the share of short-term debt in total external debt based on original maturity was 21.2 per cent, while based on residual maturity its share was higher at 42.5 per cent. The key debt sustainability indicators remained at comfortable levels as at end-June 2010 (Table III.10).

International Investment Position

III.15 India's net international liabilities increased by US$ 26.8 billion during the first quarter of 2010-11 mainly due to increase in net inflows under trade credits and loans along with FDI and portfolio investment. Total external financial assets decreased by US$ 5.3 billion to US$ 373.6 billion as at end-June 2010 over the previous quarter due to decline in reserve

Table III.10 : India's External Debt

(US$ billion)

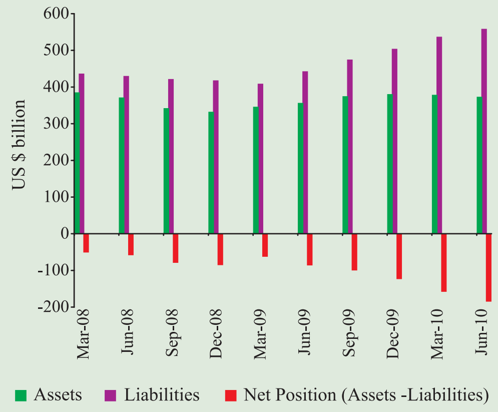
	End-March 2009	End-March 2010 PR	End-June 2010 P	Variation (June 2010 over March 2010)	
				Amount	Per cent
1	2	3	4	5	6
1. Multilateral	39.5	42.7	44.7	1.9	4.5
2. Bilateral	20.6	22.6	22.9	0.3	1.5
3. International Monetary Fund	1.0	6.0	5.9	-0.1	-2.6
4. Trade Credit (above 1 year)	14.5	16.9	17.6	0.7	4.2
5. External Commercial Borrowings	62.4	72.0	74.5	2.5	3.5
6. NRI Deposit	41.6	47.9	48.1	0.2	0.5
7. Rupee Debt	1.5	1.7	1.6	-0.1	-4.4
8. Long-term (1 to 7)	181.1	209.8	215.3	5.4	2.6
9. Short-term	43.4	52.5	57.8	5.4	10.2
Total (8+9)	**224.5**	**262.3**	**273.1**	**10.8**	**4.1**
					(Per cent)
Total Debt /GDP	20.5	18.9	-		
Short-term Debt/Total Debt	19.3	20.0	21.2		
Short-term Debt/Reserves	17.2	18.8	21.0		
Concessional Debt/Total Debt	18.7	16.7	15.9		
Reserves/Total Debt	112.2	106.4	101.0		
Debt Service Ratio	4.4	5.5	3.9		

-: Not available. P: Provisional; PR: Partially Revised.

assets and trade credits. The reserve assets declined by US$ 3.4 billion due to the valuation loss, reflecting appreciation of the US dollar against major international currencies. Total international financial liabilities increased by US$ 21.4 billion over the previous quarter to US$ 558.7 billion as at end-June 2010 (Chart III.7).

III.16 Overall, India's balance of payments situation reflected the impact of robust domestic growth, which was visible in the wider current account deficit. The upbeat growth outlook of India and rising interest rate differentials have contributed to attract larger net capital inflows, which financed the current account deficit. Going forward, the magnitude of the current account deficit may exceed the levels of the previous year, as asymmetry between the growth outlook of India and the developed countries is likely to persist, which will be reflected in export growth lagging behind import growth during the year. Recent outlook for capital flows to EMEs suggests that after the temporary uncertainty created by the sovereign risk concerns in the Euro area, capital flows to EMEs will be stronger. Although financing of the current account deficit may not be a problem, possible increase in the magnitude of the deficit could pose sustainability risks. Sustainable current account deficit is important for stable growth, and persisting high positive inflation differential will be a source of pressure on the external competitiveness of Indian exports. Containing inflation, thus, is important even for improving the external balance position.

Chart III.7: International Investment Position of India



IV. MONETARY AND LIQUIDITY CONDITIONS

The liquidity conditions, which transited from surplus to deficit in the wake of 3G/BWA auctions in May 2010, have generally remained in the deficit mode since then, reflecting the stance of monetary policy. Normalisation of policy rates, along with narrowing of the LAF corridor, and the shift from surplus to deficit liquidity conditions have resulted in an effective increase in the policy rate by 275 basis points since March 2010. Even as reserve money has grown at a fairly rapid pace, broad money (M_3) growth continues to remain relatively subdued, reflecting the decelerated growth in aggregate deposits. With persistent deficit liquidity conditions, banks have started to scale up their deposit mobilisation efforts, as reflected in the higher deposit interest rates being offered since July 2010.

IV.1 The non-disruptive normalisation of the monetary policy has significantly altered the liquidity and interest rate conditions over a few months. With repo emerging as the normal mode under the liquidity adjustment facility (LAF), and the consequent effective increase in the policy rate by 275 basis points, the transmission of monetary policy has also witnessed signs of strengthening. Since March 2010, the Reserve Bank has raised repo and reverse repo rates by 125 basis points and 175 basis points, respectively, which narrowed the LAF corridor from 150 basis points to 100 basis points. With continued build-up of government cash balances and increase in currency with the public, the LAF operations have remained mostly in deficit (injection) mode since June 2010.

IV.2 During the first quarter of the year, non-food credit growth of scheduled commercial banks (SCBs) exceeded the indicative trajectory set out in the Monetary Policy Statement for 2010-11. Notwithstanding the one-off increase in credit demand associated with payment for telecom spectrums, the growth of non-food credit during the second quarter remained close to the Reserve Bank's indicative projection. Money supply (M_3) growth, which had started picking up from July 2010 registered deceleration towards the end of the quarter and showed acceleration for the latest fortnight for which data are available. The subdued growth in M_3 has been largely conditioned by the decelerated growth in deposits, which account for over 85 per cent of money supply. On the sources side, there has been a considerable dip in the rate of growth of banking system's credit to the government (Table IV.1).

Liquidity Management

IV.3 During 2010-11 so far, the centre's surplus balance with the Reserve Bank has been a key driver of autonomous liquidity. Currency with the public, which registered high growth during the year so far, has been another key determinant of autonomous liquidity. The LAF window of the Reserve Bank, which remained in surplus mode for nearly 18 months, switched into deficit mode towards end-May 2010 and largely maintained the trend subsequently (Chart IV.1).

Table IV.1: Monetary Indicators

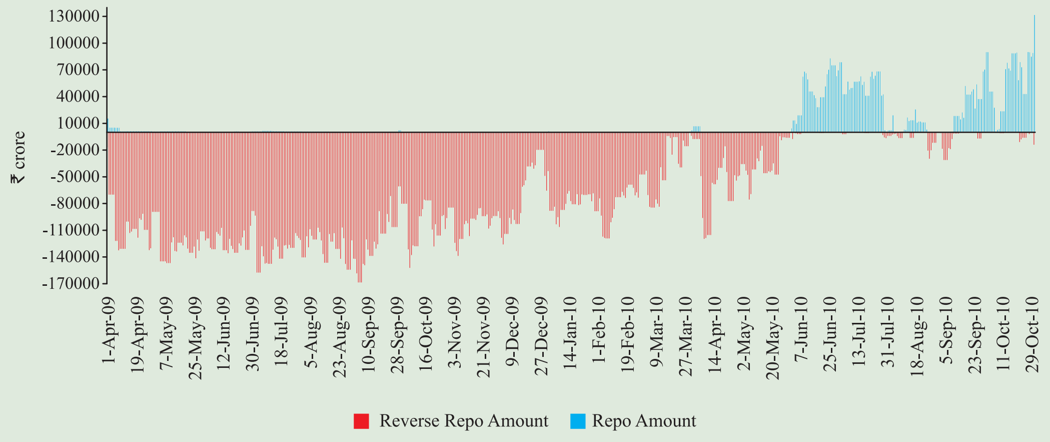
(Amount in ₹ crore)

Item	Outstanding as on October 8, 2010	Variation (year-on-year)			
		October 9, 2009		October 8, 2010	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
I. Reserve Money*	11,73,195	1,02,793	11.8	2,02,615	20.9
(Reserve Money adjusted for CRR changes)			(19.5)		(15.4)
II. Broad Money (M_3)	59,62,123	8,45,490	19.5	7,88,278	15.2
III. Components of M_3 (a + b + c)					
a) Currency with the Public	8,33,513	97,734	16.2	1,32,208	18.9
b) Aggregate Deposits	51,24,022	7,48,202	20.1	6,55,915	14.7
i) Demand Deposits	6,83,117	55,664	10.4	91,885	15.5
ii) Time Deposits	44,40,905	6,92,538	21.7	5,64,029	14.5
c) Other Deposits with RBI	4,588	-446	-9.1	155	3.5
IV. Sources of M_3 (a + b + c + d - e)					
a) Net Bank Credit to the Government (i+ii)	17,41,985	4,43,256	44.7	3,08,028	21.5
i) Net Reserve Bank Credit to the Government	1,94,702	36,641	–	1,89,336	–
of which: to the Centre	1,93,452	37,037	–	1,88,046	–
ii) Other Banks' Credit to the Government	15,47,284	4,06,615	39.8	1,18,692	8.3
b) Bank Credit to the Commercial Sector	37,20,942	2,95,084	10.4	5,94,353	19.0
c) Net Foreign Assets of the Banking Sector	13,24,951	-18,657	-1.4	-6,412	-0.5
d) Government's Currency Liabilities to the Public	11,761	955	9.9	1,151	10.9
e) Net Non-Monetary Liabilities of the Banking Sector	8,37,517	-1,24,852	-14.6	1,08,843	14.9

*: Data pertain to October 22, 2010.
Note: Data are provisional.

IV.4 With the persistence of deficit liquidity conditions, the Reserve Bank extended the liquidity-easing measures introduced in May 2010, *i.e.*, allowing SCBs to avail additional liquidity support under the LAF to the extent of up to 0.5 per cent of their NDTL till mid-July and operation of second LAF (SLAF) on a daily basis till end-July 2010. The average daily liquidity injection under the LAF was

Chart IV.1: LAF Volumes



around ₹47,000 crore during July 2010. In view of the evolving inflationary scenario, the repo and the reverse repo rates were raised by 50 basis points and 75 basis points, respectively, in two stages in July 2010 (Table IV.2).

IV.5 The liquidity conditions improved in August 2010, mainly on account of large pre-scheduled public debt redemptions towards end-July 2010, and the average daily net injection of liquidity declined to around ₹1,000 crore during the month. After a brief period of surplus liquidity (from end-August to early-September 2010), the liquidity conditions again switched to deficit mode as liquidity migrated to government balances with the Reserve Bank on account of quarterly advance tax payments.

IV.6 On the basis of the assessment of the macroeconomic situation, the Reserve Bank increased the repo rate and reverse repo rate by 25 basis points and 50 basis points, respectively, in the mid-quarter monetary policy review in September. The liquidity conditions remained in deficit mode in the second half of September 2010 as the cash balances of the centre started building-up, and the average daily net liquidity injection was around ₹24,000 crore during the month.The liquidity conditions tightened further in October 2010. In order to ease the frictional liquidity pressure, the Reserve Bank announced certain temporary measures,*viz.*, conduct of SLAF on October 29 and November 1, 2010, conduct of a special two-day repo auction under LAF on October 30, 2010 and waiver of penal interest on shortfall in maintainance of SLR on October 30-31, 2010, to the extent of 1 per cent of NDTL

Table IV.2: Movements in Key Policy Rates in India

(Per cent)

Effective since	Reverse Repo Rate	Repo Rate	Cash Reserve Ratio
1	2	3	4
April 26, 2008	6.00	7.75	7.75 (+0.25)
May 10, 2008	6.00	7.75	8.00 (+0.25)
May 24, 2008	6.00	7.75	8.25 (+0.25)
June 12, 2008	6.00	8.00 (+0.25)	8.25
June 25, 2008	6.00	8.50 (+0.50)	8.25
July 5, 2008	6.00	8.50	8.50 (+0.25)
July 19, 2008	6.00	8.50	8.75 (+0.25)
July 30, 2008	6.00	9.00 (+0.50)	8.75
August 30, 2008	6.00	9.00	9.00 (+0.25)
October 11, 2008	6.00	9.00	6.50 (–2.50)
October 20, 2008	6.00	8.00 (–1.00)	6.50
October 25, 2008	6.00	8.00	6.00 (–0.50)
November 3, 2008	6.00	7.50 (–0.50)	6.00
November 8, 2008	6.00	7.50	5.50 (–0.50)
December 8, 2008	5.00 (-1.00)	6.50 (–1.00)	5.50
January 5, 2009	4.00 (-1.00)	5.50 (–1.00)	5.50
January 17, 2009	4.00	5.50	5.00 (–0.50)
March 4, 2009	3.50 (-0.50)	5.00 (-0.50)	5.00
April 21, 2009	3.25 (-0.25)	4.75 (-0.25)	5.00
February 13, 2010	3.25	4.75	5.50 (+0.50)
February 27, 2010	3.25	4.75	5.75 (+0.25)
March 19, 2010	3.50 (+0.25)	5.00 (+0.25)	5.75
April 20, 2010	3.75 (+0.25)	5.25 (+0.25)	5.75
April 24, 2010	3.75	5.25	6.00 (+0.25)
July 2, 2010	4.00 (+0.25)	5.50 (+0.25)	6.00
July 27, 2010	4.50 (+0.50)	5.75 (+0.25)	6.00
September 16, 2010	5.00 (+0.50)	6.00 (+0.25)	6.00

Note: 1. Reverse repo indicates absorption of liquidity and repo indicates injection of liquidity.
2. Figures in parentheses indicate change in policy rates in per cent.

for availing additional liquidity support under LAF.

IV.7 Despite surplus government balance and currency with the public operating as the major drains on liquidity during the second quarter of 2010-11, when compared with the situation prevailing at the end of the first quarter, variations in both currency and government surplus had a positive contribution to autonomous liquidity in the system (Table IV.3). The liquidity situation was managed primarily through LAF (Table IV.4).

Table IV.3: Reserve Bank's Liquidity Management Operations

(₹ crore)

Item	2009-10 Q1	2009-10 Q2	2009-10 Q3	2009-10 Q4	2010-11 Q1	2010-11 Q2
1	2	3	4	5	6	7
A. Drivers of Liquidity (1+2+3+4)	**-45,110**	**-44,514**	**-66,785**	**55,055**	**-1,05,124**	**26,981**
1. RBI's net Purchase from Authorised Dealers	-15,874	2,523	436	910	816	751
2. Currency with the Public	-18,690	-9,020	-43,224	-31,650	-58,420	241
3.a. Centre's surplus balances with RBI	3,382	-67,938	-22,663	85,257	-58,249	10,953
3.b. WMA and OD	0	0	0	0	0	0
4. Others (residual)	-13,928	29,921	-1,334	538	10,729	15,036
B. Management of Liquidity (5+6+7+8)	**-21,674**	**62,376**	**89,870**	**1,618**	**67,255**	**-41,456**
5. Liquidity impact of LAF	-1,30,020	25,390	86,330	18,795	75,785	-44,545
6. Liquidity impact of OMO* (net)	43,159	32,869	3,540	2,787	1,550	2,772
7. Liquidity impact of MSS	65,187	4,117	0	16,036	2,420	317
8. First round impact of CRR change	0	0	0	-36,000	-12,500	0
C. Bank Reserves # (A+B)	**-66,784**	**17,863**	**23,085**	**56,673**	**-37,869**	**-14,475**

(+) : Injection of liquidity into the banking system. (-): Absorption of liquidity from the banking system.
* : Includes oil bonds but excludes purchases of government securities on behalf of State Governments.
# : Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.
Note: Data pertain to March 31 for Q4 and last Friday for all other quarters.

Table IV.4: Liquidity Position

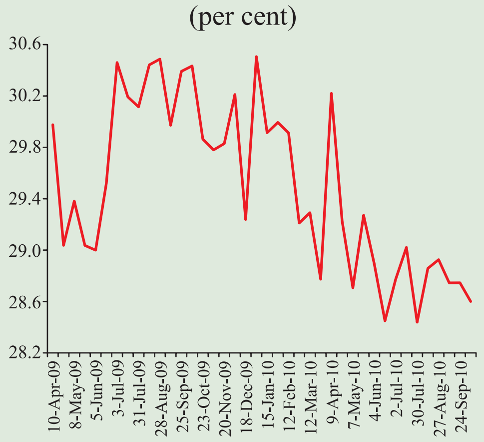
(₹ crore)

Outstanding as on Last Friday	LAF	MSS	Centre's Surplus@	Total
1	2	3	4	5 = (2+3+4)
2009				
April	1,08,430	70,216	-40,412	1,38,234
May	1,10,685	39,890	-6,114	1,44,461
June	1,31,505	22,890	12,837	1,67,232
July	1,39,690	21,063	26,440	1,87,193
August	1,53,795	18,773	45,127	2,17,695
September	1,06,115	18,773	80,775	2,05,663
October	84,450	18,773	69,391	1,72,614
November	94,070	18,773	58,460	1,71,303
December	19,785	18,773	1,03,438	1,41,996
2010				
January	88,290	7,737	54,111	1,50,138
February	47,430	7,737	33,834	89,001
March*	990	2,737	18,182	21,909
April	35,720	2,737	-28,868	9,589
May	6,215	317	-7,531	-999
June	-74,795	317	76,431	1,953
July	1,775	0	16,688	18,463
August	11,815	0	20,054	31,869
September	-30,250	0	65,477	35,227
October**	-36,800	0	75,562	38,762

@ : Excludes minimum cash balances with the Reserve Bank in case of surplus.
* : Data pertain to March 31. ** : Data pertain to October 22.
Note: 1. Negative sign in column 2 indicates injection of liquidity through LAF.
2. Negative sign in column 4 indicates WMA /OD availed by the central government.

IV.8 There has been a significant reduction in the holdings of government securities by SCBs not only because of the higher growth of non-food credit, but also because banks tapped the repo window under the LAF for their liquidity needs, leading to gradual decline in SLR maintenance (Chart IV.2). The excess SLR investments of SCBs amounted to ₹1,86,097 crore in early October 2010

Chart IV.2: SLR Maintenance by Banks
(per cent)



compared with ₹2,80,645 crore a year ago. With moderation in excess SLR, banks are making efforts to increase their deposit base as well as modulating the excess reserves maintained by them with the Reserve Bank.

Reserve Money

IV.9 Unlike the first quarter when the main component of increase in reserve money was currency in circulation, the reserve money growth in the second quarter was led by increase in banks' deposits with Reserve Bank (Table IV.5). Banks' deposits with the Reserve Bank increased in line with the increase in their net demand and time liabilities. On average, banks maintained excess reserves of ₹5,200 crore with the Reserve Bank during the quarter. Even though currency has shown strong y-o-y growth so far, the contraction during the quarter under review is consonant with the trend of subdued currency demand during the second quarter of the year (Chart IV.3).

IV.10 On the sources side, the Reserve Bank's credit to the Centre declined during the quarter, due to the combined effect of decline in the quantum of repo operations

Table IV.5: Reserve Money - Variations

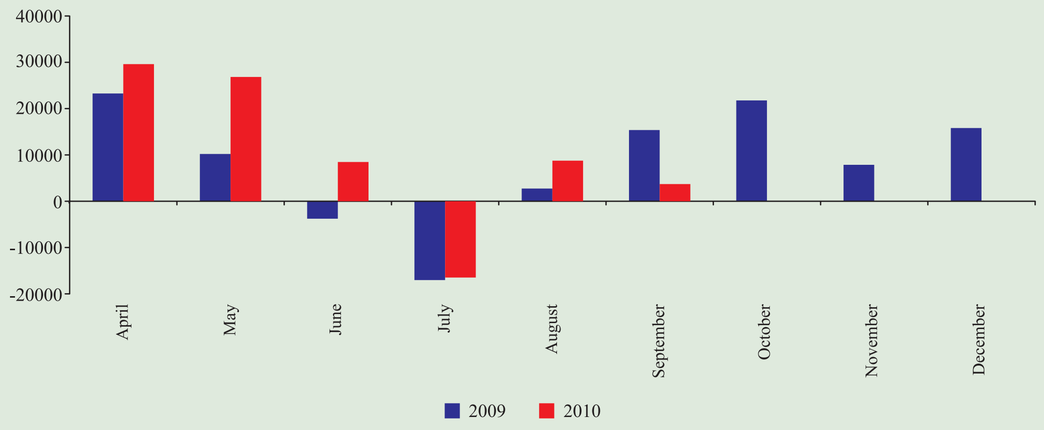
(₹ crore)

Item	2009-10				2010-11	
	Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7
Reserve Money	-38,926	16,216	51,816	1,38,583	15,125	3,370
Components (1+2+3)						
1. Currency in Circulation	29,692	1,081	45,442	32,181	64,902	-4,005
2. Bankers' Deposits with RBI	-72,664	20,680	5,456	1,07,552	-49,042	6,481
3. 'Other' Deposits with the RBI	4,046	-5,545	918	-1,150	-735	894
Sources (1+2+3+4-5)						
1. RBI's Net Credit to Government	-11,145	-14,953	51,428	1,24,676	15,796	-20,621
of which: to Centre	-11,497	-14,968	51,597	1,24,688	15,807	-20,586
2. RBI's Credit to Banks and Commercial Sector	-9,623	-3,747	-5,926	-2,384	851	323
3. Net Foreign Assets of RBI	-16,750	50,120	-15,108	-66,428	14,613	53,422
4. Governments' Currency Liabilities to the Public	254	302	309	351	355	137
5. Net Non-monetary Liabilities of RBI	1,662	15,506	-21,113	-82,369	16,491	29,890
Memo:						
LAF - Repo (+) / Reverse Repo (-)	-1,32,800	28,170	67,765	37,360	39,375	-8,135
Net Open Market Sales *	-42,001	-31,591	-1,894	17	-8	20
Centre's Surplus	-13,156	77,713	17,519	-80,112	37,405	9,890
MSS Balances	-65,187	-4,117	0	-16,036	-2,420	-317

*: Excludes Treasury Bills.

Note: 1. The sum of the memo items will not add up to the net Reserve Bank credit to the Centre as LAF and OMO transactions are at face value and also due to margin adjustment for LAF operations.
2. Data based on March 31 for Q4 and last reporting Friday for all other quarters.
3. Data are provisional.
4. Centre's surplus includes government's investment balance and cash balance with the Reserve Bank.

Chart IV.3: Monthly Change in Currency in Circulation (₹ crore)



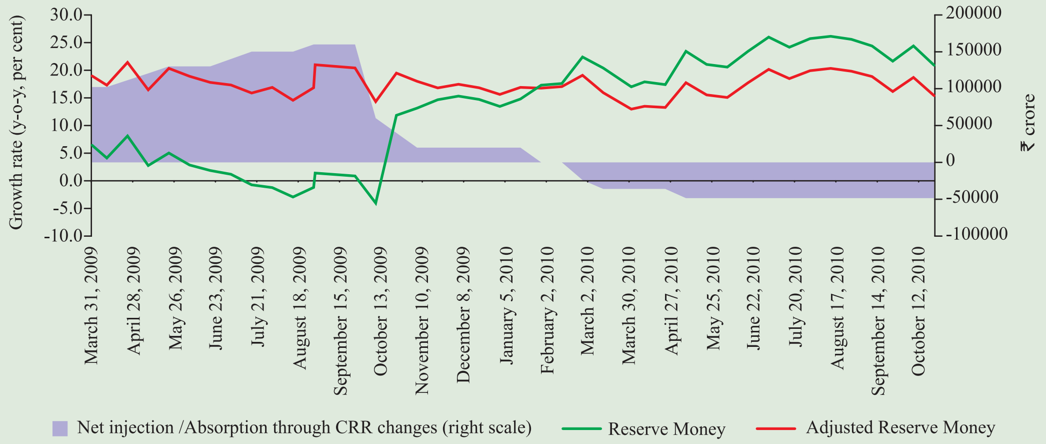
under the LAF[1] as compared to the previous quarter and build up of government balances.

IV.11 The adjusted reserve money (base money adjusted for the first round impact of monetary policy actions of the Reserve Bank in the form of CRR changes) increased by 15.9 per cent (y-o-y) as on October 22, 2010 reflecting the impact of increase in currency in circulation (on the components side) and Reserve Bank credit to the government (on the sources side) (Chart IV.4).

Money Supply

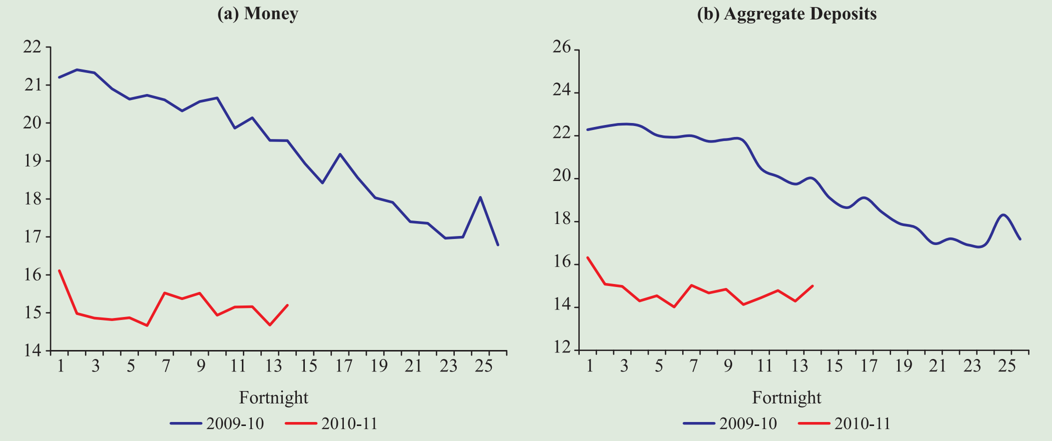
IV.12 The deceleration in the growth of broad money (M_3), that started in 2009-10, continued in the first quarter of 2010-11. Even though there was some revival in the

Chart IV.4: Reserve Money and Adjusted Reserve Money



[1] The Reserve Bank's credit to the Centre is affected by LAF operations, OMO, MSS balances and government's cash surplus with the Reserve Bank. Increase in repo/OMO purchases and decline in reverse repo/MSS balances/Government's surplus balances with Reserve Bank lead to increase in net Reserve Bank credit to the Centre, and *vice versa*.

Chart IV.5: Monetary Indicators (y-o-y growth in per cent)



growth rate of M_3 during the second quarter, it still remained below the trajectory of 17 per cent indicated in the Monetary Policy Statement 2010-11 (Chart IV.5 a). The pattern of growth in M_3 mainly tracked the behaviour of the major component of money stock, *i.e.*, aggregate deposits (Chart IV.5 b).

IV.13 Since time deposits are the major constituent of aggregate deposits (around 87 per cent), a deceleration in these deposits is reflected in the aggregate deposits as well. A disaggregated analysis of the bank group-wise data suggests that the behaviour of time deposits replicates the deposit pattern of public sector banks, as they account for a predominant share of time deposits. Foreign banks witnessed a sharp deceleration in time deposit growth rate in the recent period, while the private sector banks have bucked the overall trend, with a sharp acceleration in their time deposits (Chart IV.6 a). Further analysis suggests that long-term time deposits (maturity more than one year) witnessed a sharper deceleration (Chart IV.6 b).

Chart IV.6: Trends in Time Deposits (y-o-y growth in per cent)

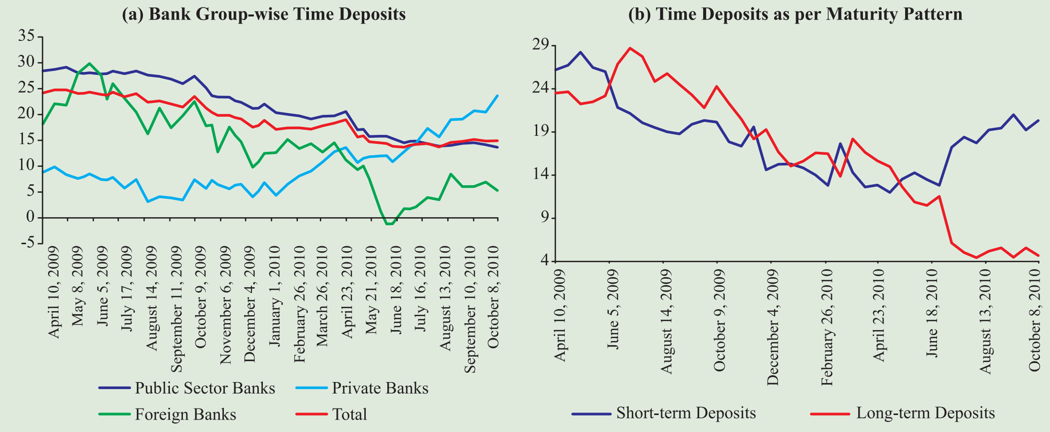
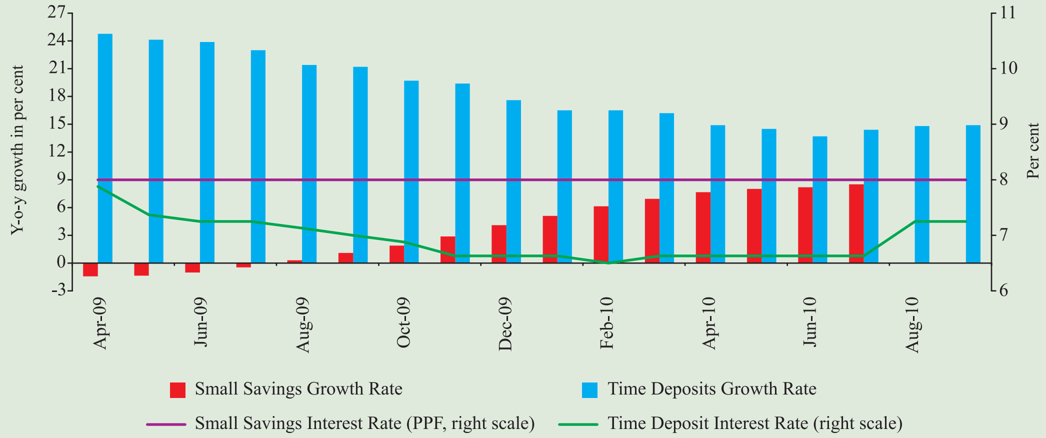


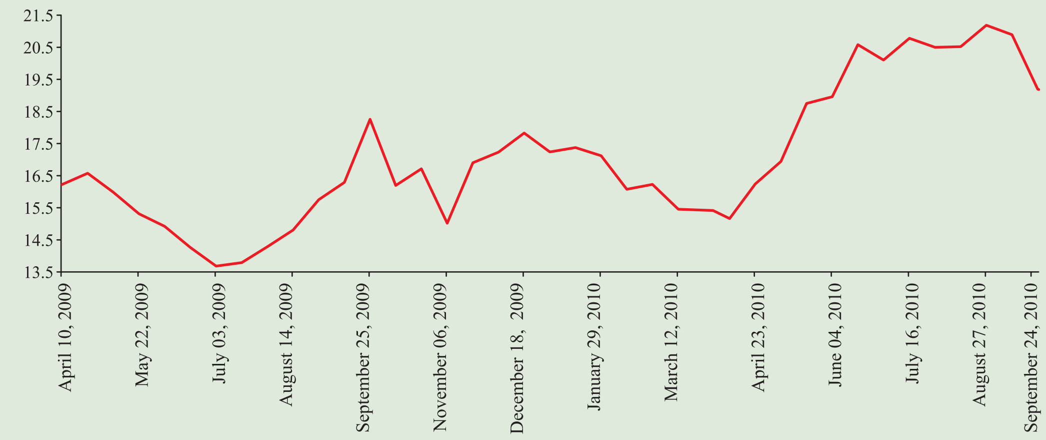
Chart IV.7: Time Deposits and Small Savings



IV.14 The growth rate of time deposits has, however, shown a moderate pick-up since July 2010 in the wake of efforts made by banks for mobilisation of deposits. Also, there has been an increased inflow into small savings schemes since August 2009 as small savings have yielded higher returns than time deposits with banks since the beginning of 2009-10 (Chart IV.7). Total incremental inflows into small savings are, however, only a small fraction of monthly increases in time deposits.

IV.15 Given the low opportunity cost of holding money in an environment of high inflation and depressed deposit interest rates, the demand for currency exhibited acceleration in growth during recent period (Chart IV.8). The increase in currency with the public is also reflective of increased asset prices and payment under schemes such as the MGNREGA. The increase in the cash component of economic transactions indicates the need for furthering financial inclusion. The

Chart IV.8: Currency with the Public (y-o-y growth in per cent))



increased currency demand and hence the currency deposit ratio as well as the 100 basis points increase in the CRR since February 2010, led to some decline in the money multiplier during the first half of the year. Money growth, thus, remains subdued relative to the higher rate of increase seen in reserve money.

IV.16 On a quarterly basis, the bulk of the increase in money stock during the second quarter of 2010-11 was owing to an increase in time deposits. (Table IV.6). Given the excess liquidity that prevailed in the system till end-May 2010, banks were not actively mobilising deposits. The transmission of the monetary tightening measures initiated by the Reserve Bank since February 2010 to the deposit interest rates has started to become visible only since July 2010 (Chapter V, Table V.7).

IV.17 As regards sources of M_3, the increase in money supply during the second quarter came mainly from banking system's credit to the commercial sector. There was a major pick-up in the growth of non-food credit extended by SCBs during the first quarter of 2010-11 as telecom companies raised credit to pay for the 3G and wireless access spectrums (Chart IV.9 a). Credit flow during the second quarter has shown a slight moderation but largely remained above or close to the indicative trajectory of 20 per cent growth set out in the First Quarter Review of Monetary Policy (July 2010). Reflecting this moderation, as well as the improved deposit mobilisation since July 2010, the incremental non-food credit deposit ratio of SCBs fell below the peak of over 100 per cent attained towards the

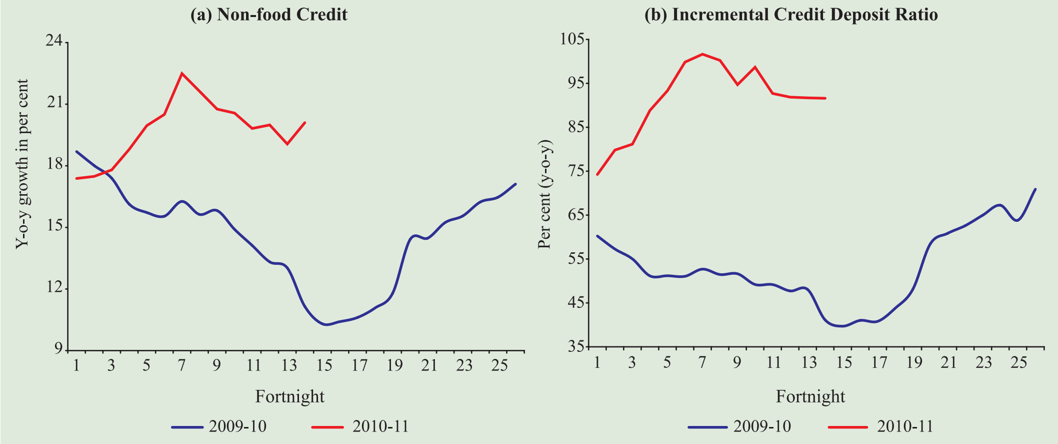
Table IV.6: Monetary Aggregates - Variations

(₹ crore)

Item	2009-10				2010-11	
	Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7
M_3 (1+2+3 = 4+5+6+7-8)	1,63,787	1,61,970	1,24,777	3,54,416	86,103	1,86,330
Components						
1. Currency with the Public	24,913	2,797	45,086	29,787	64,416	-6,237
2. Aggregate Deposits with Banks	1,34,829	1,64,717	78,773	3,22,778	22,421	1,91,672
2.1 Demand Deposits with Banks	-40,911	66,320	-26,343	1,34,985	-86,410	44,635
2.2 Time Deposits with Banks	1,75,739	98,397	1,05,116	1,90,793	1,08,831	1,47,037
3. 'Other' Deposits with RBI	4,046	-5,545	918	-1,150	-735	894
Sources						
4. Net Bank Credit to Government	1,20,816	71,703	35,598	1,61,646	47,024	36,930
4.1 RBI's Net Credit to Government	-11,145	-14,953	51,428	1,24,676	15,796	-20,621
4.2 Other Banks' Credit to Government	1,31,961	86,656	-15,830	36,970	31,228	57,551
5. Bank Credit to the Commercial Sector	-7,232	1,07,136	68,093	3,09,890	68,700	1,11,980
6. NFA of Banking Sector	-37,923	47,908	-20,701	-59,998	6,967	53,422
7. Government's Currency Liabilities to the Public	254	302	309	351	355	137
8. Net Non-monetary Liabilities of the Banking Sector	-87,872	65,079	-41,478	57,472	36,943	16,139

Note: Data are provisional.

Chart IV.9: Credit Indicators



end of the first quarter and the beginning of the second quarter (Chart IV.9 b).

IV.18 The momentum in credit growth was seen across all bank groups, with private banks showing the highest growth rate at the beginning of the third quarter of 2010-11 (Table IV.7). Public sector banks accounted for 74 per cent of the incremental credit off take on a year-on-year basis as at the beginning of October 2010. Though the pace of deposit growth for SCBs as a whole remains lower than last year, banks have increased their borrowings from overseas as well as from financial institutions. These alternative funds have supported a higher credit growth, as investment in government and other approved securities, non-SLR securities as well as foreign currency assets has exhibited deceleration or contraction in y-o-y growth (Table IV.8).

IV.19 Data on sectoral deployment of gross bank credit show significant improvement in credit flow to industry,

Table IV.7: Credit Flow from Scheduled Commercial Banks

(Amount in ₹ crore)

Item	Outstanding as on October 8, 2010	Variation (Y-o-Y)			
		As on October 9, 2009		As on October 8, 2010	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1. Public Sector Banks	25,67,838	2,83,483	15.2	4,24,171	19.8
2. Foreign Banks	1,75,580	-29,770	-15.9	17,979	11.4
3. Private Banks	6,39,361	12,076	2.4	1,24,213	24.1
4. All Scheduled Commercial Banks*	34,68,999	2,79,305	10.7	5,80,005	20.1

*: including Regional Rural Banks.

Note: Data are provisional.

Table IV.8: Select Sources and Uses of Funds of SCBs

(Amount in ₹ crore)

Item	Outstanding as on October 8, 2010	Variation (Y-o-Y)			
		As on October 9, 2009		As on October 8, 2010	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
Sources of Funds					
1. Aggregate Deposits	47,88,309	6,94,231	20.0	6,25,710	15.0
2. Call/Term Funding from Financial Institutions	1,19,336	-18,121	-15.6	20,996	21.3
3. Overseas Foreign Currency Borrowings	41,342	-34,583	-55.5	13,637	49.2
4. Capital	65,965	13,809	30.3	6,649	11.2
5. Reserves	3,69,068	48,836	17.4	39,603	12.0
Uses of Funds					
1. Bank Credit	34,68,999	2,79,306	10.7	5,80,004	20.1
of which: Non-food Credit	34,19,245	2,85,480	11.1	5,72,971	20.1
2. Investments in Government and Other Approved Securities	14,75,697	3,87,549	39.6	1,10,264	8.1
a) Investments in Government Securities	14,70,231	3,92,145	40.6	1,12,680	8.3
b) Investments in Other Approved Securities	5,466	-4,595	-36.8	-2,417	-30.7
3. Investments in non-SLR Securities	2,65,729	1,37,765	91.4	-22,823	-7.9
4. Foreign Currency Assets	66,656	19,397	84.8	24,373	57.6
5. Balances with the RBI	2,75,559	-1,29,595	-40.7	86,832	46.0

Note: Data are provisional. The sources and uses of funds will not match as the list is not exhaustive and excludes the assets and liabilities within the banking system.

services and personal loans during the current financial year, while credit to agriculture has declined further (Table IV.9). A look at the disaggregated data, however, suggests that the credit flow to industry is not yet broad-based as the growth is mainly driven by flow of credit to the infrastructure sub-sector, iron and steel, chemicals and chemical products, other metal and metal products and engineering industries.

IV.20 Overall flow of resources from the financial sector to the commercial sector increased significantly in the first half of 2010-11 relative to the flows in the corresponding period of last year (Table IV.10). While domestic non-bank sources of funds declined compared to the corresponding period last year, funding from foreign sources increased on account of higher amounts raised in the form of short-term credit and through ECBs and ADRs/GDRs. Reflecting the pick-up in demand for credit, incremental non-food credit (adjusted) exceeded the flows from non-banking sources.

IV.21 Overall, the liquidity conditions have changed consistent with the objective of calibrated normalisation of monetary policy. Net liquidity switched to deficit mode towards the end of May 2010 after eighteen months of surplus, and has largely remained so since then. Reflecting the

Table IV.9: Deployment of Gross Bank Credit by Major Sectors

(Amount in ₹ crore)

Sector	Outstanding as on September 24, 2010	Variation (financial year so far)			
		September 25, 2009		September 24, 2010	
		Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6
Non-Food Gross Bank Credit (1 to 4)	**31,99,151**	**92,341**	**3.5**	**1,62,206**	**5.3**
1. Agriculture and Allied Activities	**4,01,933**	**- 1,760**	**-0.5**	**-13,481**	**-3.2**
2. Industry	**14,17,200**	**84,982**	**8.1**	**1,07,386**	**8.2**
3. Personal Loans	**6,15,195**	**3,836**	**0.7**	**29,170**	**5.0**
Housing	3,17,150	7,891	2.8	16,195	5.4
Advances against Fixed Deposits	51,379	- 3,473	-7.1	2,771	5.7
Credit Card Outstanding	18,509	- 3,754	-13.4	-1,478	-7.4
Education	40,944	4,557	15.9	4,060	11.0
Consumer Durables	9,083	- 112	-1.4	800	9.7
4. Services	**7,64,823**	**5,281**	**0.8**	**39,130**	**5.4**
Transport Operators	53,876	- 128	-0.3	1,229	2.3
Professional Services	53,370	658	1.5	4,859	10.0
Trade	1,70,606	9,884	6.8	8,279	5.1
Commercial Real Estate	1,01,662	1,766	1.9	9,604	10.4
Non-Banking Financial Companies	1,25,667	7,192	7.3	7,746	6.6
Memo					
Priority Sector	**11,20,343**	**8,320**	**0.9**	**11,150**	**1.0**
Micro and Small Enterprises	3,94,604	20,808	6.7	19,343	5.2
Industry					
Food Processing	68,153	327	0.6	2,896	4.4
Textiles	1,23,764	3,525	3.4	2,364	1.9
Paper and Paper Products	19,969	203	1.3	933	4.9
Petroleum, Coal Products and Nuclear Fuels	57,098	2,590	3.8	-20,556	-26.5
Chemicals and Chemical Products	88,348	1,093	1.4	3,431	4.0
Rubber, Plastic and their Products	18,417	536	3.9	2,741	17.5
Iron and Steel	1,37,588	14,375	14.5	9,956	7.8
Other Metal and Metal Products	38,719	2,214	7.5	3,047	8.5
Engineering	82,987	- 893	-1.4	9,090	12.3
Vehicles, Vehicle Parts and Transport Equipments	40,915	1,818	5.2	2,166	5.6
Gems and Jewellery	33,962	1,997	7.0	2,182	6.9
Construction	42,661	- 592	-1.5	-1,074	-2.5
Infrastructure	4,69,621	48,659	18.0	87,499	22.9

Note: 1. Data are provisional and relate to select banks, which account for 95 per cent of total non-food credit extended by all SCBs.

2. Data include the effects of mergers of Bank of Rajasthan with ICICI Bank and State Bank of Indore with State Bank of India.

strengthening demand for finance consistent with robust economic growth, credit growth has picked up. Even though broad money growth remains below the trajectory envisaged in the Monetary Policy Statement for 2010-11, there has been an

Table IV.10: Flow of Financial Resources to the Commercial Sector

(₹ crore)

Item	April-March		April-September	
	2008-09	2009-10	2009-10	2010-11
1	2	3	4	5
A. Adjusted Non-food Bank Credit (NFC)	**4,21,091**	**4,80,258**	**1,06,575**	**2,55,674**
i) Non-food Credit	4,11,824	4,66,960	1,16,935	2,22,946$
ii) Non-SLR Investment by SCBs	9,267	13,298	-10,360	32,728$
B. Flow from Non-banks (B1+B2)	**4,39,926**	**5,80,821**	**2,22,780**	**2,29,519**
B1. Domestic Sources	**2,58,132**	**3,64,989**	**1,45,829**	**1,30,141**
1. Public issues by non-financial entities	14,205	31,956	13,617	10,448
2. Gross private placements by non-financial entities	77,856	1,41,964	39,420	19,702 #
3. Net issuance of CPs subscribed to by non-banks	4,936	25,835	50,999	32,812 *
4. Net credit by housing finance companies	25,876	28,485	3,581	7,519^
5. Total gross accommodation by the four RBI regulated AIFIs - NABARD, NHB, SIDBI and EXIM Bank	31,408	33,871	-3,332	15,300
6. Systemically important non-deposit taking NBFCs (net of bank credit)	42,277	60,663	18,064	30,935^
7. LIC's gross investment in corporate debt, infrastructure and social sector	61,574	42,215	23,480	13,425 ^
B2. Foreign Sources	**1,81,794**	**2,15,832**	**76,950**	**99,379**
1. ECBs/FCCBs	31,350	14,356	3,991	25,525^
2. ADR/GDR issues excluding banks and financial institutions	4,788	15,124	4,881	6,660
3. Short-term credit from abroad	-12,972	35,170	-7,137	25,455#
4. FDI to India	1,58,628	1,51,182	75,215	41,739^
C. Total Flow of Resources (A+B)	**8,61,017**	**10,61,079**	**3,29,355**	**4,85,193**
Memo Item:				
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	-32,168	96,578	1,01,956	-3,266

$: Up to October 8, 2010. #: April-June. ^: April-August. *: Up to September 15, 2010.

improvement since July 2010. With banks expected to scale up their deposit mobilisation to meet the demand for credit, broad money growth could be expected to rise. With liquidity in deficit mode and as deposit and lending rates start to move up further with some lag, the transmission of monetary policy could further strengthen.

V. FINANCIAL MARKETS

In the assessment of risk in the global financial markets, the focus shifted from sovereign debt crisis to concerns regarding the slowdown in economic recovery. This change in assessment of risk of the global investors impacted Indian financial markets through two different channels, viz. appreciation of the Indian Rupee and rise in equity prices due to sharp increase in portfolio flows. The transmission of higher policy interest rates increasingly became effective, albeit with a lag. The deficit liquidity conditions impacted various segments of financial markets viz. CPs, CDs, CBLO, Treasury Bills, government securities and bank deposits. Activities in CPs market picked up in the post Base Rate scenario as corporates explored alternative sources of finance. Housing prices in major cities witnessed a rising trend.

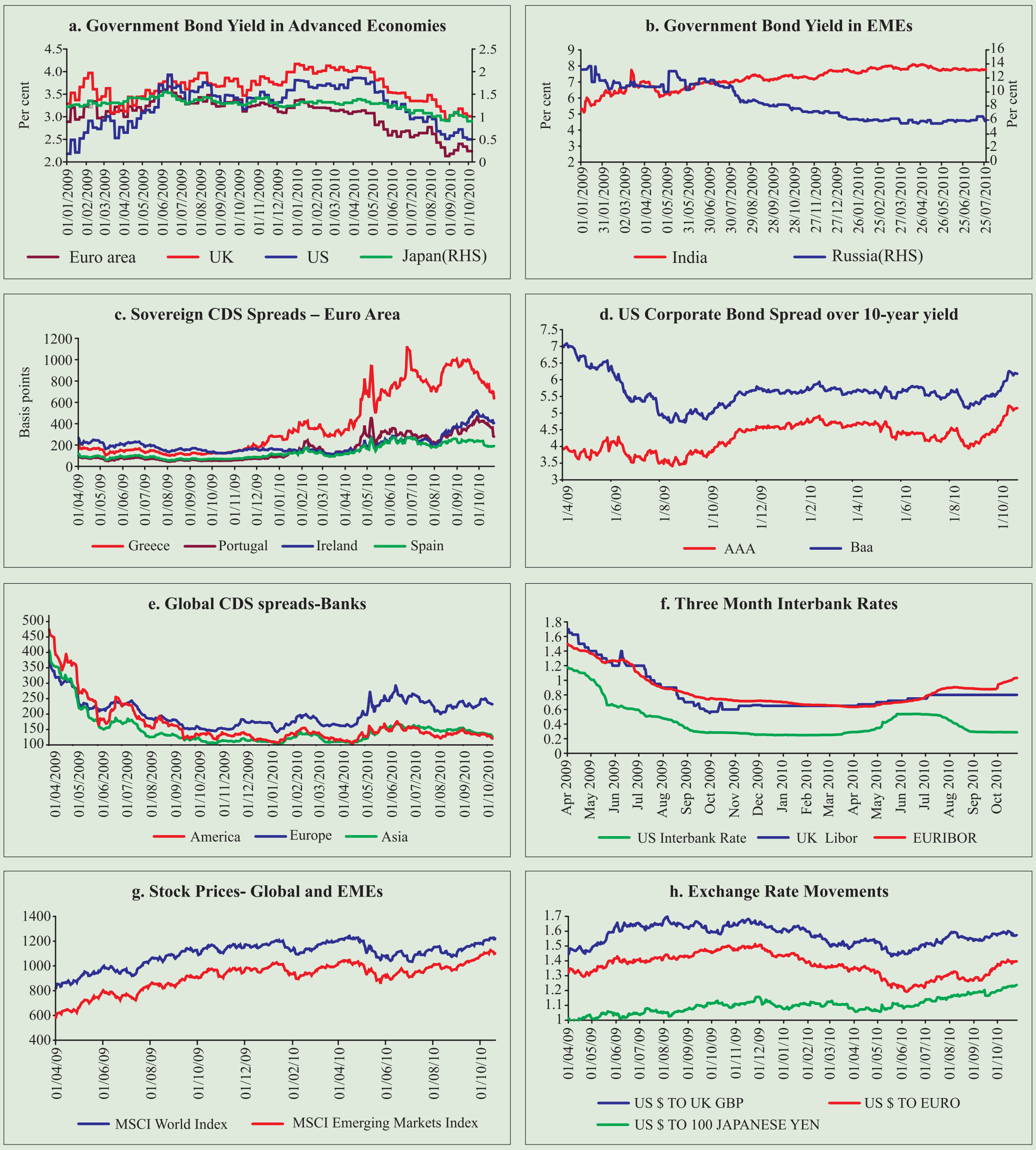
V.1 The financial markets in advanced economies had started to price in uncertainties related to the sovereign debt crisis in the Euro area and its possible spillover impact on the banking sector, when renewed concerns regarding slowdown in recovery adversely affected the investor confidence. The financial markets in emerging market economies (EMEs), however, showed signs of further strengthening mainly on account of their strong growth potential *vis-à-vis* advanced economies. As a result, capital flows to EMEs strengthened, thereby exerting pressure on currencies to appreciate and asset prices to remain upbeat. The US dollar depreciated against most of the major currencies, most notably against the Japanese Yen. Currency markets remained volatile and received greater market attention based on expectations about country specific policy responses to deal with the costs of appreciating exchange rate.

V.2 The Indian financial markets remained largely stable, with range-bound turnover and decline in volatility. Call rates gradually firmed up, in step with changes in policy rates and deficit liquidity conditions. The LAF corridor was narrowed with a view to containing volatility. Both CPs and CDs markets witnessed higher issuances, as lenders (through CDs) and borrowers (through CPs) scouted for cheaper funds against the backdrop of sustained increase in policy rates. The yield in G-Sec market hardened in the initial part of the second quarter of 2010-11 reflecting hike in policy rates, tight liquidity conditions and high inflation. Thereafter, the yields softened as liquidity conditions improved and concerns over Euro area receded. The Indian Rupee appreciated against the US dollar and the Indian stock prices rose on the back of substantial portfolio inflows. The quarterly House Price Index of the Reserve Bank suggests that prices in the housing market, especially in Tier I cities continued to show signs of acceleration, even as prices in Tier II cities registered some moderation.

International Financial Markets

V.3 The concerns relating to sovereign debt crisis, which adversely affected the global financial market conditions since end 2009, considerably receded by the beginning of the third quarter of 2010. By end-July, however, concerns relating to the global growth outlook and its implications for asset prices assumed centre stage. Increasing evidence of slowdown in economic recovery in the US and other advanced economies led to lower inflation expectations and falling bond yields (Chart V.1a). The spread between corporate bond yield and G-sec yield widened, especially after September 2010 (Chart V.1d). Increasing concerns relating to slowdown in the US and other advanced economies led to depreciation of the US dollar against all major currencies, especially against the Japanese Yen (Chart V.1h).

Chart V.1: Indicators of Global Financial Market Developments



Source: The IMF, the Federal Reserve of St. Louis, the Bloomberg and the Datastream.

V.4 Asset prices in EMEs registered significant gains as portfolio flows to these economies revived on the possibility of better returns in these countries. Their currencies also witnessed appreciation pressures (TableV.1).

V.5 The developments in the global financial markets spilled over to the Indian markets, particularly the equity and foreign exchange market. With deterioration in the outlook for growth in the advanced economies, there was a substantial increase in capital inflows led by FIIs. This contributed to significant increase in stock prices, besides leading to appreciation of exchange rate of the rupee against the US dollar. Improved global credit market conditions, and the widening interest rate differential facilitated higher access to ECBs by corporates. Financial markets in India, besides reflecting the global trend, were largely conditioned by the domestic growth-inflation outlook, monetary policy stance and the fiscal position.

Domestic Financial Markets

V.6 Strong domestic macroeconomic fundamentals and expectation of sustained high growth provided the necessary comfort to the markets. The transaction volumes in the markets remained range bound although the spreads/volatility generally declined (Table V.2 and Chart V.2).

Money Market

V.7 The money market remained orderly during the second quarter of 2010-11. The call rate firmed up, starting from end-May 2010 due to the tightening of liquidity conditions on account of 3G/BWA auctions and advance tax payments. The call rate hovered around the upper bound of the LAF corridor till July 2010 as deficit liquidity conditions persisted due to the high Central Government cash balances. The call rate declined towards the end of August and early September with the easing of liquidity conditions. As the transmission of higher policy interest rates increasingly became

Table V.1: Currency and Stock Price Movement in EMEs

(Per cent)

Items	End-March 2009 @	End-March 2010 @	End-Oct 27 2010*	Items	End-March 2009 @	End-March 2010 @	End-Oct 27 2010*
1	2	3	4	1	2	3	4
Appreciation (+)/Depreciation (-) of Currency per US Dollar				**Stock Price Variations**			
Argentine Peso	-14.8	-4.2	-2.0	Brazil (Bovespa)	-32.9	71.9	0.3
Brazilian Real	-23.8	24.6	5.4	China (Shanghai Composite)	-31.7	31.0	-3.6
Chinese Yuan	2.7	0.14	2.0	India (BSE Sensex)	-37.9	80.5	14.5
Indian Rupee	-21.6	12.9	1.4	Indonesia (Jakarta Composite)	-41.4	93.7	30.5
Indonesian Rupiah	-20.4	27.0	2.1	Malaysia (KLSI)	-30.1	51.3	13.5
Japanese Yen	2.0	5.2	14.2	Russia (RTS)	-66.4	128.0	0.7
Malaysian Ringgit	-12.6	11.4	5.3	Singapore (Straits Times)	-43.5	69.9	8.2
Mexican Peso	-24.8	14.0	-0.5	South Korea (KOSPI)	-29.2	40.3	12.8
Russian Ruble	-30.7	14.9	-3.5	Taiwan (Taiwan Index)	-39.2	52.0	4.7
South Korea Won	-28.0	21.7	1.2	Thailand (SET Composite)	-47.2	82.6	24.9
Thai Baht	-11.4	9.8	7.9				
Turkish Lira	-21.7	10.1	-23.2				

@: Year-on-year variation. * Variation over End-March.
Source: Bloomberg, IFS, IMF.

Table V.2: Domestic Financial Markets at a Glance

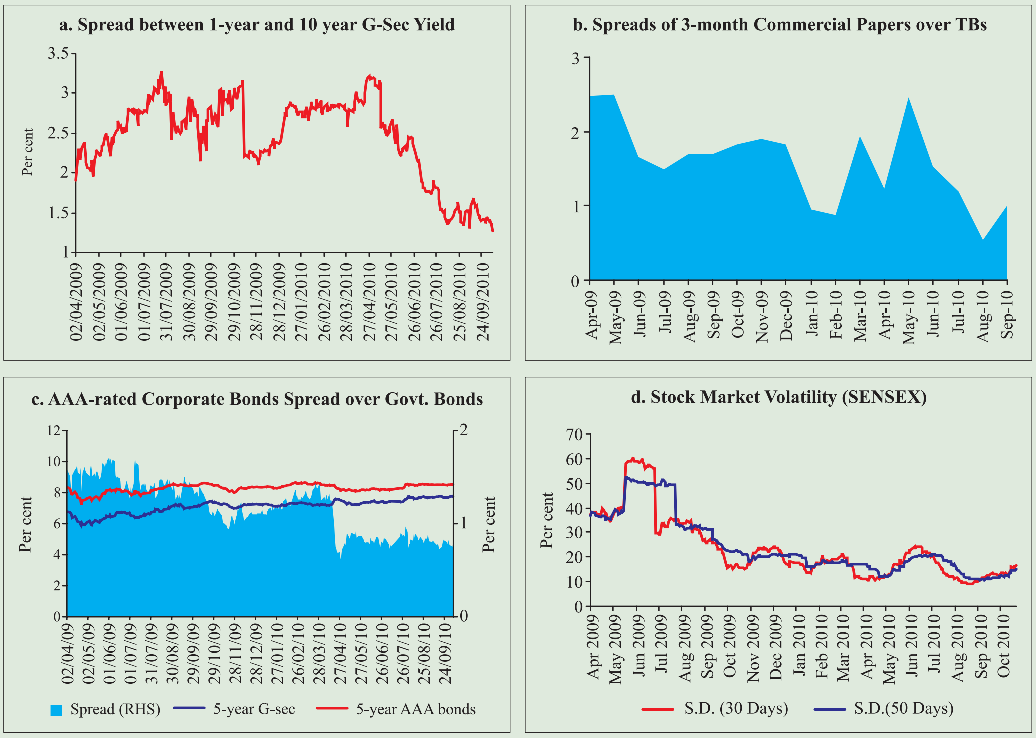
Year/Month	Call Money Market		Govt. Securities Market		Forex Market			Liquidity Management		Stock Markets			
	Daily Turnover (₹crore)	Call Rates* (Per cent)	Daily Turnover^ (₹ crore)	10-Year Yield@ (Per cent)	Daily Inter-bank Turnover (US$ mn)	Exchange rate@ (₹/ US$)	RBI's net purchase (+)/sale (-) (US$ mn)	MSS Out-standing# (₹ crore)	Average Daily LAF (₹ crore)	Daily BSE Turnover (₹ crore)	Daily NSE Turnover (₹ crore)	BSE Sensex**	CNX Nifty**
1	2	3	4	5	6	7	8	9	10	11	12	13	14
2008-09	**22,436**	**7.06**	**10,879**	**7.54**	**34,812**	**45.92**	**-34,922†**	**1,48,889**	**2,885**	**4,498**	**11,325**	**12303**	**3713**
2009-10	**15,924**	**3.24**	**14,426**	**7.23**	**30,107**	**44.95**	**-2,635†**	**23,914**	**1,00,015**	**5,651**	**16,959**	**15585**	**4658**
Apr-09	21,820	3.28	15,997	6.55	27,796	50.06	-2,487	75,146	1,01,561	5,232	15,688	10911	3360
May-09	19,037	3.17	14,585	6.41	32,227	48.53	-1,437	45,955	1,25,728	6,427	19,128	13046	3958
Jun-09	17,921	3.21	14,575	6.83	32,431	47.77	1,044	27,140	1,23,400	7,236	21,928	14782	4436
Jul-09	14,394	3.21	17,739	7.01	30,638	48.48	-55	22,159	1,30,891	6,043	18,528	14635	4343
Aug-09	15,137	3.22	9,699	7.18	27,306	48.34	181	19,804	1,28,275	5,825	17,379	14415	4571
Sep-09	16,118	3.31	16,988	7.25	27,824	48.44	80	18,773	1,21,083	6,211	18,253	16338	4859
Oct-09	15,776	3.17	12,567	7.33	28,402	46.72	75	18,773	1,01,675	5,700	18,148	16826	4994
Nov-09	13,516	3.19	17,281	7.33	27,599	46.57	-36	18,773	1,01,719	5,257	16,224	16684	4954
Dec-09	13,302	3.24	14,110	7.57	27,439	46.63	0	18,773	68,522	4,671	13,948	17090	5100
Jan-10	12,822	3.23	12,614	7.62	32,833	45.96	0	9,944	81,027	6,162	17,813	17260	5156
Feb-10	13,618	3.17	12,535	7.79	34,040	46.33	0	7,737	78,661	4,125	12,257	16184	4840
Mar-10	17,624	3.51	8,544	7.94	32,755	45.50	0	3,987	37,640	4,751	13,631	17303	5178
Apr-10	16,374	3.49	14,242	8.01	36,821	44.50	0	2,737	57,150	4,696	13,828	19679	5295
May-10	16,786	3.83	24,225	7.56	40,243	45.81	0	922	32,798	3,940	12,937	16845	5053
Jun.-10	14,258	5.16	21,300	7.59	36,953	46.57	0	317	-47,347	4,204	13,005	17300	5188
July.-10	18,954	5.54	13,691	7.69	33,978	46.84	0	254	-46,653	4,225	12,661	17848	5360
Aug.-10	15,916	5.17	16,919	7.93	36,193	46.57	–	0	-1,048	5,131	14,182	18177	5457
Sept.-10	17,212	5.50	16,215	7.96	37,249	46.06	–	0	-24,155	5,185	15,708	19353	5811

* : Average of daily weighted call money borrowing rates. ^: Average of daily outright turnover in Central Government dated securities.
@ : Average of closing rates. #: Average of weekly outstanding MSS. **: Average of daily closing indices.
† : Cumulative for the financial year. P: Provisional. – : Not available.
LAF : Liquidity Adjustment Facility. MSS: Market Stabilisation Scheme. BSE: Bombay Stock Exchange Limited.
NSE : National Stock Exchange of India Limited.
Note: In column 10, (-) indicates injection of liquidity, while (+) indicates absorption of liquidity.

effective and the liquidity conditions tightened, the call rate again firmed up from the middle of September 2010, and breached the upper bound of the informal LAF corridor. With a view to containing volatility in the call rate, the LAF corridor was reduced from 150 bps to 100 bps in two stages since July 2010(Chart V.3). The call rate has hovered around the upper bound of the informal corridor during October 2010.

V.8 Rates in the collateralised segments continued to move in tandem with the call rate, *albeit* below it, during the second quarter of 2010-11. Transaction volumes in the collateralised borrowing and lending obligation (CBLO) and market repo segments remained high during this period reflecting active market conditions (TableV.3). As in the previous quarter, banks continued to remain the major borrowers in the collateralised segment whereas mutual funds (MFs) remained the major lenders of funds in that segment. The share of MFs in the total lending in the collateralised segment declined during June-August 2010 from the level in April-May 2010. The collateralised segment of the money market continued to remain the predominant segment, accounting for more than 80 per cent of the total volume during the second quarter of 2010-11.

Chart V.2: Spread and Volatility in Domestic Financial Markets



V.9 The average fortnightly issuance of certificates of deposit (CDs) remained higher during the second quarter as compared with the previous quarter. The higher issuance of CDs is reflective of banks' efforts to raise bulk deposits at lower cost as deposit interest rates started moving northward. In line with the movement of

Chart V.3: Money Market Interest Rates

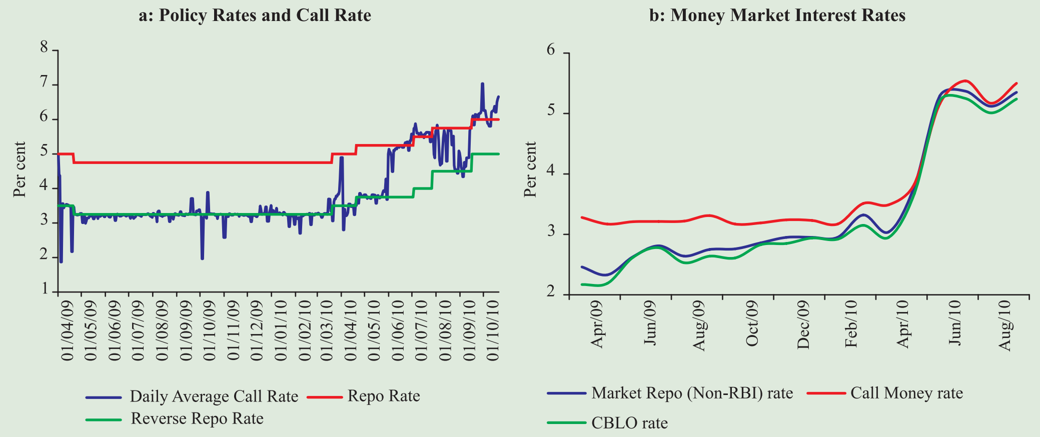


Table V.3: Activity in Money Market Segments

(₹ crore)

Year/Month	Average Daily Volume (One Leg)						Commercial Paper		Certificates of Deposit	
	Call	Market Repo	CBLO	Total (Col.2 to 4)	Money Market Rate (%)*	Term Money	Outstanding	WADR (%)	Outstanding	WADR (%)
1	2	3	4	5	6	7	8	9	10	11
Apr-09	10,910	20,545	43,958	75,413	2.41	332	52,881	6.29	2,10,954	6.48
May-09	9,518	22,449	48,505	80,472	2.34	338	60,740	5.75	2,18,437	6.20
Jun-09	8,960	21,694	53,553	84,207	2.69	335	68,721	5.00	2,21,491	4.90
Jul-09	7,197	20,254	46,501	73,952	2.83	389	79,582	4.71	2,40,395	4.96
Aug-09	7,569	23,305	57,099	87,973	2.62	461	83,026	5.05	2,32,522	4.91
Sep-09	8,059	27,978	62,388	98,425	2.73	381	79,228	5.04	2,16,691	5.30
Oct-09	7,888	23,444	58,313	89,645	2.70	225	98,835	5.06	2,27,227	4.70
Nov-09	6,758	22,529	54,875	84,162	2.87	191	1,03,915	5.17	2,45,101	4.86
Dec-09	6,651	20,500	55,338	82,489	2.91	289	90,305	5.40	2,48,440	4.92
Jan-10	6,411	14,565	50,571	71,547	2.97	404	91,564	4.80	2,82,284	5.65
Feb-10	6,809	19,821	63,645	90,275	2.95	151	97,000	4.99	3,09,390	6.15
Mar-10	8,812	19,150	60,006	87,968	3.22	393	75,506	6.29	3,41,054	6.07
Apr-10	8,187	20,319	50,891	79,397	3.03	423	98,769	5.37	3,36,807	5.56
May-10	8,393	17,610	42,274	68,277	3.72	330	1,09,039	6.85	3,40,343	5.17
Jun-10	7,129	9,481	31,113	47,723	5.22	447	99,792	6.82	3,21,589	6.37
Jul-10	9,477	12,011	29,102	50,590	5.33	385	1,12,704	6.93	3,24,810	6.69
Aug-10	7,958	15,553	45,181	68,692	5.05	281	1,26,549	7.32	3,41,616	7.17
Sept-10	8,606	15,927	53,223	77,756	5.29	617	1,12,003	7.82	3,37,322	7.34

CBLO: Collateralised Borrowing and Lending Obligation. WADR: Weighted Average Discount Rate.
*: Weighted average rate of call, market repo and CBLO.

rates in other money market segments, the weighted average discount rate (WADR) of CDs increased. The average fortnightly issuance of Commercial Paper (CPs) also remained higher during the second quarter as compared with the previous quarter. ‘Leasing and Finance’ and manufacturing corporates were major issuers of CPs (Table V.4). The higher issuance of CPs suggests efforts by the commercial sector to raise resources from alternative sources of finance in the face of tight liquidity conditions. The WADR in CPs also increased during the quarter.

Table V.4: Major Issuers of Commercial Paper

(₹ crore)

End of Period	Leasing and Finance		Manufacturing		Financial Institutions		Total Outstanding
	Amount	Share (%)	Amount	Share(%)	Amount	Share(%)	
1	2	3	4	5	6	7	8 (=2+4+6)
Mar-09	27,183	62	12,738	29	4,250	10	44,171
Jun-09	34,437	50	23,454	34	10,830	16	68,721
Sep-09	31,648	40	31,509	40	16,071	20	79,228
Dec-09	36,027	40	42,443	47	11,835	13	90,305
Mar-10	39,477	52	22,344	30	13,685	18	75,506
Jun-10	42,572	43	43,330	43	13,890	14	99,792
Sep-10	58,098	52	40,486	36	13,420	12	1,12,003

Government Securities Market

V.10 Reflecting the policy of front loading of market borrowings during the first half of the year, the Government of India has completed 63 per cent of its borrowing programme for 2010-11, ensuring that there is no crowding-out in the latter half of the year when the private credit demand is normally robust. While the average maturity of debt issuances increased during 2010-11 (up to September 2010), the weighted average yield also firmed up as compared to the corresponding period of the previous year (Table V.5). In case of borrowings by the states, 18 states have raised ₹49,362 crore on a gross basis during the first half of the year, which constituted about 32 per cent of the gross allocation for 27 States under the scheme of borrowings for 2010-11 as compared with 53.5 per cent during the corresponding period of 2009-10.

V.11 The prevalence of tight liquidity conditions on account of outflow following the 3G/BWA auctions and the rise in policy rates have resulted in an upward movement in the primary market yields for short and medium term securities, while some softening was observed at the longer end during the second quarter in anticipation of reduction in governments' market borrowings.

V.12 Taking into account the need for fiscal consolidation and other additional revenues generated so far for financing the fiscal deficit, the net market borrowings of the Government of India have been scaled down by ₹10,000 crore as per the indicative borrowing calendar issued for the second half of 2010-11. Based on the demand pattern of the market participants as also the scope for issuance of securities in different maturities, the maturity profile of dated securities is set to be elongated in the calendar. As regards the States borrowings, about one third of the gross allocations for the States have been raised till the end of the second quarter. Taking into account the comfortable cash balances of the State Governments and the borrowing programme adopted by the States so far, it appears that there may be a moderation in their borrowings during the current financial year. It is expected that the calibrated strategies adopted in the borrowing programme of the

Table V.5: Issuances of Central and State Government Dated Securities

	2007-08	2008-09	2009-10	2009-10$	2010-11$
1	2	3	4	5	6
Central Government					
Gross amount raised (₹ crore)	1,56,000	2,61,000	4,18,000	2,95,000	2,84,000
Devolvement on Primary Dealers (₹ crore)	957	10,773	7,219	6,050	3,563
Bid-cover ratio (Range)	1.6-4.8	1.2-4.5	1.4-4.3	1.4-3.6	1.4-3.9
Weighted average maturity (years)	14.9	13.8	11.2	10.9	11.3
Weighted average yield (per cent)	8.1	7.7	7.2	7.1	7.8
State Governments					
Gross amount raised (₹ crore)	67,779	1,18,138	1,31,122	63,212	49,362
Cut-off yield	7.9-8.9	5.8-9.9	7.0-8.6	7.0-8.4	8.1-8.6
Weighted average yield (per cent)	8.3	7.9	8.1	7.9	8.3

$: Up to September 30.

Table V.6: Treasury Bills in the Primary Market

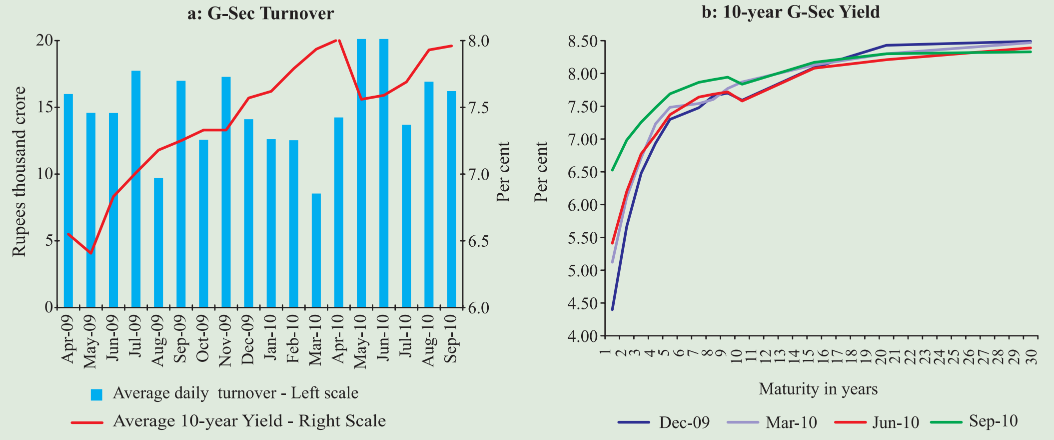
Year/ Month	Notified Amount (₹crore)	Average Implicit Yield at Minimum Cut-off Price (Per cent)		
		91-day	182-day	364-day
1	2	3	4	5
2008-09	**2,99,000**	**7.10**	**7.22**	**7.15**
2009-10	**3,80,000**	**3.57**	**4.00**	**4.37**
2010-11 (up to Sept. 30, 2010)	**1,49,500**	**5.27**	**5.56**	**5.74**
Apr-10	36,000	4.14	4.64	5.07
May-10	36,000	4.39	4.76	4.92
Jun-10	15,000	5.29	5.31	5.49
Jul-10	13,000	5.51	5.86	5.99
Aug-10	33,000	6.15	6.41	6.48
Sept-10	16,500	6.10	6.41	6.59

Government of India and the State Governments would ensure its completion in a non-disruptive manner.

V.13 The yield on 91-day Treasury Bills firmed up by 81 basis points between June and September 2010, whereas the yield on both 182-day and 364-day Treasury Bills increased by 110 bps during the same period (Table V.6). Keeping in view the comfortable cash balance of the Government of India, the Reserve Bank, in consultation with the GoI, scaled down the notified amount of Treasury Bills during the second quarter. In addition, an amount of ₹9,614 crore was bought back by the Government as part of the cash management operations during the quarter.

V.14 During Q2 of 2010-11, the G-Sec yields generally hardened till the third week of August 2010 amidst intermittent easing. The hardening of yields was mainly on account of hike in policy rates, tight liquidity conditions and high inflation. Thereafter, the yields declined as liquidity conditions improved and concerns over Euro area receded. Although liquidity conditions tightened towards the middle of September against the backdrop of quarter-end advance tax outflows, the increase in the investment limits of FIIs in the government securities and corporate bonds and lower than budgeted borrowing programme for the second half of the current fiscal year provided fillip to the market (Chart V.4). During the month of October 2010, the yields have risen on account of inflationary concerns and tight liquidity conditions.

Chart V.4: Turnover and Yield in Government Securities Market



Credit Market

V.15 The spreads on corporate bonds over the government bond yield declined further in Q2 of 2010-11 over the levels in Q1 of 2010-11, partly reflecting further reduction in risk perception for corporates due to improved growth outlook as well as lower inflationary expectations (Chart V.2c).

V.16 As part of the calibrated exit, Reserve Bank increased its repo rate by 125 bps, reverse repo by 175 bps and CRR by 100 bps during February-September 2010. In response to these policy rate changes, 72 SCBs raised their deposit rates in the range of 25-125 bps during February-October 15, 2010 across various maturities (Table V.7). On the lending side, the benchmark prime lending rates (BPLR) of SCBs remained unchanged between July 2009 and July 2010. Thereafter, several SCBs increased their BPLR in the range of 25-75 bps during July-September, 2010.

V.17 In line with hike in policy rates, several banks increased their Base Rates by 10-50 basis points by October 2010. As many as 53 banks with a share of 94 per cent in total bank credit have fixed their Base Rates in the range of 7.50-8.50 per cent, indicating convergence in the Base Rates announced by banks.

Foreign Exchange Market

V.18 The Indian rupee exhibited two-way movement against major international currencies during Q2 of 2010-11. It

Table V.7: Deposit and Lending Rates of Banks

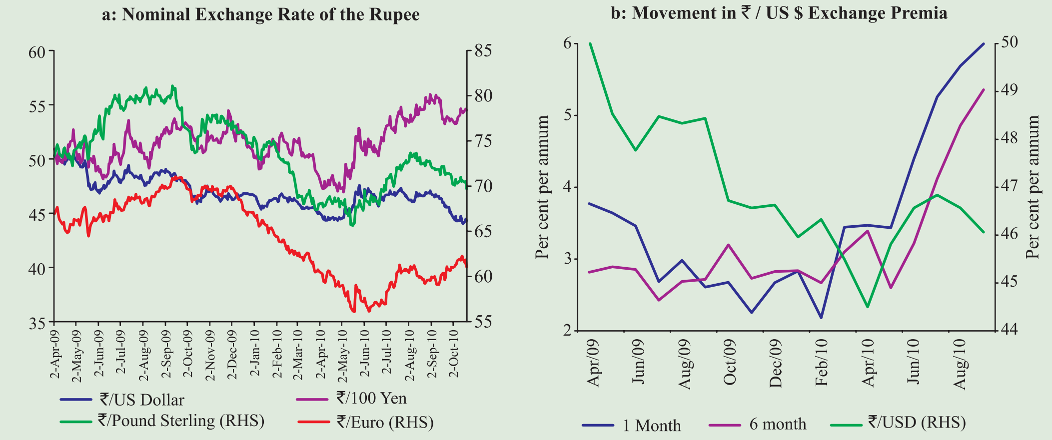
(Per cent)

	Sep 2009	Dec 2009	Mar 2010	Jun 2010	Oct 15, 2010
1	2	3	4	5	6
1. Domestic Deposit Rate					
Public Sector Banks					
Up to 1 year	1.00-7.00	1.00-6.25	1.00-6.50	1.00-6.25	1.00-7.00
> 1year-3 years	6.50-8.00	6.00-7.25	6.00-7.25	6.00-7.25	7.00-7.75
> 3 years	7.00-8.50	6.25-7.75	6.50-7.75	6.50-7.75	7.00-8.00
Private Sector Banks					
Up to 1 year	2.00-7.50	2.00-6.75	2.00-6.50	2.00-6.50	2.50-7.25
> 1year-3 years	6.00-8.75	5.25-7.50	5.25-7.75	6.25-7.50	6.50-8.25
> 3 years	6.00-9.00	5.75-8.00	5.75-8.00	6.50-8.00	6.50-9.00
Foreign Banks					
Up to 1 year	1.80-8.00	1.25-7.00	1.25-7.00	1.25-7.00	1.25-7.30
> 1year-3 years	2.25-8.50	2.25-7.75	2.25-8.00	3.00-8.00	3.00-8.00
> 3 years	2.25-9.50	2.25-8.50	2.25-8.75	3.00-8.50	3.00-8.25
2. BPLR/Base Rate					
1. Public Sector Banks	11.00-13.50	11.00-13.50	11.00-13.50	11.00-13.50	7.50-8.50#
2. Private Sector Banks	12.50-16.75	12.50-16.75	12.50-16.75	12.50-16.75	7.00-9.00#
3. Foreign Banks	10.50-16.00	10.50-16.00	10.50-16.00	10.50-16.00	5.50-9.00#
3. Actual Lending Rate*					
1. Public Sector Banks	3.50-17.50	3.25-18.00	3.25-18.00	3.25-18.00	–
2. Private Sector Banks	4.10-26.00	3.50-25.84	3.00-28.00	2.80-26.00	–
3. Foreign Banks	2.76-25.50	3.50-22.00	3.60-23.00	3.60-25.00	–

* : Interest rate on non-export demand and term loans above ₹ 2 lakh excluding lending rates at the extreme five per cent on both sides.

Base Rate system replaced BPLR system with effect from July 1, 2010.

Chart V.5: Exchange Rates



appreciated against the US Dollar, while depreciated against the Pound Sterling, Euro and Japanese Yen. During the quarter, the rupee exhibited depreciating trend against the US dollar up to the third week of July 2010 and thereafter remained largely range bound during August 2010. The Rupee has generally appreciated since the first week of September 2010 on the back of pick-up in capital inflows and strengthening of growth outlook (Chart V.5a). The 1-month as well as 3-month forward premia increased during the quarter (Chart V.5b).

V.19 The turnover in both inter-bank and merchant segments of the forex market declined during July 2010 and recovered thereafter since August 2010 (Chart V.6).

Equity and Housing Markets

V.20 Stock prices continued the bullish trend during July-September on the back of strong FII investments in equities. India, along with other EMEs experienced strong portfolio inflows as interest rate differential between these countries and advanced economies turned more lucrative. Strong macroeconomic fundamentals in the Indian markets, buoyancy in the industrial and services sector as also possibility of further increase in rural demand on expected better performance of the agricultural sector were some of the pull factors responsible for the FII inflows. As at end-September 2010, the Sensex and the Nifty both registered gains of 14.5 per cent and 14.9 per cent, respectively, over end-March 2010 (Table V.8).

Chart V.6: Daily Average Turnover in Foreign Exchange Market

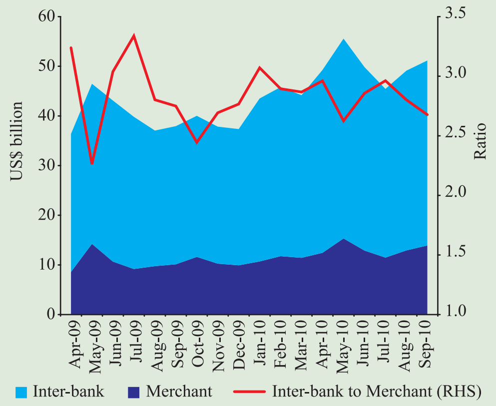


Table V.8: Key Stock Market Indicators

Indicator	BSE				NSE			
	2008-09	2009-10	2009-10 (Apr-Sept)	2010-11 (Apr- Sept)	2008-09	2009-10	2009-10 (Apr-Sept)	2010-11 (Apr-Sept)
1	2	3	4	5	6	7	8	9
1. BSE Sensex/S&PCNX Nifty								
(i) End-period	9709	17528	17127	20069	3021	5249	5084	6030
(ii) Average	12366	15585	14298	17866	3731	4658	4284	5361
2. Coefficient of Variation	24.2	11.9	12.5	4.9	23.2	11.3	11.6	4.9
3. Price-Earning Ratio (end-period)*	13.7	21.3	22.2	23.8	14.3	22.3	22.9	25.5
4. Price-Book Value Ratio	2.7	3.9	4.1	3.8	2.5	3.7	3.8	3.8
5. Market Capitalisation to GDP Ratio (per cent)@	55.4	98.9	91.6	102.7	52.0	96.4	85.9	100.3

*: Based on 30 scrips included in the BSE Sensex and 50 scrips included in the S&P CNX Nifty. @: As at end-period.
Source: Bombay Stock Exchange Ltd. (BSE) and National Stock Exchange of India Ltd. (NSE).

V.21 The activity in the primary segment of the domestic capital market continued to display signs of buoyancy during April-September 2010. The resources raised through public issues increased marginally during April-September 2010 as compared to the corresponding period last year (Table V.9). Mobilisation of resources through private placement (₹92,787 crore) also increased by 20.5 per cent during April-June 2010. The resource mobilisation by mutual funds was lower during April-September 2010 as compared to previous year due to constrained liquidity conditions and withdrawal of money by banks and corporates from mutual funds for the 3G/ BWA auction.

V.22 The FIIs were net buyers and mutual funds turned net sellers during April-October 2010. Net FII investment in Indian equities, which was subdued during April-June 2010 increased significantly during July-October 2010, encouraged by strong growth prospects of the Indian economy and improved global

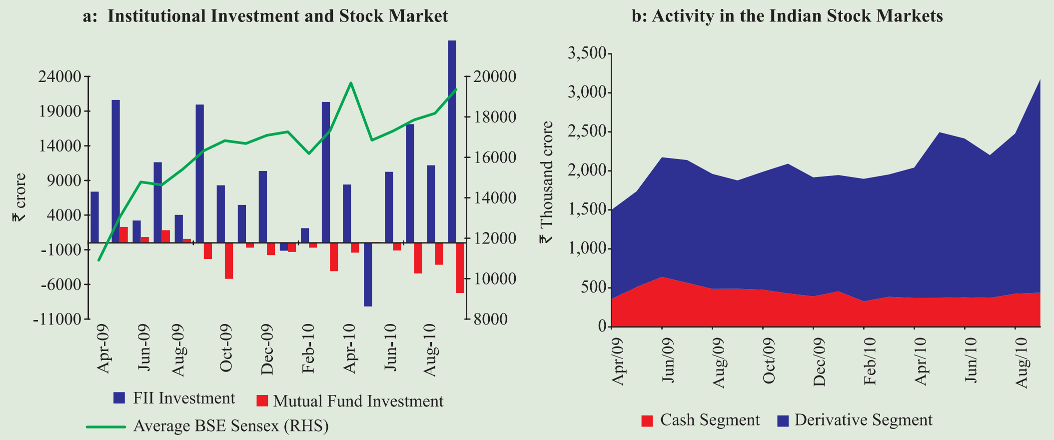
Table V.9: Resource Mobilisation from Capital Market

(₹ crore)

Category	2008-09 (Apr-Mar)	2009-10 (Apr-Mar)	2009-10 (Apr-Sept)	2010-11 (Apr- Sept)
1	2	3	4	5
A. Prospectus and Rights Issues*	14,671	32,607	13,617	14,058
1. Private Sector (a+b)	14,671	25,479	6,814	13,475
a) Financial	466	326	0.00	3,420
b) Non-financial	14,205	25,153	6,814	10,055
2. Public Sector	–	7,128	6,803	583
B. Euro Issues	4,788	15,967	12,645	7,443
C. Mutual Fund Mobilisation(net)@	-28,296	83,080	1,12,427	-452
1. Private Sector	-34,017	54,928	83,864	18,744
2. Public Sector #	5,721	28,152	28,563	-19,196

*: Excluding offer for sale. @: Net of redemptions. #: Including UTI Mutual fund.
Note: Data exclude funds mobilised under Fund of Funds Schemes.
Source: Mutual Fund data are sourced from Securities and Exchange Board of India.

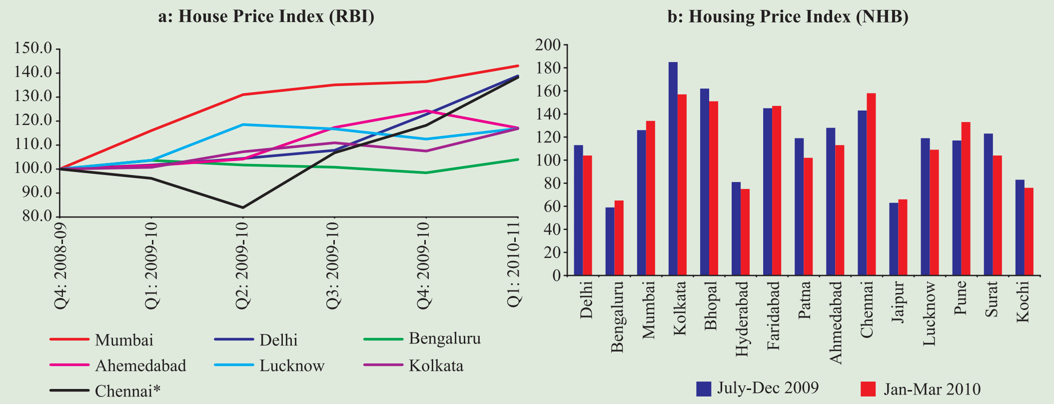
Chart V.7: Movement in Stock Prices and Turnover



liquidity conditions (Chart V.7a). The FII investments in stock markets resulted in buoyant market conditions as well as increase in turnover in both cash and derivative segments (Chart V.7b).

V.23 The quarterly House Price Index (HPI) for various centres based on data collected from the Department of Registration and Stamps (DRS) suggests that property prices are picking up in most tier I cities though some slowdown is witnessed in tier II cities (Chart V.8a). According to these data, prices in Mumbai in the last three quarters are showing moderate growth, while prices in Delhi are growing at a faster rate, which partly reflects activities relating to the Commonwealth Games. The number of transactions in Mumbai, which had registered a sharp rise in Q3 of 2009-10 seem to have reached a plateau. Housing prices in Bengaluru, which were almost flat for the past one and half years, are showing some signs of increase. This was also corroborated by the trends on NHB Residential Price Index (Chart V.8b).

Chart V.8: Trends in Housing Markets



*Chennai index is Property Price Index containing both residential and commercial properties

V.24 The growing risk perceptions and uncertainty in the global markets impacted Indian financial markets through two different channels *viz.* pressure for appreciation of the Indian Rupee and rise in equity prices due to sharp rise in portfolio flows. Despite global market uncertainties, domestic markets functioned normally, with stable volumes and lower volatility. The transmission of higher policy rates were visible in higher issuances of CDs, CPs as also higher yields on TBs and G-Sec and even in deposit rates. Lending rates have also started to move up, with a lag. In the Base Rate environment, there have been signs of corporates increasing their dependence on the CPs market. Banks have also used the CDs route to mobilise bulk deposits. Given the outlook for possible significant large increase in portfolio flows to EMEs in the near term, their impact on exchange rate and asset prices will have to be closely monitored because of their implications for domestic inflation and external competitiveness.

VI. PRICE SITUATION

The headline inflation has started to soften after staying in double-digits for five months up to July 2010, reflecting favourable base effects and some moderation in manufacturing price pressures. Despite a normal monsoon inflation remains above the comfort level mainly led by food inflation, which seems to have assumed structural character. The new series on Wholesale Price Index (WPI), with base shifted from 1993-94 to 2004-05, gives a better representation of the more recent production and consumption pattern, without any major difference in the overall trends in inflation. The inflation pressures persist and further moderation would be necessary for easing the concerns for the conduct of monetary policy. Different measures of consumer price inflation fell below double digit levels after more than a year, but still remain elevated tracking high food and fuel inflation.

VI.1 With headline inflation measured by WPI (base 2004-05) remaining in double digits for consecutive five months from March to July 2010 and the inflation process turning more generalised, the Reserve Bank's balance of policy shifted from 'managing the recovery' to containing inflation and anchoring inflationary expectations. This was reflected in the calibrated normalisation of monetary policy between January and September 2010.

VI.2 In the second quarter of 2010-11, headline inflation exhibited some moderation but remained elevated. The pace of increase in non-food manufactured products prices has moderated in recent months indicating some slowing down of the pace of generalisation of inflation as well as gradual stabilisation of price pressures. Food inflation, however, continues to remain high despite a normal monsoon, as price pressures have amplified for certain non-cereal items like milk, eggs, fish and meat whose output is less responsive to monsoon. Significant increase in primary articles and minerals prices along with building up pressures in a number of commodities globally pose upside risks to domestic inflation. Though various measures of consumer price inflation declined to single digits after more than a year, they continue to remain high. As headline inflation still remains elevated, containing inflation and anchoring inflationary expectations would continue to be a challenge for monetary policy during 2010-11.

Global Inflation

VI.3 The global inflation environment continues to remain moderate with rising divergence in inflation trends between advanced economies, which face subdued inflationary environment as recovery remains weak, and emerging and developing countries where signs of pickup in inflation coincided with their stronger recovery. The October 2010 World Economic Outlook of the IMF predicts modest increase in prices in advanced economies in 2010 with consumer price inflation expected to increase from near zero in 2009 to 1.4 per cent in 2010 and 1.3 per cent in 2011. Inflation in emerging and developing economies, however, is projected to accelerate to 6.2 per cent in 2010 from 5.2 per cent in 2009, before decelerating back to 5.2 per cent in 2011.

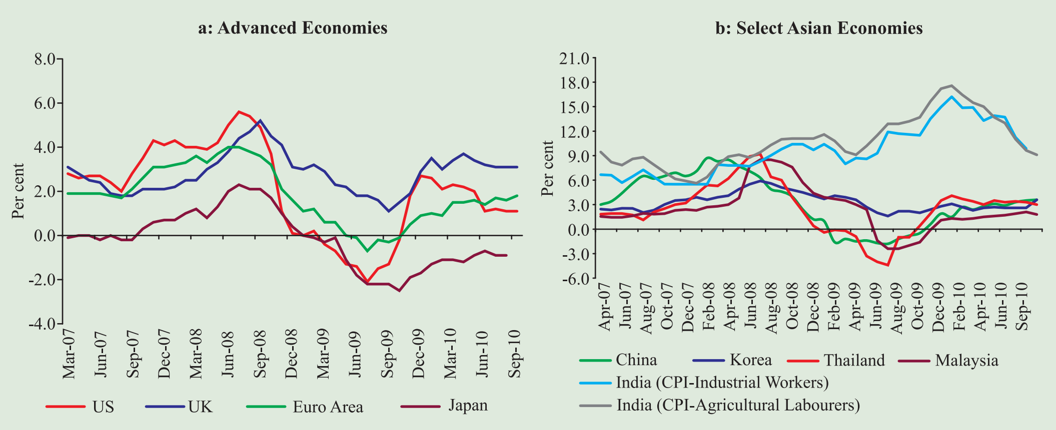
Excess capacity in most advanced economies and sluggish labour markets with unemployment rate likely to remain over 8 per cent through 2009-11 is expected to keep price pressures subdued. Soft global inflationary environment may prevail for some more time even though most advanced economies experienced some increase in headline inflation in recent months, largely from increasing energy and food prices. Core inflation in advanced economies, however, has remained subdued, indicating absence of demand side pressures on prices. This provides them the space for continuing with expansionary monetary policy to support the recovery (Chart VI.1 a).

VI.4 Year-on-year consumer price inflation in the OECD countries, which increased to 2.0 per cent in May 2010, moderated to 1.6 per cent in August 2010 following a decline in core inflation (excluding food and energy to 1.2 per cent in August 2010 from 1.6 per cent in January 2010). Private consumption demand remains relatively weak in the OECD countries, which along with lower capacity utilisation levels indicates that the low inflation conditions may continue for an extended period of time.

VI.5 Inflation in most of the EMEs increased in recent months, but remains moderate (Chart VI.1b). Significant increases in international commodity prices from their historic low levels recorded in early 2009 translated into increases in inflation as the base effect of high prices in the first half of 2008 waned. The impact of any increase in international commodity prices on inflation is more in the case of developing countries as their consumption baskets have larger shares of commodities, especially food and oil. The divergent nature of the global recovery, with a relatively strong recovery and faster closing of output gaps for the EMEs, also poses a challenge for emerging markets. As international prices of commodities are now responding more to increase in growth in EMEs, stronger growth could amplify the risk of high imported inflation.

VI.6 Policy rates in advanced economies continue to remain near zero/very low

Chart VI.1: Consumer Price Inflation



levels as the concerns on sustainability of recovery became more prominent in the second quarter of 2010-11. Assessment of most central banks pointed towards absence of pressures on inflation from demand side during the medium-term. As the pace of recovery was slowing, the Bank of Japan decided to reduce the policy rate. Israel and Canada, on the other hand, increased their policy rates in Q2 of 2010-11, recognising the inflation risks going forward. Among the emerging economies, China and Thailand raised their policy rates during Q2 of 2010-11 while South Africa reduced it (Table VI.1).

Global Commodity Prices

VI.7 During August-September 2010, international commodity prices increased again on account of the supply disruptions in many commodities. Commodity prices earlier recorded some decline during May-June 2010, as concerns over euro area

Table VI.1: Policy Rates and Inflation in Select Economies

(Per cent)

Country/ Region	Key Policy Rate	Policy Rate (as on Oct. 20, 2010)	Changes in Policy Rate (basis points)		CPI Inflation (y-o-y)	
			Apr. 09 - Aug. 09	Since Sep. 09	Sep. 2009	Sep. 2010
1	2	3	4	5	6	7
Developed Economies						
Australia	Cash Rate	4.50 (May 5, 2010)	(-) 25	175	1.3#	3.8#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	(-) 25	75	-0.9	1.9
Euro area	Interest Rate on Main Refinancing Operations	1.00 (May 13,2009)	(-) 50	0	-0.3	1.8
Japan	Uncollateralised Overnight Call Rate	0.00 to 0.10 (Oct. 5, 2010)	0	(-) 10	-2.2*	-0.9*
UK	Official Bank Rate	0.50 (Mar. 5,2009)	0	0	1.1	3.1
US	Federal Funds Rate	0.00 to 0.25 (Dec.16,2008)	0	0	-1.3	1.1
Developing Economies						
Brazil	Selic Rate	10.75 (Jul. 21, 2010)	(-) 250	200	4.3	4.7
India	Reverse Repo Rate	5.00 (Sep. 16, 2010)	(-) 25	175	11.6	9.8
	Repo Rate	6.00 (Sep. 16, 2010)	(-) 25	125 (100)		
China	Benchmark 1-year Lending Rate	5.56 (Oct.19, 2010)	0 0	25 (150)	-0.8	3.6
Indonesia	BI Rate	6.50 (Aug. 5, 2009)	(-) 125	0	2.8	5.8
Israel	Key Rate	2.00 (Oct. 1, 2010)	(-) 25	150	2.8	2.4
Korea	Base Rate	2.25 (Jul. 09, 2010)	0	25	2.2	3.6
Philippines	Reverse Repo Rate	4.00 (Jul. 9, 2009)	(-) 75	0	0.6	3.5
Russia	Refinancing Rate	7.75 (Jun. 1, 2010)	(-) 200	(-) 225	10.7	7.0
South Africa	Repo Rate	6.00 (Sep. 10, 2010)	(-) 250	(-) 100	6.1	3.2
Thailand	1-day Repurchase Rate	1.75 (Aug. 25, 2010)	(-) 25	50	-1.0	3.0

#: Q3. *August.

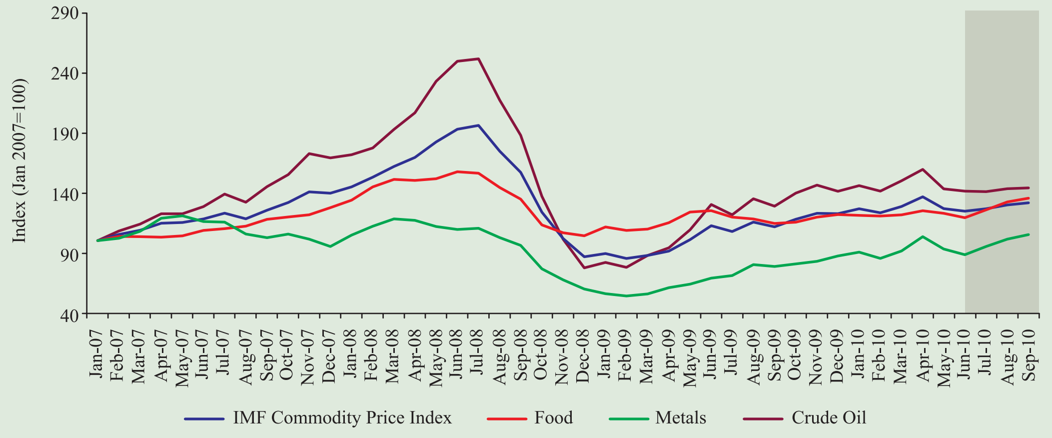
Note: 1. For India, data on inflation pertain to CPI for Industrial Workers.

2. Figures in parentheses in column (3) indicate the dates when the policy rates were last revised.

3. Figures in parentheses in column (4) and (5) indicate the variation in the cash reserve ratio during the period.

Source: International Monetary Fund, websites of respective central banks.

Chart VI.2: International Commodity Prices

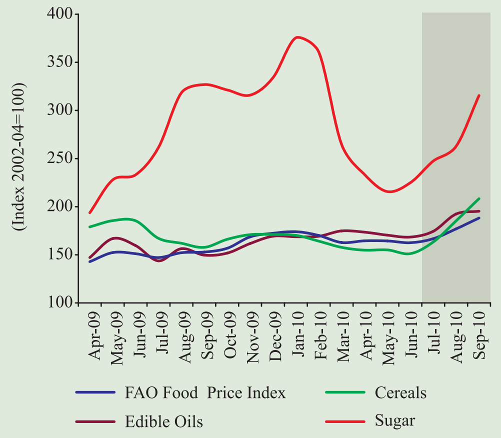


recovery and sustainability of high growth in demand in emerging economies spilled over to commodity markets. (Chart VI.2).

VI.8 Uncertainties in global recovery impacted significantly on crude oil prices. The average crude oil price for Q2 of 2010-11 was US$ 75.5 per barrel, lower than US$ 78.2 per barrel recorded in Q1. However, crude oil prices firmed up in recent weeks and the WTI crude prices were at US$ 82.2 per barrel as on October 28, 2010. According to the US Energy Information Administration, despite a slight reduction in projected global demand growth, oil prices may firm up due to gradual reduction in global oil inventories.

VI.9 International food prices, which moderated marginally during January-June 2010, firmed up in recent months (Chart VI.3). Weather related supply disruptions in a number of commodities contributed to the increase in prices. Wheat prices increased by 72 per cent during June-September 2010 because of weather related output losses in Russia and other producers and Russia's subsequent ban on grain exports. Coarse cereal prices also increased on account of expected smaller crops in the US and higher export demand given the tight wheat market condition. Edible oils prices were affected due to soyabean losses from drought in the EU and the Black Sea region, and concerns regarding next season's crop in South America. Cotton prices have increased on account of a decline in output reflecting floods in Pakistan, which is a major producer and exporter of raw cotton. Metal

Chart VI.3: International Food Prices



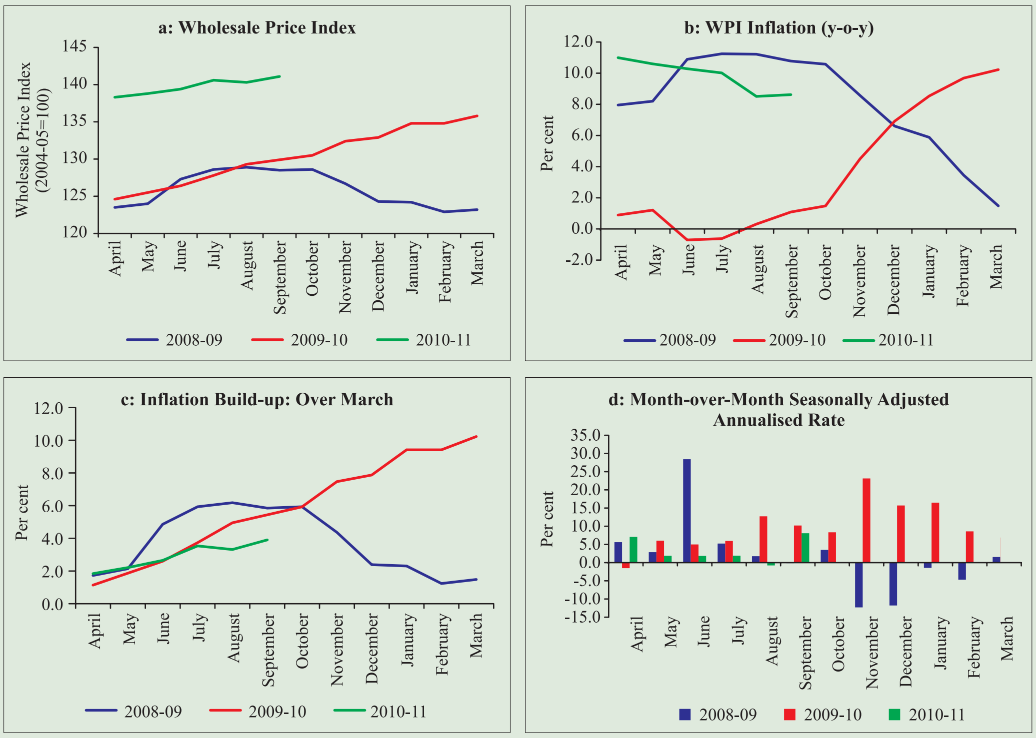
prices have also increased as China reduced the production. Simultaneous increase in prices of a number of commodities poses the risk of high imported inflation in those commodities, particularly where the domestic prices are more responsive to global trends. Administrative measures to mitigate the adverse impact of supply disruptions by countries could also lead to restrictive trade practices, which could further push up global prices.

Inflation Conditions in India

Wholesale Price Inflation

VI.10 WPI inflation increased at a faster pace since November 2009 to reach 11.0 per cent (year-on-year) by April 2010 and remained elevated in the first quarter of 2010-11 (Chart VI.4 a and b). During May-August 2010, however, some moderation in inflation was visible, indicating that inflation might have peaked off (8.6 per cent provisional in September 2010 as per the new series of WPI with base 2004-05=100). The pace of increase in WPI, which was secular since March 2009, also seems to have declined significantly in recent months and the financial year build-up in inflation is seen to be lower than the previous years (Chart VI.4 c). This was also reflected in low month-on-month seasonally adjusted annualised inflation, except in September 2010 (Chart VI.4 d).

Chart VI.4: Trends in Wholesale Price Inflation



New Series of Wholesale Price Index[1]

VI.11 On September 14, 2010, the new series of WPI with base year 2004-05 was introduced replacing the 1993-94 series. The new series reflects some shifts in the weights towards fuel and power and manufactured products from primary articles. Although changes in the weights for manufactured products are not substantial for the group as a whole, there has been a tilt in the weights towards non-food manufactured products, besides substantial increase in the new items added/revised that reflects changes in the production pattern over a decade (Table VI.2). Thus, in terms of the level of the price index, the difference between the old and the new series is primarily contributed by the manufactured products group, which reflects the impact of large number of new items included in this group (including revisions in the existing items). The number of commodities included in the new WPI series has increased from 435 to 676, even after dropping/revising 176 items from the old series. The total number of price quotations for WPI has also been increased substantially from 1,918 in the old series to 5,482 in the new series.

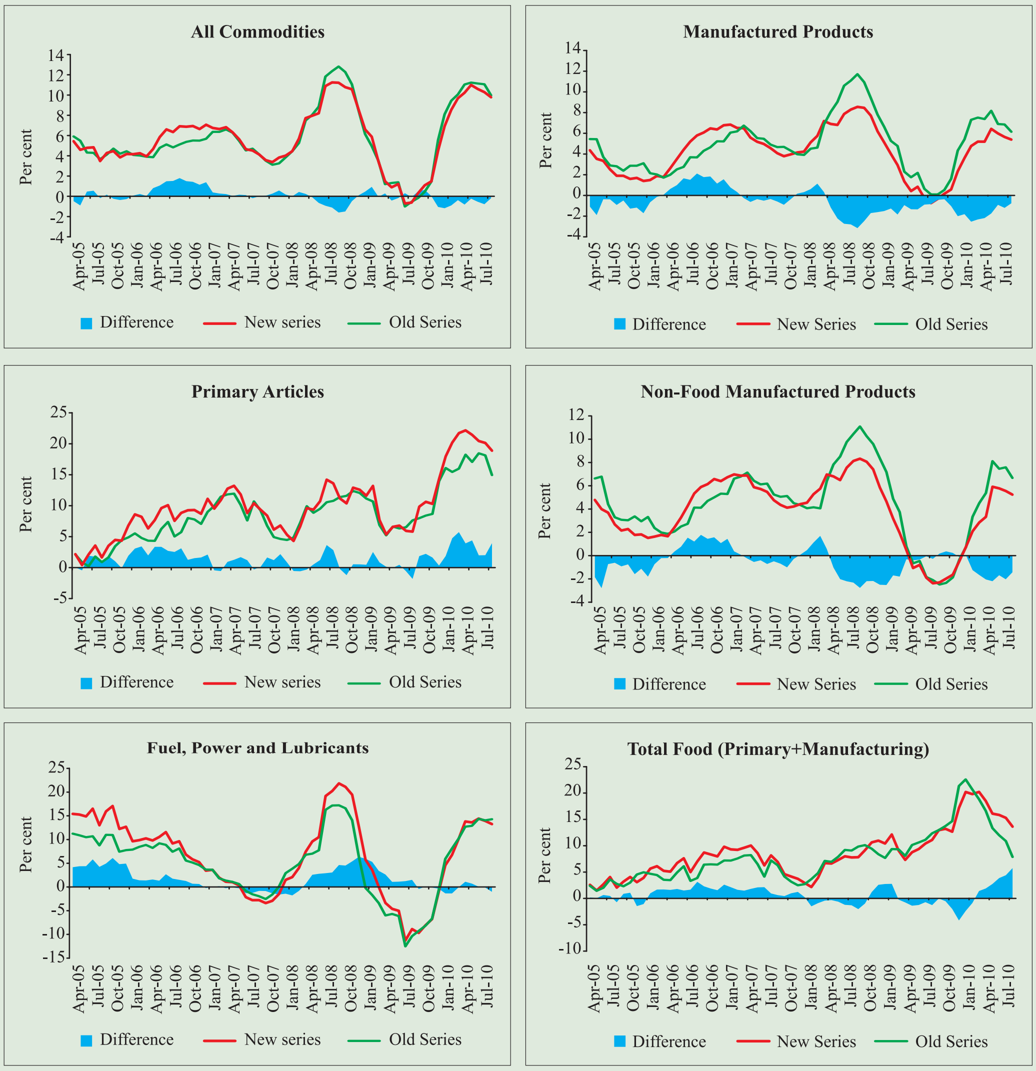
VI.12 The average overall inflation rate, according to the new series and the old series, is about 5.5 per cent for the past five years (*i.e.,* 2005-06 to 2009-10) indicating that there is not much difference in inflation between the two series. Occasional divergence in the inflation between the new and the old series was observed during different periods and in terms of rate of inflation (y-o-y), the maximum difference in any month has been about 1.8 percentage points. The differences in inflation across commodity groups, however, have been larger. Higher food inflation (both primary and manufactured) in the new series for 2010-11 is largely offset by the lower inflation in the non-food manufactured products, as a result of which the magnitude of the difference in the headline inflation remains relatively low (Chart VI.5). The inflation in non-food manufactured products, which is particularly significant for assessment of generalisation and the role of demand-side factors, suggests: (a) some moderation in recent months as per the trends in both series, and more importantly, (b) the inflation as per the new series is lower, in the range of 1.4 to 2.2 percentage points during 2010-11 (up to July), relative to the old series,

Table VI.2: Major Changes in the Weights and Commodities in the Revised WPI Series

Items		Weights		No. of Commodities		
		New Series (Base:2004-05)	Old Series (Base:1993-94)	New Series (Base:2004-05)	Old Series (Base:1993-94)	New Items added/revised
1		2	3	4	5	6
All Commodities		**100.00**	**100.00**	**676**	**435**	**417**
I.	**Primary Articles**	**20.12**	**22.03**	**102**	**98**	**11**
	Food	14.34	15.40	55	54	1
	Non-Food and Minerals	5.78	6.63	47	44	10
II.	**Fuel and Power**	**14.91**	**14.23**	**19**	**19**	**0**
III.	**Manufactured Products**	**64.97**	**63.75**	**555**	**318**	**406**
	Food	9.97	11.54	57	41	25
	Non-Food	55.00	52.21	498	277	381

[1] The Office of Economic Adviser, Ministry of Commerce and Industry have indicated that for the purpose of research and analysis, data of the new series of WPI (Base: 2004-05) can be used from April 2005. For other than research purpose, the WPI Series (Base: 2004-05) is effective only from August 2010, its date of first release *i.e.,* September 14, 2010.

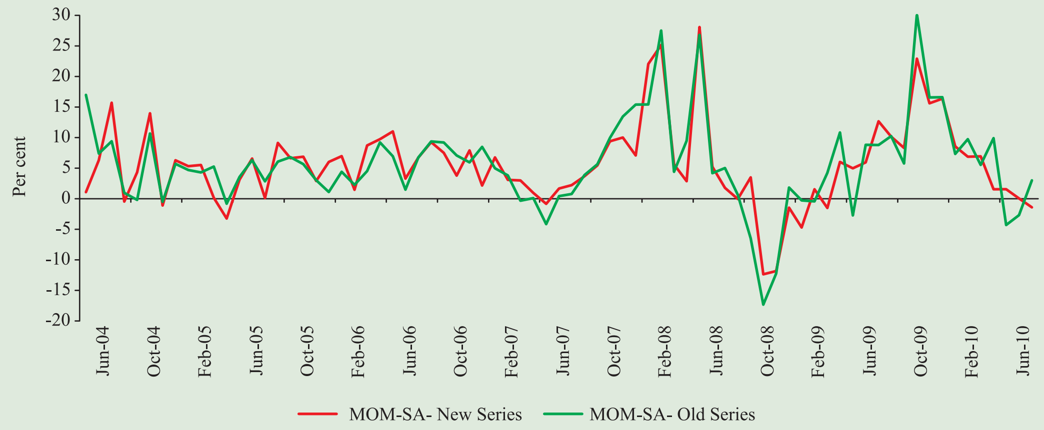
Chart VI.5: WPI Inflation – A Comparison of Old and New Series



which is largely due to a substantial change in the basket with the introduction of a number of new items (406 manufactured products added/revised).

VI.13 The new series of WPI, thus, marks a major change in terms of scope and coverage of commodities and is more representative of the changing underlying economic structure. It adequately captures the present underlying economic structure, which is consistent with changes in the production and the consumption pattern. The non-food manufactured group covers a larger basket in the new series, which includes electronic items and communication equipments, whose prices have declined overtime. The food inflation in the new series is, however, higher than in the old series, which reflects significant shifts in the pattern

Chart VI.6: Annualised Month-over-Month (Seasonally Adjusted) Inflation Rate



of household consumption in favour of protein-rich items such as egg, meat and fish, milk and pulses, where price rise has been high with changing income levels and supply response does not appear to be commensurate with the rising demand.

VI.14 The month-over-month momentum (seasonally adjusted, annualised) in both the series exhibits similar pattern, even though in recent months the new series showed generally softening bias, unlike the old series. However, price level again increased in September 2010 on the back of food price pressures (Chart VI.6).

VI.15 Although the WPI inflation exhibited some decline in recent months, it still remains significantly high. The contribution of food inflation to overall inflation has declined since January 2010 as the manufactured food products inflation declined, led by sugar. The contribution of the non-food manufacturing group remained more or less the same during the last few months with marginal decline in August and September 2010 (Chart VI.7).

Chart VI.7: Contribution to Overall Inflation- Major Groups

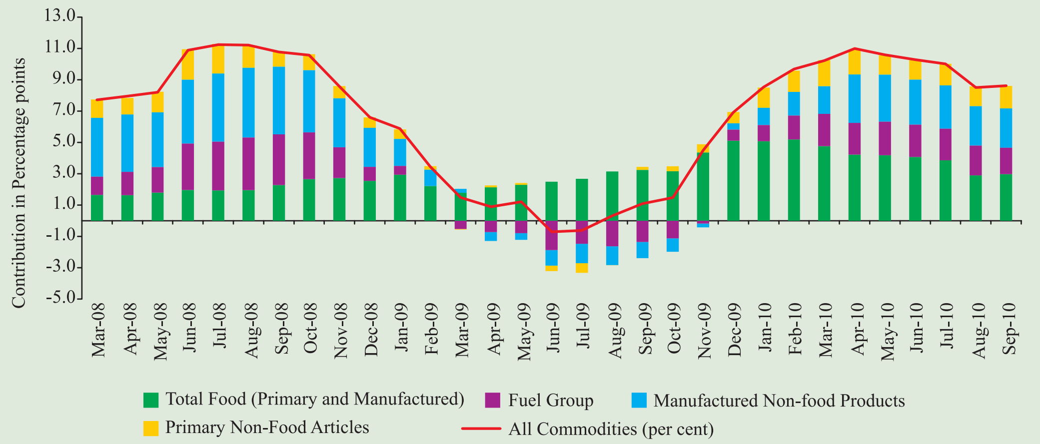
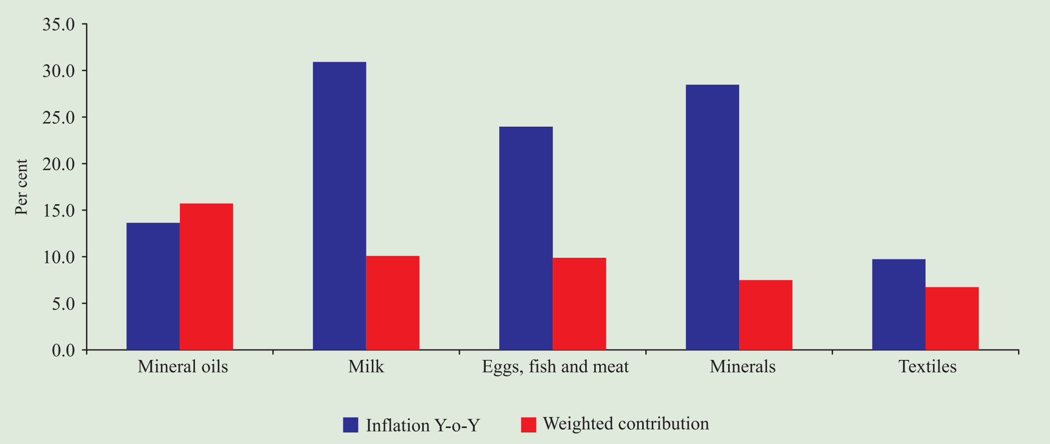


Chart VI.8: Major Contributors to WPI Inflation: September 2010

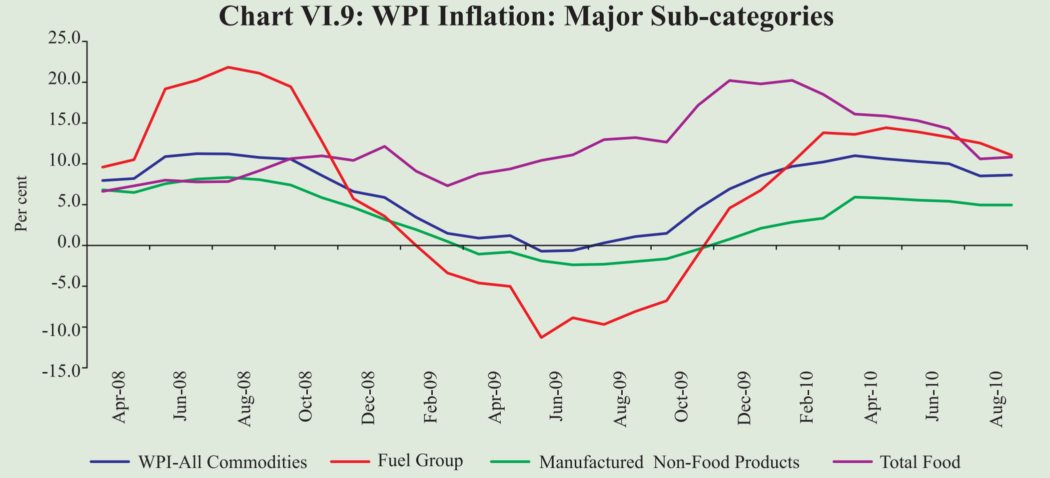


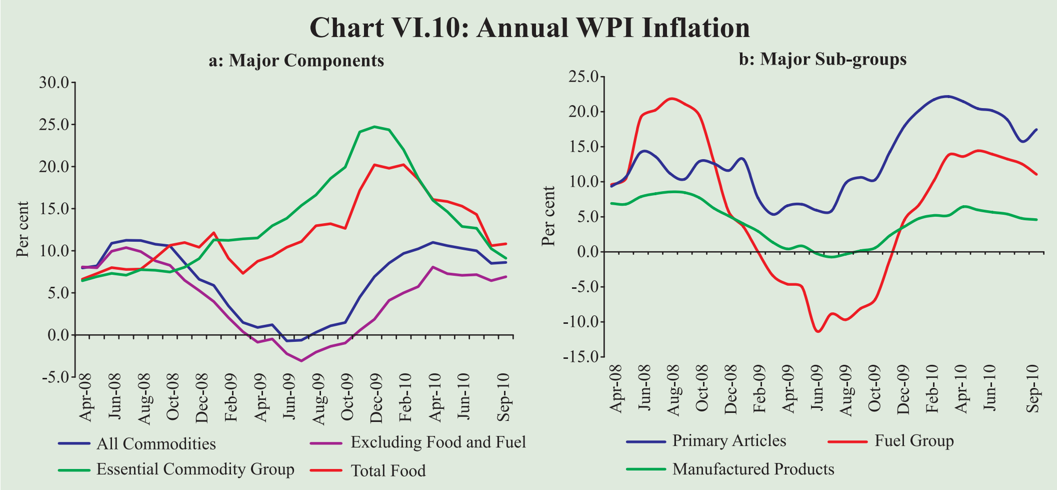
VI.16 The key commodities, which continue to contribute significantly to headline inflation, are mineral oils, food articles like milk, egg, fish and meat, minerals and textiles (Chart VI.8). Increase in food prices continues to have a significant impact on overall inflation as primary food article inflation alone contributed about 31 per cent to overall inflation in September 2010.

VI.17 Inflation across different sub-groups followed the trend in headline inflation and exhibited moderation in recent months (Chart VI.9). The decline in food inflation was largely led by manufactured food products. The increase in manufactured non-food products inflation seems to have contained and fuel inflation also exhibits moderate decline more on account of the base effect of last year's increase in prices.

VI.18 Inflation in essential commodities group, which remained significantly divergent from the overall trend during 2009-10, has also moderated (Chart VI.10a). The convergence of different sub-components of inflation, due to both the

Chart VI.9: WPI Inflation: Major Sub-categories





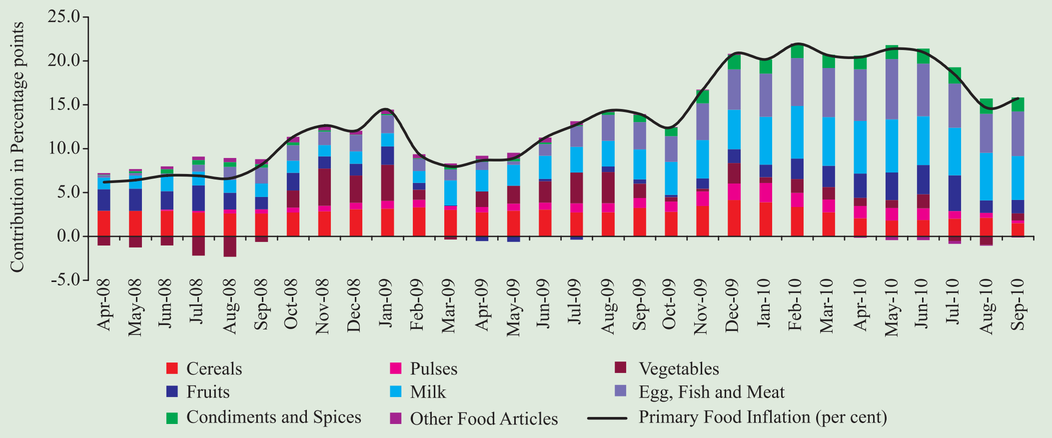
decline in food inflation and high non-food inflation points to the generalised nature of inflation process in recent months.

VI.19 Amongst the major groups, primary articles inflation, y-o-y, declined since February 2010 but exhibited some uptrend in September 2010 (Chart VI.10b). The decline in primary articles inflation, however, was more on account of the base effect of sharp increases in prices recorded a year ago. Primary food articles inflation (y-o-y) moderated to 13.8 per cent for the week ended October 16, 2010 from the peak of 22.9 per cent in mid- June 2010. However, since March 2010, primary articles index of WPI has increased by 8.6 per cent (as on October 16, 2010) led by food articles.

VI.20 Presently, an important concern from the point of view of inflation management is the downward rigidity in the primary food articles prices even after a good monsoon. With a normal monsoon, it was expected that the prices of food articles would moderate substantially. However, food articles inflation continues to remain in double digits. It needs to be emphasised that with increase in income levels, the consumption basket is getting diversified more in favour of non-cereal items such as milk, vegetables, fruits, meat, poultry and fish, which are important from the nutritional angle. The decomposition of food inflation indicates that during the recent period the key drivers of food inflation are non-cereals. In fact, since November 2009, much of the food inflation is contributed by protein rich items like milk, eggs, fish and meat, which are less responsive to monsoon (Chart VI.11). About two thirds of the primary food inflation (y-o-y) currently emanates from the two sub-groups, milk and ‘egg fish and meat’. Inflation in pulses, however, remains moderate largely reflecting the base effect of very high prices recorded a year ago. Thus, despite a decline in the contribution of cereals and vegetables to inflation in recent months, food inflation continues to remain firm.

VI.21 The sustained high level of food prices, especially of protein-based items, whose share in consumption basket has increased over time along with increases in income, points to the risk that food price inflation could acquire a structural character and become more persistent. Given the

Chart VI.11: Contributors to Primary Food Inflation



tight demand-supply conditions in food globally and prospects of firming up of commodity prices, import as an option to control food inflation may not be available for most commodities. This calls for the effective management of supply augmenting measures in the medium term to address the food inflation.

VI.22 Non-food primary articles inflation also remains high at above 20 per cent, reflecting the revision in sugarcane index by about 50 per cent in March 2010 and increase in iron ore and raw cotton prices. Iron ore prices have doubled since December 2009, while raw cotton prices increased by more than 20 per cent in September 2010. Increase in raw cotton and sugar prices in recent months in the wake of increase in global commodity prices, despite significant increase in domestic production, points towards the risk of spillover even with favourable production conditions.

VI.23 Fuel group inflation is influenced both by decisions of the Government on the administered prices and movements in freely priced petroleum products prices. As on a monthly average basis crude prices (Indian basket) have remained range bound between US $ 75-85 during 2010-11 so far, the non-administered prices under the fuel group remained more or less the same. Motivated by fiscal as well as fuel efficiency considerations, the Government increased the price of diesel (by Rs.2 per litre), PDS kerosene (by Rs.3 per litre) and domestic LPG (by Rs.35 per cylinder) and deregulated petrol prices on June 25, 2010. The direct impact of these measures was about 0.9 percentage point increase in WPI inflation, with the indirect impact on prices through input cost escalation with a lag likely to raise the full impact to about 2 percentage points, assuming partial pass-through. As the deregulated petrol prices remained almost constant during the period July-September 2010 tracking the trends in international crude prices, the pressure on headline inflation remained contained. Fuel group inflation, nevertheless, continues to remain in double digits (11.3 per cent as on October 16, 2010).

VI.24 Manufactured products inflation has declined since April 2010, led by decline in prices of food products. The manufactured products price index, however, remains almost the same during 2010-11 so far indicating that the decline in inflation was largely contributed by the high base of the previous year. Non-food manufactured products inflation declined to 5.0 per cent in September 2010 (Table VI.3).

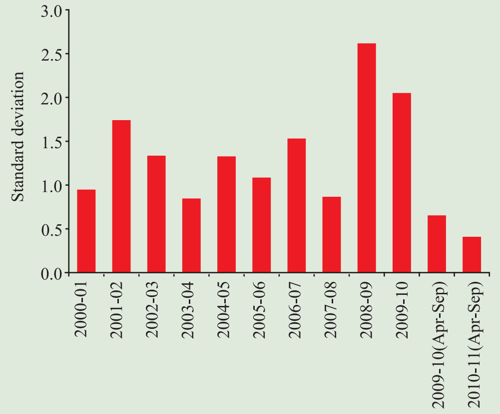
Table VI.3: Wholesale Price Inflation in India (2004-05=100) (year-on-year)

(Per cent)

Commodity	Weight	2009-10 (March)		2010-11 (September)		Financial Year (over March 2010)	
		Inflation	C*	Inflation	C*	Inflation	C*
1	2	3	4	5	6	7	8
All Commodities	**100.0**	**10.2**	**10.2**	**8.6**	**8.6**	**3.9**	**3.9**
1. Primary Articles	**20.1**	**22.2**	**4.9**	**17.5**	**4.1**	**8.3**	**2.0**
Food Articles	14.3	20.6	3.3	15.7	2.7	9.4	1.6
i. Rice	1.8	8.1	0.2	4.6	0.1	0.9	0.0
ii. Wheat	1.1	14.7	0.2	8.7	0.1	0.1	0.0
iii. Pulses	0.7	25.0	0.2	5.1	0.1	-0.1	0.0
iv. Vegetables	1.7	13.6	0.2	6.0	0.1	37.1	0.6
v. Fruits	2.1	18.2	0.4	12.0	0.3	3.6	0.1
vi. Milk	3.2	24.9	0.9	24.0	0.9	5.8	0.2
vii. Eggs, Fish and Meat	2.4	35.5	0.9	30.9	0.9	15.2	0.5
Non-Food Articles	4.3	20.4	0.9	18.2	0.8	4.6	0.2
i. Raw Cotton	0.7	20.0	0.1	27.5	0.2	14.0	0.1
ii. Oilseeds	1.8	6.7	0.1	5.2	0.1	3.1	0.1
iii. Sugarcane	0.6	53.3	0.3	53.3	0.3	0.0	0.0
Minerals	1.5	37.9	0.8	28.5	0.6	7.3	0.2
i. Crude Petroleum	0.9	58.3	0.5	9.7	0.1	-1.1	0.0
2. Fuel and Power	**14.9**	**13.8**	**2.1**	**11.1**	**1.7**	**5.4**	**0.8**
i. Coal	2.1	7.9	0.2	7.9	0.2	0.0	0.0
ii. Mineral Oils	9.4	18.6	1.7	13.6	1.4	6.8	0.7
iii. Electricity	3.5	3.4	0.1	5.0	0.1	5.0	0.1
3. Manufactured Products	**65.0**	**5.2**	**3.3**	**4.6**	**2.8**	**1.6**	**1.0**
i. Food Products	10.0	15.1	1.5	2.8	0.3	-1.7	-0.2
of which: Sugar	1.7	44.3	0.8	-4.4	-0.1	-12.8	-0.3
Edible Oils	3.0	0.4	0.0	4.9	0.1	4.2	0.1
ii. Cotton Textiles	2.6	12.7	0.3	14.9	0.3	4.7	0.1
iii. Man Made Textiles	2.2	8.4	0.2	9.4	0.2	3.5	0.1
iv. Chemicals and Products	12.0	3.7	0.4	4.3	0.5	1.7	0.2
of which : Fertilisers	2.7	1.9	0.0	7.5	0.2	4.8	0.1
v. Non-Metallic Mineral Products	2.6	3.2	0.1	2.2	0.1	0.9	0.0
of which: Cement &Lime	1.4	2.3	0.0	1.7	0.0	0.4	0.0
vi. Basic Metals, Alloys and Metal Products	10.7	1.4	0.2	6.0	0.6	3.4	0.3
of which: Ferrous Metals	8.1	0.5	0.0	6.2	0.5	3.7	0.3
vii. Machinery and Machine Tools	8.9	1.5	0.1	2.9	0.2	0.8	0.1
of which: Electrical Machinery	2.3	-1.1	0.0	2.7	0.1	0.8	0.0
viii. Transport Equipment and Parts	5.2	1.2	0.1	4.2	0.2	2.3	0.1
Memo:							
Food Items (Composite#)	**24.3**	**18.5**	**4.8**	**10.8**	**3.0**	**5.2**	**1.4**
Food Items (Protein Based)$	**6.4**	**28.7**	**2.0**	**23.9**	**1.9**	**8.6**	**0.7**
Manufactured Non-food Products	**55.0**	**3.3**	**1.8**	**5.0**	**2.5**	**2.3**	**1.1**
WPI Excluding Food	**75.7**	**7.4**	**5.5**	**7.8**	**5.6**	**3.4**	**2.5**
WPI Excluding Fuel	**85.1**	**9.6**	**8.2**	**8.2**	**6.9**	**3.6**	**3.1**
Essential Commodities	**14.4**	**18.6**	**2.9**	**9.1**	**1.5**	**2.9**	**0.5**

* : Contribution to inflation in percentage points. #: Primary Food Articles+Manufactured Food Products.
$: Includes milk, egg, fish and meat and pulses.

Chart VI.12: Volatility in Non-food Manufactured Inflation



VI.25 The inter-temporal volatility in core inflation in India, measured in terms of standard deviation of the non-food manufactured inflation, which is relevant for policy purposes, exhibited significant increase in 2008-09 and 2009-10, after a long period of relative stability (Chart VI.12). The rise in volatility in non-food manufactured inflation, to an extent, could be attributed to the global commodity shocks, as rising prices of inputs tend to cause pressure on manufactured product prices domestically. The data available for 2010-11 so far, however, suggest a significant moderation in the volatility.

Consumer Price Inflation

VI.26 Inflation, as measured by various consumer price indices, continued to moderate in 2010-11 so far. Available measures of inflation, as measured by various CPIs indicate that it remained in the range of 9.1-9.8 per cent in September 2010 (Table VI.4). The divergence between WPI and CPI inflation also reduced in recent months. (Chart VI.13).

VI.27 With strengthening of domestic growth prospects, inflation management assumed prime importance, which was reflected in the normalisation of monetary policy. Overall, the inflationary process, which originated from supply shocks, and then turned increasingly generalised, seems to have now moderated but remains elevated at beyond the comfort level. Upward revision of administered prices and lagged reporting of past price increases added momentum to the uptrend in WPI. Among the positive developments, given the expected better agricultural output than last year, food price

Chart VI.13: CPI and WPI Inflation

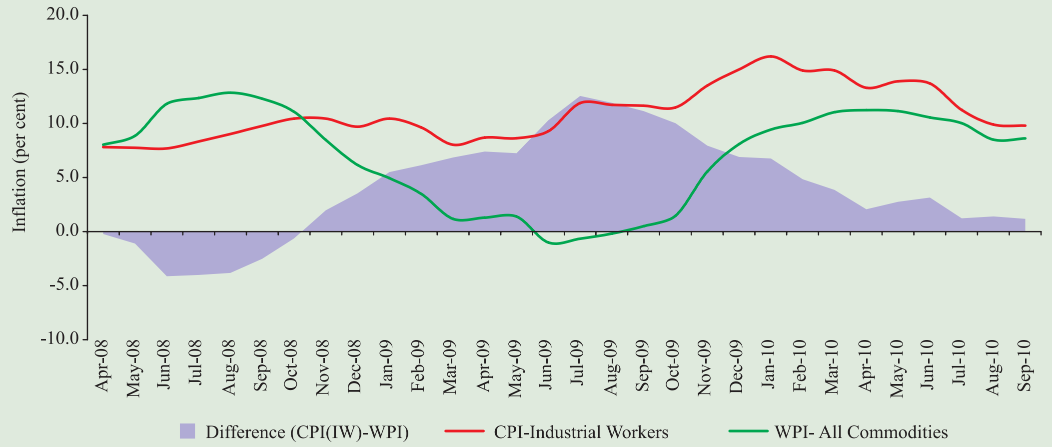


Table VI.4 : Consumer Price Inflation - Major Groups

(Year-on-year variation in per cent)

CPI Measure	Weight	Mar-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Jul-10	Aug-10	Sep-10
1	2	3	4	5	6	7	8	9	10	11	12
CPI-IW (Base: 2001=100)											
General	**100.0**	**7.9**	**8.0**	**9.3**	**11.6**	**15.0**	**14.9**	**13.7**	**11.3**	**9.9**	**9.8**
Food Group	46.2	9.3	10.6	12.2	13.5	21.3	16.0	13.9	11.6	9.8	–
Pan, Supari *etc.*	2.3	10.9	8.3	8.1	8.0	8.6	9.1	13.0	12.9	12.1	–
Fuel and Light	6.4	4.6	7.4	1.4	4.2	3.4	3.4	6.9	10.3	11.5	–
Housing	15.3	4.7	6.0	6.0	22.1	22.1	33.1	33.1	21.1	21.1	–
Clothing, Bedding *etc.*	6.6	2.6	5.0	4.1	4.1	4.1	4.0	4.8	4.7	5.5	–
Miscellaneous	23.3	6.3	7.4	6.6	5.7	4.2	4.8	4.8	5.4	4.0	–
CPI-UNME (Base: 1984-85=100)											
General	**100.0**	**6.0**	**9.3**	**9.6**	**12.4**	**15.5**	**14.9**	**14.1**	**11.5**	**10.3**	–
Food Group	47.1	7.8	12.2	13.6	14.4	21.4	16.3	13.9	11.7	9.2	–
Fuel and Light	5.5	4.6	5.9	1.3	4.2	3.5	3.3	6.9	10.2	11.6	–
Housing	16.4	4.0	5.8	6.0	22.0	22.0	33.2	33.2	21.0	21.0	–
Clothing, Bedding *etc.*	7.0	4.3	3.3	4.2	4.1	4.1	4.0	4.8	4.6	5.4	–
Miscellaneous	24.0	4.8	8.6	7.3	6.0	4.6	5.3	5.1	5.0	5.0	–
CPI-AL (Base: 1986-87=100)											
General	**100.0**	**7.9**	**9.5**	**11.5**	**13.2**	**17.2**	**15.8**	**13.0**	**11.0**	**9.6**	**9.1**
Food Group	69.2	8.5	9.7	12.4	14.6	20.2	17.7	13.7	11.3	9.1	8.8
Pan, Supari *etc.*	3.8	10.4	15.3	14.2	15.5	14.6	15.4	16.6	14.1	11.3	10.8
Fuel and Light	8.4	8.0	11.5	11.0	12.0	14.3	15.2	15.5	14.6	16.6	16.1
Clothing, Bedding *etc.*	7.0	1.8	7.4	8.3	8.1	8.2	9.1	9.6	9.9	10.1	10.2
Miscellaneous	11.7	6.1	6.5	6.1	7.1	7.0	7.6	7.7	7.0	6.3	6.0
CPI-RL (Base: 1986-87=100)											
General	**100.0**	**7.6**	**9.7**	**11.3**	**13.0**	**17.0**	**15.5**	**13.0**	**11.2**	**9.7**	**9.3**
Food Group	66.8	8.2	10.0	12.4	14.6	20.4	17.7	13.9	11.5	9.5	8.8
Pan, Supari *etc.*	3.7	10.6	15.0	14.1	15.4	14.4	15.5	16.7	14.3	11.8	11.1
Fuel and Light	7.9	8.0	11.5	11.0	12.0	14.1	15.0	15.3	14.5	16.4	15.9
Clothing, Bedding *etc.*	9.8	2.8	8.2	8.8	9.5	10.3	9.8	10.3	10.2	10.3	9.5
Miscellaneous	11.9	6.2	6.7	6.2	6.9	6.6	7.2	7.3	6.8	6.1	5.8
WPI Inflation											
BaseYear:2004-05=100		7.7	1.5	-0.7	1.1	6.9	10.2	10.3	10.0	8.5	8.6
GDP Deflator based Inflation*		4.9	7.9	0.9	0.7	5.8	4.5	11.8	–	–	–

*: Data for March pertain to full year.

IW : Industrial Workers. UNME : Urban Non-Manual Employees. AL : Agricultural Labourers. RL : Rural Labourers.

pressures may soften during the course of the year. Nevertheless, current trends suggest a possible ratchet effect, with food inflation appearing sticky and somewhat impervious to generally expected favourable impact of a normal monsoon, thus posing a key risk to the overall inflation environment. The persistence of food inflation not only has adverse welfare effects as the poor have larger share of food in their consumption basket, but could also impact the core inflation after a lag, causing a generalisation of price pressures. Another important risk to inflation could emanate from the recent upward momentum witnessed in the global commodity prices, which could partly get imported even with record domestic production, as has been the case for cotton. Capacity constraints, in some sectors, along with increasing pricing power of firms in the context of stronger growth momentum, is a source of risk to the inflation process. While non-food manufactured inflation has shown some moderation in recent months suggesting that monetary actions are having an impact, inflation still remains above the comfort level.

VII. MACROECONOMIC OUTLOOK

The output growth of the Indian economy has started to consolidate around the trend after a sharp recovery and the headline inflation also shows signs of peaking off. Going forward, various forward looking surveys conducted in the recent period suggest strong y-o-y growth. The Industrial Outlook Survey of the Reserve Bank also points to continuation of the growth momentum. The professional forecasters' survey of the Reserve Bank registered a marginal upward revision in the GDP growth rate for 2010-11, on the back of higher growth forecasts for agriculture and services sector. The overall outlook suggests that notwithstanding some recent moderation in headline inflation, the level of inflation remains above the comfort level. The Reserve Bank's policy stance is likely to be shaped by dual goals of maintaining the growth momentum in an atmosphere of global uncertainty, while striving to moderate inflation further.

VII.1 The robust recovery of the Indian economy since the second half of 2009-10 continued in the first quarter of 2010-11, mainly on account of buoyancy in the services sector and better performance of the agriculture sector. Even though the pace of growth of industrial sector was volatile, it remained in double digits (except in June and August 2010), thereby supporting the overall growth momentum. The business expectations surveys show an optimistic picture about the outlook. The Industrial Outlook Survey of the Reserve Bank indicates improvement in business situation for the assessment quarter (July-September 2010) as well as the expectation quarter (October-December 2010). The professional forecasters' survey also echoes this optimism.

Business Expectations Survey

VII.2 The forward looking surveys conducted by various agencies generally show significant y-o-y gains, though some of the surveys registered moderate decline in business expectations on a q-o-q basis (Table VII.1).

Table VII.1: Business Expectations Surveys

Period/Index	NCAER Mastercard Business Confidence Index Sept. 2010	FICCI Q1:2010-11 Overall Business Confidence Index	Dun & Bradstreet Q4: 2010 Business Optimism Index	CII Oct-Dec. 2010-11 Business Confidence Index
1	2	3	4	5
Current level of the Index	162.1	71.9	163.5	66.2
Index as per previous survey	155.9	74.8	150.0	67.6
Index levels one year back	143.7	67.2	143.2	66.1
% change (q-on-q) sequential	4.0	-3.9	9.0	-2.1*
% change (y-on-y)	12.8	7.0	14.2	0.2**

* : Percentage change over the previous survey.
** : Percentage change over October-March 2009-10 Survey.

VII.3 All the four components of the business confidence index of the NCAER survey have shown remarkable improvement over the previous quarter, with the investment climate recording highest improvement compared with the previous round. At the sectoral level, consumer durables, consumer non-durables, intermediate and capital goods have shown increase in business optimism in the most recent round over the previous round.

VII.4 The Business Confidence Survey of the FICCI for the Q1:2010-11, suggests that 78 per cent of the companies felt that the overall economic conditions *vis-à-vis* last six months are 'moderately to substantially' better. Going ahead, around 72 per cent of the companies foresee an improvement in overall economic condition in the coming six months. The overall business confidence index, however, recorded a decline over the previous quarter on account of decline at three levels *viz*., economy, industry and firm. The outlook for jobs has also been somewhat dormant, with about 64 per cent of the participants saying that they will maintain employment levels in their firms.

VII.5 In the Dun and Bradstreet Business Optimism Index (BOI) five out of the six optimism indices *viz*., volume of sales, net profits, new orders, inventory levels and selling prices have registered an increase as compared to the previous quarter. Only employee level remained unchanged. The survey findings mention that the expected moderation in inflation might provide some respite to the consumers, thereby supporting domestic cosumption demand.

VII.6 The CII Business Confidence Index (CII-BCI) for October-December 2010-11 registered a decline over the previous survey. In the present survey, 70 per cent of the respondents indicated that exports may increase.

VII.7 The seasonally adjusted HSBC Markit Manufacturing Purchasing Managers' Index (PMI) increased at the slowest pace in last ten months in September 2010, mainly reflecting slower growth in output and new orders. On the downside, the employment levels have remained stagnant since June 2009. Rising raw material prices drove the fast rise in input prices, leading to output price inflation. Notwithstanding the recent fall, the index has remained in the above neutral territory (*i.e.*, above 50) since April 2009.

VII.8 Even though the pace of growth in the HSBC Markit Services PMI showed a moderation in September 2010, it continued to point to a substantial expansion of services sector output. The pace of new hiring in the services sector slowed down, though it remains in positive territory.

Reserve Bank's Industrial Outlook Survey

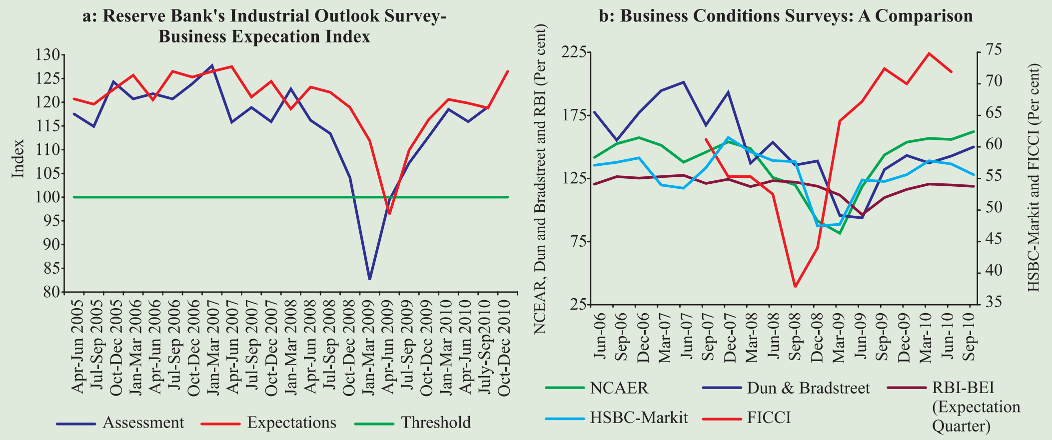
VII.9 The 51st round of the Industrial Outlook Survey of the Reserve Bank conducted during July-September 2010, based on a sample of 1,403 companies, showed an improvement for the assessment quarter (July-September 2010) as well as expectations for the October-December 2010 quarter. Moreover, both indices (*i.e.* assessment about the current quarter and expectation about the next quarter) remained in the growth terrain (*i.e.* above 100, which is the threshold that separates contraction from expansion) (Chart VII.1a). The findings of the survey are consistent with that of other surveys (Chart VII.1b).

VII.10 The Industrial Outlook Survey shows that the Indian manufacturers have an optimistic view about improvement in demand conditions *viz*. production, order books, capacity utilisation, exports and imports for both the assessment and expectation quarters, compared to previous quarter and the corresponding quarter a year ago. However, inventories are seen to be piling up for both the quarters under review. This indicates that part of the double digit growth in IIP was the result of inventory build-up, which may not persist, going forward. Manufacturers' pricing power was evident from expectations about higher selling prices. On the employment outlook, Indian manufacturers are expected to be net hirers (Table VII.2).

Survey of Professional Forecasters[1]

VII.11 The results of the thirteenth round of 'Survey of Professional Forecasters' conducted by the Reserve Bank in September 2010 shows a marginal upward revision in the overall (median) GDP growth rate for 2010-11 from 8.4 per cent to 8.5 per

Chart VII.1: Industrial Outlook Surveys



[1] Introduced by the Reserve Bank from the quarter ended September 2007. The forecasts reflect the views of professional forecasters and not of the Reserve Bank.

Table VII.2: Reserve Bank's Industrial Outlook Survey -Net Response on Expectations and Assessment about the Industrial Performance

Parameter	Optimistic Response	Oct-Dec 2009		Jan-Mar 2010		Apr-Jun 2010		July-Sept 2010		Oct-Dec 2010
		E	A	E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9	10	11
1 Overall business situation	Better	39.8	36.0	44.9	43.1	41.2	40.7	41.5	38.7	47.5
2. Overall financial situation	Better	33.5	29.5	39.3	35.8	36.3	32.2	34.1	30.6	39.6
3. Working capital finance requirement	Increase	30.4	28.8	32.7	30.5	27.7	29.9	31.1	29.3	34.8
4. Availability of Finance	Improve	26.1	23.0	29.2	25.7	26.8	26.4	28.5	26.6	31.3
5. Cost of external finance	Decrease		-14.7	-18.3	-15.9	-20.6	-21.9	-23.3	-28.3	-28.3
6. Production	Increase	35.0	28.9	40.0	36.5	35.9	35.4	40.2	40.0	49.1
7. Order books	Increase	32.3	25.9	35.8	31.9	33.4	31.3	36.3	36.1	44.8
8. Pending orders, if applicable	Below normal	11.0	11.6	5.7	8.8	6.4	6.9	4.2	5.1	1.5
9. Cost of raw material	Decrease	-38.4	-47.1	-44.3	-60.2	-48.6	-62.7	-49.3	-58.3	-49.3
10. Inventory of raw material	Below average	-1.2	-4.2	-3.6	-5.8	-2.6	-5.0	-5.1	-5.3	-6.6
11. Inventory of finished goods	Below average	-3.7	-4.3	-1.9	-4.3	-2.6	-4.1	-5.0	-4.3	-2.8
12. Capacity utilisation (Main product)	Increase	22.0	16.5	25.4	21.7	19.7	21.1	26.5	23.3	32.3
13. Level of capacity utilisation (Compared to the average in the preceding four quarters)	Above normal	-3.8	-3.9	1.3	3.0	1.6	2.5	5.8	3.1	7.2
14. Assessment of the production capacity (With regard to expected demand in the next six months)	More than adequate	6.5	5.3	5.0	6.4	7.1	3.1	4.1	3.3	5.6
15. Employment in the company	Increase	8.8	10.3	12.1	13.7	13.6	14.7	16.8	18.7	21.0
16. Exports, if applicable	Increase	12.5	9.2	20.2	12.7	18.5	15.3	20.7	20.0	26.1
17. Imports, if any	Increase	11.5	13.0	16.9	17.1	17.1	20.9	21.7	22.0	22.2
18. Selling prices are expected to	Increase	6.0	2.6	9.8	12.4	13.3	17.3	15.2	13.8	17.0
19. Increase in selling prices, if any, is expected	Increase at lower rate	19.4	19.3	16.8	21.6	19.7	17.4	14.3	15.2	13.0
20. Profit margin	Increase	-2.8	-9.9	1.1	-2.9	3.2	-4.8	3.1	-2.5	9.2

Note: 1. 'Net response' is measured as the percentage share differential between the companies reporting 'optimistic' (positive) and 'pessimistic' (negative) responses; responses indicating *status quo* (no change) are not reckoned. Higher 'net response' indicates higher level of confidence and *vice versa*.
2. E: Expectations and A: Assessment
3. 'Cost of external finance' is a newly added question from the 48th (October – December 2009) survey round.

cent, mainly on account of upward revision of the growth forecast of agriculture and services sector (Table VII.3).

Growth Projections of Different Agencies

VII.12 All available projections for GDP growth in 2010-11 generally project an optimistic picture (Table VII.4). Both IMF and ADB revised their growth projections upward for India recently.

Factors Influencing the Current Growth and Inflation Outlook

VII.13 The economic recovery, which became evident in the second half of 2009-10, has consolidated with further increase in real GDP growth in the first quarter of 2010-11. The outlook for continuation of the robust growth momentum derives support from the following factors: (a) the impact of the

Table VII.3: Median Forecasts of Select Macroeconomic Indicators by Professional Forecasters 2010-11 and 2011-12

	Actual 2009-10	Annual Forecasts				Quarterly Forecasts									
						2010-11						2011-12			
		2010-11		2011-12		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)	7.4R	8.4	8.5	8.5	8.5	8.2	8.2	8.5	8.7	8.4	8.3	8.3	8.1	–	8.5
a. Agriculture & Allied Activities	0.2R	4.1	4.6	3.0	3.2	4.0	4.2	6.0	6.5	3.9	5.1	3.0	3.2	–	3.0
b. Industry	10.4R	9.0	9.0	9.1	9.1	9.3	9.3	8.7	8.7	8.4	7.9	8.7	8.1	–	8.0
c. Services	8.3R	9.1	9.2	9.5	9.5	8.9	8.5	9.3	9.4	9.2	9.2	9.5	9.5	–	9.6
2. Gross Domestic Saving (per cent of GDP at current market price)	–	34.7	34.0	35.9	35.3	–	–	–	–	–	–	–	–	–	–
3. Gross Domestic Capital Formation (per cent of GDP at current market price)	–	36.0	36.0	37.8	37.0	36.8	36.0	36.3	35.5	36.1	37.5	37.3	36.0	–	36.5
4. Corporate profit after tax (growth rate in percent)*	28.8	22.5	20.0	21.0	23.0	18.0	10.0	18.9	15.0	25.0	20.0	25.0	20.0	–	20.0
5. Inflation WPI	3.6	8.6	8.1	6.0	5.6	9.5	8.9	8.1	7.4	7.0	6.0	6.4	5.4	–	5.9
6. Exchange Rate (INR/ USD end period)	45.1	44.5	44.5	43.5	43.5	45.5	45.0	44.8	45.0	44.5	44.4	43.8	44.3	–	43.5
7. T-Bill 91 days Yield (per cent-end period)	4.4	5.2	6.0	5.0	5.8	–	–	–	–	–	–	–	–	–	–
8. 10-year Govt. Securities Yield (per cent-end period)	7.8	7.8	7.9	7.5	7.9	–	–	–	–	–	–	–	–	–	–
9. Export (growth rate in per cent)!	-3.6	15.0	15.9	16.0	15.0	–	–	–	–	–	–	–	–	–	–
10. Import (growth rate in per cent)!	-5.6	17.9	19.7	15.0	15.7	–	–	–	–	–	–	–	–	–	–
11. Trade Balance (US$ billion)	-108.2	–	–	–	–	-34.5	-36.5	-36.5	-38.5	-33.0	-37.9	-35.9	-37.3	–	-36.9

E: Previous Round Projection. L: Latest Round Projection. R: Revised Estimate

– : Not Available. *: BSE listed companies. !: US$ on BoP basis.

Note : The latest round refers to thirteenth round for the quarter ended September 2010, while previous round refers to twelfth round for the quarter ended June 2010.

Source : Survey of Professional Forecasters, Second Quarter 2010-11.

normal monsoon on *kharif* output which will be reflected in GDP growth of Q_2 and Q_3, (b) possibility of continuation of buoyancy in the industrial sector, notwithstanding the intermittent volatility, (c) sharp rise in excise duty collections

Table VII.4: Agencies' Forecast for 2010-11

Agency	Latest Projection		Earlier Projection	
	Real GDP Growth (Per cent)	Month	Real GDP Growth (Per cent)	Month
1	2	3	4	5
Economic Advisory Council to the PM	8.5	Jul-10	8.2	Feb-10
Ministry of Finance	8.5 (+/-0.25)	Feb-10	..	..
IMF (calendar year) @	9.7	Oct-10	9.4	Jul-10
ADB	8.5	Sep-10	8.2	Jul-10
NCAER	8.4	Oct-10	8.1	Jul-10
OECD @	8.3	May-10	7.3	Nov-09

.. : Not available.

@ at market price, while others are at factor costs.

which are indicative of strong economic activity, (d) sustained buoyancy in lead indicators of services activities, (e) strong growth in corporate sales, (f) improving business environment as suggested by the Industrial Outlook Survey of the Reserve Bank, (g) pick-up in private consumption expenditure and high growth in the production of consumer durables, (h) strong growth in non-oil imports, (i) high capital expenditure plans of firms, (j) increase in credit demand from the private sector and (k) higher flow of financing from non-banking sources.

VII.14 Certain downside risks to growth however remain, which include: (a) weakening of external demand conditions, given the recently revised outlook for recovery in advanced economies, which will dampen export growth, (b) real appreciation of the exchange rate could also weaken external price competitiveness of Indian exports, (c) pressure from capital inflows on the nominal exchange rate to appreciate, (d) recent survey based evidence of some moderation in capacity utilisation and (e) persistent inflationary pressures, especially in food items.

VII.15 The headline inflation, which moderated to 8.5 per cent in August 2010, before edging up to 8.6 per cent in September, continues to be a cause of policy concern and priority. The elevated levels of food prices, with pressures emanating from non-cereal protein-based items, highlight the structural dimension of food inflation, which would require long-term supply augmenting measures. Going forward, factors which may exert upward pressure on inflation are: (a) further strengthening of pricing power of corporates with the pick-up in private demand, (b) capacity constraints in several sectors, where supply response to high prices could be slow, and (c) oil and commodity prices, which have shown signs of increase in recent months.

VII.16 Notwithstanding these risks, the factors that may help in restraining the inflationary pressures include: (a) a good *kharif* crop, which may help in moderating the food price inflation, (b) weak external demand, which may increase supply in domestic market, (c) no risk to inflation in advanced economies due to large excess capacity and high unemployment, and (d) the impact of monetary policy actions already initiated by the Reserve Bank to contain inflation and anchor inflationary expectations.

VII.17 An overall assessment suggests that GDP growth is consolidating around the trend. This growth momentum, however, needs to be sustained through improved investment demand, particularly in manufacturing and infrastructure sector. The uncertain global outlook and the dominance of supply rigidities in certain sectors that impart rigidity to the inflation path, pose greater challenge for monetary policy to anchor inflationary expectations without hurting growth.