RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments in 2011-12

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Reserve Bank of India
Mumbai

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MACROECONOMIC AND MONETARY DEVELOPMENTS IN 2011-12

Overview

1. *Monetary policy was strongly anti-inflationary until October 2011. Subsequently, decelerating growth and declining inflation momentum prompted monetary policy to move to a neutral stance since December 2011. Some easing in liquidity was effected through a total of 125 basis points reduction in the Cash Reserve Ratio (CRR) during January-March 2012. Going forward, the policy stance will need to ensure that inflationary tendencies remain under control, even as growth adjusts to its trend.*

2. *Growth in Q3 of 2011-12 dropped to 6.1 per cent as investment and external demand contracted and private consumption decelerated. Growth is likely to improve moderately in 2012-13, supported mainly by a pick up in industry on the back of consumption demand and some improvement in investment. However, the depleted investment pipeline and depressed new investment may keep the pace of recovery slow.*

3. *Inflation has fallen in Q4 of 2011-12, but is likely to remain sticky at about current levels during 2012-13. Price pressures persist with considerable suppressed inflation in oil, electricity, coal and fertilisers, the incomplete pass-through of rupee depreciation, slow supply responses and increase in indirect taxes as well as demand effects of large government transfers.*

Global Economic Conditions

Global growth likely to remain moderate in 2012

4. *The recovery in Advanced Economies (AEs) that seemed to be shaping well at the start of 2011 lost steam towards the fag-end of the year and is clouding the prospects for global growth during 2012. It lost momentum as the protracted debt crisis in the euro area and fiscal fragilities dampened business and consumer confidence. However, contrary to fears that came to the fore time and again during 2011-12, global growth did not stall.*

5. *Going into 2012, the global economy appears to be in a continuing phase of multi-speed growth. Most recent assessments indicate that the euro area is entering into a mild recession, while growth and employment conditions in the US are improving. Growth in emerging markets, especially China and India, is slowing beyond what was anticipated but these two economies are still likely to provide some support for global recovery. In sum, in spite of a dip in growth, the world economy is unlikely to lapse into another recession.*

Financial market stress eases

6. *Global financial market stress eased significantly during Q1 of 2012 after the ECB made a large liquidity injection. However, stability and structural improvements in the euro area still remain the unfinished agenda. The recovery and financial stability can still be derailed by global inflation engendered by liquidity infusion and high crude oil prices.*

Indian Economy: Developments and Outlook

Output

Growth may have bottomed out in Q3 of 2011-12, but recovery ahead likely to be slow

7. *Early indicators suggest that growth may have bottomed out in Q3 of 2011-12 but recovery may be slow during 2012-13. Lower global demand, domestic policy uncertainties*

and the cumulative impact of monetary tightening lowered the growth rate to below seven per cent over the last two quarters. Industrial growth remains subdued due to supply-side bottlenecks, particularly in the mining sector, and moderation in investment demand. With measures being taken to remove supply-side bottlenecks, progress on fiscal consolidation could create conditions for a more favourable growth-inflation dynamic.

Aggregate demand

Investment downturn extends, speeding of public investment could crowd in private investment

8. *The growth slowdown has been driven by a sharp fall in investment, some moderation in private consumption and fall in net external demand. The drag from investment is likely to continue in the near term. Corporate investment intentions continued to drop during Q3 of 2011-12. Consultations with industry and banks suggest that new project investment continue to be sluggish. However, if increased capital outlays in the latest budget are speedily translated into government capital expenditure, it could crowd in private investment.*

External sector

BoP risks accentuate

9. *The balance of payments (BoP) came under significant stress during Q3 of 2011-12 as the current account deficit (CAD) widened substantially and capital inflows declined. This resulted in a drawing down of foreign exchange reserves. The wider CAD, increase in external debt, weakening net international investment position (NIIP) and deteriorating vulnerability indicators underscore the need for more prudent external sector management and demand management policies to limit the absorption impact that is keeping import demand high. While capital inflows have revived somewhat in 2012, BoP risks remain due to high oil prices and uncertainties in the global economy.*

Monetary and Liquidity Conditions

Reserve Bank responds to tight liquidity conditions by injecting primary liquidity

10. *With falling inflation and growth, the Reserve Bank shifted gears to a more neutral policy, preparing to ease ahead if inflation trends down further. Amidst increasing structural and frictional liquidity deficits during Q4 of 2011-12, the Reserve Bank injected large amounts of primary liquidity through Open Market Operations (OMOs) and Cash Reserve Ratio (CRR). Liquidity conditions have eased substantially in April 2012 with large government spending. Going forward, barring shocks to autonomous drivers, liquidity conditions may stay comfortable in Q1 of 2012-13.*

Financial Markets

Financial market stress ease but risks remain

11. *With reduced stress in global financial markets and revival of capital inflows, financial conditions improved in India. However, tight liquidity conditions saw money market rates firm up. G-sec yields also firmed up post-budget in response to the large market borrowing programme. Going forward, there are risks of disruptive movements from euro area and financialisation of commodities.*

Price Situation

Inflation path for 2012-13 likely to be sticky

12. *Inflation has moderated in recent months to under 7 per cent, in line with the Reserve Bank's projections. However, the path of inflation in 2012-13 could remain sticky with high oil prices, large suppressed inflation, exchange rate passthrough, impact of tax hikes, wage pressure and structural impediments to supply response. The pricing power of companies has waned with moderation in demand as also lower non-oil commodity prices. This should*

help keep inflationary pressures under control in 2012-13.

Macroeconomic Outlook

Macroeconomic challenges warrant careful calibration of monetary policy

13. *Various surveys suggest that growth is likely to be only slightly higher in 2012-13 than in 2011-12. Alongside, inflation is likely to remain within a relatively narrow range during the year with probability of further significant moderation being small. The output gap is unlikely to be closed. Recent experience suggest that the non-inflationary growth rate for India may have somewhat declined from the pre-Lehman crisis period. Monetary policy would, therefore, need to support growth without risking external balance or inflation by excessively fuelling demand. Fiscal policy has a key role to speed up public investment to crowd in private investment while staying on the path of fiscal consolidation. As such, monetary actions will need to be calibrated to evolving growth-inflation dynamics and the fiscal response.*

I. OUTPUT

Global uncertainties and domestic cyclical and structural factors resulted in growth slowing down considerably to the estimated level of 6.9 per cent during 2011-12. All three sectors of the economy – agriculture, industry and services – slowed down. Moderation in agriculture growth notwithstanding, the year witnessed an all-time high foodgrains output. The services sector moderated reflecting the slowdown in construction, while industrial growth slackened due to the disappointing performance of mining and manufacturing sub-sectors. However, some indicators such as non-food credit off-take, cement production and the Reserve Bank's services sector composite indicator suggest that growth may have bottomed out in Q3 of 2011-12. Output growth is expected to gradually recover in 2012-13, albeit modestly.

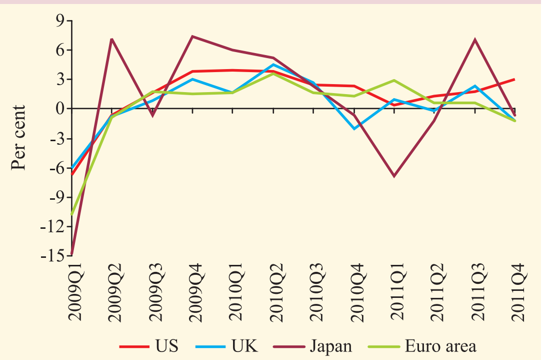
Global growth decelerates in 2011, likely to remain on slow recovery path in 2012

I.1 Global growth slowed in 2011, but the world economy stayed on the path of slow recovery, reducing the likelihood of a double-dip recession. Growth prospects for 2012 remain uncertain, with growth petering out in the euro area and losing steam in the emerging markets, while a better-than-expected recovery is shaping up in the US. The baseline scenario suggests that global growth may continue to be low in 2012, with a recession in the euro area as the region makes the needed fiscal adjustment.

I.2 There have been some positive developments in relation to advanced economies (AEs) over the previous quarter. The US economy expanded 3.0 per cent in Q4 of 2011 – the highest pace since Q2 of 2010. The Institute for Supply Management's (ISM) reading of the US manufacturing PMI for March 2012 indicates expansion in the manufacturing sector for the 32nd consecutive month. The US services sector also expanded briskly in March 2012, while the ISM index for non-manufacturing activity remained above the average for the previous 12 months. The April 2012 beige book of the Federal Reserve also notes that there was modest to moderate pace of economic expansion from mid-February through late March. Prospects for current pace of recovery extending into 2012 remain encouraging.

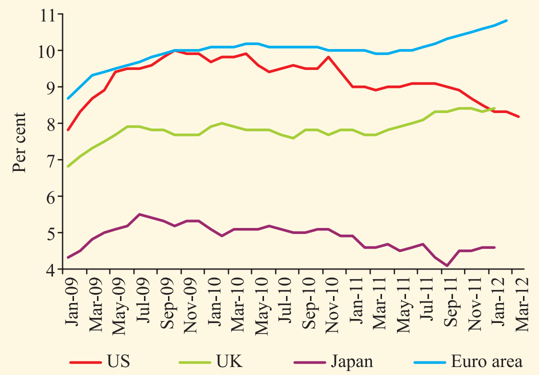
I.3 In contrast, other AEs such as the UK, Japan and the euro area registered negative q-o-q growth in Q4 of 2011 (Chart I.1). According to the interim forecast of the European Commission, the euro area will undergo a mild recession in 2012 with output contracting by 0.3 per cent. The composite PMI for the euro area, which combines services and manufacturing, fell steadily from 50.4 in January to 49.3 in February and 49.1 in March 2012, indicating contraction. While a small contraction in the euro area would have spillover effects to other regions, its fall out could be contained if the US continues to recover. Outside the euro area, the UK remains on a weak expansion path but on current assessment is likely to avert a recession. Japan is likely to continue on a slow expansion path driven by reconstruction investment and inventory rebuilding in 2012. Recent PMIs indicate that both services and manufacturing are expanding in Japan.

Chart I.1: GDP Growth in AEs



Source: Eurostat.
Unit: Annualized percentage change over previous period.

Chart I.2: Unemployment Rate



Source: Eurostat

I.4 The US unemployment rate fell to a three-year low of 8.2 per cent in March 2012, though the number of new jobs generated dipped (Chart I.2). The unemployment rate in the euro area, however, rose to a record high of 10.8 per cent in February 2012. Spain performed the worst, with an unemployment rate of 23.6 per cent and more than half the youth population unemployed.

Emerging and developing economies show signs of slowdown

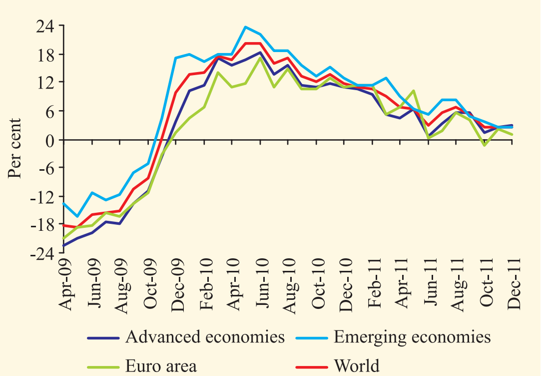
I.5 Risks to AE growth ahead also arise from the slowing emerging and developing economies (EDEs) as this may slow down their external demand. After growing at 9.2 per cent in 2011, China has reduced its growth forecast for 2012 to 7.5 per cent. Though growth is likely to exceed this pace, there are clear indications that the economy is slowing down as the growth rate has been decelerating for five successive quarters. China's economy grew at its weakest pace in nearly three years in Q1 of 2012 registering 8.1 per cent y-o-y growth. There was a modest trade surplus of US$ 0.7 billion in Q1 of 2012. Growth is also slowing in other key EDEs including India. The Brazilian economy grew by 2.7 per cent in 2011, compared with growth of 7.5 per cent in 2010, though it could moderately improve later this year on the back of a strong monetary stimulus. Russia is likely to stay with moderate growth of around 4 per cent due to fiscal stimulus, large credit expansion and high oil prices this year.

I.6 Going forward, growth in most EDEs is likely to be impacted by changes in external demand from the AEs and China. The global PMI for new export orders, while still below its long-term average, points towards a gradual recovery in the momentum of global trade (Chart I.3).

Growth of the Indian economy may have bottomed out in Q3 of 2011-12

I.7 After two successive years of fairly robust growth of 8.4 per cent, GDP is estimated to decelerate sharply to 6.9 per cent during 2011-12, with a marked slowdown in agriculture, mining and quarrying, manufacturing and construction sectors. Data relating to Q3 of 2011-12 shows that growth moderated for the fourth successive quarter to 6.1 per cent, recording the lowest rate in the last eleven quarters (Table I.1). While the moderation of growth in agriculture was largely on account of the base effect and structural impediments, the slowdown in industry reflected a number of factors including domestic policy uncertainties, cumulative impact of monetary tightening and slackening of external demand. The growth rate during July-December 2011 was below trend (Chart I.4). The momentum indicator corroborates the slowdown (Chart I.5).

Chart I.3: Growth in Export Volume (y-o-y)



Note: Calculations based on CPB World Trade Monitor Index.

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

(Per cent)

Item	2010-11*	2011-12#	2010-11				2011-12			2010-11 (Apr-Dec)	2011-12 (Apr-Dec)
			Q1	Q2	Q3	Q4	Q1	Q2	Q3		
1	2	3	4	5	6	7	8	9	10	11	12
1. Agriculture & allied activities	**7.0**	**2.5**	**3.1**	**4.9**	**11.0**	**7.5**	**3.9**	**3.2**	**2.7**	**6.8**	**3.2**
2. Industry	**6.8**	**3.6**	**8.2**	**5.6**	**7.2**	**5.3**	**6.6**	**2.8**	**0.8**	**7.0**	**3.3**
2.1 Mining & quarrying	5.0	-2.2	6.9	7.3	6.1	1.7	1.8	-2.9	-3.1	6.7	-1.4
2.2 Manufacturing	7.6	3.9	9.1	6.1	7.8	5.5	7.2	2.7	0.4	7.6	3.4
2.3 Electricity, gas & water supply	3.0	8.3	2.9	0.3	3.8	7.8	7.9	9.8	9.0	2.3	8.7
3. Services	**9.2**	**8.8**	**9.8**	**8.7**	**7.8**	**8.6**	**8.9**	**8.7**	**8.7**	**8.8**	**8.8**
3.1 Construction	8.0	4.8	8.4	6.0	8.7	8.2	1.2	4.3	7.2	7.7	4.2
3.2 Trade, hotels, transport, storage and communication, *etc.*	11.1	11.2	12.7	10.8	9.8	9.3	12.7	9.8	9.2	11.1	10.6
3.3 Financing, insurance, real estate and business services	10.4	9.1	10.0	10.4	11.2	9.0	9.0	10.5	9.0	10.6	9.5
3.4 Community, social & personal services	4.5	5.9	4.4	4.5	-0.8	7.0	5.6	6.6	7.9	2.7	6.7
4. GDP at factor cost	**8.4**	**6.9**	**8.5**	**7.6**	**8.3**	**7.8**	**7.7**	**6.9**	**6.1**	**8.1**	**6.9**

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

I.8 However, current indications are that growth may have bottomed out in Q3 of 2011-12. Given the general slack in capacity utilisation in most industries, production can be scaled up substantially. There has been strong credit off-take in February and March 2012, accounting for about 40 per cent of the total non-food credit during the year. Though the PMI for both manufacturing and services registered a deceleration in February and March, the indices remain high indicating expansion. The implicit growth rate for Q4 of 2011-12 works out to 6.9 per cent, essentially reflecting some improvement in industrial activity and the resilience of the services sector. In this context, the two-step lowering of the cash reserve ratio in January and March 2012 and the peaking of the interest rate cycle should provide some momentum.

Monsoon risk on agriculture growth remains muted

I.9 The North-East monsoon during October-December 2011 was 48 per cent below normal

Chart I.4: GDP Growth

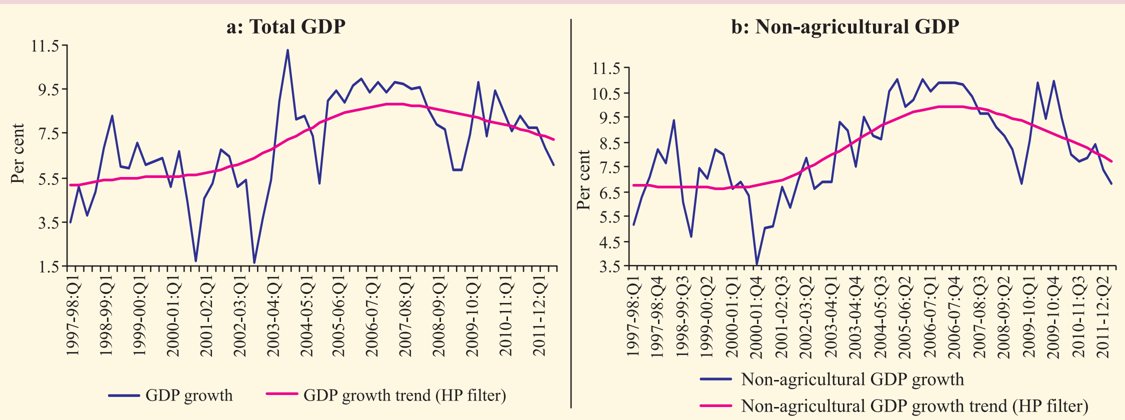


Chart I.5: Momentum Indicator of Growth

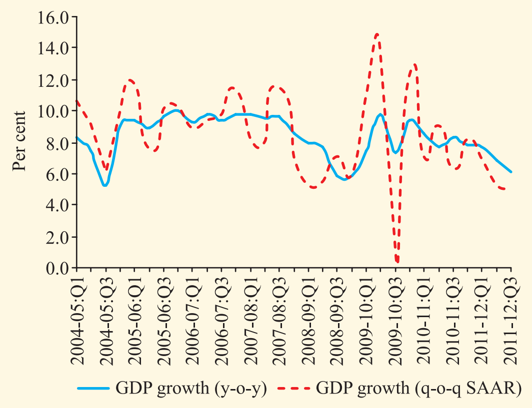


Table I.2: Agricultural Production – 2011-12

(Million tonnes)

Crop	2010-11 Final Estimates	2011-12 2nd Advance Estimates	Per cent growth in output in 2011-12
1	2	3	4
Foodgrains	244.8	250.4	2.3
Rice	96.0	102.8	7.1
Wheat	86.9	88.3	1.6
Coarse Cereals	43.7	42.1	-3.7
Pulses	18.2	17.3	-4.9
Oilseeds	32.5	30.5	-6.2
Cotton #	33.0	34.1	3.3
Jute & Mesta # #	10.6	11.6	9.4
Sugarcane (Cane)	342.4	347.9	1.6

#: Million bales of 170 kgs. each.
##: Million bales of 180 kgs. each.
Source: Ministry of Agriculture, GoI.

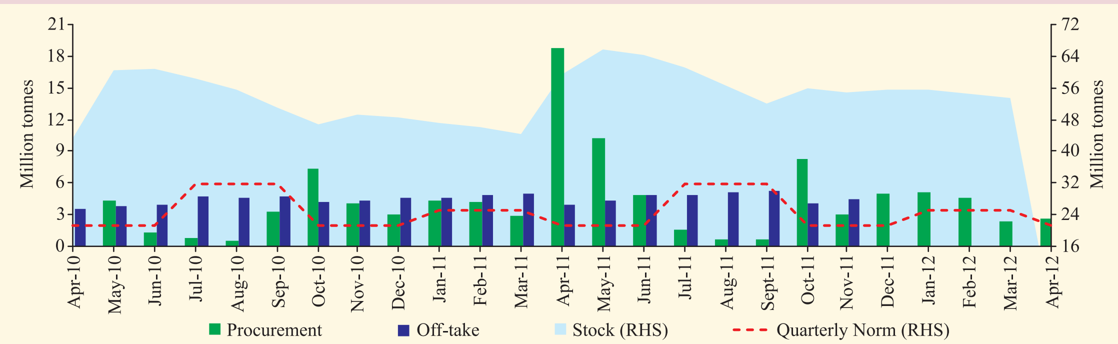
as against 21 per cent above normal in the previous year. This was the most acute deficiency in the winter monsoon in the last decade. The adverse impact of the deficient North-East monsoon on overall agricultural production is, however, not likely to be severe. While production of foodgrains during 2011-12 is estimated to reach a record level, that of pulses and oilseeds is expected to be lower than in the previous year (Table I.2).

Food management likely to be a challenge

I.10 The current stock of foodgrains, at 53 million tonnes, continues to be much higher than the quarterly buffer and security reserve requirements. This level of food stock is sufficient to meet the off-take requirement under the Targeted Public Distribution System and other welfare/poverty alleviation schemes (Chart I.6). However, the National Food Security Bill, which is currently in the Parliament, has far reaching implications for food management. It envisages legal entitlement to foodgrains at subsidised rates to up to 75 per cent of the rural population and 50 per cent of the urban population by ensuring access to adequate quantity of quality food at affordable prices.

I.11 Effective implementation of the Bill necessitates substantially higher foodgrains production in the county. This would require revitalisation of agriculture sector with large

Chart I.6: Food Stock and its Determinants



Note: 1. Data for off-take is upto November 2011, and stock as on March 31, 2012.
2. Procurement and off -take data are monthly figures.
3. Procurement for April 2012 is as on April 11, 2012.

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

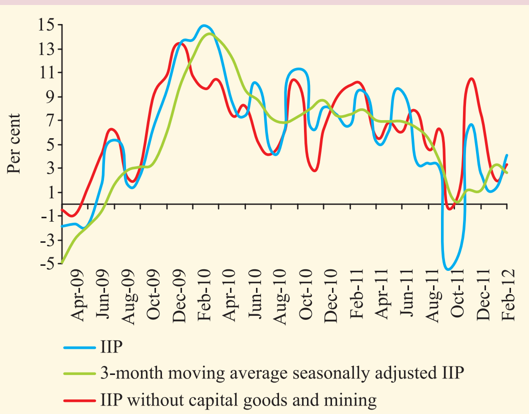
(Per cent)

Industry Group	Weight in the IIP	Growth Rate			Weighted Contribution#		
		Apr-Mar 2010-11	April-February 2010-11	April-February 2011-12 P	Apr-Mar 2010-11	April-February 2010-11	April-February 2011-12 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	14.2	5.2	5.8	-2.1	7.3	8.2	-6.8
Manufacturing	75.5	9.0	8.7	3.7	86.7	85.9	85.1
Electricity	10.3	5.5	5.3	8.7	5.9	5.9	21.6
Use-Based							
Basic Goods	45.7	6.0	5.9	5.9	29.1	29.4	66.5
Capital Goods	8.8	14.8	14.7	-1.8	25.2	25.0	-7.3
Intermediate Goods	15.7	7.4	7.8	-0.9	12.5	13.5	-3.6
Consumer Goods (a+b)	29.8	8.6	8.1	4.8	33.3	32.2	44.1
a) Consumer Durables	8.5	14.2	14.1	2.7	24.0	24.3	11.5
b) Consumer Non-durables	21.3	4.3	3.5	6.5	9.4	7.9	32.6
General	**100**	**8.2**	**8.1**	**3.5**	**100**	**100**	**100**

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

investment to support agricultural research, development of water resources, infrastructure, particularly, power, storage and transportation. In this regard, as per the Union Budget 2012-13, three million tonnes of storage capacity was to be created during 2011-12 and another five million tonnes in 2012-13, under the Private Entrepreneur's Guarantee Scheme. Also, creation of two million tonnes of storage capacity in the form of modern silos has been approved. The creation of storage capacity would boost construction activity in the country, in addition to facilitating better management of food stock.

Chart I.7: IIP Growth (y-o-y)

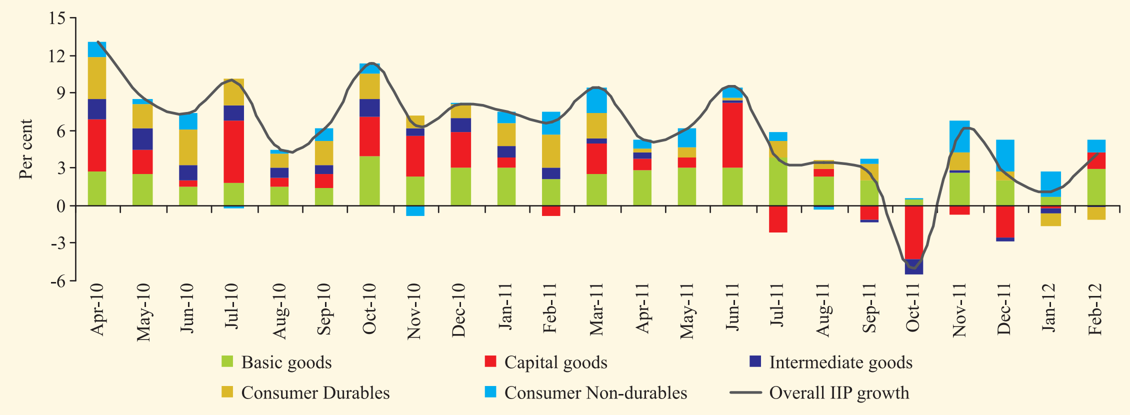


Industrial slowdown persists amidst volatility

I.12 Industrial growth slowed down sharply during 2011-12, led by contraction in mining and poor performance of the manufacturing sub-sector (Table I.3 and Chart I.7). Industrial activity lost steam on account of weak demand for consumer durables, reflecting interest rate sensitivity, deceleration in external demand and subdued investment demand due to decline in business confidence.

I.13 As per the use-based classification, moderation in growth was seen in all categories, except basic goods and consumer non-durables. Dampening of investment sentiment was manifested in the contraction of capital and intermediate goods. Moreover, industrial growth exhibited high volatility due to sharp fluctuations in the growth of capital goods (Chart I.8). Volatility, measured by standard deviation, is 3.3 for IIP excluding capital goods compared with 4.7 for the overall IIP during the period April 2009 to February 2012. Hence,

Chart I.8: Contribution to overall IIP growth



volatility in growth was primarily on account of a few items which contributed to the unevenness in the overall IIP growth.

I.14 As such, manufacturing sector growth remained volatile and highly concentrated, with seven out of the twenty two industry groups showing negative growth during April-February 2011-12. The five fastest growing manufacturing industries, with a combined weight of 18.3 per cent in manufacturing, grew at around 15.6 per cent, contributing about 68.5 per cent to the overall growth during April-February 2011-12 (Chart I.9).

I.15 With slow-paced global economic recovery extending into 2012, barring in the euro area, there could be a positive impact on domestic industrial growth. This is on account of the strong co-movement between the domestic and the global IIP series, reflected in terms of a correlation coefficient of 0.8 for the period April 2008 to January 2012 (Chart I.10).

Core industries remain a drag on industrial growth

I.16 The eight core industries grew at a subdued pace of 4.4 per cent during April-February 2011-12 compared to 5.8 per cent during the corresponding period of the previous year. This is mainly on account of contraction in natural gas and poor performance of coal and fertiliser industries (Chart I.11).

I.17 Coal output has, however, shown some improvement in the recent months. Initiatives taken by the government recently to ensure adequate coal supply to power plants is likely

Chart I.9: Growth Concentration in Manufacturing Sector

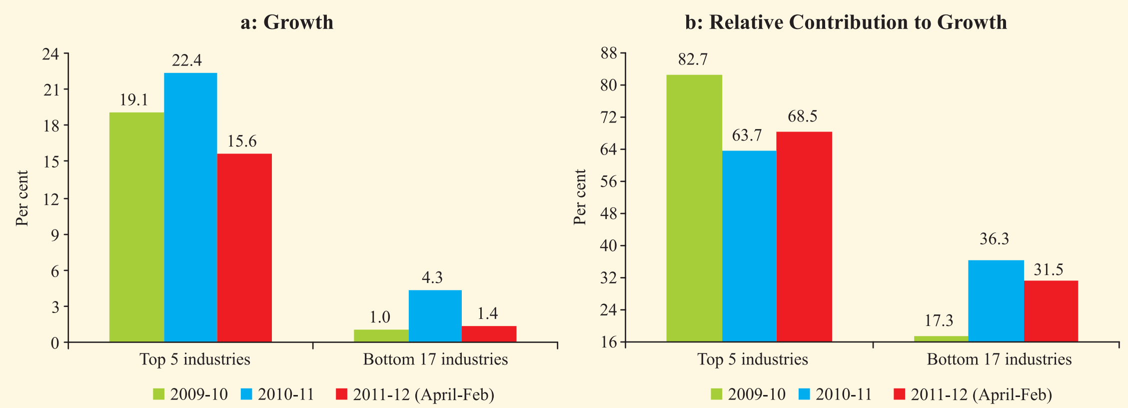


Chart I.10: Global IIP growth (y-o-y)

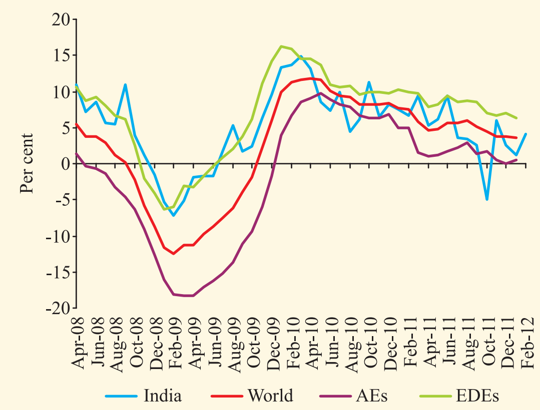


Table I.4: Capacity Utilisation in Infrastructure Sector

(Per cent)

Sector	2009-10	2010-11	2011-12*
1	2	3	4
Finished Steel (SAIL+VSP+ Tata Steel)	90.7	92.0	87.3
Cement	82.0	76.0	72.0
Fertiliser	93.6	94.5	94.4
Refinery Production-Petroleum	107.4	109.3	104.2
Thermal Power	77.7	75.1	71.6

*: Data pertains to April-November 2011.
Source: Capsule Report on Infrastructure Sector Performance, Ministry of Statistics and Programme Implementation, GoI.

to improve coal production and fuel industrial growth.

Slack evident in capacity utilisation

I.18 The Order Books, Inventory and Capacity Utilisation Survey (http://www.rbi.org.in/OBICUS16) by the Reserve Bank indicates that the y-o-y growth in new orders in Q3 of 2011-12 was lower than in Q3 of the previous two years. Even though there was a narrowing of slack in Q3 of 2011-12 compared to Q2, capacity utilisation remained well below the peak reached in 2010-11 (Chart 1.12). Also, there is a strong co-movement between capacity utilisation and manufacturing IIP.

I.19 Reflecting the decelerating output growth, capacity utilisation in various infrastructure industries slackened. During April-November 2011, excess capacity was reported in cement and thermal power (Table I.4).

Slight moderation in employment generation

I.20 The quarterly quick surveys of employment situation conducted by the Labour Bureau in select sectors of the economy indicate that employment generation slowed in Q3 of 2011-12 compared to Q2, though was marginally higher than in Q3 of 2010-11. However, employment in export units increased at a higher rate, compared to the non-export units, which could be on account of optimism engendered by a weaker rupee. Employment generation

Chart I.11: Growth in Infrastructure Industries

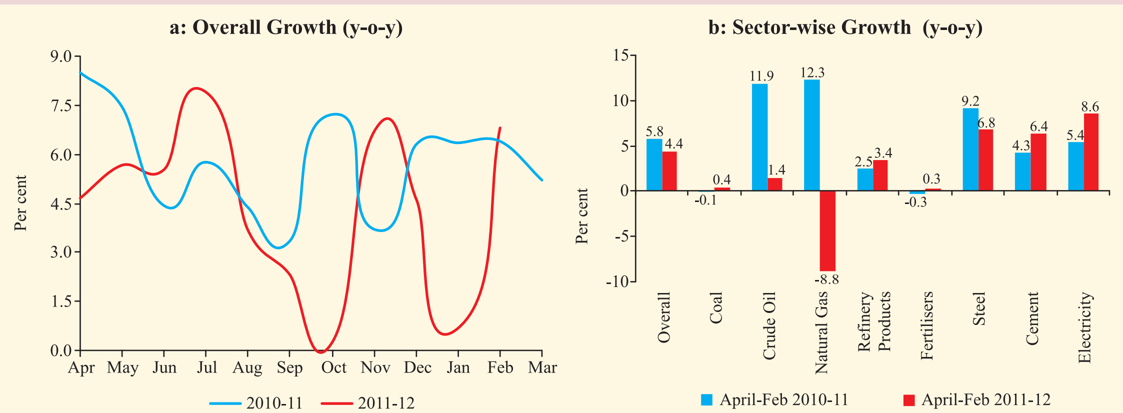


Chart I.12: OBICUS

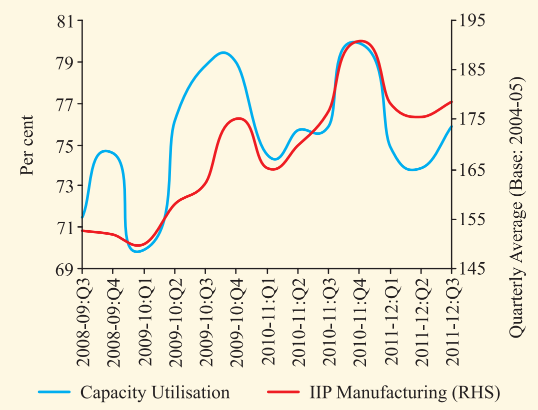
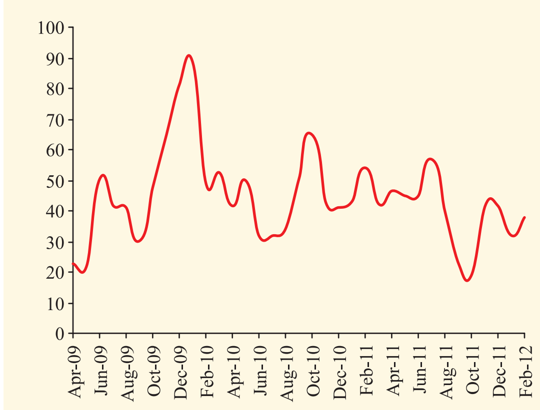


Chart I.13: Services Sector Composite Indicator



remained heavily concentrated in the IT/BPO sector (Table I.5).

Services sector growth sustains but shows weakening momentum

I.21 A services sector composite indicator based on growth in indicators of construction, trade and transport, and finance, developed by the Reserve Bank bottomed out in October 2011 and improved thereafter (Chart I.13). Construction may improve further during 2012-13 as road tendering, that proceeded at a high pace in recent quarters, translates into ground activity. A direct reading of lead indicators, however, points towards a weakening of telecom and international travel, while railway freight and domestic passenger traffic show increase (Table I.6).

I.22 A revival in domestic industrial activity and improving prospects in the US could have a favourable impact on the services sector. This should help the sector absorb any adverse impact on demand arising from the near all-encompassing tax levied in the Union budget.

Output gap likely to stay but shrink in 2012-13

I.23 On current assessment, the year 2012-13 is likely to be a year when the economy starts to recover slowly from the large negative output gap created by growth falling significantly below trend. The growth in H1 of 2012-13 may be dragged down by low pipeline investment. However, demand conditions may improve slowly. On a lower base, the odds favour an improvement in agriculture growth

Table I.5: Changes in Estimated Employment

(in million)

Industry/Group	2010-11 April-Dec	2011-12 April-Dec	2010-11 Q3	2011-12 Q2	2011-12 Q3
1	2	3	4	5	6
1. Textiles including apparels	0.22	0.09	0.04	0.04	0.08
2. Leather	0.04	-0.01	0.02	0.00	-0.01
3. Metals	0.07	0.09	0.00	0.04	0.00
4. Automobiles	0.10	0.03	0.02	0.02	-0.01
5. Gems and jewellery	0.00	0.03	-0.01	0.01	0.01
6. Transport	-0.01	0.03	0.00	-0.01	0.03
7. IT/BPO	0.38	0.48	0.14	0.20	0.11
8. Handloom / Powerloom	0.01	0.02	0.00	0.01	0.01
Overall	**0.81**	**0.76**	**0.21**	**0.31**	**0.22**

Source: Thirteenth Quarterly Quick Employment Survey, Oct 2011-Dec 2011, Labour Bureau.

Table I.6: Indicators of Services Sector Activity

(Growth in per cent)

Services Sector Indicators	2009-10	2010-11	April-Feb 2010-11	April-Feb 2011-12
1	2	3	4	5
Tourist arrivals	4.4	8.3	9.1@	8.5@
Cement	10.5	4.5	4.3	6.4
Steel	6.0	8.9	9.2	6.8
Railway revenue earning freight traffic	6.6	3.8	3.4#	4.8#
Cell phone connections (in millions) $	192.5	227.3	167.9*	82.3*
Cargo handled at major ports	5.8	1.6	1.1#	-0.3#
Civil aviation				
Domestic cargo traffic	24.3	23.7	27.0*	-5.4*
International passenger traffic	8.8	10.3	10.9*	7.2*
Domestic passenger traffic	15.6	18.1	16.8*	17.7*

@ Data pertains to April-March.
* Data pertains to April-December. # Data pertains to April-January.
$: Refers to wireless subscriber additions in actual numbers.
Source: Ministry of Statistics and Programme Implementation, Ministry of Tourism and CMIE.

during 2012-13. A combination of factors, *viz.*, some improvement in external climate and measures to address the supply-side bottlenecks would support improved industrial performance. If fiscal pressures are contained, the interest rate cycle could turn, supporting a pick-up in investment demand. Persistence of high global oil prices and slowing growth in the euro area and China, however, pose downside risks.

II. AGGREGATE DEMAND*

Most components of aggregate demand slowed down in 2011-12. Investment, as noted in aggregate capital formation as well as corporate investment intentions, has been drying up and is expected to start improving slowly in 2012-13. Net export demand dipped reflecting global slowdown. However, firmer oil prices have dented government's fiscal numbers due to high fuel subsidies and in the absence of price adjustment, added to the aggregate demand in 2011-12. While the Union Budget for 2012-13 has enunciated a commitment to cap subsidies, any slippage in the fiscal deficit numbers will have implications for demand management and could come in the way of reviving investment.

Investment downswing in conjunction with net exports drags down demand

II.1 Capital formation in the economy dipped during April-December 2011. This reflects in part, the lagged impact of the anti-inflationary monetary policy stance. Net exports also declined, particularly in Q3, reflecting an adverse base effect as well as a higher outgo on imports due to rupee depreciation (Table II.1). Given the Advance Estimates of the expenditure-side growth rates for 2011-12, the implicit growth rates of private consumption expenditure and gross fixed capital formation during Q4 of 2011-12, show a marked increase over the corresponding period of the previous year. While consumption would benefit from the dip in inflation and also election-related spending in a few states, investment should improve largely on account of the base effect. This further validates growth having bottomed out in Q3.

Decline in savings and investment rates a concern

II.2 Both investment and saving rates declined in 2010-11 (Table II.2). The decrease in the overall savings rate in 2010-11 was due

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

(Per cent)

Item	2010-11 QE	2011-12 AE	2010-11				2011-12			2010-11 Apr-Dec	2011-12 Apr-Dec
			Q1	Q2	Q3	Q4	Q1	Q2	Q3		
1	2	3	4	5	6	7	8	9	10	11	12
Growth rate											
Real GDP at market prices	9.6	7.5	9.5	8.9	10.1	7.7	8.5	6.7	6.3	9.5	7.1
Total Consumption Expenditure	8.1	6.0	9.6	9.2	7.1	7.5	5.5	3.4	5.9	8.6	5.0
(i) Private	8.1	6.5	9.3	8.7	7.6	8.0	5.9	2.9	6.2	8.5	5.1
(ii) Government	7.8	3.9	11.1	12.2	4.7	4.9	2.9	6.1	4.4	8.8	4.4
Gross Fixed Capital Formation	7.5	5.6	8.8	6.9	11.1	0.4	4.9	-4.0	-1.2	8.9	-0.2
Change in Stocks	37.4	2.9	39.4	35.5	37.7	4.6	1.8	-4.7	-0.4	37.5	-1.1
Net Exports	5.5	-30.1	-40.8	-10.1	18.6	34.8	-14.3	38.5	-33.0	-6.6	-1.6
Relative shares											
Total Consumption Expenditure	70.1	69.1	73.0	72.4	72.9	63.1	70.9	70.1	72.6	72.7	71.3
(i) Private	58.7	58.1	62.0	61.7	60.4	52.6	60.5	59.5	60.4	61.4	60.2
(ii) Government	11.4	11.0	11.0	10.6	12.5	10.5	10.4	10.6	12.2	11.4	11.1
Gross Fixed Capital Formation	32.5	31.9	32.2	34.0	32.3	32.1	31.2	30.5	30.0	32.8	30.6
Change in Stocks	3.7	3.5	3.7	3.8	3.5	3.4	3.5	3.4	3.3	3.7	3.4
Net Exports	-6.0	-7.3	-7.9	-7.9	-6.3	-3.9	-8.4	-4.6	-7.8	-7.3	-7.0
Memo:											₹ billion
Real GDP at market prices	52,368	56,277	12,088	12,268	13,538	14,693	13,120	13,093	14,389	37,894	40,602

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

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

Table II.2: Gross Domestic Savings and Gross Domestic Capital Formation

(Per cent to GDP at current market prices)

Item	2008-09	2009-10	2010-11 QE
1	2	3	4
1. Gross Domestic Savings	**32.0**	**33.8**	**32.3**
1.1 Household Sector	23.6	25.4	22.8
i) Financial savings	10.1	12.9	10.0
ii) Saving in physical assets	13.5	12.4	12.8
1.2 Private Corporate Sector	7.4	8.2	7.9
1.3 Public Sector	1.0	0.2	1.7
2. Gross Domestic Capital Formation*	**34.3**	**36.6**	**35.1**
2.1 Household Sector	13.5	12.4	12.8
2.2 Private Corporate Sector	11.3	12.7	12.1
2.3 Public Sector	9.4	9.2	8.8

* : Adjusted for errors and omissions.
QE : Quick Estimates.

to both households and the private corporate sector, which more than offset the improvement in the public sector savings rate. The household sector savings rate declined in 2010-11, after touching a record high in 2009-10. Within household savings, while the financial savings rate declined sharply, the physical savings rate increased in 2010-11. The decline in the net financial savings rate was on account of the slower growth in households' savings in bank deposits and life insurance as well as an absolute decline in investment in shares and debentures, mainly driven by redemption of mutual fund units. Even so, there was a shift in favour of small savings and currency during the year.

II.3 The decline in the rate of gross domestic capital formation (investment) in 2010-11 was on account of a decline in private corporate sector and public sector investment rates even as the household investment rate increased. Given the huge demand for infrastructure development as well as extremely strained capacity in sectors such as petroleum refinery, there is a compelling case for increasing the rate of capital formation in the economy, both in construction and in machinery and equipment. Going forward, the revival and sustainability of a high growth rate over the medium-term is contingent upon the enhancement of savings and investment rates, besides improvements in productivity.

Corporate investment remains subdued

II.4 Corporate pipeline investment has shrunk and new investment remains tepid. As such, investment revival is expected to materialise slowly in 2012-13. Analysis of the time-phasing details of projects sanctioned institutional assistance in various years reveals that intended capital expenditure incurred by private corporate (non-financial) sector during 2011-12 is likely to be lower than that in the previous year (Table II.3). Higher interest rates and rising input prices, among other factors, are likely to have adversely affected the investment sentiment.

II.5 The deceleration in capital formation is apparent in the sharp moderation in the number/ outlay of projects sanctioned finance by major banks/financial institutions (FIs). The

Table II.3: Phasing of Capital Expenditure of Projects Sanctioned Assistance by Banks/FIs

(₹ billion)

Capital Expenditure in the Year →	Up to 2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Beyond 2013-14	Grand Total
1	2	3	4	5	6	7	8	9
Year of Sanction ↓								
Up to 2007-08	1,826	1,317	583	376	98	47	-	4,247
2008-09	265	1,029	864	568	366	84	46	3,223
2009-10	2	448	1,494	1,282	853	365	116	4,560
2010-11	-	3	373	1,262	1,294	979	691	4,602
2011-12*	-	-	14	154	527	419	437	1,551
Grand Total #	**2,093**	**2,797**	**3,328**	**3,642**	**3,138**	**1,894**	**1,290**	**-**

*: Data available up to Q3:2011-12
#: The estimates are *ex ante*, incorporating only the envisaged investment, and thus are different from those actually realised/utilised.

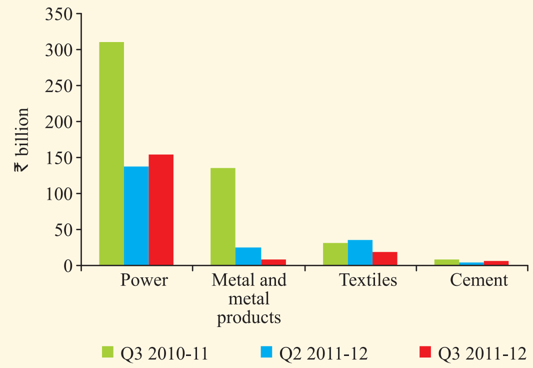
Table II.4: Institutionally Assisted Projects and their Envisaged Cost (Quarter-wise)

Period		Number of Projects*	Project Cost (₹ billion)
1		2	3
2010-11	Q1	199	1,431
	Q2	239	1,508
	Q3	173 (166)	801 (795)
	Q4	185	864
2011-12#	Q1	144	880
	Q2	176 (172)	363 (361)
	Q3**	124	310

*: Based on data reported by 39 banks/FIs.
**: Data for Q3:2011-12 is based on reported data from 34 banks/FIs. Corresponding data for Q3:2010-11 and Q2:2011-12 is given in brackets.
#: Data for 2011-12 is provisional.

moderation that started in Q3 of 2010-11 has persisted through Q3 of 2011-12 (Table II.4). The decline in outlay/projects that were sanctioned financial assistance is particularly acute for 'metal and metal products' and power industries (Chart II.1).

Chart II.1: Industry-wise Investment Intentions (by amount)



Corporate profitability hit by high interest expenses and rising input costs

II.6 While sales continued to be healthy during Q3 of 2011-12, registering higher growth on both y-o-y and q-o-q basis, operating profit and net profit declined as expenses and interest cost increased substantially (Tables II.5 and

Table II.5: Corporate Sector- Financial Performance

Item	Common Companies (y-o-y growth in per cent)						
	2010-11				2011-12		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8
No. of Companies				**2,352**			
Sales	24.7	18.9	17.6	20.6	22.6	19.3	19.4
Change in stock	411.6	-45.5	110.1	131.5	-39.4	-2.9	88.0
Expenditure,	29.1	20.1	19.6	22.7	23.0	22.8	24.9
of which Raw Material	37.1	21.6	20.9	25.3	27.9	23.6	25.6
Staff Cost	16.4	20.4	21.2	19.8	20.1	17.7	19.0
Power & fuel	17.7	13.0	19.6	26.6	27.1	26.0	30.2
Operating Profits (PBDIT)	15.4	7.3	11.1	16.6	12.5	-0.9	-5.7
Other Income*	-21.5	58.7	6.3	-15.3	39.6	25.9	69.3
Depreciation	20.1	17.5	14.7	15.2	9.8	9.8	10.4
Gross Profits (PBIT)	8.9	9.5	9.7	11.6	16.1	-0.1	-2.5
Interest	27.4	6.2	23	31.2	22.1	47.6	42.8
Tax Provision	6.2	10.0	6.5	2.2	21.6	3.8	-2.4
Net Profits (before non-operating profit)	4.5	10.4	7.0	9.6	12.3	-16.3	-16.7
Net Profits (PAT)	3.7	9.1	9.4	13.6	6.7	-15.4	-31.0
		Ratios in per cent					
Change in stock# to Sales	2.5	0.8	1.3	2.3	1.2	0.5	2.2
Interest to Sales	2.8	2.6	2.6	2.5	2.8	3.2	3.1
Interest Burden	20.7	19.2	19.6	18.6	21.7	28.6	28.5
Interest Coverage	4.8	5.2	5.1	5.4	4.6	3.5	3.5
PBDIT to Sales	16.2	15.4	15.9	15.3	14.9	12.8	12.5
PBIT to Sales	13.7	13.5	13.5	13.4	13.0	11.3	11.0
PAT to Sales	8.6	8.6	8.4	8.6	7.5	6.1	4.8
Other Income to PAT	16.4	21.7	15.9	19.9	21.4	32.3	39.6

#: For companies reporting this item explicitly.
*: Other income excludes extraordinary income/expenditure if reported explicitly.
Note: 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.

Table II.6: Corporate Sector- Financial Performance – Sequential

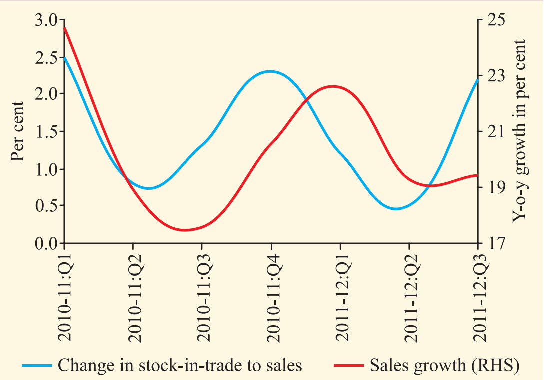
Item	Common Companies (q-o-q growth in per cent)						
	Q1:2010-11 over Q4:2009-10	Q2:2010-11 over Q1:2010-11	Q3:2010-11 over Q2:2010-11	Q4:2010-11 over Q3:2010-11	Q1:2011-12 over Q4:2010-11	Q2:2011-12 over Q1:2011-12	Q3:2011-12 over Q2:2011-12
1	2	3	4	5	6	7	8
No. of Companies				**2,352**			
Sales	-4.5	5.9	5.7	12.9	-3.1	3.1	5.7
Change in stock	100.0	-66.2	75.3	95.1	-47.7	-44.7	234.3
Expenditure,	-3.8	5.0	5.7	14.8	-3.6	4.9	7.6
of which Raw Material	-4.1	3.1	9.4	15.8	-2.3	1.6	8.4
Staff Cost	3.2	8.1	2.1	5.2	3.6	5.8	3.4
Power & fuel	11.6	1.0	4.4	7.6	12.3	-0.1	7.9
Operating Profits (PBDIT)	-2.1	0.8	8.8	8.6	-5.6	-11	3.1
Other Income*	-44.7	39.7	-24.2	44.7	-9.1	26.3	3.2
Depreciation	1.3	2.1	3.2	8.0	-3.6	2.1	3.6
Gross Profits (PBIT)	-10.1	4.5	5.8	12.4	-6.5	-9.9	2.9
Interest	17.5	-2.7	7.7	6.6	9.4	18.7	2.7
Tax Provision	-11.9	4.4	2.0	9.0	4.8	-11.2	-4.0
Net Profits (PAT)	-10.3	5.6	3.4	16.1	-15.8	-16.3	-15.6

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

II.6). Net profits were further dented on account of the large non-operating deficit of a few large companies.

II.7 The ratio of stock-in-trade to sales was higher in Q3 of 2011-12 compared to the corresponding period of the previous year and the preceding quarter (Chart II.2). The accumulation of inventory in Q3 was mainly observed in chemical fertilisers and pesticides, iron and steel, refineries and food products and beverages industries.

Chart II.2: Movement in Sales Growth and Change in Stock-in-Trade to Sales

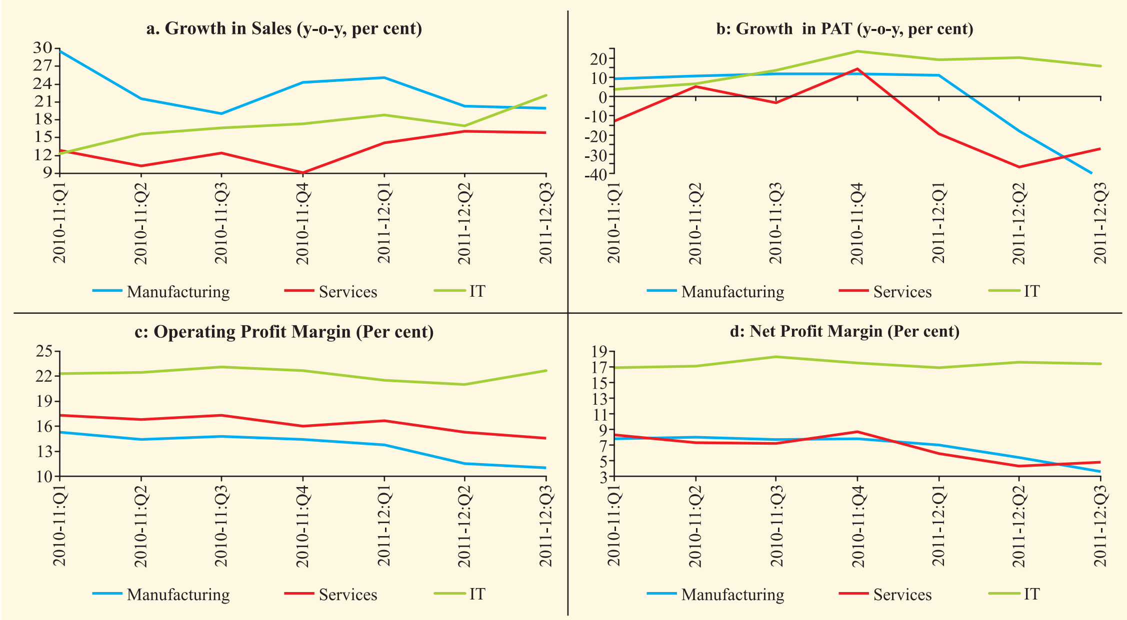


II.8 Sector-wise analysis shows that Information Technology (IT) was the best performing sector in terms of sales and operating profit. Hence, the net profit margin of the sector remained largely intact (Chart II.3). This mainly reflected the depreciation of the rupee. Higher growth in input prices and interest payments led to a decline in profits for both manufacturing and services sectors.

Significant budgeted reduction in fiscal deficit for 2012-13 needs to be supported by credible fiscal consolidation strategy

II.9 The central government could not contain its fiscal deficit within the budget estimates for 2011-12, resulting in the widening of the gross fiscal deficit (GFD)-GDP ratio to 5.9 per cent. The fiscal situation is, however, budgeted to record a significant improvement in terms of both revenue deficit and GFD indicators in 2012-13. The fiscal correction, as indicated in the Union Budget, along with other policy measures to address supply-side bottlenecks in agriculture, energy and transport sectors, are expected to create conditions for revival of investment activity in the economy.

Chart II.3: Sector-wise Corporate Performance



II.10 It may be noted that the proposed fiscal consolidation in 2012-13 is primarily based on the revenue-raising efforts of the central government. The achievement of budgeted reduction in GFD-GDP ratio would also depend on the commitment of the government to contain its expenditure on subsidies within the stipulated cap of 2 per cent of GDP in 2012-13.

II.11 The amendment of the FRBM Act, 2003 and introduction of a Medium-term Expenditure Framework Statement in the Act, which will, *inter alia*, include three-year rolling targets in respect of expenditure indicators, is expected to bring about fiscal discipline and create the fiscal space essential for the government to pursue its objective of a faster, sustainable and more inclusive growth during the Twelfth Plan. Notwithstanding the envisaged fiscal correction, the key deficits will remain higher than the path set out by the 13th Finance Commission (Table II.7).

Budgeted tax buoyancy for 2012-13 reflect tax measures but is subject to downside risks

II.12 Given the slowdown in 2011-12 as well as tax changes introduced earlier, both direct

Table II.7: Key Fiscal Indicators

(Per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Effective Revenue Deficit	Gross Fiscal Deficit
1	2	3	4	5
Centre				
2009-10	3.2	5.2	–	6.5
2010-11	1.8	3.3	2.1	4.9
2011-12 BE	1.6	3.4	1.8	4.6
2011-12 RE	2.8	4.4	2.9	5.9
2012-13 BE	1.9	3.4	1.8	5.1
13th FC	–	1.2	–	4.2
2013-14				
Rolling targets	–	2.8	1.0	4.5
13th FC	–	0.0	–	3.0
2014-15				
Rolling targets	–	2.0	0.0	3.9
13th FC	–	-0.5	–	3.0
States*				
2009-10	1.2	0.5	–	2.9
2010-11RE	1.0	0.3	–	2.7
2011-12 BE	0.6	-0.2	–	2.2
Combined				
2009-10	4.5	5.7	–	9.4
2010-11RE	3.4	3.8	–	8.1
2011-12 BE	2.5	3.2	–	7.0

BE: Budget Estimate. RE: Revised Estimate.
13th FC : Thirteenth Finance Commission.
*: Data based on budget documents of 28 state governments.
Note: Negative sign (-) indicates surplus in deficit indicators.
Source: Union Budget 2012-13 and 13th Finance Commission.

and indirect tax revenues grew at a lower rate than the budgeted rate for the year as well as the rate in 2010-11 (Table II.8). On the basis of tax measures announced in the Union Budget 2012-13, *viz.*, widening the base of services tax through stipulating a negative list of exempted categories, partial rollback of reductions in standard excise duty and service tax rates, and the rationalisation of customs duty rates, tax buoyancy is budgeted at 1.39 for 2012-13. This is significantly higher than the long-term average tax buoyancy of 1.11 for the period 2003-04 to 2011-12 as well as the average of 1.14 for the recent period 2010-11 to 2011-12.

Commitment to cap subsidy expenditure from 2012-13 onwards a positive step

II.13 As noted in the Union Budget for 2012-13, overshooting of expenditure on subsidies was one of the main reasons for deterioration of fiscal balance in 2011-12. The expenditure restructuring strategy in 2012-13 is premised on capping expenditure on subsides while raising allocations for capital expenditures (both plan and non-plan components). Restricting expenditure on subsidies to below 2 per cent of GDP in the coming years would be a major achievement towards fiscal consolidation.

II.14 There are latent pressures on the expenditure side of the central government finances for 2012-13. On the petroleum subsidy front, upside risks stem from high international crude oil prices and pressures on the exchange rate. Unless the government progresses towards phasing-in flexible pricing of administered petroleum products in the early part of the year, the risk to budget projections remain substantial. If prices for these products are not adjusted upwards, the under-recoveries in 2012-13 would well exceed that in 2011-12. This will lead to a large fiscal slippage.

II.15 Also, the budgeted growth of 3 per cent in food subsidies in 2012-13 appears to be modest when viewed in the context of the implemention of the Food Security Bill (Table II.9).

Table II.8: Central Government Finances

Item	Growth rate (per cent)			Per cent to GDP		
	2010-11	2011-12 RE	2012-13 BE	2010-11	2011-12 RE	2012-13 BE
1	2	3	4	5	6	7
1. Total Expenditure	16.9	10.1	13.1	15.6	14.8	14.7
2. Revenue Expenditure	14.1	11.6	10.7	13.6	13.0	12.7
3. Capital Expenditure	39.0	0.1	30.6	2.0	1.8	2.0
4. Non-Developmental Expenditure	7.3	15.4	16.1	7.2	7.1	7.3
5. Development Expenditure	26.1	6.8	9.2	8.7	8.0	7.6
4. Non-Plan Expenditure	13.5	9.0	8.7	10.7	10.0	9.5
5. Plan Expenditure	24.9	12.6	22.1	4.9	4.8	5.1
6. Revenue Receipts	37.6	-2.7	22.0	10.3	8.6	9.2
i) Tax Revenue (net)	24.8	12.7	20.1	7.4	7.2	7.6
ii) Non Tax Revenue	88.0	-42.9	32.0	2.8	1.4	1.6
7. Gross Tax Revenue	27.0	13.7	19.5	10.3	10.1	10.6
i) Direct Tax	18.1	12.3	13.9	5.8	5.6	5.6
ii) Indirect Tax	40.5	15.5	26.5	4.5	4.5	5.0
Memo :						
8. Revenue Deficit	-25.6	56.6	-11.3	3.3	4.4 (3.4)	3.4
9. Effective Revenue Deficit	–	56.3	-27.8	2.1	2.9 (1.8)	1.8
10. Gross Fiscal Deficit	-10.7	39.7	-1.6	4.9	5.9 (4.6)	5.1
11. Gross Primary Deficit	-32.0	76.5	76.5	1.8	2.8 (1.6)	1.9

BE: Budget Estimate. RE: Revised Estimate.
Note: Figures in parentheses are budget estimate for 2011-12 as per cent to GDP.
Source: Union Budget 2012-13.

Table II.9: Total Subsidies

(Amount in ₹ billion)

Items	2010-11		2011-12 RE		2012-13 BE	
	Amount	% to GDP	Amount	% to GDP	Amount	% to GDP
1	2	3	4	5	6	7
Total Subsidies	**1,734.2**	**2.3**	**2,163.0**	**2.4**	**1,900.2**	**1.9**
of which:						
i. Food	638.4	0.8	728.2	0.8	750.0	0.7
ii. Fertiliser	623.0	0.8	672.0	0.8	609.7	0.6
iii. Petroleum	383.7	0.5	684.8	0.8	435.8	0.4
iv. Interest subsidy	46.8	0.1	57.9	0.1	79.7	0.1
v. Other subsidies	42.2	0.1	20.0	0.0	24.9	0.0

Source: Union Budget 2012-13.

Increasing dependence on market borrowing for financing fiscal deficit could exert pressure on interest rates

II.16 The fiscal deficit financing pattern for 2012-13 shows continued reliance on market borrowings though the recourse to short-term financing through treasury bills is budgeted at 2 per cent, significantly lower than the 22 per cent in 2011-12 (Table II.10). The larger market borrowing of the central government could put pressure on yields, especially at the long end. Such pressures could exacerbate considerably if credit demand picks up with recovery in growth, increasing the interest burden on the government and crowding out private investment.

Economic recovery hinges on credible fiscal consolidation, inflation control and higher capital formation

II.17 Even though investment spending floundered in 2011-12, a slow recovery could set in during 2012-13. The recovery would be dependent on inflation not accelerating again. On current assessment, investment should start picking up at a moderate pace, especially if the cost of capital comes down. Rigidities in funding costs for the banks and the large draft of the government on financial surplus of the households, however, impart stickiness to interest rates.

II.18 The Indian economy maintained a reasonable consumption-fixed investment mix, during the 4-year period beginning 2004-05.

Table II.10: Financing Pattern of Gross Fiscal Deficit

(Amount in ₹ billion)

Item	2011-12 (BE)	2011-12 (RE)	2012-13 (BE)
1	2	3	4
Gross Fiscal Deficit	4,128.2	5,219.8	5,135.9
Financed by			
Net market borrowing*	3,531.3 (85.5)	4,843.0 (92.8)	4,930.0 (96.0)
Small savings (net)	241.8 (5.9)	-103.0 (-2.0)	12.0 (0.2)
External assistance	145.0 (3.5)	103.1 (2.0)	101.5 (2.0)
State provident fund	100.0 (2.4)	100.0 (1.9)	120.0 (2.3)
NSSF	0.9 (0.0)	60.8 (1.2)	49.4 (1.0)
Draw down of cash balances	200.0 (4.8)	-246.6 (-4.7)	– –
Others	-90.9 (-2.2)	462.5 (8.9)	-77.0 (-1.5)

RE: Revised Estimates. BE: Budget Estimates. –: Nil

* includes dated securities and 364-day treasury bills only.

Note: Figures in parentheses represent percentages to GFD.

However, in recent years the consumption component has been the predominant driver of growth, with the contribution of the fixed investment component showing a sharper decline from the pre-crisis (2005-08) levels. Deceleration in investment reduces the potential output of the economy, emphasising the importance of rebalancing. High levels of government spending do provide a consumption stimulus but compound the inflationary situation. Reigning in inflation through tight monetary policy assumes importance in promoting sustainable growth and investment, even if it results in high cost of capital in the short run.

II.19 In this context, it is important to note that fiscal consolidation as envisaged in the latest budget is subject to risks, especially with respect to subsidies. Tax revenues may also be adversely affected if the economic climate remains subdued. The indirect tax measures introduced in the budget will themselves have inflation implications. Against this backdrop, aggregate demand management poses challenges for policy during 2012-13.

III. THE EXTERNAL SECTOR

The balance of payments (BoP) came under significant stress in Q3 of 2011-12. Net capital inflows fell short of the current account deficit (CAD), resulting in a substantial drawdown of reserves. A wider CAD, rising external debt, weakening net international investment position (NIIP) and deteriorating vulnerability indicators underscore the need for greater prudence in external sector and demand management policies. While capital inflows have improved in Q4, global uncertainties, moderation in the economic growth of emerging and developing economies (EDEs), which now have a significant share in India's exports and persistently high oil prices generate downside risks to the external outlook.

BoP comes under stress, warrants caution

III.1 The balance of payments (BoP) came under stress during Q3 of 2011-12 due to deterioration of the trade balance and moderation in capital inflows. The trade balance deteriorated despite the depreciation of the rupee in the quarter, due to the inelastic nature of some of India's imports, as well as a slowdown in exports that reflected global uncertainty. The full year CAD for 2011-12 is likely to be substantial. Going forward, the CAD may still remain under pressure if import of oil and gold does not significantly moderate. Robust gold demand and continuing high crude oil prices, along with decelerating growth in EDEs may adversely affect India's trade balance. A cautious approach with regard to trade and capital accounts is, therefore, required.

III.2 Subdued global trends also adversely affected capital inflows to India in Q3, in line with the trend witnessed in some other EDEs. Even though capital inflows improved in Q4 of 2011-12, the continuation of the trend hinges on the pace of global and domestic economic recovery as well as policy reform initiatives. Risks to capital inflows exist from both global growth slowing down significantly as well as US growth rebounding substantially.

Trade deficit widening despite weaker rupee and slower growth

III.3 India's trade deficit widened considerably during April-February 2011-12 compared with the corresponding period of the previous year, owing to subdued export growth coupled with high imports (Table III.1 and Chart III.1). Notwithstanding the rupee depreciation, the trade deficit increased primarily due to a slowdown in global demand, inadequate passthrough of higher global oil prices and the relatively price inelastic nature of some of India's imports, *viz.*, gold and silver. Even the growth in non-oil non-gold imports remained sizeable despite signs of a slowdown in the domestic economy. Given the adverse global environment and elevated global crude oil prices, India's trade deficit may remain high in near future. A slight moderation may, however, be expected in imports of gold following the increase in import duty announced in the Union Budget for 2012-13.

Export growth may weaken despite continued trade diversification

III.4 India took major strides in diversifying its export markets in recent years. A shift in the share from traditional markets in advanced economies to new markets in EDEs is clearly discernible. However, exports to all major group of economies slowed due to euro area crisis in Q3 of 2011-12 (Chart III.2). Growth deceleration in exports to the OPEC and EDEs was, however, more pronounced than that for the OECD economies. Notwithstanding the slowdown, EDEs continued to account for a major share of 42.7 per cent in India's exports. It may be noted that within the group of EDEs, the respective shares of the African and Latin American economies increased in Q3 of 2011-12. If

Table III.1 : India's Merchandise Trade

(US$ billion)

Item	2009-10 (R)		2010-11 (P)		April-February			
					2010-11 (P)		2011-12 (P)	
	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth (%)
1	2	3	4	5	6	7	8	9
Exports	178.8	-3.5	251.1	40.5	220.3	39.0	267.4	21.4
Of which: Oil	28.2	2.3	41.4	46.9	36.3	48.4	53.0	46.0
Non-oil	150.6	-4.6	209.7	39.3	184.0	37.2	214.4	16.5
Imports	288.4	-5.0	369.8	28.2	335.5	29.7	434.2	29.4
Of which: Oil	87.1	-7.0	104.0	19.3	94.0	19.9	132.6	41.0
Non-oil	201.2	-4.2	265.8	32.1	241.5	33.9	301.6	24.9
Trade Deficit	**-109.6**		**-118.7**		**-115.3**		**-166.8**	
Of which: Oil	-58.9		-62.6		-57.7		-79.6	
Non-Oil	-50.6		-56.1		-57.5		-87.2	

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

growth in India's major trading partner economies continues to remain sluggish, as projected by the IMF, India's export growth may decelerate further.

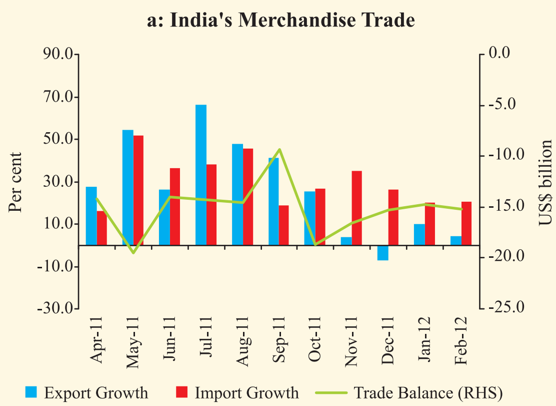
Persistently wide CAD has implications for external resilience

III.5 The current account deficit (CAD) widened further in Q3 of 2011-12 reflecting the impact of continuing global uncertainties as well as domestic factors. The CAD at 4.3 per cent of GDP in Q3 of 2011-12 was significantly higher than 2.3 per cent recorded in Q3 of 2010-11 (Table III.2). The widening of CAD to these levels does pose a challenge for external sector management. Moderation in capital and finance account (excluding change in reserves) necessitated the financing of CAD by drawing down foreign exchange reserves in Q3 of 2011-12, which shows the weakening external resilience of the Indian economy (Table III.3).

Capital flows responded to policy measures

III.6 Capital inflows remained subdued in Q3 amidst fragile global financial conditions, the euro area crisis and a worsening global economic outlook. Recognising the impact of global developments, various measures were undertaken in Q2 and Q3 to facilitate inflows: deregulation of interest rates on rupee

Chart III.1: India's Merchandise Trade



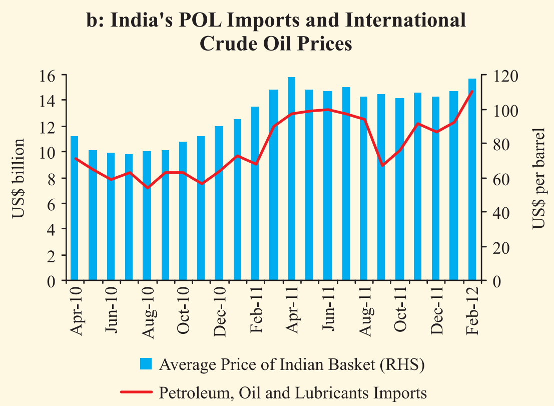


Table III.2: Major Items of India's Balance of Payments

(US$ billion)

	2010-11	2010-11				2011-12		
		Q1	Q2	Q3	Q4	Q1 (PR)	Q2 (P)	Q3 (P)
1	2	3	4	5	6	7	8	9
1. Goods Exports	250.6	55.2	52.0	66.0	77.4	74.4	76.5	71.2
2. Goods Imports	381.1	87.2	89.0	97.4	107.4	115.6	119.8	118.8
3. Trade Balance(1-2)	-130.4	-32.0	-37.0	-31.4	-30.0	-41.3	-43.4	-47.7
4. Services Exports	131.7	26.5	31.1	38.8	35.3	33.0	32.4	36.7
5. Services Imports	83.0	16.7	19.2	26.3	20.7	17.9	18.4	21.7
6. Net Services (4-5)	48.7	9.7	11.9	12.5	14.6	15.1	14.0	15.0
7. Goods & Services Balances (3+6)	-81.8	-22.3	-25.1	-19.0	-15.5	-26.2	-29.4	-32.6
8. Primary Income (Net) *(compensation of Employees and Investment Income)*	-17.3	-3.5	-4.8	-4.6	-4.5	-4.3	-4.6	-4.5
9. Secondary Income (Net) (*Pvt. Transfers)*	53.1	13.1	13.0	13.4	13.6	14.8	15.6	17.5
10. Net Income (8+9)	35.8	9.6	8.2	8.8	9.1	10.5	11.0	13.0
11. Current Account Balance (7+10)	-46.0	-12.6	-16.9	-10.1	-6.3	-15.7	-18.4	-19.6
12. Capital and Financial Account Balance, Net *(Excl. changes in reserves)*	62.0	17.3	21.6	14.0	9.1	22.2	17.2	8.2
13. Change in Reserves *(-) increase / (+) decrease*	-13.1	-3.7	-3.3	-4.0	-2.0	-5.4	-0.3	12.8
14. Errors & Omissions (-) (11+12+13)	-3.0	-0.9	-1.4	0.1	-0.8	-1.0	-1.5	-1.4
Memo: (as a percentage of GDP)								
15. Trade Balance	-7.7	-8.5	-9.8	-7.0	-6.3	-9.1	-9.8	-10.5
16. Net Services	2.9	2.6	3.1	2.8	3.0	3.3	3.1	3.3
17. Net Income	2.1	2.6	2.2	2.0	1.9	2.3	2.5	2.9
18. Current Account Balance	-2.7	-3.4	-4.5	-2.3	-1.3	-3.5	-4.1	-4.3
19. Capital and Financial Account, Net *(Excl. changes in reserves)*	3.7	4.6	5.7	3.1	1.9	4.9	3.9	1.8

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

denominated NRI deposits and enhancing the all-in-cost ceiling for ECBs with average maturity of 3-5 years. Furthermore, the lock-in period of long-term infrastructure bonds for FIIs (up to US$ 5 billion within the overall ceiling of US$ 25 billion) was reduced to one year, and ceilings for FIIs in government securities and corporate bonds were raised by US$ 5 billion each. Capital flows under these segments responded positively to the policy measures. FII inflows picked up significantly, in both equity and debt, in January and February, while FDI inflows remained broadly stable. Besides, while ECB inflows improved in Q4, NRI deposits remained stable (Table III.4). Trends in capital flows in coming quarters, however, will largely depend on global and domestic economic and financial conditions, including the pace of domestic policy reforms. It must be noted that even though debt inflows provide a means for financing the CAD, they have implications for India's external debt position and, consequently, for financial stability.

Chart III.2: Country Group-wise India's Export Growth

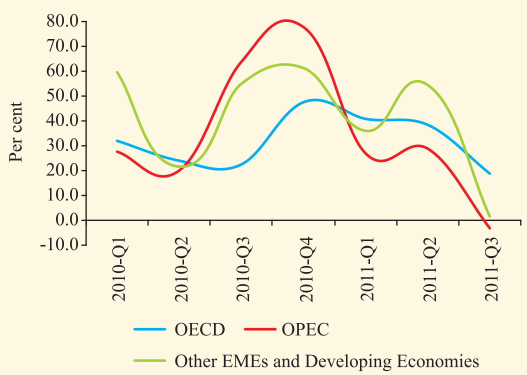


Table III.3: Disaggregated Items of Financial Account

(US$ billion)

	Apr-Jun 2011 (PR)	Apr-Jun 2010 (PR)	Jul-Sept 2011 (PR)	Jul Sept 2010 (PR)	Oct-Dec 2011 (P)	Oct -Dec 2010 (PR)
1	2	3	4	5	6	7
1. Direct Investment (net)	**7.8**	**3.5**	**4.0**	**3.6**	**4.5**	**1.2**
1.a Direct Investment in India	13.3	6.7	7.0	7.5	6.4	6.1
1.b Direct Investment by India	-5.6	-3.3	-3.0	-3.9	-1.9	-4.9
2. Portfolio Investment	**2.3**	**3.5**	**-1.4**	**18.7**	**1.8**	**6.1**
2.a Portfolio Investment in India	2.5	3.5	-1.6	18.8	1.9	7.2
2.b Portfolio Investment by India	-0.2	0.0	0.2	-0.1	0.0	-1.1
3. Other investment	**12.4**	**10.4**	**14.4**	**-0.7**	1.8	**6.6**
3.a Other equity (ADRs/GDRs)	0.3	1.1	0.2	0.5	0.1	0.2
3.b Currency and deposits	1.2	1.1	2.8	0.4	3.2	0.3
Deposit-taking corporations, except the central bank: (NRI deposits)	1.2	1.1	2.8	1.0	3.3	0.2
3.c Loans*	15.2	7.6	9.5	0.4	-5.9	9.7
3.c.i Loans to India	15.2	7.7	8.8	0.7	-6.4	9.3
Deposit-taking corporations, except the central bank	11.5	2.9	3.9	-3.6	-8.7	4.6
General government (External Assistance)	0.4	2.5	0.3	0.6	1.4	1.2
Other sectors (ECBs)	3.3	2.3	4.6	3.7	0.9	3.5
3.c.ii Loans by India	0.0	-0.1	0.6	-0.3	0.5	0.3
General government (External Assistance)	0.0	0.0	0.0	0.0	0.0	0.0
Other sectors (ECBs)	0.0	0.0	0.6	-0.3	0.5	0.3
3.d Trade credit and advances	3.1	4.3	2.9	2.6	-0.1	1.3
3.e Other accounts receivable/payable	-7.3	-3.7	-0.9	-4.6	4.5	-4.9
4. Reserve assets	**-5.4**	**-3.7**	**-0.3**	**-3.3**	**12.8**	**-4.0**
Financial Account (1+2+3+4)	**17.0**	**13.6**	**16.7**	**18.3**	**20.9**	**9.9**

Note: The total of sub-components may not tally with the aggregate due to rounding off.
*: Includes external assistance, ECBs, non-NRI banking capital and short term trade credit.
P: Provisional. PR: Partially revised.

Rupee recovers in Q4 of 2011-12 after being volatile in Q3

III.7 In nominal terms, the rupee generally depreciated against the US dollar from the last week of August 2011 to mid-December 2011 after being largely range bound during the first four months of 2011-12. Subsequently, the exchange rate stabilised in response to the measures undertaken by the Reserve Bank and the government aimed at improving dollar supply in the foreign exchange market as also to curb speculation. The magnitude of the intervention by the Reserve Bank, which amounted to over US$ 20 billion up to February 2012, also helped to reduce volatility in the foreign exchange market. The cumulative impact of these measures considerably reversed the movement of the rupee against the US dollar from the historical low of ₹54.2 per US dollar on December 15, 2011 to ₹49.7 per US dollar

Table III.4: Capital Flows in 2011-12

(US$ billion)

Component	2011-12 (Apr-Aug)	2011-12 (Sep-Dec)	2011-12 (Jan-Feb)
	(Monthly Average)		
1	2	3	4
FDI in India	4.8	3	3.1
FDI by India	1.0	0.8	0.8*
FIIs (net)	0.4	0.1	4.7*
ADRs/GDRs	0.1	0.1	0.0
ECB Inflows	1.3	0.6	1.0
NRI Deposits (net)	0.5	1.2	1.2

*: January-March.

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

[Per cent, appreciation(+)/depreciation(-)]

	Index Mar. 30, 2012 (P)	Year-on-Year Variation (Average)				2011-12 (Dec. 2011 over Sep. 2011)	2011-12 (Mar. 2012 over Dec. 2011)
		2008-09	2009-10	2010-11 (P)	2011-12 (P)		
1	2	3	4	5	6	7	8
36-REER	94.2	-9.9	-3.2	8.0	-3.3	-8.1	4.7
36-NEER	82.9	-11.0	-2.6	3.1	-6.5	-8.0	4.2
30-REER	86.1	-10.3	-4.6	4.8	-2.9	-8.5	4.2
30-NEER	85.2	-8.4	-2.2	1.1	-5.5	-7.9	3.8
6-REER	105.5	-9.3	-0.3	13.0	-2.9	-7.9	4.2
6-NEER	79.9	-13.6	-3.7	5.7	-7.5	-8.3	4.5
₹/US$ (Average)	48.0	-12.4	-3.2	4.0	-5.0	-9.6	4.7
₹/US$ (end-March)	51.2	-21.5	12.9	1.1	-12.7	-8.2	4.1

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

by end-January 2012. The rupee have weakened somewhat recently as a result of volatility of capital flows.

III.8 The real effective exchange rate (*i.e.*, REER based on 6, 30 and 36 currency baskets) witnessed appreciation in Q4 reflecting the recovery of the rupee in nominal terms that emanated from the impact of policy measures to improve dollar supply in the foreign exchange market (Table III.5).

Increase in external debt as ECB and short -term debt rise

III.9 India's external debt increased to US$ 335 billion at end-December 2011 from US$ 324 billion at end-September 2011 largely reflecting a sharp increase in ECB and short term debt (Table III.6). Keeping in view the developments in international financial markets and global economic conditions, the Reserve Bank enhanced the all-in-cost ceiling on ECBs and deregulated interest rates on NRE and NRO accounts. The full year external debt is likely to be higher reflecting greater reliance on debt flows to finance CAD. Nonetheless, it is expected that external debt will remain at a manageable level.

External vulnerability indicators show deterioration

III.10 The key external sector vulnerability indicators worsened in Q3 of 2011-12 (Table III.7). The reserve cover of imports, the ratio of short-term debt to total external debt, the ratio of foreign exchange reserves to total debt, and the debt service ratio deteriorated during the quarter. India's net international investment

Table III.6: India's External Debt

(US$ billion)

Item	End-Mar 2011 (PR)	End-Jun 2011 (PR)	End-Sep 2011 (PR)	End-Dec 2011 (P)	Variation (end-Dec 2011 over end-Sep 2011)	
					Amount	Per cent
1	2	3	4	5	6	7
1. Multilateral	48.5	49.4	49.1	49.9	0.8	1.6
2. Bilateral	25.7	26.2	27.1	27.1	0.0	0.2
3. International Monetary Fund	6.3	6.4	6.2	6.1	-0.1	-1.7
4. Trade Credit (above 1 year)	18.6	18.7	19.5	19.9	0.4	1.9
5. External Commercial Borrowings	88.8	93.4	96.8	100.1	3.3	3.3
6. NRI Deposits	51.7	52.9	52.3	52.5	0.2	0.4
7. Rupee Debt	1.6	1.6	1.4	1.3	-0.1	-8.8
8. Long-term (1 to 7)	241.1	248.4	252.4	256.9	4.5	1.7
9. Short-term	65.0	68.5	71.5	78.1	6.5	8.4
Total (8+9)	**306.1**	**316.9**	**323.9**	**334.9**	**11.0**	**3.3**

P: Provisional. PR: Partially Revised.

Table III.7: External Sector Vulnerability Indicators

(Per cent)

Indicator	End-March 2010	End-June 2010	End-March 2011	End-June 2011	End-Sep 2011	End-Dec 2011
1	2	3	4	5	6	7
1. Ratio of Total Debt to GDP	18.0	–	17.8	15.9	17.8	20.0
2. Ratio of Short-term to Total Debt (Original Maturity)	20.0	20.9	21.2	21.6	22.1	23.3
3. Ratio of Short-term to Total Debt (Residual Maturity)	41.2	42.5	42.2	43.3	43.4#	–
4. Ratio of Concessional Debt to Total Debt	16.8	15.9	15.5	15.1	14.8	14.3
5. Ratio of Reserves to Total Debt	106.9	98.0	99.5	99.6	96.2	88.6
6. Ratio of Short-term Debt to Reserves	18.8	21.0	21.3	21.7	23.0	26.3
7. Reserves Cover of Imports (in months)	11.1	10.7	9.6	9.2	8.5	7.7
8. Reserves Cover of Imports and Debt Service Payments (in months)	10.5	10.1	9.1	8.8	8.0	7.3
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	5.8	4.1	4.3	4.8	5.2	7.9
10. External Debt (US$ billion)	261.0	270.3	306.1	316.9	323.9	334.9

-: Not available. #: RBI Estimate.

position (NIIP) also weakened as net liabilities increased to US$ 216 billion at end-December 2011 from US$ 204 billion at end-September 2011. As a result, the NIIP-GDP ratio deteriorated moderately in Q3 (Table III.8).

Table III.8: Overall International Investment Position of India

(US$ billion)

Period	Dec-10 (PR)	Mar-11 (PR)	Jun-11 (PR)	Sep-11 (PR)	Dec-11 (P)
1	2	3	4	5	6
NIIP	-210.0	-211.1	-224.6	-204.0	-215.7
Assets	423.6	439.5	451.2	453.0	432.3
Liabilities	633.5	650.6	675.7	657.0	648.0
NIIP-GDP Ratio*	-13.1	-12.4	-12.4	-11.4	-12.0

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

III.11 With significant downside risks to India's external sector, caution is warranted in external sector policies and aggregate demand management so that CAD does not widen further and the external account parameters remain at prudent levels. In this regard, steps need to be taken to facilitate a complete passthrough of international commodity prices, especially by raising domestic prices of petroleum products, curb the demand for precious metals and accelerate reforms to attract FDI.

IV. MONETARY AND LIQUIDITY CONDITIONS

With inflation remaining high, even though declining, the Reserve Bank has maintained policy rates since December 2011. Against the backdrop of a large and persisting liquidity deficit, the Reserve Bank continued to inject durable primary liquidity into the system during Q4 of 2011-12 with a view to preserving stable credit conditions. During Q4 of 2011-12, broad money growth fell below the indicative trajectory of the Reserve Bank for end-March 2012, reflecting a deceleration in deposit growth on the components side and credit growth on the sources side. The secondary impact of durable liquidity injections by way of CRR cuts and OMO purchases is expected to considerably ease liquidity conditions in Q1 of 2012-13 while the evolving growth-inflation dynamics will continue to influence the monetary trajectory.

The Reserve Bank shifts gears to a neutral policy stance

IV.1 The Reserve Bank persisted with its monetary tightening between February 2010 and October 2011 with continuing inflation risks. In this cycle, policy rates were effectively raised by 525 bps starting in March 2010. The tightening was necessary even if it meant sacrificing some growth in the short term as the risks from high inflation to the economy's sustainable growth rate were large.

IV.2 As expected, domestic demand slowed, partly due to monetary policy actions. Following moderation in demand-side pressures, headline inflation started moderating in line with the anticipated trajectory, which led the Reserve Bank to shift gears to a neutral policy stance. The shift was motivated to a substantial extent by deceleration in investment activity as well as expected deceleration in consumption demand (Table IV.1 and Chart IV.1).

IV.3 The downside risks to growth, however, continued to rise reflecting weakening global economic outlook and domestic policy uncertainties. While room for easing policy rates exist from here, the timing and extent of cuts will need to factor in the inflation risks that persist in 2012-13.

The Reserve Bank responds to structural liquidity deficit

IV.4 Since November 2011, the liquidity deficit increased beyond the Reserve Bank's broad indication of keeping it at about 1 per cent of NDTL (Chart IV.2). This deficit was largely structural caused in part by foreign exchange intervention that became necessary in the face of the sharp 19 per cent depreciation of the rupee between end-July and mid-December of 2011

Table IV.1: Movements in Key Policy Variables

(Per cent)

Effective since	Repo Rate	Cash Reserve Ratio
1	2	3
May 3, 2011	7.25 (+0.50)	6.00
Jun 16, 2011	7.50 (+0.25)	6.00
July 26, 2011	8.00 (+0.50)	6.00
Sept. 16, 2011	8.25 (+0.25)	6.00
Oct. 25, 2011	8.50 (+0.25)	6.00
Jan. 28, 2012	8.50	5.50 (-0.50)
Mar. 10, 2012	8.50	4.75 (-0.75)

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

Chart IV.1: Change in Policy Rates: Pre- and Post-Crisis

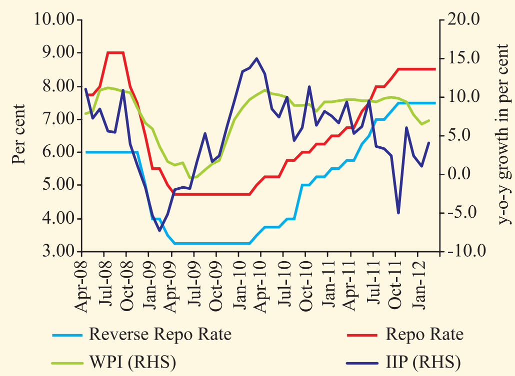
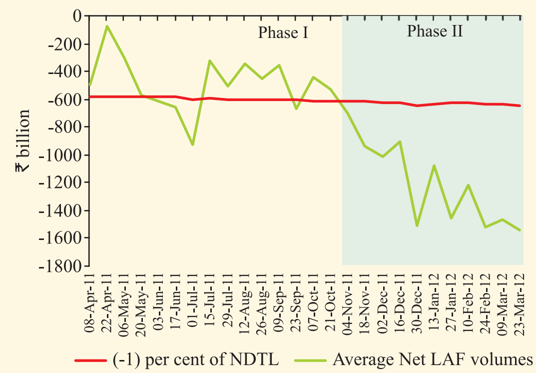
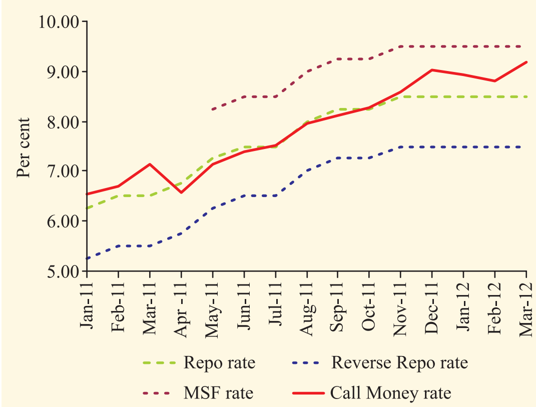


Chart IV.2: Phases in Liquidity Conditions



Note: Negative LAF volumes indicate injection of liquidity.

Chart IV.3: LAF Corridor and Call Rates



and the increasing divergence between deposits mobilised and credit extended by commercial banks. During 2011-12, the Reserve Bank injected primary liquidity through Open Market Operation (OMO) purchases, aggregating around ₹1.3 trillion, and through CRR cuts infusing around ₹0.8 trillion. Thus, sizeable durable liquidity injection was provided even after offsetting the withdrawal of rupee liquidity consequent to foreign exchange operations. However, the net liquidity position remained tight because of frictional factors such as the sizeable build up of government cash balances during Q4 of 2011-12, especially advance tax collections around mid-March. These balances saw an intra-quarter swing of around ₹1.8 trillion during Q4 of 2011-12 as the government transited from WMA and occasional overdraft. Going forward, liquidity conditions are likely to return towards acceptable deficits as a result of anticipated government spending in the near term.

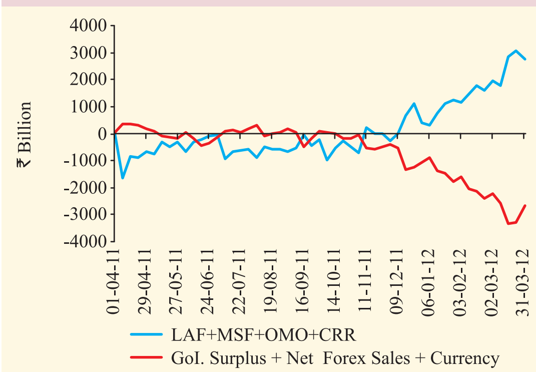
IV.5 The new monetary policy operating procedure helped in liquidity management as the overnight rates have not spiked as in the past episodes of large liquidity deficits. They remained range bound within the formal corridor defined by the LAF reverse repo rate and the MSF rate. Despite the significant tightening of liquidity conditions, on-tap availability of 'emergency' liquidity through the MSF window capped the Reserve Bank's operating target, *viz*., weighted average overnight call money market rate, and facilitated its range-bound movement (Chart IV.3). Monetary transmission, therefore, remained effective.

IV.6 The Reserve Bank's liquidity management measures largely offset the sharp drain in liquidity from autonomous drivers (Chart IV.4). In addition to the liquidity management measures indicated above, measures to dissuade funding of speculative positions in the foreign exchange market also helped limit pressures on short-term domestic money market rates.

Structural liquidity deficit reflected in low reserve money expansion

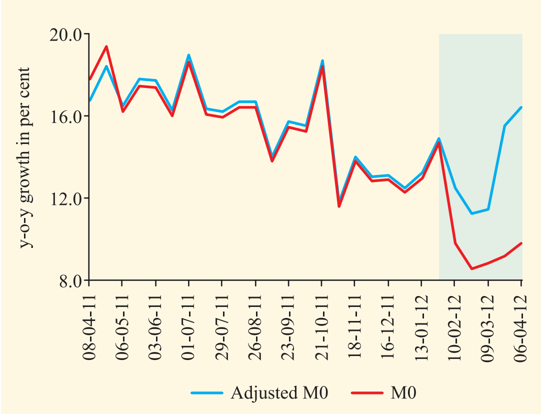
IV.7 A predominantly bank-based economy requires secular expansion in reserve money to fund economic growth. The sources of reserve money arise from the Reserve Bank's forex and domestic liquidity management operations. Structurally, India is a current account deficit

Chart IV.4: Drivers and Management of Liquidity during 2011-12



Note: (+) injection, (-) absorption

Chart IV.5: Growth in Reserve Money



(CAD) economy. This underlines the dependence on capital inflows to finance CAD as also to build up forex reserves. During 2011-12, forex operations drained rupee liquidity and domestic monetary policy operations, therefore, not only had to fund the demand for reserves but also offset the domestic liquidity impact of the forex operations. As a result, reserve money growth decelerated during the year (Chart IV.5).

IV.8 The deceleration in reserve money during Q4 of 2011-12 also reflected the reduction in CRR by 125 basis points in two steps during January and March 2012. Since such reduction implies reduction in impounded liquidity and thus reflects easing of liquidity conditions, the change in reserve money needs to be adjusted for the reduction in CRR. Adjusted for CRR, reserve money recorded a year-on-year growth of 16.4 per cent as on April 6, 2012, which is marginally lower than 16.8 per cent a year ago. Going forward, the multiplier effect of primary liquidity injection is likely to further increase the growth in reserve money.

Currency expansion moderates

IV.9 During 2011-12, there was a reversal in currency demand that reflected deceleration in real economic activity and in inflation. In particular, items of household expenditure, such as food items, that are cash intensive, witnessed a sharp decline in inflation. Further, public expenditure on the government's flagship social sector scheme, MGNREGS declined in 2011-12. The higher opportunity cost of holding currency following hikes in interest rates on term deposits by banks also caused a shift in household savings from currency (Chart IV.6a).

Deposit growth moderates in Q4

IV.10 Term deposits recorded robust growth during calendar year 2011 mainly reflecting substitution from the other components of monetary aggregates and small savings as the increase in deposit rates by banks incentivised the holdings of interest-bearing deposits. During Q4 of 2011-12, however, term deposit growth decelerated, mainly reflecting the dominance of the base effect and tight liquidity conditions (Chart IV.6b). Consequently, banks increased their recourse to non-deposit sources, such as borrowings by way of debt instruments and LAF during 2011-12 compared with the previous year.

Chart IV.6: Behaviour of Deposits and Currency

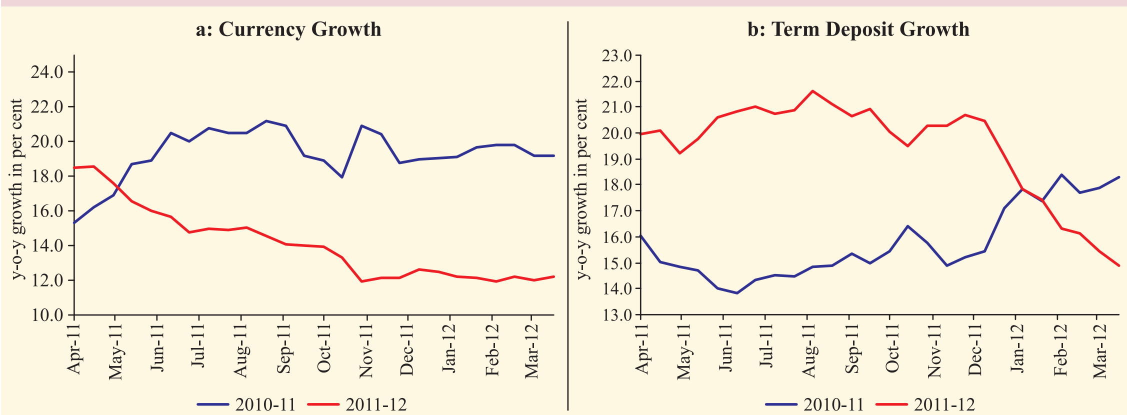


Table IV.2: Monetary Indicators

Item	Outstanding as on March 31, 2012 (₹ billion)	Y-o-Y variations (per cent)	
		2010-11	2011-12
1	2	3	4
Reserve Money (M_0)*	**13,875**	**17.8**	**9.8**
Reserve Money (Adjusted)*		**16.8**	**16.4**
Broad Money (M_3)	**73,441**	**16.1**	**12.9**
Main Components of M_3			
Currency with the Public	10,266	18.8	12.6
Aggregate Deposits	63,144	15.7	13.0
of which: Demand Deposits	7,002	0.7	-3.1
Time Deposits	56,142	18.3	15.4
Main Sources of M_3			
Net Bank Credit to Govt.	23,608	18.9	19.0
Bank Credit to Commercial Sector	49,503	21.3	16.8
Net Foreign Assets of the Banking Sector	15,237	8.7	9.4

Note: 1. Data are provisional.
2. * : Data pertain to April 6, 2012.

Money supply decelerates below the indicative trajectory

IV.11 Broad money (M_3) growth fell below the indicative trajectory of the Reserve Bank towards the last quarter of 2011-12 (Table IV.2). This could be partly due to the time lag involved in the liquidity generation process that operates through the money multiplier following CRR cuts. The deceleration in M_3 demand could also be attributed to the slackening pace of economic activity during 2011-12 and deceleration in inflation from December 2011.

IV.12 All components of M_3 decelerated during 2011-12. On the sources side, the growth in M_3 was led by increase in banking system credit to the government; of this, the net Reserve Bank credit to the government sector, reflected the OMO and LAF operations of the Reserve Bank.

Both demand and supply factors cause credit growth to slow

IV.13 Non-food credit growth had been showing a decelerating trend from December 2010, reflecting both demand- and supply-side factors. On the demand side, with the transmission of cumulative monetary actions having their desired impact on economic activity, particularly credit-intensive manufacturing, there was a deceleration. On the supply side, banks appeared to be averse to taking risks with some parameters that indicate the health of banks' balance sheets deteriorating during the year. Banks opted for safer avenues of investment resulting in a compositional shift in the banks' asset portfolio in favour of investments in government securities.

IV.14 The divergence between credit and the deposit growth rates had narrowed during the first three quarters of 2011-12. The sharper deceleration in deposit growth during Q4 of 2011-12 and turnaround in credit growth during March 2012, however, caused the divergence to increase (Chart IV.7). As deposit growth moderated, commercial banks' recourse to non-deposit sources of finance (*viz.*, borrowings) increased.

Chart IV.7: Divergence between Credit and Deposit Growth

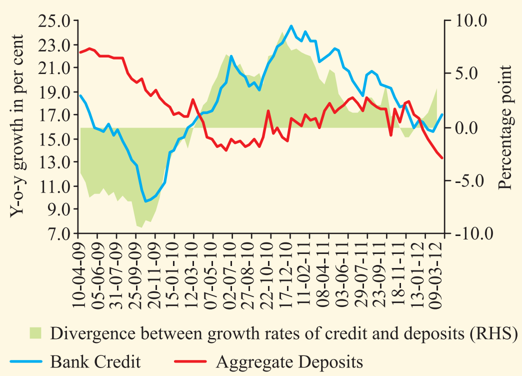


Table IV.3: Credit Flow from Scheduled Commercial Banks

(Amount in ₹ billion)

Item	Out-standing as on March 23, 2012	Variation (Y-on-Y)			
		As on Mar 25, 2011		As on Mar 23, 2012	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1. Public Sector Banks*	33,956	5,063	21.0	4,752	16.3
2. Foreign Banks	2,345	310	18.6	366	18.5
3. Private Banks	8,726	1,444	24.7	1,434	19.7
4. All Scheduled Commercial Banks	46,116	6,973	21.5	6,695	17.0

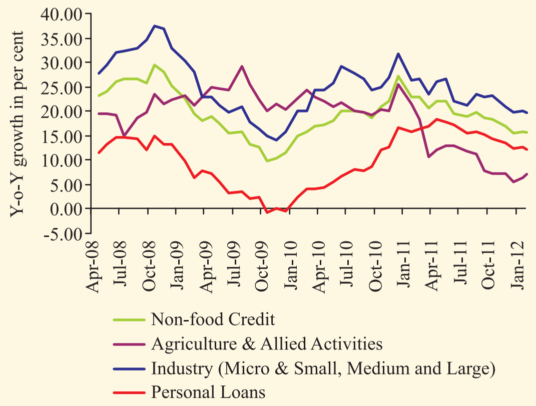
Note: 1. Data as on March 23, 2012 are provisional.
2. *Excluding Regional Rural Banks.

IV.15 Credit growth decelerated across bank groups during 2011-12. Since public sector banks account for around three-fourth of the outstanding credit, the deceleration in their credit growth impacted the overall credit expansion of SCBs taken together (Table IV.3). Increasing stress in the corporate sector was reflected in the quantum jump in the corporate debt that came up for restructuring before the Corporate Debt Restructuring Cell during 2011-12. Banks tend to become risk averse as corporate profitability impinges on the health of their balance sheets and the possibility of adverse selection increases in a rising interest rate environment.

IV.16 The deceleration in year-on-year non-food credit growth as at end-February 2012 was contributed by all the sectors, *viz*., agriculture, industry, services and personal loans (Chart IV.8). The deceleration was particularly sharp in agriculture, real estate, hotels and restaurants, professional services, telecommunication, power, cement, textiles, iron and steel and personal vehicle loans.

IV.17 Reflecting the deceleration in growth and the introduction of system-driven identification of NPAs by public sector banks (PSBs), the asset quality of PSBs deteriorated sharply during 2011-12 (up to December) (Table IV.4). Further, the capital to risk-weighted assets ratio (CRAR) of commercial banks, particularly, nationalised banks, declined during 2011-12 (up to December). These factors appear to have a bearing on their capacity to extend credit.

Chart IV.8: Sectoral Credit Growth



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

IV.18 Non-bank sources emerged as the dominant source for financing the commercial sector during 2011-12. Within non-bank sources, external sources of funds accounted for 71 per cent of the increase, mainly contributed by FDI (Table IV.5). The increase in domestic non-bank funds was accounted for by NBFCs while issuance of commercial paper (CPs) by corporates and subscribed to by non-banks increased significantly.

Liquidity deficit eases

IV.19 The expansion of M_3 in relation to nominal GDP *i.e.* declining income velocity of M_3 is reflective of the increasing monetisation of the Indian economy (Chart IV.9).

IV.20 Monetary and liquidity conditions remained tight during 2011-12. Liquidity turned

Table IV.4: Change in CRAR and Net NPA (End-December 2011 over End-March 2011)

(Percentage points)

	SBI Group	Nation-alised Banks	New Private Sector Banks	Old Private Sector Banks	Foreign Banks	All Banks
1	2	3	4	5	6	7
CRAR	-0.60	-1.13	-0.70	-0.96	-1.50	-0.91
Gross NPA/ Gross Advances	1.36	0.65	-0.23	0.04	-0.65	0.59
Net NPA/Net Advances	0.93	0.40	-0.07	0.09	-0.17	0.41

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

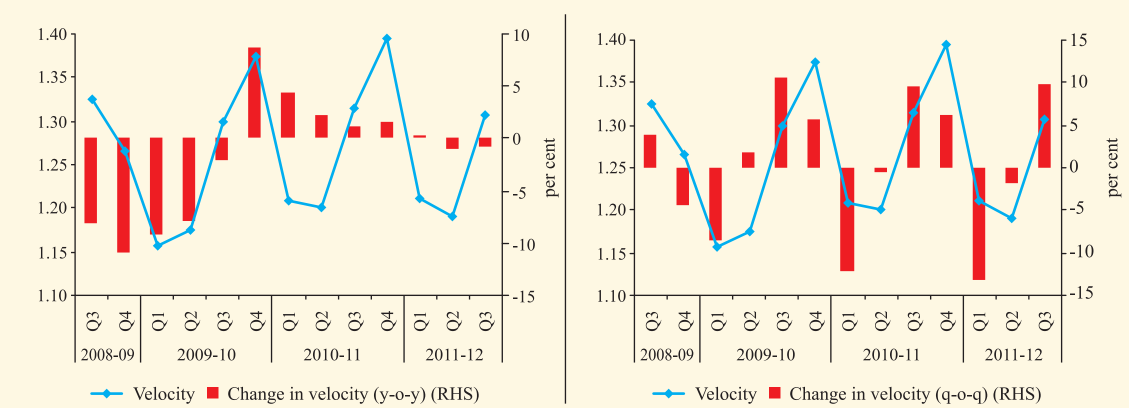
(₹ billion)

Item	2009-10	2010-11	2011-12 P
1	2	3	4
A. Adjusted Non-food Bank Credit (NFC)	**4,786**	**7,110**	**6,764**
i) Non-Food Credit	4,670	6,815	6,525
of which: petroleum and fertiliser credit	100	-242	24
ii) Non-SLR Investments by SCBs	117	295	239
B. Flow from Non-banks (B1+B2)	**5,850**	**5,286**	**5,894**
B1. Domestic Sources	**3,652**	**2,956**	**3,132**
1. Public issues by non-financial entities	320	285	70
2. Gross private placements by non-financial entities	1,420	674	401
3. Net issuance of CPs subscribed to by non-banks	261	172	738
4. Net credit by housing finance companies	285	384	356
5. Total gross accommodation by the four RBI regulated AIFIs - NABARD, NHB, SIDBI & EXIM Bank	338	400	346
6. Systemically important non-deposit taking NBFCs (net of bank credit)	607	679	926
7. LIC's gross investment in corporate debt, infrastructure and social sector	422	361	295
B2. Foreign Sources	**2,198**	**2,330**	**2,762**
1. External Commercial Borrowings / FCCBs	120	555	504
2. ADR/GDR Issues excluding banks and financial institutions	151	92	27
3. Short-term credit from abroad	349	502	262
4. FDI to India	1,578	1,181	1,969
C. Total Flow of Resources (A+B)	**10,636**	**12,396**	**12,659**
Memo Item:			
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	966	-367	-109

P : Provisional and partial data on certain items.
Note: FDI data include equity capital and reinvested earnings of incorporated entities & unincorporated entities for the period April-February and include other capital for the period April-December.

excessively tight since November 2011 reflecting sudden large autonomous outflows. In response, as also in recognition of the downside risks to growth during the latter part of 2011-12, the Reserve Bank stepped up injecting durable discretionary liquidity through OMO purchases and CRR cuts. As a result, and also reflecting frictional factors, liquidity deficit has declined considerably in April 2012 so far. The pace of reserve money creation, adjusted for first round impact of CRR cuts, has also picked up. This has partly offset the structural drivers of liquidity.

Chart IV.9: Income Velocity of Money



V. FINANCIAL MARKETS

Global market sentiments have improved following policy interventions in the euro area and positive data from the US. Risks to EDEs capital flows from the deleveraging by European banks, although still prevalent, appear to have moderated in the wake of the ECB's initiatives to extend liquidity support. Taking cues from favourable international developments, Indian financial markets revived in Q4 of 2011-12. The revival, however, has been primarily liquidity driven and expectations led. For the recovery to be sustained, macroeconomic fundamentals need to improve.

Stress in euro area eases, but firewalls remain weak

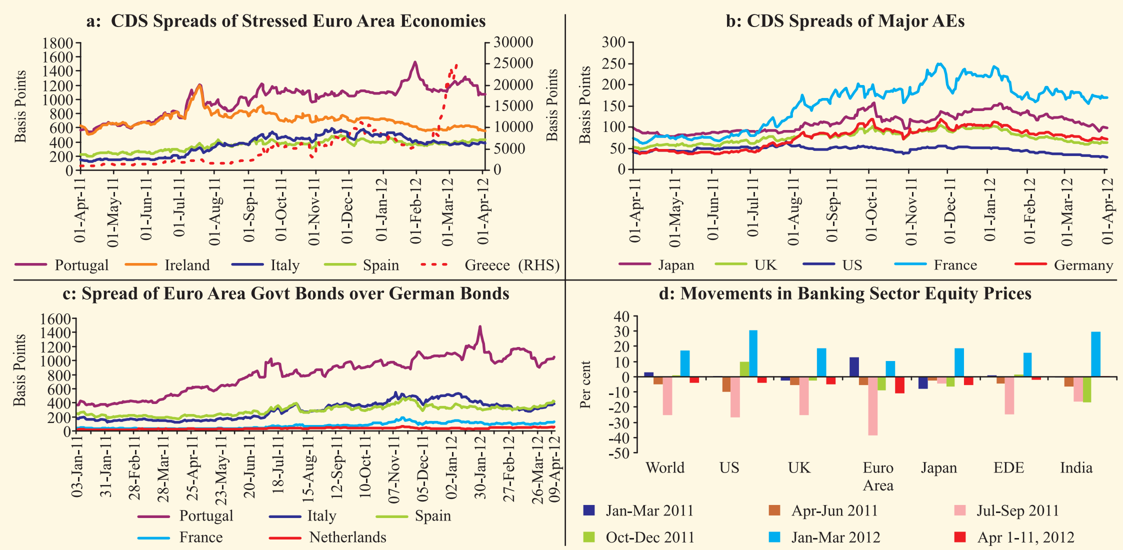
V.1 The imminent risks of a region-wide spread of contagion from the adverse feedback loop between the banks' balance sheet and sovereign debt in the euro area that conditioned the global markets in Q3 of 2011-12 somewhat waned in the following quarter. Though risks from falling growth and high unemployment in parts of the euro area remain, funding pressures of the euro area banks have eased for the time being. This follows the European Central Bank (ECB)'s actions to infuse liquidity coupled with the individual sovereigns' policy initiatives. Under the long-term refinancing operations (LTRO) of the ECB in December 2011 and February 2012, around €1 trillion has been injected.

V.2 Yet another major development in the region has been the completion of the sovereign bond swap in Greece, amounting to €177 billion of debt, aimed at reducing the debt burden and financial stress. The agreement on a second bailout for Greece valued at €130 billion (which is backed by €28 billion contribution from the IMF) has also helped in improving global market sentiments.

V.3 Some revival in the euro area term money markets and interbank activity was seen, indicating that the pressure on euro area banks may have temporarily eased. Market perception of falling sovereign credit risk is evident from the decline in sovereign spreads and improved equity market performance (Chart V.1).

V.4 Notwithstanding the reduction in financial market stress, euro area firewalls remain weak.

Chart V.1: Movement in Global Financial Markets



Source: Bloomberg and Datastream.

Euro area member states have agreed to increase the size of the firewall to about € 800 billion (US$ 1 trillion). As a result, concerns about the adequacy of the firewall may have somewhat eased. However, in view of the mild recession the euro area is currently experiencing, widespread austerity measures could have implications for economic growth and tax revenue. Although the LTROs have pumped in a large amount of liquidity in the euro area banking system, a large part of this liquidity is finding its way to the overnight deposit facility of the ECB (Chart V.2a). Therefore, the amount of onward transmission of credit remains to be seen. It is possible that in search of yields a part of this liquidity is being channeled into emergining and developing economies' (EDEs) equity markets. Consequently, FII inflows into equity markets of EDEs have increased in 2012 so far (Chart V.2b).

Ongoing easy monetary policy in AEs possibly enhances capital inflows to EDEs

V.5 Elsewhere in the advanced economies (AEs), central banks continue with easy monetary policies that enhance global liquidity. The Bank of England decided to purchase an additional £50 billion worth of government securities, while the Bank of Japan announced an increase in its asset purchase programme. The Fed, aside from continuing with its policy stance of excessively low interest rates, observed that the majority of the large US banks display robust health in the face of conservative stress tests, and are capable of meeting the requisite capital adequacy norms even under adverse conditions. All these factors coupled with better than expected recovery in the US growth have temporarily helped reduce the stress in global financial markets and could have channeled FII flows into EDEs in search of higher yields.

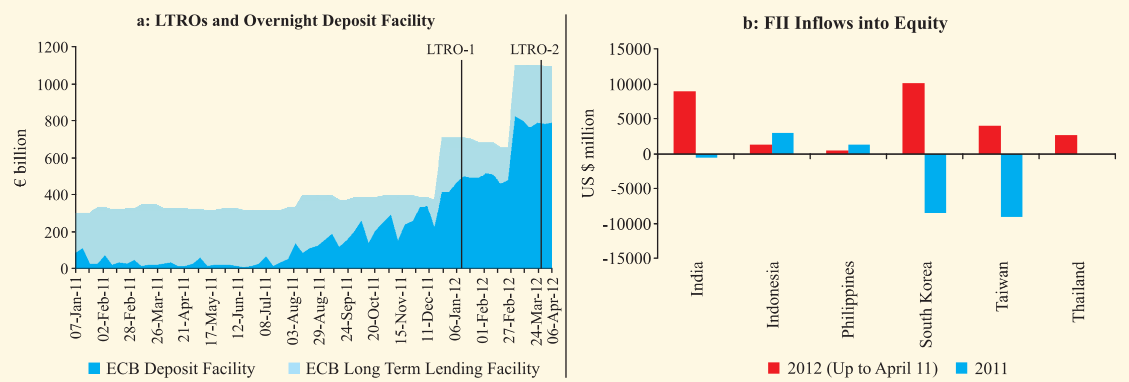
Pressures ease in domestic markets, but some volatility persists

V.6 Despite the slowdown in domestic growth and the recent oil price increase, Indian equity markets stayed upbeat in Q4 of 2011-12, conditioned by the revival in global markets, the surge in FII inflows and the decline in domestic inflation. Reflecting the prevailing structural liquidity deficit coupled with outflows for advance tax payment by companies, money market rates remained elevated. The yields on government bonds fell for most part of the quarter, although the trend reversed following the budget announcements of higher borrowing in 2012-13. Policy measures taken by the Reserve Bank have reduced volatility in the currency markets.

Money market rates remained elevated reflecting deficit liquidity conditions

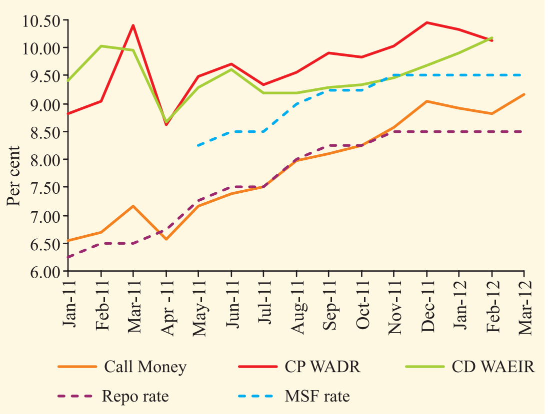
V.7 In view of the tight liquidity conditions in the system, call rate remained at levels above the policy (repo) rate during H2 of 2011-12

Chart V.2: Global Liquidity and FIIs inflows to some EDEs



Source: Bloomberg

Chart V.3: Movements in Interest Rates



(Chart V.3). Following the CRR cut in January 2012, the call rate that had risen to 9.0 per cent in December 2011 declined slightly. However, it again moved up in March 2012 following tight liquidity conditions on account of quarterly advance tax payments. The rates in the collateralised segments (*i.e.*, CBLO and market repo) moved in tandem with call rate, *albeit* at a lower level, during Q4. The prevailing deficit liquidity conditions prompted a few banks to access funds from the MSF window.

V.8 During 2011-12, while the share of call money in total overnight money market volume increased, that of collateralised segments declined. In the collateralised segment, banks and primary dealers remained the major groups of borrowers, and mutual funds (MFs) dominated as lenders (Table V.1).

V.9 The weighted average effective interest rates (WAEIR) on certificates of deposits (CDs) firmed up during Q4 of 2011-12. The increase was significant towards the end of February 2012, due to tight liquidity conditions and lower rollover of CDs by MFs.

V.10 In the primary g-sec market, the yields on auction Treasury Bills (TBs) generally firmed up till March 2012 in line with the large issuance and tight liquidity conditions.

Yields harden following the announcement of higher government borrowing programme

V.11 In the secondary market, the g-sec yield declined initially and was range-bound for most of Q4 reflecting improved sentiment on account of the OMO purchases by the Reserve Bank, an increase in the ceiling for investment in government securities by foreign institutional investors (FIIs) and expectation of moderation in inflation. The divergent trend in yield movements of TBs and dated securities resulted in an inverted yield curve during the period. This largely reflected the large issuances of TBs at the short-end of the yield curve. Following

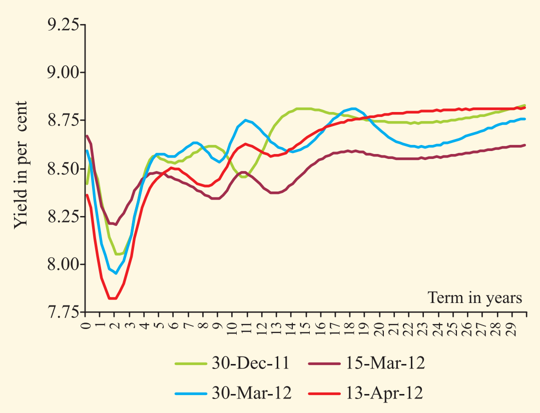
Table V.1: Average Daily Volumes in Domestic Financial Markets

(₹ billion)

	Money Market						Bond Market		Forex Market Inter-bank (US$ bn)	Stock Market##
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificates of Deposit*	G-Sec@	Corporate Bond #		
1	2	3	4	5	6	7	8	9	10	11
Mar-11	-809.63	112.78	151.34	432.01	803.05	4,247.40	81.44	22.69	22.21	148.18
Jun-11	-741.25	115.62	166.50	413.13	1,046.89	4,237.67	128.44	23.35	24.05	127.99
Sep-11	-559.20	137.82	138.93	451.19	1,446.21	3,834.72	123.20	22.44	22.38	137.57
Dec-11	-1,166.62	148.80	99.47	264.93	1,341.49	4,030.03	205.72	30.03	17.80	108.64
Jan-12	-1,292.32	172.60	89.12	279.59	1,498.83	3,909.39	233.44	24.52	17.70	131.46
Feb-12	-1,405.26	141.55	121.69	331.22	1,613.94$	4,028.85	157.93	35.74	17.68	198.36
Mar-12	-1,574.26	175.10	111.75	379.82			98.58	26.12		151.90

*: Outstanding position.
#: Average Daily Trading in Corporate Bonds.
^: As at mid-June 2011.
@: Average daily outright trading volume in Central Government dated securities.
##: Average daily Turnover in BSE and NSE.
$: Feb 15, 2012.
Note: In col. 2, (-) ve sign indicates injection of liquidity while (+) ve sign indicates absorption of liquidity.

Chart V.4: Movements in G-sec yield



the Union Budget announcement of a higher than anticipated market borrowing programme and the subsequent issuance of auction calendar for dated securities, the 10 year yield rose steadily to 8.63 per cent by March 30, 2012 as compared to 8.54 per cent as on December 30, 2011 (Chart V.4).

V.12 According to SEBI data, FIIs made investment in debt worth ₹189.3 billion in Q4 of 2011-12. MFs also bought debt worth ₹1317.8 billion during the same period.

V.13 The gross market borrowing programme of the central government through dated securities during 2011-12 to the tune of ₹5,100 billion, a 16.7 per cent hike over the previous year, was successfully completed. The bid-cover ratio stood in the range of 1.39-5.12 as against 1.39-3.87 during the previous year. The cash balance of the central government transited into surplus from WMA/OD since February 7, 2012.

V.14 During 2011-12, 24 states and the UT of Puducherry raised ₹1,586 billion on a gross basis which was almost 52 per cent higher than that during the previous year. The weighted average yield firmed up to 8.79 per cent from 8.39 per cent during the previous year.

Base rate remains sticky reflecting higher cost of funds

V.15 During Q4 of 2011-12, deposit rates of SCBs remained mostly unchanged from their peak levels attained in H1 of 2011-12. Lending rates marginally notched up and seem to have plateaued in H2 of 2011-12 in line with the peaking of the policy rate cycle. Despite tight liquidity conditions, successive policy rate hikes and high cost of funds for banks, the base rate remained sticky on account of the slow down in non-food credit growth during H2 of 2011-12 (Table V.2).

Table V.2: Deposit and Lending Rates of Banks

(per cent)

	Mar-2011	Jun-2011	Sep-2011	Dec-2011	Mar-2012
1	2	3	4	5	6
1. Domestic Deposit Rate (1-3 year tenor)					
Public Sector Banks	8.00-9.75	8.25-9.75	8.55-9.75	8.55-9.75	9.00-9.75
Private Sector Banks	7.75-10.10	8.00-10.50	8.00-10.50	8.00-10.50	8.00-10.50
Foreign Banks	3.50-9.10	3.50-10.00	3.50-9.75	3.50-9.75	3.50-9.75
2. Base Rate					
Public Sector Banks	8.25-9.50	9.25-10.00	10.00-10.75	10.00-10.75	10.00-10.75
Private Sector Banks	8.25-10.00	8.50-10.50	9.70-11.00	10.00-11.25	10.00-11.25
Foreign Banks	6.25-9.50	6.25-9.50	6.25-10.75	6.25-10.75	6.25-11.85
3. Median Lending Rate*					
Public Sector Banks	8.88-14.00	9.50-14.50	10.50-15.25	10.25-15.25	-
Private Sector Banks	9.00-14.50	9.25-15.00	9.00-15.25	10.00-15.50	-
Foreign Banks	7.70-14.05	7.70-14.50	9.13-14.75	9.50-14.38	-

* : Median range of interest rates at which at least 60 per cent of business has been contracted. -: Not Available.

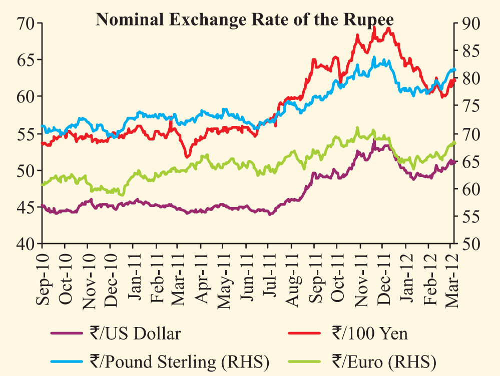
Note: Bank group-wise variations in deposit/lending interest rates worked out from the table would differ from those reported in the text as the latter are based on bank-wise and tenor-wise variations in deposit interest rates and bank-wise variations in case of lending rates.

Rupee stays volatile on CAD concerns and global uncertainty

V.16 The policy measures undertaken to improve capital inflows have generally yielded the intended results, thereby enabling smoother financing of higher CAD. This, in turn, has led to the movement of the exchange rate in a narrow range from the last week of January 2012. The rupee moved up to 51.4 per US dollar as on April 13, 2012 from a low of 54.2 per US dollar recorded on December 15, 2011 (Chart V.5).

V.17 A notable aspect of capital flows was that both debt and equity flows improved during Q4 led by policy measures, global liquidity conditions and investor perception. However, rising crude oil prices due to geo-political factors, and increased dollar demand led to a moderate depreciation of rupee since the first week of March 2012.

Chart V.5: Exchange Rate Movement against Major Currencies



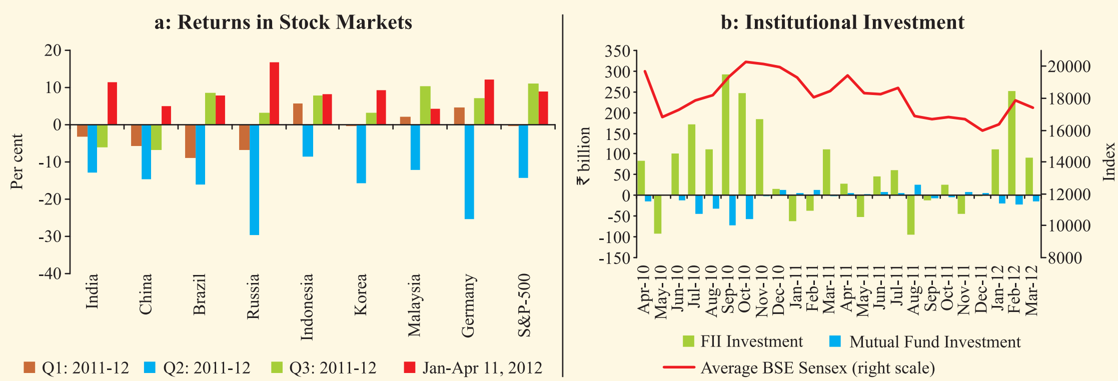
Secondary equity markets improve with renewed FII inflows

V.18 The Indian equity market saw a strong pick up in Q4 on the back of renewed FII support, a fall in inflation and firm trends in the global equity markets (Chart V.6). This recovery was broad-based, with all major sectoral indices moving up in line with the Sensex. According to SEBI data, FIIs bought shares worth ₹453.4 billion in Q4 of 2011-12; on the other hand, MFs sold shares worth ₹ 54.4 billion. FIIs have been the major contributors to the rally, presumably on account of higher global liquidity driven by the easy monetary policy pursued by AEs, the ECB's long term lending programme and increase in the size of asset purchase programme by some AE central banks. However, in April 2012 so far (up to April 11) the Indian equity market declined in line with global markets.

The primary markets show incipient signs of recovery

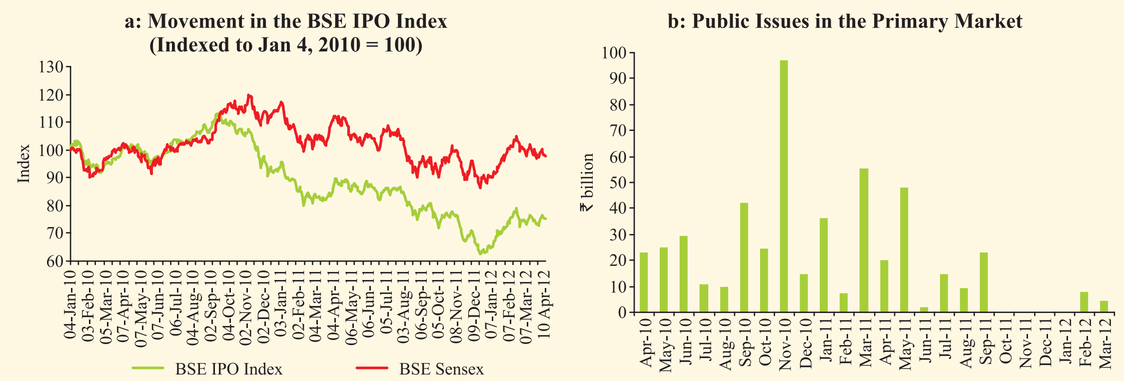
V.19 Almost dormant in Q3, the primary market witnessed a few issuances in the equity segment in Q4, indicating a slow recovery on the backdrop of the equity indices recovering from lower levels. However, the primary market sentiment still remains cautious on account of lower risk appetite of investors in the primary market following the negative returns on initial public offers (IPOs) during previous quarters (Chart V.7). On the supply side, corporates too abstained from the primary market for resource mobilisation due to the

Chart V.6: Equity Market and Institutional Investment



Source: Bloomberg, SEBI and BSE

Chart V.7: Developments in the Primary Market



Source: BSE and SEBI

uncertain macroeconomic environment and investor sentiments (Table V.3).

V.20 Certain policy announcements in the Union Budget 2012-13 may help to revive the primary market. These include simplification in the issuance process of IPOs and the introduction of the Rajiv Gandhi Equity Savings Scheme. According to SEBI data, private placement increased to ₹2.4 trillion during 2011-12 (up to February) from ₹2.0 trillion during the corresponding period of the previous year.

Housing price increases remain contained

V.21 The Reserve Bank's quarterly House Price Index (HPI), based on official data on property transaction from 9 cities, indicates that

Table V.3: Resource Mobilisation from Capital Market

(₹ billion)

Category	2009-10	2010-11	2011-12
1	2	3	4
A. Prospectus and Rights Issues*	**326**	**376**	**129**
1. Private Sector (a+b)	255	244	83
a) Financial	3	39	9
b) Non-financial	252	205	74
2. Public Sector	71	132	46
B. Euro Issues	**160**	**94**	**27**
C. Mutual Fund Mobilisation (net)@	**831**	**-494**	**617$**
1. Private Sector	549	-192	495$
2. Public Sector #	282	-302	123$

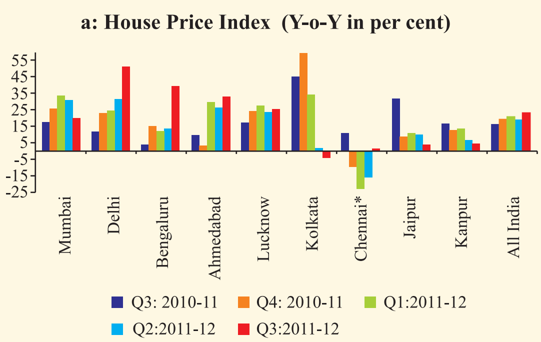
*: Excluding offer for sale. @: Net of redemptions.
#: Including UTI MF. $: Apr-Feb.
Source: Mutual Fund data are sourced from SEBI and exclude funds mobilised under Fund of Funds Schemes.

during Q3 of 2011-12, house price increased for all cities, barring Kolkata on an annual basis. However, price increases moderated in Mumbai, Jaipur and Kanpur (Chart V.8). The number of transactions on an annual basis declined in Mumbai, Bengaluru and Kanpur, while the y-o-y increase moderated in Ahmedabad and Jaipur.

Risks of disruptive movements in financial markets remain from euro area and financialisation of commodities

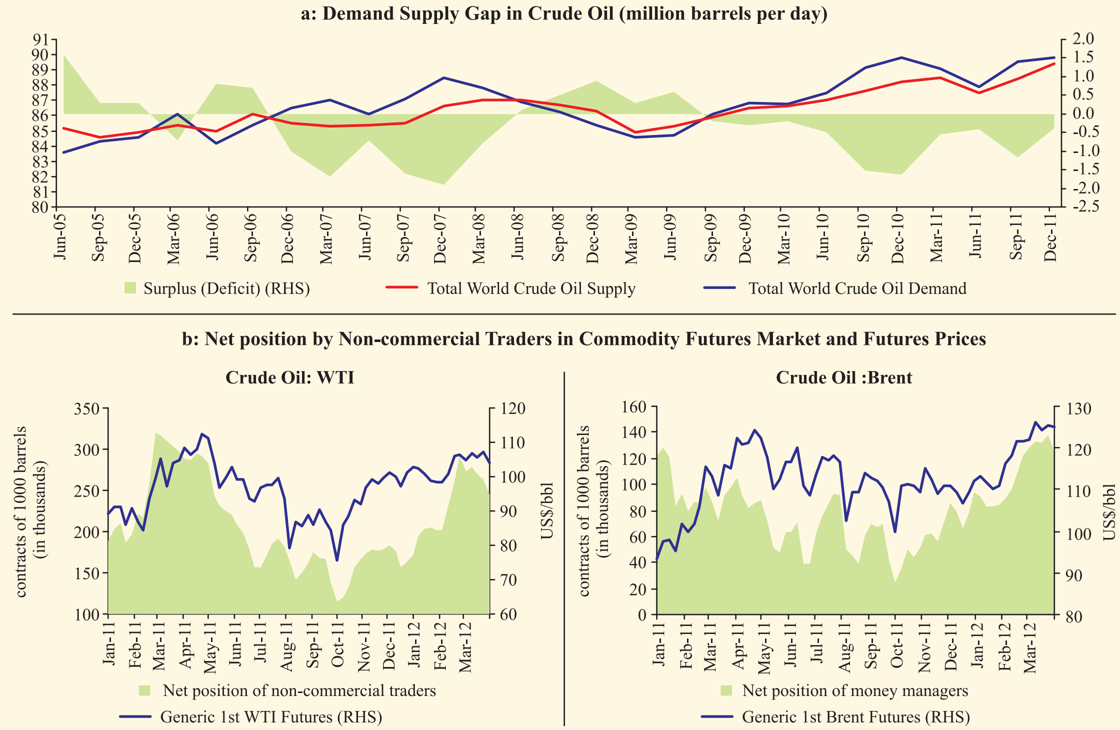
V.22 Notwithstanding the signs of stabilisation over the past quarter, risks that stress in financial markets could return in 2012-13 remain. The focus has shifted to Spain, which faces high borrowing cost due to the burgeoning budget deficit. Recession looms large in Spain and this also raises concerns about possible contagion.

Chart V.8: Trends in Housing Market



*Chennai index is based on both residential and commercial properties
Note: All India index is a weighted average of city indices, weights based on population proportion.

Chart V.9: Movements in Crude Oil



Note : Net non-commercial position includes net non-commercial as well as net non-reportable positions. Net long (+) , net short (-).
Source : Bloomberg, EIA.

Debt sustainability of Portugal and Greece remain fragile. The adequacy of the lending capacity of the European Financial Stability Facility (EFSF) is uncertain, given the size of debt of Italy and Spain.

V.23 The recent surge in crude oil prices due to geo-political tensions has emerged as a new risk factor to global and domestic financial markets. Volatile oil trades can occur in coming months given the uncertainty about the ongoing political initiatives. Furthermore, the EU sanctions on Iran may kick in only from July 2012. The financialisation of commodity markets has been considerable and with daily trading volumes of over US$ 1 trillion in oil markets alone, the uncertainty about oil price movement in 2012-13 remains. While as a baseline, global oil prices in 2012-13 could average around current levels, the upside risks are greater than the downside risks due to tighter inventory levels and lower spare capacities, which could result in supply shortages (Chart V.9). Should these upside risks materialise, the negative spillovers on Indian markets could be large given their impact on India's inflation and with lag on growth, as also its fiscal and external sector positions.

V.24 In March 2012, both the US Energy Information Agency (EIA) and OPEC revised their 2012 oil demand projections downwards. While the spike in oil prices largely reflected concerns about supply disruption from Iran and the Strait of Hormuz through which 20 per cent of global oil supplies (about 17 million barrels) pass each day, price movements in 2012-13 could continue to be impacted by the July event. If the geo-political tensions recede, high crude oil prices may not be sustained, given the weak global growth outlook. Sustained high oil prices could themselves dampen the already weak global growth outlook. Nonetheless tight supply -demand conditions, alongside the presence of large liquidity in the global economy leave the commodity price outlook highly uncertain.

VI. PRICE SITUATION

2011-12 was marked by strong inflationary pressures that began easing only in December. The recent fall in inflation has been largely supported by transitory factors such as a seasonal decline in vegetable prices and favourable base effect. However, demand moderation, reflected in the dampening of the pricing power of producers has also played a role. Meanwhile, more permanent supply-side responses, for example in the dairy sector, have just begun to take shape. Going forward, inflation in 2012-13 is likely to remain around current levels. Importantly, the near-term inflation trajectory is subject to significant upside risks, in particular from high oil prices and unsustainable levels of suppressed inflation, the lagged pass-through impact of rupee depreciation, higher freight rates and taxes, sustained wage pressures, and the structural nature of protein-food inflation.

Central banks eased further with larger risks to global growth even as global inflation risks remain

VI.1 Weak global growth momentum kept global inflation risk under check during 2011. However, global metal prices, after softening for large part of the year firmed up during Q4 of 2011-12. Global crude prices that surprised on the up for most of 2011-12, not only remained elevated but also increased significantly during Q4 of 2011-12. As a result, upside risks persist. Inflation divergence between emerging and developing economies (EDEs) and advanced economies (AEs) also persisted. As EDEs have a higher share of commodities in their consumption baskets, higher commodity prices are likely to exert larger pressure on inflation in EDEs than on AEs.

VI.2 The uncertainty in the global growth outlook and volatility in commodity prices impart considerable uncertainty on the near-term global inflation outlook. Incomplete deleveraging of the private sector and the urgency of fiscal consolidation in many parts of the AEs to reduce the looming debt burden may further weaken demand-side risks to inflation. On the other hand, sustained easy monetary conditions and supply disruptions in commodity markets pose significant upside risks.

VI.3 The monetary policy focus across countries, both AEs and EDEs has changed course significantly since mid-2011 as concerns about sustaining the recovery of economic growth in AEs and strength of growth impetus in EDEs increasingly weighed in the monetary policy stance adopted by the central banks. Central banks in AEs have generally reduced their policy rates or kept them at near-zero levels while the ECB also resorted to long-term repurchase operations (LTRO). The central banks of EDEs, which were earlier raising policy rates to control inflation, turned course and reduced policy rates and eased liquidity conditions to address growth concerns (Table VI.1).

Upside risks to global commodity prices are significant in 2012-13

VI.4 Global commodity price pressures, except those on crude oil, generally remained subdued for most of 2011-12 before accelerating in Q4 (Chart VI.1). Global crude oil prices also increased significantly in Q4 of 2011-12 as geo-political tensions and concerns about supply disruptions contributed to price pressures. The path of global commodity prices in 2012-13 is uncertain. On current assessment, during the year, Indian basket crude oil prices could average around the current levels of about US$ 120/barrel but both upside and downside risks to this projection remain large. The slow growth in AEs and the deceleration in China coupled with the fact that commodity prices have hardened significantly in the past two years

Table VI.1: Global Inflation Indicators

Country/ Region	Key Policy Rate	Policy Rate (as on April 13, 2012)	Changes in Policy Rates (basis points)			CPI Inflation (y-o-y, per cent)	
			Sep15, 2008 to Aug. 23, 2009	Aug 23, 2009 to Oct 25, 2011	Since Oct 25, 2011	Mar-11	Mar-12
1	2	3	4	5	6	7	8
Advanced Economies							
Australia	Cash Rate	4.25 (Dec. 7, 2011)	(-) 400	175	(-) 50	2.7#	3.1#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	(-) 275	75	0	2.2$	2.6$
Euro area	Interest Rate on Main Refinancing Operations	1.00 (Dec. 14, 2011)	(-) 325	50	(-) 50	2.7	2.6
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10 (Oct. 5, 2010) *	(-) 40	(-) 10	0	-0.5$	0.3$
UK	Official Bank Rate	0.50 (Mar. 5,2009)	(-) 450	0	0	4.4$	3.4$
US	Federal Funds Rate	0.0 to 0.25 (Dec.16,2008)*	(-) 200	0	0	2.7	2.7
Developing Economies							
Brazil	Selic Rate	9.75 (March 8, 2012)	(-) 500	275	(-)175	6.3	5.2
India	Repo Rate	8.50 (Oct. 25, 2011)	(-) 425 (-400)	375 (100)	0 (-125)	8.8$	7.6$
China	Benchmark 1-year Deposit Rate	3.50 (Jul. 7, 2011)	(-) 214	100	0	5.4	3.6
	Benchmark 1-year Lending Rate	6.56 (Jul. 7, 2011)	(-) 241 (-200)	100 (600)	0 (-100)		
Indonesia	BI Rate	5.75 (Feb. 9, 2012)	(-) 275	0	(-) 75	6.7	4.0
Israel	Key Rate	2.50 (Jan. 23, 2012)	(-) 375	275	(-) 75	4.2$	1.7$
Korea	Base Rate	3.25 (Jun 10, 2011)	(-) 325	125	0	4.1	2.6
Philippines	Reverse Repo Rate	4.00 (March 1, 2012)	(-) 200	25	(-) 50	4.8	2.6
	Repo Rate	6.00 (March 1, 2012)	(-) 200	25	(-) 50		
Russia	Refinancing Rate	8.00 (December, 26 2011)	(-) 25	(-) 250	(-) 25	9.5$	3.7$
South Africa	Repo Rate	5.50 (Nov. 19, 2010)	(-) 500	(-) 150	0	3.7$	6.1$
Thailand	1-day Repurchase Rate	3.00 (Jan. 25, 2012)	(-) 250	225	(-) 50	3.1	3.5

*: Change is worked out from the minimum point of target range. #: Q4 of 2011. $: February.
Note: Figures in parentheses in column (3) indicate the effective dates when the policy rates were last revised.
Figures in parentheses in column (4, 5 & 6) indicate the variation in the cash reserve ratio during the period.
For India, data on inflation pertain to CPI for Industrial Workers.
Source: Websites of respective central banks/statistical agencies.

provide some hope that high commodity prices may correct somewhat during the course of the year. However, the global liquidity glut and the financialisation of global commodity markets

Chart VI.1: Trends in Global Commodity Prices

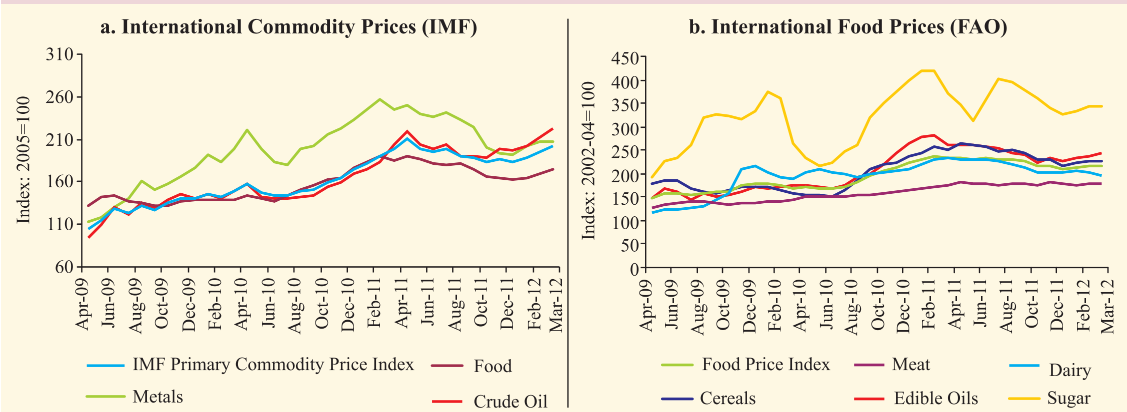
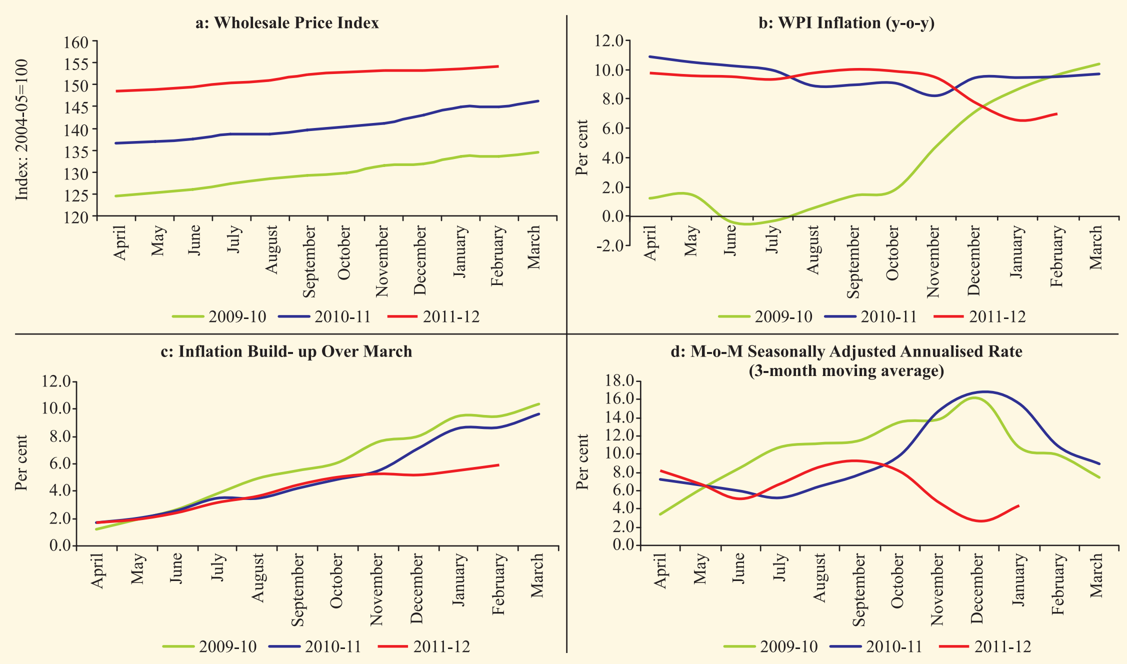


Chart VI.2: Trends in Wholesale Price Inflation



constitute a significant upside risk (see V.23-V.24).

Headline inflation in India softened in line with projected trajectory

VI.5 After almost two years of sustained high inflation, inflation started declining from November 2011. Headline inflation, which was at 10 per cent in September 2011, declined to 6.6 per cent by January 2012. Though inflation increased marginally in February 2012, the momentum indicators, as measured by 3-month moving average seasonally adjusted month-over-month changes, suggest softening of price pressures (Chart VI.2).

VI.6 In terms of contribution to overall inflation, the decline has been prominent for food (Chart VI.3). The contribution of non-food manufactured products has declined gradually over the recent months alongside the deceleration in growth momentum. The contribution of the fuel group to overall inflation remains high, despite the current levels of domestic petroleum prices not fully reflecting global market prices.

Primary food inflation reversed after the sharp decline as transitory effects waned

VI.7 The sharp decline in primary food inflation witnessed during Q3 of 2011-12 was the result of favourable base effect and a more than expected seasonal decline in vegetable prices. As was assessed in the previous edition of this document, the decline of food inflation to negative territory was a temporary phenomenon and primary food inflation

Chart VI.3: Contribution to Inflation: Major Groups

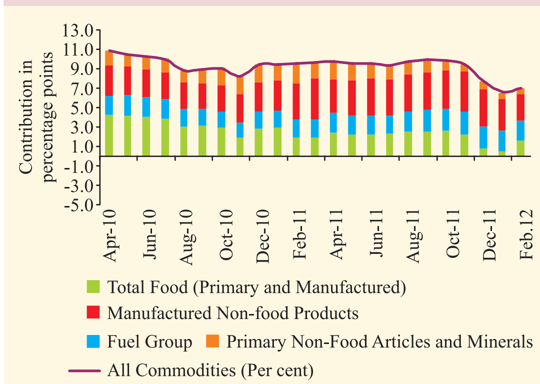
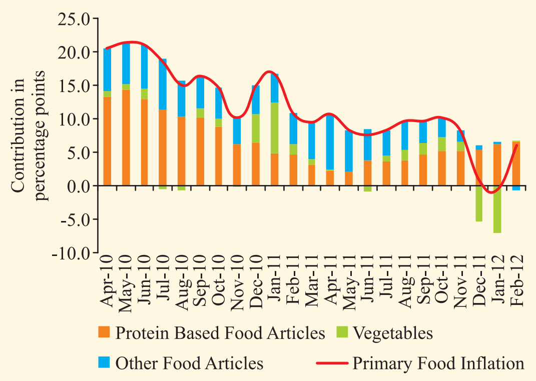


Chart VI.4: Contributors to Primary Food Inflation



increased sharply from -0.5 per cent in January 2012 to 6.1 per cent in February 2012 (Chart VI.4). Both the waning base effect and the increase in prices of vegetables from a seasonal trough contributed to the rebound in food inflation.

Although protein inflation declined in 2011-12, structural demand-supply imbalances keep it high

VI.8 On a yearly average basis, protein inflation softened to about 10 per cent in 2011-12 (April-February) after remaining close to 20 per cent in the preceding two years. However, it still remains high and has been rising steadily since August 2011 (Chart VI.5). High inflation in protein-rich food items along with significant upward revisions in Minimum Support Prices (MSP) and increases in rural wages in excess of inflation have imparted upward push to food inflation. Besides the lagged supply response, input cost pressures have led to sustained double-digit inflation in protein-rich food items. Recognising the importance of supply-augmenting measures to address the concerns about food inflation, the government in the Union Budget for 2012-13 announced a number of measures to augment supply and improve storage and warehousing facilities. These schemes include a ₹22 billion project to improve productivity in the dairy sector, and a national mission for 'Food Processing', apart from provisions to add storage capacity for foodgrains. These supply-side measures will help in containing food inflation but the overall benefits will be realised only with a lag.

Energy prices likely to remain a significant source of inflation

VI.9 A major concern on the inflation front continues to be high fuel prices driven by the increase in international oil prices. Domestic fuel group inflation that captures changes in energy prices has been in double-digit for 25 successive months (up to February 2012). The increase in fuel group inflation has largely been driven by increase in prices of mineral oils, besides moderate increases in coal and electricity prices. Most importantly, suppressed inflation in administered prices continues to remain substantial and significant increases in

Chart VI.5: Primary Food Articles: Index and Inflation

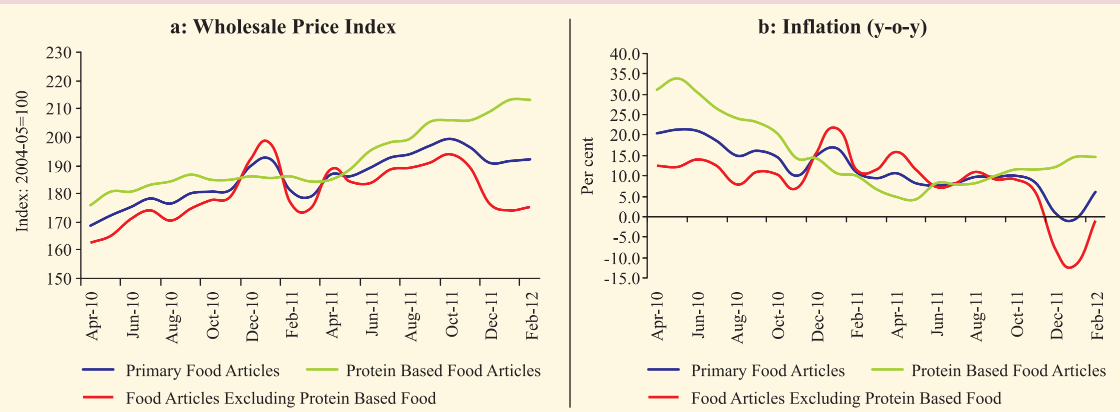


Chart VI.6: Global and Domestic Fuel Prices

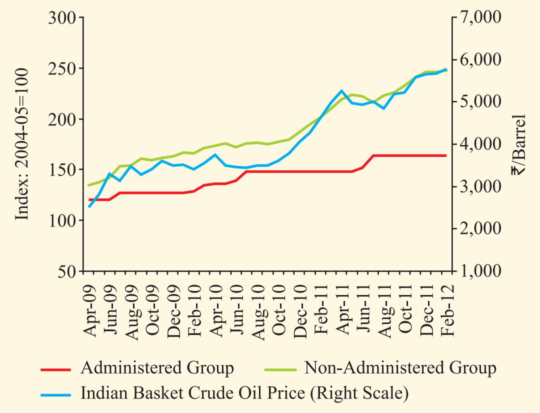
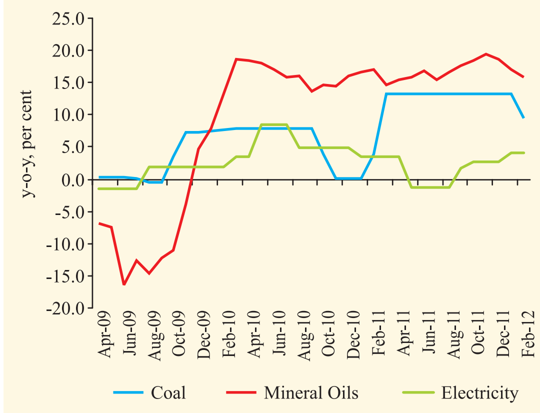


Chart VI.7: Fuel Inflation: Components



crude oil prices in Q4 of 2011-12 and exchange rate depreciation in H2 of 2011-12 have amplified the magnitude of suppressed inflation (Chart VI.6). Currently, the estimated under-recoveries by domestic oil marketing companies for diesel and PDS kerosene are ₹14.36 and ₹31.04 per litre, respectively, and ₹570.50 per cylinder for domestic LPG. The Union Budget for 2012-13 has budgeted a lower amount towards fuel subsidy; if subsidies have to be contained within the budgeted limits, it would require a significant revision in administered fuel prices, which would lead to spike in price levels. This would translate into higher price level in the near-term but inflation would later moderate and suppressed inflation pressures would also wane. Therefore, while fuel inflation risks remain significant in the near term, even if global crude prices ease moderately from current levels, the deregulation of fuel prices is a desired policy option.

VI.10 Apart from oil prices, another source of risk to inflation is the possible upward revision in coal prices. Electricity prices are also likely to come under pressure from higher input costs (Chart VI.7).

Generalised price pressures soften as growth deceleration eases demand

VI.11 After remaining over 7 per cent for 11 consecutive months, non-food manufactured products inflation started to decline from January 2012 and reached 5.8 per cent by February 2012 as growth deceleration dampened demand pressures. Month-over-month increases in prices have moderated in recent months (as per the 3-month moving average SAAR) (Chart VI.8). The increase in railway freights and the rollback of an earlier cut in excise duty (as part of the Railway Budget and Union Budget, respectively), however, will increase cost pressures, which could lead to an increase in the prices of non-food manufactured products, thereby increasing inflation in the short-term. The pass-through of these fiscal measures over time do not constitute an upside risk to the medium-term inflation trajectory.

VI.12 Pressure from input costs is yet to soften and input cost increases continue to be much higher than increases in output prices, as is borne out by the HSBC Markit Purchasing Managers Index (PMI) for input and output

Chart VI.8: Manufactured Non-food Products Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes

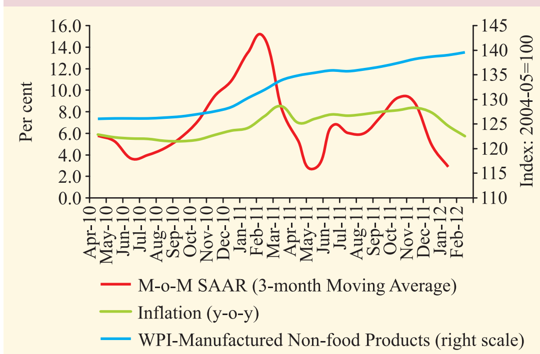


Chart VI.9: Purchasing Managers Index (PMI) Output and Input Prices (Seasonally Adjusted)

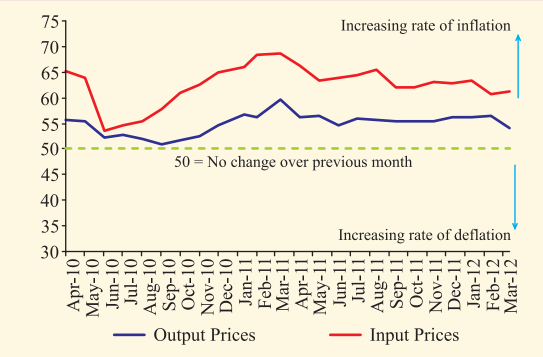
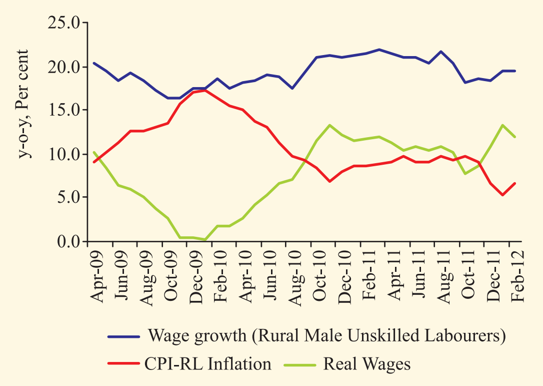


Chart VI.10: Increase in Rural Wages Relative to Inflation



prices (Chart VI.9). This could further squeeze profit margins in an environment of weak demand.

Exchange rate pass-through risks remain significant

VI.13 Since August 2011, the depreciation of the rupee has emerged as a major upside risk to the inflation trajectory (Table VI.2). Even though global commodity prices moderated, the sharp depreciation of the rupee between August and December 2011 more than offset the impact of declining commodity prices. Since January 2012, the rupee has appreciated while international commodity prices have firmed up. Apart from the commodity price outlook, exchange rate movements have added uncertainty to the inflation trajectory. Pass-through of both depreciation of the exchange rate and higher oil prices have been partial so far due to suppressed inflation in the fuel group.

Wage pressures in both rural and urban areas are yet to soften

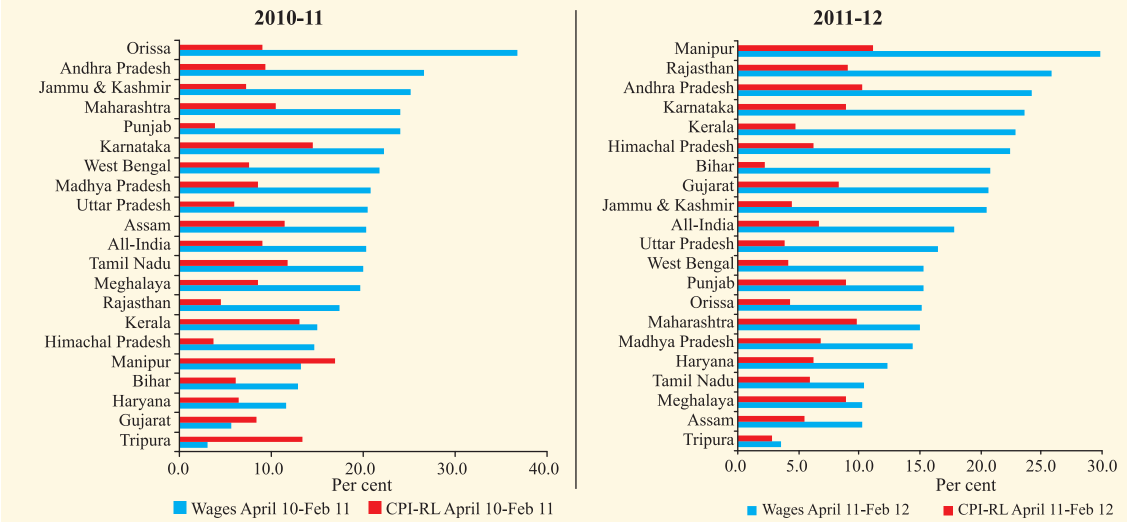
VI.14 The pressure on generalised inflation from sustained increase in wage costs has been one important characteristic of the recent high inflation episode. Wage increases for unskilled labourers in rural areas continue to be at a rate faster than the comparable rate of inflation (*i.e.,* CPI-RL) (Chart VI.10). There are, however, significant divergences across major States (Chart VI.11). Similarly, in the formal sector, the analysis of company finance data suggests that growth in staff costs remain firm (Chart VI.12). Private market surveys also suggest relatively higher rates of increase in salaries and perks in the organised sector in India compared with other countries. A host of factors could explain the increase in wages, including high inflation, withdrawal of the labour force with increased participation in education and

Table VI.2: Comparative Movement of Oil Price and Exchange Rate Since July 2011

	July 2011	December 2012	Fortnight March 16-31, 2012	Changei n per cent (July 2011-December 2012)	Changei n per cent (December 2012-March 16-31, 2012)
1	2	3	4	5	6
Crude oil Indian Basket (US$)	112.5	107.2	123.2	-4.7	14.9
Exchange Rate (₹/US$)	44.4	52.7	50.8	18.6	-3.6
Crude Indian Basket (₹)	4995.8	5646.8	6253.1	13.0	10.7

Note: The composition of Indian Basket of Crude Oil represents the Average of Oman & Dubai for sour grades and Brent (Dated) for sweet grade in the ratio of 67.6:32.4.
Source: Petroleum Planning and Analysis Cell.

Chart VI.11: State-wise Inflation and Wage growth (Rural Labourers)



government schemes such as MGNREGS. Though rising real wages could enhance welfare, the inflationary implications of high increases in wages have to be managed to sustain the benefits from high growth.

New CPIs show sustained increase in price levels

VI.15 Annual inflation according to the new CPI became available for the first time in January 2012. The latest data show that inflation was higher in urban areas (9.5 per cent) than in rural areas (8.4 per cent) leading to all-India inflation of 8.8 per cent for February 2012 (Table VI.3). While part of the higher CPI inflation reflects the high weight of food in the consumption basket (49.7 per cent for all-India), stronger price pressures in services included in the CPI basket point to the persistence of generalised inflation. This is also reflected in the all-India CPI excluding food and fuel inflation being high at 10.1 per cent as compared to the WPI excluding food and fuel inflation of 7.0 per cent for February 2012. Once longer time series information on CPI inflation becomes available, trends in services prices will improve the assessment of the generalised inflation process. CPI- Industrial Workers inflation was at 7.6 per cent while CPI-Rural Labourers and CPI-Agricultural

Chart VI.12: Staff Cost in the Corporate Sector

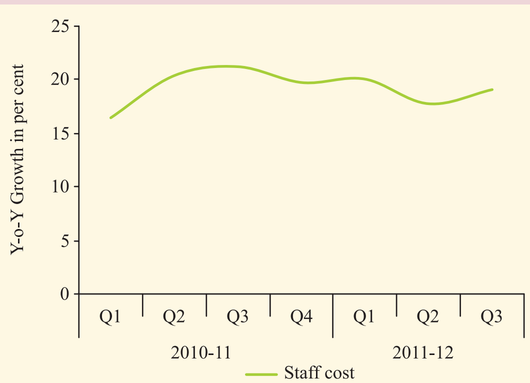


Table VI.3: All-India New CPI Inflation: February 2012

y-o-y, per cent

Category	Rural		Urban		Combined	
	Weight	Inflation	Weight	Inflation	Weight	Inflation
1	2	3	4	5	6	7
General Index (All Groups)	100.0	8.4	100.0	9.5	100.0	8.8
Food and beverages	59.3	6.3	37.2	7.2	49.7	6.6
Fuel and light	10.4	13.1	8.4	12.2	9.5	12.8
Clothing, bedding and footwear	5.4	12.7	3.9	14.0	4.7	13.2
Housing	--	--	22.5	13.6	9.8	13.6
Miscellaneous (Services)	24.9	9.1	28.0	7.2	26.3	8.3

Labourers inflation were at 6.7 and 6.3 per cent, respectively, in February 2012, which are much lower than the inflation reported by the new CPI.

Inflation moderated in response to slowing growth but upside risks remain

VI.16 The impact of the slowdown in growth momentum on generalised inflation has been visible as inflation in the non-food manufactured products category receded in recent months. However, the inflation outlook for 2012-13 needs to factor in significant upside risks. These emerge from volatile commodity prices, lagged pass-through of the exchange rate depreciation, sustained wage push pressures, unsustainable levels of suppressed inflation and likely sustained government spending as consolidation is mainly due to revenue-augmenting fiscal measures. The spatial and temporal distribution of the south-west monsoon has always been a major determinant of short-term food inflation, while structural factors continue to play a major role in conditioning food inflation dynamics. Recent measures announced in the Union Budget to improve supply responses in the agriculture sector and protein-rich food are expected to yield positive results, but not immediately. Against this backdrop, monetary policy has to recognise the need for keeping inflation expectations anchored in an environment of significant upside risks to inflation, while shifting the balance of policy to arrest the deceleration in growth momentum.

VII. MACROECONOMIC OUTLOOK

Growth faces increased pressure from both moderation in investment demand and an uncertain global environment. Surveys on business expectations show that business conditions and sentiments remain subdued. Transitory factors have helped moderate inflation, but inflation is likely to turn sticky in 2012-13. The balance of risk is on the upside due to significant suppressed inflation and high oil prices. As such, while addressing the slackening growth and investment demand is a policy challenge, inflation and other macroeconomic risks have to be kept firmly in mind.

Modest recovery likely in 2012-13

VII.1 The recent firming up of growth fundamentals in the US coupled with policy measures in the euro area have helped abate fears of a double dip recession in the advanced economies (AEs). This has helped stabilise the troubled global financial markets. Nevertheless, signs of a mild recession in the euro area, slowdown in emerging and developing economies (EDEs) including China, and surging crude oil prices bring to the fore risks to recovery in global growth and inflation. High liquidity from the extended easy monetary policy regimes globally has associated risks for capital flows to the EDEs.

VII.2 The Reserve Bank, in its Mid-Quarter Monetary Policy Review on March 15, 2012 gave indications of peaking of the interest rates cycle in line with the evolving growth inflation dynamics. Also, the structural liquidity deficit in the system necessitated a 125 bps cut in CRR in Q4 of 2011-12. Although, global developments since then have been more on the positive side, in view of the slackening domestic growth consequent upon weak pipeline investment and supply-side bottlenecks, the near-term prospects for growth suggest, at best, room for a modest acceleration.

VII.3 Early forecasts by international weather agencies regarding the South-West monsoon present a mixed picture. The Reserve Bank's own assessment of leading indicators based on land/ocean temperatures to predict India's South-West monsoon suggests that the 2012 monsoon may be normal. However, a clearer picture will emerge after the forecast by the India Meteorological Department (IMD). With the likelihood of a normal monsoon and a low base, the prospects for agriculture growth during 2012-13 are encouraging.

VII.4 A revival in the industrial sector hinges on the impetus to ease supply-side constraints, especially the energy and mineral deficits, and revive investment demand. The easing of inflationary pressures, government initiatives to revive the power sector, some improvement in investment demand and revival in external demand on the back of the improved global outlook could help revive the growth momentum. However, the overall slack may prevail in short-term, in the face of poor investment demand.

VII.5 Services sector growth is likely to be conditioned by the revival in global demand and pickup in industrial growth. Overall, services growth may stay largely resilient, though some spillover may occur from the slow pace of industrial growth. Road tendering by National Highways Authority (NHAI) has proceeded at a brisk pace in 2011-12 and investment driven by road sector is expected to pick up in 2012-13. With this, construction activity including housing could improve, especially in the hinterland of new highways, as execution of tendered road projects picks up.

Inflation risks remain significant

VII.6 Headline WPI inflation has declined since December 2011 largely on account of transitory factors including a favourable base effect and seasonal decline in vegetable prices, broadly in line with the Reserve Bank's indicative trajectory.

Table VII.1: Business Expectations Survey

Period/Index	NCAER-Business Confidence Index Apr 2012	FICCI Overall Business Confidence Index Q2: 2011-12	Dun & Bradstreet Business Optimism Index Q1: 2012-13	CII Business Confidence Index Q3: 2011-12
1	2	3	4	5
Current level of the Index	134.9	51.5	150.0	48.6
Index as per previous survey	125.2	51.6	156.2	53.6
Index levels one year back	145.3	76.2	183.3	66.2
% change (q-o-q) sequential	7.7	-0.2	-3.9	-9.3
% change (y-o-y)	-7.2	-32.3	-18.2	-26.6

VII.7 Risks from high crude oil prices and the impact of the lagged pass-through of rupee depreciation, suppressed inflation in energy and fertilisers and possible fiscal slippage, however, continue to pose significant threat. Unless significant measures are put in place to address the unsustainable levels of suppressed inflation, the risks to inflation stay active, *inter alia*, compounded also by the sustained wage pressures and the structural protein food inflation.

VII.8 The upside risks to inflation on the one hand and the depressed domestic growth outlook on the other, warrant calibrated measures to maintain a sustainable balance in a dynamic growth-inflation scenario.

Business expectations, industrial outlook surveys suggest mixed trend

VII.9 Recent surveys conducted by different agencies indicate mixed trends in business climate. The latest NCAER survey shows a noticeable pick up in business confidence from the previous period of survey. However, the Dun & Bradstreet index for Q1 of 2012-13 points to declining business optimism (Table VII.1).

VII.10 The seasonally adjusted HSBC Markit Purchasing Managers' Indices **(**PMI**)** for both manufacturing and services (March 2012) exhibited sustained expansion though at a decelerating rate, despite a moderate rise in the new orders received during the month. The PMIs also indicate an increase in job creation. Input cost pressures, however, remained strong.

Industrial Outlook Survey indicates some improvement in Q4 of 2011-12

VII.11 The Reserve Bank's 57th round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS57) conducted during January-March 2012, indicates that demand conditions in Indian manufacturing sector for Q4 of 2011-12 showed an improvement, while expectations for Q1 of 2012-13 showed a slight moderation.

Chart VII.1: Industrial Outlook Surveys

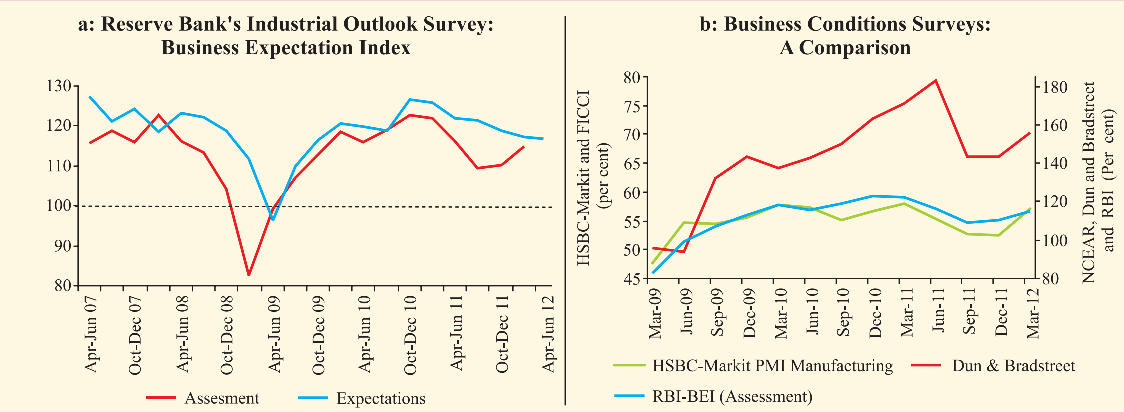


Table VII.2: Reserve Bank's Industrial Outlook Survey

Parameter		Optimistic Response	Net Response								
			2011						2012		
			Apr-Jun		Jul-Sep		Oct-Dec		Jan-Mar		Apr-Jun
			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	41.4	32.6	39.8	18.7	35.2	17.7	33.6	26.5	34.9
2.	Overall Financial Situation	Better	33.4	24.1	30.6	11.7	26.3	11.2	25.2	18.5	27.7
3.	Availability of Finance	Improve	27.3	21.5	24.2	12.1	20.2	10.4	19.0	15.8	22.9
4.	Cost of External Finance	Decrease	-35.0	-49.0	-39.7	-50.2	-41.0	-50.6	-38.8	-37.4	-22.7
5.	Production	Increase	40.0	32.1	40.6	22.6	39.9	25.3	40.4	33.1	34.7
6.	Order Books	Increase	38.4	28.1	35.9	20.3	33.4	18.4	31.3	24.8	29.5
7.	Capacity Utilisation	Increase	24.0	17.2	25.0	9.9	22.2	10.8	24.3	16.7	19.9
8.	Cost of Raw Material	Decrease	-57.0	-65.5	-51.7	-58.1	-49.7	-61.2	-50.1	-59.4	-49.0
9.	Employment in the Company	Increase	17.4	18.2	19.4	15.6	16.5	11.3	13.6	12.9	14.6
10.	Exports	Increase	24.0	18.2	25.8	13.1	22.1	11.5	18.6	14.2	20.7
11.	Imports	Increase	18.9	17.6	19.0	15.7	16.9	11.6	15.5	14.4	15.7
12.	Selling Price	Increase	23.7	21.5	18.3	10.7	16.0	8.9	14.7	13.5	19.0
13.	Profit Margin	Increase	3.8	-9.9	2.5	-17.1	-1.6	-17.3	-2.9	-11.3	-1.2

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.

VII.12 The Business Expectation Index (BEI), a composite indicator based on several business related parameters for the assessment and expectation quarters, shows an increase for Q4 of 2011-12 and a marginal decline for the quarter ahead (Q1 of 2012-13) (Chart VII.1).

VII.13 The survey results also indicate optimism with regard to production and order books for the assessment quarter, but going forward the trends are expected to decline. Net response on capacity utilisation increased during Q4 of 2011-12. Financing pressures seemed to have eased as indicated by the improvement in the availability and cost of finance for both quarters under review. Pressures from the cost of raw material continue, however, slight moderation is expected in Q1 of 2012-13. The net response on profit margin remained negative but a higher percentage of respondents reported increased profit margins in the assessment quarter (Table VII.2).

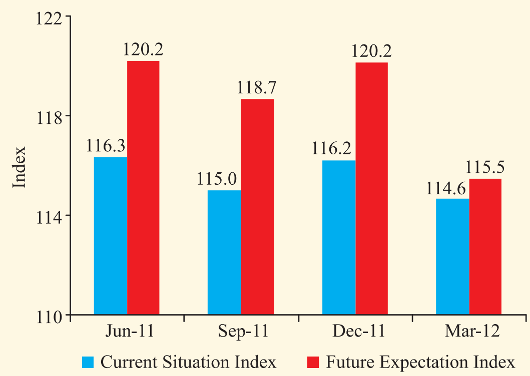
Consumer Confidence Survey notes decline in spending intentions

VII.14 The 8th round of the Consumer Confidence Survey conducted by the Reserve Bank of India in March 2012 (http://www.rbi.org.in/CCS8) indicates marginal decline in positive perceptions of the household after recording a slight improvement in December 2011. Survey also suggests visible decrease in future expectation mainly due to a decline in perceptions about income and spending (Chart VII.2).

External agencies see slow revival in domestic growth

VII.15 The Government of India has placed its domestic growth projection for 2012-13 at 7.6 per cent (+/- 0.25 per cent) (Table VII.3). This is against the backdrop of the CSO's

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



advance estimates for 2011-12 growth at 6.9 per cent. Most external agencies see a moderate rebound in growth, as indicated by their conservative forecasts for 2012-13, and have pegged their forecasts in the range of 7.0-7.6 per cent.

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

Agency	Latest Projection	
	Real GDP Growth (Per cent)	Month
1	2	3
Economic Advisory Council to the PM	7.6	Feb-12
Finance Ministry	7.6 (+/- 0.25)	Feb-12
IMF	7.0	Jan-12
World Bank	7.5	Mar-12
ADB	7.0	Apr-12

Survey of professional forecasters[1]

VII.16 The results of the 19th round of 'Survey of Professional Forecasters' (http://www.rbi.org.in/SPF19) conducted by the Reserve Bank show marginal decline in the overall growth projection for 2012-13 (Table VII.4). The revisions in projections for 2012-13 are mostly positive. While majority of the professional forecasters envisage a slow pick up in growth from Q2 of 2012-13, the average inflation is expected to hover around current levels.

Table VII.4: Median Forecasts of Select Macroeconomic Indicators by Professional Forecasters 2011-12 and 2012-13

	Actual 2010-11	Annual Forecasts				Quarterly Forecast									
		2011-12		2012-13		2011-12		2012-13							
						Q4		Q1		Q2		Q3		Q4	
		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)	8.4#	7.0	6.9*	7.3	7.2	7.0	6.9	6.8	6.6	7.1	7.1	7.3	7.4	-	7.5
a. Agriculture & Allied Activities	7.0#	3.4	2.5*	3.0	3.0	3.5	3.0	3.0	3.0	3.2	3.2	3.3	3.1	-	3.0
b. Industry	6.8#	4.1	3.6*	5.8	6.0	3.8	4.5	4.4	4.6	5.1	5.5	5.8	6.3	-	6.2
c. Services	9.2#	9.0	8.8*	8.8	8.8	8.5	8.9	8.5	8.4	8.7	8.5	8.8	8.8	-	8.6
2. Gross Domestic Saving (per cent of GDP at current market price)	32.3#	33.0	31.9	33.5	32.8	-	-	-	-	-	-	-	-	-	-
3. Average WPI-Inflation	9.6	8.8	8.8	6.5	6.9	6.8	6.7	6.4	6.6	6.2	6.9	6.3	6.7	-	6.7
4. Exchange Rate (₹/US$ end period)	44.65	52.0	51.2&	48.0	48.3	52.0	51.2&	50.8	49.5	49.3	48.8	49.0	48.0	-	47.8
5. T-Bill 91 days Yield (per cent-end period)	8.2	8.2	8.8	7.5	7.9	-	-	-	-	-	-	-	-	-	-
6. 10-year G-secYield (per cent-end period)	8.4	8.3	8.4	8.0	8.2	-	-	-	-	-	-	-	-	-	-
7. Export (growth rate in per cent)@	37.3	17.5	19.0	14.3	13.2	-	-	-	-	-	-	-	-	-	-
8. Import (growth rate in per cent)@	26.7	20.6	23.7	14.4	15.0	-	-	-	-	-	-	-	-	-	-
9. Trade Balance (US$ bn)	-130.6	-	-	-	-	-34.0	-41.2	-43.8	-50.2	-40.2	-47.7	-47.0	-44.8	-	-48.0

E: Previous Round Projection. L: Latest Round Projection. #: Quick Estimate. *: Advance Estimate.
- : Not Available. &: Actual. @: US$ on BoP basis.

Note : The latest round refers to Nineteenth round for the quarter ended March 2012, while previous round refers to Eighteenth round for the quarter ended December 2011.

Source : Survey of Professional Forecasters, Fourth Quarter 2011-12.

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

Inflation expectations moderate

VII.17 The Inflation Expectations Survey of Households (IESH) (http://www.rbi.org.in/IESH27) for January-March 2012 indicates a decrease in households' perception of both the current quarter inflation as well as expectations of future inflation. The survey spanned 12 cities covering 4,000 households and seven occupational categories.

Policy aims to support recovery, action to factor in inflation and macro-risks

VII.18 Policy actions thus far have helped moderate inflation and contain inflationary expectations. However, against the backdrop of uncertain global conditions and fragile domestic demand, the recovery in the economy is expected to remain moderate. Demand revival, especially in investment, is critical for growth. In this context, business as also consumer confidence needs to be addressed by the policy initiatives.

VII.19 At the current juncture, reviving growth in a non-inflationary manner poses many challenges. Given that the recent experience suggests that potential output may itself be lower than in the pre-crisis years, the output gap could be small. Inflationary pressures, though moderating, could re-emerge if the upside risks materialise. Moreover, policy choices have to keep in view the risks arising from fiscal and external imbalances. The policy design to achieve macro-objectives hinges on deregulation and the upward adjustment of oil prices by letting the demand effects work towards diminishing fiscal and external risks. This would provide space for fiscal and monetary policy to act in tandem to achieve the growth and inflation objectives in 2012-13 that otherwise appear to be at cross purposes. Overall, monetary policy has to tread with care in working towards reviving growth, while not exacerbating inflation and other risks.