RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments First Quarter Review 2013-14

Issued with the First Quarter Review of Monetary Policy 2013-14

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Macroeconomic and Monetary Developments First Quarter Review 2013-14

Reserve Bank of India
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MACROECONOMIC AND MONETARY DEVELOPMENTS FIRST QUARTER REVIEW 2013-14

Overview

1. *After reducing policy rates by 100 basis points (bps) in 2012-13, the Reserve Bank cut its policy rate further by another 25 bps in May 2013, but paused in its Mid Quarter Review in June 2013. The forward guidance in May and the more cautious monetary policy stance in June substantially reflected concerns with the current account deficit (CAD) and its financing. While monetary policy is largely guided by the growth-inflation dynamics, it is also tempered by considerations of risks of external imbalances. Accordingly, policy initiatives were taken in mid-July to address exchange rate volatility so that it does not risk macroeconomic stability and growth sustainability. The measures taken included capping allocation of funds under LAF for each individual bank to 0.5 per cent of its own NDTL, increasing marginal standing facility (MSF) rate and bank rate by 200 bps each to 10.25 per cent and mopping up some liquidity through open market operations (OMO) sales and stipulating banks to maintain a minimum daily CRR balance of 99 per cent of the average fortnightly requirement.*

2. *Developments in the external sector since the third week of May 2013 brought to fore not just stress in the financial markets and asset prices, but also their impact on other macroeconomic parameters, including growth, public finances and inflation, as also financial stability. The buffers built and the fresh responses during the stress period have helped India to contend with a precipitous situation. However, global financial conditions remain stressed and domestic policy changes have not sufficiently improved business conditions. Growth continues to be slack, while inflation concerns, especially in the form of high consumer price inflation linger. Consequently, policy choices will need to be carefully evaluated and would need to preserve stable macroeconomic and financial conditions while addressing the growth concerns. In this context, structural reforms become important to reduce CAD to sustainable levels and to support growth.*

Global Economic Conditions

Global recovery prospects remain weak

3. *Global growth remained subdued, with improvements in some advanced economies (AEs), especially the US and Japan, getting counterbalanced by slowing growth in key emerging market and developing economies (EMDEs), including China and India. The International Monetary Fund (IMF) in its World Economic Outlook has revised the global growth down to 3.1 per cent in 2013 from 3.3 percent earlier.*

Global commodity price cycle stay benign, but with upside risks to crude prices

4. *With weak global growth, global commodity price inflation is expected to remain contained in the near term. The ongoing deleveraging and slowing growth in China is expected to put further downward pressure on global commodity prices. However, upside risks to global crude oil prices remain from rising geo-political uncertainties in the oil producing*

regions. Also, the impact of softer commodity prices has been offset in varying degrees for various countries due to depreciation of EMDE currencies vis-à-vis the US dollar.

Global financial markets have entered into a period of fresh turbulence

5. *Volatility and spillovers from the likely tapering of quantitative easing (QE) have gripped global financial markets since mid-May 2013. Financial markets are re-pricing risks factoring in the inevitability of monetary stimulus getting withdrawn at some stage. The global bond sell off in May and June 2013 has resulted in most currencies depreciating against the US dollar, causing further portfolio outflows across equities and commodities. Going forward, as a baseline case, global interest rates may continue to harden over the medium term. This is likely to tighten financial conditions further and episodically keep markets under stress.*

Indian Economy: Developments and Outlook

Output

Slow-paced recovery likely to shape later in 2013-14

6. *The Indian economy continued to remain sluggish in Q4 of 2012-13, though it still maintained a pace faster than most of the EMDEs. The growth in the full year, 2012-13, slipped to 5.0 per cent. The persistence in slowdown is reflected in below trend growth for seventh consecutive quarters since Q2 of 2011-12. The slowdown has also turned pervasive with most sectors growing below trend. Leading indicators do not suggest immediate improvement in production activity and a slow-paced recovery is likely to shape only later in 2013-14, supported by good monsoon that could shore up rural demand.*

Aggregate Demand

Improvement in aggregate demand requires overcoming high consumer price inflation and infrastructure bottlenecks

7. *Aggregate demand of the Indian economy during Q4 of 2012-13 remained slack with little improvement in investment activity and deceleration in consumption demand. Private consumption in real terms has decelerated due to persistent high inflation, while investment is hobbled by structural constraints. Corporate results indicate weak sales growth with corporate investment intentions remaining listless. In this situation, key to turning around the economy lies in re-balancing government spending from current to capital expenditures with a view to crowding-in private investment.*

External sector

Reducing CAD and ensuring its financing through stable flows are needed

8. *Even though the current account deficit (CAD) to GDP ratio moderated to 3.8 per cent in Q4 of 2012-13 from its historic high of 6.5 per cent in Q3 of 2012-13, indications are that it may have widened again in Q1 of 2013-14. Going forward, the current account is expected to show improvement with likelihood that gold imports may fall. However, risks to CAD financing have increased due to capital outflows from EMDEs. This has put rupee under pressure. Vulnerability indicators of the external sector have deteriorated. In this milieu, concerted policy reforms are needed to reduce CAD and to improve financing by attracting more stable capital flows to the Indian economy.*

Monetary and Liquidity Conditions

Policy recalibration became necessary with increased macro-financial risks

9. *The Reserve Bank eased monetary policy during 2012-13 and Q1 of 2013-14 while*

guarding against re-emergence of inflation. The transmission of this easing has reduced lending rates significantly. There was marked easing in liquidity conditions in Q1 of 2013-14, which broadly remained in line with policy objectives. However, the policy was recalibrated and availability and cost of rupee liquidity was tightened in July 2013, with a view to restoring stability to the foreign exchange market. Broad money (M3) growth remained broadly in line with the indicative trajectory. The deceleration in domestic growth and deterioration in asset quality of the banking sector has kept credit growth below the indicative trajectory in Q1 of 2013-14.

Financial Markets

Contagion from global bond sell off generates stress in Indian markets

10. *The policy statements by the Fed in May 2013 accentuated the global bond sell off. It also made markets jittery, leading to significant volatility in bonds, currencies, commodities and equities in EMDEs. Contagion from markets across Asia spilled over to India. Policy action was taken on a wide front to limit these spillovers. This helped stabilise rupee exchange rate, though interest rates increased. The subsequent policy indications by the Fed in July also appear to have temporarily calmed investor sentiments, but the overall situation remains in a state of flux.*

Price Situation

Headline inflation moderates but upside risks persist

11. *Moderation of global commodity prices, negative output gap and past monetary policy actions contributed to disinflationary momentum in the headline WPI inflation which fell below 5 per cent by May 2013. Non-food manufactured product inflation declined sharply to its lowest level in the past three years. However, food inflation has risen in May and June 2013 and is putting pressures on general price-level. These pressures could moderate somewhat if the monsoon remains on track during the rest of the season. Meanwhile, consumer price inflation remains stubbornly high and recent currency depreciation and upward revisions in fuel prices have increased upside risks to both wholesale and consumer price inflation.*

Macroeconomic Outlook

Amplifying macro-financial risks warrant cautious monetary policy stance

12. *Recovery in growth may take time and is expected to shape slowly as the year progresses. Moreover, sustainable recovery requires control over consumer price inflation that has continued to hover around double digits for the past 15 months. Going forward, business confidence remains subdued and the latest expectations surveys show a further fall in business sentiments. Meanwhile macro financial risks have amplified with global interest rate cycle starting to turn and causing capital outflows. External sector stress has increased and rupee has depreciated significantly. With recent liquidity tightening measures the Reserve Bank has curbed exchange rate volatility providing a temporary breather. While monetary policy focuses on restoring stability in the currency market it is important to push through structural reforms to support growth. The strategy will succeed only if structural reforms help reduce CAD and augment savings and investment.*

I. OUTPUT

With global growth remaining subdued and structural impediments continuing to hinder recovery at home, the downshift in India's growth persisted during Q4 of 2012-13. Domestic policy uncertainties, governance concerns, the impact of earlier monetary tightening and slack external demand conditions, apart from a weak monsoon, had weighed down on the growth process for the year as a whole. This brought down growth to a 10-year low of 5.0 per cent during 2012-13. While moderate improvement in growth during 2013-14 is expected, on the back of good monsoon, the downside risks have increased as a result of the global interest rate cycle starting to turn.

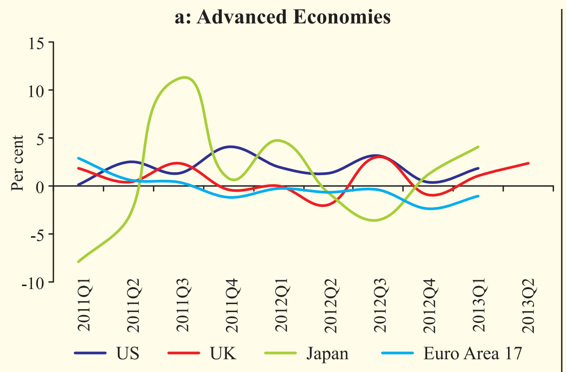
Global recovery prospects remain weak

I.1 Global growth stayed subdued, with improvements in some advanced economies (AEs), especially the US and Japan, getting counterbalanced by slowing growth in key emerging market and developing economies (EMDEs), including China and India. Moreover, the prospects of global recovery remains weak. With the global interest rate cycle turning, volatile financial conditions have emerged that may reduce capital flows to EMDEs. These are likely to affect macro-financial conditions in EMDEs and may protract their current slow growth. Although currently AEs seem to be on a recovery track, the fiscal drag continues to be an inhibiting factor.

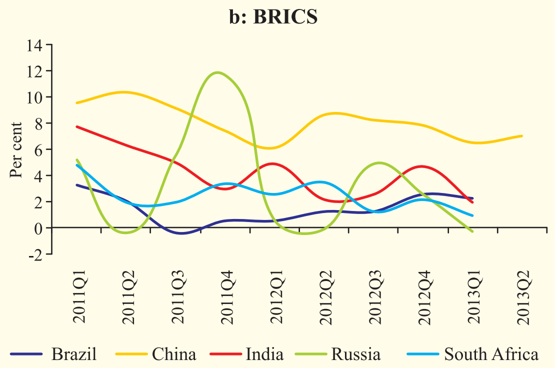
I.2 The International Monetary Fund (IMF) in its July 2013 update of the World Economic Outlook (WEO) has projected that global growth will stay subdued at 3.1 per cent in 2013, the same as in the previous year. This marks a downward revision of 0.2 percentage points from its earlier growth forecast made in April 2013. Growth for 2014 has also been revised downward by 0.2 percentage points to 3.8 per cent. The cuts in forecasts for both the years have been sharper for EMDEs, with a significant downgrade of growth projections for Brazil and China. The IMF has projected India to grow at 5.6 per cent in 2013-14 and 6.3 per cent in 2014-15.

I.3 During Q1 of 2013, AEs witnessed a multi-paced recovery. US GDP grew at 1.8 per cent (seasonally adjusted annualised quarter-on-quarter growth rate, q-o-q saar), up from 0.4 per cent growth in Q4 of 2012 (Chart I.1a). Growth came from personal consumption expenditure, private inventory investment and residential fixed investment, while cuts in federal, state and local government spendings, as also low exports dragged growth down.

Chart I.1: Growth in Advanced Economies and BRICS (Q-o-Q SAAR)



Source: Eurostat



Source: OECD, Stat Extracts

Japan's economy grew at 4.1 per cent in Q1 2013 (q-o-q saar), the fastest pace among G-7 countries, mainly driven by an aggressive monetary and fiscal stimulus. The UK registered a growth of 2.4 per cent and 1.1 per cent (q-o-q saar) in Q2 and Q1 of 2013, respectively, as against a decline of 0.9 per cent in Q4 of 2012.

I.4 In contrast, the euro area (EU-17) continued to be in recession with continued contraction for the sixth consecutive quarter. Its GDP declined by 1.1 per cent (q-o-q saar) in Q1 of 2013 after a 2.4 per cent decline in the previous quarter. France slipped back into recession in Q1, while Italy and Spain continued in a prolonged contraction mode. Germany managed to avert falling into recession with a meagre positive growth of 0.3 per cent (q-o-q saar) during Q1 of 2013.

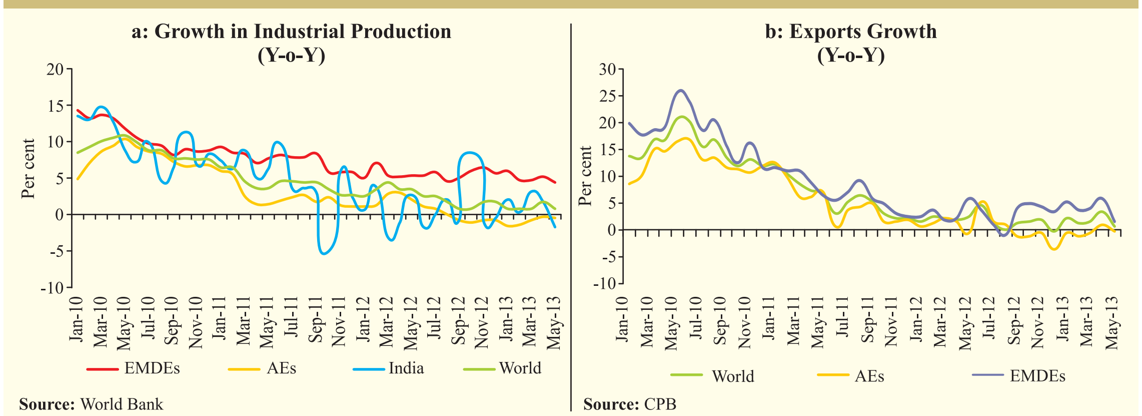
I.5 Among EMDEs, growth has slowed across the BRICS nations which in past had been an engine for global recovery. During Q1 of 2013, growth in Brazil slowed to 2.2 per cent (q-o-q saar), down from 2.6 per cent (q-o-q saar) in the previous quarter (Chart I.1b). Russia's GDP contracted in Q1 of 2013. China's GDP growth picked up in Q2 of 2013 to 7.0 per cent (q-o-q saar) from 6.6 per cent in Q1. South Africa slowed to an annualised growth of 0.9 per cent in Q1 of 2013, which was lower than 2.1 per cent in Q4 of 2012.

I.6 Apart from GDP growth, labour market conditions have also diverged in the AEs, with a distinct improvement in the US, but continued dampened conditions in the euro area. Non-farm payroll in the US economy increased by 195,000 jobs in June 2013 and the numbers for the previous two months were also revised upwards significantly. Although the unemployment rate remained unchanged at 7.6 per cent in June due to the improved rate of labour force participation, the overall data suggest that the economy is gaining some traction. However, the unemployment rate in the euro area continues to increase, and touched a new high of 12.2 per cent in May 2013. For some time now, the unemployment rates in Spain and Greece have continued to be anchored around 26 per cent, with their youth unemployment rates at over 55 per cent. Overall, growth and employment have been dented by slow expansion in industrial growth and global trade (Chart I.2).

Slowdown persists in the Indian economy

I.7 India's growth continues to languish. Although India is still growing faster than most EMDEs, the deceleration in growth over the last two years has been marked. The year-on-year (y-o-y) growth, as also the seasonally adjusted growth rate in Q4 of 2012-13, were marginally higher than in the previous quarter,

Chart I.2: Global Industrial Production and Exports



Source: World Bank

Source: CPB

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

(Per cent)

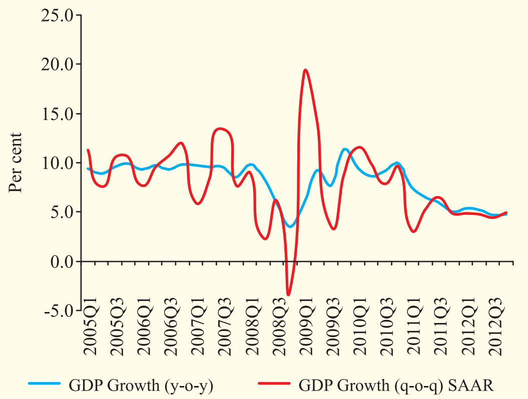
Item			2011-12				2012-13			
	2011-12*	2012-13#	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture, forestry & fishing	**3.6**	**1.9**	**5.4**	**3.2**	**4.1**	**2.0**	**2.9**	**1.7**	**1.8**	**1.4**
2. Industry	**2.7**	**1.2**	**6.5**	**2.7**	**0.9**	**1.0**	**-0.2**	**0.5**	**2.3**	**2.0**
2.1 Mining & quarrying	-0.6	-0.6	-0.4	-5.3	-2.6	5.2	0.4	1.7	-0.7	-3.1
2.2 Manufacturing	2.7	1.0	7.4	3.1	0.7	0.1	-1.0	0.1	2.5	2.6
2.3 Electricity, gas & water supply	6.5	4.2	6.6	8.4	7.7	3.5	6.2	3.2	4.5	2.8
3. Services	**7.9**	**6.8**	**8.3**	**8.2**	**8.1**	**7.0**	**7.6**	**7.1**	**6.2**	**6.3**
3.1 Trade, hotels, transport, storage and communication	7.0	6.4	9.5	7.0	6.9	5.1	6.1	6.8	6.4	6.2
3.2 Financing, insurance, real estate and business services	11.7	8.6	11.6	12.3	11.4	11.3	9.3	8.3	7.8	9.1
3.3 Community, social & personal services	6.0	6.6	3.5	6.5	6.8	6.8	8.9	8.4	5.6	4.0
3.4 Construction	5.6	4.3	3.8	6.5	6.9	5.1	7.0	3.1	2.9	4.4
4. GDP at factor cost (Total 1 to 3)	**6.2**	**5.0**	**7.5**	**6.5**	**6.0**	**5.1**	**5.4**	**5.2**	**4.7**	**4.8**

*: First Revised Estimates. #: Provisional Estimates.
Source: Central Statistics Office.

but were still not indicative of recovery setting in (Table I.1 and Chart I.3). The persistence in slowdown is reflected in below-trend growth for the seventh consecutive quarter since Q2 of 2011-12 (Chart I.4).

I.8 The year 2012-13, as a whole, witnessed a moderated GDP growth of 5.0 per cent – the lowest since 2002-03. Domestic policy uncertainties, governance concerns, the impact of earlier monetary tightening, slack external demand conditions and a weak monsoon, weighed down on the growth process during the year.

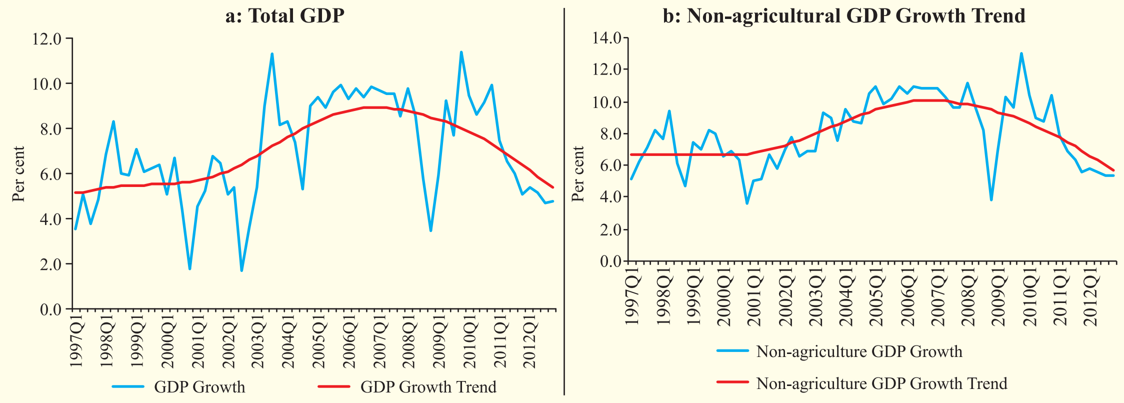
Chart I.3: Momentum Indicator of Growth



Agriculture growth is expected to pick up

I.9 The south-west monsoon of 2013 arrived on time and is forecasted to be normal by the India Meteorological Department (IMD). The progress of the monsoon has also been encouraging, with 29 out of 36 sub-divisions receiving excess or normal rainfall as of July 24, 2013 as against 14 last year. Six of the seven sub-divisions in east and north-east India besides the sub-division of 'Haryana and Chandigarh' have received deficient rainfall so far. However, the temporal and spatial progress of rainfall during the rest of the monsoon season may also influence the overall size of the *kharif* crop. In this context, the IMD forecast of normal rainfall during August 2013 at 96 per cent of the long period average (LPA) augurs well for *kharif* crops. The Reserve Bank's foodgrains' production weighted rainfall index for the period June 1 - July 24, 2013 indicate that the

Chart I.4: GDP Growth



rainfall was 17 per cent higher than the long period average compared with 24 per cent deficiency in the same period last year. *Kharif* sowing until July 26, 2013 was nearly 18 per cent higher than that of the previous year (Table I.2). It was also somewhat higher than the normal area sown at this point of time. Due to heavy rainfall in the current monsoon season so far, storage level of 85 major reservoirs as on July 25, 2013 was 66 per cent higher than the last 10 years' storage level. Although we are only half way through the monsoon season, it is expected that the performance of the agricultural sector during 2013-14 would be better than last year.

I.10 The current stock of rice and wheat, at 73.95 million tonnes, is lower by around 7 million tonnes than during last year, largely due to lower procurement on account of a decline in production and higher off-take under the public distribution system (PDS) during 2012-13. The higher off-take under PDS is expected to help reduce the prices of cereals, which have remained elevated in recent months. The drawdown of foodgrain stocks would also help reduce the carrying cost and ease the strains on

Table I.2: *Kharif* Production and Sowing

(Area in million hectares and production in million tonnes)

Crop Name	Sowing*		*Kharif* Production			Percentage Change		
	2012	2013	2010	2011	2012	Sowing	Production	
						2013	2011	2012
1	2	3	4	5	6	7	8	9
Foodgrain	34.1	41.9	120.9	131.3	128.2	22.9	8.6	-2.4
Rice	18.4	19.6	80.7	92.8	92.8	6.5	15.0	0.0
Coarse cereals	11.7	14.9	33.1	32.4	29.5	27.4	-2.1	-9.0
Pulses	4.0	7.4	7.1	6.1	5.9	85.0	-14.1	-3.3
Oilseeds	13.8	16.7	21.9	20.7	20.9	21.0	-5.5	1.0
Sugarcane	5.0	4.8	342.4	361.0	339.0	-4.0	5.4	-6.1
Cotton#	9.7	10.5	33.0	35.2	34.0	8.2	6.7	-3.4
Jute and mesta##	0.8	0.8	10.6	11.4	11.3	0.0	7.5	-0.9
All-crops	63.5	74.8	-	-	-	17.8	-	-

* : As on July 26. - : Not available.
#: Million bales of 170 kg each. ## : Million bales of 180 kg each.
Source: Ministry of Agriculture, GoI.

the storage capacity. Although the existing stocks of foodgrain are sufficient, the requirements may have to be re-assessed in light of the expected higher off-take under the National Food Security Bill (NFSB), when implemented.

Industrial sector growth remains subdued

I.11 The Index of Industrial Production (IIP) nearly stagnated during 2012-13, registering a dismal 1.1 per cent growth on a low base of 2.9 per cent in the preceding year. During April-May 2013, the IIP registered a marginal growth of 0.1 per cent as compared with 0.6 per cent during April-May 2012 (Table I.3). The pervasiveness of the slowdown is reflected across a wide range of industrial classifications. The contraction of the mining sector and capital goods continues to affect the overall performance of the industrial sector. Excluding capital goods and mining, the growth of the IIP during April-

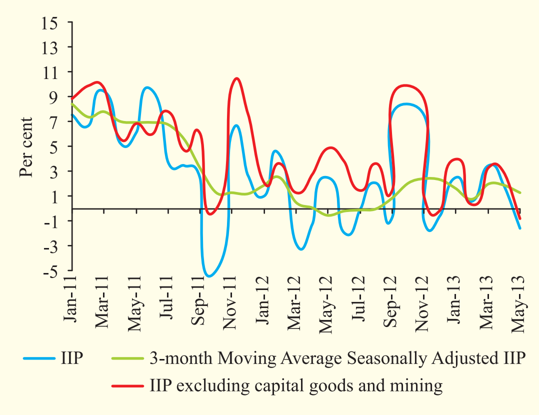
Table I.3: Index of Industrial Production: Sectoral and Use-Based Classification of Industries

(Per cent)

Industry Group	Weight in the IIP	Growth Rate		
		Apr-Mar 2012-13	April-May 2012-13	April-May 2013-14P
1	2	3	4	5
Sectoral				
Mining	14.2	-2.4	-1.7	-4.5
Manufacturing	75.5	1.2	0.4	0.1
Electricity	10.3	4.0	5.2	5.3
Use-Based				
Basic Goods	45.7	2.4	3.2	0.7
Capital Goods	8.8	-6.1	-15.2	-1.5
Intermediate Goods	15.7	1.6	0.8	2.1
Consumer Goods (a+b)	29.8	2.4	4.0	-1.0
a) Consumer Durables	8.5	2.0	7.5	-9.6
b) Consumer Non-durables	21.3	2.7	1.1	6.7
General	**100**	**1.1**	**0.6**	**0.1**

Note: P: Provisional
Source: Central Statistics Office.

Chart I.5: Industrial Growth (y-o-y)



May 2013 was 1.0 per cent (Chart I.5). Excluding volatile items, the truncated IIP (96 per cent of IIP) growth in April-May 2013 was 0.2 per cent (Chart I.6).

I.12 Manufacturing sector growth remained almost stagnant during April-May 2013. Important industries such as machinery and equipment, basic metals, fabricated metal products, computing machinery, food products and motor vehicles registered contraction in output during the period.

I.13 Persistent power shortages affected the capacity utilisation of the manufacturing sector. As a result, backlogs of work accumulated in the sector. The growth of power generation has remained at 5.3 per cent during April-May 2013. However, going forward, power generation is

Chart I.6: IIP vis-a-vis Truncated IIP (Y-o-Y)

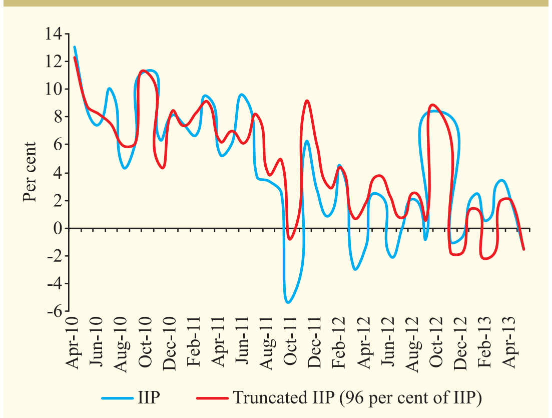
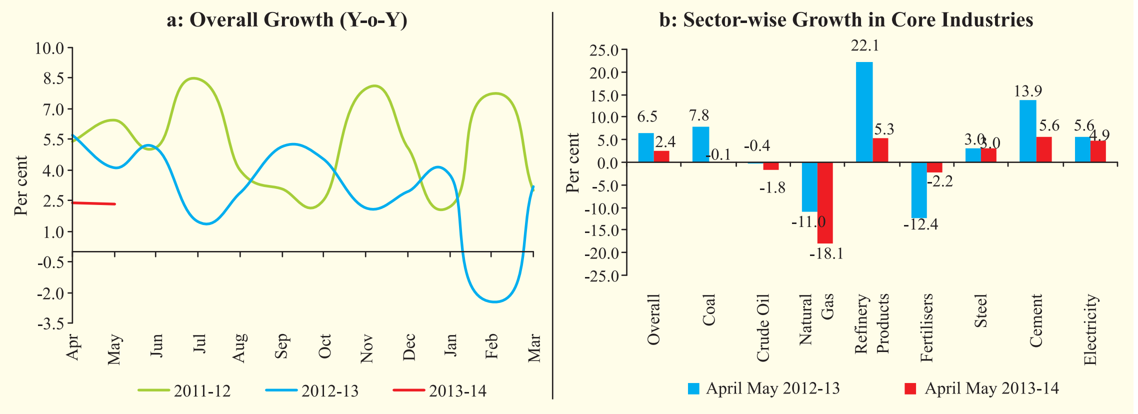


Chart I.7: Growth in Core Industries



expected to accelerate during the year with a normal monsoon and capacity additions, although the supply of coal may remain a constraint.

I.14 As per the use-based classification of industries, with the exception of intermediate goods and consumer non-durables, the growth of all other categories declined during April-May 2013 (Table I.3). The output of consumer durable goods has declined since December 2012, mainly due to a fall in the production of passenger cars and motor-cycles. The contraction of the capital goods sector continued in 2013-14. However, fast-tracking of investment projects is expected to generate higher demand for machinery and construction-related items and is, thus, likely to augment production in the capital goods sector.

Supply bottlenecks constraining core industries

I.15 Core industries continued to be adversely affected by supply bottlenecks and infrastructure constraints, thereby growing only at 2.4 per cent during April-May 2013-14, which is much lower than in the corresponding period of the previous year. While the output of coal, natural gas, fertilisers and crude oil contracted during the period, there was deceleration in the production of electricity, petroleum refinery products and cement (Chart I.7).

I.16 The recent initiatives by the government are expected to somewhat ease supply bottlenecks in the core industrial sector. In particular, the Union Cabinet's approval for setting up an independent regulatory authority for the coal sector is likely to benefit coal-dependent industries such as power, steel and cement. The envisaged changes in the gas pricing policy will incentivise investment in the Indian upstream sector and help boost production. Also, the target of rolling out ₹1 trillion worth of PPP projects in the infrastructure sector in the next six months will provide a boost to industry.

Capacity utilisation increased

I.17 Capacity utilisation (CU), as measured by the 21st Round of the Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank, recorded a seasonal increase in Q4 of 2012-13 over the previous quarter (http://www.rbi.org.in/OBICUS21). However, it remained well below the peaks observed in Q4 of 2010-11 and 2011-12. There is broad co-movement of the CU and de-trended IIP (Chart I.8). Although new orders continued to increase, its growth was lower than in the previous quarter. The raw material inventory to sales ratio, which had been increasing since Q1 of 2012-13, reversed its trend in Q4 of 2012-13, whereas the finished goods inventory to sales ratio increased considerably after reaching its lowest level in the previous quarter.

Chart I.8: Capacity Utilisation and De-trended IIP (Manufacturing)

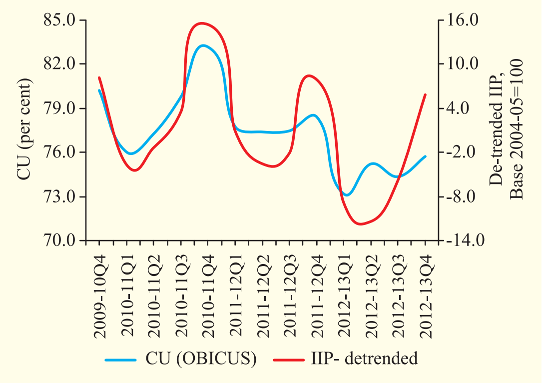
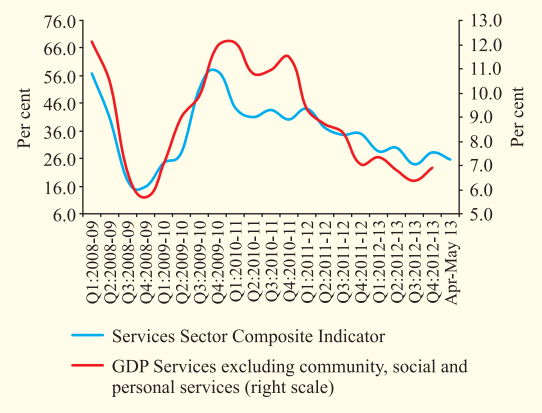


Chart I.9: Services Sector Composite Indicator



Services sector signals slowdown in growth

I.18 The services sector recorded the lowest growth in 11 years at 6.8 per cent during 2012-13. Activity in the 'financing, insurance, real estate & business services' and 'trade, hotels, restaurant, transport & communication' sectors decelerated. The decline in lead indicators, such as automobile sales, cargo handled at major ports and civil aviation sector, during April-June 2013 signal a further slowdown in the services sector (Table I.4). The Reserve Bank's services sector composite indicator, which is based on growth in indicators of construction, trade and transport and finance, showed an upturn in Q4 of 2012-13, but indicated a slight fall during April-May 2013 (Chart I.9).

Employment scenario weakened during 2011-2013

I.19 There has been a continuous decline in employment generation in the eight key sectors over the years. As per the Labour Bureau Survey, there was a significant decline in employment growth during 2012-13 compared

Table I.4: Lead Indicators of Services Sector Activity

(Growth in per cent)

Services Sector Indicators	2010-11	2011-12	2012-13	April-June 2012-13	April-June 2013-14
1	2	3	4	5	6
Tourist arrivals	10.0	9.7	2.9	1.7	1.8
Cement	4.5	6.7	9.3	13.9#	5.6#
Steel	13.2	10.3	2.5	3.0#	3.0#
Automobile sales	16.8	11.1	2.6	9.8	-2.1
Railway revenue-earning freight traffic	3.8	5.2	4.1	4.8	4.9
Cargo handled at major ports	1.5	-1.6	-2.5	-5.5	-1.0
Civil Aviation					
Domestic cargo traffic	23.8	-4.8	-3.4	2.0*	-6.8*
International cargo traffic	17.7	-1.9	-4.2	-6.0*	-0.2*
International passenger traffic	10.3	7.6	5.5	5.7*	8.3*
Domestic passenger traffic	18.1	15.1	-4.3	8.3*	-0.2*

Note : *: Data refers to April. #: Data refers to April-May.

Source: Ministry of Statistics and Programme Implementation, Ministry of Tourism, Press Information Bureau, Indian Ports Association, SIAM and CMIE.

Table I.5: Changes in Employment

(million)

Industry/Group	2009-10	2010-11	2011-12	2012-13
1	2	3	4	5
Textiles, including Apparel	0.06	0.1	0.09	0.14
Leather	0.01	0.03	-0.02	0.01
Metals	0.09	0.09	0.08	0.04
Automobiles	0.08	0.11	0.03	0.02
Gems and Jewellery	0.07	0.00	0.03	0.02
Transport	-0.01	0.00	0.04	0.00
IT/BPO	0.69	0.67	0.58	0.12
Handloom/Power loom	0.07	-0.01	0.00	0.00
Overall	**1.07**	**0.98**	**0.83**	**0.35**

Source: Employment Surveys, Labour Bureau.

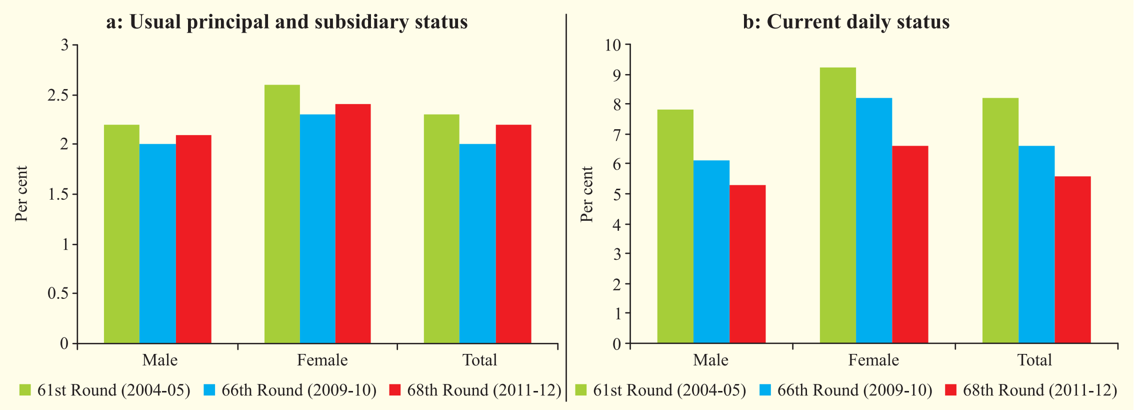
with the previous year (Table I.5). The IT/BPO sector, which has been taking the lead in employment generation, performed badly during 2012-13, reflecting the bearish business sentiments across the globe. However, as reported by the Labour Bureau, during January-March 2013, with the exception of transport, all sectors have shown a rise in employment compared with the same period last year.

I.20 As per the NSSO 68th Round (2011-12), the unemployment rate in terms of usual principal and subsidiary status (UPSS) increased in 2011-12 to 2.2 per cent (Chart I.10a). On a current daily status (CDS) basis, however, the unemployment rate continued its fall from 6.6 per cent in 2009-10 to 5.6 per cent in 2011-12, which reflects an increase in seasonal/contract employment (Chart I.10b). The Report shows that the CDS unemployment rate has decreased at a higher pace for females than males during 2011-12 over 2009-10.

Growth likely to improve at a slow pace

I.21 India's GDP growth is expected to improve in 2013-14, with recovery expected to take shape as the year progresses. The pace of recovery is, however, likely to be slow in view of the structural constraints. Recent policy measures by the government in various segments, especially in the infrastructure sector, are likely to help improve production activity. Timely, normal and well-spread rainfall will have a positive impact on agriculture production, which, in turn, may improve rural demand for industrial goods and services. The improvement in water storage levels in reservoirs due to heavy rainfall would enable the hydro power sector to enhance capacity utilisation. On the global front, the pick-up in growth in the US and Japan is likely to have a positive impact on global trade. The recent rupee depreciation, augurs well for India's exports. However, risks to growth in 2013-14 have increased significantly, with prospects that the global interest rate cycle could turnaround and diminish capital inflows to India.

Chart I.10: Unemployment Rate



II. AGGREGATE DEMAND*

Aggregate demand, as reflected on the expenditure side of GDP, remained sluggish during Q4 of 2012-13. Apart from investment, private consumption decelerated, adding to the drag on demand during 2012-13. Depressed private consumption, to a large part, has been the result of high consumer price inflation. Corporate investment intentions also remained languid, reflecting the overall negative business sentiment arising from slack cyclical conditions and structural factors. Corporate sales decelerated during Q4 of 2012-13, while earnings contracted. This, in turn, may have an adverse impact on new investment. In this situation, the key to turning around the economy will be re-balancing government spending from current to capital expenditures with a view to 'crowding-in' private investment.

Aggregate demand continued to remain weak

II.1 The expenditure-side GDP indicates that the aggregate demand of the Indian economy during Q4 of 2012-13 remained slack (Table II.1). Private final consumption expenditure, which is the principal component of GDP at market prices, continued to decelerate during the quarter on the back of weak agricultural production and persistent high consumer price inflation. Even so, it remains the largest contributor to growth in aggregate demand (Table II.2). The growth rate of government final consumption expenditure also moderated during Q4, reflecting fiscal consolidation efforts. Even though the growth rate of fixed investment

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

(Per cent)

Item	2011-12@	2012-13#	2011-12				2012-13			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
Growth Rates										
GDP at market prices	6.3	3.2	8.3	6.4	5.8	5.2	3.4	2.5	4.1	3.0
Total Consumption Expenditure	8.1	3.9	6.9	7.0	9.0	9.3	4.7	4.0	3.8	3.3
(i) Private	8.0	4.0	6.6	6.3	9.2	9.7	4.3	3.5	4.2	3.8
(ii) Government	8.6	3.9	8.4	10.7	8.1	7.6	7.2	6.9	2.2	0.6
Gross Fixed Capital Formation	4.4	1.7	13.9	3.8	-1.7	2.6	-2.2	1.1	4.5	3.4
Change in Stocks	-30.6	73.4	-27.5	-30.4	-32.0	-32.4	69.8	71.7	75.8	76.0
Valuables	6.6	-12.0	16.1	-13.3	8.4	16.0	-20.9	4.3	-6.9	-20.2
Net Exports	-42.5	-17.3	-14.8	-17.7	-82.1	-83.3	-6.7	-21.4	-23.7	-16.4
Relative shares										
Total Consumption Expenditure	70.5	71.0	71.2	71.8	73.7	65.7	72.1	72.8	73.5	65.9
(i) Private	59.2	59.6	60.6	61.2	61.4	54.3	61.1	61.8	61.4	54.7
(ii) Government	11.3	11.3	10.6	10.5	12.3	11.5	11.0	11.0	12.1	11.2
Gross Fixed Capital Formation	33.7	33.2	35.7	35.1	31.8	32.5	33.8	34.6	32.0	32.6
Change in Stocks	2.3	3.8	2.4	2.4	2.2	2.2	3.9	4.0	3.7	3.8
Valuables	2.4	2.0	2.8	2.1	2.2	2.3	2.1	2.2	2.0	1.8
Net Exports	-8.8	-10.0	-9.3	-9.3	-9.5	-7.4	-9.6	-11.0	-11.3	-8.4
Memo:										
GDP at market prices (₹ billion)	56314	58137	13252	13207	14473	15382	13702	13536	15062	15836

@: First Revised Estimates. #: Provisional Estimates.
Source: Central Statistics Office.

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

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

(Per cent)

Item	2011-12				2012-13			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9
1. Private Final Consumption Expenditure	4.1	3.9	5.4	5.0	2.6	2.2	2.6	2.1
2. Government Final Consumption Expenditure	0.9	1.1	1.0	0.9	0.8	0.7	0.3	0.1
3. Gross Fixed Capital Formation	4.7	1.4	-0.6	0.9	-0.8	0.4	1.4	1.1
4. Change in Stocks	-1.0	-1.1	-1.1	-1.1	1.7	1.7	1.7	1.7
5. Valuables	0.4	-0.3	0.2	0.3	-0.6	0.1	-0.2	-0.5
6. Net Exports	-1.3	-1.5	-4.6	-3.6	-0.6	-2.0	-2.3	-1.2
(i) Exports	4.3	4.3	2.4	3.1	3.0	1.2	-0.9	-0.2
(ii) Imports	5.6	5.8	6.9	6.6	3.6	3.2	1.4	1.1
7. Sum (1 to 6)	7.8	3.4	0.4	2.4	3.0	3.1	3.5	3.2
8. Discrepancies	0.5	3.0	5.4	2.7	0.4	-0.6	0.6	-0.3
9. GDP at Market Prices	8.3	6.4	5.8	5.2	3.4	2.5	4.1	3.0

*: Contribution-weighted growth rate of a component of expenditure-side GDP is obtained as follows: (Y-o-y change in the component ÷ Y-o-y change in GDP at constant market prices) × Y-o-y growth rate of GDP at constant market prices.
Source: Central Statistics Office.

during Q4 of 2012-13 was slightly higher than in the corresponding quarter of the previous year, aggregate fixed investment in the full year decelerated further.

Initiatives have started addressing infrastructure bottlenecks, although progress is slow

II.2 Infrastructure bottlenecks have been a major factor in India's low growth. Project implementations are getting delayed due to delays in land acquisition, forest/environment clearances, insurgency problems in mining belts, geological surprises, contractual issues, etc. As on May 1, 2013, nearly half of 566 central sector projects (of ₹1.5 billion and above) got delayed due to these problems, for which cost overruns are estimated to be around 18.2 per cent.

II.3 To address these issues, the government has taken several initiatives. For speedy clearance of projects, in addition to the Cabinet Committee on Infrastructure (CCI), a Project Monitoring Group (PMG) has been set up by the Prime Minister's Office (PMO) with the objective of resolving hurdles facing mega projects (above ₹10 billion).

II.4 In the power sector, the government has initiated several measures, such as renovation and modernisation of old power plants, improvement of coal and gas supplies, and greater emphasis on power generation from renewable sources. The government has also set up a committee (under the chairmanship of Dr. Vijay Kelkar) to prepare a road map to enhance domestic production of oil & gas.

II.5 With regard to road projects, the response to the PPP mode of road building remained poor. Several projects have not elicited bids. The developers have been facing a severe shortage of equity and, consequently, are unable to raise the required debt. The government has decided to adopt the Engineering, Procurement and Construction (EPC) mode for national highways which are not viable on a PPP basis. However, the Cabinet Committee on Economic Affair's (CCEA) decisions in June 2013 to facilitate harmonious substitution of concessionaire in ongoing and completed National Highway projects and insulating the National Highway Authority of India (NHAI) from heavy financial claims and unnecessary disputes are likely to expedite the implementation of road projects.

II.6 With the cancellation of 2G licences in February 2012, the telecommunications sector has been struggling, with a noticeable decline in investor interest. However, investor interest is expected to improve once the recent decision by the Telecom Commission approving 100 per cent FDI in the sector gets ratified.

Corporate investment intentions remain subdued

II.7 Corporate investment intentions remain subdued. Additionally, some of the institutionally assisted projects which received sanction in 2010-11 and 2011-12 have been cancelled. The aggregate project cost envisaged from new projects for which assistance was sanctioned by major banks/FIs, aggregated ₹2.0 trillion in 2012-13 and remained almost at the same level as that of the previous year (₹1.9 trillion) but significantly below that in 2010-11 (₹3.8 trillion) (Table II.3). An industry-wise analysis revealed that during Q4 of 2012-13, the share of envisaged expenditure on new projects is the highest in the metal & metal products sector (56.0 per cent), followed by the power industry (30.0 per cent) (Chart II.1).

Sales growth remained sluggish during Q4 of 2012-13

II.8 Sales growth for listed Non-Government Non-Financial (NGNF) companies decelerated further in Q4 of 2012-13 to 4.1 per cent (Table II.4). The decline in sales was more distinct in the case of motor vehicles, electricity

Chart II.1: Share of Envisaged Investment in Major Industries in Aggregate cost of Projects (per cent)

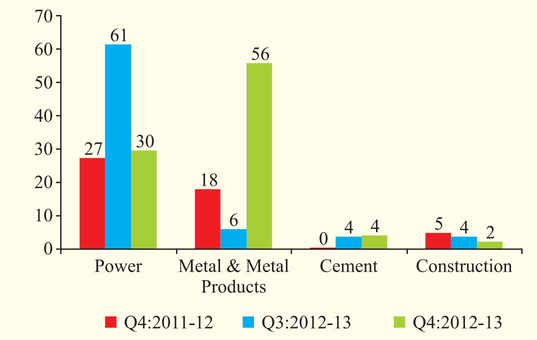


Table II.3: Institutionally Assisted Projects and their Envisaged Cost (Quarter-wise)*

Financial Year		No. of Projects	Project Expenditure (₹ billion)
1		2	3
2010-11	Q1	178	1,139
	Q2	196	1,043
	Q3	157	752
	Q4	166	818
2011-12	Q1	147	749
	Q2	184	452
	Q3	137	462
	Q4	168	253
2012-13	Q1	110	413
	Q2	132	666
	Q3	89	256
	Q4	94	629

Note: Based on data reported by 39 banks/FIs.
*: Data are provisional. Past data has been revised due to subsequent reporting, including the cancellation of projects.

Table II.4: Performance of Non-Government Non-Financial Companies

(Per cent)

	Q4 of 2011-12	Q1 of 2012-13	Q2 of 2012-13	Q3 of 2012-13	Q4 of 2012-13
1	2	3	4	5	6
No. of Companies			**2,419**		
			Growth Rates (y-o-y)		
Sales	15.6	14.0	11.7	9.4	4.1
Value of Production	14.1	13.4	12.4	8.1	4.0
Expenditure, *of which*	16.7	16.4	12.6	8.2	4.7
Raw Materials	16.7	13.6	14.6	9.3	2.6
Staff Cost	14.3	17.7	15.3	13.1	13.5
Power & Fuel	30.6	26.2	20.9	11.0	3.5
Operating Profits (EBITDA)	-0.7	-3.4	11.3	7.9	-0.2
Other Income*	49.4	28.4	49.2	0.3	-1.4
Depreciation	10.7	10.4	10.1	10.3	8.4
Gross Profits (EBIT)	4.0	-2.5	18.9	5.6	-2.7
Interest	40.2	38.4	11.3	17.1	11.1
Tax Provision	1.2	-3.4	11.0	5.1	-2.7
Net Profits (without NOP)	-6.7	-18.5	26.2	-0.7	-9.2
Net Profits	-6.4	-9.7	23.1	24.3	-15.5
			Select Ratios		
Change in stock to Sales #	0.9	0.8	1.4	0.8	0.9
Interest Burden	26.6	32.5	27.2	33.1	30.5
EBITDA to Sales	13.3	12.9	13.2	12.6	12.7
EBIT to Sales	12.6	11.6	12.8	11.3	11.8
Net Profit to Sales	7.1	6.1	7.1	5.8	5.7

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

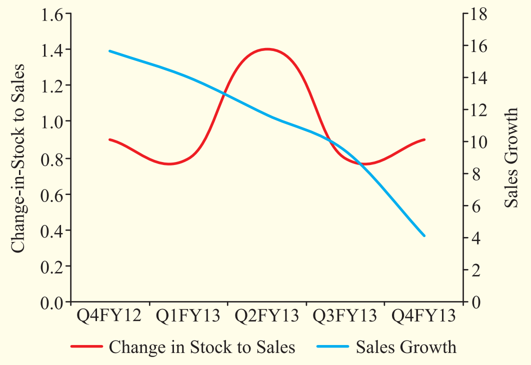
Table II.5: Performance of Non-Government Non-Financial Companies (Sequential Growth)

(Q-o-Q, per cent)

Indicator	Number of Companies: 2,419				
	2011-12	2012-13			
	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6
Sales	9.5	-4.5	0.7	3.8	4.4
Value of Production	8.4	-4.6	1.2	3.2	4.4
Expenditure, *of which*	7.7	-4.2	0.9	3.9	4.4
Raw Materials	10.0	-6.1	1.9	3.8	3.0
Staff Cost	2.1	6.0	3.4	1.3	2.4
Power & fuel	3.4	9.7	-3.2	0.1	-2.4
Operating Profits (EBITDA)	13.7	-7.3	3.4	-0.9	4.9
Other Income**	30.3	-22.6	41.1	-27.9	23.2
Depreciation	6.2	-1.7	1.8	3.7	3.1
Gross Profits (EBIT)	19.2	-12.1	11.0	-8.7	9.0
Interest*	7.6	7.3	-7.1	10.9	0.7
Tax Provision	15.3	-0.9	3.4	-11.0	6.5
Net Profits	52.0	-17.8	17.0	-15.0	3.1

*: Some companies report interest on net basis.
**: Other income excludes extraordinary income/expenditure, if reported explicitly.

Chart II.2: Movement in Sales Growth and Stock-in-Trade to Sales (per cent)



generation and supply, iron & steel and real estate. In tandem with the slow growth in sales, net profits went down in Q4 of 2012-13 due to higher employee expenses and lower support from other income. Sequentially (q-o-q), however, net profit recorded an improvement in Q4 (Table II.5). Further, profitability in terms of EBITDA and EBIT margins improved marginally in Q4 in comparison with the previous quarter. The net profit margin, however, recorded a marginal decline. Inventory accumulation (as reflected in change in stock-in-trade to sales ratio), which went up in Q2 of 2012-13, has reverted to earlier levels (Chart II.2). Early results for Q1 of 2013-14 suggest that sales growth has decelerated further.

Corporate leverage has increased gradually

II.9 The leverage of the corporate sector at the aggregate level, as measured by the total borrowing to equity ratio, increased in 2011-12, reversing a gradual and declining trend in the previous two years (Table II.6). Based on the available annual results of 621 non-government non-financial public limited companies, leverage is observed to have increased further in 2012-13.

Table II.6: Total borrowing to Equity: 2009-10 to 2011-12

	2009-10	2010-11	2011-12
1	2	3	4
Manufacturing	72.0	68.1	71.7
Of which			
Food products and beverages	112.8	116.4	114.7
Textiles	187.2	191.9	208.2
Coke and refined petroleum	46.2	44.8	46.4
Chemicals and chemical products	61.7	60.4	69.4
Cement and cement products	73.4	45.0	52.5
Iron and steel	112.6	106.7	115.3
Electrical equipment	50.5	48.4	38.9
Machinery	36.5	39.8	53.1
Motor vehicles and accessories	66.5	53.3	52.4
Electricity, gas, steam and air conditioning supply	61.6	70.6	114.6
Construction	89.0	95.5	80.8
Services	62.3	65.7	68.6
Of which			
Transportation and storage	121.3	241.5	338.9
Telecommunications	61.8	87.7	78.9
Computers and related activities	20.8	18.6	19.8
Real estate	70.1	76.1	62.0
All companies	**69.7**	**69.0**	**72.3**
Size by sales			
Large	66.6	65.2	71.5
Medium	79.9	82.4	85.2

Note: Large companies – annual sales above ₹10 billion; Medium companies – annual sales between ₹1 billion and ₹10 billion.

Fiscal consolidation resumed during 2012-13 mainly through expenditure cutbacks

II.10 The central government restricted its gross fiscal deficit (GFD) to 4.9 per cent of GDP during 2012-13, less than the budget estimate of 5.1 per cent (Table II.7). The containment in GFD, despite lower tax and non-tax revenues, was achieved mainly through a cutback in plan expenditure. Non-plan expenditure, on the other hand, was higher due to a sharp increase in expenditure on the revenue account. Subsidies on food, fertilisers and petroleum accounted for 2.5 per cent of GDP as against the 1.8 per cent that had been budgeted for the year. Overall, the revenue expenditure as a proportion of GDP was lower than the budget estimate by 0.3 percentage points, although it could not offset the shortfall in revenue receipts, which resulted in a higher revenue deficit.

Table II.7: Key Fiscal Indicators

(Per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal Deficit	Outstanding Liabilities @
1	2	3	4	5
	Centre			
2011-12	2.7	4.4	5.7	51.9
2012-13 PA	1.8 (1.9)	3.6 (3.4)	4.9 (5.1)	51.9#
2013-14 BE	1.5	3.3	4.8	51.1
	States*			
2011-12	0.4	-0.1	1.9	22.3
2012-13 RE	0.8	-0.2	2.3	22.0
2013-14 BE	0.6	-0.4	2.1	21.6
	Combined*			
2011-12	3.3	4.3	7.7	65.5
2012-13 RE	2.9	3.7	7.5	65.8
2013-14 BE	2.2	2.9	6.9	66.1

@: Includes external debt at current exchange rates.
#: Pertains to revised estimates.
*: Data in respect of states pertains to 26 state governments, of which one is Vote on Account.
PA: Provisional Accounts. BE: Budget Estimates.
RE: Revised Estimates.
Note: 1. Figures in parentheses are budget estimates.
2. Combined liabilities of 2013-14 are adjusted for states' investment in Treasury Bills as on July 19, 2013.
Source: Budget documents of central and state governments.

Tax collection remains weak during 2013-14 so far

II.11 During April-May 2013, key deficits of the Centre as percentages to budget estimates were higher than in the corresponding period of last year. The widening of the revenue deficit and higher capital expenditure resulted in a higher gross fiscal deficit during April-May 2013 than a year ago.

II.12 The revenue deficit as a percentage to budget estimate during April-May 2013 was higher due to both higher revenue expenditure and lower tax revenues. Gross tax revenue in absolute terms declined mainly due to a decline in revenues from corporation tax and union excise duties. The collection of income tax and service tax as percentages to budget estimates were also lower than a year ago.

II.13 Total expenditure, as a percentage of the budget estimate in the first two months (April-May) of 2013-14, was higher than a year ago, mainly due to higher plan and capital expenditure, which registered growth rates of 52.6 per cent and 48.9 per cent, respectively, over April-May 2012. On the other hand, despite higher payments of subsidies, non-plan expenditure in the revenue account, was lower than in the corresponding period of the previous year.

II.14 If the government's revenues fall short of the target due to slowdown in growth, a cutback in expenditure will be required to achieve the budgeted fiscal deficit. It is, therefore, important to contain subsidies and re-prioritise expenditure towards plan and capital expenditures, thereby enhancing the growth prospects of the economy.

State finances expected to remain on the consolidation track

II.15 Despite an increase in the consolidated GFD-GDP ratio in 2012-13 (RE), over the previous year, the GFD-GDP ratio was within the target set by the Thirteenth Finance Commission. The revenue account at the consolidated level recorded a surplus in 2012-13 (RE), *albeit* lower than budgeted.

II.16 The consolidated position of the state governments for 2013-14[1] is budgeted to show an increase in the revenue surplus-GDP ratio and a marginal improvement in the GFD-GDP ratio. The surplus in revenue account would be achieved by a reduction in the revenue expenditure-GDP ratio, while the revenue receipts-GDP ratio is budgeted to remain unchanged from the previous year's level. The expenditure pattern of the states shows that while the development expenditure-GDP ratio is budgeted to decline, the non-development expenditure-GDP ratio is budgeted to increase marginally during 2013-14. However, the capital outlay-GDP ratio is budgeted to be higher in 2013-14 than in 2012-13 (RE).

Table II.8: Combined Finances of Central and State Governments*

Item	Per cent to GDP		
	2011-12	2012-13 RE	2013-14 BE
1	2	3	4
1. Total Expenditure	26.4	27.9	27.9
2. Revenue Expenditure	22.5	23.8	23.4
3. Capital Expenditure	3.9	4.2	4.5
Of which: Capital Outlay	3.4	3.7	4.2
4. Non-development Expenditure	10.8	11.0	11.3
5. Development Expenditure	15.3	16.6	16.1
6. Revenue Receipts	18.3	20.0	20.4
i) Tax Revenue (net)	16.0	16.9	17.5
ii) Non-tax Revenue	2.2	3.1	3.0

*: Data in respect of states pertains to 26 state governments.
RE: Revised Estimates. BE: Budget Estimates.
Source: Budget documents of central and state governments.

Combined government finances budgeted to improve in 2013-14

II.17 Data on combined finances show that the revenue deficit and fiscal deficit as ratios to GDP in 2012-13 (RE) were lower by 0.6 percentage points and 0.2 percentage points, respectively, over the previous year. The decline in the combined GFD-GDP ratio was entirely on account of the lower fiscal deficit of the Centre (Table II.7). In 2013-14, the combined fiscal position is budgeted to improve further on account of fiscal plans of both the Centre and the states (Table II.8).

Need to keep the momentum of the fiscal consolidation and increase government investment in productive sectors

II.18 The government's fiscal consolidation process has contributed to improving the state of public finances in India at a critical juncture. The low collection of both tax and non-tax revenue during 2012-13 complicated the task of reducing fiscal imbalances. Thus, the containment of GFD in 2012-13 was brought about by expenditure compression on plan revenue account and also plan and non-plan capital account. The cuts in union government's capital expenditure were undertaken at a time when private investment had already decelerated. This raised concerns about the quality of fiscal consolidation. It is, therefore, important for the Centre to take steps to contain its non-plan revenue expenditure within the limit set in the Union Budget 2013-14 through subsidy reforms. Staying on the path of fiscal consolidation in the current year, however, remains challenging. Moderation in aggregate demand poses risks to budgetary projections for revenue. The recent exchange rate depreciation has compounded the problems in restraining subsidies. At the present juncture, it is important that the government restrains its subsidy commitments, strikes a judicious balance under its various budgetary heads by increasing investment in the productive sectors so as to crowd-in private investments. Tax reforms also need to be expedited to improve the tax/GDP ratio.

[1] Based on budget documents of 26 state government for 2013-14 of which one is Vote on Account.

III. THE EXTERNAL SECTOR

India's external sector imbalances have persisted and brought the rupee under pressure. Despite the moderation in the current account deficit (CAD) in Q4 of 2012-13, it remained above the sustainable level. The trade gap widened during Q1 of 2013-14 compared with Q1 of 2012-13. Exports contracted in Q1, while gold imports increased significantly. With uptrend in US yields, portfolio outflows since mid-May 2013 have caused the rupee to depreciate sharply against the US dollar. This was, however, broadly in line with other EMDE currencies, which also weakened as financial markets across the globe re-priced risks. Going forward, the CAD is expected to moderate in 2013-14. However, volatile markets and the potential tapering of quantitative easing in the US pose a risk to CAD financing. External sector policies would need to be carefully calibrated over the short to medium term with a view to containing the CAD within manageable levels and financing it through more stable flows.

Global trade remains subdued

III.1 With global growth remaining weak, world trade has remained subdued. The exports of many EMDEs, *viz.*, Brazil, Russia, Malaysia and Indonesia, have contracted in recent months (Table III.1). The subdued trend in Chinese export growth in May and June 2013, coupled with signs of its economic activity slowing, has further dimmed the prospects of global trade expansion.

III.2 India followed the trend of major EMDEs with a decline in its exports during Q1 of 2013. Improving export growth during 2013-14 will remain a challenge given the subdued prospects of global trade expansion. The IMF, in its July 2013 update of the WEO, has lowered the growth projection of world trade volume for 2013 by 0.5 percentage points to 3.1 per cent.

Trade deficit continues to be a concern in Q1 of 2013-14

III.3 Trends in exports and imports in Q1 of 2013-14 suggest a widening of the merchandise trade deficit. The trade deficit widened from US$ 42.2 billion in Q1 of 2012-13 to US$ 50.2 billion in Q1 of 2013-14, mainly on account of a sharp increase in gold imports. Reflecting global demand conditions, exports contracted in May and June 2013 after recording growth for five consecutive months (since December 2012). The engineering goods, gems & jewellery, electronics and iron ore sectors were the main contributors to the decline in exports in Q1 of 2013-14 (Chart III.1).

III.4 In contrast, imports grew by 6.0 per cent in Q1 of 2013-14 as against a decline of 5.7 per cent in Q1 of 2012-13. Gold imports have almost doubled from US$9.2 billion in Q1 of 2012-13 to US$ 17.9 billion in Q1 of 2013-14. Notwithstanding a fall of 5.7 per cent in international crude oil prices (Indian basket) in Q1 of 2013-14 (y-o-y), POL imports grew by 6.4 per cent. Non-oil non-gold imports continued

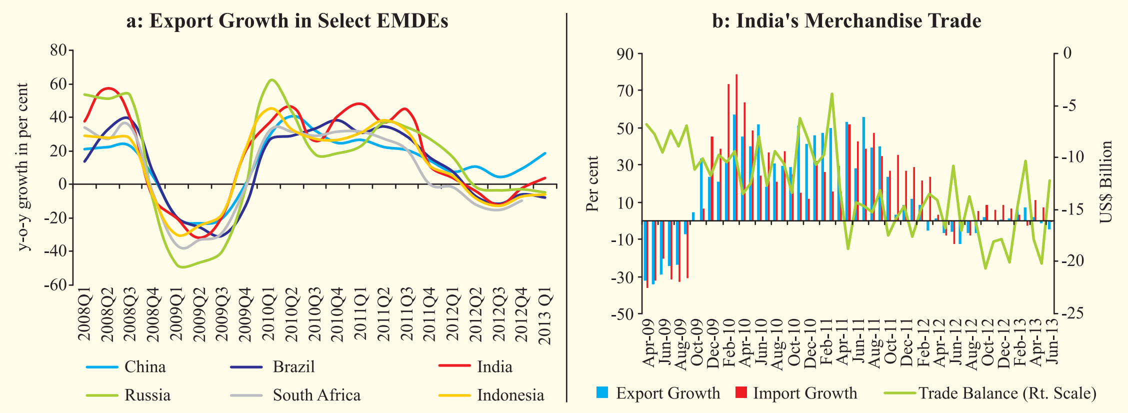
Table III.1: Country-wise Merchandise Export Growth

(Per cent)

	2012				2013		
	Q1	Q2	Q3	Q4	Q1	Apr	May
1	2	3	4	5	6	7	8
Brazil	7.5	-7.4	-11.6	-6.1	-7.7	5.4	-6.0
Hong Kong	-1.1	2.1	4.3	7.4	4.0	9.0	..
China	7.6	10.5	4.5	9.4	18.4	14.7	1.0
Euro area	-3.0	-12.5	-12.1	-3.4	-3.2	2.5	..
India	4.0	-4.0	-8.5	0.7	4.7	1.7	-1.1
Indonesia	5.3	-8.1	-12.9	-7.2	-6.1	-5.2	..
Malaysia	3.5	-0.4	-4.7	0.7	-3.2	-3.3	-5.8
Russia	16.3	-1.5	-3.6	-3.2	-4.9	-2.3	..
Singapore	6.0	-0.6	-5.9	-0.1	-6.8	2.7	1.6
Thailand	-2.9	0.7	-6.4	16.1	4.4	4.2	..
UK	2.5	-3.6	0.3	-2.9	-3.9	1.2	..
US	8.7	5.7	1.1	2.7	0.5	1.8	..

Source: International Financial Statistics, IMF and respective statistical agencies.

Chart III.1: Merchandise Trade Growth



to show contraction, reflecting subdued domestic growth conditions. Apart from gold and POL, the rise in imports of pearls, precious & semi-precious stones, non-ferrous metals and electronic goods also contributed to higher imports in Q1 of 2013-14 (Table III.2).

CAD narrowed significantly in Q4 of 2012-13

III.5 The current account deficit (CAD) moderated sharply to 3.6 per cent of GDP in Q4 of 2012-13 from 6.5 per cent in Q3 (4.4 per cent of GDP in Q4 of 2011-12). This was owing to the narrowing of the merchandise trade deficit underpinned by a pick-up in exports and a decline in imports (BoP basis) in Q4. However, net service exports remained subdued in Q4. The moderation in net secondary income compared with Q4 of 2011-12 mainly reflected a fall in net private remittances from abroad. Further, there was a significant outflow on account of income payments, reflecting growing liability-servicing obligations (Table III.3).

III.6 Despite the moderation in the CAD in Q4, the overall CAD during 2012-13 at 4.8 per

Table III.2: India's Merchandise Trade

(US$ billion)

Item	April–March				April–June			
	2011-12		2012-13 P		2012-13		2013-14	
	Value	Growth	Value	Growth	Value	Growth	Value	Growth
1	2	3	4	5	6	7	8	9
Exports	306.0	21.8	300.6	-1.8	73.5	-4.0	72.5	-1.4
Of which: Oil	56.0	35.1	60.0	7.1	13.0	-15.2	13.2	1.6
Non-oil	249.9	19.2	240.6	-3.7	60.4	-1.2	59.2	-2.0
Gold	6.7	10.9	6.5	-3.3	1.6	-3.1	1.4	-13.6
Non-oil Non-gold	243.2	19.5	234.1	-3.8	58.8	-1.1	57.8	-1.7
Imports	489.3	32.3	491.5	0.4	115.7	-5.7	122.6	6.0
Of which: Oil	155.0	46.2	169.4	9.3	39.4	-0.2	41.9	6.4
Non-oil	334.4	26.7	322.1	-3.7	76.4	-8.3	80.8	5.8
Gold	56.5	39.3	53.8	-4.7	9.2	-42.6	17.9	93.5
Non-oil Non-gold	277.9	24.5	268.3	-3.4	67.1	-0.1	62.9	-6.3
Trade Deficit	-183.4		-190.9		-42.2		-50.2	
Of which: Oil	-98.9		-109.4		-26.3		-28.6	
Non-oil	-84.4		-81.5		-15.9		-21.5	
Non-oil Non-gold	-34.7		-34.2		-8.3		-5.1	

Source: DGCI&S.

cent of GDP was far above the sustainable level (Table III.3). Trends in trade data suggest that the CAD may remain high in Q1 of 2013-14. However, in subsequent quarters, the CAD is expected to improve, since the import demand for gold may moderate. The global price of gold has declined sharply, partly due to US dollar appreciation and signs of recovery in the US economy. With the end of the gold super-cycle, the speculative demand for gold is likely to decline. Besides, various measures have been undertaken domestically to curb import demand for gold, that *inter alia* include (i) a hike in customs duty to 8 per cent and (ii) measures towards rationalisation of gold imports by both nominated agencies and banks.

III.7 In particular, on July 22, 2013, all nominated banks / agencies were instructed to ensure that at least one fifth of every lot of import of gold (in any form/purity) is retained in customs bonded warehouses for the purpose of export and fresh imports of gold is permitted only after 75 per cent of the retained gold is actually exported. This new measure replaced the earlier restrictions on import of gold on consignment basis and opening letters of credit subject to 100 per cent cash margin. To some extent, the recently launched inflation-linked bonds may also wean away investors who use gold as a hedge against inflation. If the current recovery in the US and Japan continues, it may help improve India's exports to these destinations. The combined influence of these factors may augur well for India's CAD during 2013-14.

Capital flows became volatile

III.8 Although net capital flows moderated in Q4 of 2012-13, they were adequate to finance the CAD, and indeed there was net accretion of US$ 2.7 billion in India's foreign exchange reserves during this period. The lower net capital flows in Q4 of 2012-13 were mainly due

Table III.3: Major Items of India's Balance of Payments

(US $ billion)

	2011-12 (PR)	2012-13 (P)	2012-13			
			Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (P)
1	2	3	4	5	6	7
1. Goods Exports	309.8	306.6	75.0	72.6	74.2	84.8
2. Goods Imports	499.5	502.2	118.9	120.4	132.6	130.4
3. Trade Balance (1-2)	-189.7	-195.7	-43.8	-47.8	-58.4	-45.6
4. Services Exports	140.9	145.7	35.8	35.0	37.1	37.8
5. Services Imports	76.9	80.8	20.8	18.7	20.4	20.9
6. Net Services (4-5)	64.0	64.9	15.0	16.3	16.6	17.0
7. Goods & Services Balances (3+6)	-125.7	-130.7	-28.8	-31.5	-41.7	-28.7
8. Primary Income (Net)	-16.0	-21.5	-4.9	-5.6	-5.8	-5.2
9. Secondary Income (Net)	63.5	64.4	16.8	16.1	15.7	15.8
10. Net Income (8+9)	47.5	42.9	11.9	10.5	9.9	10.6
11. Current Account Balance (7+10)	-78.2	-87.8	-16.9	-21.0	-31.9	-18.1
12. Capital Account Balance	-0.1	-0.3	-0.2	-0.2	0.02	0.2
13. Financial Account Balance	80.7	85.4	16.1	21.0	30.8	17.6
of which: Change in Reserves	12.8	-3.8	-0.5	0.2	-0.8	-2.7
14. Errors & Omissions -(11+12+13)	-2.4	2.7	1.1	0.2	1.1	0.3
Memo: As a ratio to GDP						
15. Trade Balance	-10.1	-10.6	-10.2	-11.4	-12.0	-9.0
16. Net Services	3.3	3.5	3.5	3.9	3.4	3.3
17. Net Income	2.5	2.3	2.8	2.5	2.0	2.1
18. Current Account Balance	-4.2	-4.8	-4.0	-5.0	-6.5	-3.6
19. Capital and Financial Account, Net (Excl. changes in reserves)	3.6	4.8	3.8	4.9	6.5	4.0

Note: Total of sub-components may not tally with aggregate due to rounding off.
P: Preliminary; PR: Partially Revised.

Table III.4: Disaggregated Items of Financial Account

(US$ billion)

	2011-12 (P)	2012-13 (P)	2012-13 Q1 (PR)	2012-13 Q2 (PR)	2012-13 Q3 (PR)	2012-13 Q4 (P)
1	2	2	3	4	5	6
1. Direct Investment (net)	**22.1**	**19.8**	**3.8**	**8.2**	**2.1**	**5.7**
1.a Direct Investment to India	33.0	26.9	5.9	9.5	4.3	7.2
1.b Direct Investment by India	-10.9	-7.1	-2.1	-1.4	-2.2	-1.4
2. Portfolio Investment	**16.6**	**26.7**	**-2.0**	**7.6**	**9.7**	**11.3**
2.a Portfolio Investment in India	16.8	27.6	-1.7	7.9	9.8	11.5
2.b Portfolio Investment by India	-0.2	-0.9	-0.3	-0.3	-0.1	-0.2
3. Financial Derivatives & Employee Stock Options	**-**	**-2.3**	**-0.6**	**-0.5**	**-0.4**	**-0.9**
4. Other Investment	**29.2**	**45.2**	**15.4**	**5.6**	**20.0**	**4.2**
4.a Other equity (ADRs/GDRs)	0.6	0.2	0.1	0.1	0.0	0.0
4.b Currency and deposits	12.1	15.3	6.4	3.5	2.6	2.8
Deposit-taking corporations, except the central bank: (NRI Deposits)	11.9	14.8	6.6	2.8	2.7	2.8
4.c Loans*	16.8	10.7	3.5	3.0	5.7	-1.6
4.c.i Loans to India	15.7	11.1	3.5	3.3	5.9	-1.6
Deposit-taking corporations, except the central bank	4.1	1.3	3.0	2.0	2.7	-6.3
General government (External Assistance)	2.5	1.3	0.1	0.1	0.4	0.6
Other sectors (ECBs)	9.1	8.6	0.4	1.2	2.9	4.1
4.c.ii Loans by India	1.0	-0.4	0.1	-0.3	-0.2	0.0
General government (External Assistance)	-0.2	-0.3	-0.1	-0.1	-0.1	-0.1
Other sectors (ECBs)	1.2	-0.1	0.1	-0.3	-0.1	0.1
4.d Trade credit and advances	6.7	21.7	5.4	4.1	7.7	4.5
4.e Other accounts receivable/payable	-6.9	-2.7	-0.1	-5.1	4.0	-1.5
5. Reserve assets	**12.8**	**-3.8**	**-0.5**	**0.2**	**-0.8**	**-2.7**
Financial Account (1+2+3+4)	**80.7**	**85.4**	**16.1**	**21.0**	**30.8**	**17.6**

Note: Total of sub-components may not tally with aggregate due to rounding off.
P: Preliminary; PR: Partially Revised.
*: Includes External Assistance, ECBs, non-NRI Banking Capital and short term trade credit.

to higher repayments of short-term trade credit and overseas borrowings by banks compared with Q3. Net FDI flows were, however, significantly higher in Q4 of 2012-13 than in the preceding quarter (Table III.4).

III.9 Trends to date in 2013-14 suggest an uptrend in capital flows in the form of FDI and NRI deposits, while ECBs showed a decline as compared with previous quarter (Table III.5). Net FII flows were substantial until the third week of May 2013, followed by a significant outflow in the subsequent period. Since the last week of May 2013, there was a net outflow of US$ 12.1 billion on account of FIIs (till July 18). The reversal of FII flows from the domestic market was mainly evident in the debt segment. The outflows of FIIs from the domestic debt market was led by the global bond sell-offs on Fed signals that raised the prospects of global interest rates hardening, shifts in yield spreads and the elevated cost of hedging a volatile rupee (Chart III.2).

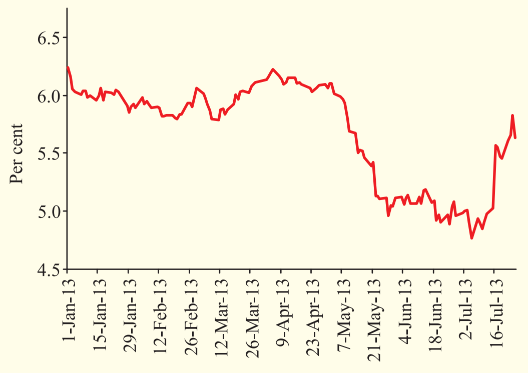
Table III.5: Trend in Capital Flows

(US$ billion)

	2012-13 (Monthly Average) Q1	Q2	Q3	Q4	2013-14 Apr-May
1	2	3	4	5	6
FDI in India	2.0	3.2	1.4	2.4	2.7
FDI by India	0.7	0.5	0.7	0.5	0.3
FIIs	-0.6	2.6	3.3	3.8	-0.2#
ADRs/GDRs	0.03	0.03	0.0	0.0	0.0
ECBs	0.1	0.4	1.0	1.4	0.8
NRI Deposits	2.2	0.9	0.9	0.9	1.5

#: Apr-Jun 2013

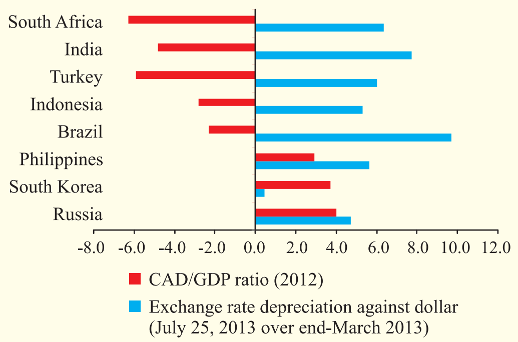
Chart III.2: Spread between 10-year Sovereign Yield of India and USA



Rupee depreciated significantly in Q1 of 2013-14

III.10 In line with most EMDEs, the Indian rupee depreciated by around 9 per cent during Q1 of 2013-14 (Chart III.3). The Rupee appreciated in April 2013, but the trend reversed from the start of May, with dollar gaining strength on better growth prospects. Wider trade deficit and rising gold imports also put pressure on the rupee. Since the Fed Chairman's May 22, 2013, testimony the rupee depreciated significantly (by 7.5 per cent) till July 15 as global investors began unwinding their risky positions in emerging markets, anticipating that the US Fed could begin tapering its asset purchases. The dollar strengthening against major currencies, coupled with widening trade deficit drove the rupee to a new low of ₹61.05 against the dollar on July 8, 2013.

Chart III.3: CAD and Exchange Rate Movement (in per cent)



Note: CAD/GDP ratio for India pertains to FY 2012-13.

III.11 The Reserve Bank's measures on July 15, 2013 to address exchange rate volatility helped stabilise the rupee subsequently. The government's announcement on July 16, 2013 proposing to liberalise FDI in single brand retail, petroleum and natural gas, defence production and some other sectors also improved sentiments and work towards bring some stability to the rupee.

III.12 In terms of the real exchange rate, as at the end of Q1 of 2013-14, the 6-currency and 36-currency REER showed depreciation of 9.0 per cent and 7.9 per cent, respectively, over March 2013, reflecting weakening of the rupee in nominal terms (Table III.6).

External debt rose further in Q4 of 2012-13

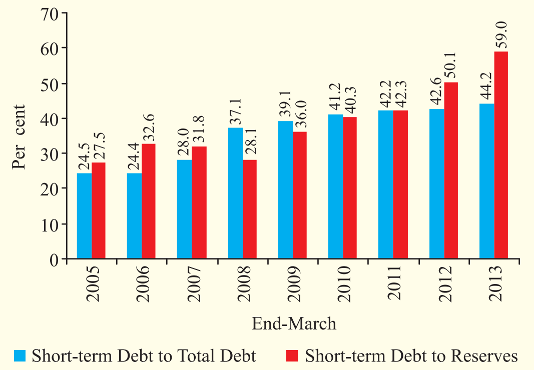
III.13 The widening CAD, financed through higher debt flows, resulted in a significant rise in India's external debt during 2012-13 (Chart III.4). India's external debt stood at US$ 390 billion at end-March 2013. There has been a sizeable rise in external commercial borrowings (ECBs) and rupee-denominated non-resident Indian deposits. Short-term debts, on residual maturity basis have surged by about US$ 25

Table III.6: Nominal and Real Effective Exchange Rates: Trade-Based (Base: 2004-05=100)

	Index July 19, 2013 (P)	y-o-y Variation (Average) 2012-13	FY Variation (July 19, 2013) over March 2013
1	2	3	4
36- REER	87.72	-6.7	-7.7
36-NEER	72.39	-10.4	-8.0
6-REER	96.85	-5.8	-9.3
6-NEER	69.14	-10.3	-9.5
₹/US$ (over end-March)	59.80	-11.9	-9.0

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

Chart III.4: Short Term Debt Indicators (based on residual maturity)



billion in 2012-13 (Table III.7). In view of the rise in external debt and shortening maturities, there is a need to keep a close vigil on external debt levels and its components, especially private corporate debt. In this milieu, the Reserve Bank has proposed to levy capital and provisioning requirements for corporates that have unhedged foreign currency exposure and issued draft guidelines for the same.

Table III.7: India's External Debt

(US$ billion)

Item	End-March 2011 (PR)	End-March 2012 (PR)	End-Dec 2012 (PR)	End-Mar 2013 (P)	Variation (end-Mar 2013 over end-Dec 2012) Per cent
1	2	3	4	5	6
1. Multilateral	48.5	50.5	51.6	51.6	0.0
2. Bilateral	25.7	26.9	26.4	25.1	-4.9
3. IMF	6.3	6.2	6.1	5.96	-2.5
4. Trade Credit (above 1 year)	18.6	19.1	18.6	17.7	-4.7
5. ECBs	88.5	104.8	112.7	120.9	7.2
6. NRI Deposits	51.7	58.6	67.6	70.8	4.8
7. Rupee Debt	1.6	1.4	1.3	1.3	0.3
8. Long-term (1 to 7)	240.9	267.3	284.3	293.3	3.2
9. Short-term (Original Maturity)	65.0	78.2	93.3	96.7	3.6
10. Short-term (Residual Maturity) #	129.1	147.4	166.1	172.3	3.7
Total (8+9)	**305.9**	**345.5**	**377.6**	**390.0**	**3.3**

PR: Partially Revised, P: Provisional, #: RBI Estimate.
Note: Growth rates are based on data up to 3 decimal points.

Vulnerability indicators show further worsening

III.14 With rising debt and deceleration in GDP growth, external sector vulnerability increased in 2012-13 compared with the previous year. India's external debt to GDP ratio increased to 21.2 per cent at end-March 2013 from 19.7 per cent at end-March 2012. Moreover, the ratio of short-term debt (both original and residual maturity) to total external debt increased further at end-March 2013. The ratio of reserves to total debt deteriorated through 2012-13 and stood at 74.9 per cent by the end of March 2013. Reflecting widening CAD, the net international investment position (IIP) as a ratio to GDP worsened from (–)14 per cent at end-March 2012 to (–)16.7 per cent at end-March 2013 (Table III.8).

Table III.8: External Sector Vulnerability Indicators

(per cent)

Indicator	End-Mar 2011	End-Mar 2012	End-Mar 2013
1	2	3	4
1. Ratio of Total Debt to GDP	17.5	19.7	21.2
2. Ratio of Short-term to Total Debt (Original Maturity)	21.2	22.6	24.8
3. Ratio of Short-term to Total Debt (Residual Maturity)#	42.2	42.6	44.2
4. Ratio of Concessional Debt to Total Debt	15.5	13.9	11.7
5. Ratio of Reserves to Total Debt	99.7	85.2	74.9
6. Ratio of Short-term Debt to Reserves	21.3	26.6	33.1
7. Ratio of Short-term Debt (Residual Maturity) to Reserves#	42.3	50.1	59.0
8. Reserves Cover of Imports (in months)	9.5	7.1	7.0
9. Debt-Service Ratio (Debt Service Payments to Current Receipts)	4.4	6.0	5.9
10. External Debt (US$ billion)	305.9	345.5	390.0
11. International Investment Position (IIP) (US$ billion)	-207.0	-249.5	-307.3
12. IIP/GDP ratio	-11.9	-14.0	-16.7

RBI Estimate

CAD may moderate in 2013-14, but risks to its financing remain

III.15 The CAD narrowed somewhat in Q4, but it remained above the sustainable level. It is likely that the widening trade deficit in Q1 of 2013-14 compared with the corresponding period of the previous year may manifest in a wider CAD in the quarter. However, the CAD could moderate over subsequent quarters if gold imports show significant contraction, global crude oil prices stay low and exports get some support from global recovery. Nevertheless, the CAD is likely to stay significantly higher than the sustainable level of 2.5 per cent. As such, a strategy aiming at its reduction and at the same time ensuring its financing with stable and non-debt resources, such as FDI will be necessary. It is also important to remove structural impediments constraining India's export competitiveness and to sustain non-debt-creating flows over the medium term.

III.16 There are certain global risks that call for appropriate policy attention. International crude oil prices, though showing a downtrend since February 2013, would largely be impacted by the outlook on global growth, geo-political uncertainties and supply-side factors. High remittances underpinned by significant depreciation of the rupee in recent months and anticipated recovery in source countries may attenuate concerns relating to financing the CAD. However, the most important risk is that at some stage, exit from accommodative monetary policy in the US may tighten global liquidity, with implications for capital flows to EMDEs, including India. The resulting volatile capital flows could impede smooth financing of the CAD in 2013-14. In this context, continued policy reforms assume utmost importance to ensure a conducive economic and business environment to attract more stable capital flows to the Indian economy.

IV. MONETARY AND LIQUIDITY CONDITIONS

With moderation in headline inflation, the Reserve Bank eased the repo rate by 25 basis points in May 2013 on top of a 100 bps rate cut during 2012-13. During Q1 of 2013-14, liquidity conditions improved considerably and broad money growth broadly remained in line with the indicative trajectory. Credit growth decelerated with the slack in economic activity and deterioration in asset quality. The Reserve Bank took a slew of measures during July 2013 with a view to alter monetary and liquidity conditions and thereby to restore stability in the forex market. Going forward, the monetary policy will be conditioned by the need to maintain stable macro-economic environment by moving towards attaining external and internal balance and to support growth, while anchoring inflation expectations.

The Reserve Bank undertakes monetary policy measures to curb forex volatility

IV.1 The stance of the Reserve Bank's monetary policy for 2013-14 has been shaped to address risks to growth and guard against re-emergence of inflation while maintaining overall macro-financial stability. On the back of empirical evidence that inflation below threshold level is conducive to sustained growth, the Reserve Bank has emphasised low and stable inflation in promoting growth over the long term. In 2012-13, after frontloading a 50 bps policy rate reduction, the Reserve Bank strived to address sluggish credit growth and tight liquidity conditions with a series of calibrated measures that included cuts in the CRR and SLR and ₹1.5 trillion in outright OMO purchases, besides large accommodation provided through LAF repos. With headline inflation moderating, the Reserve Bank reduced the repo rate by 25 bps in May 2013, over and above the 50 bps reduction in Q4 of 2012-13. With capital outflows, wide current account deficit and high consumer price inflation the Reserve Bank kept the repo rate

Table IV.1: Movements in Key Policy Variables

(per cent)

Effective since	Reverse Repo Rate	Repo Rate	Marginal Standing Facility@	Cash Reserve Ratio*	Statutory Liquidity Ratio*
1	2	3	4	5	6
May 03, 2011	6.25 (+0.50)	7.25 (+0.50)	8.25 (+0.50)	6.00	24
June 16, 2011	6.50 (+0.25)	7.50 (+0.25)	8.50 (+0.25)	6.00	24
July 26, 2011	7.00 (+0.50)	8.00 (+0.50)	9.00 (+0.50)	6.00	24
September 16, 2011	7.25 (+0.25)	8.25 (+0.25)	9.25 (+0.25)	6.00	24
October 25, 2011	7.50 (+0.25)	8.50 (+0.25)	9.50 (+0.25)	6.00	24
January 28, 2012	7.50	8.50	9.50	5.50 (-0.50)	24
March 10, 2012	7.50	8.50	9.50	4.75 (-0.75)	24
April 17, 2012	7.00 (-0.50)	8.00 (-0.50)	9.00 (-0.50)	4.75	24
August 11, 2012	7.00	8.00	9.00	4.75	23 (-1.00)
September 22, 2012	7.00	8.00	9.00	4.50 (-0.25)	23
November 03, 2012	7.00	8.00	9.00	4.25 (-0.25)	23
January 29, 2013	6.75 (-0.25)	7.75 (-0.25)	8.75 (-0.25)	4.25	23
February 09, 2013	6.75	7.75	8.75	4.00 (-0.25)	23
March 19, 2013	6.50 (-0.25)	7.50 (-0.25)	8.50 (-0.25)	4.00	23
May 03, 2013	6.25 (-0.25)	7.25 (-0.25)	8.25 (-0.25)	4.00	23
July 15, 2013	6.25	7.25	10.25 (+2.00)	4.00	23

*: Per cent of net demand and time liabilities. @: With effect from Feb 13, 2012 Bank Rate was aligned to MSF rate.
Note: Figures in parentheses indicate changes in percentage points.

unchanged in the mid-quarter review of the monetary policy, 2013-14 (Table IV.1) subsequently, in order to restore stability in the forex market, the Reserve Bank has taken several measures since mid-July 2013, which, include: (i) hike in Marginal Standing Facility rate/Bank Rate; (ii) restriction on banks' access to funds under LAF repo; (iii) OMO sales; (iv) maintenance of minimum daily CRR balances by SCBs at 99 per cent of the requirement; (v) capping of PDs' access to LAF at 100 per cent of their individual net owned funds; and (vi) restrictions on gold import.

IV.2 Cumulatively, there has been a 125 bps reduction in the policy rate since the start of 2012-13. The transmission of monetary easing enabled the Weighted Average Lending Rates (WALR) based on all borrowal accounts to decline by 41 bps during 2012-13 (Table IV.2). The modal deposit rate and the modal base rate of the banks declined by 11 bps and 50 bps, respectively. More recent data suggest that the WALR of fresh rupee loans sanctioned by reporting banks declined considerably during April-June 2013. The softening of rates on fresh loans were visible in the commercial vehicle segment and housing loans under both personal and commercial segments.

IV.3 During Q1 of 2013-14, with the increase in the government's spending, liquidity conditions eased. Moreover, the Reserve Bank conducted two OMO purchase auctions during the first quarter, injecting liquidity to the tune of ₹165 billion. An increase in the currency in circulation and in banks' excess balances maintained with the Reserve Bank led to the withdrawal of liquidity from the banking system during the quarter (Chart IV.1(a) and (b)).

Liquidity conditions eased in Q1 of 2013-14

IV.4 Liquidity condition improved in April 2013, which was followed by a marginal increase in the liquidity deficit during May 2013 mainly on account of an increase in the currency in circulation. Liquidity conditions again improved in June 2013, with the liquidity deficit staying within the Reserve Bank's comfort zone of (–1) per cent of

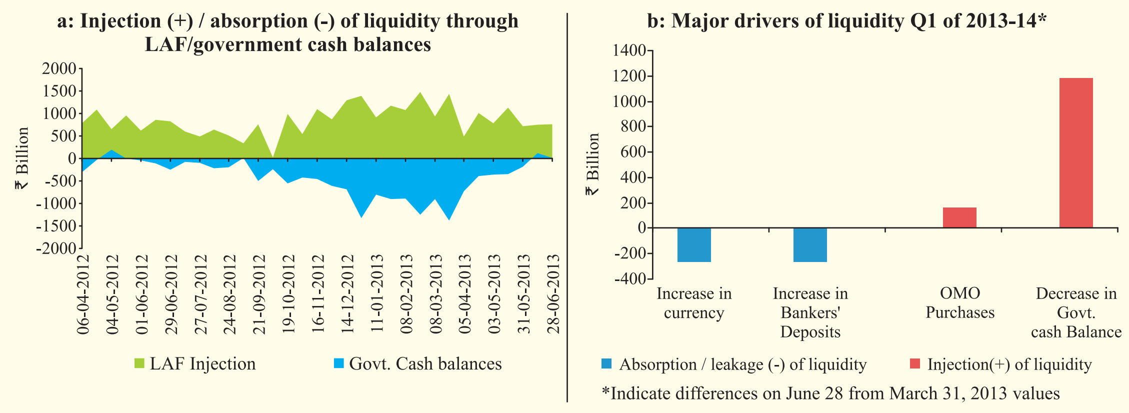
Table IV.2: Deposit and Lending Rates of Banks

(Per cent)

Items	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	June-13
1	2	3	4	5	6	7
1. Domestic Deposit Rate (1-3 year tenor)						
i) Public Sector Banks	9.00-9.75	8.75-9.50	8.50-9.30	8.50-9.10	8.75-9.10	8.00-9.10
ii) Private Sector Banks	8.00-10.50	8.00-10.00	8.00-9.75	8.00-9.75	8.00-9.65	8.50-9.50
iii) Foreign banks	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.60	3.60-9.88
Modal Deposit Rate of SCBs (all tenors)	***7.42***	***7.40***	***7.29***	***7.33***	***7.31***	***7.26***
2. Base Rate						
i) Public Sector Banks	10.00-10.75	10.00-10.50	9.75-10.50	9.75-10.50	9.70-10.25	9.70-10.25
ii) Private Sector Banks	10.00-11.25	9.75-11.25	9.75-11.25	9.70-11.25	9.70-11.25	9.60-11.25
iii) Foreign Banks	7.38-11.85	7.38-11.85	7.25-11.75	7.20-11.75	7.20-14.50	7.20-14.00
Modal Base Rate of SCBs	***10.75***	***10.50***	***10.50***	***10.50***	***10.25***	***10.25***
3. Weighted Average Lending Rate (WALR)*						
i) Public Sector Banks	12.65	12.36	12.29	12.19	12.14	12.06
ii) Private Sector Banks	12.31	12.42	12.32	12.14	12.13	12.01
iii) Foreign Banks	11.86	12.00	11.64	11.51	12.10	12.24
WALR of SCBs	***12.54***	***12.35***	***12.26***	***12.14***	***12.13***	***12.07***

*: Based on Loan outstanding as on end-quarter.
Note: Data on WALR are provisional.

Chart IV.1: Liquidity and its Drivers



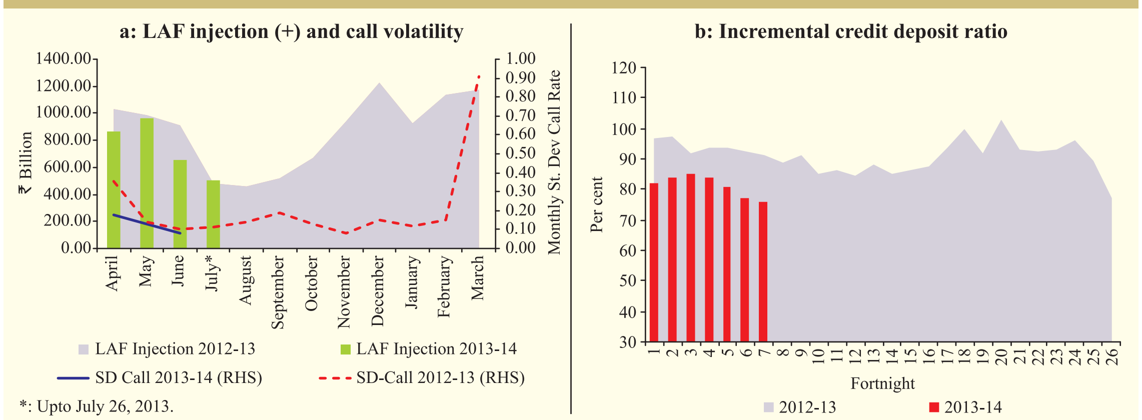
NDTL, despite quarter-end advance tax outflows from the banking system. Banks' recourse to liquidity from the Reserve Bank's LAF window also moderated as credit growth decelerated. Consequently, the incremental credit-deposit ratio has declined in Q1 of 2013-14 and the gap between deposit and credit has closed (Chart IV.2).

IV.5 Reflecting the comfortable liquidity conditions in Q1 of 2013-14, SCBs took recourse to MSF on only four occasions during the quarter and borrowed around ₹20 billion.

IV.6 However, global financial market developments following the signalling on likely tapering of QE in the US brought new risks to the fore, prompting monetary policy to recalibrate towards addressing them. The Fed signals triggered outflows of portfolio investment, particularly from the debt segment. This has led to significant depreciation of the rupee since end-May 2013.

IV.7 In face of rupee volatility the Reserve Bank announced measures on July 15, 2013 to restore stability to the foreign exchange market that had effects on the inter-bank liquidity. The MSF rate was re-calibrated at 300 basis points above the policy repo rate under the LAF. Further, the overall allocation of funds under LAF was capped at 1.0 per cent of the Net Demand and Time Liabilities (NDTL) of the banking system, with the cap reckoned at ₹750 billion. The Reserve Bank also conducted open market sales of G-secs withdrawing liquidity to the tune of ₹25 billion on July 18, 2013.

Chart IV.2: Liqidity Easing and Call Volatility



IV.8 While the above set of measures had a restraining effect on volatility with a concomitant stabilising effect on the exchange rate, based on a review of these measures, and an assessment of the liquidity and overall market conditions going forward, it was decided on July 23, 2013 to modify the liquidity tightening measures. The modified norms have set the overall limit for access to LAF by each individual bank at 0.5 per cent of its own NDTL outstanding as on the last Friday of the second preceding fortnight effective from July 24, 2013. Moreover, effective from the first day of the fortnight beginning from July 27, 2013 banks will be required to maintain a minimum daily CRR balance of 99 per cent of the average fortnightly requirement.

Reserve money adjusted for CRR changes grew at a reasonable pace

IV.9 During Q1 of 2013-14, y-o-y growth of reserve money picked up and was at 7.0 per cent compared with 5.6 per cent in Q1 of the previous financial year. Growth in currency in circulation decelerated, reflecting the impact of the economic slowdown. Bankers' deposits with the Reserve Bank, after having a negative y-o-y growth for 2012-13 mainly because of CRR cuts, recorded a low but positive y-o-y growth in Q1 of 2013-14. The reserve money, adjusted for the CRR changes, recorded a y-o-y growth at 10.2 per cent in Q1 of 2013-14 (Chart IV.3).

IV.10 On the sources side, the path of reserve money was influenced by both developments in the net domestic asset (NDA) and net foreign assets (NFA). In Q1, the Reserve Bank's net credit to the Centre increased because of the decline in the government's cash balances. However, this increase was matched by a decline in the LAF, which partially offset reserve money growth. The NFA, adjusted for revaluation, recorded a marginal decline over the quarter. On the components side, the expansion was matched by an increase in currency in circulation and in bankers' deposits.

Broad money growth remained broadly in line with indicative trajectory

IV.11 The y-o-y M_3 growth at 12.8 per cent was broadly in line with the indicative trajectory of 13.0 per cent for the 2013-14 (Chart IV.4). On the components side, a deceleration was observed in both the currency with the public and aggregate deposits. On the sources side, there was a marked deceleration in bank credit to the commercial sector as well as net bank credit to the government.

IV.12 The aggregate deposit growth, which generally decelerated during 2012-13 on account of near-zero real interest rates, continued to decelerate in Q1 of 2013-14 even with the increase in WPI-adjusted real interest rates on deposits. During Q1 of 2013-14, the

Chart IV.3: Trends in Reserve Money

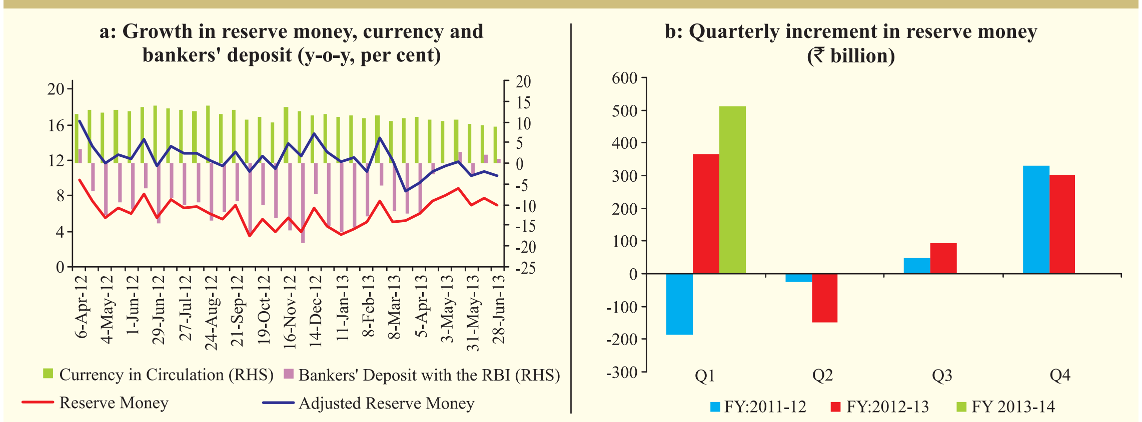
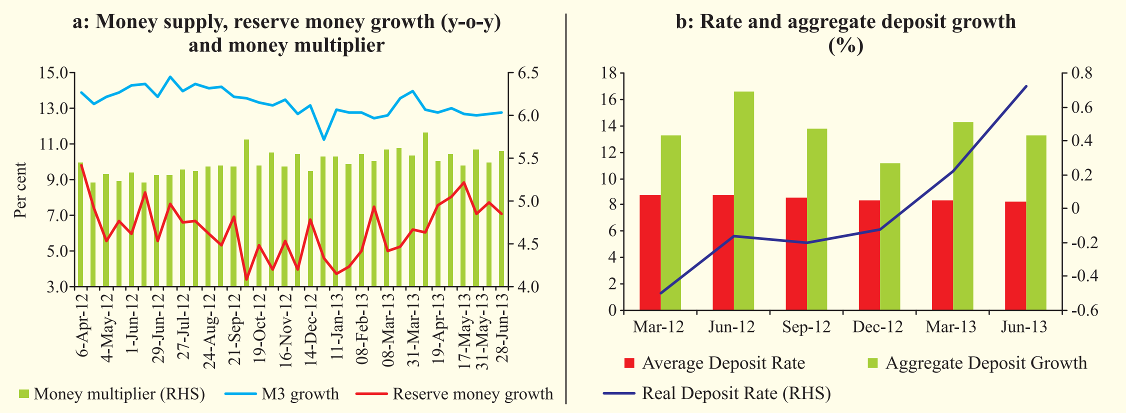


Chart IV.4: Broad Money and Deposit Movements



modal deposit rate of banks declined marginally by 5 bps, following a reduction in the repo rate and easing of liquidity conditions. The large increase in import of gold during Q1 of 2013-14 could indicate that some part of household savings was channelised to purchase the yellow metal, taking advantage of its lower prices. Time deposits, the largest component of aggregate deposits, decelerated further in Q1 of 2013-14 compared with the previous year (Table IV.3 and Chart IV.5).

IV.13 Despite a comfortable liquidity situation and a marginal decline in WALR during Q1 of 2013-14, SCBs' non-food credit growth remained below the Reserve Bank's indicative trajectory. On the demand side, the deceleration in domestic growth adversely affected the demand for credit in India. The deterioration in credit quality, on the other hand, impeded the supply of domestic credit (Table IV.4). The deceleration was observed across all bank groups, being high for PSBs and private sector banks, which jointly account for above 90 per cent of the SCB credit.

Risk aversion impacting credit, as asset quality concerns persist

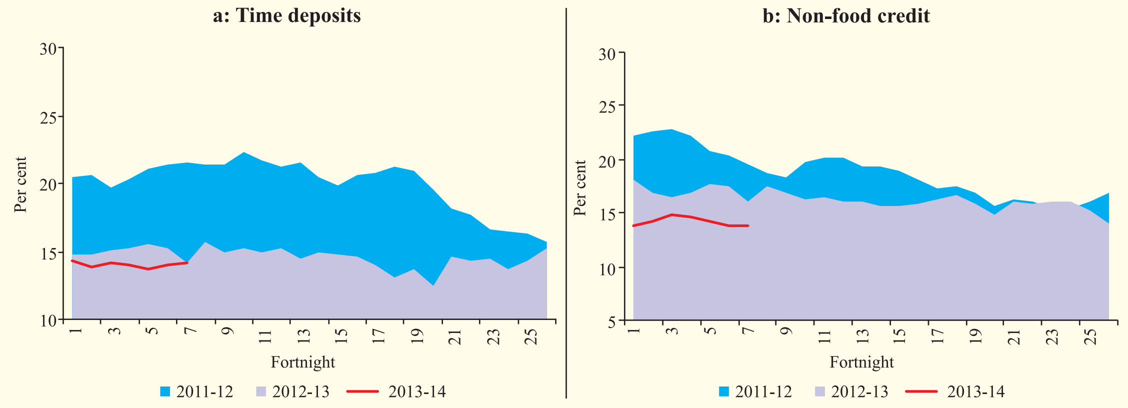
IV.14 Besides sluggish demand, a major factor that could have led to the low credit

Table IV.3: Monetary Indicators

Item	Outstanding Amount (₹ billion) 12-July-13	FY variations (per cent) 2012-13	FY variations (per cent) 2013-14	Y-o-Y variations (per cent) 13-July-12	Y-o-Y variations (per cent) 12-July-13
1	2	3	4	5	6
Reserve Money (M_0)*	**15,364.3**	**3.8**	**1.4**	**9.6**	**3.8**
Reserve Money (Adjusted)*		**3.6**	**1.3**	**15.7**	**7.1**
Broad Money (M_3)	**87,567.9**	**5.4**	**4.5**	**14.8**	**12.8**
Main Components of M_3					
Currency with the Public	11,801.6	5.4	3.1	13.2	9.5
Aggregate Deposits	75,661.3	5.4	4.6	15.0	13.3
of which: Demand Deposits	7,392.1	-6.0	-1.0	7.1	10.6
Time Deposits	68,269.1	6.8	5.2	15.9	13.6
Main Sources of M_3					
Net Bank Credit to Government	29,737.5	8.1	9.8	20.0	16.0
Bank Credit to Commercial Sector	58,003.5	2.9	2.4	18.0	13.7
Net Foreign Assets of the Banking Sector	17,236.8	4.7	5.3	14.7	6.6

Note: 1. Data are provisional.
2. *: Data for Reserve Money pertain to July 19, 2013.

Chart IV.5: Path of Time Deposit and Non-food Credit Growth of SCBs



growth of public sector banks (PSBs) over the past quarters relates to deterioration in their asset quality. Asset quality indicators of the banking sector, which had suffered significantly during 2011-12, worsened in 2012-13. Although data indicate worsening asset quality across bank groups during 2012-13, it continued to be led by public sector banks (PSBs), which account for the major portion of bank advances (Table IV.5) Deterioration in both asset quality and in macroeconomic conditions resulted in risk aversion in the banking sector.

Sectoral deployment of credit indicates deceleration across most sectors

IV.15 An analysis of the sectoral deployment of credit based on data from select banks (which cover 95 per cent of total non-food credit extended by all SCBs) for June 2013 reveals that deceleration in credit growth was observed in all major sectors (*viz.*, agriculture, industry and services), except for personal loans. The y-o-y bank credit growth to industry moderated to 14.1 per cent in June 2013 from 20.7 per cent in June 2012. Deceleration in credit growth to industry was observed in all the major sub-sectors, barring food processing, textiles, leather & leather products, cement & cement products and infrastructure. Credit growth to industry excluding infrastructure was much lower, at 11.7 per cent in June 2013 compared with 22.4 per cent a year ago.

IV.16 During 2013-14 so far (up to July 12, 2013), the estimated total flow of financial resources from banks and non-banks, including external sources, to the commercial sector was slightly higher compared with the same period last year. Despite a decline in non-SLR investments by banks the flow of resources

Table IV.4: Credit Flow from Scheduled Commercial Banks (in ₹ billion)

Item	As on July 12, 2013 Outstanding Amount	Variation (y-o-y)			
		As on July 13, 2012		As on July 12, 2013	
Bank Credit		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1 Public Sector Banks*	39,175.8	4,900.6	16.5	4,581.7	13.2
2 Foreign Banks	2,794.1	406.5	19.9	344.3	14.1
3 Private Sector Banks	10,546.5	1,607.1	21.6	1,508.9	16.7
4 All Scheduled Com. Banks@	53,983.8	7,115.9	17.7	6,724.0	14.2

*: Excluding RRBs in public sector banks. @: Including RRBs.
Note: Data as on July 12, 2013 are provisional.

Table IV.5: Bank Group Wise Asset Quality Indicators

	End March	All Banks	Foreign Banks	New Private Sector Banks	Old Private Sector Banks	Public Sector Banks
1	2	3	4	5	6	7
Gross NPAs to Gross Advances (%)	Mar-12	2.9	2.7	2.2	1.8	3.2
	Dec-12	3.7	2.9	2.0	2.2	4.2
	Mar-13	3.4	3.0	1.9	1.9	3.8
Net NPAs to Net Advances (%)	Mar-12	1.2	0.6	0.4	0.6	1.5
	Dec-12	1.7	1.0	0.5	0.9	2.1
	Mar-13	1.5	1.0	0.3	0.6	1.8
Restructured Std. Asset to Gross Advances (%)	Mar-12	4.7	0.1	1.1	3.5	5.7
	Dec-12	5.9	0.2	1.1	4.1	7.4
	Mar-13	5.7	0.1	1.2	3.8	7.1
CRAR	Mar-12	14.2	16.8	16.7	14.1	13.2
	Dec-12	13.5	17.2	17.1	13.4	12.0
	Mar-13	13.8	17.5	17.5	13.7	12.4
Slippage Ratio (%)	Mar-12	2.6	2.3	1.2	1.1	2.9
	Dec-12	2.9	1.9	1.4	1.5	3.3
	Mar-13	2.8	1.6	1.2	1.4	3.2

from banks was marginally higher due to increase in non-food credit by SCBs. Flow of resources from foreign sources was higher due to external commercial borrowings / FCCBs and higher foreign direct investment to India. The domestic non-bank sources declined on account of decrease in net issuance of CPs subscribed by non-banks, total gross accommodation by four Reserve Bank regulated AIFIs and net-investment by LIC (Table IV.6).

Table IV.6: Resource Flow to the Commercial Sector

(₹ billion)

	April-March		April 1 to July 12	
	2011-12	2012-13	2012-13	2013-14
1	2	3	4	5
A. Adjusted Non-Food Bank Credit (NFC)	**6,773**	**6,849**	**1,030**	**1,093**
i) Non-Food Credit	6,527	6,335	927	1,207
of which: petroleum and fertiliser credit	*116*	*141*	*-84*	*-114 &*
ii) Non-SLR Investment by SCBs	246	514	104	-113
B. Flow from Non-Banks (B1+B2)	**5,383**	**7,335**	**1,502**	**1,517**
B1. Domestic Sources	**3,079**	**4,212**	**1,267**	**1,134**
1. Public issues by non-financial entities	145	119	5	9 &
2. Gross private placements by non-financial entities	558	1,038 P	-	-
3. Net issuance of CPs subscribed to by non-banks	36	52	744	658
4. Net Credit by housing finance companies	539	859	60	87 &
5. Total gross accommodation by 4 RBI-regulated AIFIs: NABARD, NHB, SIDBI & EXIM Bank	469	515	36	-32 *
6. Systemically important non-deposit taking NBFCs (net of bank credit)	912	1,188	360	405 &
7. LIC's net investment in corporate debt, infrastructure and social sector	419	441	62	7 &
B2. Foreign Sources	**2,304**	**3,123**	**235**	**383**
1. External Commercial Borrowings/FCCBs	421	466	14	88 &
2. ADR/GDR Issues, excluding banks and financial institutions	27	10	0	0 &
3. Short-term credit from abroad	306	1,177	-	-
4. Foreign Direct Investment to India	1,550	1,470	221	295 &
C. Total Flow of Resources (A+B)	**12,156**	**14,184**	**2,532**	**2,610**
Memo:				
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	-185	830	195	411 &

Note: *: Up to June 2013 &: Upto May 2013 -: Not Available P : Provisional

Monetary policy to aim at stable macro-financial conditions

IV.17 The Reserve Bank, through its monetary policy, has been aiming to achieve a low and stable inflation environment that is conducive to growth. In this endeavour, during 2012-13 the Reserve Bank reduced the repo rate by 100 bps and injected liquidity through CRR and SLR cuts as also through OMOs. In continuation of its stance, the Reserve Bank in May 2013 reduced the repo rate by 25 bps and injected liquidity through OMOs during the first quarter of 2013-14. The transmission of the rate easing lowered nominal lending rates significantly in 2012-13. However, global currency market movements in June-July 2013 have prompted a re-calibration of monetary policy. Going forward, the Reserve Bank will endeavour to actively manage liquidity to reinforce monetary transmission that is consistent with the growth-inflation balance and macro-financial stability. It will also endeavour to maintain stable conditions by moving towards attaining external and internal balance.

V. FINANCIAL MARKETS

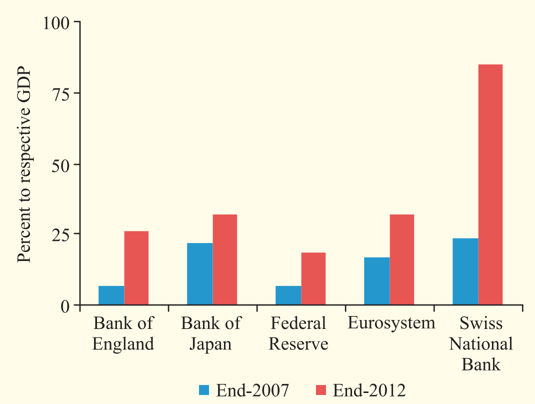
Global financial markets have experienced renewed turbulence, especially since the latter half of May 2013, following the Fed's signalling on tapering off of quantitative easing. Taking the cue that the global interest rate cycle may reverse, financial markets witnessed bond sell-offs across the globe. Financial markets in EMDEs came under intense pressure as the sell-off led to portfolio outflows from emerging markets, including India. Consequently, yields hardened and exchange rates depreciated against the US dollar. The Reserve Banks's policy intervention helped curb rupee volatility but money markets rates firmed up. The primary market witnessed an improvement in resource mobilisation during the quarter. However, the risk of volatile and tight financial conditions arising ahead remains.

Spillovers from the Fed's forward guidance on exit from QE brings global financial markets under stress

V.1 During 2012 and early 2013, global bond and equity markets had significantly rallied following central banks' massive quantitative easing (QE) programmes in advanced economies. Though global growth remained sluggish, the risk appetite improved and the markets aggressively priced the perceived reduction in risks. However, during Q1 of 2013-14, particularly in May and June, the global financial markets experienced renewed turbulence. This followed the signalling by the Chairman of the US Federal Reserve on May 22, 2013 that the Fed may taper off its asset purchase programme if economic conditions improve rapidly. The signal was followed by a more explicit forward guidance by the Fed Chairman on June 19, 2013 on moderating its asset purchases starting later this year and, in measured steps, unwinding the QE by mid-2014. The subsequent statement by the Fed of a 'highly accommodative' monetary policy in July appears to have calmed the market to a large extent.

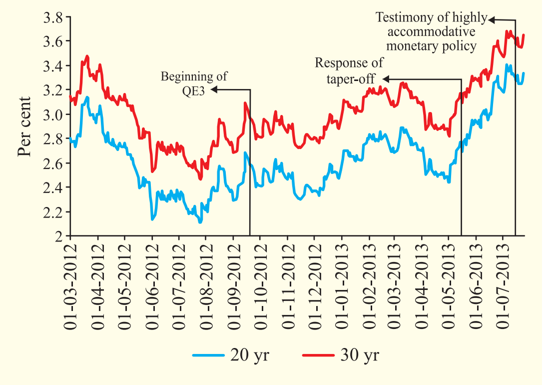
V.2 It may be observed in this context that the balance sheets of central banks in advanced economies have expanded significantly since the inception of the crisis in 2007 (Chart V.1). Therefore, the Fed's signal of an exit from QE raised the prospects of the global interest cycle turning thus posing the prospects of significant losses on existing bond holdings. Consequently, there was a large sell-off in US treasuries as well as bonds all over the globe. Asian markets came under intense pressure as the bond sell-off was accompanied by the reverse flight of capital back into the US. While bond markets in the US had started pricing the exit from ultra-easy monetary policy even before the Fed signalling (Chart V.2), the yields in EMDEs rose sharply following the testimony (Chart V.3a).

Chart V.1: Balance sheet of central banks



V.3 In the euro area, the Cyprus crisis receded following the bail-out in March 2013 and gold sales in April 2013. Portugal, however, emerged as a troubled spot during Q1 of 2013-14, raising fresh doubts whether the improved terms for sovereign borrowings for Spain and Italy could be sustained. Portugal's sovereign debt is seen

Chart V.2: Movements in US Long-term Government Bond Yields



rising over the next three years and refinancing difficulties are expected to recur. Euro area periphery bond spreads also widened (Chart V.3b). The ECB President commented that the central bank "will stay accommodative for the foreseeable future" and that it was open to "all other possible instruments", adding that an exit from accommodative policy remained "distant". This helped in calming markets. However, the euro area sovereign debt and banking sector fragilities remain an important risk for global financial stability.

V.4 As portfolio capital, especially in bond markets, witnessed outflows from EMDEs, their currencies came under severe pressure. This, in turn, added to the sell-offs in the equity markets by global investors, especially in EMDE markets. The liquidity crunch in the Chinese inter-bank markets also adversely impacted the sentiments across equity markets in Asia and the Pacific region (Chart V.4).

Rupee depreciates in response to Fed announcements

V.5 Following the Fed Chairman's response on May 22, 2013, the rupee depreciated by 5.8 per cent until July 26, 2013. The rupee touched an all-time low of 61.05 against the dollar on July 8, 2013, when Reserve Bank instructed authorised dealers to stop taking proprietary trading in currency futures or exchange-traded currency options markets. While speculative positions on the exchange came down as a result, the OTC segment of the foreign exchange market continued to face volatility. The rupee depreciation since May 22 had touched 7.5 per cent by July 15, 2013. Faced with large volatility, the Reserve Bank stepped in on July 15, 2013 to address it through liquidity monetary measures. It also took additional measures on July 23, 2013. These measures imparted stability. Subsequent to the measures, the rupee has appreciated 1.9 per cent against the US dollar till July 26, 2013.

V.6 Other EMDE currencies also depreciated considerably after the Fed announcement, including those for countries with current account surpluses (Chart V.5). During 2013-14 (up to July 24, 2013), the currency depreciation was highest in case of Brazil, followed by India and

Chart V.3: Movements in Bond Yields in Select EMDEs and Euro Area Economies

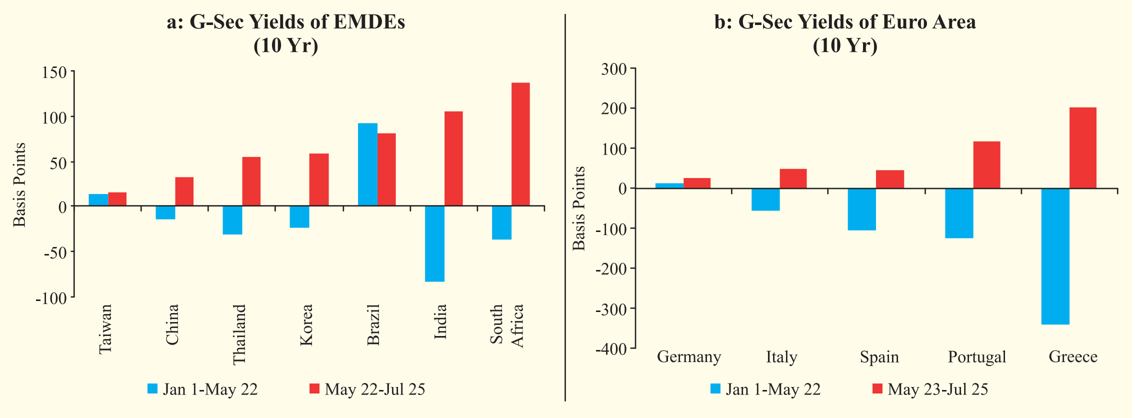
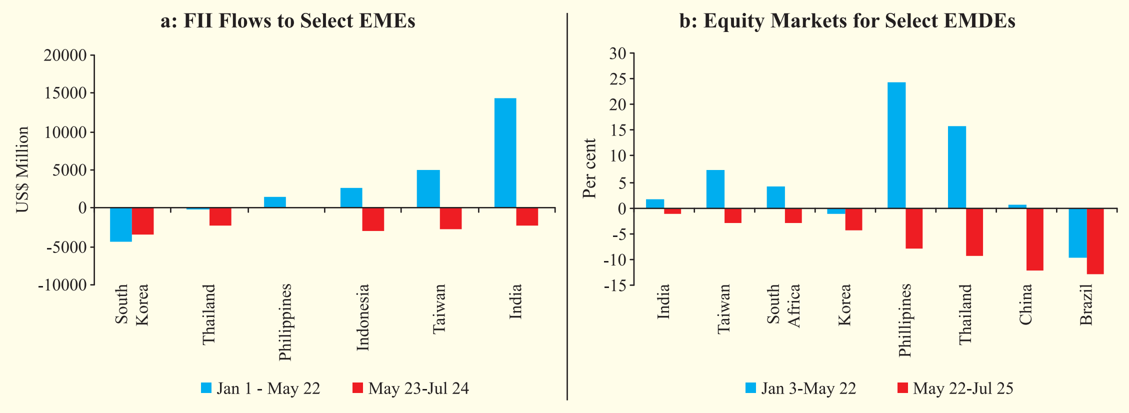


Chart V.4: Trends in the Equity and FII Flows to Select EMDEs



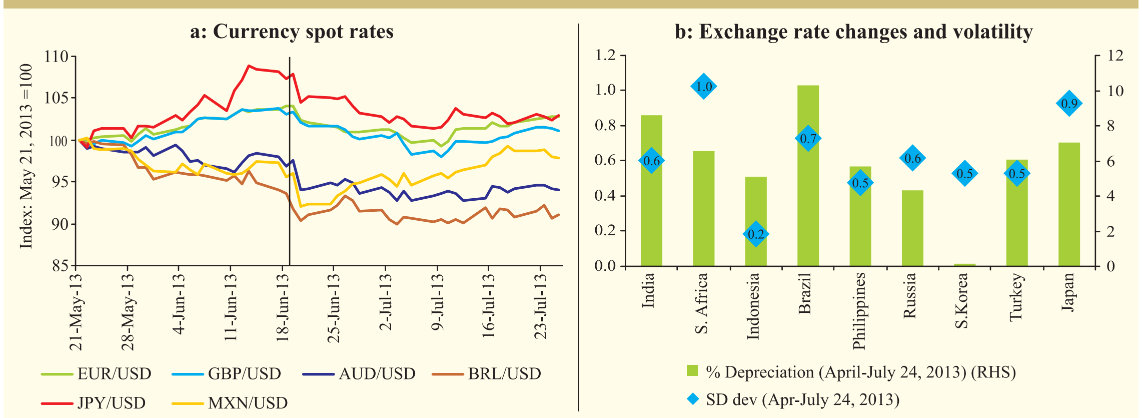
South Africa. The South African Rand witnessed the highest volatility followed by Brazilian Real, Russian Rouble and Indian Rupee.

Domestic markets respond to liquidity tightening measures

V.7 Subsequent to the measures taken on July 15, 2013, which were unanticipated for the market, G-sec yields and corporate bond yields firmed up. Overnight rates, after an initial jump, subsided. Liquidity tightened and amidst tighter liquidity, the Reserve Bank announced a Special Repo window for a notified amount of ₹250 billion to enable banks to lend to mutual funds. In addition, the borrowing limit below the stipulated SLR requirement under the MSF was raised from 2.0 per cent of NDTL to 2.5 per cent of NDTL for a temporary period, with the higher MSF limit of 0.5 per cent being available only for the Special Repo window. The Reserve Bank conducted the OMO sale auction of G-secs for ₹120 billion on July 18, 2013. However, given the bidding pattern and the market yields, it accepted bids for ₹25 billion only.

V.8 The situation in the money market was quite comfortable during the first half of July 2013. However, the measures taken by the Reserve Bank on July 15 and July 23, 2013 to contain exchange rate volatility impacted the money market. The call rate, which stood at 7.21 per cent prior to the Reserve Bank's policy measures on July 15, 2013, initially increased to 8.53 per cent on July 16, 2013 but subsequently came down to 7.14 per cent on July 23, 2013. However, announcement of additional measures by Reserve Bank on July 23, 2013 led to

Chart V.5: Movements in International Forex Markets

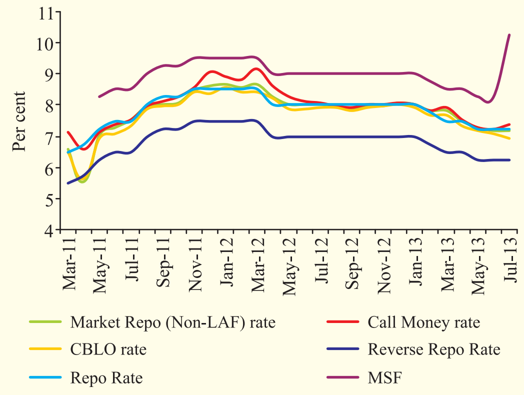


hardening of call rate to around 9.05 per cent on July 24, 2013. The rates in the collateralised segment also hardened as a result of these measures, with the CBLO rate increasing to 8.68 per cent on July 24, 2013. CD and CP rates also hardened. It subsequently reverted to the level prior to the measures.

V.9 Earlier, the money markets in India remained orderly during Q1 of 2013-14, with the call rates hovering within the corridor set by the reverse repo and the MSF rate and remaining close to the policy (Repo) rate. Reflecting a moderate easing of liquidity, the daily weighted average call rate declined to 7.53 per cent during April 2013 from 7.90 per cent during March 2013. The reduction in the repo rate in the Annual Monetary Policy Statement, 2013-14 (May 3, 2013) pushed the average call money rate further down to 7.29 per cent during May 2013. During June 2013, the call rate declined further to 7.24 per cent, reflecting an improvement in the liquidity conditions (Chart V.6).

V.10 The rates in the collateralised segments (*i.e.*, CBLO and market repo) moved in tandem with the call rate, but generally remained below it during Q1 of 2013-14. The collateralised segment continued to remain the predominant part of the overnight money market; its share increased to around 84 per cent during Q1 of 2013-14 from 81 per cent during Q4 of 2012-13.

Chart V.6: Movement of Money Market Rates



V.11 Given the lower demand for funds, the average gross fortnightly issuance of CDs amounted to ₹333 billion in 2012-13 compared with ₹384 billion during 2011-12. The average gross fortnightly issuance of CDs during Q1 of 2013-14 stood at ₹340 billion. Accordingly, the outstanding amount of CDs, which was ₹4,252 billion at end-June 2012, decreased to around ₹3,645 billion at end-June 2013. Given the reduction in banks' preference for bulk deposits, the weighted average effective interest rate (WAEIR) of CDs also declined to 8.19 per cent as on June 28, 2013 from 9.30 per cent as on June 29, 2012 (Table V.1).

V.12 During 2012-13, the average fortnightly gross issuance of commercial papers (CPs) stood at around ₹319 billion as against the average gross issuance of ₹244 billion during

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

(in ₹ billion)

Month	Money Market						Bond Market		Forex Inter Bank (US $ bn)	Stock Market #
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificate of Deposits*	G-Sec	Corporate Bond#		
1	2	3	4	5	6	7	8	9	10	11
June 12	-913	152	180	376	1258	4252	258	30	19	117
Sep 12	-517	143	185	502	1706	3572	260	36	21	143
Dec 12	-1231	142	147	398	1818	3328	197	28	19	145
Mar 13	-1173	186	221	462	1093	3896	307	43	23	133
Apr 13	-863	201	274	590	1575	3860	443	62	22	124
May 13	-960	161	306	487	1732	3609	839	55	21	128
June 13	-657	155	245	616	1356	3645	428	44	21	124
July 13@	-528	153	255	792	1694**	-	-	47	17##	122

*: Outstanding position. #: Average daily turnover in BSE and NSE. @: upto July 25, 2013.
**: Fortnight ended July 15, 2013. ## : Upto July 12, 2013.
Note: In column 2, (-) ve sign indicates injection of liquidity into the system.

2011-12. The average fortnightly gross issuance of CPs during Q1 of 2013-14 stood at ₹338 billion.

V.13 The outstanding amount of CPs issued by corporates, which was around ₹1,258 billion as of end-June 2012, increased to around ₹1,356 billion as of end-June 2013. The weighted average discount rate (WADR) in respect of aggregate CP issuances decreased to 8.54 per cent at end-June 2013 from 10.10 per cent at end-June 2012. 'Leasing and Finance' and 'manufacturing companies' remained the major issuers of CPs.

Yields harden following the Fed's response

V.14 During the period April-May 2013, the G-sec yields softened, taking cues from (i) a lower reading of CPI and WPI numbers for March and April, (ii) softening of international commodity prices and (iii) the decision to reduce withholding tax on FII interest income on G-secs to 5 per cent from 20 per cent, although S&P's decision to re-affirm the negative rating outlook on India put some pressure on bond yields (Chart V.7).

V.15 Yields started hardening towards end-May 2013 as part of the global bond sell-off that followed the Fed Chairman's response in May 2013 and subsequent forward guidance in June 2013. The 10-year generic yield hardened from 7.12 per cent on May 24, 2013 to 7.60 per cent by July 15, 2013 (Chart V.8).

V.16 In response to the measures announced by the Reserve Bank on July 15, 2013, bond yields hardened further. The 10-year generic G-sec yields increased by over 50 basis points to close at 8.13 per cent on July 16, 2013. The measures taken by the Reserve Bank on July 23, 2013 led to further hardening of yields, with the 10-year generic yield standing at 8.46 per cent on July 24, 2013. However, the yields fell sharply on July 25, 2013. The 10-year yield declined by 23 basis points after the Reserve Banks' signals for higher short-term rates and as market perceived the Reserve Bank's action as working to bring stability to the rupee exchange rate.

V.17 The average daily trading volume of central government securities in the secondary market increased to around ₹570 billion during Q1 of 2013-14 from ₹376 billion during Q4 of 2012-13. The traded volume in G-secs generally varied inversely with G-sec yields.

V.18 The gross market borrowings of the central government through dated securities during 2013-14 were to the tune of ₹2,100 billion (net borrowings of ₹1,972 billion) up to July 26, 2013 compared with ₹2,340 billion (net borrowings of ₹1,594 billion) during the corresponding period of the previous year. The weighted average maturity of the dated securities increased to 14.96 years from 13.62 years during the corresponding period of the

Chart V.7: Yield curves for Government Securities

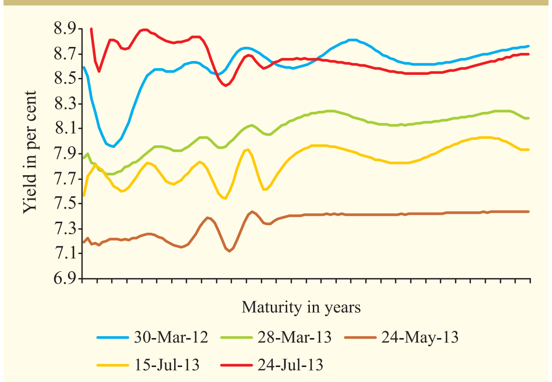


Chart V.8: Average Daily Volume and 10-Year Generic Yield

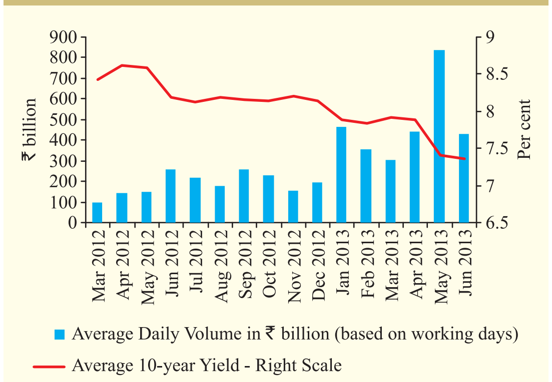


Table V.2: Issuances of Central and State Government Dated Securities*

Item	2012-13	2013-14
1	2	3
Central Government		
Gross amount raised (₹ billion)	1880	1650
Devolvement on primary dealers (₹ billion)	11.95	Nil
Bid-cover ratio (range)	1.47-3.59	2.38-6.08
Weighted average maturity (years)	13.38	14.92
Weighted average yield (per cent)	8.57	7.57**
State Government		
Gross amount raised (₹ billion)	310.9	379.1
Cut-off yield range (Per cent)	8.80-9.31	7.57-8.51
Weighted average yield (Per cent)	9.07	7.92

* Up till July 3, 2013. Includes Inflation-Indexed Bond (IIB) issuances.

previous year. The weighted average yield during the primary auctions eased to 7.64 per cent from 8.52 per cent during the corresponding period of the previous year. The weighted average yield during the primary auctions eased to 7.64 per cent from 8.52 per cent during the corresponding period of the previous year (Table V.2). The bid-cover ratio stood in the range of 1.41-6.09 as against 1.47-3.59 during the corresponding period of the previous year. The government availed of ways and means advances (WMA) on three occasions up to end-June 2013. As on July 16, 2013 the outstanding WMA position of the government was ₹3.06 billion.

V.19 During 2013-14 (up to July 16, 2013), 18 states have raised ₹401.2 billion on a gross basis (net amount of ₹252.3 billion) compared with ₹419.8 billion (net amount of ₹369.6 billion) raised by 20 states during the corresponding period of the previous year. The weighted average yield eased to 7.98 per cent up to July 16, 2013 from 9.01 per cent during the corresponding period of the previous year.

V.20 The yields on auction of Treasury Bills showed a declining trend till the middle of the quarter ending June 2013, but started hardening subsequent to the Fed Chairman's response in May 2013. Yields on Treasury Bills went up significantly (by 352 bps and 291 bps for 91-day and 364-day treasury bills, respectively) subsequent to the liquidity tightening measures announced by the Reserve Bank in mid-July 2013.

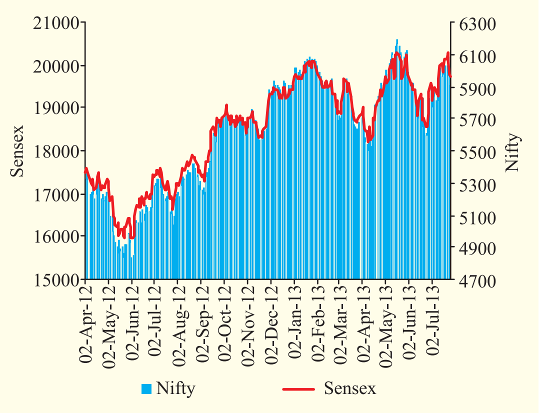
Domestic equity markets record marginal increase amid global uncertainties

V.21 During the financial year 2013-14 (up to July 26, 2013), the BSE Sensex and CNX Nifty recorded gains of 4.8 per cent and 3.6 per cent, respectively (Chart V.9). The stock market recorded significant gains at the beginning of the quarter due to sustained FII buying and easing of concerns about the twin deficits due to moderation in commodity prices. However, the market pared some of its earlier gains in June 2013 due mainly to worries over capital outflows arising from the signals of gradual tapering of monetary stimulus by the US Fed and weak industrial output data of the domestic economy. Other ancillary factors such as the weak growth outlook for China, the persistent weakness of the rupee *vis-à-vis* the US dollar and net sales by FIIs reinforced the pressures.

V.22 In response to the measures announced by the Reserve Bank on July 15, 2013, the BSE Sensex declined by over 180 points (0.9 per cent) on July 16, 2013. The BSE Bankex was among the worst hit, declining by nearly 5 per cent. Reflecting the impact of July 23 measures, the BSE Bankex declined by 590 points (4.6 per cent) on July 24, while the drop in the Sensex was over 200 points (1.04 per cent).

V.23 During Q1 of 2013-14, FIIs made net sales of ₹90 billion in the capital market (both

Chart V.9: Movement of Sensex and Nifty



equity and debt) as against net investment of ₹19 billion during Q1 of 2012-13. In the equity market, FIIs made net investments of ₹153 billion in Q1 of 2013-14 as against net sales of ₹7 billion during Q1 of the previous year, while in the debt market, FIIs made net sales of ₹243 billion in Q1 of 2013-14 as against net investment of ₹25 billion in Q1 of the previous year (Table V.3). However, after the response of the US Fed Chairman on May 22, 2013, both debt and equity markets recorded net outflows amounting to ₹522 billion and ₹116 billion, respectively, between May 22 and July 24, 2013.

V.24 Mutual funds, on the other hand, made net investments of ₹1,376 billion during Q1 2013-14 in the capital market (both equity and debt) compared with ₹1,383 billion during Q1 of the previous year. Mutual funds, however, made net sales of ₹52 billion in the equity market compared with net sales of ₹6 billion during Q1 of the previous year. But they remained net buyers in the debt market.

V.25 Equity market volatility, measured by NSE's VIX index, which was subdued during a major part of 2012-13, witnessed a marginal increase in the first quarter of 2013-14 (Chart V.10).

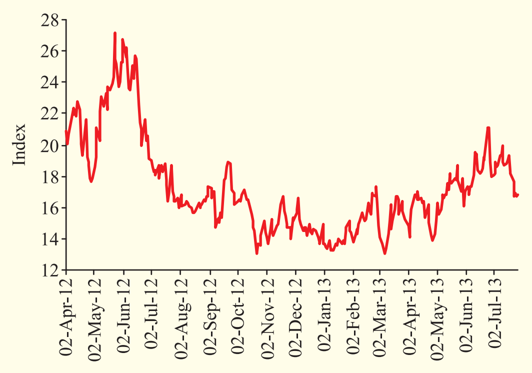
Table V.3: Institutional Investment in Equity and Debt Market

(₹ billion)

	Equity Market	Debt Market	Total
1	2	3	4
FII			
Q1 2012-13	-6.6	25.3	18.7
Q2 2012-13	397.5	44.6	442.1
Q3 2012-13	455.4	96.1	551.5
Q4 2012-13	560.1	148.7	708.9
Q1 2013-14*	152.9	-243.3	-90.3
Q2 2013-14@	-61.6	-126.9	-188.4
Mutual Funds			
Q1 2012-13	-6.4	1389.8	1383.4
Q2 2012-13	-68.2	835.7	767.5
Q3 2012-13	-76.2	1033.9	957.8
Q4 2012-13	-76.7	1488.5	1411.7
Q1 2013-14	-52.0	1427.7	1375.7
Q2 2013-14#	-9.4	-23.7	-33.1

*: Data up to June 27, 2013. @: Data upto July 24, 2013.
#: Data upto July 23, 2013.
Source: SEBI.

Chart V.10: Closing value of NSE's Volatility Index VIX



Healthcare and FMCG continued to outperform the Sensex

V.26 During Q1 of 2013-14, the BSE healthcare and FMCG sectors continued to outperform the benchmark BSE Sensex. Indices of these sectors recorded increase of 10 per cent and 9 per cent, respectively, compared with an increase of 3 per cent in the BSE Sensex. However, a large segment of the market underperformed the benchmark index: realty, consumer durables, metals and IT were the worst performing indices.

Improvements in resource mobilisation from the primary market

V.27 During April-May 2013, the total resource mobilisation from the primary equity market more than doubled to ₹9.3 billion compared with ₹3.9 billion mobilised during April-May 2012 (Table V.4). The higher resource mobilisation in equity was due to a recovery in the secondary market and the floatation of a mega issue in May 2013. Resource mobilisation *via* the private placement route continued its growth momentum. During April-May 2013, mobilisation through private placements increased by nearly 59 per cent to ₹756 billion as compared to ₹475 billion in the corresponding period last year. Led by private sector mutual funds, resources mobilised by mutual funds during April-June 2013 also registered an

Table V.4: Primary Market Trends

(₹ billion)

Category	2012-13 (Apr-Mar)	2012-13 (Apr-June)	2013-14 (Apr-June)
1	2	3	4
a. Public Issue (i) + (ii)	**219**	**4***	**11***
i) Public Issue (Equity)	65	4*	9*
of which: IPOs	65	4*	9*
FPOs	0	0*	0*
ii) Public Issue (Debt)	154	0*	1*
b. Rights Issue	89	1*	0*
Total Equity Issues (i+b)	**155**	**4***	**9***
c. Euro Issues (ADR/GDR)	10	2	1
d. Mutual Fund Mobilisation (net)	765	-4995	956
i) Private Sector	638	-3985	774
ii) Public Sector	127	-1010	182
e. Private Placement in Corporate Debt market	3615	475*	756*
f. QIP	160	0.3*	32*

Source: SEBI.
*: Data upto May.

increase to ₹956 billion as against net sales of ₹4,995 billion during April-June 2012.

House prices remain at elevated levels

V.28 The y-o-y growth in the Reserve Bank house price index was around 19 per cent in Q4 of 2012-13. The q-o-q increase remained moderate at 2.1 per cent. On a y-o-y basis, the increase has been the highest in Kolkata, whereas it witnessed a decline in Kanpur. During the past four years, the index of house prices has increased by over 110 per cent (up to Q4:2012-13) (Table V.5).

Risks to financial conditions remain from spillovers and slowing growth

V.29 Although the immediate risks to the euro area appear to have receded, the early signs of recovery in the US are posing fresh challenges for policymakers. As the evidence over the past couple of months suggests, the challenges of communicating an exit from unconventional monetary policy exist as such signals can lead to spillovers with consequences of heightened volatility and possibilities of markets overshooting. In turn, this poses newer challenges for policymaking in EMDEs. It, therefore, becomes important for EMDEs to ensure adequate buffers and hedges in order to manage such sharp and sudden risks.

V.30 While the slew of measures taken over the past several months on the domestic front provide comfort, the balance of risks still appears to be on the downside, with weaknesses in corporate and banks' balance sheets feeding into each other. Weaknesses in the macro-financial environment are also adding to the pressures. The balance sheet effects from slowing growth can impact the evolving financial market conditions. It is, therefore, important to continuously monitor these risks and take preventive policy actions to ride over this downside.

Table V.5: House Price Indices (Base - Q4: 2008-09=100)

Quarter	Mumbai	Delhi	Bengaluru	Ahmedabad	Lucknow	Kolkata	Chennai *	Jaipur	Kanpur	All-India
1	2	3	4	5	6	7	8	9	10	11
Q1:2011-12	191.6	152.8	116.9	152.3	149.3	157.0	106.3	161.1	135.4	152.0
Q2:2011-12	206.1	153.0	116.0	162.8	159.2	159.0	113.9	165.1	138.3	157.8
Q3:2011-12	191.7	168.6	146.1	171.8	172.3	155.0	120.3	163.5	140.0	164.1
Q4:2011-12	224.7	195.3	140.6	177.2	169.7	158.4	117.0	164.4	148.7	176.9
Q1:2012-13	231.8	217.3	140.2	176.6	179.4	204.2	133.9	171.9	144.9	188.6
Q2:2012-13	232.4	225.2	143.0	183.4	208.9	226.9	129.5	177.7	135.8	194.3
Q3:2012-13	248.5	247.8	147.9	187.8	221.6	247.3	149.2	179.4	117.0	206.8
Q4:2012-13	248.6	259.2	148.3	193.5	218.8	258.6	148.0	194.0	116.9	211.2
Growth in per cent										
y-o-y	10.6	32.7	5.5	9.2	28.9	63.3	26.5	18.0	-21.4	19.4
q-o-q	0.0	4.6	0.3	3.0	-1.3	4.6	-0.8	8.1	-0.1	2.1

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

VI. PRICE SITUATION

Lower global commodity prices, a negative output gap and past monetary policy actions contributed to a decline in headline wholesale price index (WPI) inflation to below 5 per cent in Q1 of 2013-14. Non-food manufactured product inflation also came down sharply to its lowest level in the past three years. Food inflation increased again in May and June 2013, putting pressures on the general price level. It could moderate somewhat if the monsoon remains on track during the rest of the season. However, the recent currency depreciation and upward pressure on fuel prices due to geo-political uncertainties pose upside risks to inflation. Near double-digit consumer price inflation also remains a major concern.

Inflation remains moderate in advanced and some emerging economies

VI.1 Inflation pressures eased in advanced economies (AEs) and some emerging market and developing economies (EMDEs) during Q2 of 2013. In most AEs, inflation remained at low levels due to subdued demand and a correction in energy prices. Consumer price inflation in OECD countries was 1.8 per cent in June 2013, lower than the average of 2.3 per cent during 2012. In view of the subdued recovery and benign inflationary pressures, central banks in AEs continued with an accommodative monetary policy stance to support recovery. The European Central Bank reduced the policy rate by 25 basis points to 0.50 per cent against the backdrop of contracting output, high unemployment rate and depreciation in exchange rate *vis-à-vis* the US dollar (Table VI.1).

VI.2 Unlike AEs, mixed inflation trends appeared from EMDEs. In China inflation edged up to 2.7 per cent in June 2013 from 2.1 per cent in May. Similar upward pressures were seen in the case of Russia and Brazil. Most of the EMDEs kept their policy rate on hold, with Brazil and Indonesia being notable exceptions, which raised the policy rate on inflation concerns. Some decline in commodity prices in the wake of the withdrawal of stimulus measures and uneven recovery in major regions of the world pose a downside risk. However, a significant upside risk is expected from the recent currency depreciation in several countries with respect to the US dollar as well as geo-political tensions that could lead to further pressure on energy prices.

Global commodity prices eased in Q2 of 2013, but crude oil prices rebounded in recent weeks

VI.3 The moderation in global commodity prices witnessed in Q1 of 2013 continued in Q2. The IMF commodity price index declined by about 2.0 per cent during the first six months of the year (Chart VI.1). The moderation was driven by improved supply prospects in most commodities and weak demand conditions on account of growth slowdown, especially in EMDEs. Despite the benign trends, the pass-through of commodity price correction to domestic inflation was partly abated by the recent appreciation of the US dollar across different currencies.

VI.4 Global crude oil prices generally trended down in Q2 of 2013 on account of weak demand, build-up of stocks and improvements in supply. After increasing to US$ 119 per barrel in early February 2013, the Brent crude oil spot price fell to a low of US$ 97 per barrel in mid-April and then recovered to an average of US$ 103 per barrel in May and June. The US Energy Information Administration (EIA) had recently projected that the Brent crude oil spot price would average US$ 102 per barrel over the second half of 2013 conditional on the absence of disruptions to energy markets arising from the recent geo-political unrest. However, Brent oil prices rose to over US$ 108 in July 2013 as the escalating political crisis in Egypt increased fears that it could affect the rest of West Asia and disrupt world crude supplies.

Table VI.1: Global Inflation and Policy Rates

Country/ Region	Key Policy Rate	Policy Rate (as on July 26, 2013)	Changes in Policy Rates (basis points)		CPI Inflation (Y-o-Y, per cent)	
			Sep 2009 to Dec 2011	Jan 2012 to Jul 2013	Jun-12	Jun-13
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	2.75 (May 8, 2013)	125	(-) 150	1.2#	2.4#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	75	0	1.5	1.2
Euro area	Interest Rate on Main Refinancing Operations	0.50 (May. 08, 2013)	0	(-) 50	2.4	1.6
Israel	Key Rate	1.25 ((Jun 1, 2013)	225	(-) 150	1.0	2.0
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10* (Oct. 5, 2010)	(-) 10	0	-0.1	0.2
Korea	Base Rate	2.50 (May 9, 2013)	125	(-) 75	2.2	1.0
UK	Official Bank Rate	0.50 (Mar. 5, 2009)	0	0	2.4	2.9
US	Federal Funds Rate	0.0 to 0.25* (Dec. 16, 2008)	0	0	1.7	1.8
Emerging and Developing Economies						
Brazil	Selic Rate	8.50 (Jul 11, 2013)	225	(-) 250	4.9	6.7
China	Benchmark 1-year Deposit Rate	3.00 (Jul. 6, 2012)	125	(-) 50	2.2	2.7
	Benchmark 1-year Lending Rate	6.00 (Jul. 6, 2012)	125 (600)	(-) 56 (-) 150		
India	Repo Rate	7.25 (Mar. 19, 2013)	375 (100)	(-) 125 (-200)	9.9	9.9
Indonesia	BI Rate	6.50 (Jul.11, 2013)	(-) 50	50	4.5	5.9
Philippines	Reverse Repurchase Rate	3.50 (Oct. 25, 2012)	50	(-) 100	2.8	2.8
	Repurchase Rate	5.50 (Oct. 25, 2012)	50	(-) 100		
Russia	Refinancing Rate	8.25 (Sep. 14, 2012)	(-) 275	25	4.3	6.9
South Africa	Repo Rate	5.00 (Jul. 20, 2012)	(-) 150	(-) 50	5.5	5.5
Thailand	1-day Repurchase Rate	2.50 (May 29, 2013)	200	(-) 75	2.6	2.3

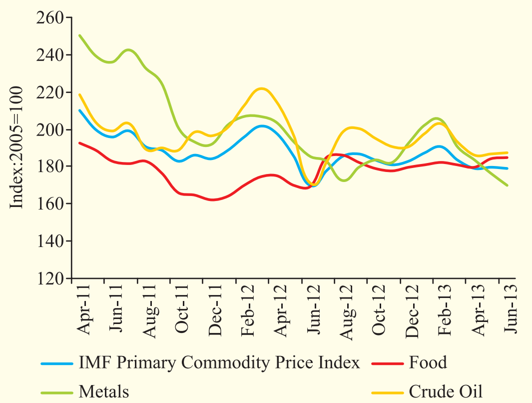
*: Change is worked out from the minimum point of target range. #: Q2 (Apr-Jun)

Note: Figures in parentheses in Column (3) indicate the effective dates when the policy rates were last revised. Figures in parentheses in Columns (4), and (5) indicate the variation in the cash reserve ratio during the period. For India, data on inflation pertain to New CPI (Combined: rural + urban)

Source: Websites of respective central banks/statistical agencies.

VI.5 Metal prices declined on concerns about the moderation in global demand, particularly from China. The FAO Food Price Index declined marginally in May and June, reflecting supply conditions in cereals, sugar and oil and fats. Going forward, the path of global commodity prices would largely depend on growth prospects in emerging and developing Asia, particularly China. Further, the recent global developments and overall macroeconomic conditions do not indicate any substantial rise in the oil and non-fuel segment of commodity prices, which is broadly in line with the baseline assumption for inflation forecast for 2013 across several central banks. However, commodity prices, especially oil prices, continue to remain vulnerable to short-term supply disturbances.

Chart VI.1: International Commodity Prices



Domestic headline inflation declines below 5 per cent

VI.6 Headline inflation, as measured by year-on-year changes in the Wholesale Price Index (WPI), declined to 4.7 per cent (provisional) in May 2013 before edging up to 4.9 per cent in

Chart VI.2: Wholesale Price Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes

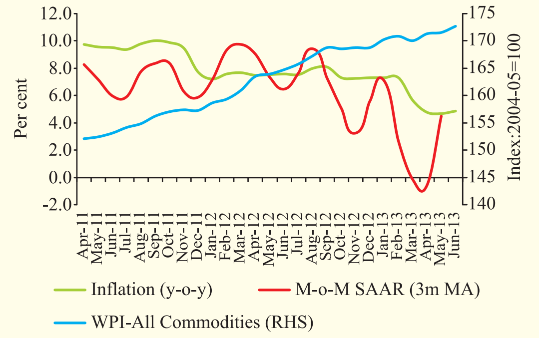
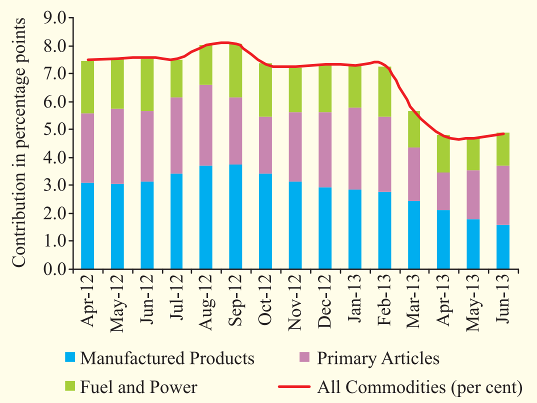


Chart VI.3: Drivers of WPI Inflation



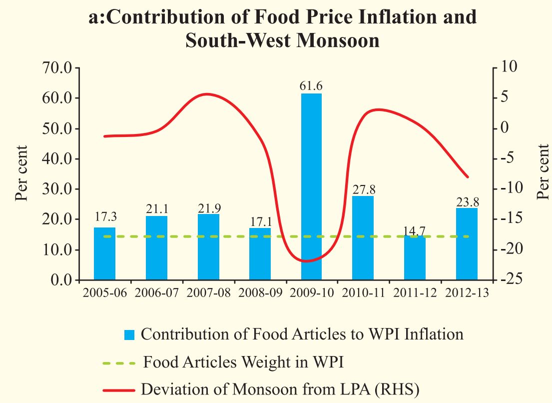
June 2013 on account of an uptick in food and fuel prices (Chart VI.2). Average inflation during Q1 of 2013-14 at 4.8 per cent remained significantly lower than the average inflation of 7.5 per cent during Q1 of 2012-13 and 7.4 per cent during the year 2012-13. The seasonally adjusted month-over-month (annualised) changes in the WPI (3-month moving average) (m-o-m saar), turned negative in the recent period, but returned to positive territory in June 2013, pointing to a turnaround in the momentum.

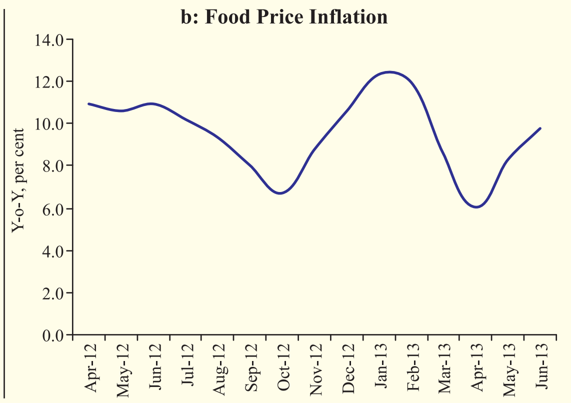
VI.7 On the whole, headline inflation exhibited a softening bias during Q1 of 2013-14, driven by all three major sub-groups, *viz.*, primary articles, fuel and power and manufactured products (Chart VI.3). The major contribution, however, came from the non-food manufactured products group, with inflation in this segment declining sharply to 2.0 per cent (by June 2013) and reaching its lowest level in the past three years. This was partly facilitated by lower international commodity prices, leading to benefits from lower imported inflation. The deceleration in growth to below the potential level also translated into weak demand conditions, contributing to moderation in inflation.

Food prices increased in recent months, but good monsoon may contain price rise

VI.8 Food price inflation has been a major driver of headline inflation in recent years (Chart VI.4a). High input costs, rising wages and inelastic supply responses to demand led to higher food price inflation. The delayed monsoon with a skewed spatial distribution contributed to high food inflation during most

Chart VI.4: Recent Trends in Food Price Inflation





part of 2012-13. Food articles inflation, however, receded sharply from 12.3 per cent in January 2013 to 6.1 per cent in April 2013 reflecting improved supply conditions and arrival of *rabi* crops. A surge in the prices of vegetables, cereals and 'eggs, meat and fish' led to a reversal of trend during May and June 2013 (Chart VI.4b). Going forward, the satisfactory progress of monsoon so far has boosted the prospects for improved foodgrain production for the current year. The increases in Minimum Support Prices (MSPs) for *kharif* food crops for 2013-14 work out to an average of 4.1 per cent (using WPI weights). This is significantly lower than the average increase of 16.3 per cent during 2007-08 to 2012-13. The lower order increase in MSPs this year could also ease some of the pressures on food inflation, although several other structural impediments still continue to put pressure on food prices.

Revisions in administered prices restrict the moderation in inflation

VI.9 The revisions in administered prices, particularly of diesel and electricity, led to a pick-up in inflation for administered price items during April-May 2013 (Chart VI.5). These revisions reflect both lagged pass-through of past increases in global prices as well as increases in input costs. Given these adjustments in administered prices, the moderation in overall inflation remained constrained. Inflation for the non-administered price group was much lower at 4.1 per cent compared with the headline inflation of 4.9 per cent for June 2013. Given the increase in global crude oil prices and rupee depreciation in recent weeks, further increases in administered prices could become inevitable which could lead to higher inflation readings.

Fuel inflation is driven by global oil prices and administered price revisions

VI.10 The moderation in international oil prices during Q1 of 2013-14 led to some decline in the prices of freely priced fuel products. This was reflected in a decline in fuel inflation to a 40-month low of 7.1 per cent in June 2013. The revision in the administered prices of diesel in a staggered manner, however, partly offset the impact of lower oil prices. Even though the gap between administered and non-administered products under the mineral oils group declined in the recent period, it remains significant (Chart VI.6). The depreciation of the rupee as well as the firming up of global crude prices following the political uncertainties in the Middle East led to some increase in the prices of freely priced fuel products in June–July 2013.

VI.11 During 2012-13, the total reported under-recoveries of the oil marketing companies (OMCs) was ₹1.61 trillion, of which 57 per cent was on account of diesel. Since September 2012, under-recoveries declined significantly, driven both by lower global crude prices and administered price revisions (Chart VI.7). During the initial months of 2013-14, falling

Chart VI.5: Administered and Non-Administered Price Inflation in India

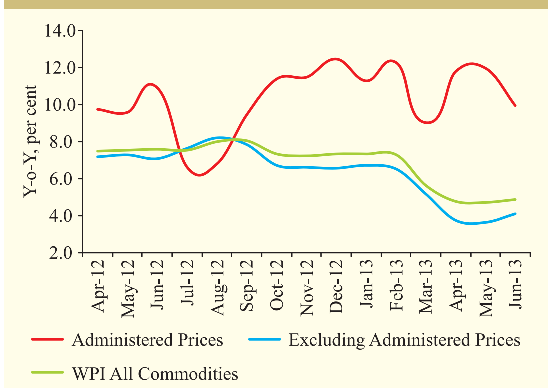


Chart VI.6: Global and Domestic Fuel Prices

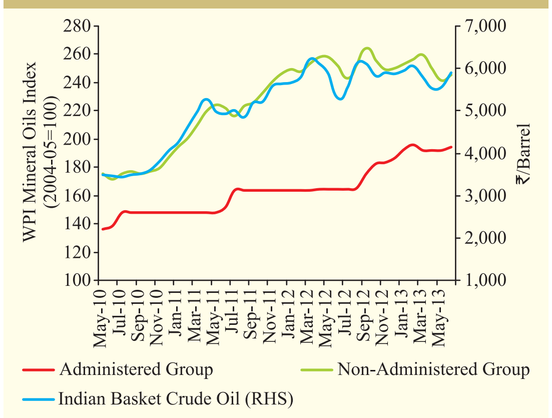
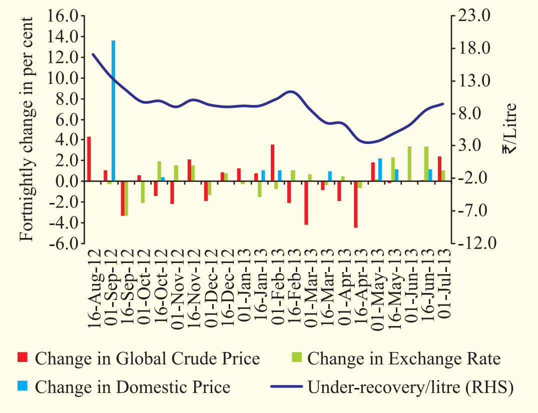


Chart VI.7: Trends in Under-recovery in Diesel



global crude prices and a relatively stable exchange rate led to a significant decline in the extent of under-recoveries. Since mid-May 2013, however, the depreciation in the exchange rate and the increase in global crude oil prices offset the moderating impact of staggered increases in domestic prices. The per-litre under-recovery for OMCs from the sale of subsidised diesel increased to ₹9.5 per litre effective July 16, 2013, from a low of ₹3.7 per litre during the second fortnight of May 2013.

VI.12 Coal India has revised upwards the prices of coal from May 28, 2013, which could lead to an increase in input cost pressures for coal-consuming industries. Given the problems in the coal sector in terms of availability of coal, the government approved the proposal to set up an independent regulatory authority for the coal sector and also approved the introduction of the Coal Regulatory Authority Bill, 2013 in Parliament. This is expected to remove constraints in the sector and ensure improved supply and better clarity in pricing.

VI.13 Several State Electricity Boards (SEBs) revised their prices upwards in May 2013, which led to a 13 per cent increase in the electricity price index in the WPI. Further increases in electricity prices cannot be ruled out, as the increase in coal prices could lead to input price pressures. Further, the government has approved the recommendations of the Rangarajan Committee on natural gas pricing, according to which, domestic natural gas prices would be based on competitive international prices from April 2014. This could lead to increases in costs of production for gas-based power and fertiliser plants. The impact on inflation, however, could depend on how end-user prices are adjusted in line with increasing costs.

Generalised inflationary pressures ease, as the output gap remains negative

VI.14 The non-food manufactured products (NFMP) inflation, which is seen as an indicator of generalised inflationary pressures, declined significantly in recent months to reach 2.0 per cent by June 2013, largely driven by a decline in inflation in the metals and chemicals groups (Chart VI.8). Global metal prices have declined significantly in recent months, leading to a decline in domestic prices, even after accounting for the impact of rupee depreciation.

VI.15 Along with declining input cost pressures, demand conditions also remained weak, leading to lower pricing power of the firms. The Purchasing Managers Index (PMI) for manufacturing indicates that both input costs and output price pressures had ebbed in recent months (Chart VI.9). The PMI for output price declined to below 50 in May 2013, indicating a contraction in output prices. However, the PMI for input price exhibited a sharp turnaround in June 2013, reflecting the impact of rupee depreciation.

Chart VI.8: Contributors to Non-food Manufactured Products Inflation

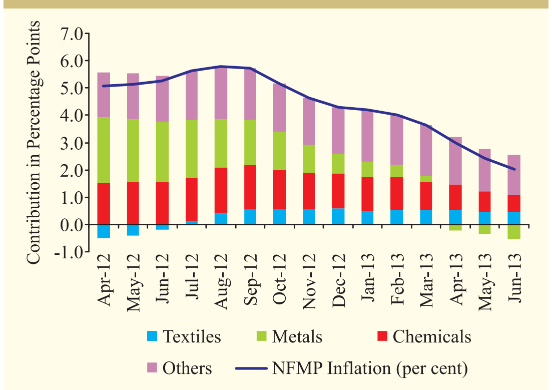
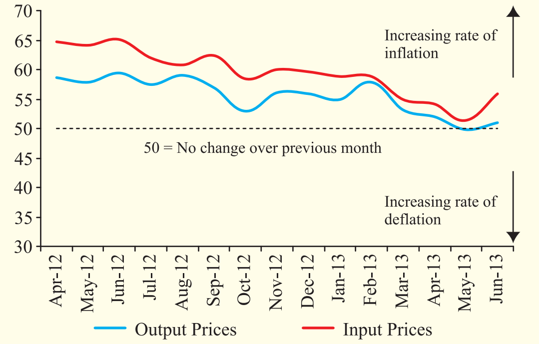


Chart VI.9: Purchasing Managers Index (PMI) Output and Input Prices (Seasonally Adjusted)



Source: HSBC Markit.

Pass-through of exchange rate depreciation could offset benefits from falling commodity prices

VI.16 Global commodity prices have exhibited negative inflation since March 2012. The impact of this on domestic inflation, however, remained muted, as the exchange rate depreciation acted as an offsetting factor (Chart VI.10). In the case of crude oil, the recent firming of global prices along with rupee depreciation pass-through could lead to higher domestic fuel prices. In terms of empirical estimates, while the pass-through of rupee depreciation has come down over period, the impact of the recent depreciation of the rupee on WPI inflation could still be significant. Recent estimates indicate that a 10 per cent depreciation could lead to about 1.0 percentage point increase in the WPI inflation. However, the exact impact could be conditional on a number of factors including how administered prices are adjusted in line with changes in rupee cost of imports and the pricing power of firms.

Real wage growth moderates in the recent period, driven by higher inflation in rural areas

VI.17 Rural wages, which were growing at over 20 per cent (y-o-y) during 2010-12, grew at a slower pace during 2012-13, but still remain in the high double digits. A significant pick-up in rural inflation in recent months contributed to a faster decline in real wage growth (Chart VI.11). There is, however, significant variation in wages and inflation across states (Chart VI.12).

Divergence between WPI and CPI inflation remains wide

VI.18 The Consumer Price Index (CPI-combined: rural + urban) inflation remained close to double digits compared with WPI inflation, which fell below 5 per cent during Q1 of 2013-14 (Chart VI.13). This further widened the gap between WPI and CPI inflation. From the compilation point of view, the CPI and the WPI differ on several counts, such as coverage of commodity/service, weighting diagram, the stage at which price quotations are collected, associated market (*i.e.*, wholesale market, retail market) and base year.

VI.19 The difference between wholesale and retail price levels can largely be attributed to trade

Chart VI.10: Exchange Rate and Commodity Price Movements

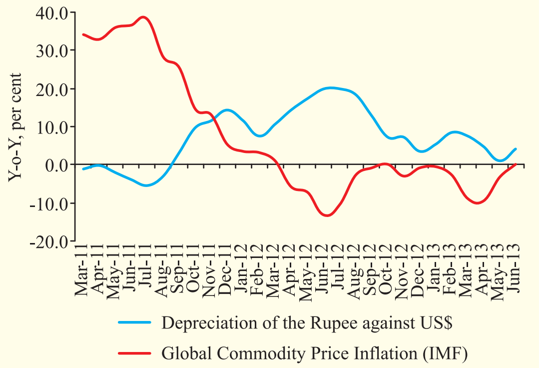


Chart VI.11: Rural Wages and Inflation

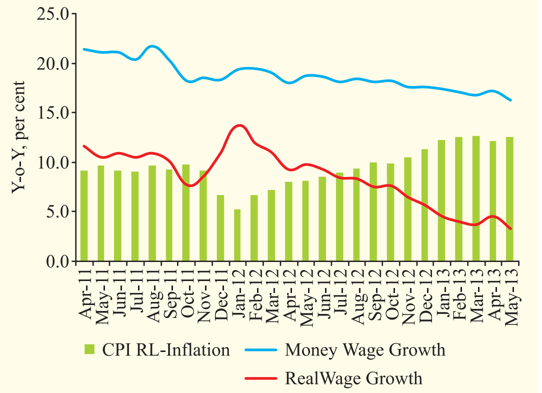
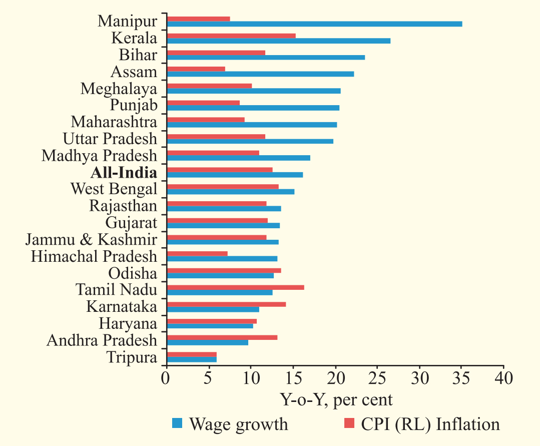


Chart VI.12: State-wise Inflation and Rural Wages, May 2013



and transports margins and taxes across states. In the case of market integration the price pressures should reflect identically in the wholesale and retail markets as movements in wholesale prices should translate to the retail market with some lag. However, supply-demand gap at the regional level, could lead to greater pressures on retail prices than in the wholesale market. This requires improving the current state of supply chain management to provide better market access to farmers, storage facilities and transportation.

Divergence in wholesale and retail inflation remains high in some food items

VI.20 Apart from the divergence attributed to weights and commodities, there has been a divergence in price movements at the commodity group levels. Food price inflation in the WPI moderated at a faster rate than in CPI during February-April 2013 (Chart VI.14). The sharper moderation in the WPI food inflation was due to a decline in inflation of fruits and vegetables along with some softening in the inflation of cereals and pulses, except in May and June 2013. In the CPI, inflation in cereals and pulses remained high, with some moderation in inflation in vegetables and fruits during the same period.

Headline inflation has moderated, but upside risks persist

VI.21 The moderation in headline inflation during Q1 of 2013-14 was on account of declining international commodity prices, negative output gap and past monetary policy actions. The pick-up in headline WPI and CPI inflation in June 2013 suggest that inflation remains a concern even as the non-food manufactured products inflation has recorded a sharp decline to a low of 2.0 per cent. Moreover, CPI inflation rules close to double digit. While slow growth is likely to keep demand conditions largely subdued, risks persist from the recent exchange rate depreciation and the pick-up in global commodity prices, especially of crude oil. These risks underscore the need for continuous vigil and monitoring on the inflation front.

Chart VI.13: WPI and New CPI Inflation

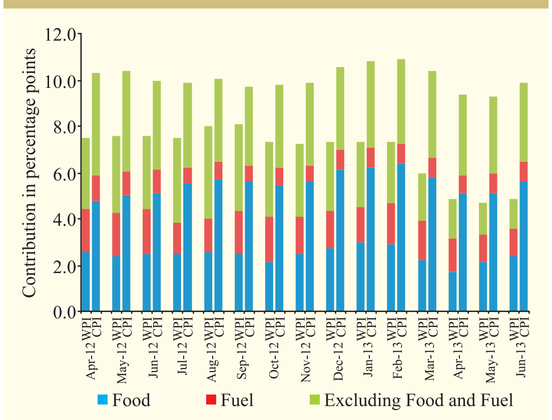
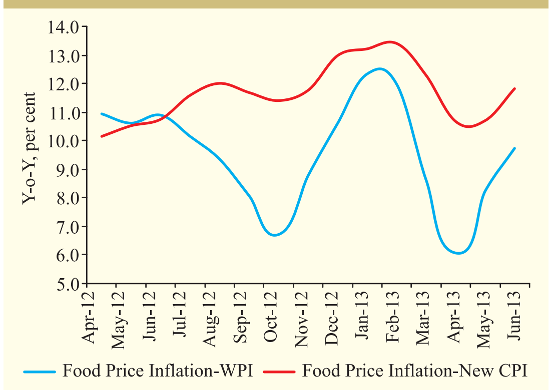


Chart VI.14: Divergence in Food Prices in CPI and WPI



VII. MACROECONOMIC OUTLOOK

Going forward, macroeconomic outcomes crucially hinge on evolving macro-financial conditions and domestic policy response. These conditions worsened during Q1 of 2013-14 as financial volatilities, which were set off from signals that the global interest rate cycle may start to turn, disrupted capital inflows to the EMDEs. If these trends amplify, there may be a risk to both growth recovery and inflation moderation. Business confidence remains low, as is evident from recent expectations surveys. Growth is expected to pick only slowly as the year progresses. While headline inflation has moderated, high consumer price inflation remains a concern. While recent measures to address exchange rate volatility have provided a temporary breather, it is important that structural reforms are pushed through to support growth revival and reduce CAD.

Recovery may take time, although growth is expected to improve as the year progresses

VII.1 After two years of deceleration, growth appears to be stabilising. Growth in Q4 of 2012-13 was broadly the same as in the previous quarter. Early indications for Q1 of 2013-14 suggest that the recovery is yet to shape in the economy. IIP growth stagnated during April-May 2013 recording a growth of 0.1 per cent. The contraction in May has been large on a seasonally adjusted basis. However, there are emerging signs that the downturn could be getting contained. Agricultural prospects for 2013-14 are encouraging given the good monsoon so far. Revival in mining and manufacturing will take some more time but some improvement is likely later in the year. The robust rural demand on the back of a good monsoon is likely to render some support. Meanwhile, the deceleration in services sector activity has added to the growth worries and lead indicators for the services sector suggest that services activity remains weak.

VII.2 The well-distributed rainfall so far, that has been excess or normal in all regions except Haryana, east and north east, raises the prospects of improved agricultural growth and a pick-up in demand for consumer goods. The increase in the water storage levels in the reservoirs would also enable the hydro-power sector to enhance their capacity utilisation and contribute to improved electricity output. However, growth revival would require a pick-up in a range of services activities that fall under construction and 'trade, hotels, transport and communications'. Overall, revival will not materialise until stable policy and regulatory regimes supportive of industrial activity are firmly in place and the envisaged plans to remove structural bottlenecks are quickly and fully implemented.

Sustainable recovery requires control over consumer price inflation

VII.3 India's consumer price inflation has been hovering around the double digits for 15 consecutive months. Such high inflation is a source of internal and external disequilibrium. It causes real consumption demand to fall along with lowering of household savings that provide the bulk of financial surpluses to support private and public investments. High consumer price inflation does not help public finances either as it puts pressure for larger fiscal subsidies. As domestic savings get eroded, it widens the external gap reflected in the CAD. High inflation also means large inflation differential *vis-à-vis* global trading partners which then makes the economy vulnerable to currency pressures. India's current macroeconomic deterioration to a large extent, reflects the three years of high inflation, which is well above the threshold at which it turns detrimental to growth. While the fall in headline WPI inflation affords some comfort, it is important to bring consumer price inflation under control.

VII.4 Going forward, inflation risks remain. The recent rupee depreciation of about 9 per cent in Q1 of 2013-14 is likely to put some fresh pressure on domestic inflation as pass-through occurs. Fuel under-recoveries have risen sharply due to the exchange rate depreciation and domestic price rigidities. Given the wide CAD, it is important to keep fiscal deficits under check. Therefore, it is necessary to pass on increases and adjust administered prices in the energy sector, including coal and electricity. However, in the short-run it poses challenges for inflation management.

Surveys show business confidence continues to weaken

VII.5 Recent surveys on business expectations show that business confidence has weakened further. There has been moderation on a y-o-y and q-o-q basis in the key indices that capture business prospects (Table VII.1). According to the FICCI survey, stiff global economic outlook, weak demand and the cost of credit continue to be concerns. The Dunn and Bradstreet Business Confidence Index declined by 7.8 per cent compared to the previous quarter due to uncertainty in economic outlook, both external and domestic, and constrained pricing power due to weak demand. According to CII, economic and political instability, high levels of corruption and infrastructure and institutional shortages are the three top concerns of firms. The latest NCAER survey shows some improvement on a q-o-q basis, but a decline on a y-o-y basis. While the seasonally adjusted HSBC Markit Purchasing Managers' Index (PMI) for manufacturing improved marginally during June 2013, the PMI for services declined although it remained in expansionary mode. The input and output price indices for both the sectors increased.

Business expectations remain weak

VII.6 The 62nd Round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS62) conducted during Q1 of 2013-14 showed a weakening of business sentiments with the Business Expectations Index (BEI) for Q1 of 2013-14 touching the lowest level in the past three financial years. However, the index showed improvement for Q2 of 2012-13 (Chart VII.1).

VII.7 An analysis of the net responses among various components of demand conditions shows that sentiments on production, order books, capacity utilisation and exports dropped substantially, whereas the sentiments on imports remained broadly unchanged. However, their outlook for Q2 of 2013-14 shows slightly improved optimism.

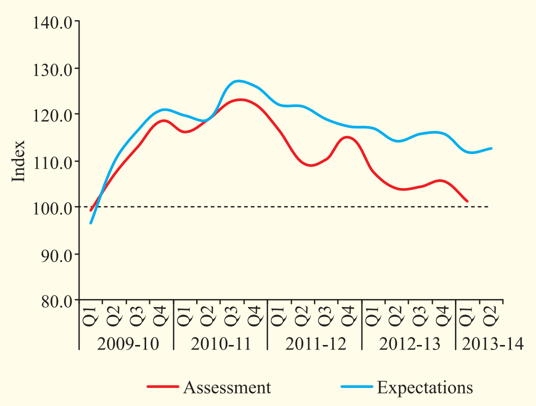
VII.8 The results also pointed to deterioration in the overall financial situation which dropped for Q1 of 2013-14 but showed improved

Table VII.1: Business Expectations Surveys

Period Index	NCAER- Business Confidence Index July 2013#	FICCI Overall Business Confidence Index Q4:2012-13	Dun & Bradstreet Business Optimism Index Q3: 2013	CII Business Confidence Index Q1: 2013-14
1	2	3	4	5
Current level of the Index	117.7	57.4	130.6	51.2
Index as per previous survey	114.1	61.2	141.6	51.3
Index level one year back	126.6	60.3	136.1	55.0
% change (q-on-q) sequential	3.2	-6.2	-7.8	-0.2
% change (y-on-y)	-7.0	-4.8	-4.0	-6.9

to be released.

Chart VII.1: Business Expectation Index



optimism for Q2 of 2013-14. Although the cost of external finance is perceived to rise, the percentage of respondents expecting this rise has been declining since Q4 of 2011-12. Sentiments remained broadly unchanged for availability of finance. While the cost of raw material is expected to rise, there is a marginal drop in sentiments for rise in selling price in Q2 of 2013-14. The perception on profit margins continued to remain in negative terrain, but showed some improvement for Q2 of 2013-14 (Table VII.2).

Consumer confidence on current situation remains weak, although optimism about the future improves

VII.9 The 13th Round of the Consumer Confidence Survey (http://www.rbi.org.in/CCS13) conducted by the Reserve Bank in June 2013 indicated subdued consumer confidence with the Current Situations Index (CSI) remaining at the same level as in the previous quarter. However, Future Expectations Index (FEI) indicates some improvement in consumer confidence, with an increase in positive perceptions on income and employment (Chart VII.2). The CSI and FEI have been estimated based on current and future perceptions of economic conditions, household

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

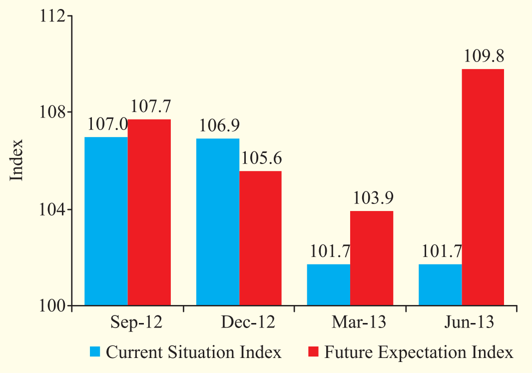
Parameter	Optimistic Response	Net Response[1]								
		Jul -Sep 2012		Oct-Dec 2012		Jan-Mar 2012		Apr-Jun 2013		Jul-Sep 2013
		E	A	E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9	10	11
1. Overall Business Situation	Better	30.6	16.1	32.2	17.2	37.5	18.4	29.6	12.8	30.0
2. Overall Financial Situation	Better	23.6	12.2	25.8	12.7	27.0	11.8	21.9	9.5	24.1
3. Production	Increase	33.6	18.8	35.7	18.6	37.1	18.6	24.4	9.8	28.5
4. Order Books	Increase	29.9	12.0	30.3	12.9	29.8	14.0	22.3	9.7	25.3
5. Capacity Utilisation	Increase	18.4	6.3	20.0	5.7	21.7	7.8	11.7	2.3	15.9
6. Exports	Increase	20.5	10.0	18.0	9.3	18.4	10.8	16.7	8.6	18.6
7. Imports	Increase	15.5	9.8	14.0	8.8	13.5	8.3	11.9	8.0	11.2
8. Employment in the Company	Increase	12.3	8.3	13.3	6.7	10.3	5.5	8.0	3.2	7.7
9. Availability of Finance (from internal accruals)*	Improve						12.1	18.7	10.8	17.2
10. Availability of finance (from banks and other sources)*	Improve						13.4	15.3	12.1	15.2
11. Availability of finance (from overseas)*	Improve						3.4	6.3	5.0	7.0
12. Cost of External Finance	Decrease	-24.0	-27.4	-20.6	-24.4	-18.1	-17.6	-14.3	-14.5	-12.4
13. Cost of Raw Material	Decrease	-51.4	-59.6	-48.6	-50.7	-45.0	-53.5	-45.6	-49.9	-43.4
14. Selling Price	Increase	18.8	18.5	17.3	10.2	15.8	9.1	14.9	7.3	12.1
15. Profit Margin	Increase	-3.6	-15.1	-1.3	-16.7	-2.0	-15.3	-4.9	-18.4	-3.7

[1] *Net response* is the percentage difference between the *optimistic* (positive) and *pessimistic* (negative) responses; responses indicating status quo (no change) are not reckoned. Higher 'net response' indicates higher level of optimism and *vice versa*.

*: These questions are newly added by splitting the questions on availability of finance (both internal and external sources) in the 61st Round (Jan-Mar 2013).

E: Responses for Expectation quarter A: Responses for Assessment quarter

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



circumstances, income, spending, price level and employment situation.

External agencies revise India's growth projections downwards

VII.10 Most external agencies have revised India's growth projections downwards. These include the International Monetary Fund (IMF), the World Bank, the Organisation for Economic Co-operation and Development (OECD) and the Asian Development Bank (ADB). The external agencies' growth projections range between 5.3 and 6.7 per cent (Table VII.3).

Survey of Professional Forecasters indicates expectations of higher growth during 2013-14[1]

VII.11 The Reserve Bank's 24th Round of the Survey of Professional Forecasters outside the Reserve Bank (http://www.rbi.org.in/SPF24) expects recovery in growth from 5.0 per cent during 2012-13 to 5.7 per cent during 2013-14. Growth is expected to rise further to 6.5 per cent in 2014-15. Average WPI inflation is expected to moderate to 5.3 per cent during 2013-14. The twin deficits are also expected to improve during 2013-14 (Table VII.4).

Table VII.3: Agencies' Projections for 2013-14

Agency	Latest Projection		Earlier Projection	
	Real GDP Growth (per cent)	Month/ Year	Real GDP Growth (per cent)	Month/ Year
1	2	3	4	5
Finance Ministry	6.1 to 6.7	Feb. 2013	-	-
PMEAC	6.4	Apr. 2013	-	-
IMF	5.6	July 2013	5.8	Apr. 2013
World Bank	5.7	Jun. 2013	6.1	Apr. 2013
OECD*	5.3	May. 2013	5.9	Dec. 2012
ADB	5.8	Jul. 2013	6.0	Apr. 2013
NCAER	6.2	May. 2013	6.2	Jan. 2013

* GDP at market prices.

Inflation Expectations Survey of Households

VII.12 The latest round of the Inflation Expectations Survey of Households (IESH Round 32) (http://www.rbi.org.in/IESH32), conducted across 5,000 households in 16 cities and 7 occupational classes during June 2013, indicates that the three-month ahead and one-year ahead median inflation expectations remain at similar levels as in the previous quarter (Chart VII.3). However, the proportion of respondents expecting a price increase *'more than current rate'* in the one-year ahead period has diminished for all product groups (food products, non-food products, household durables, housing and cost of services). In the case of the three-month ahead period, those proportions have marginally diminished for food products and cost of services.

Amplifying macro-financial risks warrant a cautious monetary policy stance

VII.13 Although headline inflation has receded in Q1 of 2013-14 and the CAD has moderated during Q4 of 2012-13, macro-financial risks increased distinctly during Q1 of 2013-14. Faced with exchange market pressures, the Reserve Bank responded in July 2013 with

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

Table VII.4: Median Forecasts of Select Macroeconomic Indicators by Professional Forecasters 2013-14 and 2014-15

	Actual 2012-13	Annual forecasts				Quarterly Forecast									
		2013-14		2014-15		2013-14								2014-15	
						Q1		Q2		Q3		Q4		Q1	
		E	L	E	L	E	L	E	L	E	L	E	L	E	L
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. Real GDP growth rate at factor cost (%)	5.0	6.0	5.7	-	6.5	5.5	5.0	5.8	5.4	6.2	6.1	6.4	6.2	-	6.1
a. Agriculture & Allied Activities	1.9	3.0	3.0	-	3.0	2.7	2.5	3.0	3.1	3.3	3.5	3.0	3.3	-	3.0
b. Industry	1.2	4.4	3.6	-	5.5	3.7	3.0	4.1	3.7	4.4	4.0	4.7	3.8	-	4.6
c. Services	6.8	7.1	7.1	-	7.6	6.8	6.4	7.0	6.8	7.4	7.2	7.7	7.4	-	7.5
2. Gross Domestic Saving (% of GDP at current market price)	-	30.0	30.3	-	31.3	-	-	-	-	-	-	-	-	-	-
3. Average WPI-Inflation (%)	7.4	6.5	5.3	-	5.7	-	-	6.0	4.8	6.5	5.4	6.8	5.5	-	5.6
4. Exchange Rate (₹/US$ end period)	54.4	-	-	-	-	-	-	54.8	60.0	54.4	59.5	54.0	59.5	-	59.5
5. 10-year Central Govt. Securities Yield (% end period)	8.0	7.7	7.4	-	7.0	-	-	-	-	-	-	-	-	-	-
6. Export (growth rate in %)!	-1.0	8.7	4.4	-	9.0	-	-	-	-	-	-	-	-	-	-
7. Import (growth rate in %)!	0.5	7.4	3.9	-	7.0	-	-	-	-	-	-	-	-	-	-
8. Trade Balance (US$ billion)	-195.7	-	-	-	-	-48.6	-50.6	-52.0	-50.0	-59.6	-55.2	-56.6	-47.6	-	-55.0
9. Current Account Deficit (% of GDP)	4.8	4.5	4.4	-	3.9	-	-	-	-	-	-	-	-	-	-
10. Central Government Fiscal Deficit (% of GDP)	4.9	5.0	4.8	-	4.7	-	-	-	-	-	-	-	-	-	-

E: Previous Round Projection. L: Latest Round Projection. - : Not Available. !: US$ on BoP basis

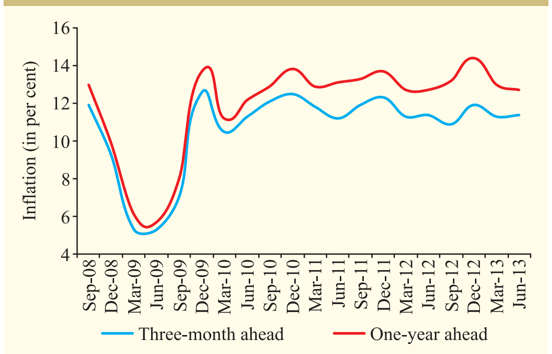
Note: Latest round refers to 24th Round for the quarter ended June 2013, while Previous Round refers to the 23rd Round for the quarter ended March 2013.

Source: Survey of Professional Forecasters, First Quarter 2013-14.

measures designed to curtail rupee liquidity with a view to curb the volatility in the rupee exchange rate. The immediate reaction of the measures has been rupee positive.

VII.14 However, macro-financial risks could still amplify further under a number of possible developments. First, financial market conditions could tighten further with, or in anticipation of, partial withdrawal of monetary stimulus in AEs. This, in turn, could trigger further portfolio shifts of capital from EMDEs to AEs and magnify the impact. Second, recovery in AEs could falter again with fiscal multipliers feeding through to slacken growth on the back of expenditure cuts and tax increases. Third, growth in key EMDEs, especially China, could slow further if rising inflation and financial sector fragilities force monetary prudence. Fourth, global trade deceleration may get extended if global growth slows again. Fifth, if domestic growth continues to decelerate, it could have a spiraling effect on the fiscal deficit, as revenues will fall. This could pose

Chart VII.3: Three-month and one-year ahead median inflation expectations- Inflation Expectation Survey of Households



risk to macroeconomic and financial stability, especially if wider fiscal deficit spills over to the current account gap. Sixth, fiscal deficit could widen if the exchange rate pass-through is constrained by holding back administered price revisions. Seventh, sustained high consumer price inflation could slow real demand and savings in the economy. Finally, political uncertainties could rise as part of the electoral cycle, which could affect the macroeconomy through different channels.

VII.15 Macroeconomic conditions have distinctly weakened during Q1 of 2013-14. There is no evidence yet of recovery in growth even as headline inflation has moderated. Consumer price inflation, especially food inflation, remains high, although a good monsoon should help in this regard. Business confidence remains low, as is evident from recent expectations surveys. The external sector is under stress. While recent liquidity tightening measures instituted by the Reserve Bank to curb volatility in the exchange rate provide at best some breathing time, it is important to push through structural reforms necessary to inspire the trust and confidence of both domestic and foreign investors. The priority for monetary policy now is to restore stability in the currency market so that macro-financial conditions remain supportive of growth. This strategy will succeed only if reinforced by structural reforms to reduce the CAD and step up savings and investment.

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