RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments Third Quarter Review 2011-12

Issued with the Third Quarter Review of Monetary Policy 2011-12

January 23, 2012

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Reserve Bank of India
Mumbai

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MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2011-12

Overview

1. *Global growth is slowing down again, after a contraction in 2009 and a recovery in 2010. The euro area appears headed for recession. A slowing global economy will continue to drag domestic recovery in 2012-13. However, available information suggests that in spite of a dip in growth, the world economy is unlikely to enter another recession.*

2. *Growth in India is moderating more than was expected earlier. It is likely to be below potential during 2011-12, but is expected to recover at a modest pace in 2012-13. The slack in investment and net external demand components of aggregate demand may keep the pace of recovery low. Inflation has started to fall, broadly in line with the projected trajectory. Nonetheless, price pressures remain, with risks emanating from suppressed domestic energy prices, the incomplete pass-through of rupee depreciation and slippage in fiscal deficit. The decline in food inflation is likely to reverse ahead with the waning of base effects and seasonal factors behind the fall.*

3. *The growth slowdown, high inflation and currency pressures, complicate policy choices. While monetary policy's main goal is to maintain low and stable inflation, it also has to take into account the downturns in growth for possible counter-cyclical responses. These responses need to factor in the overall macro-economic situation, including fiscal and current account gaps. So, while the course of monetary policy ahead will be largely calibrated and shaped by the evolving growth-inflation dynamics, the impact of other macro-variables would have to be considered as they condition these dynamics.*

Global Economic Conditions

Global growth moderates, hinging on euro area debt resolution

4. *Global recovery is likely to lose traction due to the continuing euro area debt crisis. The news flow from the US has been mixed, with growth accelerating in Q3 of 2011 but getting revised downwards substantially from the initial estimates. Unemployment rate fell to 8.5 per cent in December 2011 and consumer confidence improved. However, growth in euro area is already stagnating and as fiscal austerity progresses, the area could enter into a recession. With growth decelerating in emerging and developing economies (EDEs), the spillovers from euro area are likely to pull down global growth. As such, global growth hinges on resolution of euro area debt problem, which, notwithstanding significant policy responses in recent months, faces impediments.*

Financial market stress rises as sovereign credit risks mount with private sector bailouts

5. *Global financial markets came under stress during Q3 of 2011-12. An adverse feedback loop between bank and sovereign debt generated significant refinancing risks that could only be contained in the interim through policy actions in the euro area. These*

measures may still fall short of successful debt resolution and the risk of contagion may continue to loom. The S&P's sovereign rating downgrade of nine euro area countries on January 13, 2011, with four of them being downgraded by two notches, was reflective of the rising sovereign balance sheet problems. Tightening credit conditions, rising risk premiums, deleveraging, weakening economic growth in the euro area are keeping global financial markets under stress.

Global commodity prices continue to moderate, but oil prices hold

6. *Global commodity prices, especially those of metals, continue to moderate. The LME Metals index has softened and the FAO food index has also dropped. However, oil prices have defied the trend. The current Brent crude oil price is still 30 per cent higher than its average for 2010-11, reflecting a combination of demand and supply factors along with financial impact of large quantitative easing by Advanced Economies (AEs). Going forward, some further softening in commodity prices on the back of weaker global growth is likely in 2012-13. However, upside risk to oil price remain from rising geo-political uncertainty.*

Indian Economy: Developments and Outlook

Output

Global linkages reinforce domestic factors to slow down economy

7. *Global spillovers through trade and capital flow channels are slowing down India's growth more than earlier anticipated. The impact has been exacerbated by domestic factors, both cyclical and structural. Industrial growth has been adversely affected by contraction in mining, deceleration in manufacturing and slowdown in construction activity. This will have some adverse impact on the growth of services sector.*

Aggregate Demand

External and investment demand may drag growth ahead

8. *Growth in the economy has been impacted by lower external and investment demand during last three quarters. There has been a sharp decline in new corporate fixed investment since H2 of 2010-11 and this trend continues. Going forward, investment may start recovering in 2012-13 contributing to growth recovery. There is need to contain fiscal slippage and rebalance public spending from consumption to investment to support medium-term growth.*

External Sector

CAD risks amplify as capital flows moderate

9. *Early indicators suggest that the current account came under increased pressure during Q3 of 2011-12. Inelastic demand for oil and rising gold imports have widened the trade deficit, while exports decelerated. As capital flows have also moderated since August 2011, financing pressure on the current account deficit (CAD) translated into exchange rate pressures. While various external vulnerability indicators deteriorated, India's net international investment position improved. To reduce external sector pressures, moderation in import demand and acceleration in domestic reforms are needed.*

Monetary and Liquidity Conditions

Monetary growth keeps pace even as money market liquidity tightens

10. *Monetary policy rate was kept on hold in December 2011 based on forward-*

looking assessment of risk to growth and moderation in inflation. However, a turnaround in the monetary cycle would depend on how growth-inflation dynamics shape ahead. Money market liquidity tightened significantly since November 2011 partly due to dollar sales by RBI, but monetary growth has kept pace with the money multiplier rising endogenously. Credit growth slowed below the indicative projection due to demand as well as supply side factors. Demand for credit weakened in response to slack in real activity. Supply also slowed down with rising risk aversion stemming from deteriorating macroeconomic conditions and rising non-performing loans.

Financial Markets

Markets come under pressure from global spillovers

11. *Global spillovers and macroeconomic deterioration resulted in pressures on equity and currency markets. The sharp depreciation of the rupee during August-December 2011 contributed to the drying up of foreign equity inflows and in turn, further weakened the rupee. The sudden stop of equity financing also impacted investment financing. The impact was compounded by poor resource mobilisation in the primary capital market. The stress in the financial markets was mitigated by policy measures that included infusion of rupee and dollar liquidity. As a result, call money rates largely remained within the interest rate corridor and the spikes were effectively contained.*

Price Situation

Inflation trending down but exchange rate pass-through to limit fall

12. *Inflation is moderating as result of fall in vegetable prices, favourable base effects and some fall in pricing power of the manufacturers. The current momentum of decline in inflation is likely to persist through Q4 of 2011-12. However, the as yet incomplete exchange rate pass-through, pressures from suppressed energy prices and structural factors contributing to protein-based food inflation are likely to limit the decline in inflation. Furthermore, expansionary fiscal policy is likely to impact price stability by affecting aggregate demand. Since the fiscal expansion is largely on revenue account and capital spending remains low, it can adversely affect the supply responses needed to lower long-run inflation.*

Macroeconomic Outlook

Growth outlook weakens, calibrated response needed as inflation risks stay

13. *The Growth outlook has weakened as a result of adverse global and domestic factors that have been mentioned above. Business and consumer confidence has been impacted. Professional forecasters now see a weaker growth in the economy. However, inflation and expectations of inflation remain high and upside risks emanate from exchange rate pass-through, revisions in administered prices and higher-than-expected current fiscal spending. Consequently, monetary actions will need to strike a balance between risks to growth and inflation.*

I. OUTPUT

The global economy seems headed for another downturn after just three years. While parts of euro area are headed for a recession, slowdown is evident in most other advanced economies as well as emerging and developing economies. There has been a slowdown in growth in India as well given the external conditions, dampened investment demand and high inflation. While agriculture is so far the least impacted sector, the secondary and tertiary sectors have been underperforming. Deceleration in mining and construction sectors that have extensive forward linkages, continued volatility in production of capital goods and slowing activity in some services are of significant concern.

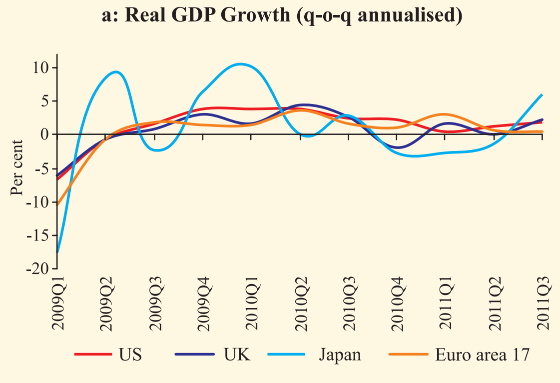
Global growth headed for downturn again as recession risks mount in euro area

I.1 Fiscal and financial uncertainty in the euro area and the slower recovery in the advanced economies (AEs) have compounded the risks of a sharp downturn in the global economy, with risk of a deep and prolonged recession in the euro area. GDP growth rates in Q3 of 2011 in the major AEs were stagnant or improved only marginally (Chart I.1a). The US economy grew at an annualised rate of 1.8 per cent (revised downwards from the earlier estimate of 2.0 per cent and first estimate of 2.5 per cent) in Q3 of 2011. Japan, though, showed some post-Tsunami recovery and grew at an annualised rate of 6.0 per cent in Q3, as against a decline of 1.3 per cent in Q2 of 2011. During Q3 of 2011, euro area GDP grew by 0.5 per cent quarter-on-quarter. Italy contracted, while Spain recorded zero growth.

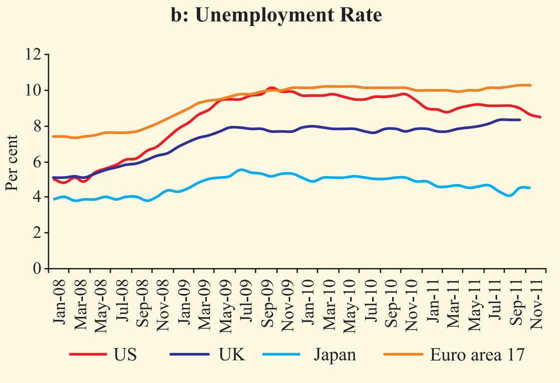
I.2 Unemployment rates in the AEs have persistently remained at high levels, though there was some improvement in the US where the unemployment rate dropped to a two and half year low of 8.5 per cent in December 2011 (Chart I.1b). Unemployment rate in the euro area is presently in double digits. With the sovereign debt crisis forcing several European countries to implement tough fiscal policies, risks of further worsening of the economic cycle in the region get accentuated.

I.3 Reflecting the knock on effects of the contagion to the emerging and developing economies (EDEs) China's growth decelerated for the third consecutive quarter in 2011 to 9.1 per cent in Q3 (y-o-y), the lowest in more than two years. Brazil's GDP growth decelerated to 2.1 per cent in Q3, compared with 3.3 per cent in Q2.

Chart I.1: Increasing Risks of Global Downturn



Source: Eurostat.



Source: Eurostat.

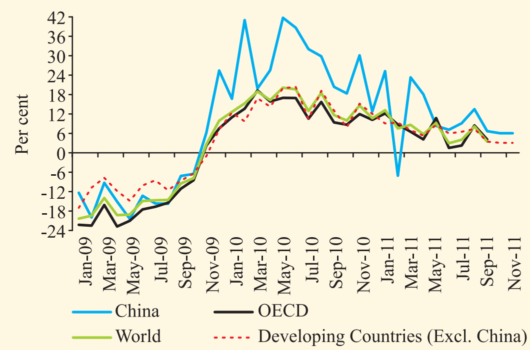
Cooling emerging markets' growth may further dampen India's external demand

I.4 EDEs, which were relatively insulated from the global slowdown during H1 of 2011, are now being subject to the effects of reduced external demand as AEs' export markets slump (Chart I.2). Chinese export growth decelerated to 13.8 per cent in November, with the overall trade surplus declining 35 per cent over November 2010. A credit crunch as a result of worsening of the euro area sovereign debt crisis could have implications for global trade as trade finance may dry up, causing trade volumes to fall more steeply. India has witnessed a slowdown in export growth in Q4 of 2011 in the wake of cooling external demand. Merchandise exports grew less than 4 per cent in November 2011.

Growth moderation in India significant

I.5 Growth in India is moderating on account of large linkages of the manufacturing sector with global demand, investment uncertainty and high interest rates. GDP growth moderated for the sixth consecutive quarter to 6.9 per cent in Q2 of 2011-12, the lowest growth in the last nine quarters (Table I.1). Momentum indicators, as reflected by the q-o-q seasonally adjusted annual growth rate (SAAR), have also shown a decline since Q4 of 2009-10 (Chart I.3).

Chart I.2: Goods Exports Growth in Volume (y-o-y)



Source: World Bank.

I.6 The deceleration in GDP growth in H1 of 2011-12 to 7.3 per cent from 8.6 per cent in the previous year was driven by a decline in 'mining and quarrying' and sharp moderation in manufacturing sector growth, even as 'electricity, gas and water supply' continued to gain momentum. The services sector also moderated, with the slack evident mainly in construction and 'community social and personal services'. The growth rate of the agriculture sector, however, remained steady during H1 of 2011-12.

I.7 The slack in both industrial and services sectors is partly reflective of the inter-linkages between the two sectors. However, in a

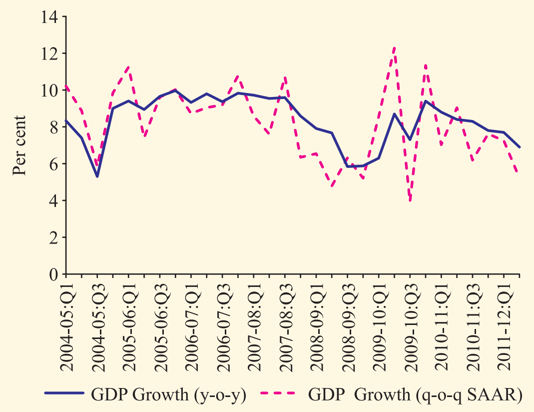
Table I.1: Sectoral GDP Growth (2004-05 prices)

(Per cent)

Item	2009-10*	2010-11#	2010-11				2011-12		2010-11	2011-12
			Q1	Q2	Q3	Q4	Q1	Q2	H1	H1
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture & allied activities	**0.4**	**6.6**	**2.4**	**5.4**	**9.9**	**7.5**	**3.9**	**3.2**	**3.7**	**3.6**
2. Industry	**8.3**	**7.8**	**9.7**	**7.3**	**6.2**	**5.3**	**6.7**	**2.8**	**8.5**	**4.7**
2.1 Mining & quarrying	6.9	5.8	7.4	8.0	6.9	1.7	1.8	-2.9	7.7	-0.5
2.2 Manufacturing	8.8	8.3	10.6	7.8	6.0	5.5	7.2	2.7	9.1	4.9
2.3 Electricity, gas & water supply	6.4	5.7	5.5	2.8	6.4	7.8	7.9	9.8	4.1	8.9
3. Services	**9.7**	**9.2**	**10.1**	**9.2**	**8.6**	**8.6**	**8.9**	**8.7**	**9.6**	**8.8**
3.1 Construction	7.0	8.1	7.7	6.7	9.7	8.2	1.2	4.3	7.2	2.7
3.2 Trade, hotels, transport, storage & communication, *etc.*	9.7	10.3	12.1	10.2	8.6	9.3	12.8	9.9	11.1	11.3
3.3 Financing, insurance, real estate & business services	9.2	9.9	9.8	10.0	10.8	9.0	9.1	10.5	9.9	9.8
3.4 Community, social & personal services	11.8	7.0	8.2	7.9	5.1	7.0	5.6	6.6	8.0	6.1
4. GDP at factor cost	**8.0**	**8.5**	**8.8**	**8.4**	**8.3**	**7.8**	**7.7**	**6.9**	**8.6**	**7.3**

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

Chart I.3: Momentum Indicator of Growth



downturn the services growth is likely to show resilience relative to the industrial growth.

I.8 On the whole, the growth rate of GDP remained below trend in H1 of 2011-12 (Chart I.4). The trend growth rate, which was estimated around 8.5 per cent on an average during 2005-06 to 2007-08, has dipped gradually thereafter and is presently about 8.0 per cent, indicating a structural decline in growth rate of the economy *vis-a-vis* 2005-08.

I.9 The downside risks to growth in 2011-12 and the next year emanate from the possible recession in the euro area, deceleration in export growth in recent months, the lagged impact of weak investment activity and uncertainty with regard to availability of crucial inputs such as coal.

Impact of dismal north-east monsoon limited, agriculture growth likely to stay around trend

I.10 As per the First Advance Estimates for *kharif* 2011-12, production of foodgrains, oilseeds, and other commercial crops, barring pulses, was higher than the *kharif* output in 2010-11. This is significant given the record production of these crops in the previous year. In the final analysis, the performance of *rabi* crops will determine the overall outcome for the agriculture sector. The progress of *rabi* sowing, so far in the season, has been satisfactory (Table I.2). Late rains received during September and October resulted in improved soil moisture level which is favourable for *rabi* crops. The water storage level in the major reservoirs, though lower than last year, is at a comfortable level. Although the below par performance of the north-east monsoon thus far can have some adverse impact on *rabi* production, the impact, nonetheless, is expected to be limited.

Managing food stock and reforming agriculture marketing

I.11 Foodgrain stocks continued to be higher than the requirement under the quarterly buffer norm and security reserve requirements (Chart I.5). The proposed National Food Security Bill (NFSB) has implications for the food management operations. These operation would need to be scaled up considerably, even while the off-take of stocks could improve.

Chart I.4: Trend GDP Growth

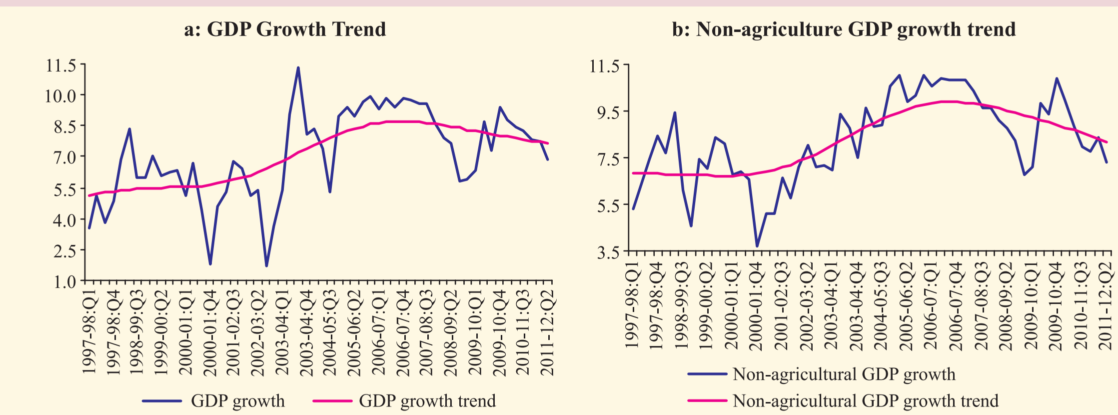


Table I.2: *Rabi* Area Sown

(Million hectares)

Crop	Sowing as on January 20			
	Normal Area	2011	2012	Per cent of Normal 2012
1	2	3	4	5
Total Foodgrains	**50.7**	**51.0**	**51.0** ***(0.0)***	**100.6**
of which				
Wheat	27.8	29.1	29.4 *(1.0)*	105.8
Rice	4.4	1.3	1.3 *(0.0)*	29.5
Coarse Cereals	**6.3**	**5.9**	**5.8** ***(-1.7)***	**92.1**
Cereals	**38.5**	**36.4**	**36.5** ***(0.3)***	**94.8**
Total Pulses	**12.3**	**14.7**	**14.5** ***(-1.4)***	**117.9**
of which				
Gram	7.6	9.3	8.9	117.1
Lentil	1.4	1.6	1.6	114.3
Peas	0.7	0.7	0.8	114.3
Urad	0.7	0.8	0.9	128.6
Moong	0.6	0.5	0.5	83.3
Total Oilseeds	**9.5**	**9.0**	**8.4** ***(-6.7)***	88.4
of which				
Rapeseed & Mustard	6.4	7.1	6.5	101.6
Sunflower	1.2	0.5	0.4	33.3
Groundnut	0.9	0.7	0.7	77.8
All Crops	**60.2**	**60.1**	**59.4** ***(-1.2)***	**98.7**

Note : Figures in parentheses are percentage change over previous year.
Source : Ministry of Agriculture, Government of India.

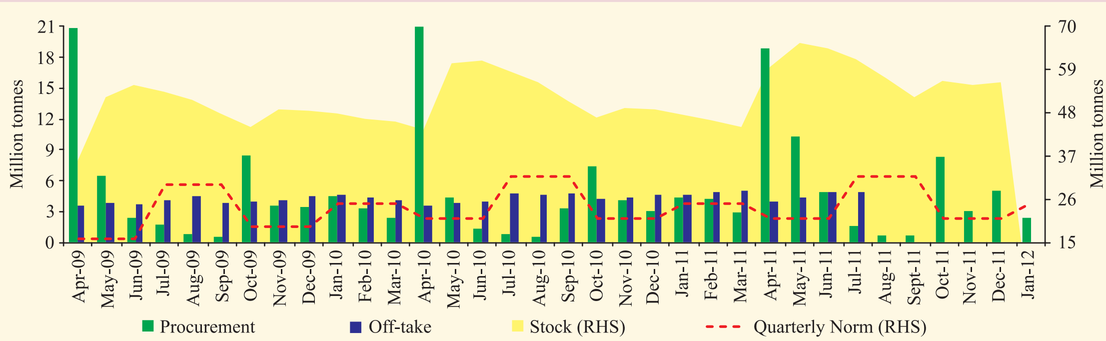
Expanded coverage and entitlements, as envisaged under the Bill, would warrant increase in procurement. This would require massive scaling up of storage facilities, which are already stretched beyond their carrying capacities, and other components of the delivery and distribution mechanism, including operation costs.

I.12 Implementation of the provisions of the model APMC Act, which provides for direct purchase and marketing, contract farming and setting up of markets in private and co-operative sectors, is expected to facilitate better market access to farmers, reduce transportation costs and increase farmers' income. 19 states/union territories have amended their APMC Acts so far. Faster implementation of the Act would enable better supply chain management, especially for perishable commodities such as fruits and vegetables.

Industrial slack emerges as export and domestic demand decelerate

I.13 With the slowdown in demand, both domestic as well as external, the Index of Industrial Production (IIP) growth moderated during April-November 2011 (Table I.3). Several factors have contributed to this moderation. Contraction in mining, *inter-alia*, reflects short-term impact of legal enforcements towards better governance. Poor performance of manufacturing underpins slack investment demand in the face of excess capacities built earlier and lower demand. Moderation in consumption expenditure, especially in interest-rate sensitive commodities, underperformance of the construction sector, hardening of interest rates and global economic uncertainty are some of the major factors behind the moderation in industrial growth. There is strong co-movement

Chart I.5: Food Stock and its Determinants



Note: 1. Data for off-take is upto July 2011, and stock as on December 31, 2011.
2. Procurement and off -take data are monthly figures.
3. Procurement for January 2012 is as on the January 13, 2012.

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

(Per cent)

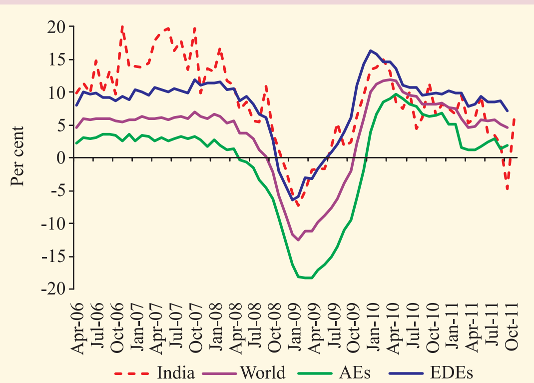
Industry Group	Weight in IIP	Growth Rate			Weighted Contribution#		
		Apr-Mar 2010-11	Apr-Nov		Apr-Mar 2010-11	Apr-Nov	
			2010-11	2011-12 P		2010-11	2011-12 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	14.2	5.2	7.0	-2.5	7.3	9.5	-7.4
Manufacturing	75.5	9.0	9.0	4.1	86.7	85.5	85.5
Electricity	10.3	5.5	4.5	9.5	5.9	4.9	21.8
Use-Based							
Basic Goods	45.7	6.0	5.4	6.2	29.1	26.5	63.7
Capital Goods	8.8	14.8	18.2	-1.0	25.2	29.5	-3.8
Intermediate Goods	15.7	7.4	8.1	-0.3	12.5	13.6	-1.0
Consumer Goods (a+b)	29.8	8.6	8.0	4.9	33.3	30.3	40.7
a) Consumer Durables	8.5	14.2	14.6	5.3	24.0	24.3	20.4
b) Consumer Non-durables	21.3	4.3	2.9	4.6	9.4	6.1	20.2
General	**100.0**	**8.2**	**8.4**	**3.8**	**100.0**	**100.0**	**100.0**

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

between the domestic and global IIP series, with a correlation coefficient of 0.72 for the period April 2006 to October 2011 (Chart I.6).

I.14 Manufacturing sector growth decelerated to 4.1 per cent during April-November 2011 from 9.0 per cent during the corresponding period last year, mainly on account of negative growth in sub-sectors such as 'textiles', 'chemicals and chemical products', 'machinery and equipment not elsewhere classified' and 'wearing apparel, dressing and dyeing of fur', which account for about 30 per cent of the weight in the manufacturing sector. High input

Chart I.6: Industrial Growth - India and the World (Y-o-Y)

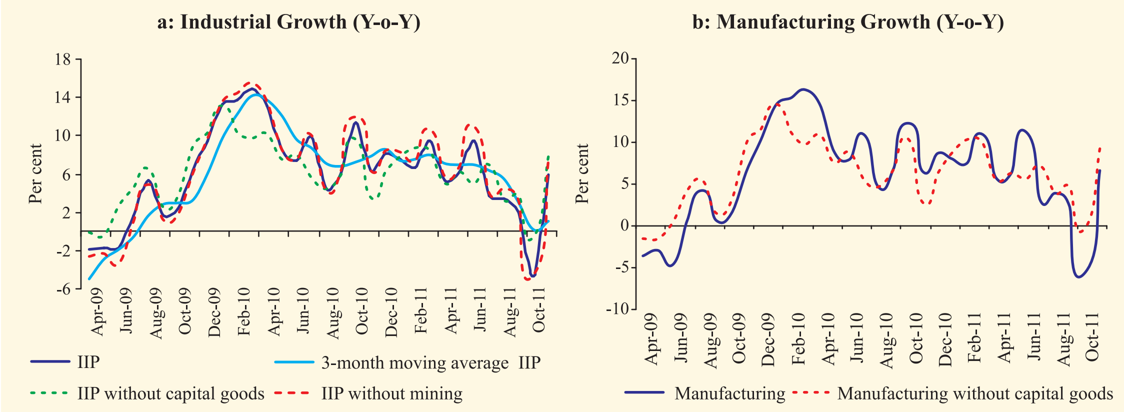


and capital costs and uncertain global economic outlook were the major factors constraining the growth of the manufacturing sector during the year.

I.15 As per the use-based classification, growth in all categories, except basic goods and consumer non-durables, moderated. Contraction of 1.0 per cent in capital goods output in April-November 2011, relative to a healthy 18.2 per cent expansion during the same period in 2010, highlights the weakening of investment activity. Also, the slowdown in the growth of consumer durables signals dampening of consumer demand.

I.16 The IIP witnessed a revival in growth to 5.9 per cent in November 2011 as against a decline of 4.7 per cent in the previous month. Robust growth in electricity generation and a revival in manufacturing production were the major drivers of IIP growth during the month. Production in the mining sector continued to contract. Use-based classification reveals that the manufacturing growth was driven by strong performance of the consumer goods and basic goods sectors. Capital goods and intermediate goods continued to under-perform. Excluding capital goods, the overall IIP and the

Chart I.7: Growth in Index of Industrial Production



manufacturing output increased by 7.8 per cent and 9.2 per cent, respectively (Chart I.7).

I.17 Overall, the pace of manufacturing sector growth remained uneven and highly concentrated across the sub-sectors, with eight out of the twenty two industry groups showing negative growth during April-November 2011-12. The top five manufacturing industries, with a combined weight of around 23 per cent in manufacturing, grew at 14.7 per cent, contributing about 78 per cent to the overall growth during April-November 2011-12 (Chart I.8).

Core industries crucial to reviving industrial growth

I.18 The core sector performance at 6.8 per cent in November 2011, was an improvement compared to 3.7 per cent in November 2010. However, during April-November 2011 the growth of core industries decelerated to 4.6 per cent as compared with 5.6 per cent during the corresponding period in 2010. The growth is mainly supported by the robust performance of electricity and steel sectors (Chart I.9). The recent slowdown in production in crucial infrastructure industries such as coal and natural gas raises concerns about the sustainability of industrial growth. The poor performance of coal sector may be partly attributed to regulatory and environmental issues and also excessive rainfall during the current year in the regions with major coalfields.

Capacity utilisation remains flat

I.19 The Order Books, Inventories and Capacity Utilisation Survey (OBICUS) [http://www.rbi.org.in/OBICUS15] of the Reserve Bank for Q2

Chart I.8: Growth Concentration in the Manufacturing Sector

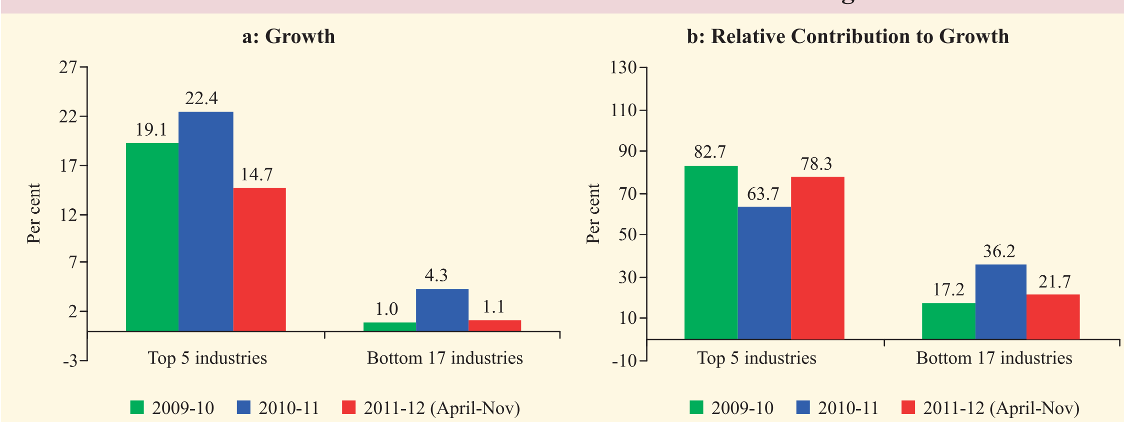
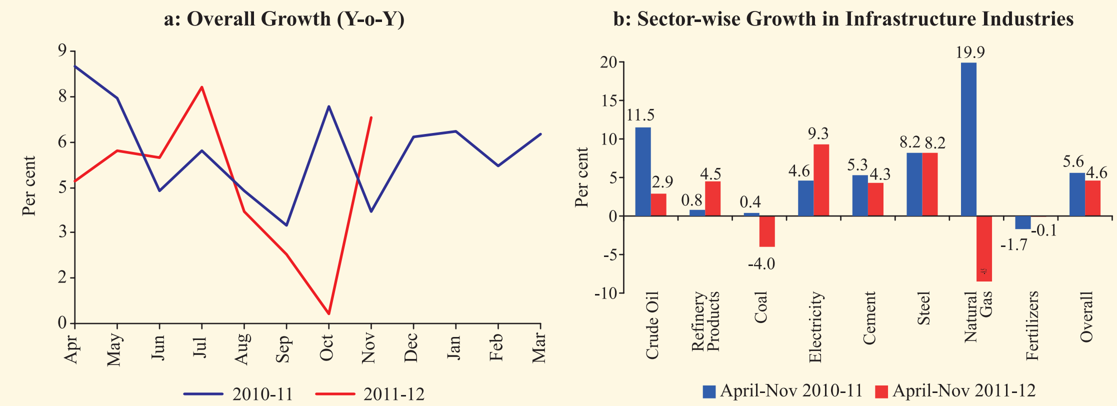


Chart I.9: Growth in Infrastructure Industries



of 2011-12 shows significant growth in new orders particularly in the case of basic metals, food products, motor vehicles, textiles, machinery & equipment and other non-metallic mineral products.

I.20 During H1 of 2011-12, capacity utilisation (CU) remained virtually flat and well below the peak level achieved in Q4 of 2010-11 (Chart I.10).

I.21 Nonetheless, reflecting the slowdown in production in infrastructure industries, most sectors operated with excess capacity during April-September 2011-12 with the exception of petroleum refinery products (Table I.4).

Services sector growth moderates led by weak construction and trade activity

I.22 The moderation in the services sector in H1 of 2011-12 was largely due to the sharp deceleration in the growth of the construction sector and 'community, social and personal services'. Services associated with trading activity registered a lower growth in Q2 of 2011-12 as compared with Q1.

I.23 The various lead indicators of services sector also point towards a weakening of momentum with telecommunication, civil aviation and construction industries registering lower growth compared to the previous year (Table I.5). This has been reinforced by credit slowdown to these sectors largely reflecting risk aversion by banks due to rising bad loans.

Upward trend in employment continues

I.24 The quarterly quick surveys of employment situation conducted by the Labour Bureau in select sectors of the economy indicate that employment has increased in eight major industries by 0.32 million during Q2 of 2011-12. This was the highest increase in employment

Chart I.10: OBICUS (Capacity Utilisation)

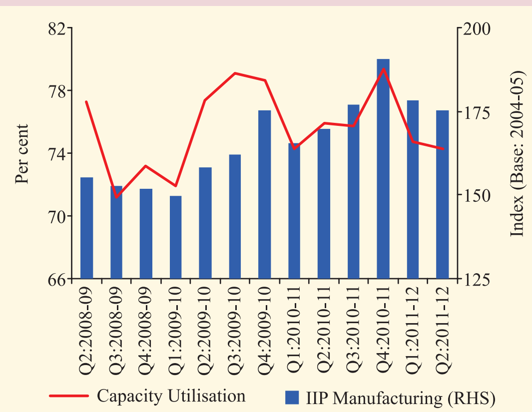


Table I.4: Capacity Utilisation in Core Sectors

(Per cent)

Sector	2009-10	2010-11	2011-12*
1	2	3	4
Finished Steel (SAIL+VSP+ Tata Steel)	90.7	92.0	88.1
Cement	82.0	76.0	72.0
Fertiliser	93.6	94.5	93.7
Refinery Production-Petroleum	107.4	109.3	110.7
Thermal Power	77.7	75.1	71.2

*: Data pertain to April-September 2011.

Source: Capsule Report on Infrastructure Sector Performance, Ministry of Statistics and Programme Implementation, GoI.

Table I.5: Indicators of Services Sector Activity

(Growth in per cent)

Services Sector Indicators	2008-09	2009-10	2010-11	Apr-Nov 2010	Apr-Nov 2011
1	2	3	4	5	6
Tourist arrivals	-2.7	4.4	8.3	8.3#	8.1#
Cement	7.2	10.5	4.5	5.3	4.3
Steel	1.9	6.0	8.9	8.2	8.2
Railway revenue earning freight traffic	4.9	6.6	3.8	3.3	4.1
Cell phone connections*	80.9	47.3	18	26.7$	-42.9$
Cargo handled at major ports	2.2	5.8	1.6	0.8	1.2
Civil aviation					
Domestic cargo Traffic	-2.8	24.3	23.7	30.8$	-6.1$
International cargo Traffic	0.3	10.5	17.7	23.9$	0.1$
International Passenger Traffic	5.9	8.8	10.3	11.7$	7.8$
Domestic Passenger Traffic	-11.2	15.6	18.1	16.8$	19.0$

#: Data pertain to April-December. $: Data pertain to April-October.
*: Data refers to wireless subscribers additions.
Source: Ministry of Tourism; Ministry of Statistics and Programme Implementation and CMIE.

Table I.6: Changes in Estimated Employment

(in '000s)

Industry/Group	2010-11 Q1	2010-11 Q2	2010-11 Q3	2010-11 Q4	2011-12 Q1	2011-12 Q2
1	2	3	4	5	6	7
1. Textiles including apparels	-63	245	40	-121	-33	42
2. Leather	21	4	16	-8	1	-2
3. Metals	45	27	0	16	53	38
4. Automobiles	51	29	18	13	18	22
5. Gems and jewellery	4	4	-10	-2	13	7
6. Transport	-21	13	-1	6	-2	-5
7. IT/BPO	129	108	141	287	164	204
8. Handloom / Powerloom	-4	6	3	-18	1	9
Overall	**162**	**435**	**207**	**174**	**215**	**315**

Source: Twelfth Quarterly Quick Employment Survey, June 2011-Sept 2011, Labour Bureau.

during the last one year. However, employment generation is heavily concentrated in the IT/BPO sector, which accounted for 64.8 per cent of the increase in employment during Q2 of 2011-12 (Table I.6). Export-oriented units such as textiles and handloom also registered an increase in employment.

Growth outlook depends on global conditions and domestic policy reforms

I.25 The economy registered below trend growth in Q2 of 2011-12. The performance of both industry and services sector was below par, partly reflecting macro-factors that include softening demand and loss of business confidence due to fear of global downturn. This also reflects micro-factors such as structural impediments that require public policy to be more supportive of business activity and willingness of the business sectors to abide by better corporate governance practices.

I.26 While growth is slowing down, some recovery in Q4 of 2011-12 is likely. A deficient north east monsoon so far notwithstanding, agriculture output is likely to be satisfactory in 2011-12. The data suggest continued slowdown in industry, but the Purchasing Managers' Index (PMI) for December indicates strong expansion. Industrial growth, including that in core industries, rebounded in November 2011. However, the rebound was supported by seasonal spurt in consumer non-durables and capital goods output that remain volatile on month-to-month basis and so its sustainability is unclear. As such, the dismal performance of mining sector and several headwinds for the manufacturing sector leave the timing of a revival uncertain, though some recovery is expected in Q4 of 2011-12.

I.27 Several inter-linked micro-impediments to industrial production need to be addressed quickly. For instance, the underperformance of the coal sector is affecting thermal power generation. Services, which have a strong correlation with the overall economic activity, are also likely to stay downcast. The lower global growth is another factor that portends growth moderation in the domestic economy. On the upside, as inflation decelerates, we could see revival of demand and pick-up in momentum of production activity. If inflation recedes, the revival could be supported by monetary policy.

II. AGGREGATE DEMAND*

Aggregate demand softened as a result of dampening external and investment demand. With global uncertainties adversely impacting exports, external demand slowed. There was a rapid drying up of corporate investment pipeline in Q2 of 2011-12 which affected growth. Private consumption continues to moderate slowly, while government consumption spending is on the rise. Central government's deficit indicators are under duress due to higher subsidies and lower tax collections in a slowing economy. Going forward, there is a need for rebalancing public spending from consumption to investment to recover growth as well as to enhance its potential rate.

Falling external and investment demand may drag 2012-13 growth

II.1 Softening consumption demand coupled with decelerating investment and contracting external demand led the moderation in GDP at market prices to 7.6 per cent in H1 of 2011-12 (Table II.1). Consumption softened on account of high inflation and tapering of demand in interest-rate sensitive sectors. Investment decelerated due to both monetary and non-monetary factors. Net exports declined sharply in H1 of 2011-12, largely reflecting the slackening of global demand.

II.2 Slow down in investment and weakning external demand could have unfavourable impact on growth. Estimates indicate that a one percentage point decline in gross fixed capital formation rate would shave off about 0.2

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

(Per cent)

Item	2009-10*	2010-11#	2010-11				2011-12		2010-11	2011-12
			Q1	Q2	Q3	Q4	Q1	Q2	H1	H1
1	2	3	4	5	6	7	8	9	10	11
					(Growth Rates)					
Real GDP at market prices	9.1	8.8	9.1	8.6	9.2	7.7	8.5	6.7	8.9	7.6
Total Consumption Expenditure	8.7	8.0	9.1	8.5	7.4	7.5	5.7	5.6	8.8	5.6
(i) Private	7.3	8.6	9.5	9.0	8.6	8.0	6.3	5.9	9.2	6.1
(ii) Government	16.4	4.8	6.7	6.4	1.9	4.9	2.1	4.0	6.5	3.1
Gross Fixed Capital Formation	7.3	8.6	11.1	10.3	7.8	0.4	7.9	-0.6	10.7	3.5
Change in Stocks	90.8	7.4	9.3	6.5	5.1	4.6	4.7	1.5	7.9	3.1
Net Exports	10.2	-15.3	33.3	14.2	-52.6	-34.8	21.5	-35.0	23.0	-6.9
					(Relative Shares)					
Total Consumption Expenditure	70.1	69.5	72.8	70.9	72.3	63.1	70.9	70.1	71.8	70.5
(i) Private	58.5	58.3	61.7	59.9	60.1	52.6	60.5	59.5	60.8	60.0
(ii) Government	11.6	11.2	11.1	10.9	12.2	10.5	10.4	10.7	11.0	10.5
Gross Fixed Capital Formation	32.0	32.0	31.4	32.8	30.5	32.1	31.2	30.5	32.1	30.9
Change in Stocks	3.5	3.5	3.6	3.6	3.3	3.4	3.5	3.4	3.6	3.5
Net Exports	-7.2	-5.6	-7.7	-7.6	-3.8	-3.9	-8.6	-4.7	-7.7	-6.6
Memo:										(₹ billion)
Real GDP at market prices	48693	52981	12126	12376	13702	14693	13154	13210		

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

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

percentage point from the potential output. Growth rate cycles of the Indian and the world economy have shown increasing convergence. Estimates indicate that a one percentage point decline in the growth rate of the world economy would result in about a 0.3 percentage point decline in the growth rate of non-agricultural GDP in India.

Sharp decline in investment intentions of corporates

II.3 During 2010-11, envisaged corporate investment in new projects dipped sharply by about 43 per cent in H2 from H1. It remained about the same level in Q1 of 2011-12 but again fell steeply in Q2 on a sequential basis. Project finance data of banks/financial institutions indicate a near 77 per cent decline in total outlay of projects sanctioned in Q2 of 2011-12 from the same period of the previous year (Table II.2).

II.4 Industry-wise, the share of new investment planned for power and metal and metal products witnessed a sharp sequential decline in Q2 of 2011-12, while textiles and cement industries registered improvement.

II.5 Based on time-phasing details of projects sanctioned institutional assistance, capital expenditure by private corporate (non-financial) sector during the year 2011-12 is likely to be lower than in the previous years. The rise in interest rates and cost of raw materials may have adversely affected the investment sentiment (Table II.3).

Table II.2: Institutionally Assisted Projects and their Envisaged Cost

Period		Number of Projects*	Project Cost (₹ billion)
1		2	3
2009-10	Q1	150	914
	Q2	193	1,415
	Q3	175	1,402
	Q4	236	829
2010-11	Q1	199	1,431
	Q2	(231) 239	(1,495) 1,508
	Q3	173	801
	Q4	185	864
2011-12	Q1	(142) 144	(876) 880
	Q2**	167	339

*: Based on data reported by 39 banks/FIs.
**: Data for Q2:2011-12 is based on reported data are from 36 banks/FIs. Corresponding data for Q2:2010-11 and Q1:2011-12 are given in brackets.

Corporate margins slide on rising costs, slowing demand

II.6 There was a moderate slackening of sales growth in Q2 of 2011-12 compared with the previous two quarters, reflecting gradual waning of demand (Table II.4). Increase in interest payment, staff cost and raw material cost led to erosion of net profits (Table II.5). Inventory accumulation, however, was lower than that during the previous quarter as well as

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

(₹ billion)

Capital Expenditure in the Year →	Up to 2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Beyond 2013-14	Grand Total
1	2	3	4	5	6	7	8	9
Year of Sanction ↓								
Up to 2007-08	1,826	1,317	583	376	98	47	-	4,247
2008-09	265	1,029	864	568	366	84	46	3,223
2009-10	2	448	1,494	1,282	853	365	116	4,560
2010-11	-	3	373	1,262	1,294	979	691	4,602
2011-12*	-	-	12	119	426	323	339	1,219
Grand Total #	**2,093**	**2,797**	**3,326**	**3,607**	**3,037**	**1,798**	**1,192**	**-**

*: Data available up to Q2:2011-12.
#: The estimates are *ex ante*, incorporating only the envisaged investment, and thus are different from those actually realised/utilised.

Table II.4: Corporate Sector- Financial Performance

Item	2010-11				2011-12	
	Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7
No. of Companies	2023					
(Year-on-year growth rates in per cent)						
Sales	25.8	19.9	18.2	20.5	22.6	**19.3**
Expenditure	30.5	21.2	20.3	22.8	23.1	**22.9**
Raw Material	39.1	21.7	20.6	27.2	27.9	**23.4**
Staff Cost	15.8	20.2	21.5	20.3	20.1	**18.0**
Operating profits (PBDIT)	16.1	8.8	11.7	15.9	11.3	**-0.6**
Other Income*	-13.6	52.3	13.0	-24.1	41.5	**31.7**
Depreciation provision	20.9	17.3	13.9	14.5	9.0	**9.8**
Interest payments	30.7	6.3	22.9	32.9	22.0	**47.5**
Profits after tax	3.8	9.8	11.2	13.4	9.4	**-13.0**
(Ratios in per cent)						
Change in stock# to Sales	3.0	1.1	1.3	1.9	1.5	**0.9**
Operating Profits to Sales	16.5	15.9	16.0	15.3	14.9	**13.2**
Profits After Tax to Sales	8.6	8.8	8.5	8.6	7.7	**6.4**
Interest to Sales	2.9	2.6	2.6	2.5	2.8	**3.2**
Interest to Gross Profits	20.6	18.8	19.4	19.1	21.9	**27.7**
Interest Coverage (Times)	4.9	5.3	5.1	5.2	4.6	**3.6**

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

corresponding quarter of the previous year (Chart II.1).

Table II.5: Corporate Sector- Financial Performance – Sequential

Item	Common Companies (QoQ Growth in Per cent)					
	Q1 FY11 over Q4 FY10	Q2 FY11 over Q1 FY11	Q3 FY11 over Q2 FY11	Q4 FY11 over Q3 FY11	Q1 FY12 over Q4 FY11	Q2 FY12 over Q1 FY12
1	2	3	4	5	6	7
No. of Companies	**2023**					
Sales	-5.2	6.3	5.5	13.1	-3.3	**3.4**
Expenditure, of which	-3.6	5.0	5.6	14.8	-3.3	**4.9**
Raw Material	-4.4	2.0	9.0	17.5	-3.1	**1.4**
Staff Cost	2.2	8.4	2.2	5.5	3.3	**5.8**
Operating Profits (PBDIT)	-1.9	2.3	6.6	7.8	-5.5	**-8.4**
Other Income	-43.8	36.1	-21.8	28.2	2.0	**28.7**
Depreciation	1.3	1.0	3.2	8.2	-3.7	**1.9**
Interest	15.9	-3.3	7.6	7.9	8.4	**18.3**
Profits after tax	-10.4	8.4	1.9	14.1	-13.4	**-13.6**

II.7 IT companies bucked the trend and registered 22.2 per cent growth in net profits (Chart II.2). Also, while large companies registered strong growth in sales and compression only of margins, small companies suffered on both counts (Chart II.3).

II.8 Available early results of 85 companies for Q3 of 2011-12 (which account for only 10 per cent of sales of all non-government non-

Chart II.1: Movement in Sales Growth and Change in Stock in Trade to Sales (Per cent)

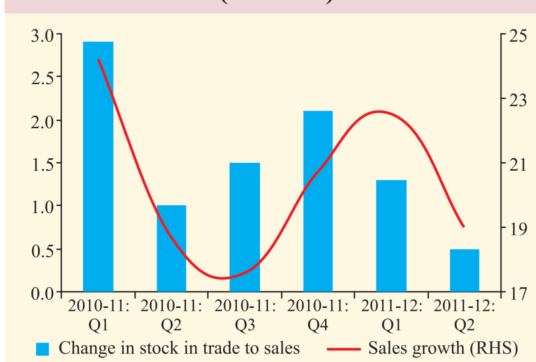
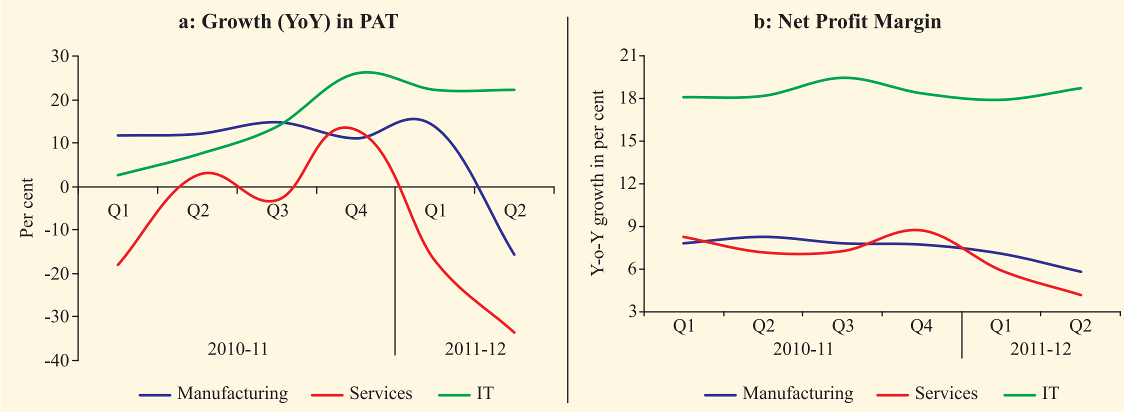


Chart II.2: Net Profit



financial listed companies), suggest that sales growth remained healthy and growth in operating profits (PBDIT) and net profits (PAT) were higher as compared with Q2 of 2011-12.

Fiscal space constrained as structural deficit rises on top of cyclical pressures

II.9 The Central government's key deficit indicators widened during 2011-12 (April-November), reflecting an interplay of cyclical and structural factors. The growth moderation has impacted total tax revenues, more so because direct tax collections have suffered on account of significant quantum of tax refunds and lower corporate profits. Impact of growth cycles of the economy has been visible over the years with downturns raising deficits and recoveries reducing them (Chart II.4).

II.10 Fiscal imbalances have continued to reflect structural rigidities on the expenditure side on account of inability of the government to control subsidy expenditures despite budgeting a decline in such expenditures. Consequently, the Centre could not meet its mid-year FRBM benchmarks. The benchmarks were for revenue and fiscal deficits at not more than 45 per cent of budget estimates and non-debt receipts at not less than 40 per cent of budget estimates.

Chart II.3: Major Performance Indicator – Size-wise

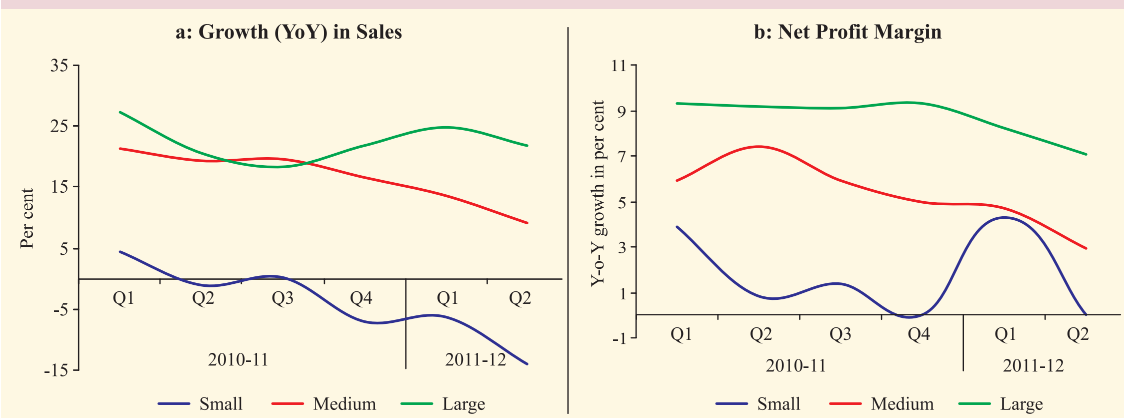
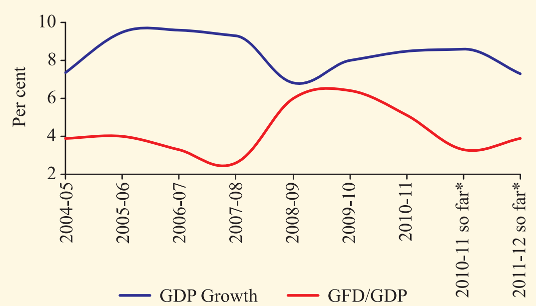
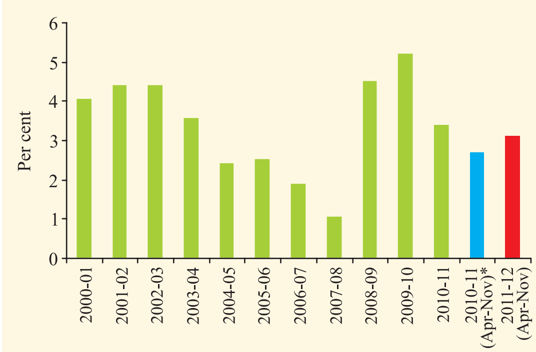


Chart II.4: Growth Cycles and Centre's Fiscal Deficit-GDP Ratio



*Refers to fiscal years up to September for GDP growth and up to November for GFD/GDP ratio. For 2010-11, GFD is adjusted for excess than budgeted specturm receipts

Chart II.5: Centre's Revenue Deficit - GDP ratio



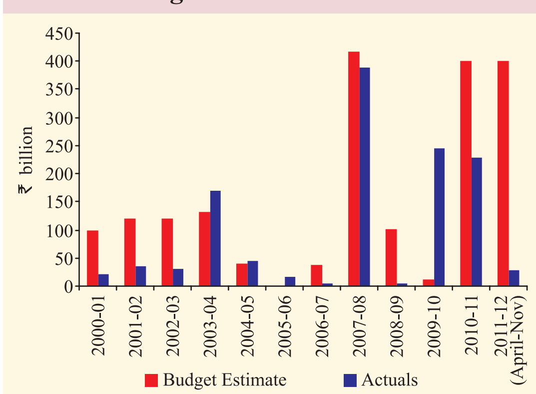
* RD is adjusted for excess than budgted spectrum receipts.

Increasing revenue account imbalance causes concern

II.11 Mounting revenue deficit (RD) is putting fiscal position under strain and impacting the Government's ability for capital spending. The Centre had budgeted no change in RD-GDP ratio (3.4 per cent) for 2011-12 recognising that the one-off receipts in respect of non-tax revenues from spectrum auctions a year ago would not be available. Accordingly, it had projected sharp deceleration in growth rates for both revenue receipts and revenue expenditure. However, revenue expenditure decelerated only marginally while revenue receipts contracted. Consequently, revenue deficit during the first eight months turned out to be 91.3 per cent of the annual budgeted target for 2011-12. Thus, RD-GDP ratio was also higher during 2011-12 (April-November) from that in the corresponding period of the previous year even after adjustment is made for excess than budgeted spectrum receipts (Chart II.5). Although the ratio of RD to gross fiscal deficit (GFD), an important benchmark for assessment of the quality of fiscal consolidation, worked out lower at 79.5 during 2011-12 (April-November) as compared with adjusted ratio of 81.8 percent during 2010-11 (April-November), it remained higher than the budgeted ratio (73.9 per cent) for 2011-12 as a whole. This indicates that a large portion of borrowings are used to finance the revenue deficit, thereby reducing the availability of resources to undertake capital outlays. This could have adverse implications for India's potential growth.

II.12 There has been a shortfall in total non-debt receipts in 2011-12 (April-November) with growth in tax revenues lagging even the conservatively projected growth in the Union Budget. The government appears to have fallen short of its budgeted targets for disinvestment of Central Public Sector Undertakings (CPSUs) (Chart II.6). Also, expenditure is likely to surpass the budgeted level, as evident from additional requisitions made in the second supplementary demands for grants in November 2011. Current assessment indicates that fiscal deficit may turn out to be higher than the budget estimates of 2011-12 by around one percentage point of GDP. In this context, it

Chart II.6: Disinvestment of CPSUs - Budgeted *vis-a-vis* Actuals



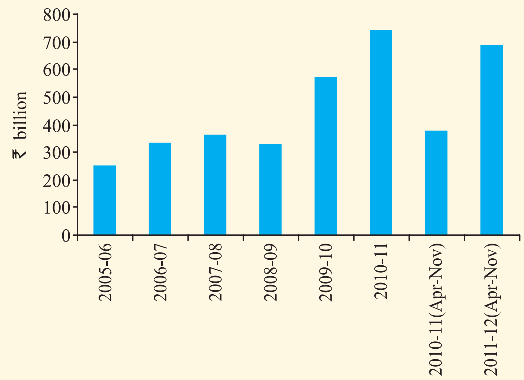
may be noted that fiscal slippage could be higher in the event of further economic slowdown. The Centre's mid-year analysis of its fiscal conditions recognised that it would be challenging to meet the deficit targets for 2011-12.

II.13 Prospectively, improvement in fiscal situation in 2012-13 is not only contingent upon the growth performance but also on the progress in implementation of tax and expenditure reforms. A delay in enactment of the Direct Tax Code (DTC) Bill (presently under consideration of the Standing Committee on Finance) may affect its scheduled introduction from April 1, 2012. In respect of Goods and Services Tax (GST), while the Bill to amend the Constitution for introducing this tax was tabled in March 2011, the draft GST legislation requires consensus on a number of issues involving both the Centre as well as State governments. On the expenditure front, the government needs to move towards deregulation of pricing of diesel for controlling its expenditure on petroleum subsidies. Unless fiscal reforms are expedited, the Centre could miss the rolling target of fiscal deficit at 4.1 per cent of GDP for 2012-13 as set out in the Union Budget 2011-12.

Tax revenue may fall short of 2011-12 budgeted level, further buoyancy depends on growth and reforms

II.14 Growth in tax revenue decelerated during 2011-12 (April-November), affected by significant direct tax refunds, reduction in duties in respect of petroleum products and moderation in economic growth. Sharp deceleration was observed in growth of corporation tax revenues on account of refunds as well as slowdown in industrial activity. Significantly higher direct tax refunds during the current year so far indicates that fiscal correction witnessed during 2010-11 could have been, to some extent, contributed by excess collections which have been refunded during the current year so far (Chart II.7). Overall indirect tax growth during the current year so far remained in line with the budgeted growth.

Chart II.7: Direct Tax Refunds



Source : Central Board of Direct Taxes, GOI

Need to step up public investment as lower corporate investment pipeline may delay recovery

II.15 Given the deceleration in private investment intention, drying up of public investment may further delay recovery of economic growth. During 2011-12 (April-November), the rate of growth of plan expenditure (both revenue and capital) was slower than the budgeted growth for the full year. The growth rate of capital outlays was lower than in the corresponding period a year ago. This was mainly due to lower plan expenditures in various Ministries/Departments like rural development, agriculture, health and family welfare and drinking water supply.

Subsidies exerting unsustainable pressure, need for budgetary solution to enhanced commitments

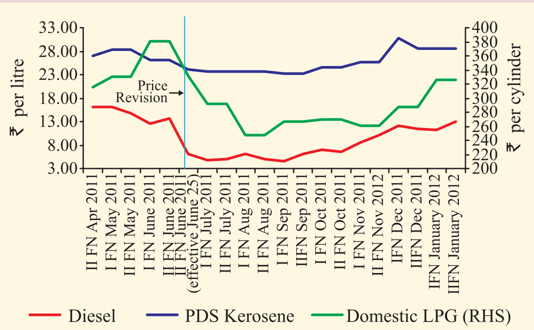
II.16 The deceleration in aggregate expenditure growth in the current fiscal year so far was mainly driven by lower plan expenditure growth. Non-plan expenditure, on the other hand, recorded a higher growth attributable to higher expenditure on major subsidies and interest payments.

II.17 The per unit under-recovery on sale of diesel and PDS kerosene, which had moderated in the second half of December 2011, increased in January 2012, in line with the hardening of global crude oil prices and weakening of the rupee (Chart II.8). By current indications, the under-recoveries of oil marketing companies (OMCs) for sale of administered petroleum products are projected at around ₹1,323 billion for 2011-12. The Centre has already exhausted its budgetary provision for petroleum subsidies and has indicated additional provisions (₹300 billion) in the second supplementary demand for grants presented in November 2011. It is estimated that the higher expenditure on petroleum subsidy could drive up the fiscal deficit by around 0.8 percentage points of GDP for 2011-12. The government will face additional pressures on account of food subsidies when the proposed Food Security Bill is enacted and implemented. Consequently, the government needs to control its expenditure on petroleum subsidies. This would require further deregulation of the prices of administered petroleum products.

Amended FRBMs of States reflect resumption of rule-based fiscal consolidation

II.18 The consolidated revenue account of the States is budgeted to record surplus in 2011-12, indicative of the return to the fiscal consolidation path as envisaged by the Thirteenth Finance Commission. The improvement in the revenue account, which is largely on account of a compression in the revenue expenditure, is

Chart II.8: Under Recoveries of Oil Marketing Companies per unit of Product



Note: IFN : Ist fortnight IIFN: Second fortnight
Source: PPAC, Ministry of Petroleum and Natural Gas.

expected to not only provide the necessary resources to increase capital outlay but also to enable a reduction in the GFD to GDP ratio that is budgeted to fall by 0.4 percentage point. The States were required to amend their Fiscal Responsibility and Budget Management Acts (FRBMs) mapping out paths for elimination of revenue deficit and graduated reductions in fiscal deficit to 3 per cent of their Gross State Domestic Product (GSDP), latest by 2014-15, in order to be eligible for State-specific grants and interest relief on NSSF loans. Majority of the State governments have already amended their FRBMs during 2011-12.

II.19 Notwithstanding the committed stance for reduction in budgetary imbalances, the growing contingent liabilities of State governments, particularly those relating to the exposure of State Power Utilities have emerged as an area of concern in State finances. The High Level Panel (HLP) on Financial Position of Distribution Utilities (Chairman: Shri V.K. Shunglu) in its report recently submitted to the Planning Commission has noted that the accumulated losses of power distribution companies (discoms) during 2005-10 amounted to ₹820 billion. Over 70 per cent of the losses have been financed by public sector banks and 42 per cent of these loans are backed by State government guarantees. In case of default, the invocation of the State guarantees could have a significant impact on State finances as the cushion available in the form of States' guarantee redemption funds remains inadequate (₹40 billion).

Tighter adherence to fiscal rules necessary as increasing dependence on market borrowings is worrisome

II.20 In the current fiscal year so far, the Centre financed its GFD and withdrawals in its public account mainly through market borrowings in the wake of lower net accretion under National Small Savings Fund. There was also recourse to Ways and Means Advances, thereby leading to monetisation of deficit. Further, there was

Table II.6 : Sources of Financing the Gross Fiscal Deficit of Central Government

(Percentage share in GFD)

Item	Apr-Nov 2011	Apr-Nov 2010
1	2	3
Market Borrowing	97.0	140.1
State Provident Fund	0.9	2.3
National Small Savings Fund	2.6	7.9
Cash Balances {Decrease(+)/Increase(-)}	0.5	-13.7
Investment (-) / Disinvestment (+) of Surplus Cash	4.6	-17.1
External Assistance	1.8	7.8
Ways and Means Advances	5.6	0.0
Others *	-13.1	-27.3

* Includes items such as special deposits, suspense and remittances and other capital receipts.
Source : Controller General of Accounts, Ministry of Finance, Government of India.

draw-down of cash balances and disinvestment of surplus cash by the Centre (Table II.6). The Centre has twice revised its market borrowings target upwards for the second half of 2011-12, thereby raising the gross market borrowings through dated securities for 2011-12 by 22.3 per cent above the budgeted amount. The centre has also taken a significant recourse to financing deficit through T-bills. Higher government borrowing pushes up yields and also crowds out the domestic funding available for private investment.

Reforms required for a turnaround in 2012-13

II.21 Amidst general macro-economic weakness, with a widening current account deficit, larger fiscal spending could further affect growth and stability in the economy. There is need for cutting government's consumption expenditure and stepping up its capital spending in order to lift both the current and future growth. This will help the economy to get back to higher potential growth that it had realised in the pre-crisis period.

II.22 With inflation projected to decline in Q4 of 2011-12 and monetary rate cycle peaking, a revival of business optimism could occur, especially if fiscal imbalances are contained so as to provide more room on monetary side. For 2012-13, while tax revenues could be affected by risks associated with global uncertainty and its impact on domestic growth scenario, the attainment of Union Budget 2011-12's rolling target of gross tax revenue-GDP ratio of 10.8 per cent for 2012-13 critically depends on timely implementation of DTC. It is expected that DTC system would improve compliance levels as rates of corporation tax and surcharge are reduced and tax base is widened. While greater uncertainty surrounds the introduction of GST, a consensus needs to be built for the successful rollout of GST in order to further improve compliance and enable overall tax buoyancy to return to pre-crisis levels. In the short-run, reliance on temporary measures such as disinvestment cannot be avoided. However, plans in this regard would need to be calibrated to market conditions, so that revenue proceeds can be well spaced. Furthermore, reforms on the revenue side need to be backed by steps to contain subsidies so that they can be funded out of the budget on a sustainable basis.

III. THE EXTERNAL SECTOR

Early indicators suggest that pressure on current account deficit (CAD) and its financing persisted through Q3 of 2011-12, while capital inflows turned weaker. CAD is expected to widen during the year despite a faster rate of growth of exports compared with imports during the first half. Import demand has remained strong, notwithstanding rupee depreciation, reflecting the inelastic demand for oil and increasing gold demand. The composition of capital inflows shifted in favour of debt, with a rise in the proportion of short-term flows. Widening CAD, diminishing capital flows and moderately deteriorating vulnerability indicators, notwithstanding improved net international investment position (NIIP), warrant acceleration of the domestic reform process. This will encourage renewed equity flows.

Overall external sector outlook deteriorates

III.1 The rising uncertainties associated with the euro zone sovereign debt crisis, the slowdown in advanced economies (AEs) and the weakening domestic economy have contributed to deterioration of India's external sector outlook in terms of current account balance, capital flows and vulnerability indicators. Despite depreciating rupee, if moderation in export growth observed in Q3 of 2011-12 persists and imports stay closer to prevailing trend amidst insufficient elasticity responses in the short run, the trade deficit is likely to remain high. Even as the rupee depreciation may improve flow of remittances, the current account deficit (CAD) is likely to widen further in Q3 of 2011-12 before possible contraction in Q4 reflecting the seasonal pattern, leaving the full-year CAD wider. Furthermore, with rupee stabilising since the latter half of December, equity investment inflows are starting to come back.

Slippage in export performance likely as global growth and trade slows again

III.2 India's merchandise exports may fall short of the target of US$ 300 billion set for 2011-12 as global trade has slowed down again amidst global financial market uncertainties and the weakening demand conditions in advanced economies. After performing well during the first half of 2011-12, merchandise exports decelerated in Q3 of 2011 (Table III.1 and Chart III.1a).[1] Austerity measures undertaken

Table III.1 : India's Merchandise Trade

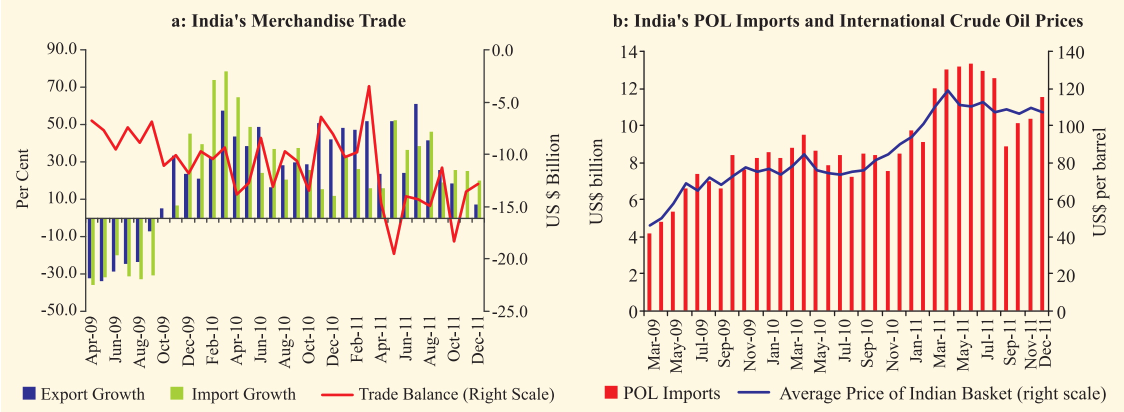
(US$ billion)

Item	2009-10 (R)		2010-11 (P)		April-December			
					2010-11		2011-12	
	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth (%)
1	2	3	4	5	6	7	8	9
Exports	178.8	-3.5	250.1	39.9	173.0	36.0	217.6	25.8
Of which: Oil	28.2	2.3	41.4	46.8	28.3	45.3	43.9	55.0
Non-oil	150.6	-4.6	208.7	38.6	144.7	32.8	173.7	20.1
Imports	288.4	-5.0	369.8	28.2	269.1	29.8	350.9	30.4
Of which: Oil	87.1	-7.0	104.0	19.4	75.2	22.0	105.6	40.4
Non-oil	201.3	-4.2	265.8	32.0	193.9	33.1	245.3	26.5
Trade Deficit	-109.6		-119.7		-96.1		-133.3	
Non-oil Trade Deficit	-50.7		-57.1		-49.2		-71.6	

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

[1] Based on updated data incorporating downward revision of US$ 9 billion in merchandise exports by DGCI&S.

Chart III.1: India's Merchandise Trade



by the European economies and decline in consumption expenditure may further impact India's exports in the coming period. Notably, in 2010-11, exports grew strongly on the back of market and product diversification measures by the government which helped raise the elasticity of India's exports to world GDP. The sluggishness of advanced economies (AEs) is, however, now proving to be a dampener to the trade volume growth of emerging and developing economies (EDEs). Against this global backdrop, measures aimed at diversification of India's export markets may have limited impact in the short-term.

Inelastic import demand for oil and gold widens the trade deficit

III.3 The widening trade deficit recorded up to December 2011 was largely driven by imports of 'oil' and 'gold and silver'. Import of oil is relatively inelastic to changes in international prices and exchange rate. On the other hand, apart from traditional purposes, demand for gold as an investment asset appears to have increased in the recent period. The rise in import of petroleum, oil and lubricants (POL) is largely reflective of increase in international oil prices (Chart III.1b). While the average international price of Indian oil basket increased by 38.6 per cent during April-December 2011 over April-December 2010, imports of POL (in value terms) expanded by 40.1 per cent during the same period. Similarly, there has been sharp increase in import of gold and silver by 53.8 per cent during April-December 2011. Estimates based on disaggregated data available up to September 2011 reveal that the rise in gold import has been both on account of price as well as quantum factors. During April-September 2011, quantum of gold import is estimated to have risen by 25.1 per cent to 554 million tonnes and international prices of gold on average during the same period rose by 31.1 per cent to US$ 1607 per troy ounce.

Upward risks to CAD become more pronounced with likely moderation of software earnings - the mainstay of services

III.4 The increase in global economic uncertainties has amplified the risks to CAD (Table III.4). While weaker demand for merchandise exports along with inelastic oil and gold imports may further widen the trade deficit, CAD may, in addition, be prone to risks emanating from moderation in receipts on account of software exports, business services and investment income. If euro area debt crisis remains unresolved and contagion spreads to other AEs, companies in US and EU countries could reduce their IT budgets which may affect prospects for India's software exports. Similarly, weakening of economic activity in AEs can lead to a downtrend in business services as was observed during Q4 of 2008-09 to Q4 of 2009-10. As a result, CAD is expected to remain under pressure after having widened sequentially to 3.7 per cent of GDP in Q2 of 2011-12 from 3.4 per cent in Q1 of 2011-12 (Table III.2).

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

(US$ billion)

	2010-11 (PR)	2010-11 (PR)				2011-12	
		Q1	Q2	Q3	Q4	Q1 (PR)	Q2 (P)
1. Goods exports	250.6	55.2	52.0	66.0	77.4	74.4	76.6
2. Goods Imports	381.1	87.2	89.0	97.4	107.4	116.1	120.5
3. Trade Balance(1-2)	-130.4	-32.0	-37.0	-31.4	-30.0	-41.7	-43.9
4. Services Exports	131.7	26.5	31.1	38.8	35.3	33.3	34.0
5. Services Imports	83.0	16.7	19.2	26.3	20.7	17.9	18.5
6. Net Services (4-5)	48.7	9.7	11.9	12.5	14.6	15.4	15.5
7. Goods & Services Balances (3+6)	-81.8	-22.3	-25.1	-19.0	-15.5	-26.3	-28.4
8. Primary Income, Net *(Compensation of Employees and Investment Income)*	-17.3	-3.5	-4.8	-4.6	-4.5	-4.4	-4.7
9. Secondary Income, Net *(Pvt. Transfers)*	53.1	13.1	13.0	13.4	13.6	14.8	16.2
10. Net Income (8+9)	35.8	9.6	8.2	8.8	9.1	10.4	11.5
11. Current Account Balance (7+10)	-46.0	-12.6	-16.9	-10.1	-6.3	-15.8	-16.9
12. Capital and Finance Account, Net *(Excl. changes in reserves)*	62.0	17.2	21.6	14.0	9.1	22.5	18.4
13. Change in Reserves *(-) increase/(+) decrease*	-13.1	-3.7	-3.3	-4.0	-2.0	-5.4	-0.3
14. Errors & Omissions -(11+12+13)	-3.0	-0.9	-1.4	0.1	-0.8	-1.3	-1.2
Memo Items (As percentage of GDP):							
15. Trade Balance	-7.5	-8.3	-9.5	-6.8	-6.1	-9.0	-9.6
16. Net Services	2.8	2.5	3.1	2.7	3.0	3.3	3.4
17. Net Income	2.1	2.5	2.1	1.9	1.9	2.3	2.5
18. Current Account Balance	-2.7	-3.3	-4.4	-2.2	-1.3	-3.4	-3.7
19. Capital and Finance Account, Net	3.6	4.5	5.6	3.0	1.9	4.9	4.0

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

Likely shift in financing pattern of CAD as equity flows turned weak

III.5 Risk aversion in the global financial markets has slackened the pace of capital flows to India (Table III.3). FDI inflows remained robust averaging US$ 4.9 billion per month during April-August 2011 but moderated to US$ 3.2 billion per month during September-November 2011 (Table III.4). If the pace of FDI inflows does not pick up once again and FII equity inflows revert to the decelerating trend, CAD may have to be largely financed through debt creating flows in the coming quarters. Recent pick up in FII flows has been mainly on account of investment in debt instruments.

Even the debt creating capital inflows are subject to risk aversion

III.6 Several measures have been undertaken to improve inflows of external commercial borrowings (ECBs) and NRI deposits. While inflows on account of NR(E)RA and NRO accounts were higher during April-December 2011, the same on account of FCNR (B) accounts were negative. ECBs and FCCBs by Indian companies due for redemption in Q4 of 2011-12 are estimated to be less than US$ 4 billion. Recognising the global macro-economic and financial market conditions, the Reserve Bank raised all-in-cost ceiling on ECBs. The increase in the all-in-cost ceiling, and emphasis on bringing immediately the proceeds of the ECBs meant for rupee expenditure in India, augur well for raising overseas borrowings and financing the CAD. Also, greater flexibility has been given to banks in mobilising non-resident deposits by further deregulating interest rates on NRE and NRO accounts.

III.7 Although recent measures by the European Central Bank and other central banks may have eased financing conditions

Table III.3: Net Financial Account

(US$ billion)

	April-June 2011 (PR)	April-June 2010 (PR)	July-September 2011 (P)	July-September 2010 (PR)
1	2	3	4	5
1. Direct Investment (net)	**7.9**	**3.5**	**4.4**	**3.6**
1.a Direct Investment to India	13.3	6.7	7.3	7.5
1.b Direct Investment by India	-5.4	-3.3	-2.9	-3.9
2. Portfolio Investment (net)	**2.3**	**3.5**	**-1.4**	**18.7**
2.a Portfolio Investment in India	2.5	3.5	-1.6	18.8
2.b Portfolio Investment by India	-0.2	0	0.2	-0.1
3. Other investment (3.a+3.b+3.c+3.d+3.e)	**12.6**	**10.4**	**15.2**	**-0.7**
3.a Other equity (ADRs/GDRs)	0.3	1.1	0.2	0.5
3.b Currency and deposits	1.2	1.1	2.8	0.4
Deposit-taking corporations (NRI Deposits)	1.2	1.1	2.8	1.0
3.c Loans (net)*	15.5	7.6	11.3	0.4
3.c.i. Loans to India	15.5	7.7	10.6	0.7
Deposit-taking corporations	11.5	2.9	3.9	-3.6
General government (External Assistance)	0.4	2.5	0.3	0.6
Other sectors (ECBs)	3.6	2.3	6.4	3.7
3.c.ii Loans by India	-	-0.1	0.6	-0.3
Other sectors (ECBs)	-	-0.1	0.6	-0.3
3.d Trade credit and advances	3.1	4.3	2.9	2.6
3.e Other accounts receivable/payable	-7.4	-3.7	-1.9	-4.6
4. Reserve assets	**-5.4**	**-3.7**	**-0.3**	**-3.3**
Financial Account (1+2+3+4)	**17.4**	**13.6**	**17.9**	**18.3**

Note: Total of subcomponents may not tally with aggregate due to rounding off.
P: Preliminary. PR: Partially Revised. (-) : nil/negligibles
*: includes External Assistance, ECBs and non-NRI Banking Capital.

for banks in the euro area, deleveraging by some European banks has begun to affect cross-border lending to the emerging markets. Therefore, actual ECB inflows in the coming quarters would largely depend on risk perception of European banks. If risk aversion persists in the global financial markets, there might be some implications for cost of obtaining external funding.

Table III.4: Capital Flows in 2011-12

(US$ billion)

Component	2011-12 (Apr.-Aug.) (Monthly Average)	2011-12 (Sep.-Dec.) (Monthly Average)
1	2	3
FDI to India*	4.9	3.2
FDI by India	1.0	0.8
FIIs (net)	0.4	0.1
ADRs/GDRs	0.1	0.1
ECB Inflows (net)	1.3	0.6
NRI Deposits (net)	0.5	1.2

* : April-November.

Flight to dollar cause currency pressures in many emerging markets

III.8 Declining risk tolerance of investors resulted in a flight to the US dollar as a global safe haven currency. Dollar value generally strengthened, especially against EDE currencies. Currencies of the EDEs running current account deficit came under significant pressure, when compared with those with current account surplus EDEs (Chart III.2). Some central banks, including those of Brazil, Russia and South Korea, have intervened in currency markets to smoothen exchange-rate volatility. Until risk aversion subsides, EDE currencies may continue to remain under pressure. With higher CAD and subdued capital flows during 2011-12 so far, the depreciation of the Indian rupee reflected interplay of forces operating through the trade, capital and confidence channels.

Chart III.2: Major EDE Currency Movements *vis-à-vis* US $

Note : Figures in parenthesis represent WEO's estimated/projected CAD for the year 2011, except in case of India, where actual data point for the period April-September 2011 is given.
Source : Exchange rate data from Bloomberg.

Table III.5: Nominal and Real Effective Exchange Rates - Trade Based

(Base: 2004-05=100)
(Per cent, appreciation+/depreciation-)

	Index Jan.13, 2012P	Year-on-Year Variation (Average)			2011-12 (end-July over March)	2011-12 (Jan. 13 over end-July)
		2008-09	2009 10	2010-11P		
1	2	3	4	5	6	7
36-REER	94.2	-9.9	-3.1	8.0	1.2	-10.0
36-NEER	83.1	-10.9	-2.6	3.0	-0.2	-10.5
30-REER	86.0	-10.3	-4.6	4.8	1.7	-10.1
30-NEER	85.1	-8.4	-2.2	1.1	-0.3	-9.9
6-REER	107.2	-9.3	-0.3	13.1	1.2	-9.8
6-NEER	80.7	-13.6	-3.7	5.7	-0.1	-10.9
₹/US$ (Average)	47.4	-12.4	-3.2	4.0	3.0	-3.8#
₹/US$ (end-March)	50.7*	-21.5	12.9	1.1	1.1	-11.9*

NEER: Nominal Effective Exchange Rate.
REER: Real Effective Exchange Rate.
P: Provisional. *: As on January 18, 2012.
#: April-January 13, 2012 over April-January 13, 2011.

Depreciation in REER as rupee weakens in nominal terms

III.9 The real effective exchange rate (*i.e.*, REER based on 6, 30 and 36 currency baskets) continued to show depreciating trend in Q3 reflecting sharp depreciation of the rupee in nominal terms. The indices, however, recorded an appreciation in January so far (up to January 13, 2012) as rupee appreciated in nominal terms during the same period (Table III.5).

Depreciation of the rupee and decline in equity indices can have a balance sheet impact

III.10 Due to subdued sentiments in the Indian equity market, Indian companies may require to plan innovatively to facilitate conversion of FCCBs into equity. This is to guard against consequent deterioration in the debt-equity ratio which may have a balance sheet impact. Amidst rising fragilities and uncertainties surrounding the global economic outlook, rolling over of overseas borrowings of Indian companies may become more expensive. Furthermore, the depreciating rupee may also offset the advantage of interest rate differential between domestic and overseas borrowings and impact the balance sheet of corporates. It is incumbent upon corporates to suitably hedge their receivables and payables against exchange rate volatilities.

External debt may rise but will remain manageable

III.11 The rise in external debt from US$ 306.4 billion at end-March 2011 to US$ 326.6 billion at end-September 2011 is largely attributed to the increase in ECBs, export credits and short-term debt (Table III.6). With increasing recourse to debt creating flows for financing the CAD, India's external debt is likely to rise further. Increased flows on account of ECBs and NRI deposits may have some implications for India's external debt in coming quarters. Nonetheless, it is expected that external debt will remain manageable. India's non-debt external capital being large, the strong long-term growth could make external debt rollovers relatively smooth.

External vulnerability indicators worsened marginally

III.12 There was marginal decline in some external sector vulnerability indicators in Q2

Table III.6: India's External Debt

(US$ billion)

Item	End-Mar 2011 PR	End-Jun 2011 PR	End-Sep 2011 P	Variation (End-Sep. 2011 over End-Jun 2011) Amount	Per cent
1	2	3	4	5	6
1. Multilateral	48.5	49.4	49.1	-0.2	-0.5
2. Bilateral	25.8	26.3	27.3	1.0	3.7
3. International Monetary Fund	6.3	6.4	6.2	-0.2	-2.4
4. Trade Credit (above 1 year)	18.6	18.7	19.7	1.0	5.3
5. External Commercial Borrowings	88.9	93.8	99.0	5.3	5.6
6. NRI Deposits	51.7	52.9	52.3	-0.6	-1.1
7. Rupee Debt	1.6	1.6	1.4	-0.1	-9.3
8. Long-term (1 to 7)	241.4	249.0	255.1	6.1	2.4
9. Short-term	65.0	68.5	71.5	3.1	4.5
Total (8+9)	**306.4**	**317.5**	**326.6**	**9.1**	**2.9**

P: Provisional. PR: Partially Revised.

of 2011-12 (Table III.7). The reserve cover of imports was lower as at end-September 2011 and the ratio of short-term external debt to total external debt also increased marginally. However, India's Net International Investment Position (IIP) showed an improvement as net international liabilities declined to US$ 224.9 billion at end-September 2011 from US$ 237.5 billion at end-June 2011 (Table III.8). As a result, the declining trend in the ratio of India's net international financial liabilities to GDP continued in Q2 of 2011-12. The decline mainly reflected valuation changes emanating from exchange rate movements.

Adjustment necessary through absorption and expenditure-switching policies

III.13 The rising CAD is expected to correct with a lag as exports respond to a weaker rupee, while import demand dampens with exchange rate pass-through. Decelerating aggregate demand should also help to contain CAD. However, if this adjustment is delayed in an uncertain global environment, policy responses

Table III.7: External Sector Vulnerability Indicators

(Per cent)

Indicator	End-March 2010	End-June 2010	End-March 2011	End-June 2011	End-Sep 2011
1	2	3	4	5	6
1. Ratio of Total Debt to GDP*	18.0	17.6	17.4	17.2	17.8
2. Ratio of Short-term to Total Debt (Original Maturity)	20.0	20.9	21.2	21.6	21.9
3. Ratio of Short-term to Total Debt (Residual Maturity)	41.2	42.5	42.2	43.3	43.4#
4. Ratio of Concessional Debt to Total Debt	16.8	15.9	15.5	15.1	14.7
5. Ratio of Reserves to Total Debt	106.9	98.0	99.5	99.6	95.4
6. Ratio of Short-term Debt to Reserves (Original Maturity)	18.8	21.0	21.3	21.7	22.9
7. Ratio of Short-term Debt to Reserves (Residual Maturity)	38.6	42.1	42.3	43.5	45.5#
7. Reserves Cover of Imports (in months)	11.1	10.7	9.6	9.2	8.5
8. Reserves Cover of Imports and Debt Service Payments (in months)	10.5	10.1	9.1	8.8	8.0
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	5.8	4.1	4.3	4.7	4.9
10. External Debt (US$ billion)	261.0	270.3	306.4	317.5	326.6

* : Ratios for end-June 2010, end-June 2011 and end-September 2011 are based on annualised GDP.
# : RBI Estimate.

Table III.8: Overall International Investment Position of India

(US $ billion)

Period	Sep-10 (PR)	Dec-10 (PR)	Mar-11 (PR)	Jun-11 (PR)	Sep-11 (P)
1	2	3	4	5	6
Net IIP	-205.0	-221.8	-224.3	-237.5	-224.9
Assets	406.9	412.0	426.6	438.8	434.7
Liabilities	611.9	633.7	650.9	676.3	659.6
Net IIP / GDP ratio	-13.3	-13.5	-13.0	-12.9	-12.3

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

may become necessary. Both expenditure reducing and expenditure switching policies may be necessary in this setting.

III.14 The depreciation of exchange rate since August 2011 itself would have a favourable impact on exports during 2012-13. However, keeping in view the dominance of inelastic importable items in India's import basket, and presence of imperfect labour markets, expenditure switching policies may not necessarily bring about the desired adjustment in CAD. Further, to restrain the oil demand, further deregulation of prices of petroleum products may be expedited. Also, fiscal spending may need to be restrained so that absorption is contained and twin deficits do not feed on one another.

III.15 Close monitoring of the short-term external debt will be required in 2012-13. On the capital account, recent policy measures have stimulated debt capital flows in the form of investments by FIIs in debt instruments and NRI deposits. Going forward, however, it would be necessary to reduce dependence on debt inflows and accelerate the reform process in order to ensure revival of equity flows as investors look for strong growth opportunities in an otherwise gloomy global environment.

IV. MONETARY AND LIQUIDITY CONDITIONS

Factoring in increased downside risks to growth and expected moderation in inflation, monetary policy rate was kept on hold in December 2011. The trajectory of the monetary cycle would be shaped by evolving growth-inflation dynamics. During Q3 of 2011-12, credit growth slowed down partly reflecting the slowing economic activity and the portfolio adjustment to the Non-Performing Assets (NPA) cycle. On the monetary side, the rising money multiplier has kept the broad money growth at high levels despite low reserve money creation. Money market rupee liquidity, however, tightened partly as Reserve Bank sold dollars to contain exchange rate pressures. The liquidity stress was handled by the Reserve Bank by injecting liquidity through open market operations (OMO), including repos under the LAF, to balance the demand for liquidity.

Monetary space to support growth exists, but pace of action will depend on evolving growth-inflation dynamics

IV.1 The anti-inflationary monetary policy stance adopted since early 2010 continued till October 2011 as the Reserve Bank carefully calibrated policy response to the dilemma of anchoring inflationary expectations while ensuring that the growth impulses of the economy are not hampered. Factoring in the switchover from reverse repo mode to repo mode, the effective policy rate tightening was 525 bps during this period. In continuation of this policy stance, the Reserve Bank raised the policy repo rate by 25 bps to 8.5 per cent in October 2011 (Table IV.1). Subsequently, however, while inflation remained on its projected trajectory, downside risks to growth increased due to global risks and domestic policy uncertainties. Consequently, policy rates were kept unchanged in the Mid-Quarter Review on December 16, 2011 (Chart IV.1).

Table IV.1: Movements in Key Policy Rates in India – 2011-12

(Per cent)

Effective Since	Repo Rate	Cash Reserve Ratio
1	2	3
May 3, 2011	7.25 (+0.50)	6.00
Jun 16, 2011	7.50 (+0.25)	6.00
July 26, 2011	8.00 (+0.50)	6.00
Sept. 16, 2011	8.25 (+0.25)	6.00
Oct. 25, 2011	8.50 (+0.25)	6.00
Dec. 16, 2011	8.50	6.00

Note : 1. Repo indicates injection of liquidity.
2. As announced in Monetary Policy Statement 2011-12, the reverse repo rate is pegged at a fixed 100 bps below repo rate and rate of interest on Marginal Standing Facility (MSF) will be 100 bps above the repo rate.
3. Figures in parentheses indicate change in policy rates in percentage points.

IV.2 The global economic outlook has weakened considerably in recent weeks. While the recent moderation in inflation may provide some policy comfort, monetary policy actions ahead will depend on the evolving dynamics between growth and inflation.

RBI infuses liquidity as rupee and dollar liquidity tightens

IV.3 The Liquidity Adjustment Facility (LAF) has remained in injection mode since June 2010, in line with the stated policy objective of the Reserve Bank. During this period the anti-inflationary monetary policy stance was supported by deficient liquidity conditions.

Chart IV.1: Pre- and Post- Crisis: Rate Scenario

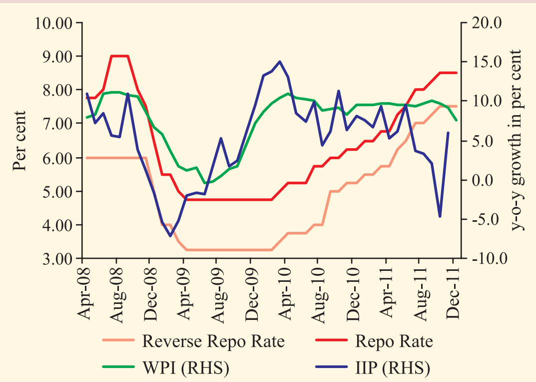
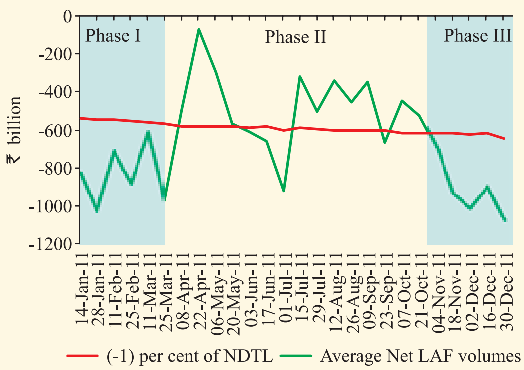


Chart IV.2: Phases in Liquidity Conditions



Note: Negative LAF volumes indicate injection of liquidity.

Monetary transmission is usually more effective in a deficit liquidity situation, as money market rates respond immediately to a policy shock. The extent of liquidity deficit, however, was not uniform throughout this period with the drivers of liquidity changing over time.

IV.4 Three broad phases for the year 2011 can be identified: first phase from January 2011 till end-March 2011, when frictional factors like large government cash balances with the Reserve Bank and structural factors like imbalances in deposit and credit growth and above trend growth in currency resulted in severe liquidity pressure (Chart IV.2).

IV.5 Subsequently, in the second phase during end-March 2011 to mid-October 2011, the liquidity pressure moderated as both structural and frictional liquidity drivers eased (Table IV.2). The average daily LAF injection came down to ₹476 billion during this period. During the above period, liquidity deficit largely remained within the comfort zone of the Reserve Bank. The main factors behind this easing of liquidity pressure were the drawdown of government cash balances and narrowing divergence between credit and deposit growth.

IV.6 In the current phase, which began since mid-October 2011, pressures on liquidity reemerged with the decline in the level of WMA/OD and the forex market operations conducted by the Reserve Bank (Chart IV.3). Consistent with the stance of monetary policy and based on the assessment of prevailing

Table IV.2: Reserve Bank's Liquidity Management Operations

(₹ billion)

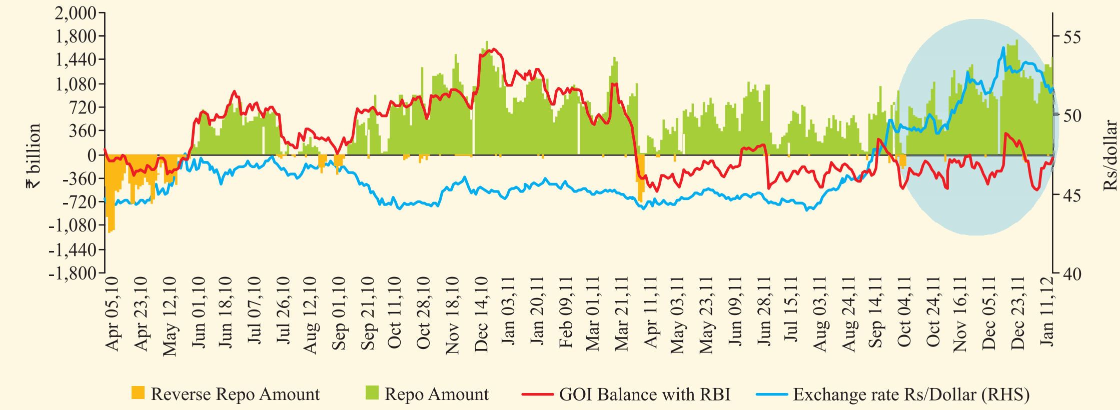
Item	Phase I	Phase II	Phase III
	Dec. 31, 2010 to Mar. 31, 2011	Mar. 31, 2011 to Oct. 21, 2011	Oct. 21, 2011 to Nov. 25, 2011
1	2	3	4
A. Drivers of Liquidity (1+2+3+4)	**736.4**	**-27.7**	**-286.1**
1. RBI's net Purchases from Authorised Dealers	0.0	-41.4	-170.2
2. Currency with the Public	-455.3	-396.1	-188.2
3. a. Centre's surplus balances with RBI	-1,280.2	-328.4	375.5
b. WMA and OD	0.0	164.3	49.0
4. Others (residual)	2,471.9	573.9	-352.2
B. Management of Liquidity (5+6+7+8)	**157.7**	**-216.7**	**296.8**
5. Liquidity impact of LAF	-74.1	-262.4	189.9
6. Liquidity impact of OMO (net)	231.8	45.7	106.9
7. Liquidity impact of MSS	0.0	0.0	0.0
8. First round impact of CRR change	0.0	0.0	0.0
C. Bank Reserves # (A+B)	**894.1**	**-244.5**	**10.7**

(+) Injection of liquidity into the banking system.
(-) Absorption of liquidity from the banking system.
#: Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.

and evolving liquidity conditions, the Reserve Bank undertook several measures to alleviate the liquidity pressure. These include open market purchases, additional repo on December 16, 2011 and MSF facility being extended against excess SLR holdings. The pressure on liquidity has persisted in January 2012 so far. During the current financial year liquidity amounting to ₹ 614 billion have been injected under the OMOs till January 16, 2012. Some banks also tapped the MSF window during December 2011 and January 2012.

IV.7 The domestic liquidity deficit has remained significantly above the Reserve Bank's comfort zone of 1 per cent of NDTL since November 2011. Even though liquidity

Chart IV.3: LAF Volumes



deficit was largely beyond this zone during this third phase, the new operating procedures introduced in May 2011 helped keep money market stress under check. The short-term rates were less volatile and remained largely anchored within the corridor set by the reverse repo rate and the MSF rate. In earlier periods of similar liquidity mismatches, the spikes in short-term rates were much larger. The Reserve Bank's timely policy actions of providing liquidity without compromising on the anti-inflationary policy objective or funding speculative positions in the foreign exchange market, also helped in limiting pressures on short-term rates. Going forward, liquidity deficits need to be addressed in a calibrated manner.

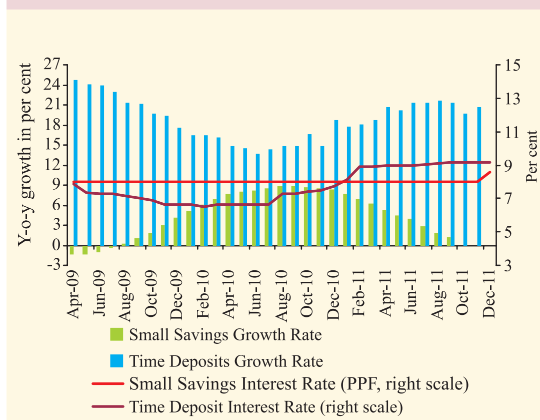
IV.8 Currently, the holding of government securities by the banking system is around 29 per cent of NDTL, which is nearly five percentage points above the statutory requirement. This provides a relatively large scope for liquidity infusion. The OMOs have been an instrument of first preference for the purpose, but additional instruments could be considered as and when required.

Currency expansion moderates, but deposit growth remains firm, aided by interest rate cycle

IV.9 Currency growth, which witnessed a sharp increase in 2010-11 on account of strong rebound in economic growth coupled with inflationary pressures, has been decelerating in 2011-12 so far. The deceleration in currency growth can be attributed to economic agents' response to the high opportunity cost of holding money as interest rates on deposits increased. A substitution from currency to term deposits is evident in the current financial year so far.

IV.10 The term deposits have been registering robust growth since December 2010 due to successive hikes in interest rates (Chart IV.4). The mirror image of this growth was evident in the deceleration in currency growth and also in the sharp decline in demand deposit growth. Major reforms in the area of interest rates have been introduced by the Reserve Bank in the recent period. Effective October 25, 2011, the Reserve Bank deregulated the deposit rate on savings

Chart IV.4: Behaviour of Time Deposits



bank accounts. This move, besides improving the transmission of monetary policy, is also expected to bring saving deposit rates in sync with the changing market conditions.

Credit decelerating on cyclical considerations

IV.11 Non-food credit growth has been generally showing a decelerating trend since December 2010. The recent deceleration reflects overall slowdown in economic activity and some risk aversion by banks as well as impact of cumulative monetary actions taken so far.

IV.12 The divergence between credit and deposit growth rate, which was high and growing during the first three quarters of 2010-11, has progressively narrowed since then (Chart IV.5).

IV.13 At the broad bank group level, the deceleration in credit growth of the public sector banks was particularly sharp. This reflected rising risk aversion of these banks that is leading to portfolio switch to investments in risk-free G-secs on the back of large government market borrowing . As the public sector banks are the largest lenders in terms of outstanding credit, the deceleration in their credit growth pulls down the overall credit expansion of SCBs taken together. The credit growth of foreign banks, which had witnessed sharp decline during October 2008-October 2009 period, has witnessed a rebound since then. Private sector banks, which registered strong credit growth in the post-crisis period, have however witnessed a moderation in credit growth in recent period. (Table IV.3 and Chart IV.6).

Table IV.3: Credit Flow from Scheduled Commercial Banks

(Amount in ₹ billion)

Item	Outstanding as on Dec. 30, 2011	Variation (y-o-y) Dec. 31, 2010 Amount	Dec. 31, 2010 Per cent	Dec. 30, 2011 Amount	Dec. 30, 2011 Per cent
1	2	3	4	5	6
1. Public Sector Banks*	32,129	5,418	24.1	4,190	15.0
2. Foreign Banks	2,300	315	19.8	392	20.6
3. Private Banks	8,166	1,515	28.2	1,274	18.5
4. All Scheduled Commercial Banks	43,656	7,408	24.5	6,003	15.9

Note: 1. Data as on December 30, 2011 are provisional.
2. *Excluding Regional Rural Banks.

IV.14 The deceleration in non-food credit growth since December 2010 is contributed by all the sectors, including industry, personal loans, services and especially agriculture (Chart IV.7). While the deceleration in agriculture is partly on account of definitional changes effected during February-March 2011, the high growth of NPAs in agriculture sector also possibly contributed to the slowdown (Chart IV.8).

IV.15 During last two years, the growth rate of gross NPAs has remained high, even during the period when economic growth was robust.

Chart IV.5: Divergence between Credit and Deposit Growth

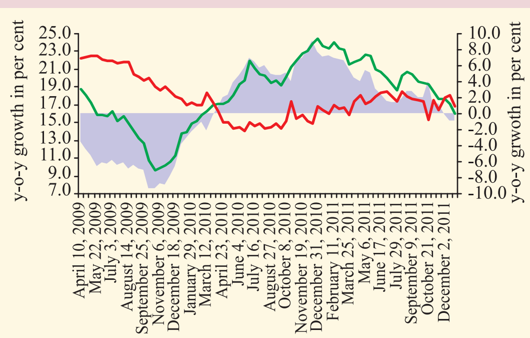


Chart IV.6: Bank Group wise Credit Growth

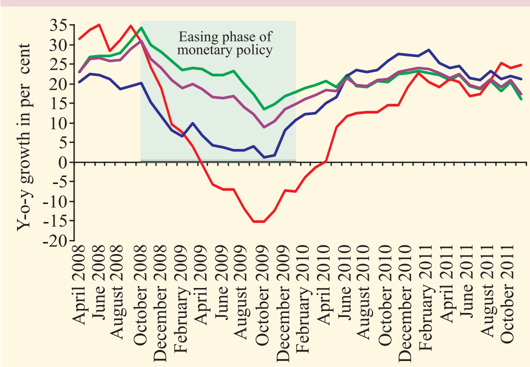
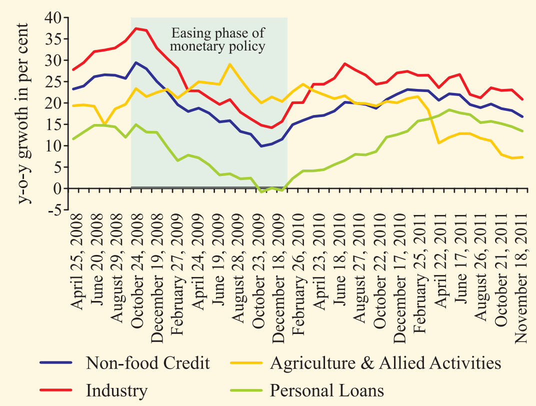


Chart IV.7: Sectoral Credit Growth



While the high NPA levels partly reflect implementation of better reporting system, the slippage remains a cause of concern.

IV.16 An analysis of credit flow to 19 industrial groups using a Normalised Herfindahl Index reveals that the concentration of industrial credit has increased over a period (Chart IV.9). On the positive side however, the present level of the index merely indicates transition from low to moderate concentration and to that extent the vulnerability of banks to particular sector specific shocks is limited.

Rising money multiplier keeps monetary expansion in spite of low primary money creation

IV.17 The deceleration in reserve money was led by a moderation in the demand for currency. Notwithstanding the sharp deceleration in reserve money growth, broad money supply growth has mostly remained above the indicative trajectory of the Reserve Bank (Chart IV.10). This is mainly on account of sharp growth in money multiplier and indicates a need to maintain a delicate balance between provision of liquidity and maintaining control thereupon to restrain inflation. The growth in money supply in Q3 of 2011-12 is led mainly by growth in time deposits on the component side (Table IV.4). This growth in time deposits was mainly on account of rising opportunity cost of holding cash or demand deposits as the interest rates on time deposits responded to the anti-inflationary monetary policy stance of the Reserve Bank. On the sources side the rise in broad money supply was led by increase in net RBI credit to government sector, reflecting OMO and LAF operations of the Reserve Bank.

Chart IV.9: Normalised Herfindahl Index for Industrial Credit

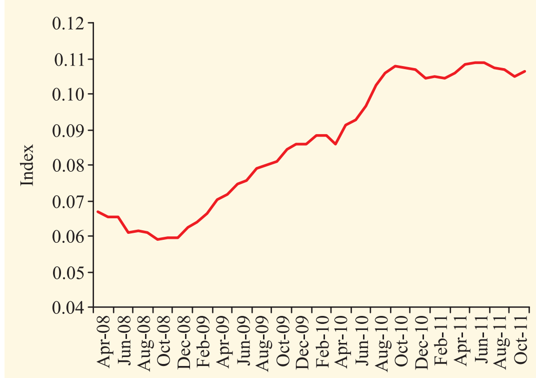


Chart IV.8: Sector-wise Gross NPAs as per cent of Gross Advances of SCBs

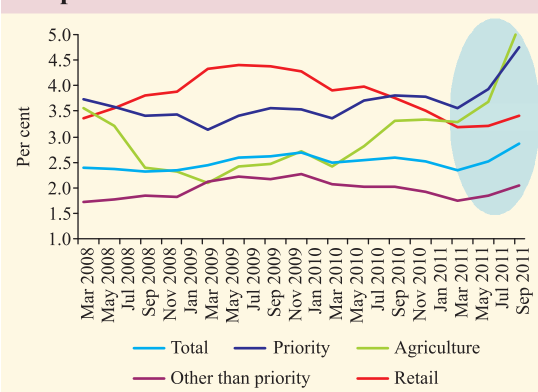


Chart IV.10: Base Money Growth *vis-a-vis* Broad Money Growth

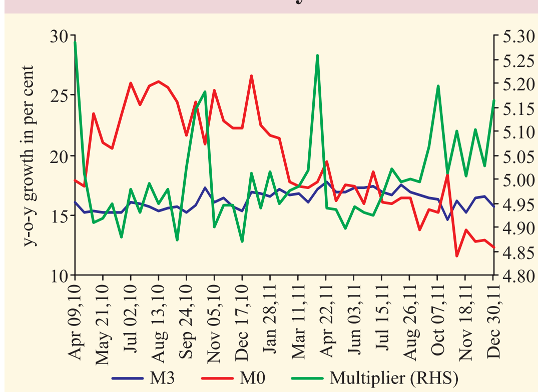


Table IV.4 : Monetary Indicators

Item	Outstanding Amount (₹ billion) Dec. 30, 2011	FY variations (per cent)		Y-o-Y Variations (per cent)	
		2010-11	2011-12	Dec. 31, 10	Dec. 30, 11
1	2	3	4	5	6
Reserve Money (M_0)*	**14,200.5**	**8.7**	**3.1**	**22.5**	**13.0**
Broad Money (M_3)	**71,986.8**	**11.1**	**10.8**	**16.9**	**15.6**
Main Components of M_3					
Currency with the Public	9,779.9	13.2	7.0	19.1	12.6
Aggregate Deposits	62,184.0	10.8	11.4	16.6	16.2
of which: Demand Deposits	7,093.9	0.2	-1.2	13.5	-1.4
Time Deposits	55,090.1	12.6	13.3	17.1	18.9
Main Sources of M_3					
Net Bank Credit to Govt.	22,351.1	7.7	12.7	17.3	24.4
Bank Credit to Commercial Sector	46,817.9	16.0	10.5	23.9	15.6
Net Foreign Assets of the Banking Sector	15,905.6	5.3	14.2	1.0	17.9

Note: 1. Data are provisional.
2. * Data pertain to January 13, 2011.

Non-bank sources continue to dominate the flow of resources to the commercial sector

IV.18 Non-bank sources, whose share in total flow of resources was 43.0 per cent in April-December 2010, are now the dominant sources of finance with its share close to 53.9 per cent. Within domestic financing, the number of public issues by non-financial entities has reduced substantially mainly reflecting the subdued trends in the stock market (Table IV.5).

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

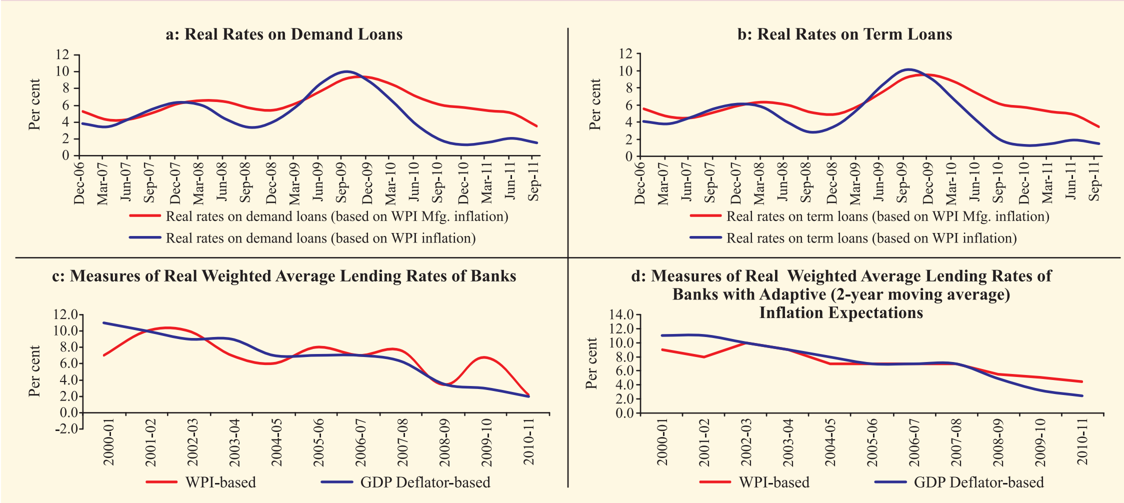
(₹ billion)

Item	April-March		April-December	
	2009-10	2010-11	2010-11	2011-12
1	2	3	4	5
A. Adjusted Non-food Bank Credit (NFC)	**4,786**	**7,110**	**5,391**	**4,253**
i) Non-Food Credit	4,670	6,815	5,031	4,033
of which petroleum and fertilizer credit	100	-242	-231	6.63 ^
ii) Non-SLR Investment by SCBs	117	295	359	220
B. Flow from Non-banks (B1+B2)	**5,850**	**5,286**	**4,064**	**4,972**
B1. Domestic Sources	**3,652**	**2,956**	**2,257**	**2,539**
1. Public issues by non-financial entities	320	285	232	62
2. Gross private placements by non-financial entities	1,420	674	393	327 *P
3. Net issuance of CPs subscribed to by non-banks	261	172	369	867 %
4. Net credit by housing finance companies	285	384	229	248 ^
5. Total gross accommodation by the four RBI regulated AIFIs - NABARD, NHB, SIDBI & EXIM Bank	338	400	323	216
6. Systemically important non-deposit taking NBFCs (net of bank credit)	607	679	515	611 ^
7. LIC's gross investment in corporate debt, infrastructure and social sector	422	361	196	210
B2. Foreign Sources	**2,198**	**2,330**	**1,806**	**2,433**
1. External Commercial Borrowings / FCCBs	120	555	434	608
2. ADR/GDR Issues excluding banks and financial institutions	151	92	83	26
3. Short-term credit from abroad	349	502	319	269 *
4. FDI to India	1,578	1,181	970	1,530 ^
C. Total Flow of Resources (A+B)	**10,636**	**12,396**	**9,454**	**9,225**
Memo Item:				
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	966	-367	-300	-54

* : Up to September, 2011. ^: Up to November 2011. % : Up to November 15, 2011. P : Provisional.

Note: FDI Data include equity capital and reinvested earnings of incorporated entities & unincorporated entities for the period April-November and include other capital for the period of April-September.

Chart IV.11: Real Rate of Interest on Demand Loans and Term Loans



Real interest rates remain low

IV.19 In the recent period despite monetary tightening, real lending rates have remained low reflecting high inflation (Chart IV.11). Low but positive real lending rates paved the way for anti-inflationary stance to work, while allowing growth to moderate gradually.

Deteriorating macro-economy poses multiple challenges for monetary policy

IV.20 With visible signs of slowdown, rate hikes were paused. While food inflation has since turned negative, this is mainly on account of the high base and seasonal fall in vegetable prices. The critical factors in rate actions ahead will be core inflation and exchange rate pass-through. At the same time enabling smooth functioning of other markets by ensuring that the liquidity deficit remains within acceptable limits is also a policy priority. The monetary policy stance in the near future needs to balance various considerations.

V. FINANCIAL MARKETS

Global financial markets witnessed increased stress during Q3 of 2011-12. An adverse feedback loop between bank and sovereign debt brought euro area closer to contagion across region. Significant policy actions by the EU in December2011 helped provide a temporary reprieve, but did not avert the sovereign rating downgrade of nine euro area countries in January 2012. Indian financial markets, especially currency and equity, witnessed pressures from global spillovers and weakening macroeconomy. Both dollar and rupee liquidity tightened, but countervailing steps helped mitigate the strains. Pressure on domestic liquidity was effectively contained by the OMO purchases by the Reserve Bank. Dollar flows were enhanced through capital account measures that curbed speculation. Going forward, markets may face more episodes of spillovers.

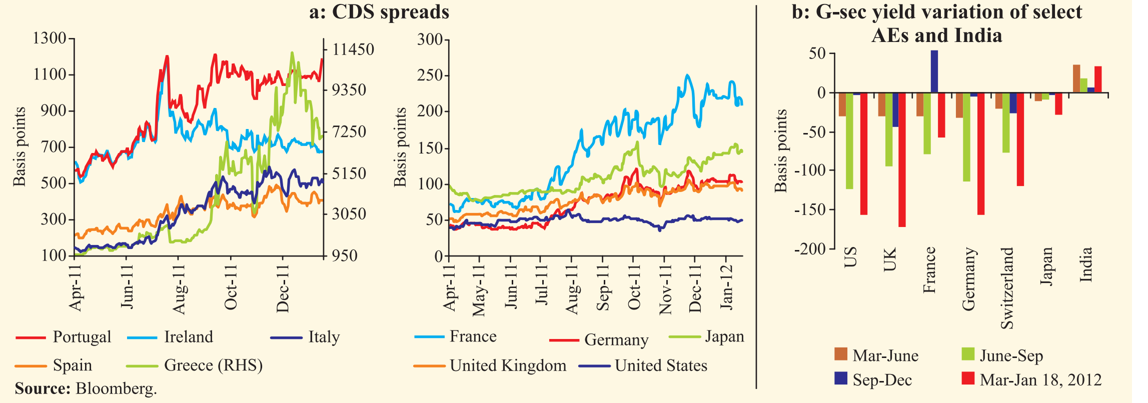
Global financial markets witness stress amidst sovereign debt crisis

V.1 Intensifying concerns over the fragile global recovery and debt sustainability, challenges involved in meeting fiscal austerity targets, European banks' high balance sheet exposure to troubled sovereign debt loomed large over the global financial market functioning during Q3 of 2011-12. The EU responded with significant policy action during December 2011, but continued stress was reflected in rating downgrade of European Financial Stability Fund (EFSF) and nine euro area countries by S&P, of which four were downgraded by two notches. In this backdrop sovereign risk premia has risen sharply in the euro area (Chart V.1). Going forward, financial markets in 2012 are likely to witness continued volatility.

Bailouts in face of strong feedback loop between bank and sovereign debt provide temporary reprieve

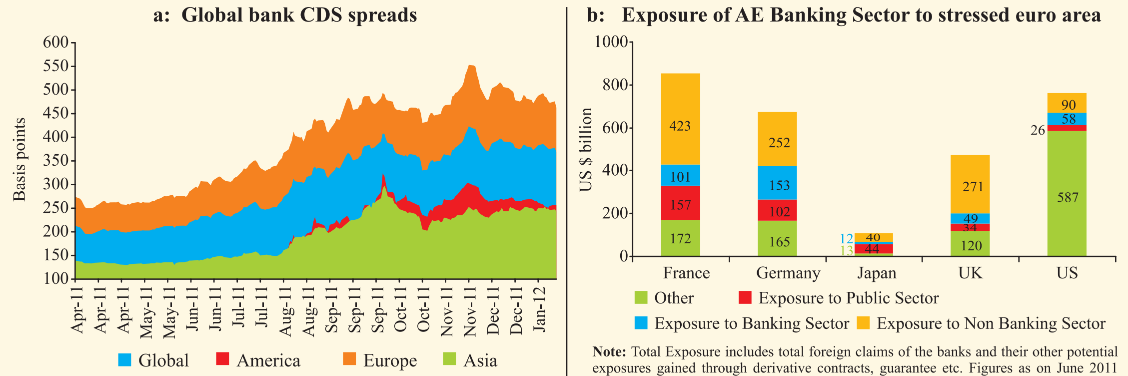
V.2 With euro area sovereigns compelled to fund bailouts for private debt to avert a meltdown, an adverse feedback loop has been generated from private to sovereign balance sheets and then from the latter to the former. With rising risk premia and the impact of large supply of government paper, losses have been inflicted on the existing bondholders. With falling value of sovereign guarantees and increasing sensitivity to sovereign debt shocks, both private and sovereign balance sheets have weakened. Initially, the bank CDS spreads in the euro area widened (Chart V.2a). Thereafter, with bailouts, sovereign spreads came under pressure.

Chart V.1: Spillover risks from sovereign debt crisis challenge growth recovery



Source: Bloomberg.

Chart V.2: Banking Sector Exposure to Sovereign Risk



Source: Bloomberg.

Note: Total Exposure includes total foreign claims of the banks and their other potential exposures gained through derivative contracts, guarantee etc. Figures as on June 2011

Source: RBI staff calculations based on data from BIS.

V.3 During Q3 of 2011-12, significant policy action has been taken to reduce stress. On October 26, 2011, euro area leaders reached a deal built on (i) bank recapitalisation (estimated at €106 billion); (ii) voluntary bond exchange at discount (implying 50 per cent haircut for private holders of Greek debt); and (iii) upscaling the €440 billion EFSF via bond insurance and Special Purpose Vehicles (SPVs) leveraging resources 4 to 5 times to a headline figure of around €1 trillion, aimed at preventing the spread of crisis. Again in December, the euro area countries reached a deal towards fiscal targets to be met, and to provide additional funding of €150 billion to the IMF to support further bailouts. The ECB also stepped in, first cutting policy rate and then lending €489 billion in a single operation of 3-year long-term repo to over 500 euro area banks. The US Fed, the ECB and four other central banks agreed to halve the cost of US$ swap lines to 50 bps over overnight index swaps (OIS). On January 18, 2012, the IMF has proposed to raise its funding potential by $500 billion.

V.4 Most of these measures provided temporary reprieve but did not lead to resolution of debt crisis. Current assessment is that financial volatility may persist as haircuts required on Greek debt are larger than being sought. Extra repo funding by the ECB may not seamlessly flow to the sovereign debt markets. Wide scale downgrades of banks and sovereigns have made debt refinancing more difficult in the face of such uncertainty.

Risk of contagion of euro area crisis to AE banking sector looms large

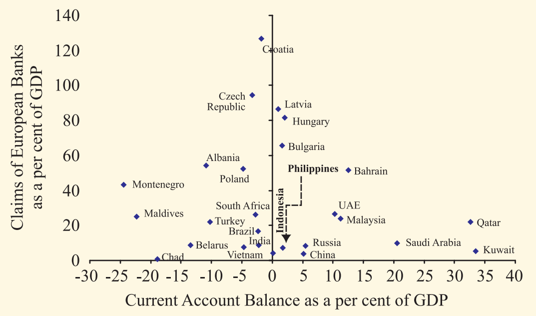
V.5 Latest stress tests conducted by the European Banking Authority (EBA) show that the capital shortfall of German banks has trebled during October – December 2011 to € 13.1 billion while the combined Europe-wide capital deficit of banks rose from €106 billion to €115 billion. Banks in most AEs, including core euro area, have significant direct and indirect exposure to distressed euro area economies (such as Portugal, Ireland, Italy, Greece and Spain). The most exposed are the banks in euro area, like Germany and France, followed by US and UK (Chart V.2b). This increases the risk of a more generalised contagion to other AEs through the banking channel.

V.6 In the event of a financial landslide in these distressed euro area economies, the vulnerability of the AE banks would limit the credit availability and the fallout on real activity of these AEs could be severe. According to the latest surveys, the deepening euro area debt crisis is limiting banks' lending capacity in UK. Similarly, the US Fed's latest survey of loan officers concluded that credit conditions in the recent months have tightened.

Deleveraging by European banks may exacerbate capital outflows from EDEs

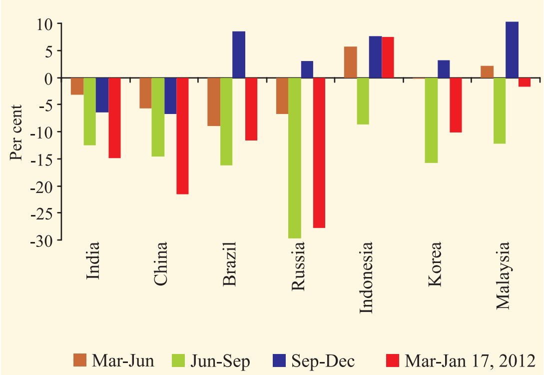
V.7 Intensifying concern about the capital constraints of euro area banking system (due to the balance sheet effects of sovereign debt problems) is likely to trigger deleveraging by

Chart V.3: Deleveraging by European Banks and the Sustainability of Current Account in EDEs



Source: RBI staff calculations based on data from BIS and IMF.

Chart V.4: Q-o-Q movements in EDE equity market indices



European banks and their lending to EDEs could decline. The dependence on European banks for funding can be expressed by the European banks' claims in these countries as a proportion of their GDP (Chart V.3).

V.8 However, those EDEs which have both a CAD and a high exposure to European banks face an additional problem of sustaining their current account deficit in the event of deleveraging and capital outflows. India has low exposure to European claims. Nevertheless, India too may face some shrinkage in the availability of credit, particularly trade credit, and escalation in the cost of borrowing.

Indian financial markets witness pressures from global spillovers

V.9 The impact of the global financial instability on India has been discernible, though the impact has been limited by the flexibility of exchange rate. Equity and currency markets faced pressures. India is a structurally current account deficit country. The deficit is financed by capital inflows, which generally have been large and stable to finance CAD and support growth. However, global market turmoil resulted in rising risk aversion and moderation in capital inflows that resulted in currency pressures during August-December 2011, just as it did during July 2008 to February 2009. However, equity markets and exchange rate have recovered from their end-December 2011 levels in January 2012 (up to January 18, 2012) with net FII inflows on the back of moderation in the inflation, among other factors.

Indian equity markets face stress due to macro-risks and rupee depreciation

V.10 Indian equity prices continued their declining trend in Q3 of 2011-12, led by worsening macroeconomic environment and anticipated lower earning growth that resulted in net sales by FIIs (Chart V.4). Heightened risk aversion and deleveraging induced by the euro area crisis impacted financial markets in EDEs, including India, in Q3 of 2011-12. The negative trend in S&P CNX Nifty was in line with EDE indices. As a result of significant correction, PE ratio of Indian equity market has moderated to 16.9 as at end-December 2011 from 17.6 as at end-March 2011. Equity markets, however, turned around during 2012 so far.

Dampened capital inflows drive sharp fall in value of rupee

V.11 Capital flow moderation coupled with higher trade deficit led to a sharp fall in the exchange rate of the Indian rupee during August-December 2011. Speculative trades reinforced this trend. After slipping to an all time low of ₹ 54.3 per US dollar on December 15, 2011, the rupee reversed to 50.3 as on January 20, 2012. The reversal followed measures to boost capital inflows. The rupee depreciation reflected drying up of portfolio flows to India and the resulting gap in financing higher CAD (*please refer to Chart III.2,* Chart V.5). Against the backdrop of the prevailing external economic environment, the confidence channel seem to have also played a significant role. An increase in the FII investment limit coupled with the high risk adjusted rate of return boosted net FII inflows into the debt segment during 2011.

Primary market resource mobilisation dries up

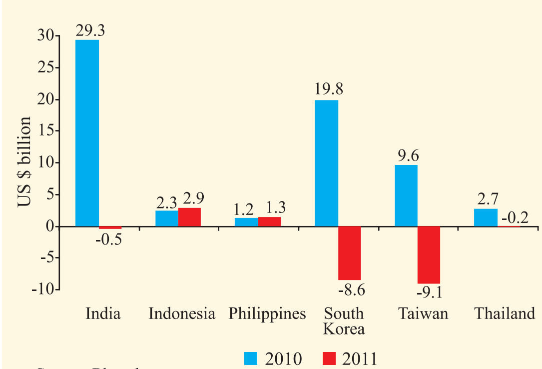
V.12 Firms abstained from mobilising resources by way of public issues during October-December 2011 when investors' risk appetite was low. The continued negative returns in stock markets and IPOs after their listing during the first half of 2011-12 adversely affected investor and promoter sentiments (Chart V.6a). On the external front, resources mobilised through Euro issues were lower due to tight liquidity conditions in the European banking system on the back of the persisting euro area debt crisis.

V.13 During 2011-12 (up to end-December), FIIs made net sales of ₹43.8 billion in the equity segment while mutual funds made net purchases of ₹42.2 billion (Chart V.6b). However, FIIs made net purchase of ₹54 billion in January 2012 (up to January 18, 2012).

G-sec yields soften despite higher government borrowings

V.14 During Q3, the G-sec yields hardened till mid-November 2011 in the wake of large government borrowing and market anticipation of fiscal slippage during the year. However, the G-sec yields softened since mid-November 2011 primarily due to enhancement of FII investment limit in debt, pause in monetary tightening, signs of softening in inflation and open market operations (OMOs). Inspite of the

Chart V.5: Portfolio Flows into Equity



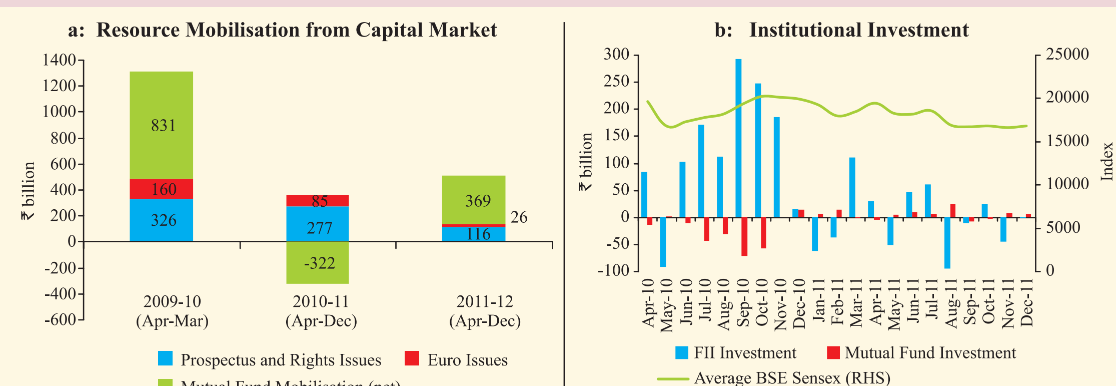
Source: Bloomberg.

large additional market borrowing by the government, yield did not rise as the Reserve Bank purchased G-secs of ₹719 billion (up to January 20, 2012) through OMOs in response to the systemic liquidity deficit (Chart V.7). The Reserve Bank's commitment to conduct further OMOs as and when deemed appropriate also assuaged market sentiment.

Interest rates stay firm

V.15 Interest rates stayed firm during Q3 of 2011-12 on the back of October rate hike, large government borrowings, tight liquidity and interest rate deregulation. Unlike the forex and equity markets, the money and G-sec markets were relatively unaffected by the global factors, but continued to be predominantly conditioned by domestic macroeconomic dynamics. The money market rates continued to be relatively high in Q3 of 2011-12, reflecting tight liquidity

Chart V.6: Resource Mobilisation and Institutional Investment



Source: SEBI. **Source:** Bloomberg.

Chart V.7: Movement in G-sec yield

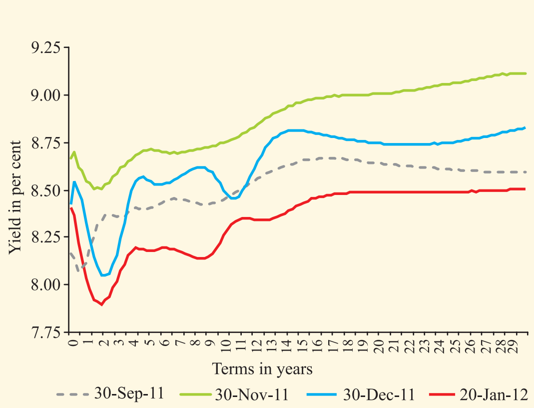
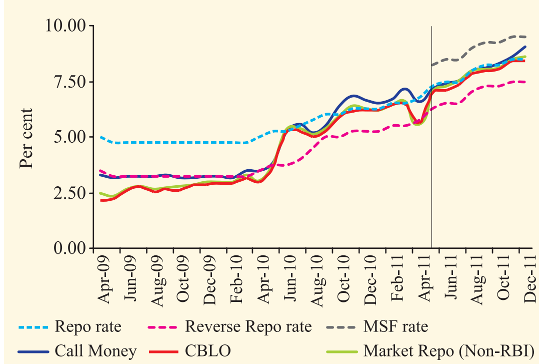


Chart V.8: Money Market Rates



Note: Effective May 9, 2011, the MSF rate and reverse repo rate constitute the upper and lower bounds of the formal corridor.

conditions and the effect of successive hikes in policy rates by the Reserve Bank (Chart V.8).

V.16 The call rate hardened in December 2011, averaging 9.04 per cent on the backdrop of tight liquidity conditions largely on account of advance tax outflows. Tracking the call rate, the rates in the collateralised segments (*i.e.*, CBLO and market repo) also rose. To ease the liquidity pressure in the system, apart from the purchase of G-secs through OMOs, the Reserve Bank allowed banks to avail overnight funds under the Marginal Standing Facility (MSF) also against their excess SLR holdings from December 21, 2011.

V.17 The yields on auction Treasury Bills (TBs) firmed up till mid-December 2011 reflecting the marked increase in the short-term borrowings of the Centre through issuances of TBs and cash management bills and the rise in the policy rates in October 2011. The auction cut-offs declined following the mid-quarter guidance on policy rates, notwithstanding the seasonal hardening of liquidity conditions.

Modest rise in deposit rates

V.18 Following the move to deregulate the savings bank deposit interest rate as laid out in the Second Quarter Review of Monetary Policy 2011-12 (October 25, 2011), six scheduled commercial banks (SCBs) have raised their rates in the range of 100-300 bps so far. While the major banks with large outstanding CASA holdings did not raise their saving bank deposit rate in response to the deregulation of savings bank deposit rates, as per the latest available information, all public sector banks, major private sector banks and five foreign banks offered higher competitive rates to their NRE term deposit accounts following its deregulation effective December 16, 2011. These banks have so far increased their average NRE term deposit rates in the range of 430-516 bps across various maturities.

V.19 During Q3 of 2011-12, banks increased their deposit rates with relatively sharper rise for maturities up to 1 year, particularly by private sector and foreign banks. For maturity up to 1 year, the modal deposit rate for SCBs increased by 44 bps while the modal Base Rate continued to remain at 10.75 per cent during Q3 of 2011-12 (Table V.1).

Housing market witness price rigidities amidst falling demand

V.20 Despite the deceleration in overall credit off-take, housing loans continued to grow at a higher rate during Q2 of 2011-12 than the corresponding quarter of the previous year. Higher housing loans coupled with price rigidities in the housing market reflect the continued pricing power with the developers as also the increasingly stretched balance sheets of residential buyers. The lower volume of transactions implies that many other households are getting priced out from the housing market (Chart V.9). But data for Q2 of 2011-12 indicate further increase in property prices in most cities though at a slower pace. Also, in contrast with the preceding quarter, there was some increase

Table V.1 : Deposit and Lending Rates

(Per cent)

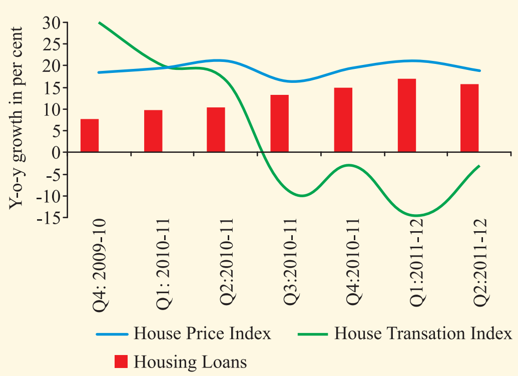
Interest Rates	Dec-2010	Mar-2011	Jun-2011	Sept-2011	Dec-2011
1	2	3	4	5	6
I. Domestic Deposit Rates (1-3 year tenure)					
i) Public Sector Banks	7.00-8.50	8.00-9.75	8.25-9.75	8.55-9.75	8.55-9.75
ii) Private Sector Banks	7.25-9.00	7.75-10.10	8.00-10.50	8.00-10.50	8.00-10.50
iii) Foreign Banks	3.50-8.50	3.50-9.10	3.50-10.00	3.50-9.75	3.50-9.75
II. Base Rate					
i) Public Sector Banks	7.60-9.00	8.25-9.50	9.25-10.00	10.00-10.75	10.00-10.75
ii) Private Sector Banks	7.00-9.00	8.25-10.00	8.50-10.50	9.70-11.00	10.00-11.25
iii) Foreign Banks	5.50-9.00	6.25-9.50	6.25-9.50	6.25-10.75	6.25-10.75
III. Median Lending Rate*					
i) Public Sector Banks	8.75-13.50	8.88-14.00	9.50-14.50	10.50-15.25	-
ii) Private Sector Banks	8.25-14.50	9.00-14.50	9.25-15.00	9.00-15.25	-
iii) Foreign Banks	8.00-14.50	7.70-14.05	7.70-14.50	9.13-14.75	-

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

in transaction volume. These volumes, however, remained lower on a y-o-y basis. Property markets are facing moderation in demand, but price correction has not occurred as real estate firms are holding land banks and slowing new launches and sales to retain pricing power.

V.21 The Reserve Bank's Quarterly House Price Index (HPI), based on the data on transaction of properties collected from the registration departments of respective state governments, now covering 9 cities indicates a hike in q-o-q prices in all cities during Q2 of 2011-12 except for Bengaluru. On the other hand, the data on volume of transactions for the same period show increase in the number of transactions in six cities, except Mumbai and the recently included cities of Kanpur and Jaipur.

Chart V.9: Housing Market



Financial stability risks may increase if euro area stress increases

V.22 Going forward, the funding costs of the domestic banking and corporate sectors will be impacted by a host of domestic and global factors. The on-going deceleration in economic activity and a benign inflation environment can reduce the domestic funding costs. Reversal of capital flows cannot be ruled out if euro area stress increases further. The Indian banks continued to be resilient notwithstanding a marginal decline in capital adequacy and a slight increase in the level of non-performing assets in certain sectors in the recent period and should be able to withstand the adverse fallouts of the euro area crisis.

V.23 Global factors aside, the rising import bill, decelerating export growth, pace of reform initiatives towards boosting capital flows and domestic growth concerns are likely to influence the movements in the Indian financial markets. As inflation moderates ahead, the policy priority will shift towards revival of growth, which should help boost investor confidence and restore market sentiment. Nonetheless, the policy logjam in the euro area, the pace of recovery in AEs and growth momentum in EDEs will continue to influence capital flows to EDEs, including India.

VI. PRICE SITUATION

Headline inflation decelerated to a two-year low of 7.5 per cent in December 2011 driven by sharp decline in food inflation. While the inflation path is broadly evolving in line with the 7 per cent projection for March 2012, upside risks persist. They come from the insufficient supply responses, exchange rate pass-through and suppressed inflation in the energy segment. Inflation in non-food manufactured products remains persistently high, reflecting input cost pressures, as the impact of imported inflation resulting from the rupee depreciation more than offset the sobering impact of weakening domestic demand and softer global commodity prices. Primary food inflation declined sharply and turned negative reflecting seasonal fall in vegetable prices and high base, and hence, this phase is expected to be short-lived. High protein inflation continues due to structural demand-supply imbalances.

Global inflation expected to ease as growth risks amplify

VI.1 Inflation worldwide is still exhibiting divergent trends. Faster recovery in emerging and developing economies (EDEs) after the crisis led to a resurgence of CPI inflation in 2010 in these countries, while inflation remained subdued in the advanced economies (AEs). In 2011, especially in the recent months, inflation rose in AEs, while EDEs witnessed stable to softening bias (Table VI.1).

VI.2 Going forward, global inflation is expected to remain subdued with global growth projected to slow down further in 2012. Softening global commodity prices are also expected to feed into softer CPI inflation. Simultaneous deleveraging of both the public and private sectors in many parts of the AEs may further weaken demand and thereby ease inflationary risks notwithstanding sustained easy monetary conditions. Relatively stronger growth in EDEs could keep inflation differentials to persist between AEs and EDEs, even though softening of inflationary pressures could be a general trend.

Global interest rate cycle in easing mode

VI.3 Receding risks to price stability and increasing risks to growth have also influenced the monetary policy stance of central banks in major economies. As the intensified financial market tensions were continuing to dampen economic activity in the euro area and wage price pressures were expected to remain moderate, the ECB reduced its key policy rate cumulatively by 50 basis points to 1 per cent during November-December 2011. Major economies like Australia and Israel have also reduced their policy rates. Many EDEs, which were earlier increasing policy rates to address inflation concerns have also started reducing policy rates as growth risks became imminent. Central banks of EDEs like Brazil, Indonesia, Russia and Thailand have reduced policy rates during Q3 of 2011-12 while China reduced the required reserve ratio for deposit taking institutions (Table VI.1).

Global commodity prices soften but oil prices exhibit stickiness

VI.4 Global commodity prices continued to moderate during Q3 of 2011-12 even though the levels remain significantly high (Chart VI.1a). Metal prices have softened significantly. The general softening in commodities prices reflects a combination of weakening demand, order deferrals from purchasing managers given the global economic outlook and appreciation of the US dollar against major currencies. Crude oil prices, however, have exhibited stickiness. Brent crude prices on an average have been 30 per cent higher in 2011-12 so far, compared with the preceding year. In spite of weakening global growth conditions, it stayed elevated

Table VI.1: Global Inflation Indicators

(Per cent)

Country/ Region	Key Policy Rate	Policy Rate (as on January 20, 2012)	Changes in Policy Rates (basis points)			CPI Inflation (y-o-y)	
			Sep15, 2008 to Aug. 23, 2009	Aug 23, 2009 to Oct 24, 2011	Since Oct 24, 2011	Dec-10	Dec-11
1	2	3	4	5	6	7	8
Advanced Economies							
Australia	Cash Rate	4.25 (Dec. 7, 2011)	(-) 400	175	(-) 50	2.8#	3.5#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	(-) 275	75	0	2.4	2.3
Euro area	Interest Rate on Main Refinancing Operations	1.00 (Dec. 14, 2011)	(-) 325	50	(-) 50	2.2	2.8
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10 (Oct. 5, 2010)*	(-) 40	(-) 10	0	0.1^	-0.5^
UK	Official Bank Rate	0.50 (Mar. 5,2009)	(-) 450	0	0	3.7	4.2
US	Federal Funds Rate	0.0 to 0.25 (Dec.16,2008)*	(-) 200	0	0	1.5	3.0
Developing Economies							
Brazil	Selic Rate	10.50 (Jan. 19, 2012)	(-) 500	275	(-)100	5.9	6.5
India	Repo Rate	8.50 (Oct. 25, 2011)	(-) 425 (-400)	350 100	0	8.3^	9.3^
China	Benchmark 1-year Deposit Rate	3.50 (Jul. 7, 2011)	(-) 214	100	0	4.6	4.1
	Benchmark 1-year Lending Rate	6.56 (Jul. 7, 2011)	(-) 241 (-200)	100 600	0 (-50)		
Indonesia	BI Rate	6.00 (Nov. 10, 2011)	(-) 275	0	(-) 50	7.0	3.8
Israel	Key Rate	2.75 (Dec. 1, 2011)	(-) 375	275	(-) 50	2.7	2.2
Korea	Base Rate	3.25 (Jun 10, 2011)	(-) 325	125	0	3.0	4.2
Philippines	Reverse Repo Rate	4.50 (May. 5, 2011)	(-) 200	25	0	3.0	4.2
	Repo Rate	6.50 (May. 5, 2011)	(-) 200	25	0		
Russia	Refinancing Rate	8.00 (Dec. 26, 2011)	(-) 25	(-) 250	(-) 25	8.1^	6.8^
South Africa	Repo Rate	5.50 (Nov. 19, 2010)	(-) 500	(-) 150	0	3.4	6.4
Thailand	1-day Repurchase Rate	3.25 (Nov. 30, 2011)	(-) 250	225	(-) 25	3.0	3.5

* Change is worked out from the minimum point of target range. # : Q3. ^ : November.

Note : Figures in parentheses in column (3) indicate the effective dates when the policy rates were last revised. Figures in parentheses in column (4,5 and 6) indicate the variation in the cash reserve ratio during the period. For India, data on inflation pertain to CPI for Industrial Workers.

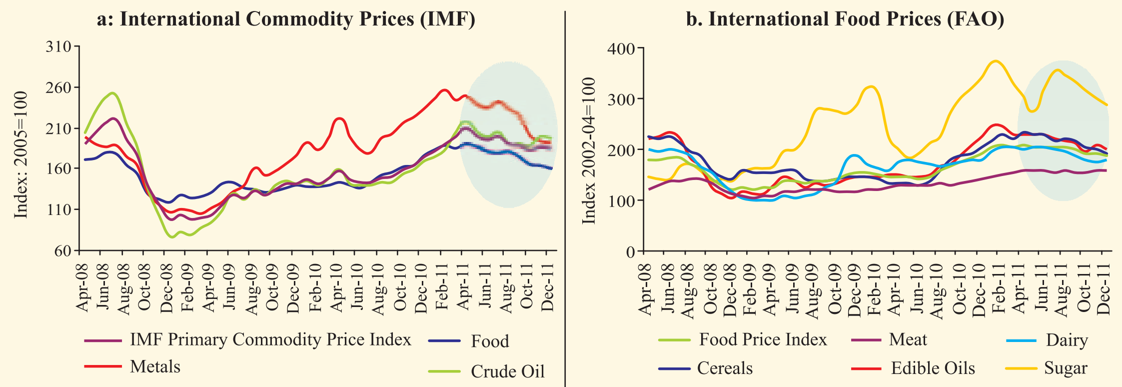
Source : Websites of respective central banks/statistical agencies.

mainly due to easy liquidity and search for returns, US proposal on sanctions on Iran, reversal of Seaway pipeline project that lifted the prices of WTI (West Texas Intermediate) crude and higher demand during winter.

VI.5 Global food prices have also moderated during 2011-12 so far and the FAO Food Price Index in December 2011 was about 13 percent below its historical peak in February 2011 (Chart VI.1b). Improved supply prospects and comfortable stock positions indicate that global food prices are likely to remain range bound in the medium term. It may, however, be noted that the global food price levels are significantly high compared to historical levels.

VI.6 Apart from fuel, the major source of price pressure from imported inflation in recent years for India has been the sharp increases in metals and other input prices globally. During 2011-12 so far, however, prices of metals and other raw materials have been showing a declining trend, except in the case of fertilizers. The salutary effect of this moderation, however, has been largely offset by the depreciation of the rupee.

Chart VI.1: Trends in Global Commodity Prices



Source: International Monetary Fund (IMF).

Source: Food and Agriculture Organisation (FAO).

Sticky inflation path edges down, with dampened momentum

VI.7 Inflation in India remains high, but with signs of moderation. Inflation, as measured by year-on-year changes in WPI declined sharply to 7.5 per cent (provisional) in December 2011 from 9.1 per cent in November 2011, which is the lowest level recorded since January 2010. Price pressures are moderating with lower pace of increase in wholesale price index (WPI) in recent months, lower financial year build-up of inflation and dampening month-over-month seasonally adjusted annualised rate (3 month moving average) of inflation (Chart VI.2).

VI.8 In terms of contribution to overall inflation, the relative shares of food and non-food primary articles to overall inflation have declined in recent months (Chart VI.3). The fuel group continues to contribute significantly to overall inflation, while the contribution of manufactured non-food products marginally increased.

Chart VI.2 : Trends in Wholesale Price Inflation

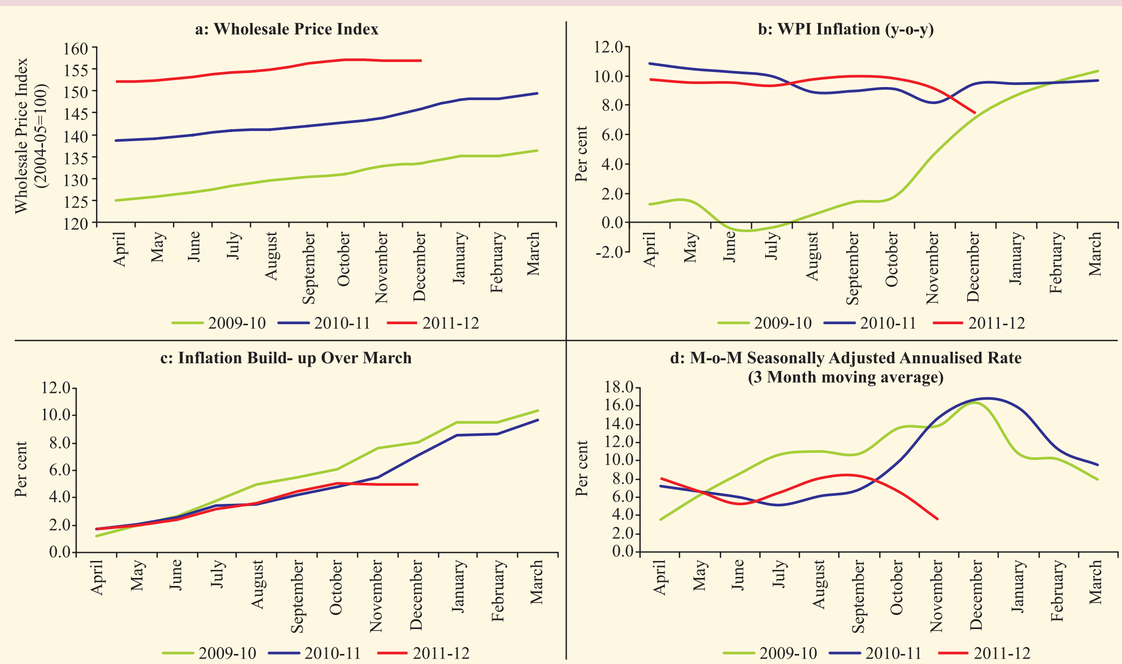
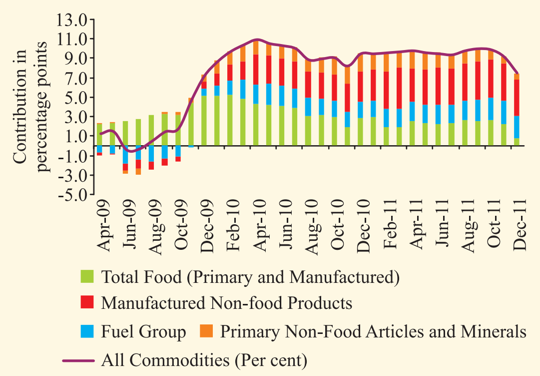


Chart VI.3: Contribution to Inflation: Major Groups



Sharp decline in primary food inflation reflects high base and seasonal moderation, but comfort may fade fast

VI.9 During Q3 of 2011-12, primary food articles inflation edged up to double digits in October partly reflecting the seasonal demand (Chart VI.4). Since then, primary food articles prices have declined by nearly 4.6 per cent. Reflecting the impact of favourable base effect and sharp seasonal decline in vegetables prices, food inflation declined over ten consecutive weeks to a 13-year low of -3.4 per cent as on December 24, 2011 before marginally increasing in the following two weeks, while still remaining negative. But for the seasonal sharp decline in vegetables prices, food inflation would have remained sticky, as inflation in protein-rich items continued to be in double digits (Chart VI.4b). Price pressures in protein-rich items may continue due to structural demand-supply imbalances. Moreover, starting January 2012, the base effects are expected to wane and primary food inflation may firm up once the seasonal moderation ends (Chart VI.5).

Structural sources of pressures on food inflation persist

VI.10 Structural sources of food price pressures persist. Changing dietary patterns with rising incomes that have contributed to inflation in protein-rich items and significant upward revisions in Minimum Support Prices (MSP) are expected to keep up the food inflation pressures. Significant increases in rural wages and input costs in recent years are feeding into the MSPs, as MSP fixation follows a cost plus pricing approach. Despite large increases in MSPs, in some parts of the country farmers have reportedly preferred "crop holidays", fearing inability to realise remunerative prices in an environment of significant input cost pressures.

Inflation in non-food primary articles dips sharply but with wide variations across commodities

VI.11 Trends in non-food primary articles prices provide lead information on the nature of generalised inflation as the input cost movements get reflected in manufactured

Chart VI.4: Primary Food Articles: Index and Inflation

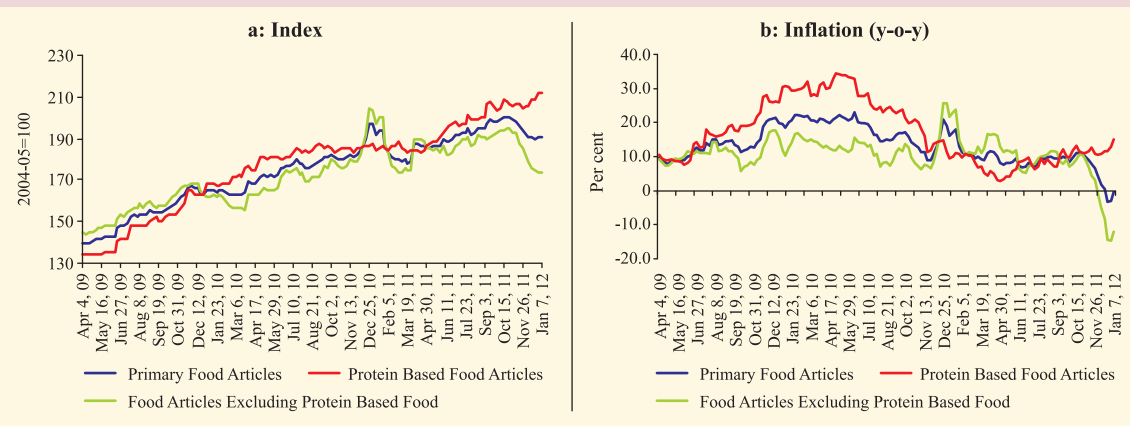
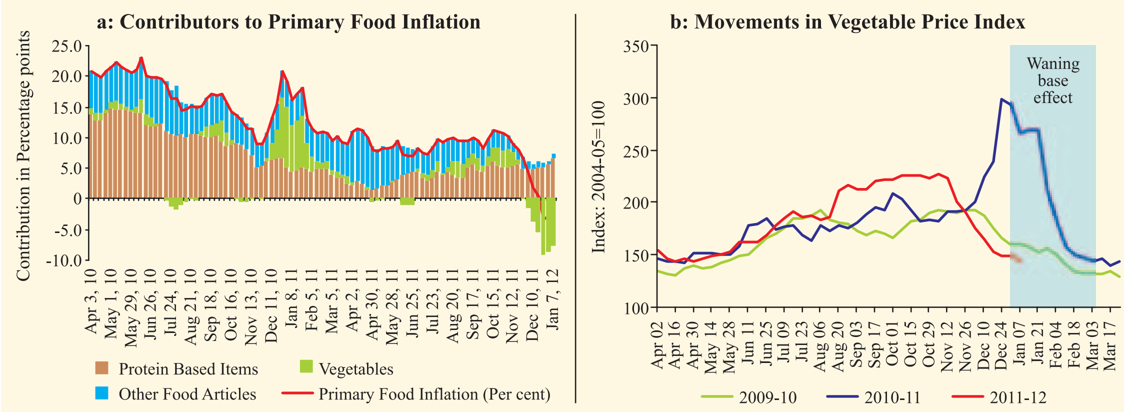


Chart VI.5: Decomposition of Primary Food Inflation



products prices with a lag. Prices of primary non-food articles like raw cotton and raw rubber have declined during the year leading to price index of this group declining by about 4.7 per cent during 2011-12 so far (as on January 7, 2012) and inflation in this category reached near zero levels, before edging up recently (Chart VI.6). On the other hand, oilseeds prices have increased during the year so far. The Minerals group index in WPI has increased significantly during the year so far, partly reflecting the lagged reporting of past increases in crude oil prices.

Fuel group inflation remains high and partly suppressed

VI.12 Energy prices have been and are expected to continue exerting significant pressures on inflation. Domestic fuel group inflation remains in double digits for successive 23 months (up to December, 2011), driven both by upward revisions in administered prices as well as increase in freely priced petroleum product prices (Chart VI.7). Even after revisions in administered prices, under-recoveries persist. Currently, the estimated under-recoveries by domestic oil marketing companies for Diesel and PDS Kerosene are ₹12.95 and ₹28.50 per litre, respectively and ₹326 per cylinder for domestic LPG. As the price of Indian crude oil basket remains firm, rupee depreciation has led to an increase in the cost in Rupee terms, which has resulted in the revision of petrol (but for the marginal cuts in November and December) and other freely priced petroleum product prices (Table VI.2).

VI.13 Despite softening global coal prices in recent months, upward revision in coal prices

Chart VI.6: Trends in Primary Non-Food Articles Inflation (y-o-y)

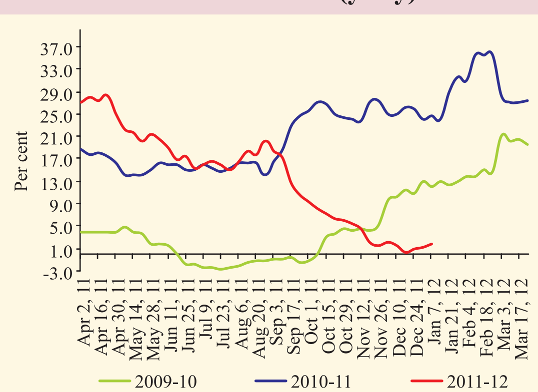


Chart VI.7: Global and Domestic Fuel Inflation (y-o-y)

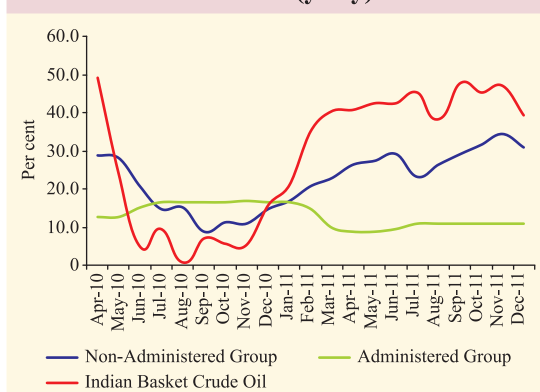


Table VI.2: Comparative Movement of Oil Price and Exchange Rate Since July 2011

	July 2011	Fortnight (January 1-15, 2012)	Change in Per cent
1	2	3	4
Crude Oil - Indian Basket (US$ per barrel)	112.5	110.9	-1.4
Exchange Rate (Rupee/Dollar)	44.4	52.5	18.2
Crude Oil - Indian Basket (Rupee per barrel)	4995.8	5827.1	16.6

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

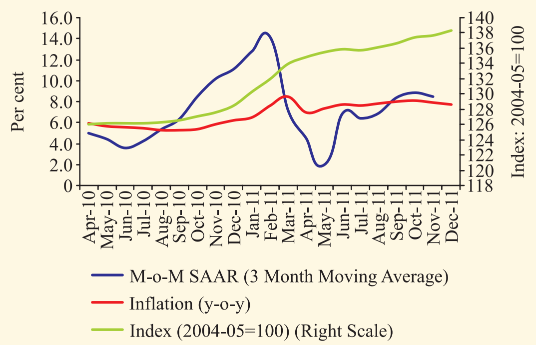
Source: Petroleum Planning and Analysis Cell.

have become necessary as the divergence between domestic and international coal prices still persist (Chart VI.8). The revision in coal pricing formula effected in January 2012 is likely to have an inflationary impact, the quantum of which would depend on substitution in usage of various grades of coal. The increase in electricity prices in September 2011 was modest relative to the increase in input costs. Since then, the revision in coal pricing formula, on an average, would raise the costs for electricity generation further, necessitating tariff revision.

Inflationary pressures in core component persist even as pricing power has been dampened

VI.14 Over 11 consecutive months, non-food manufactured products inflation has remained at or above 7 per cent as compared to its long term average of about 4 per cent before its current surge. Even though corporate margins have come under pressure, M-o-M (SAAR) price pressures are significant (Chart VI.9). The depreciation of the rupee and the associated pick-up in input cost pressures as well as the increase in imported final products prices have more than offset the softening impact of weakening demand.

Chart VI.9: Manufactured Non-food Products : Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes



VI.15 The HSBC Markit Purchasing Managers Index (PMI) for input prices and output prices, which provide leading information on trends in costs and prices, indicate that the pressure on input costs have been much higher than the pricing power for output (Chart VI.10). This pattern suggests that for the manufactured non-food inflation to subside significantly, input cost pressures have to ease considerably.

Chart VI.8: Global and Domestic Coal Prices

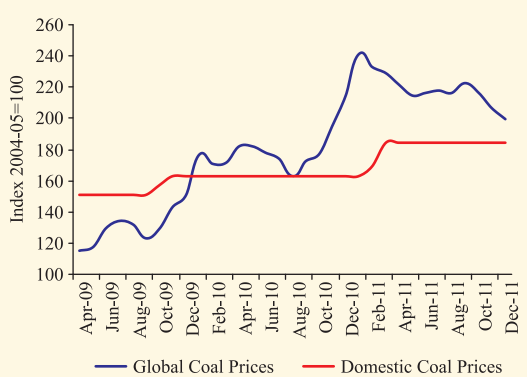
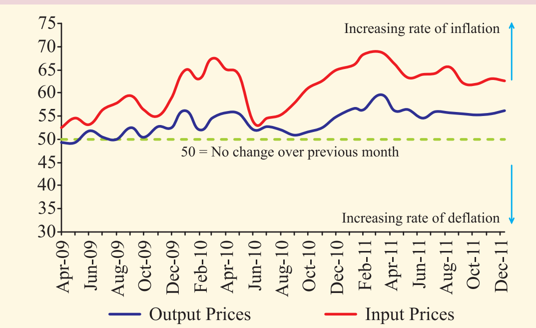


Chart VI.10: Purchasing Managers Index (PMI) Output and Input Prices (Seasonally Adjusted)



Source: HSBC Markit PMI.

Exchange rate pass-through poses risk to inflation trajectory

VI.16 Depreciation of the rupee has accentuated input cost pressures and poses a risk to the inflation trajectory. It was expected that with moderation in global commodity prices and dampened domestic demand, inflation should fall quickly in 2012. The pass-through of sharp depreciation of the rupee since August 2011 has more than offset this favourable impact and prices of metals, chemicals and textiles have increased significantly. The pass-through impact, however, has been partial so far due to suppressed inflation in the fuel group as also the lags in domestic price changes to reflect the full impact of depreciation.

VI.17 Most of the key items under the fuel and 'manufactured products' groups within WPI also account for significant shares in total imports (Table VI.3). Ten product groups with a combined share of 72 per cent in total imports, however, have a much lower weight of 38 per cent in WPI, as a result of which the first round pass-through of depreciation may yield a relatively low upward pressure on WPI headline inflation. The second round impact through input costs and the lagged pass-through of the first round may sustain and even amplify the price pressures in the next few months. Given that imported goods account for 22 per cent of GDP, the inflationary impact could be significant. There is some evidence that the pass-through coefficient has increased over time. The eventual pass-through impact may vary over time depending on the trends in other determinants of inflation, in particular aggregate demand (or output gap) and commodity prices.

Table VI.3 : Imports and WPI – Risk of Depreciation Induced Price Pressures

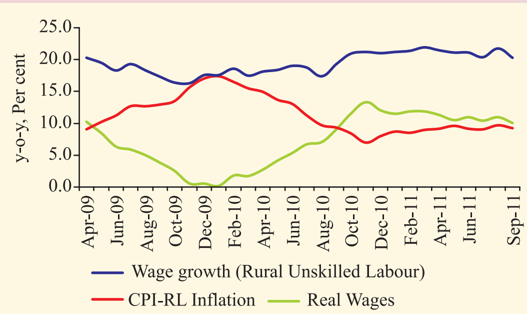
Items	Weight of the Item in WPI (2004-05=100)	Share of the Imported Item in Total Imports	
		2010-11	2011-12 (April-Sep)
1	2	3	4
Petroleum, crude & products	10.26	28.65	31.43
Iron & steel	8.30	2.63	2.20
Transport equipments	5.21	3.10	1.81
Electrical machinery except electronic	4.17	1.04	1.00
Machinery except electric & electronic	3.05	6.45	6.35
Vegetable oils fixed (edible)	3.04	1.77	2.06
Fertilizers	2.66	1.87	1.66
Coal, coke & briquettes *etc*.	2.09	2.65	3.68
Organic chemicals	1.95	3.14	2.87
Artificial resins, plastic materials, *etc*.	1.86	1.86	1.52
Manufactures of metals	1.31	0.90	0.81
Inorganic chemicals	1.19	0.98	1.11
Pulp and waste paper	1.02	0.31	0.28
Non-ferrous metals	1.00	1.10	1.16
Electronic goods	0.96	7.19	7.22
Pulses	0.72	0.42	0.35
Gold	0.36	10.97	12.24

Note: The items presented in col. 2 and 3 & 4 may not exactly correspond, given differences in classification of items in WPI and Imports.

Wage increases remain significant in both rural and urban areas

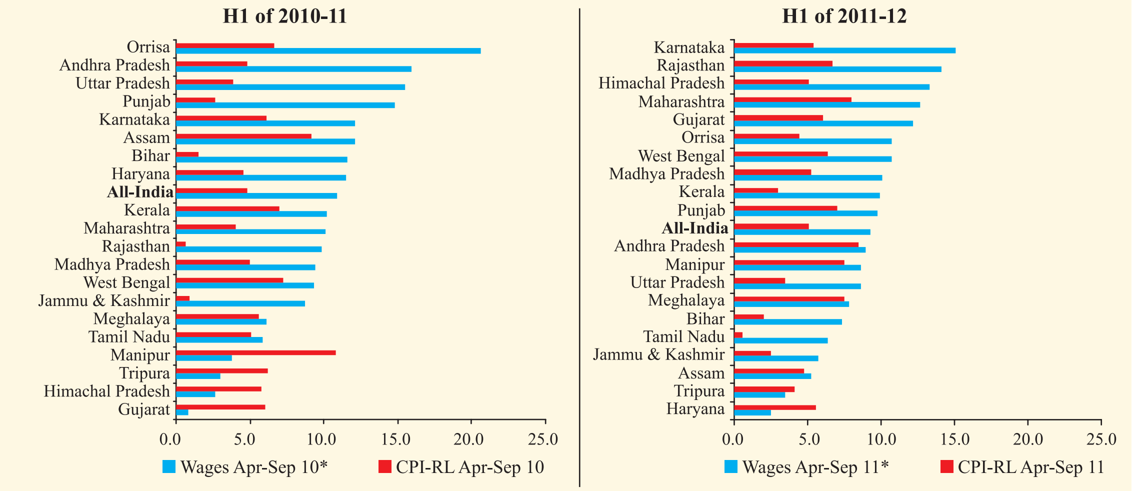
VI.18 Increase in wages for unskilled labourers in rural areas, at a rate higher than inflation (Consumer Price Index for Rural Laboures (CPI-RL)), has continued during 2011-12 so far (Chart VI.11). Similar pattern was witnessed across states, suggesting the broad based nature of the wage pressures (Chart VI.12). Similarly, in the formal sector, analysis of company finance data suggests

Chart VI.11: Increase in Rural Wages Relative to Inflation*



*: Growth in Rural Unskilled Labour (Male) wage and CPI-Rural Labourers inflation.
Source: Labour Bureau, Ministry of Labour.

Chart VI.12: Increase in CPI for Rural Labourers (CPI-RL) and Rural Wages^



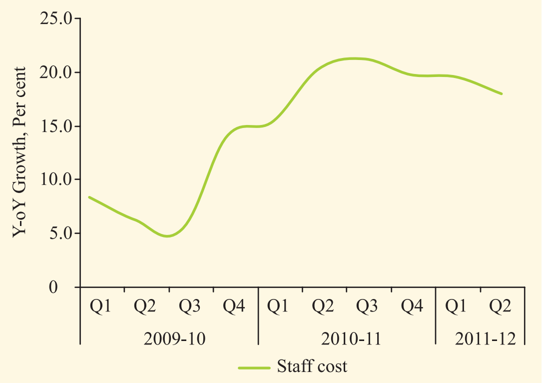
^: During April-September. *: Growth in rural unskilled labour (male) wage.

that staff costs have risen at a faster rate since the middle of 2009-10 (Chart VI.13). Rising real wages could be desirable from a social welfare point of view as the primary objective of development is to raise standards of living through higher incomes. However, wages rising faster than productivity could be inflationary. In an environment of growth moderating to below trend, sustained wage pressures would complicate the monetary policy response to inflation.

New CPIs show sustained increase in price levels

VI.19 The new CPIs introduced for rural and urban areas along with a composite All-India CPI suggest some moderation in price pressures in December 2011 (Chart VI.14). The price pressures have been relatively more in rural areas as compared to the urban areas. Among the major groups, price increases have been more significant in textiles and fuel while food prices have moderated in December 2011.

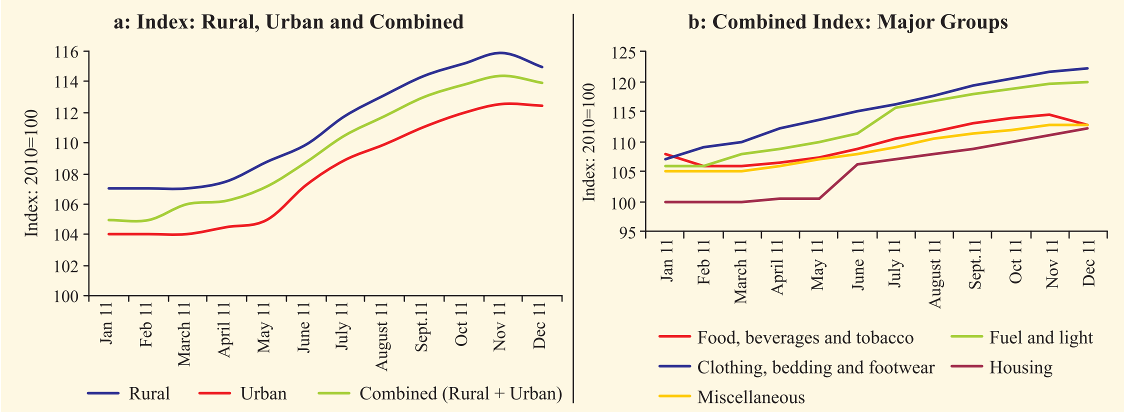
Chart VI.13: Staff Costs in the Corporate Sector



Fiscal stance dampens the impact of moderation in private demand on inflation

VI.20 Reflecting the lagged impact of anti-inflationary monetary policy actions and the spillover from unfavourable global macro-financial conditions, domestic private demand has softened, which was expected to ease the pressure on manufactured non-food products inflation. The expected overshooting of the fiscal deficit from the budgeted level (as outlined in Chapter II), and the associated expansion in government demand, however, would partly offset the salubrious impact of moderating private demand on inflation. Moreover, subsidies and the resultant higher fiscal deficit may help in keeping inflation suppressed in near term, but over time the impact of higher subsidy induced deficit would exert pressure on the inflation path. Going forward, return to fiscal consolidation and reorientation of public expenditure in favour

Chart VI.14: Price Trends in New CPI



of supply augmenting capital expenditure would be necessary to ensure a more subdued inflation path.

Inflation expected to moderate gradually, but risks of persistence remain

VI.21 The moderation in growth momentum and subdued international commodity prices are expected to ease the inflationary pressures in non-food manufactured products. The pace of moderation will, however, depend on exchange rate changes and its pass-through to domestic prices. If depreciation induced cost pressures and the current order of increases in rural wages persist in 2012, the expected softening of inflationary pressures on account of weakening demand conditions could be much weaker and pose a difficult challenge for monetary policy. Inflation is expected to remain in line with the projected moderation toward 7 per cent by March 2012, but supply side and external drivers of inflation could persist into 2012-13.

VI.22 Food inflation has declined significantly. The decline has clearly been caused by transitory factors like seasonal decline in vegetables prices and a high base and the reversal may be quick. Softer commodity prices could ease the inflationary pressures directly, as well as indirectly through lower pressures on the fiscal deficit and current account deficit. But global easy liquidity conditions and search for return on financial investments in an atmosphere of depressed global growth could work against any major softening of commodity prices. While the expected gradual softening of the inflation could suggest the need for easing monetary policy, medium-term inflation risks in the absence of adequate supply side measures and fiscal slippage warrant careful calibration.

VII. MACROECONOMIC OUTLOOK

Both global and domestic factors have increased the downside risks to growth. Inflation has shown some moderation as anticipated though upside risks remain from incomplete pass-through of rupee depreciation, suppressed inflation in energy segment and expansionary fiscal policy. The weakening business climate is corroborated by business expectation surveys of various agencies, as well as the Reserve Bank's industrial outlook survey. The professional forecasters' survey also suggests growth moderation. Most international and domestic agencies have revised downward their earlier growth projections for the Indian economy. Even as growth slowdown emerges as the major challenge, inflation risks persist, posing a challenge for monetary policy in achieving low and stable inflation with minimal sacrifice of growth.

Growth outlook weakens as global headwinds and domestic factors accentuate downside risks

VII.1 Although a moderation in growth was anticipated previously, developments over the past few months in the global economy indicate that the degree and spread of the slowdown may turn out to be higher than earlier thought. EDEs too have started to face slowdown concerns as the contagion from unfavourable global environment is weighing in on growth prospects. OECD's composite leading indicators (CLI) which are designed to provide early signals of business cycle movements, have declined for almost all major economies. Consumer and business confidence have been showing signs of growing pessimism. This could further delay recovery as fiscal space for stimulus in the debt ridden global economy is limited.

VII.2 Amidst weakening global growth, India's near-term growth outlook has deteriorated and poses challenges for economic management. The Reserve Bank in its Second Quarter Review of Monetary Policy 2011-12 on October 25, 2011 revised downwards the baseline projection of GDP growth for 2011-12 from 8.0 per cent to 7.6 per cent on the basis of the macro-economic situation prevailing then. Since then, developments on both the global and domestic fronts have not been favourable and the growth is likely to turn weaker than earlier anticipated.

VII.3 Outlook for Agriculture in 2011-12 is encouraging. However, the headwinds facing the domestic economy thus far, *viz.,* inflationary pressures, which resulted in high interest rates, global uncertainty and the domestic policy environment, have adversely impacted the industrial sector performance in 2011-12. A bigger risk arise from inflation and the downturn in investment cycle as they pose threat to growth sustainability. Services sector also faces downside risks both from weakening global demand and slowing industrial growth.

VII.4 It is possible to raise growth from the current levels but restoration of business confidence is the key. The pause in the tightening of the monetary policy and further moderation in inflation should help activity regain some momentum. Higher IIP growth in November 2011 and rise in manufacturing and services PMI for December 2011 already indicates some improvement. However, on balance, the downside risks to real GDP growth during 2011-12 have increased.

Inflation moderates, but risks remain as exchange rate pass-through has enlarged

VII.5 Headline WPI inflation decelerated since November 2011. The recent decline in inflation has largely been on account of the base effects and seasonal fall in food prices, especially vegetables. Even though food inflation has been pushed into negative territory, inflation in protein-rich items persist in double digits. Therefore, once the seasonal moderation ends and base effect wanes, food inflation could revert course significantly.

VII.6 Decline of growth to below potential is expected to ease pressures on aggregate demand and thereby have a softening impact on generalised inflation. Apart from this, declining international commodity prices, has also emerged as a favourable factor. The pass-through of rupee depreciation and expansionary fiscal policy, however, have emerged as major risks, offsetting the favourable impact from the lower demand pressures and commodity prices. The suppressed inflation from energy prices further complicates policy options as revisions in these prices could be inevitable. Wage inflation is still high in rural areas and real wages increased, though at a lower pace than previous year.

VII.7 Overall, the emerging trend in inflation so far is broadly in line with the projected path towards 7.0 per cent by March 2012. The risks to softening of inflationary pressures, however, remain. The policy response to emerging macroeconomic conditions has to take these risks into account.

Business expectations, industrial outlook surveys suggest confidence ebbs

VII.8 Surveys conducted by different agencies corroborate the overall moderation in business climate. Both CII and FICCI business confidence indices declined from the previous quarter and the current levels are lower than what was recorded a year ago. The latest survey of NCAER on business confidence also shows a decline both on y-o-y basis and from the previous period of survey (Table VII.1). Dun & Bradstreet Business Optimism Index, however, showed some improvement over the survey period. Weakening demand, increased global uncertainties, lower availability of credit and higher input costs are seen to be the significant factors affecting the overall business sentiment.

Industrial Outlook Survey suggests weakening ahead

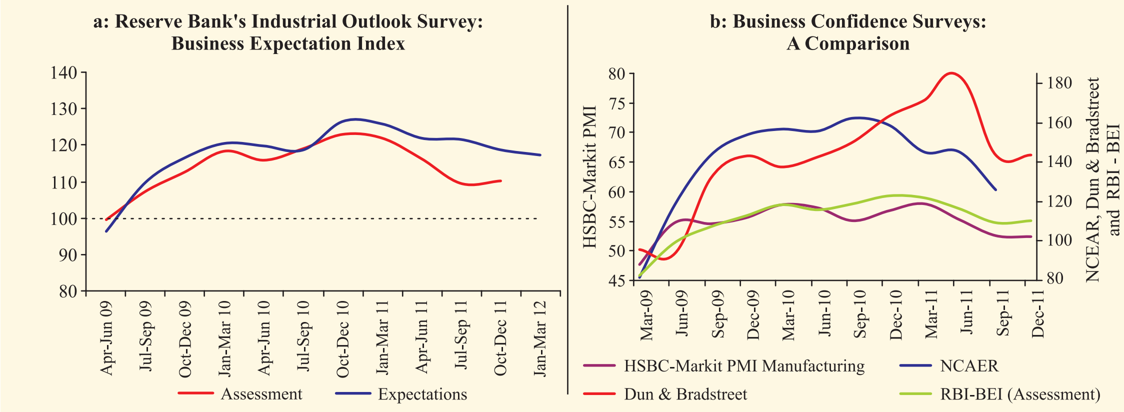
VII.9 The 56th round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS56) of the Reserve Bank conducted during October-December 2011, showed marginal increase in the Business Expectation Index (BEI) for the assessment quarter (October-December 2011) whereas marginal decline was recorded in expectation for the next quarter (January-March 2012) (Chart VII.1). The index is a composite indicator based on assessment of several business related parameters for the assessment quarter as well as for the expectation quarter.

VII.10 Analysis of the net responses among various components of the BEI indicates that the assessment on 'production' was marginally higher in Q3 of 2011-12, while the expectation for Q4 of 2011-12 remains flat. Net response on 'order books' continued to decline for fourth consecutive quarter. Level of optimism on 'availability of finance' lowered further. While increasing proportion of respondents reported rise in 'cost of finance' over previous 7 quarters, the trend appears to have reversed for Q4 of 2011-12. Most of the respondents felt that pressure from 'cost of raw material' continued and was expected to elevate further

Table VII.1: Business Expectations Surveys

Period/Index	NCAER-Business Confidence Index January 2012	FICCI Overall Business Confidence Index Q1: 2011-12	Dun & Bradstreet Business Optimism Index Q1: 2012	CII Business Confidence Index Q3: 2011-12
1	2	3	4	5
Current level of the Index	125.2	51.6	156.2	48.6
Index as per previous survey	125.4	63.7	143.7	53.6
Index levels one year back	158.5	71.9	171.2	66.2
% change (q-o-q) sequential	-0.2	-19.0	8.7	-9.3
% change (y-o-y)	-21.0	-28.2	-8.8	-26.6

Chart VII.1: Industrial Outlook Surveys



in the next quarter. The optimism on 'selling price' and 'profit margins' further declined in both the assessment and expectation quarter (Table VII.2).

Consumer confidence indicate some improvement

VII.11 The seventh round of Consumer Confidence Survey (http://www.rbi.org.in/CCS7), conducted by the Reserve Bank in December 2011, indicates some improvement in positive perceptions of the household after recording marginal decline in the previous quarter (Chart VII.2). High inflation, however, continues to remain as the major drag factor on overall positive sentiments.

Agencies lower growth forecasts

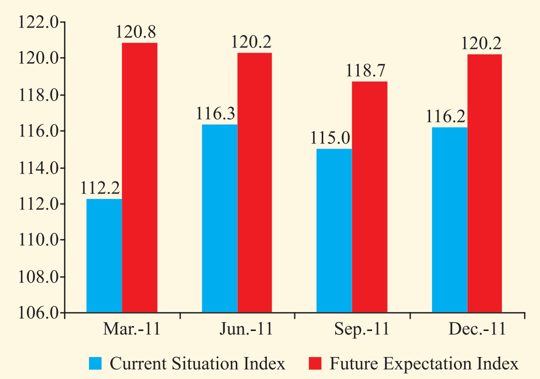
VII.12 The Government of India had revised downwards significantly its growth projection

TableVII.2 : Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response: Jan-Mar 2011 E	Jan-Mar 2011 A	Apr-Jun 2011 E	Apr-Jun 2011 A	July-Sept 2011 E	July-Sept 2011 A	Oct-Dec 2011 E	Oct-Dec 2011 A	Jan-Mar 2012 E
1	2	3	4	5	6	7	8	9	10	11
1. Overall Business Situation	Better	50.1	38.6	41.4	32.6	39.8	18.7	35.2	17.7	33.6
2. Overall Financial Situation	Better	41.1	27.1	33.4	24.1	30.6	11.7	26.3	11.2	25.2
3. Availability Of Finance	Improve	32.3	23.8	27.3	21.5	24.2	12.1	20.2	10.4	19.0
4. Cost Of External Finance	Decrease	-31.3	-42.5	-35.0	-49.0	-39.7	-50.2	-41.0	-50.6	-38.8
5. Production	Increase	48.6	41.4	40.0	32.1	40.6	22.6	39.9	25.3	40.4
6. Order Books	Increase	44.0	34.7	38.4	28.1	35.9	20.3	33.4	18.4	31.3
7. Capacity Utilisation	Increase	33.1	27.4	24.0	17.2	25.0	9.9	22.2	10.8	24.3
8. Cost of Raw Material	Decrease	-53.6	-71.9	-57.0	-65.5	-51.7	-58.1	-49.7	-61.2	-50.1
9. Employment in the Company	Increase	20.6	18.7	17.4	18.2	19.4	15.6	16.5	11.3	13.6
10. Exports	Increase	26.3	18.9	24.0	18.2	25.8	13.1	22.1	11.5	18.6
11. Imports	Increase	21.3	19.9	18.9	17.6	19.0	15.7	16.9	11.6	15.5
12. Selling Price	Increase	18.6	26.5	23.7	21.5	18.3	10.7	16.0	8.9	14.7
13. Profit Margin	Increase	8.3	-4.3	3.8	-9.9	2.5	-17.1	-1.6	-17.3	-2.9

Note: 1. 'Net response' is measured as the percentage share differential between the companies reporting 'optimistic' (positive) and 'pessimistic' (negative) responses; responses indicating status quo (no change) are not reckoned. Higher 'net response' indicates higher level of confidence and vice versa.
2. E: Expectations and A: Assessment.

Chart VII.2: Net Response to Current Situation Index and Future Expectation Index



for 2011-12 to 7.5 per cent (+/- 0.25 per cent) on December 9, 2011(Table VII.3). Some of the other agencies also had scaled down their projections earlier even as their updates are expected to be lower.

Table VII.3: Agencies' Projections for 2011-12

Agency	Latest Projection		Earlier Projection	
	Real GDP Growth (Per cent)	Month	Real GDP Growth (Per cent)	Month
1	2	3	4	5
Economic Advisory Council to the PM	8.2	July-11	9.0 (+/- 0.25)	Feb-11
Finance Ministry	7.5 (+/-0.25)	Dec-11	8.6	July-11
IMF*	7.6	Sept-11	8.0	June-11
World Bank	6.8	Jan-12	7.5	Sept-11
OECD (at market prices)	7.6	Nov-11	8.5	May-11
ADB	7.9	Sept -11	8.2	April-11
NCAER	7.9	Oct -11	8.3	Jul-11

* IMF's forecast is 7.7 per cent for GDP at market prices for FY 2011.

Survey of professional forecasters sees weak growth and softer inflation[1]

VII.13 In the 18th round of 'Survey of Professional Forecasters' (http://www.rbi.org.in/SPF18), conducted by the Reserve Bank, GDP growth forecasts for 2011-12 and 2012-13 have been revised downwards as compared to previous survey (Table VII.4). There has been a significant downward revision of growth forecast for industry for 2011-12 and for services, it is revised downwards marginally. Average inflation is projected to decline over 2011-12 and 2012-13. The survey results indicate lower optimism on growth while inflation is expected to show gradual moderation.

Inflation expectations remain sticky

VII.14 The latest round of Inflation Expectations Survey of Households (IESH) (http://www.rbi.org.in/IESH26) indicate that the perception of current quarter inflation as well as the expectations on future inflation have increased. The rate of increase in expectations, however, has slowed down in the recent period. The survey was conducted among 4000 households across 12 cities and seven occupational categories in December 2011.

Heading into 2012-13, some challenges persist, others arise along with some opportunities

VII.15 In the final quarter of 2011-12 and going forward into 2012-13, the Indian economy has to deal with several persistent challenges as well as some new ones. While inflation is showing welcome signs of moderation, which creates some space for monetary policy to address growth concerns, it is important to remember that demand-supply mismatches are never very far from the surface in a variety of commodities and services, not to mention human capital. A sharp inflationary response to even a modest recovery in growth is a persistent risk, which materialised in late 2009, and against which monetary policy has to be constantly on guard. Beyond this, adverse global conditions, both in terms of trade and capital flows amidst a hostile oil price environment have clouded growth and stability prospects for the past three years.

[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 2011-12 and 2012-13

	Actual 2010-11	Annual Forecasts				Quarterly Forecasts									
		2011-12		2012-13		2011-12				2012-13					
						Q3		Q4		Q1		Q2		Q3	
		E	L	E	L	E	L	E	L	E	L	E	L	E	L
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. Real GDP growth rate at factor cost (in per cent)	8.5#	7.6	7.0	7.7	7.3	7.7	6.7	7.8	7.0	7.6	6.8	7.6	7.1	-	7.3
a. Agriculture & Allied Activities	6.6#	3.2	3.4	3.0	3.0	2.7	3.3	3.1	3.5	3.0	3.0	3.2	3.2	-	3.3
b. Industry	7.8#	6.4	4.1	6.9	5.8	7.1	2.7	7.6	3.8	7.2	4.4	6.8	5.1	-	5.8
c. Services	9.2#	9.1	9.0	9.0	8.8	9.2	8.9	9.1	8.5	8.9	8.5	9.1	8.7	-	8.8
2. Gross Domestic Saving (per cent of GDP at current market price)	-	34.0	33.0	34.6	33.5	-	-	-	-	-	-	-	-	-	-
3. Average WPI-Inflation	9.6	8.8	8.8	6.7	6.5	8.8	8.8*	7.0	6.8	6.6	6.4	6.6	6.2	-	6.3
4. Exchange Rate (INR/1USD end period)	44.6	47.0	52.0	45.0	48.0	48.0	53.3*	47.0	52.0	46.1	50.8	45.8	49.3	-	49.0
5. T-Bill 91 days Yield (per cent-end period)	8.2	8.3	8.2	7.7	7.5	-	-	-	-	-	-	-	-	-	-
6. 10-year Govt. Securities Yield (per cent-end period)	8.4	8.3	8.3	8.0	7.9	-	-	-	-	-	-	-	-	-	-
7. Export (growth rate in per cent)!	37.3	19.5	17.5	20.0	14.3	-	-	-	-	-	-	-	-	-	-
8. Import (growth rate in per cent)!	26.7	24.4	20.6	18.0	14.4	-	-	-	-	-	-	-	-	-	-
9. Trade Balance (US$ billion)	-130.6	-	-	-	-	-37.7	-42.4	-39.0	-34.0	-38.0	-43.8	-38.0	-40.2	-	-47.0

E: Previous Round Projection. L: Latest Round Projection. #: Revised Estimate.
-: Not available. *: Actual. ! : In US$ on BoP basis.
Note :The latest round refers to Eighteenth round for the quarter ended December 2011, while previous round refers to Seventeenth round for the quarter ended September 2011.
Source : 18th round of Survey of Professional Forecasters, Q3: 2011-12.

VII.16 New challenges have emerged in the form of large and rapid movements in the exchange rate. The consequences of these movements for both flow (balance of payments, fiscal deficit) and stock (balance sheet) indicators are unquestionably adverse. However, in the event of a prolonged non-resolution of global problems, considerations of financial and external stability are critical. A prudent policy approach is to accommodate the pressure of depreciation in a way which reduces the likelihood of a much more severe and, perhaps uncontrollable, shock. As expectations of a quick and robust resolution to the European sovereign debt crisis diminish, it is all the more important for India to maintain adequate capacity to withstand further external shocks.

VII.17 Finally, amidst these formidable challenges, there are clear opportunities. Several policy initiatives that address the critical bottlenecks of food availability, fiscal capacity, infrastructure investment, land acquisition and skill formation are in advanced stages of design. Credible progress in the implementation of even some of these initiatives will have a dramatic impact on the investment climate, which is essential to the sustainability of a high-growth and low-inflation environment. While in the short run, moderating inflation will provide some space for monetary policy to address growth concerns, in the absence of structural measures to address a range of supply bottlenecks, this will be, at best, temporary respite.

Alco Corporation