RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments First Quarter Review 2011-12

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

July 25, 2011

Macroeconomic and Monetary Developments First Quarter Review 2011-12

Reserve Bank of India
Mumbai

Contents

MACROECONOMIC AND MONETARY DEVELOPMENTS FIRST QUARTER REVIEW 2011-12

Overview

1. Drivers of inflation changed over the course of 2010-11. With evidence emerging that not only did headline inflation persist at around 9 per cent, but that it had become generalised with significant price pressures in non-food manufacturing since December 2010, monetary policy was tightened more aggressively. Following up on a series of rate hikes through 2010-11, policy rates were raised by 75 bps in Q1of 2011-12, through a 50 bps hike in May and 25 bps in June. Altogether, in a span of 15 months starting March 2010, operational policy rates were raised by 425 bps – one of the sharpest monetary tightenings seen across the world.

2. Monetary transmission improved further during this quarter. In response to the monetary tightening, most banks raised their deposit and lending rates. As a result, deposit growth picked up and credit growth decelerated, though it remained above the projected trajectory. Also, real lending rates remained positive despite high inflation. These dynamics helped limit the overheating pressures in the economy. However, inflationary pressures have persisted due to a series of supply-side shocks that spilled over in the face of strong demand stoking generalised inflation. While growth has showed some signs of softening in Q1 of 2011-12, it is likely to stay around the trend. Inflationary pressures are likely to stay, if not intensify, in Q2 of 2011-12, before moderating.

Global Economic Conditions

Recovery at risk with global growth entering soft patch

3. Globally, the momentum of recovery appears to be stalling. High oil and commodity prices, the Middle East political strife, Japanese earthquake, sovereign debt problems in the Euro zone and the impasse on the fiscal and debt problems in the US have taken a toll on economic activity and business as well as consumer confidence.

4. In its June 17, 2011 update of the World Economic Outlook, the IMF marginally lowered its global growth projection for 2011 to 4.3 per cent from 4.4 per cent. The IMF lowered the estimate for advanced economies by 0.2 percentage points, but projected that growth in most emerging and developing economies will stay. It also retained its growth forecast for India at 8.2 per cent at market prices corresponding to 8.0 per cent at factor cost.

Inflation surprise in advanced economies increases global risks

5. Global inflation is rising rapidly. The IMF revised its 2011 consumer price inflation forecast for advanced economies upwards by 0.4 percentage points. There are indications that inflation may start cooling off in some key emerging market economies. However, the wedge between producer price and headline consumer price inflation, as also between the latter and the core inflation component have widened disconcertingly. This has triggered a debate over how much longer advanced economies can defer an exit from an excessively accommodative monetary policy stance. The ECB has already raised policy rates twice this year, but policy dilemmas are palpable elsewhere.

6. Unemployment is proving to be intransigent to policy action, and with growth relapsing amidst increasing fiscal and debt burdens, the fragility of global recovery and its vulnerability to macroeconomic shocks remains.

Indian Economy: Developments and Outlook

Output

Signs of moderation after acceleration in 2010-11

7. Growth showed signs of some moderation during Q1 of 2011-12 after it reverted to the recent trend in 2010-11. Signs of moderation were visible from deceleration in IIP growth in April-May, poor performance of certain core industries, especially cement and natural gas and consumption deceleration in cement, steel and automobiles. Manufacturing and services PMIs also show that growth is turning softer. Even as some deceleration is expected in 2011-12, overall growth is likely to stay around trend growth of about 8 per cent in the face of still strong consumption demand. The monsoon may be close to normal and services sector momentum has been maintained.

Aggregate demand

Investment demand slows down, private spending still strong

8. Aggregate investment dipped in H2 of 2010-11 and is yet to show signs of improvement. Corporate investment intentions in projects that received financial assistance dropped by 43 per cent sequentially during the second half of the year. Private consumption demand remains strong but is adjusting downwards. Corporate sales growth remained strong during Q4 of 2010-11 and is expected to retain the pace in Q1 of 2011-12. Profits, however, have been impacted by margin pressures from high interest rates and raw material costs. A rebalancing of demand from government consumption to private investment is necessary in 2011-12. This rebalancing will require shifting of government expenditure from revenue expenditure to capital expenditure, beyond what has been envisaged in the budget. Reduction in subsidies through better targeting is also needed. Despite recent initiatives to scale down subsidies, there is likelihood of a fiscal slippage in 2011-12. In face of decelerating investment, improved project execution and governance can also help in improving investment demand.

External sector

Trade diversification, invisibles turnaround help moderate CAD

9. A significant pick-up in exports, supported by a strategy of trade diversification in composition and direction, and strong software services exports, helped in moderating the CAD during 2010-11. Going forward, CAD is expected to remain manageable. However, risks to current account persist from a slowdown in global growth. Risks to capital account arise from rising sovereign debt risks in the Euro zone and the uncertainties on in the US debt ceiling.

10. FDI flows have picked up in 2011-12 so far. Portfolio flows have started to rise again since the last week of June. The inflows at the current rate can be absorbed by the CAD, but it is necessary to adjust the structural balance of flows by attracting larger FDI inflows.

Monetary and Liquidity Conditions

Tight monetary and liquidity conditions bringing desired adjustment

11. Liquidity conditions, though still in a deficit mode, have eased during the first quarter of 2011-12. The increase in deposit rates by banks helped deposit growth to pick-up, which eased the structural liquidity gap. The runaway growth in currency has also been arrested consequent to the rising opportunity cost of holding cash. Reserve money growth decelerated with low primary liquidity creation, but monetary growth increased with accelerating time deposit growth. Credit growth decelerated during the quarter, but remains above the indicative trajectory.

Financial Markets

Indian markets see range bound fluctuations, amidst low volatility

12. Notwithstanding the firming up of interest rates, there has been no stress visible across the financial markets. Financial asset prices have shown low volatility. Conditional volatility in equity prices that had dropped significantly after the global financial crisis continued to be low during Q1 of 2011-12. Exchange rate movements remained orderly obviating the need for interventions. The yield curve flattened, largely in response to policy rate hikes. Property prices and volume of transactions were on the upswing after a subdued movement in Q3 of 2010-11.

Price Situation

Generalised inflation with near-term upside risks do not provide any comfort

13. Inflation became generalised in Q4 of 2010-11 and has remained unchanged in trajectory as also in composition in 2011-12 so far. This was in line with the Reserve Bank's projections. While some revision in fuel prices hike was factored in the projected path of inflation, the pass-through is yet incomplete which will keep up the near term pressure. The softening of global commodity prices since May 2011 may provide some relief in the short run, but price pressures will persist as a result of a combination of demand side factors and structural drivers. Food inflation may not soften much even with a normal monsoon as the increase in MSP will provide a higher floor to food prices. Electricity prices are yet to reflect the rising input costs. Near term trends on non-food manufacturing inflation will be critical in shaping the future macroeconomic dynamics.

Macroeconomic Outlook

In the midst of downside risks to growth, inflation stays above comfort level

14. Monetary and liquidity conditions have remained tight in the wake of inflation persistence. The anti-inflationary monetary policy stance adopted by the Reserve Bank since October 2009 continued well into the first quarter of 2011-12 as inflation persisted beyond Reserve Bank's comfort level. Inflationary pressures, which initially emanated from supply side constraints, spilled over to wages and output prices as demand conditions remained buoyant. Currently, inflationary expectations are further feeding on themselves and warrant a close watch. While consumer demand remains strong, higher input costs and increased cost of borrowing are now eroding profit margins impacting the pricing power of corporate. On the other hand, indications of moderation in growth have surfaced, making the policy challenge even more complex. However, the persisting high inflation and its expected slow decline warrant that the Reserve Bank continue with its anti-inflationary policy stance.

I. OUTPUT

Growth showed signs of moderation in Q1 of 2011-12. Downside risks have increased as a result of forecast of sub-normal monsoon, global growth entering into a soft patch and persistence of high inflation. The new base IIP data confirms that industrial growth had not weakened during H2 of 2010-11, though it decelerated thereafter. The services sector had also maintained its momentum of growth, although its growth stayed below the pre-crisis rate. Going forward there could be some impact on growth from high input prices, high inflation and higher interest rates, but the economy is still likely to grow close to its trend.

Growth shows signs of moderation

I.1 Signs of moderation in growth have emerged lately. Sequentially, growth had decelerated in each quarter of 2010-11, though it still remained close to trend in the fourth quarter. The new base Index of Industrial Production (IIP) decelerated during April-May 2011. Core infrastructure industries growth also moderated, mainly on account of a decline in natural gas and cement production and subdued growth in coal production. Automobile sales witnessed moderation during Q1 of 2011-12. The manufacturing PMI has dipped to a nine-month low in June 2011, but still suggests a strong month-on-month expansion in industrial output. The services PMI also indicates an expansionary mode but the readings in Q1 of 2011-12 were slightly lower than the preceding quarter. Cement dispatches and steel consumption were slack during Q1 of 2011-12.

Notwithstanding some moderation, growth is likely to be near trend

I.2 As indicated in the Monetary Policy Statement of May 2011, growth is likely to decelerate in 2011-12 but stay close to the trend. The Policy Statement had placed the baseline projection at around 8.0 per cent, with a 90 per cent probability of it falling in the 7.4-8.5 per cent range. Though the downside risks have since increased, growth is still likely to stay near the trend. Even as there is some evidence of deceleration in interest-rate sensitive sectors (*viz.*, sales of automobiles and commercial vehicles), credit growth remains strong on a deseasonalised basis. House prices and transactions firmed up during Q4 of 2010-11.

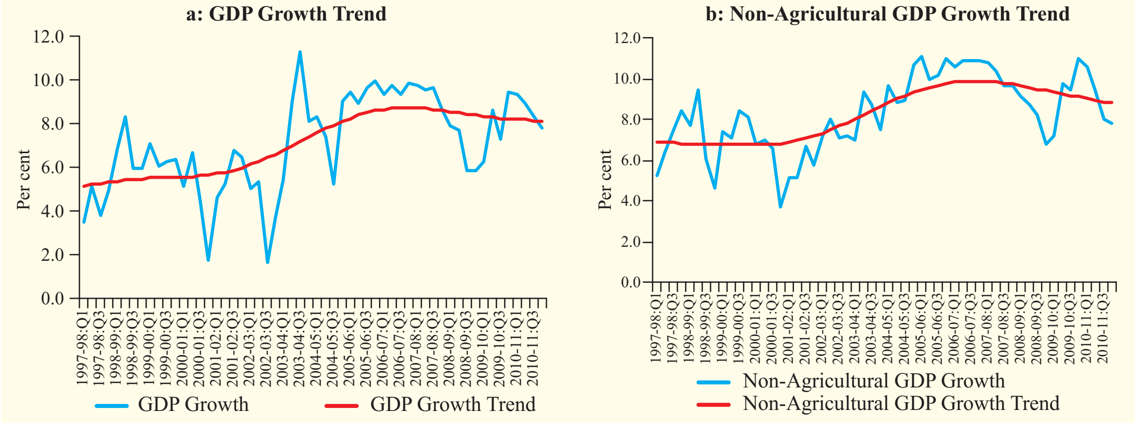
I.3 In 2010-11, the growth at 8.5 per cent was supported by a strong performance of the agriculture sector. While GDP growth in 2010-11 was near trend, non-agricultural GDP growth was below trend (Chart I.1).

I.4 Year-on-year quarterly growth rates of GDP declined during successive quarters of 2010-11 (Table I.1). As the revised IIP index has not yet been incorporated in the quarterly GDP data, these numbers could see some upward revision. The sharp deceleration during Q4 of 2010-11 was mainly on account of the base effect as concomitantly the GDP estimate for Q4 of 2009-10 was revised upwards substantially. Notwithstanding the near-trend growth in 2010-11, some moderation in growth is expected in 2011-12. The downside risks emanate from slightly below normal monsoon forecast for the year, uncertain global economic environment, high inflation and the impact of past monetary actions to curb aggregate demand.

Monsoon starts well, expected to weaken ahead

I.5 The agricultural sector emerged as the key driver of growth in 2010-11. As per the Fourth Advance Estimates, there was record production of foodgrains in 2010-11 (Table I.2). During 2011-12, agricultural growth may be lower on account of high base and some monsoon-related concerns.

Chart I.1: GDP Growth and Trend



I.6 In June 2011, the India Meteorological Department (IMD) revised its earlier forecast of a normal South-West monsoon for 2011 from 98 per cent of the Long Period Average (LPA) to below normal at 95 per cent of the LPA. The downside risks have thus increased, but the downward revision is only marginally lower than the normal range of 96-104 per cent of LPA. Therefore, it may not have a dampening effect on the performance of the *kharif* crops provided the spatial distribution of rainfall continues to remain satisfactory. There has been timely arrival and advancement of the monsoon during the year so far and the IMD has forecast an equitable spatial distribution over the four homogeneous regions in the range of 94-97 per cent of the LPA.

1.7 For the country as whole, rainfall during June 1-July 20, 2011 was 1 per cent below the LPA, compared with 14 per cent below the LPA in the corresponding period of the previous year. The Reserve Bank's Production (foodgrains weighted) Rainfall Index (PRN) stood at 104 per cent for the period June 1, 2011 to July 20, 2011, compared with 87 per cent in the same period of the previous year, while the IMD rainfall index (area weighted) was 99 (Chart I.2). *Kharif* sowing with respect to rice, sugarcane, and jute and mesta as on July 22, 2011, was higher than the corresponding period

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

(Per cent)

Item	2009-10*	2010-11#	2009-10				2010-11			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture & allied activities	**0.4**	**6.6**	**1.8**	**1.2**	**-1.6**	**1.1**	**2.4**	**5.4**	**9.9**	**7.5**
2. Industry	**8.3**	**7.8**	**2.9**	**6.3**	**10.0**	**13.7**	**11.3**	**9.0**	**6.2**	**5.3**
2.1 Mining & quarrying	6.9	5.8	6.9	6.6	5.2	8.9	7.1	8.2	6.9	1.7
2.2 Manufacturing	8.8	8.3	2.0	6.1	11.4	15.2	12.7	10.0	6.0	5.5
2.3 Electricity, gas & water supply	6.4	5.7	6.2	7.5	4.5	7.3	5.6	2.8	6.4	7.8
3. Services	**9.7**	**9.2**	**8.5**	**10.8**	**9.2**	**10.1**	**10.3**	**9.5**	**8.6**	**8.6**
3.1 Construction	7.0	8.1	5.4	5.1	8.3	9.2	7.7	6.7	9.7	8.2
3.2 Trade, hotels, restaurants, transport and communication *etc*	9.7	10.3	5.4	8.2	10.8	13.7	12.6	10.9	8.6	9.3
3.3 Financing, insurance, real estate and business services	9.2	9.9	11.5	10.9	8.5	6.3	9.8	10.0	10.8	9.0
3.4 Community, social & personal services	11.8	7.0	13.0	19.4	7.6	8.3	8.2	7.9	5.1	7.0
4. GDP at factor cost (total 1 to 3)	**8.0**	**8.5**	**6.3**	**8.6**	**7.3**	**9.4**	**9.3**	**8.9**	**8.3**	**7.8**

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

Table I.2: Agriculture Production and *Kharif* Area Sown

(Area in Million hectares; Production in Million tonnes)

Crop	Sowing as on July 22				Production	
	Normal	2010	2011	Per cent of Normal 2011	Final 2009-10	4th Advance Estimates 2010-11
1	2	3	4	5	6	7
Rice	39.4	15.4	15.5 (0.6)	39.3	89.1	95.3 (7.0)
Total Coarse Cereals	22.0	14.1	12.5 (-11.3)	56.8	33.6	42.2 (25.6)
Total Cereals	61.3	29.6	28.0 (-5.4)	45.7	203.5	223.5 (9.8)
Total Pulses	10.6	4.9	4.5 (-8.2)	42.5	14.7	18.1 (23.1)
Total Foodgrains	**72.0**	**34.5**	**32.5 (-5.8)**	**45.1**	**218.1**	**241.6 (10.8)**
Total Nine Oilseeds	17.7	13.0	13.0 (0.0)	73.4	24.9	31.1 (24.9)
Cotton #	9.4	9.7	9.3	99.0	24.2	33.4
Jute & Mesta ##	0.9	0.8	0.9	100.0	11.8	10.6
Sugarcane (Cane)	4.6	4.9	5.2	113.0	292.3	339.2
All Crops	**104.6**	**62.9**	**61.0 (-3.0)**	**58.3**	**-**	**-**

-: Nil/Not Available. #: Million bales of 170 kgs. each ##: Million bales of 180 kgs. each.
Note: Figures in parentheses are percentage change over previous year.
Source: Ministry of Agriculture, Government of India.

of the previous year, while that for pulses, cereals and cotton was lower. The picture will become clearer in the weeks ahead.

Storage augmentation, reform of food security strategy needed

I.8 Against the backdrop of record procurement and food stocks, augmentation of storage capacity and reform of the food security strategy need urgent attention. Agricultural production has improved in recent years. However, certain structural bottlenecks such as inadequate storage capacity, inefficient supply-chain and marketing infrastructure are constraining the sector. With a record *rabi* production in 2010-11, there was unprecedented level of procurement during April-July 2011 (Chart I.3). Food stocks reached a record high of 65.6 million tonnes on June 1, 2011, which is more than twice the buffer stock norm and food security reserve requirement. This also exceeds the existing storage capacity in the country. Pending the implementation of the proposed National Food Security Bill, which may further increase the procurement requirement, failure to fast-track the existing

Chart I.2: PRN Index *vis-a-vis* IMD Index

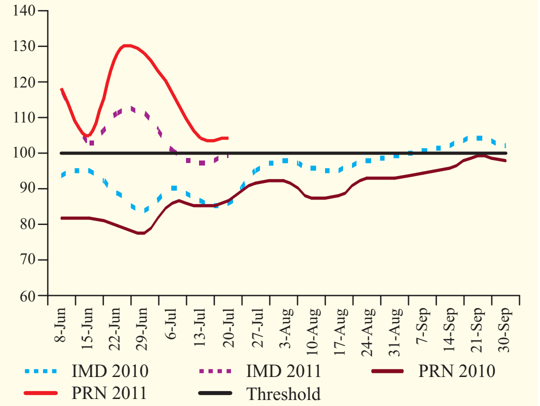
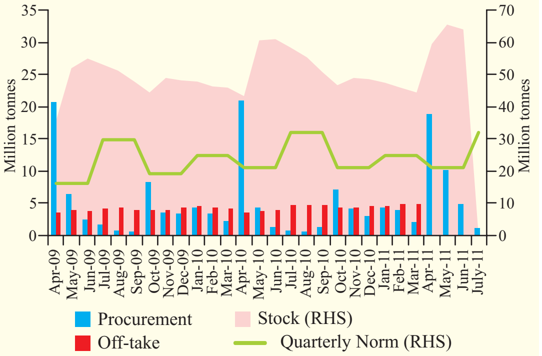


Chart I.3: Food Stock and its Determinants



Note: 1. Data for off-take is up to March 2011 and stock up to June 2011.
2. Procurement and off-take data are monthly figures.
3. Procurement for July 2011 is as on July 20.

projects and initiate new projects on augmenting storage capacity will lead to continued and increasing wastage and losses.

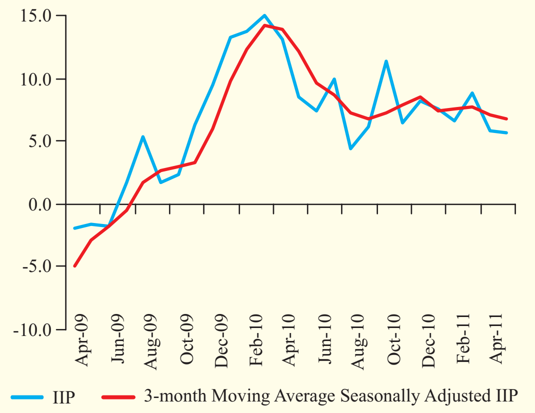
Need for improving post-harvest management of perishable crops

I.9 With respect to fruit and vegetables, the country is estimated to be losing about 40 per cent of the yearly produce on an annual basis due to lack of storage, cold chain and transport infrastructure. The seasonality and perishability of these items further magnify the demand-supply gap, which manifests in erratic movements in prices. This underscores the need to strengthen the existing schemes of clusters, cold-chains and transportation facilities.

Robust industrial growth in 2010-11, some moderation in early 2011-12

I.10 The new series of the IIP, with base 2004-05 that was released in June 2011 reinforced the Reserve Bank's view that the industrial growth had not significantly moderated in H2 of 2010-11. The new series gives better coverage and is more representative of the recent production structure based on 399 item groups as against 303 under the old base. The new series suggests that the recovery from the industrial downturn induced by the global financial crisis further consolidated in 2010-11, with IIP growth accelerating to 8.2 per cent from 5.3 per cent in the preceding year (Table I.3).

Chart I.4: Industrial Growth (Y-o-Y, per cent)



I.11 Industrial growth, however, moderated in April and May 2011 and turned out to be the lowest since September 2010. The deceleration is particularly strong for mining and manufacturing sectors. While lower growth in mining reflects the shortages in coal production, 14 out of the 22 industry groups that comprise manufacturing witnessed a deceleration. The slowdown in IIP growth during April-May 2011 can be partly attributed to the high base. Seasonal factors do not seem to have contributed to this deceleration (Chart I.4).

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

(Per cent)

Industry Group	Weight in the IIP	Growth Rate Apr-Mar 2010-11	Growth Rate Apr-May 2010-11	Growth Rate Apr-May 2011-12 P	Weighted Contribution # Apr-March 2010-11	Weighted Contribution # Apr-May 2010-11	Weighted Contribution # Apr-May 2011-12 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	14.2	5.2	8.5	1.3	7.4	9.3	2.7
Manufacturing	75.5	8.9	11.6	6.0	86.7	85.2	83.8
Electricity	10.3	5.5	6.3	8.4	6.0	5.6	13.4
Use-based							
Basic Goods	45.7	6.0	6.4	7.0	29.2	24.7	49.4
Capital Goods	8.8	14.9	25.2	6.6	25.5	28.0	15.9
Intermediate Goods	15.7	7.3	11.8	2.6	12.4	15.3	6.6
Consumer Goods (a+b)	29.8	8.4	10.5	4.9	33.0	32.0	28.0
a) Consumer Durables	8.5	14.1	19.0	4.5	24.0	24.5	11.8
b) Consumer Non-durables	21.3	4.1	4.3	5.3	9.0	7.5	16.2
General	**100.0**	**8.2**	**10.8**	**5.7**	**100.0**	**100.0**	**100.0**

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

Manufacturing growth has turned more broad-based

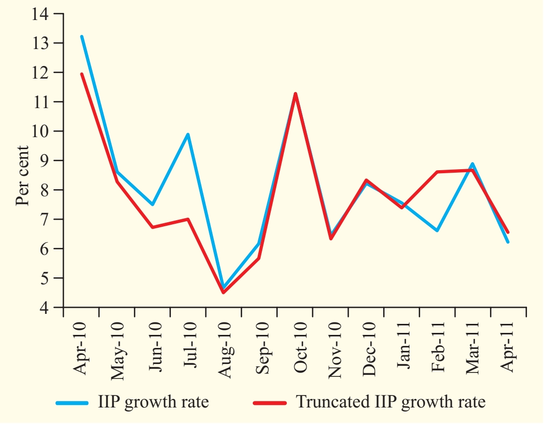
I.12 The acceleration in IIP growth in 2010-11 was accompanied by more broad-based growth. The bottom 17 industries registered improved growth performance in 2010-11 compared to the previous year and their contribution to growth more than doubled (Chart I.5). The IIP data for April-May 2011 indicates continuation of this trend.

I.13 The Reserve Bank's truncated measure of IIP[1] (ex-volatile items) based on new series exhibits movements similar to the overall IIP in the recent months, suggesting broad-based industrial growth (Chart I.6).

Subdued growth in some core industries a drag on overall industrial growth

I.14 The core sector growth decelerated in 2010-11 led by decline in coal production, stagnation in fertiliser and deceleration in production of electricity, cement and natural gas. The deceleration has continued in 2011-12, with lower growth during April-May 2011 compared to the corresponding period of the previous year (Chart I.7). Natural gas production declined mainly on account of lower production from the Krishna-Godavari basin. As a corollary of the revision in the base year of IIP, the base for computing the index of the core infrastructure sector has also been revised to 2004-05 from 1993-94. With the addition of natural gas and fertilisers, the core infrastructure sector now has eight industries with a combined weight of 37.9 in the IIP.

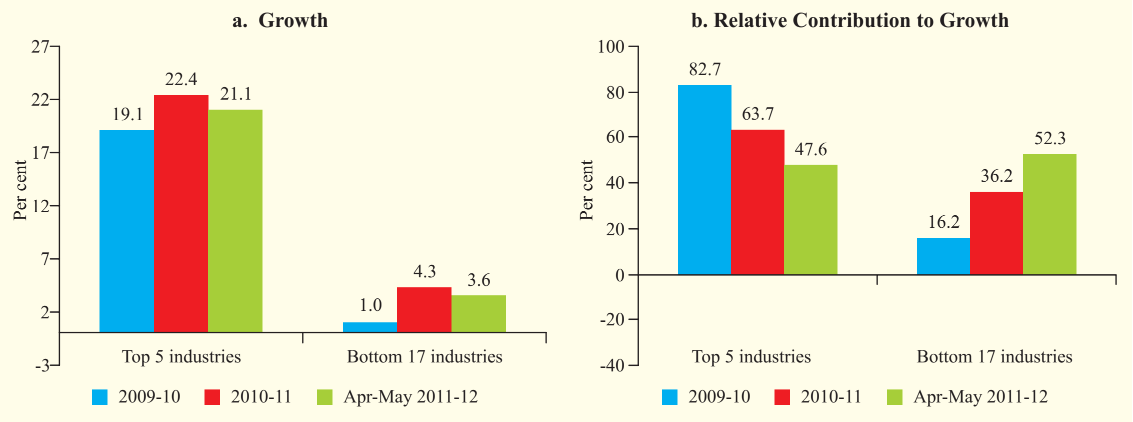
Chart I.6: IIP Truncated Index



Capacity utilisation firms up

I.15 Capacity pressures are building up in the economy. Capacity utilisation, an indicator of demand pressure, was the highest in three years during the fourth quarter of 2010-11 (Chart I.8). Increase in capacity utilisation during Q4 of 2010-11 was observed in 17 out of 22 industries covered under the Order Book, Inventory and Capacity Utilisation Survey (OBICUS). The order books of machinery and equipment, basic metal, textiles and cement firms increased during the quarter.

Chart I.5: Growth Concentration in Manufacturing Sector



[1] Computed by excluding top 10 and bottom 10 volatile items in terms of growth (out of 399 sub-item groups of IIP) that may at times tend to undermine the overall momentum of IIP.

Chart I.7: Growth in Infrastructure Industries

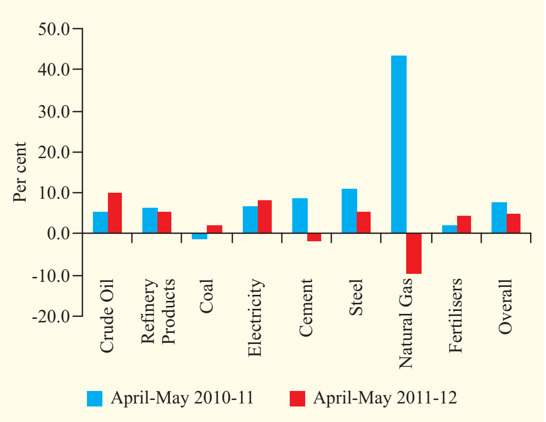
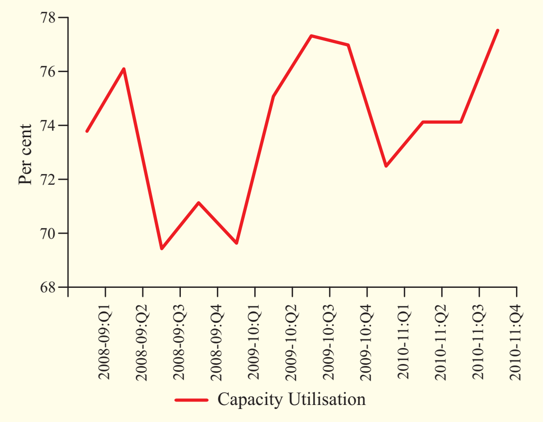


Chart I.8: OBICUS (Capacity Utilisation)



Services sector sustains momentum

I.16 The services sector growth of 9.2 per cent in 2010-11 was only marginally lower than that in the previous year. This was largely due to deceleration in 'community, social and personal services' reflecting fiscal consolidation undertaken by the government. The main drivers of growth in the service sector during the year were 'trade, hotels, transport, storage and communication' and 'financing, insurance, real estate and business services'. Most of the lead indicators of services sector such as growth in tourist arrivals, railway freight traffic, cargo handled at major ports and passengers handled at international terminals showed sustained momentum. The number of cell phone connections and cement production, however, declined (Table I.4).

Unemployment shows declining trend

I.17 The 66th Round of Employment/ Unemployment Survey of the National Sample Survey Office (NSSO) shows that the overall unemployment rate, measured by current daily status, declined to 6.6 per cent in 2009-10 from 8.2 per cent in 2004-05. The quarterly quick surveys of employment situation conducted by the Labour Bureau to study the impact of the global economic slowdown on employment in the Indian economy indicate that employment has increased in the recent period in major industries. As per the quarterly surveys of employment situation in eight major industries, employment increased by 9.8 lakh in 2010-11 in the industries surveyed. The IT/BPO sector accounted for 68 per cent of the increase during

Table I.4: Indicators of Services Sector Activity

(Growth in per cent)

Services Sector Indicators	2009-10	2010-11	April 2010	April 2011
1	2	3	4	5
Tourist arrivals	5.7	8.3	6.3#	10.6#
Cement	10.5	4.5	8.7$	-1.7$
Steel	6.0	8.9	10.9$	5.5$
Railway revenue earning freight traffic	6.6	3.8	3.2	7.4
Cell phone connections	47.4	18.0	42.0	-9.1
Cargo handled at major ports	5.8	1.6	2.7	6.3
Civil aviation				
Export cargo handled	11.4	13.4	13.1	6.0
Import cargo handled	8.1	20.6	29.9	14.6
Passengers handled at international terminals	5.7	11.5	6.9	18.1
Passengers handled at domestic terminals	14.5	16.1	27.0	14.0

: Data pertain to April-June. $: Data pertain to April-May.
Source: Ministry of Tourism; Ministry of Statistics and Programme Implementation and CMIE.

Table I.5 : Changes in Estimated Employment

(in lakh)

Industry/Group	2010-11:Q1	2010-11:Q2	2010-11:Q3	2010-11:Q4	2010-11
1	2	3	4	5	6
Textiles including apparels	-0.63	2.45	0.40	-1.21	1.01
Leather	0.21	0.04	0.16	-0.08	0.33
Metals	0.45	0.27	0.00	0.16	0.88
Automobiles	0.51	0.29	0.18	0.13	1.11
Gems and jewellery	0.04	0.04	-0.10	-0.02	-0.04
Transport	-0.21	0.13	-0.01	0.06	-0.03
IT/BPO	1.29	1.08	1.41	2.87	6.65
Handloom / Powerloom	-0.03	0.06	0.03	-0.18	-0.12
Overall	**1.62**	**4.35**	**2.07**	**1.74**	**9.79**

Source: Tenth Quarterly Quick Employment Survey, January-March 2011, Labour Bureau.

the year, with the bulk of the increase occurring during the fourth quarter (Table 1.5).

Some moderation in growth expected in 2011-12

I.18 Growth in 2011-12 is likely to moderate compared with the growth in 2010-11. Despite the scaling down of the monsoon forecast to slightly below normal in 2011-12, agriculture growth is expected to stay broadly on track. Near-normal monsoon performance will, however, be an important factor for sustaining robustness of growth in 2011-12. There is evidence of continued strong growth in the services sector. Fiscal consolidation undertaken by the government is likely to further pull down growth in 'community, social and personal services'. There is possibility of some softening in the industrial sector which is faced with high input cost pressures and escalating cost of capital. Given that non-agricultural GDP growth was below trend in 2010-11, a further softening poses downside risk to growth.

II. AGGREGATE DEMAND

Aggregate demand decelerated in Q4 of 2010-11 mainly due to investment slowdown. Corporate investment intentions also moderated significantly during H2 of 2010-11. There are no signs of improvement in investment during 2011-12 as yet. Private consumption demand may be adjusting downwards, but still remains strong. Corporate sales growth remained robust during Q4 of 2010-11 and is expected to stay so in Q1 of 2011-12. Profits, however, decelerated in 2010-11 with margins coming under pressure from rising interest and raw material costs. A rebalancing of demand from government consumption spending to private consumption spending occurred during 2010-11. Going forward, some rebalancing towards investment is required to sustain the growth momentum. Though fiscal indicators improved during 2010-11, high growth in subsidies led to a moderation in GDP at market prices. Despite recent initiatives to downsize petroleum subsidies, there is a likelihood of fiscal slippage in 2011-12.*

Investment soft patch continues

II.1 Expenditure side data of GDP indicates a significant slowdown in gross fixed capital formation, as well as inventory formation during Q4 of 2010-11 (Table II.1). While these numbers could be possibly revised, there is evidence to suggest that investment entered a soft patch during H2 of 2010-11. Updated information on corporate investment intentions, as captured by projects sanctioned financial assistance by banks and financial institutions, suggest that project expenditure on new projects, that were sanctioned assistance, was strong during H1 of 2010-11, but dipped sharply in H2 of 2010-11.

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

(Per cent)

	2009-10 Q.E.	2010-11 R.E.	2009-10				2010-11			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
			(Growth Rate)							
Real GDP at Market Prices	9.1	8.8	6.5	7.6	9.2	12.6	9.4	9.1	9.2	7.7
Total Final Consumption Expenditure	8.7	8.0	9.3	12.2	7.4	6.5	8.6	8.5	7.4	7.5
Private	7.3	8.6	7.3	8.5	7.0	6.6	8.9	8.9	8.6	8.0
Government	16.4	4.8	21.3	37.5	9.6	6.2	6.7	6.4	1.9	4.9
Gross Fixed Capital Formation	7.3	8.6	-0.4	0.3	8.7	19.2	17.4	11.9	7.8	0.4
Change in Stock	90.8	7.4	78.9	86.1	95.4	102.1	11.7	9.0	5.1	4.6
Net Exports	10.2	-15.3	5.4	-21.1	15.0	70.8	33.8	14.1	-52.6	-34.8
			(Share in GDP)							
Total Final Consumption Expenditure	70.1	69.5	73.1	71.4	73.6	63.2	72.6	71.0	72.3	63.1
Private	58.5	58.3	61.8	60.2	60.5	52.4	61.6	60.1	60.1	52.6
Government	11.6	11.2	11.3	11.2	13.1	10.8	11.0	10.9	12.2	10.5
Gross Fixed Capital Formation	32.0	32.0	30.4	31.9	30.9	34.5	32.6	32.7	30.5	32.1
Change in Stock	3.5	3.5	3.5	3.6	3.5	3.5	3.6	3.6	3.3	3.4
Net Exports	-7.2	-5.6	-6.3	-7.3	-8.8	-6.5	-7.7	-7.6	-3.8	-3.9
Memo:										(₹ crore)
Real GDP at Market Prices	48,69,317	52,98,129	11,12,318	11,37,985	12,55,040	13,63,974	12,17,270	12,41,332	13,70,188	14,69,339

Q.E.: Quick Estimates. R.E. : 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.

While the envisaged corporate investment in 2010-11 was marginally higher than that in the previous year, the slowdown was perceptible with a 43 per cent drop in the second half from the level of first half of 2010-11.

II.2 This slowdown since Q3 of 2010-11 is a concern, requiring some rebalancing of aggregate demand towards investment. In 2010-11, 796 projects were sanctioned assistance for planned project expenditures of ₹4,60,000 crore versus 754 projects that were sanctioned assistance in 2009-10 for planned project expenditures of ₹4,56,000 crore. Corporate investments are driven by the power sector followed by metal and metal products and telecommunication and have still not become broad-based. While some adverse impact on investment may come from high interest rates that have become necessary to combat inflation, better implementation can help in improving investment. The Government has made clear its intentions to remove constraints in investment and also encourage FDI in certain sectors such as multi-brand retail.

Private consumption demand decelerates but remains strong

II.3 The drivers of growth from the expenditure side revealed the continued predominance of private final consumption expenditure (PFCE). The buoyancy in private consumption was largely driven by improved agriculture growth and support from the consumer durables segment (Table II.1).

Corporate sales growth remains robust but profits moderate

II.4 Reflecting strong private consumption demand, sales of non-government non-financial (NGNF) listed companies grew by around 20 per cent during 2010-11 as also in the fourth quarter of the year (Table II.2). Further, in anticipation of better demand, companies accumulated stocks leading to a rise in stock-in-trade to sales ratio (Chart II.1). Operating profits and net profits, however, decelerated in 2010-11, due to higher input and interest costs. With decline in profit margins and increase in interest outflow, the interest coverage ratio,

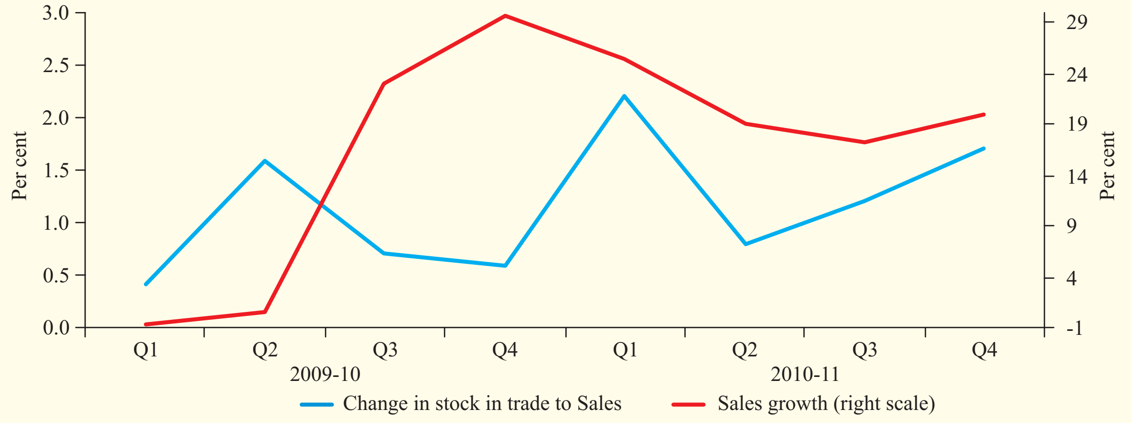
Table II.2: Corporate Sector- Financial Performance

(Per cent)

	2009-10	2010-11 (P)	2009-10				2010-11			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
No. of Companies					2196					
Growth rates in per cent										
Sales	12.8	19.7	-0.8	0.6	23.0	29.8	25.3	19.2	17.1	19.9
Other Income*	15.5	3.8	51.5	3.4	7.8	8.3	-23.0	56.2	8.4	-24.7
Expenditure, *of which*	10.6	22.3	-4.8	-2.3	20.6	30.9	29.8	20.5	19.1	22.4
Raw Material	13.2	25.7	-13.8	-4.2	33.5	43.7	37.7	21.5	19.7	26.6
Staff Cost	8.5	18.4	8.4	6.3	5.3	14.0	16.3	20.0	20.5	20.0
Operating Profits (PBDIT)	27.8	11.5	6.7	14.4	59.3	39.4	15.4	7.8	10.5	14.6
Depreciation	22.0	15.3	22.4	21.2	23.2	21.2	20.2	16.7	13.1	13.3
Interest	-3.8	20.0	5.5	-0.2	-13.6	-3.9	29.9	5.7	21.9	29.5
Net Profits (PAT)	32.4	7.5	7.6	12.9	91.0	43.4	1.6	9.2	9.1	11.9
Ratios in per cent										
Change in stock# to Sales	1.0	1.7	0.4	1.6	0.7	0.6	2.2	0.8	1.2	1.7
PBDIT to Sales	16.8	15.7	17.5	17.3	16.8	15.9	16.2	15.6	15.9	15.1
PAT to Sales	9.4	8.5	10.4	9.5	9.0	9.1	8.5	8.6	8.3	8.4
Interest to Sales	2.6	2.6	2.7	2.9	2.6	2.3	2.9	2.6	2.7	2.5
Interest to Gross Profits	17.6	19.6	17.2	19.8	17.6	16.1	21.1	19.1	19.7	19.1
Interest Coverage (Times)	5.7	5.1	5.8	5.1	5.7	6.2	4.8	5.2	5.1	5.2

* : Other income excludes extraordinary income/expenditure if reported explicitly.
\# : For companies reporting this item explicitly.
PBDIT : Profit before depreciation, interest and tax. PAT : Profit after tax.
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.

Chart II.1: Sales Growth and Stock-in-Trade to Sales Ratio



which indicates the number of times gross profits cover the interest payment, also declined in 2010-11 compared to the previous year. Earnings forecasts for Q1 of 2011-12, suggest a robust top line growth, indicating that the demand environment remains good. However, margin compression may decelerate profits somewhat. Early results are broadly in line with these expectations (Table II.3).

External demand improves, but uncertainty remains

II.5 There has been some improvement in net external demand during Q4 of 2010-11. With exports growing at a faster pace than imports, the extent of negative contribution of net exports to GDP declined. Going forward, there is some uncertainty about external demand given the renewed global growth concerns, but typically, external demand has been a small contributor to aggregate demand in India.

Table II:3 Early Results for Q1:2011-12

	2010-11		2011-12
	Q1	Q4	Q1
1	2	3	4
No. of companies		127	
Growth rates in per cent			
Sales	27.3	26.1	27.1
Other Income*	-15.1	17.3	85.4
Expenditure, of which	35.8	29.6	25.0
Raw Material	50.9	34.9	29.8
Staff Cost	15.4	25.8	26.3
Operating Profits (PBDIT)	16.2	23.5	24.4
Depreciation	5.1	26.1	27.4
Interest	26.8	26.6	14.6
Net Profits (PAT)	12.4	33.8	29.2
Ratio in per cent			
Change in stock# to Sales	4.6	1.5	2.2
PBDIT to Sales	18.7	19.3	18.3
PAT to Sales	13.1	15.1	13.3
Interest to Sales	1.3	1.2	1.2
Interest to Gross Profits	7.4	6.1	6.6
Interest Coverage (Times)	13.5	16.3	15.1

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

Improvement in deficit indicators augurs well for growth rebalancing

II.6 Provisional accounts of the Central government for 2010-11 turned out to be significantly better than the revised estimates (RE). Key deficit indicators showed an improvement over the RE reflecting higher realisation of tax and non-tax revenues and lower plan expenditure for both revenue and capital components. Preliminary indications are that the combined fiscal deficit of the Centre and States had narrowed to 7.7 per cent of GDP in 2010-11 (Tables II.4 and II.5). The combined revenue deficit had also fallen significantly. The higher than anticipated revenues in 2010-11 were utilised by the Centre for financing increased outlays in key priority areas (rural infrastructure, implementation of the Right to Education Act, plan assistance to States and recapitalisation of public sector banks).

Subsidies likely to overshoot budget estimates

II.7 Notwithstanding improvements during 2010-11 concerns about possible fiscal slippage

Table II.4 : Key Fiscal Indicators

(Per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal deficit	Outstanding Liabilities
1	2	3	4	5
		Centre		
2009-10	3.1	5.2	6.4	53.7
2010-11 RE	2.0	3.4	5.1	49.9
	(1.7)	(3.1)	(4.7)	
2011-12 BE	1.6	3.4	4.6	48.5
		States*		
2009-10	1.1	0.5	2.8	22.7
2010-11 RE	0.9	0.3	2.5	21.0
2011-12 BE	0.6	-0.2	2.1	20.6
		Combined		
2009-10	4.5	5.7	9.2	68.9
2010-11 RE	3.2	3.7	7.7	64.0
2011-12 BE	2.4	3.3	6.8	62.7

RE: Revised Estimates. BE: Budget Estimates.
* : Data in respect of States pertains to 24 State governments of which four are Vote on Accounts.
Note: Figures in parentheses are from the provisional accounts released by the Controller General of Accounts on May 31, 2011.
Source: Budget documents of the Central and State Governments.

during 2011-12 remain. The government's budgetary stance of expenditure-driven fiscal correction for 2011-12 was viewed as a move towards fiscal consolidation and anchoring inflation expectations. However, the lower gross fiscal deficit (GFD)-GDP ratio budgeted for 2011-12 is challenging on account of sizeable upside risks to subsidies and downside risks to revenues from moderation in growth.

II.8 Although the petroleum subsidy has been budgeted lower in 2011-12 than the RE for 2010-11, the actual level of petroleum subsidy is expected to exceed the budgeted level for 2011-12. It could overshoot by about 0.5 per cent of GDP even after partial upward revision in domestic prices of diesel, PDS kerosene and domestic LPG in June 2011 as the under-recoveries could still be close to ₹1,10,000 crore. Furthermore, payments undertaken for compensation of under-recoveries of oil marketing companies for the fourth quarter of 2010-11 would also add another 0.2 per cent of GDP to the subsidy burden of the current fiscal year. The elimination/reduction of customs/excise duty on petroleum products is estimated to also cause revenue losses to the Centre to the extent of nearly 0.3 per cent of GDP and impact the fiscal balance of the Central government. The total fiscal slippage for the Centre from oil sector, could thus be about 1 per cent of GDP. In addition, there could be spillover in fertiliser subsidies. Therefore, for durable correction in revenue account, tax buoyancy must recover to the pre-crisis level

Table II.5 : Combined Finances

Item	Growth rate (per cent)			Per cent to GDP		
	2009-10	2010-11 (RE)	2011-12 (BE)	2009-10	2010-11 (RE)	2011-12 (BE)
1	2	3	4	5	6	7
1. Total Expenditure	15.8	21.7	6.5	28.0	28.4	26.5
2. Revenue Expenditure	16.4	20.0	6.4	23.9	23.9	22.3
3. Capital Expenditure	12.2	32.2	7.3	4.1	4.5	4.2
4. Non-Developmental Expenditure	20.7	14.3	9.9	11.7	11.1	10.7
5. Development Expenditure	12.5	26.9	4.1	16.0	16.9	15.4
6. Revenue Receipts	8.4	32.6	7.7	18.3	20.1	19.0
i) Tax Revenue (net)	6.3	25.6	17.1	15.0	15.6	16.1
ii) Non-tax Revenue	18.8	63.9	-25.0	3.3	4.5	3.0

and administered pricing of diesel, kerosene and LPG needs to be phased out at the earliest. Besides, fertiliser subsidies need to be contained.

II.9 During April-May 2011, the revenue deficit and the GFD of the Central government turned out to be higher than during the corresponding period of the previous year mainly due to decline in revenue receipts. Lead information for the first quarter of 2011-12 indicates that although gross direct tax collections have increased, the substantial amount of corporation tax refunds have resulted in a decline in net tax collections over April-June 2010.

State finances appear to be on track

II.10 State governments also reverted to the process of fiscal consolidation in 2010-11, after a setback during 2008-10. The RE for 2010-11, based on the 2011-12 budgets of 24 States received so far, confirms that at the consolidated level, States could broadly achieve the budgeted reduction in key deficit ratios in 2010-11. This indicates increasing credibility of State governments' commitment towards fiscal consolidation.

II.11 A disaggregated analysis shows that the budgeted improvement in revenue account of States in 2011-12 is mainly due to decline in revenue expenditure while revenue receipts-GDP ratio is expected to remain stable at 11.7 per cent. However, the moderation in revenue expenditure growth is attributable to a sharp deceleration in growth of development expenditure (comprising social and economic services) to 9.0 per cent in 2011-12, from 26.0 per cent in 2010-11 (RE). In line with the improvement in the revenue account, States' GFD-GDP ratio is budgeted to be lower in 2011-12. However, capital outlay to GDP ratio, budgeted at 2.1 per cent in 2011-12, is yet to revert to the high levels achieved during 2006-09. With several States reducing their State levies on petroleum products, there could be some impact on State finances.

II.12 Overall, States seem to be committed to bring their finances on a sustainable path in the medium-term and the present pace of fiscal consolidation appears to be in tandem with the path suggested by the Thirteenth Finance Commission. Thus, the fiscal position of the States appears encouraging, but the challenge lies in translating intentions into outcomes of fiscal consolidation, while not compromising on the quality of the fiscal correction process.

Moderation in demand in 2011-12 is likely

II.13 There are chances of further moderation in both investment and consumption as high inflation erodes real consumption and monetary policy actions to restrain demand in the short run work through the system. The slowdown in consumption has been restricted so far to interest rate sensitive sectors like car sales getting impacted. Some re-balancing of demand towards investment would be helpful, and industrial policy action and execution could go a long way to help bring about this rebalancing. Firm commitment towards fiscal consolidation by the government would also help the rebalancing of aggregate demand.

III. THE EXTERNAL SECTOR

Better than expected performance of exports and invisibles receipts in Q4 of 2010-11 led to a considerable moderation in the current account deficit (CAD). With strong momentum in exports continuing during the first quarter, the current account is expected to remain manageable during 2011-12. Nevertheless, the size of current and capital accounts remains somewhat clouded in view of uncertain and uneven recovery in advanced economies (AEs), sovereign debt problems in the Euro zone periphery and volatile movements in global oil prices. While an improvement in FDI flows during the initial two months of 2011-12 augurs well for the economy, the volatility of flows, particularly with regard to portfolio investments as also the evolving composition of flows in favour of debt, remains a concern necessitating constant vigil.

CAD moderated in 2010-11

III.1 The CAD moderated significantly during Q4 of 2010-11 with moderation in trade deficit coupled with an upturn in net invisibles surplus. Merchandise exports expanded at a faster pace than imports and the trade deficit shrank in absolute terms. The turnaround in invisibles was supported by higher earnings from software exports. Accordingly, CAD at 2.6 per cent of GDP during 2010-11 turned out to be lower than 2.8 per cent in 2009-10. Capital flows remained moderate and were substantially absorbed by the CAD. Going forward, the external account is expected to remain manageable.

Risks to trade as global growth enters a soft patch

III.2 There are risks to current account arising from global growth entering a soft patch (Chart III.1a). If growth in advanced economies (AEs) weakens further and the soft patch turns into a more prolonged downturn, exports could face a distinctly tougher climate.

III.3 Global economic activity exhibited signs of slowing down in Q2 of 2011 as downside risks increased again. High commodity prices, political strife in the Middle East, the earthquake in Japan, sovereign debt problems in the Euro zone and rising fiscal and debt problems in the US took a toll on the levels of economic activity and business and consumer confidence. Private consumption is expected to be subdued as oil price hikes in the previous quarters cut into households' real incomes. After GDP growth for US and Japan decelerated markedly in Q1 of 2011(Chart III.1b), PMIs for US and Euro zone and leading indicators for OECD evidenced a dip.

Divergence between global economic activity of AEs and EMEs likely to remain in 2011

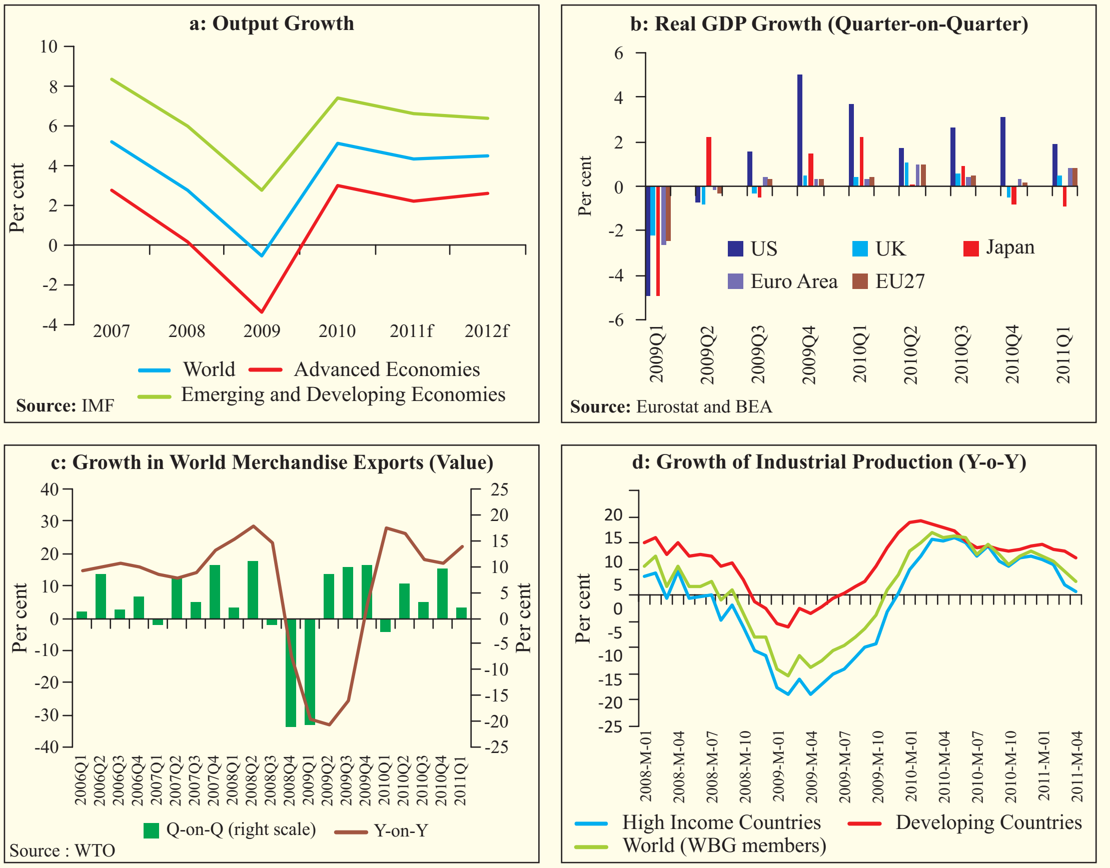
III.4 IMF has assessed that growth in most emerging and developing economies (EMDEs) would continue to be strong in 2011. Accordingly, the global economic recovery remains multi-paced with a further divergence in their growth rates. Moderation in commodity prices, especially oil, and government bond yields do offer hope for an economic turnaround during the second half of 2011.

III.5 The termination of QE2 by the US in June, tightening of monetary policy in the Euro Area and most of the EMEs, and fiscal consolidation initiatives/austerity measures and deepening of debt crises in the Euro periphery could, however, depress global demand. Nonetheless, there remains a possibility of QE3 if the US economy fails to regain momentum in the second half of 2011. In the US, fiscal and sovereign debt risks are rising because of the absence of credible consolidation and reform plans, while in Japan, the fiscal response to the earthquake has raised challenges to medium-term fiscal sustainability.

Risks to capital flows as global fiscal and sovereign debt risks come to the fore

III.6 There are risks to capital flows to EMEs arising from the global fiscal and sovereign debt

Chart III.1: Key Global Indicators



risks. These risks have been evident in the Euro zone, where stress has come time and again, compelling multilateral action to bailout private investors by incurring higher sovereign debt. However, the approach has its limits. It can precipitate a sovereign debt crisis at some stage. While simmering fiscal risks and sovereign debt problems in AEs encourage capital inflows into EMEs, a full-blown crisis has a contagion risk that can adversely impact risk appetite and moderate capital flows all around. While we are currently seeing a surge in capital flows to India, net outflows were seen in March 2011, associated with elevated global risk aversion and increased concerns about inflation.

World trade recovers to exceed the pre-crisis high, but may moderate ahead

III.7 Global trade is recovering with the value of world merchandise trade exceeding the pre-crisis high of July 2008 for the first time in March 2011. In value terms, the world trade was 22.3 per cent higher in the first quarter of 2011 compared to the same period of 2010 (Chart III.1c). On account of downside risks to growth, world trade growth, in volume terms, is expected to moderate in 2011.

World industrial activity is progressing at a moderate pace

III.8 Industrial output growth once again decelerated in the first quarter of 2011, after expanding toward the end of 2010, reflecting the decline in the Japanese production in March 2011 and similar declines in some of the North African countries (Chart III.1d). Excluding these countries, growth momentum in the rest of the world has been well above the longer-term trend growth rate.

Exports continue to grow aided by trade diversification

III.9 India's merchandise exports during 2011-12 so far (up to June) continued to register strong growth primarily led by engineering, gems and jewellery and petroleum products. The resilience in export performance appeared to have resulted from the supportive government policy, focussing on the diversification in terms of higher value-added products in engineering and petroleum sectors and destinations across developing economies. Trade policy is supporting exports through schemes like focus market scheme (FMS), focus product scheme (FPS) and duty entitlement passbook scheme (DEPB). This trend seems to have continued in the current year as well.

III.10 Disaggregated data that are available up to February 2011 show that the share of developing economies in total exports improved, while the share of OECD countries declined. Countries like China and South Africa accounted for nearly 32 per cent of the increase in share of exports to developing countries. In terms of products, the share of engineering and petroleum products increased, while the share of labour intensive products declined (Chart III.2 a, b & c). Within engineering goods, transport equipment, metals and iron and steel were the major contributors to the rise in exports during the year.

Trade deficit increases marginally, reflecting large non-oil imports

III.11 During Q1 of 2011-12, though export growth continued to outstrip import growth, the trade deficit increased marginally in absolute terms. Import growth was primarily led by a spurt in gold and silver (a rise of 200 per cent)

Chart III.2: India's Merchandise Trade

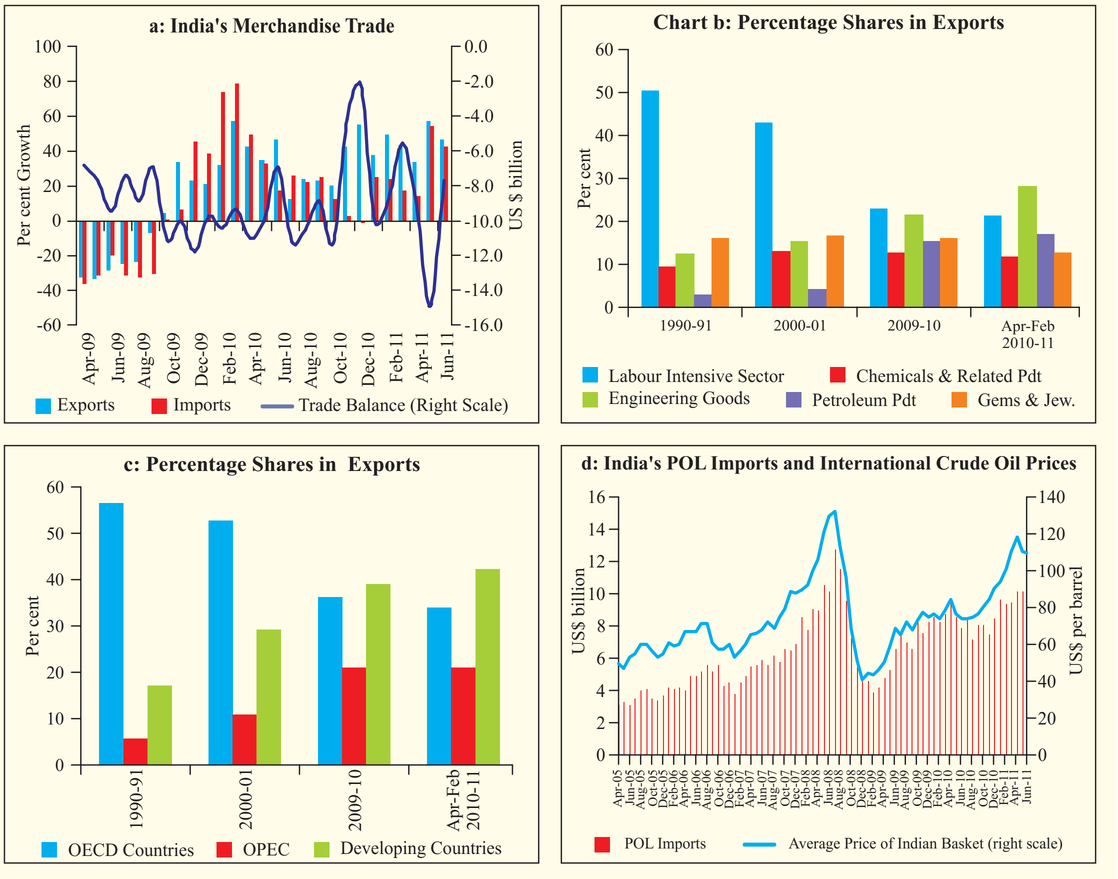


Table III.1 : India's Merchandise Trade

(US$ billion)

Item	2009-10 (R)		2010-11 (P)		April-June (P)			
					2010-11		2011-12	
	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth	Absolute (%)	Growth (%)
1	2	3	4	5	6	7	8	9
Exports	178.2	-2.5	245.6	37.8	54.2	41.2	79.0	45.7
Oil	28.0	1.7	42.5	51.8	8.7	96.8	14.0	60.9
Non-oil	150.2	-3.2	203.1	35.2	45.5	33.9	65.0	42.9
Imports	287.4	-3.8	350.5	21.9	84.2	35.0	110.6	31.4
Oil	87.1	-7.0	101.6	16.6	25.9	55.3	30.5	17.8
Non-oil	200.3	-2.4	248.9	24.2	58.4	27.6	80.1	37.2
Trade Balance	**-109.2**	**-5.9**	**-104.9**	**-3.9**	**-30.0**	**25.4**	**-31.6**	**5.3**
Non-Oil Trade Balance	**-50.1**	**0.4**	**-45.8**	**-8.6**	**-12.9**	**9.1**	**-15.1**	**17.1**

R: Revised. P: Provisional. Source: DGCI&S and Press Release, Department of Commerce Government of India.

and machinery (49 per cent). However, growth in oil imports at 18 per cent has been lower than that during the corresponding period of the previous year, reflecting some moderation in demand (Chart III.2d and Table III.1).

Invisibles remain the mainstay of current account

III.12 During Q4 of 2010-11, the current account balance improved further over the corresponding period of the previous year as well as the preceding quarter as a result of continued good performance of both merchandise and invisibles exports (Table III.2). Interestingly, the increase in oil exports offset the increase in oil imports implying that oil trade balance did not deteriorate further during 2010-11.

III.13 Among invisibles receipts, services exports showed higher growth primarily due to software services, travel, transportation and business services. Private transfers remained buoyant despite uncertainties in MENA countries (Table III.3).

III.14 A noteworthy aspect in respect of services data was the release by the Reserve Bank of provisional aggregate data on international trade in services for the first time for the month of April 2011 as a follow up of the implementation of the recommendations of the Working Group on Balance of Payments Manual for India (Chairman: Shri Deepak Mohanty). Henceforth, the aggregate data on trade in services will be released on a monthly basis after a gap of about 45 days.

Table III.2: India's Balance of Payments

(US $ billion)

	2009-10PR	2010-11P	2009-10	2010-11			
			Q4PR	Q1PR	Q2PR	Q3PR	Q4P
1	2	3	4	5	6	7	8
1. Exports	182.2	250.5	52.5	55.3	52.0	65.9	77.2
2. Imports	300.6	380.9	84.1	87.2	89.3	97.4	107.1
3. Trade Balance (1-2)	-118.4	-130.5	-31.6	-31.9	-37.3	-31.5	-29.9
4. Net Invisibles	80.0	86.2	18.8	19.8	20.5	21.5	24.5
5. Current Account Balance (3+4)	-38.4	-44.3	-12.8	-12.1	-16.8	-10.0	-5.4
6. Gross Capital Inflows	345.7	496.0	90.3	94.5	112.1	173.7	115.7
7. Gross Capital Outflows	292.3	436.3	74.5	77.7	90.8	160.3	107.5
8. Net Capital Account (6-7)	53.4	59.7	15.8	16.8	21.4	13.4	8.2
9. Overall Balance (5+8)#	**13.4**	**13.1**	**2.1**	**3.7**	**3.3**	**4.0**	**2.0**

Overall balance also includes errors and omissions apart from items 5 and 8.
PR: Partially Revised. P: Preliminary.

Table III.3: Net Invisibles

(US $ billion)

Item	April-March		January-March	
	2009-10 (PR)	2010-11 (P)	2009-10 (PR)	2010-11 (P)
1	2	3	4	5
A. Services	35.7	47.7	8.5	14.5
Of which				
Travel	2.5	4.0	0.8	1.3
Transportation	-0.8	0.4	-0.5	0.9
Software	48.2	56.8	14.0	16.7
Business Services	-6.7	-3.8	-1.8	-0.8
Financial Services	-0.9	-1.0	-0.4	-0.4
B. Transfers (Private)	52.1	53.4	12.6	13.8
C. Income	-8.0	-14.9	-2.3	-3.8
Investment Income	-7.2	-13.9	-2.0	-3.6
Compensation of employees	-0.8	-1.0	-0.3	-0.2
Total (A+B+C)	**80.0**	**86.2**	**18.8**	**24.5**

PR: Partially Revised. P: Preliminary.

Capital flows remain buoyant so far

III.15 As per the latest available information for the period April-May 2011, FDI inflows increased significantly. The increase in FDI was largely led by power, healthcare and pharmaceutical sectors. Net FII flows exhibited a considerable volatility during 2011-12 so far (Please see Chapter IV for details). ECB approvals, however, continued to increase on the back of strong domestic demand and interest rate differentials (Table III.4). The volatility in FII flows warrants a continuous monitoring of the evolving situation.

Table III.4: Capital Flows in 2011-12 so far

(US $ billion)

Component	Period	2010-11	2011-12
1	2	3	4
FDI to India	April-May	4.4	7.8
FIIs (net)	April-July, 15	6.2	3.1
ADRs/GDRs	April-June	1.1	0.3
ECB Approvals	April-June	5.3	8.1
NRI Deposits (net)	April-June	1.1	1.5

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

III.16 Net capital flows during Q4 of 2010-11 were lower than those during the corresponding period of the previous year primarily due to a reversal in FII flows and lower net FDI flows (Table III.5). The moderation in inflows under FDI and short-term trade credits continued during the quarter. FDI moderated mainly on account of lower FDI inflows under services and 'construction, real estate and mining'.

Broad-based REER indices depreciate moderately during Q1 of 2011-12

III.17 In nominal as well as real terms, broad-based 30 and 36-currency indicators of effective exchange rate for rupee depreciated during Q1 of 2011-12 (Table III.6). The real effective

Table III.5 : Net Capital Flows

(US $ billion)

Item	April-March		January-March	
	2009-10 (PR)	2010-11 (P)	2009-10 (PR)	2010-11 (P)
1	2	3	4	5
Net Capital flows	53.4	59.7	15.8	8.2
Of which				
1. Foreign Direct Investment	18.8	7.1	3.4	0.6
Inward FDI	33.1	23.4	6.1	4.9
Outward FDI	-14.4	-16.2	-2.7	-4.3
2. Portfolio Investment	32.4	30.3	8.8	0.2
Of which:				
FIIs	29.0	29.4	8.5	-0.03
ADR/GDRs	3.3	2.0	0.1	0.2
3. External Assistance	2.9	4.9	1.0	0.8
4. External Commercial Borrowings	2.8	11.9	0.4	2.4
5. NRI Deposits	2.9	3.2	-0.6	0.9
6. Short-term Trade Credit	7.6	11.0	4.5	2.7

P: Preliminary. PR: Partially Revised.

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

(Per cent, appreciation+/depreciation-)

	Index July 15, 2011 P	Year-on-Year Variation (Average)			
		2008-09	2009 10 P	2010- 11P	2011-12 P (April-June)
1	2	3	4	5	6
36-REER	102.0	-9.9	-3.1	7.7	-0.7
36-NEER	92.5	-10.9	-2.6	2.9	-3.5
30-REER	93.1	-10.2	-4.6	4.5	-0.6
30-NEER	94.1	-8.3	-2.2	1.0	-2.5
6-REER	118.5	-9.3	-0.3	13.1	1.5
6-NEER	90.5	-13.6	-3.7	5.7	-4.3
Rs/USD	44.5	-12.5	-3.1	4.1	2.1
Rs/USD (end-March)	44.7	-21.5	12.9	1.1	-0.2

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

exchange rate (REER) indices for 6-currency, however, showed a moderate appreciation, partly reflecting the higher inflation differential with the countries covered under the basket.

External debt indicators mixed, reserve accretion modest

III.18 India's external debt stock as at end-March 2011 showed an increase of 17.2 per cent over the level as at end-March 2010 reflecting increase in ECBs, bilateral and multilateral borrowings and short-term trade credit (Table III.7).

III.19 Key debt sustainability indicators such as debt to GDP ratio and debt service ratio improved while other indicators showed some deterioration during 2010-11 on account of the continued dominance of debt creating flows (Table III.7 and Table III.8). Debt creating flows could increase further going forward reflecting the interest rate differentials in a liquidity surfeit global economy characterised by multi-paced recovery as also the recent policy measures aimed at raising the limit on investments by FIIs in debt markets. The debt creating flows and the volatile FII flows need to be monitored closely to avoid risks emanating from unforeseen adverse global developments.

International Investment Position deteriorates

III.20 India's net international liabilities increased moderately despite the decline in the

Table III.7: India's External Debt

(US$ billion)

Item	End-March 2009	End-March 2010 PR	End-March 2011 P	Variation (March 2011 over March 2010)	
				Amount	Per cent
1	2	3	4	5	6
1. Multilateral	39.5	42.9	48.5	5.6	13.1
2. Bilateral	20.6	22.6	26.0	3.4	14.9
3. International Monetary Fund	1.0	6.0	6.3	0.3	4.4
4. Trade Credit (above 1 year)	14.5	16.9	18.6	1.8	10.4
5. External Commercial Borrowings	62.4	70.8	88.3	17.5	24.7
6. NRI Deposit	41.6	47.9	51.7	3.8	7.9
7. Rupee Debt	1.5	1.7	1.6	-0.1	-3.4
8. Long-term (1 to 7)	181.2	208.7	240.9	32.2	15.4
9. Short-term	43.4	52.3	65.0	12.7	24.2
Total (8+9)	**224.5**	**261.0**	**305.9**	**44.9**	**17.2**

P: Provisional. PR: Partially Revised.

Table III.8: External Sector Vulnerability Indicators

(Per cent)

Indicator	End-March 2010	End-September 2010	End-December 2010	End-March 2011
1	2	3	4	5
1. Ratio of Total Debt to GDP	18.0	–	–	17.3
2. Ratio of Short-term to Total Debt (Original Maturity)	20.0	21.0	20.7	21.2
3. Ratio of Short-term to Total Debt (Residual Maturity)	41.2	42.9	-	42.2
4. Ratio of Concessional Debt to Total Debt	16.8	16.0	15.7	15.6
5. Ratio of Reserves to Total Debt	106.8	101.4	100.5	99.6
6. Ratio of Short-term Debt to Reserves	18.8	20.7	20.6	21.3
7. Reserves Cover of Imports (in months)	11.1	10.4	10.0	9.6
8. Reserves Cover of Imports and Debt Service Payments (in months)	10.5	9.8	9.5	9.2
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	5.5	4.1	4.0	4.2

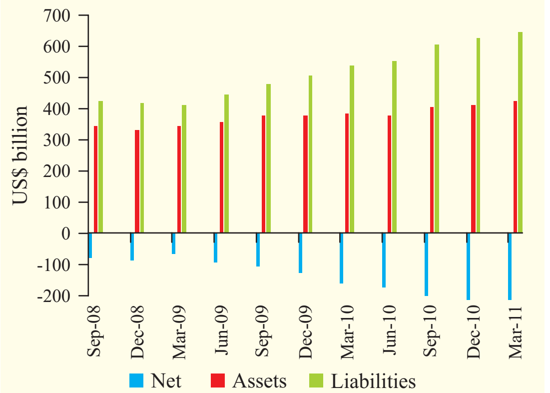
CAD during Q4 over the preceding quarter. The increase primarily reflected the valuation effects due to the depreciation of the US dollar against major international currencies (Chart III.3).

Oil prices and the pattern of capital flows likely to determine external balance

III.21 India's external debt and CAD are likely to remain manageable over the medium-term. However, some pressures could emerge with event risks. The continued diversification in terms of products and destinations with supportive policies of the government, however, augur well for realising India's export growth potential over the medium-term. This is also reflected in the robust performance of exports during 2011-12 so far. Services exports are also likely to remain buoyant.

III.22 Elevated oil prices may have adverse implications for the import bill necessitating adoption of energy efficient technology, step-up in exploration of oil and research on developing oil substitutes. In an uncertain global financial and macroeconomic environment, capital flows can turn more volatile. A favourable investment climate would be necessary to further boost FDI inflows which have recovered in the early months of 2011-12. Overall, the BoP outlook for 2011-12 remains stable though it necessitates a constant monitoring due to global uncertainties.

Chart III.3: International Investment Position



IV. MONETARY AND LIQUIDITY CONDITIONS

Liquidity conditions eased further during Q1 of 2011-12 while remaining in deficit mode. This brought about an adjustment in liquidity in line with the policy objective. The easing reflected mainly structural factors, as the divergent trend between credit growth and deposit growth narrowed with rising interest rates. The sharp rise in currency growth observed during 2010-11 was also reversed as the opportunity cost of holding currency increased with rise in deposit rates. Following the pick-up in the deposit growth, the money supply growth remained above the indicative trajectory. Though credit growth moderated, partly reflecting base effect, it is still above the indicative trajectory.

Monetary conditions remain tight in line with policy stance

IV.1 Monetary conditions remained tight during Q1 of 2011-12 with interest rates firming, deposit growth picking up and credit growth decelerating. The Reserve Bank persisted with its anti-inflationary monetary policy stance during Q1 of 2011-12. As inflation became increasingly generalised, the Reserve Bank raised policy repo rate by 50 bps in May, followed by another 25 bps in June. The Reserve Bank has thus raised the reverse repo rate, repo rate and the CRR by 325 basis points (bps), 275 bps and 25 bps respectively since March 2010. Following a shift from absorption mode to injection mode in the liquidity adjustment facility (LAF), there has been, in effect, a rise in policy rates by 425 bps since February 2010 till date as the money market rate started hovering around the upper bound from the lower bound of the LAF corridor (Table IV.1).

IV.2 Based on the recommendations of the Working Group on Operating Procedures of Monetary Policy (Chairman: Shri Deepak Mohanty), the Reserve Bank in its Monetary Policy Statement for 2011-12 effected the following changes to the operating procedure of monetary policy: (i) the weighted average overnight call money rate has become the operating target of monetary policy; (ii) the repo rate has become the only independently varying policy rate; (iii) the reverse repo rate, pegged at 100 bps below the repo rate, provides the lower bound to the corridor of overnight interest rate and (iv) a new Marginal Standing Facility (MSF) has been instituted at 100 bps above the repo rate that provides the upper bound to the corridor. Banks can borrow overnight from the MSF up to one per cent of their respective net demand and time liabilities (NDTL). The new operating procedure became operational in May 2011.

Liquidity conditions continue to be in deficit mode

IV.3 Liquidity conditions eased significantly during Q1 of 2011-12. The average availment

Table IV.1: Movements in Key Policy Rates in India

(Per cent)

Effective Since	Reverse Repo Rate	Repo Rate	Cash Reserve Ratio
1	2	3	4
Apr. 21, 2009	3.25 (-0.25)	4.75 (-0.25)	5.00
Feb. 13, 2010	3.25	4.75	5.50 (+0.50)
Feb.27, 2010	3.25	4.75	5.75 (+0.25)
Mar. 19, 2010	3.50 (+0.25)	5.00 (+0.25)	5.75
Apr. 20, 2010	3.75 (+0.25)	5.25 (+0.25)	5.75
Apr. 24, 2010	3.75	5.25	6.00 (+0.25)
Jul. 2, 2010	4.00 (+0.25)	5.50 (+0.25)	6.00
Jul. 27, 2010	4.50 (+0.50)	5.75 (+0.25)	6.00
Sept. 16, 2010	5.00 (+0.50)	6.00 (+0.25)	6.00
Nov. 2, 2010	5.25 (+0.25)	6.25 (+0.25)	6.00
Jan. 25, 2011	5.50 (+0.25)	6.50 (+0.25)	6.00
Mar. 17, 2011	5.75 (+0.25)	6.75 (+0.25)	6.00
May 3, 2011	6.25 (+0.50)	7.25 (+0.50)	6.00
Jun 16, 2011	6.50 (+0.25)	7.50 (+0.25)	6.00

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

of liquidity under LAF was lower at around ₹49,300 crore in Q1 of 2011-12 as compared with around ₹84,400 crore in Q4 of 2010-11. The easing was mainly on account of sharp drawdown in Government's cash balances with the Reserve Bank. With the Government transiting to Ways and Means Advances/ Overdraft in early April, reflecting, *inter alia*, tax refunds, the liquidity conditions were in absorption mode for a brief period in early April 2011. As part of their usual year-end balance sheet adjustments, banks maintained higher cash reserves with the Reserve Bank, which following their unloading, also had an easing effect on liquidity conditions in early April 2011.

IV.4 Liquidity conditions reverted to the deficit mode in the second week of April 2011. Seasonally, the month of April has mostly seen surplus liquidity in terms of the net absorption under LAF, reflecting lower credit demand and Government's cash draw-down. This year turned out to be contrarian in that April experienced liquidity deficit on an average daily basis (around ₹19,000 crore, *albeit,* lower than that of ₹81,000 crore in March 2011) (Chart IV.1). The deficit liquidity conditions were in line with stated policy objective of the Reserve Bank. With the Government substituting WMA by issuances of cash management bills (CMBs) and additional borrowing through Treasury Bills from the market, the average daily net liquidity injection under the LAF increased to around ₹55,000 crore in May 2011.

IV.5 Even as liquidity was in the surplus mode during early April 2011, the Reserve Bank had anticipated reversal in liquidity conditions based on its liquidity assessment for the subsequent period. Accordingly on April 8, 2011, the Reserve Bank had pre-emptively extended the additional liquidity support to SCBs under the LAF to the extent of up to one per cent of their NDTL till May 6, 2011. Moreover, the second LAF (SLAF) on a daily basis was also extended up to May 6, 2011. Following the introduction of MSF on May 9, 2011, where banks can submit their bids during 15.30 - 16.30 hrs, the second LAF was discontinued. Further, under the MSF scheme, banks need not seek a specific waiver for default in SLR compliance arising out of use of this facility. Till date the maximum availment of liquidity under MSF has been ₹4,105 crore

IV.6 Liquidity in the banking system remained in deficit mode in June as Government balances increased reflecting quarterly advance tax outflows (Table IV.2). The average daily net outstanding liquidity injection was around ₹74,000 crore in June 2011. Liquidity conditions eased in early July reflecting drawdown of Government cash balances including, *inter alia,* redemption of a security amounting to around ₹37,000 crore on July 2, 2011. The average daily net liquidity injection is placed at around ₹41,000 crore during July 1 to 22, 2011.

Chart IV.1: LAF Volumes and GoI Balances

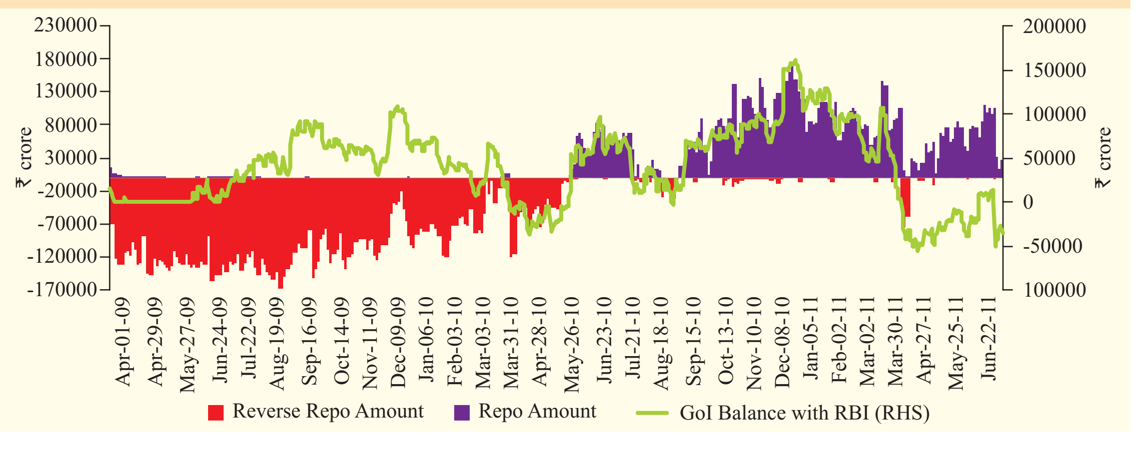


Table IV.2: Liquidity Position

(₹ crore)

Outstanding as on last Friday	LAF	MSS	Centre's Surplus@	Total
1	2	3	4	5=(2+3+4)
2010				
April	35,720	2,737	-28,868	9,589
May	6,215	317	-7,531	-999
June	-74,795	317	76,431	1,953
July	1,775	0	16,688	18,463
August	11,815	0	20,054	31,869
September	-30,250	0	65,477	35,227
October	-1,17,660	0	86,459	-31,201
November	-1,03,090	0	93,425	-9,665
December	-1,13,415	0	1,44,437	31,022
2011				
January	-76,730	0	1,18,371	41,641
February	-72,005	0	77,397	5,392
March*	-1,06,005	0	16,416	-89,589
April	-39,605	0	-35,399	-75,004
May	-75,795	0	-9,544	-85,339
June	-96,205	0	8,339	-87,866
July^	-38,450 #	0	-39,232	-77,682

@ : Excludes minimum cash balances with the Reserve Bank in case of surplus.
* : Data pertain to March 31 ^ : As on July 15, 2011.
\# : MSF of ₹ 4,105 crore has been included in LAF figure for July 15, 2011.
Note: 1. Negative sign in column 2 indicates injection of liquidity through LAF.
2. Negative sign in column 4 indicates WMA /OD availed by the Central Government.

Structural drivers ease pressure on liquidity

IV.7 During the third quarter of 2010-11, the deficit liquidity conditions were driven by structural as well as frictional factors. The structural factors included a sharp rise in currency demand and divergent trends in credit and deposit growth, while the frictional factors included maintenance of surplus cash balances by the Government with the Reserve Bank (Table IV.3). During Q4 of 2010-11, the liquidity conditions eased marginally due to pick-up in government spending, staggered OMOs carried out by the Reserve Bank and narrowing divergence between credit growth and deposit growth. The currency growth, however, continued to be strong. In contrast, the deficit liquidity conditions during the first quarter of 2011-12 were largely driven by frictional factors, *i.e.,* Government's cash balance with the Reserve Bank. The structural drivers of liquidity responded to the monetary policy signals, thereby alleviating the pressure on liquidity.

Narrowing divergence between credit growth and deposit growth

IV.8 During the first three quarters of 2010-11, the divergence between credit growth and deposit growth was high and growing. As the cost of funds under LAF increased progressively with the rise in the repo rate, banks raised their deposit and lending rates making the monetary policy transmission

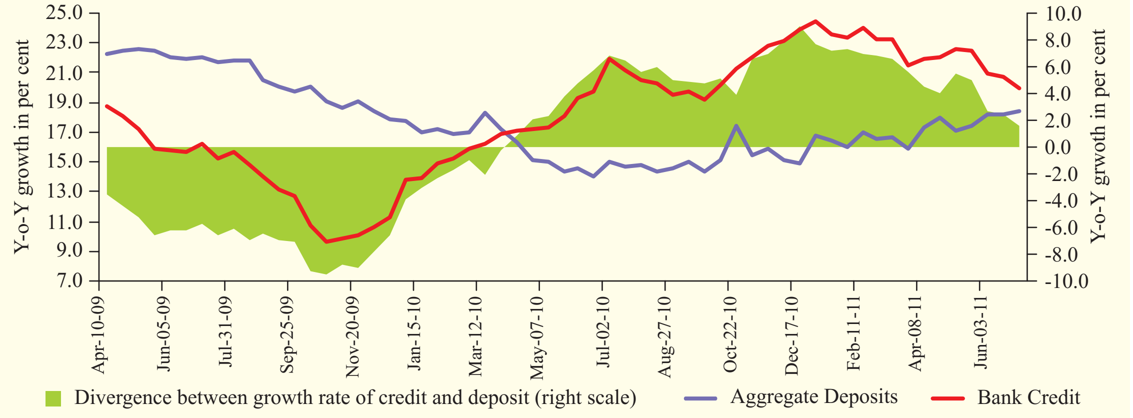
Table IV.3: Reserve Bank's Liquidity Management Operations

(₹ crore)

Item	2010-11				2011-12
	Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6
A. Drivers of Liquidity (1+2+3+4)	**-1,05,124**	**26,981**	**-1,12,597**	**79,222**	**-34,844**
1. RBI's net Purchase from Authorised Dealers	816	751	5,991	0	0
2. Currency with the Public	-58,421	240	-45,969	-45,487	-39,078
3. a. Centre's surplus balances with RBI	-58,249	10,953	-78,960	1,28,021	8,077
3. b. WMA and OD	0	0	0	0	0
4. Others (residual)	10,730	15,037	6,341	-3,312	-3,843
B. Management of Liquidity (5+6+7+8)	**67,255**	**-41,456**	**1,34,075**	**10,088**	**-8,965**
5. Liquidity impact of LAF	75,785	-44,545	83,165	-7,410	-9,800
6. Liquidity impact of OMO* (net)	1,550	2,772	50,910	23,181	835
7. Liquidity impact of MSS	2,420	317	0	0	0
8. First round impact of CRR change	-12,500	0	0	0	0
C. Bank Reserves # (A+B)	**-37,869**	**-14,475**	**21,478**	**89,311**	**-43,809**

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

Chart IV.2: Aggregate Deposits and Bank Credit



increasingly effective. This resulted in narrowing of the divergence between deposit and credit growth from 9 percentage points in mid-December to 5.6 percentage points in March and further to 1.5 percentage points in July 2011 (Chart IV.2).

Currency growth moderates as opportunity cost of holding currency increases

IV.9 Currency growth, which had witnessed significant acceleration and remained above trend for most part of 2010-11, decelerated below the trend during the first quarter of 2011-12 (Chart IV.3). The currency growth was strong during 2010-11 mainly on account of stronger GDP growth and persistent high inflation. In addition, as deposit interest rates were low, the opportunity cost of holding currency was also low for most part of the year. The cumulative rise in the deposit rates, however, progressively raised the opportunity cost of holding idle currency; accordingly, a switch from currency holdings and demand deposits to time deposits ensued. The moderation in economic activity and correction in asset markets further aided this phenomenon.

Reserve money growth moderates

IV.10 During the first three quarters of 2010-11, reserve money growth was high reflecting the injection of primary liquidity by the Reserve Bank in response to the tight liquidity conditions. The injection of primary liquidity was mainly through repo operations under the LAF and open market purchases. Reserve money growth also reflected the increase in CRR. During the same period however, growth in money supply was restrained due to sharp

Chart IV.3: Currency Growth

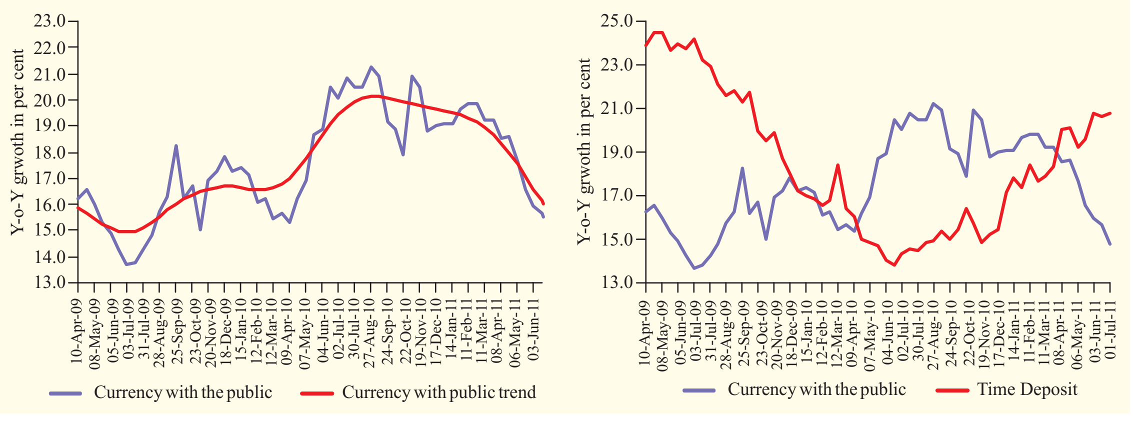


Chart IV.4: Base Money Growth *vis-a-vis* Broad Money Growth

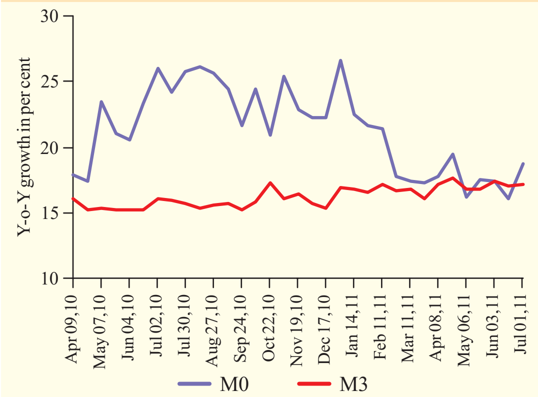
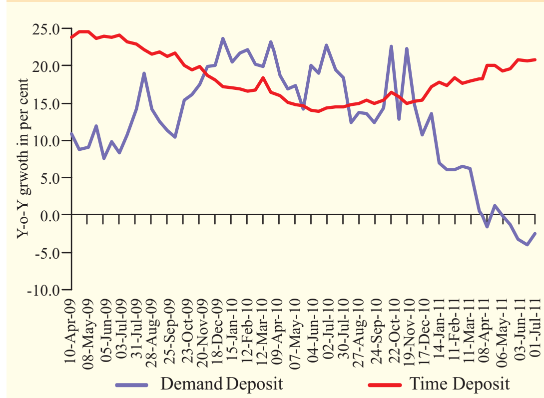


Chart IV.5: Behaviour of Money Supply and Deposits



moderation in the growth of aggregate deposits as a response to low deposit rates in an environment of high inflation.

IV.11 Liquidity conditions eased during Q1 of 2011-12 as reflected in the lower average availment of LAF window by banks. No primary liquidity was added by way of the Reserve Bank's forex management. The slowdown in the injection of primary liquidity by the Reserve Bank has resulted in a deceleration in reserve money growth since the peak attained in end-December 2010 (Chart IV.4).

Money supply growth remains above projection

IV.12 Even though reserve money growth decelerated, broad money growth increased faster in Q1 of 2011-12 as deposit growth picked-up. The broad money supply growth thus remains above the indicative trajectory of the Reserve Bank (Table IV.4). Time deposits, which account for nearly 88 per cent of aggregate deposits, have especially witnessed a strong growth as interest rates increased sharply in response to the deficit liquidity conditions coupled with steady increase in policy rates. Demand deposits declined on a year-on-year basis as the opportunity cost of holding money in low interest bearing deposits increased (Chart IV.5).

Credit growth stays above indicative trajectory

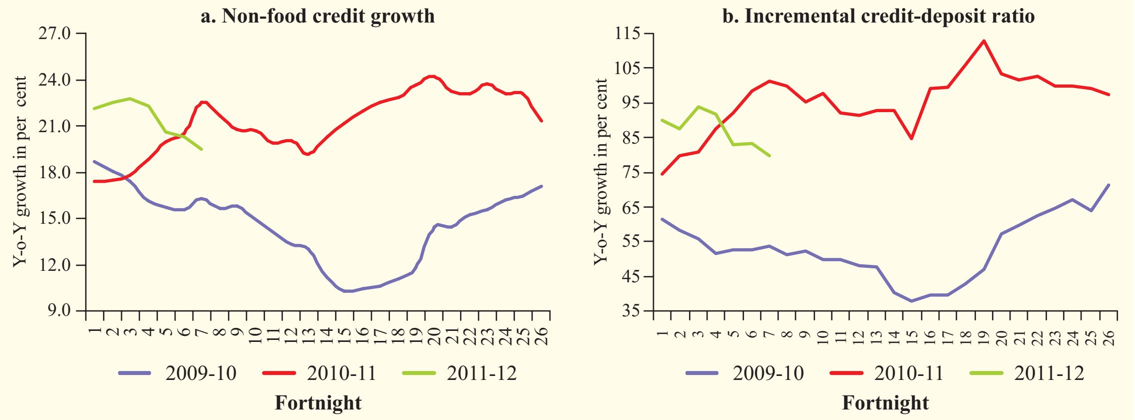
IV.13 Credit growth, which had witnessed sharp acceleration in 2010-11, moderated in the

Table IV.4: Monetary Indicators

Item	Outstanding Amount (₹ crore) July 01, 2011	FY variations (per cent)		Y-o-Y Variations (per cent)	
		2010-11	2011-12	Jul 02, 2010	Jul 01, 2011
1	2	3	4	5	6
Reserve Money (M_0)*	**13,62,693**	**1.5**	**-1.0**	**24.2**	**16.1**
Broad Money (M_3)	**68,12,286**	**3.8**	**4.8**	**16.0**	**17.1**
Main Components of M_3					
Currency with the Public	9,41,915	6.9	3.0	20.0	14.8
Aggregate Deposits	58,66,583	3.3	5.1	15.4	17.5
of which: Demand Deposits	6,79,369	-2.9	-5.3	22.7	-2.5
Time Deposits	51,87,215	4.4	6.6	14.3	20.8
Main Sources of M_3					
Net Bank Credit to Government	20,86,919	3.9	5.3	22.3	20.4
Bank Credit to Commercial Sector	43,78,440	5.0	3.4	20.9	19.4
Net Foreign Assets of the Banking Sector	14,43,817	2.4	3.6	-0.2	10.0

Note: 1. Data are provisional.
2. *: Data pertain to July 15, 2011.

Chart IV.6: Credit Indicators



first quarter of 2011-12 on a year-on-year basis, partly reflecting transmission from higher lending rates and partly due to the base effect. Notwithstanding this deceleration, non-food credit growth remains high in the financial year so far, in contrast to the seasonal slack generally seen during this period. Currently, it is above the indicative trajectory. The higher interest rates also prompted sharper growth in deposits, especially time deposits. As a result, the incremental credit-deposit ratio moderated (Chart IV.6).

Chart IV.7 : Real Rate of Interest on Demand Loans and Term Loans

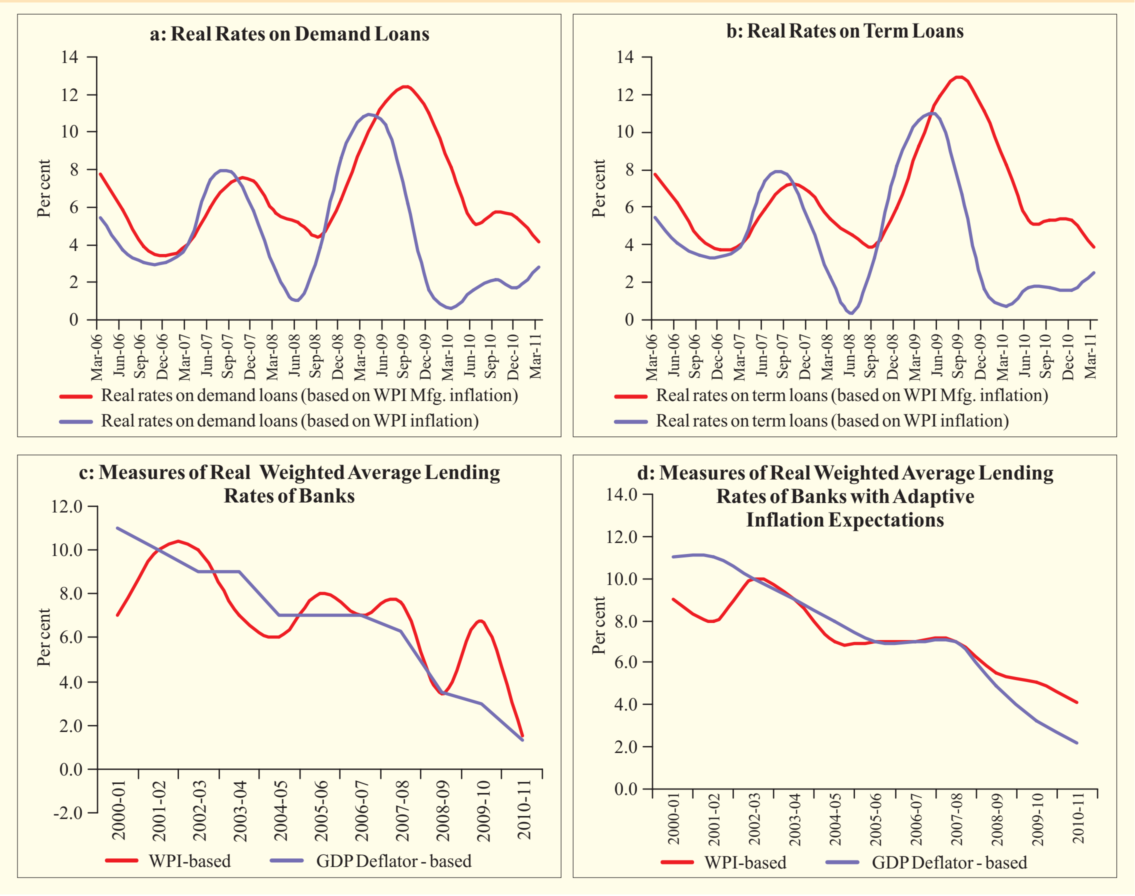


Table IV.5: Credit Flow from Scheduled Commercial Banks

(Amount in ₹ crore)

Bank Groups	Outstanding as on July 01, 2011	Year-on-Year Variation as on			
		July 02, 2010		July 01, 2011	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1. Public Sector Banks*	30,32,648	4,65,942	22.6	5,03,142	19.9
2. Foreign Banks	2,08,635	19,401	12.2	30,430	17.1
3. Private Banks	7,49,089	1,11,509	22.0	1,30,566	21.1
4. All Scheduled Commercial Banks	40,86,327	6,12,578	21.9	6,78,182	19.9

Note: 1. Data as on July 01, 2011 are provisional.
2. * Excluding Regional Rural Banks.

Real rates remain positive

IV.14 With the recent acceleration in inflation, some real interest rates, measured *ex post*, by subtracting current inflation from the nominal interest rates are negative, giving an impression that the policy stance is not contractionary enough. The policy repo rate at 7.5 per cent seen against the current headline inflation rate of 9.4 per cent is negative. However, an appropriate way of calculation of real policy rates is by using expected inflation rate for calculations. The Reserve Bank has projected 6.0 per cent inflation rate by the end of 2011-12. *Ex-ante*, on this basis, the real rate is positive at the current level. However, what is important is the level of real lending rate which continues to remain positive in the various alternative ways of calculation (Chart IV.7). Taking a two-year moving average series of headline inflation rate to represent adaptive inflation expectations, the smoothened real lending rate series reinforces the observation that real interest rates remain positive.

Credit expansion shows a differential trend

IV.15 The moderation in credit growth on a y-o-y basis is especially evident in the case of public sector banks, as lending rates rose. Foreign banks, which had sharply cut back on

Table IV.6: Sectoral Deployment of Credit

(Per cent)

Sector	Outstanding Credit as on June 17, 2011 (₹ crore)	Y-o-Y Variation		Financial Year Variation	
		June 18, 2010/ June 19, 2009	June 17, 2011/ June 18, 2010	June 18, 2010/ March 26, 2010	June 17, 2011/ March 25, 2011
1	2	3	4	5	6
Non-food Credit	**3,708,927**	**20.2**	**19.6**	**2.0**	**1.1**
Agriculture & Allied Activities	**453,812**	**21.7**	**12.8**	**-3.3**	**-1.4**
Industry	**1,667,577**	**29.2**	**22.0**	**4.2**	**2.9**
Of which, Mining and Quarrying (incl. Coal)	26,890	32.6	41.6	5.0	17.6
Food Processing	86,482	26.8	24.8	5.5	1.8
Basic Metal & Metal Product	214,921	28.6	25.9	4.8	2.4
Infrastructure	552,682	50.0	30.2	11.8	5.0
Of which, Power	292,342	52.8	39.8	11.3	8.6
Telecommunications	94,319	72.0	16.7	36.1	-6.1
Roads	99,038	46.7	27.9	5.2	7.0
Services	**892,281**	**16.2**	**20.9**	**1.6**	**-0.9**
Of which, Transport Operators	58,254	35.8	11.2	-0.3	-11.0
Trade	185,142	16.3	11.4	1.0	-0.6
Commercial Real Estate	113,376	-4.5	23.2	-0.1	1.4
NBFCs	169,321	25.0	44.5	3.3	-3.6
Personal Loans	**695,257**	**6.6**	**17.3**	**1.2**	**1.4**
Of which, Housing (Including Priority Sector)	358,828	9.7	17.0	2.0	3.7
Credit Card Outstanding	18,134	-27.0	-5.8	-4.4	0.2
Vehicle Loans	82,330	11.0	22.9	5.0	3.8

Note: Based on data collected from select SCBs that account for 95 per cent of the total non-food credit extended by all SCBs. These data are dissemintaed every month from November 2010.

Table IV.7: Flow of Financial Resources to the Commercial Sector

(₹ crore)

Item	April-March		April-June	
	2009-10	2010-11	2010-11	2011-12
1	2	3	4	5
A. Adjusted Non-food Bank Credit (NFC)	**4,78,614**	**7,11,031**	**1,67,496**	**1,23,180 +**
i) Non-Food Credit	4,66,960	6,81,501	1,57,396	1,28,919 +
of which petroleum and fertilizer credit	10,014	-24,236	-18,288	6,435 *
ii) Non-SLR Investment by SCBs	11,654	29,530	10,100	-5,739 +
B. Flow from Non-banks (B1+B2)	**5,88,784**	**5,11,006**	**95,111**	**1,16,488**
B1. Domestic Sources	**3,65,214**	**2,92,084**	**60,031**	**69,265**
1. Public issues by non-financial entities	31,956	28,520	5,187	1,521
2. Gross private placements by non-financial entities	1,41,964	63,947	-	-
3. Net issuance of CPs subscribed to by non-banks	26,148	17,207	31,795	40,846 *
4. Net credit by housing finance companies	28,485	38,386	4,028	6,386 *
5. Total gross accommodation by the four RBI regulated AIFIs - NABARD, NHB, SIDBI & EXIM Bank	33,783	40,007	3,281	-6,732
6. Systemically important non-deposit taking NBFCs (net of bank credit)	60,663	67,937	15,122	21,701 *
7. LIC's gross investment in corporate debt, infrastructure and social sector	42,215	36,080	618	5,543 *
B2. Foreign Sources	**2,23,570**	**2,18,922**	**35,080**	**47,223**
1. External Commercial Borrowings / FCCBs	15,674	52,899	10,425	11,196
2. ADR/GDR Issues excluding banks and financial institutions	15,124	9,248	4,832	1,237
3. Short-term credit from abroad	34,878	50,177	-	-
4. FDI to India	1,57,894	1,06,598	19,823	34,790 *
C. Total Flow of Resources (A+B)	**10,67,398**	**12,22,037**	**2,62,607**	**2,39,668**
Memo Item:				
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	96,578	-36,707	8,335	10,186

*: Up to May 2011 +: Up to July 1, 2011 - : Data is not available

Note: FDI Data include equity capital of incorporated entities for the period April-May and does not include reinvested earnings, other capital and equity capital of unincorporated entities.

their lending during the crisis period, significantly increased their lending in the recent period (Table IV.5).

IV.16 The year-on-year flow of credit continued to register high growth to industrial, services and personal loans sectors (Table IV.6). Credit to industry was led by sectors such as mining and quarrying, infrastructure, food processing and basic metal and metal products. While bank credit to NBFC sector continues to accelerate sharply, the sharp rise in credit to infrastructure sector is also noteworthy as it is on a high base.

IV.17 Even though banks continued to be the dominant source of finance to the commercial sector, non-bank sources also contributed significantly to the credit requirements of the economy during Q1 of 2011-12 (Table IV.7). The share of non-bank sources to total flow of financial resources increased from about 36 per cent in April-June 2010-11 to 49 per cent in April-June 2011-12, with both domestic and foreign funding increasing. Within domestic sources, net issuance under CPs and NBFC-ND-SI, LIC and housing finance companies (HFCs) increased. The resource flow from external sources went up on account of higher mobilisation through foreign direct investment and external commercial borrowings.

Tight monetary conditions likely to prevail

IV.18 The Reserve Bank has been pursuing an anti-inflationary monetary policy stance since October 2009, with a view to containing inflation and anchoring inflationary expectations. The steady rise in policy rates was reflected in increase in borrowing as well as lending interest rates. As a result, reserve money creation has been restrained. This may keep monetary conditions tight in near term. Credit and money supply growth may decelerate further and help in sustaining monetary transmission.

V. FINANCIAL MARKETS

Interest rates generally firmed up further across the spectrum during Q1 of 2011-12 as monetary transmission strengthened in a liquidity deficit mode. Equity markets remained sluggish but rallied towards the end of the quarter with valuations turning attractive. The Rupee exhibited two-way movement. Financial asset prices generally remained range bound, though property prices stayed on up-course in Q4 of 2010-11. Going forward, the possibility of delayed exit from monetary easing by advanced economies, sovereign default risks in the Euro zone and the possibility of rating downgrades for major economies will have ramifications for capital flows and financial markets.

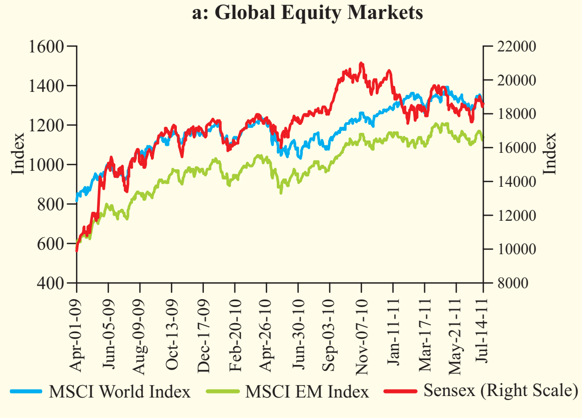
Global financial market conditions remained tepid in Q1 of 2011-12

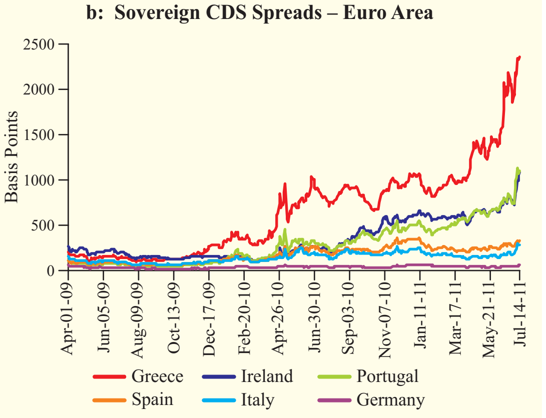
V.1 Global financial markets were generally in a corrective mode since end-April 2011 (Chart V.1a). Stagnant real estate markets, high unemployment and weak sovereign balance sheets in Advanced Economies (AEs) continue to pose major concerns for the financial markets. In the IMF June 2011 Market Update of the Global Financial Stability Report, a rise in the financial risks was reported due to (i) downside risks to the multi-speed recovery baseline; (ii) concern about debt sustainability in Europe's periphery; and (iii) "search for yield" pushing investors into riskier assets. The flattening of yield curves in both AEs as well as Asian Emerging Market Economies (EMEs), particularly since end-March 2011 suggest moderation in economic growth, *albeit* differentially, during 2011-12.

Widening credit spreads, rating downgrades reflect micro and macro prudential risks

V.2 On an average, credit spreads widened during Q1 of 2011-12 as balance sheet risks came to fore. Sovereign Credit Default Swap (CDS) spreads rose sharply in the Euro Area following the accentuation of the Greek debt crisis and the indications that the crisis may spread from periphery to some core Euro zone countries (Chart V.1b). Rating downgrades or downward revision of outlook in case of the US, Japan, Spain and Italy impacted financial market confidence that were reflected in widening spreads. Amplification of refinancing risks in Greece and Portugal and the sharp four-notch downward revision by Moody's of Portugal's credit rating to junk status with a negative outlook in early July reconfirmed the Euro zone fragilities.

Chart V.1: Indicators of Global Financial Market Developments





V.3 Recapitalisation of the banking system in the fragile Euro zone countries is the most important element of an enduring Euro zone solution. The stress tests conducted by the European Banking Authority (EBA) have not succeeded in restoring confidence amongst investors and creditors. The EU needs to deal with capital shortfalls for banks that fail stress tests, but market access is limited for weaker sovereigns like Greece, Portugal and Ireland. On the other hand, with hardly any fiscal space and the potential moral hazard risk from bailouts, the solution is not easy. Euro zone risks may lead to global financial market volatility.

Financial risks increased while interest rates softened

V.4 While interest rates are firming up in the Indian economy, global financial markets witnessed rising financial risks and softening interest rates in Q1 of 2011-12. Libors for 1-month to 1-year tenors edged down marginally even from the low prevailing rates. G-sec yields across maturity spectrum eased by 30-50 bps in 5-10 year segment for the US, the UK and Germany. Falling interest rates co-existed with (1) policy rate hikes by some AE central banks, most notably by the ECB in April and again in July, (2) rising sovereign and credit spreads and (3) inflation in the AEs with escalating energy and food prices that have spilled over to rising producer price and headline inflation. It remains to be seen whether the movements in interest rates reflect temporary overreaction or are on the basis of expectations of future global growth.

Indian financial markets remain orderly and range bound

V.5 Even as domestic and global factors resulted in two-way movements in the Indian financial markets, asset price movements remained broadly range-bound and orderly. This was despite the challenges posed by persistent inflation, tight liquidity conditions and uncertainty in the international markets on account of Greek sovereign debt crisis and slowdown in AEs.

V.6 The call rate declined in the beginning of Q1 of 2011-12 on the backdrop of surplus liquidity, but firmed up thereafter, in step with policy rate hikes since May 2011. The interest rates on commercial paper (CP) and Certificates of Deposit (CDs) moved in tandem with the overnight money market rates. The yield curve for Government securities (G-sec) shifted upwards during the first two months of the quarter in line with the policy rate hike, but moderately shifted downwards in June 2011.

Table V.1: Stock Price Movement and PE Ratios in EMEs (Year-on-Year Variations)

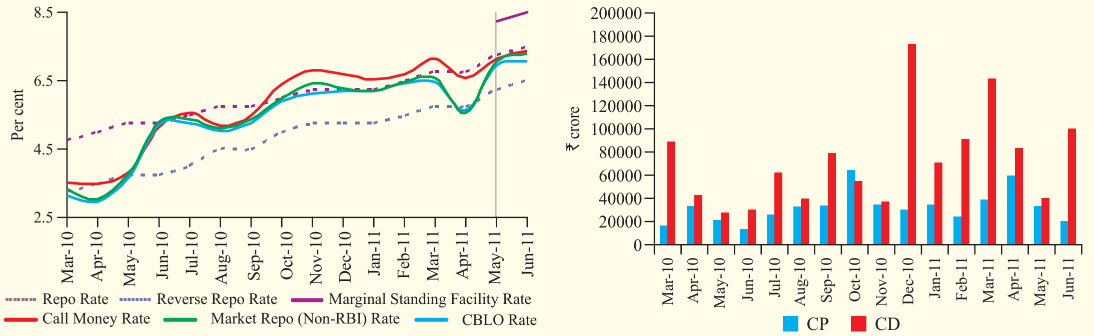
Items	Stock Price Variations (Per Cent)			P/E- Ratios		
	End-Mar 2010@	End-Mar 2011@	End-Jun 2011*	End-Mar 2010	End-Mar 2011	End-Jun 2011
1	2	3	4	5	6	7
Indonesia (Jakarta Composite)	93.7	32.5	5.7	16.6	16.9	17.9
Brazil (Bovespa)	71.9	-2.5	-9.0	16.2	10.9	9.8
Thailand (SET Composite)	82.6	32.9	-0.6	12.4	13.3	13.3
India (BSE Sensex)	80.5	10.9	-3.1	17.7	17.6	17.1
South Korea (KOSPI)	40.3	24.4	-0.3	12.2	13.8	13.9
China (Shanghai Composite)	31.0	-5.8	-5.7	23.0	16.3	15.4
Taiwan (Taiwan Index)	52.0	9.6	-0.4	19.1	15.7	15.5
Russia (RTS)	128.0	30.0	-6.7	9.0	8.4	7.6
Malaysia (KLCI)	51.3	17.0	2.2	18.9	17.0	16.8
Singapore (Straits Times)	69.9	7.6	0.5	13.4	10.3	10.5

@: Year-on-year variation. *: Variation Over End-March 2011.

Source: Bloomberg.

Chart V.2: Movement in Money Market Rates and Turnover

a: Policy Rates and Money Market Rates | **b: Monthly Issuance of CP and CD**



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

Note: CP data for June 2011 is for the first half of the month.

V.7 Stock prices fell during Q1 of 2011-12, *albeit* at a lesser pace than that of other BRIC nations, influenced by domestic and global concerns. There was, however, some rally towards the end of the quarter due to FII inflows. The P-E ratio of Indian equities was higher than those of other BRIC nations (Table V.1). On a quarter-on-quarter basis, prices in the housing market firmed up during Q4 in majority of cities tracked by the Reserve Bank after showing signs of moderation during Q3 of 2010-11.

Money market rates firm up on tight liquidity and rate hikes but do not exhibit signs of stress

V.8 Short-term rates moved up further, but there were no signs of stress in money markets. The interest rate movement tracked the 75 bps repo rate hike during the quarter and the tight liquidity conditions. Monetary transmission strengthened further during Q1 of 2011-12. The call rate, which had declined in April 2011 on the back of easing of liquidity conditions, firmed up thereafter, in response to the increase in the repo rate in May and June 2011 (Chart V.2a, Table V.2). The rates in the collateralised segments (*i.e.*, CBLO and market repo) moved in tandem with the call rate, but generally remained below it.

V.9 Transaction volumes in the CBLO and market repo segments were higher during the Q1 of 2011-12 than in the preceding quarter (Table V.3). During the quarter, banks and primary dealers were the major groups of borrowers in the collateralised segments

Table V.2: Domestic Financial Markets at a Glance

	Money Market					Bond Market		Forex Market	Stock Market Indices	
	Call Rate* (Per cent)	Market Repo Rate (Non-RBI) (Per cent)	CBLO Rate (Per cent)	Commercial Paper WADR (Per cent)	Certificates of Deposit WAEIR (Per cent)	G-Sec 10-year yield@ (Per cent)	Corporate Bonds Yield AAA 5-Yr bond (Per cent)	Exchange Rate@@ (₹/US$)	CNX Nifty#	BSE Sensex#
1	2	3	4	5	6	7	8	9	10	11
Mar-10	3.51	3.32	3.15	6.29	6.07	7.94	8.61	45.50	5178	17303
Mar-11	7.15	6.56	6.46	10.40	9.96	8.00	9.23	44.99	5538	18457
Apr-11	6.58	5.55	5.63	8.62	8.66	8.05	9.25	44.37	5839	19450
May-11	7.15	7.05	6.94	9.49	9.30	8.31	9.48	44.90	5492	18325
Jun-11	7.38	7.30	7.06	10.15^	9.61	8.28	9.63	44.85	5473	18229

*: Average of daily weighted call money borrowing rates. #: Average of daily closing indices.
@: Average of daily FIMMDA closing rates. @@: Average of daily RBI reference rate. ^: As at mid-June 2011.
WADR: Weighted Average Discount Rate. WAEIR: Weighted Average Effective Interest Rate.

Table V.3: Average Daily Volumes in Domestic Financial Markets

(₹ crore)

	Money Market						Bond Market		Forex Market	Stock Market#
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificates of Deposit*	G-Sec@	Corporate Bond	Inter-bank (US$ mn)	
1	2	3	4	5	6	7	8	9	10	11
Mar-10	37,640	8,812	19,150	60,006	75,506	3,41,054	6,621	1,598	16,082	9,191
Mar-11	-80,963	11,278	15,134	43,201	80,305	4,24,740	8,144	1,314	22,211	7,276
Apr-11	-18,809	13,383	14,448	56,160	1,24,991	4,47,354	6,928	1,053	25,793	8,277
May-11	-54,643	10,973	15,897	40,925	1,21,221	4,33,287	7,356	691	24,167	6,668
Jun-11	-74,125	11,562	16,650	41,313	1,23,400^	4,23,767	12,844	1,168	19,099**	6,404

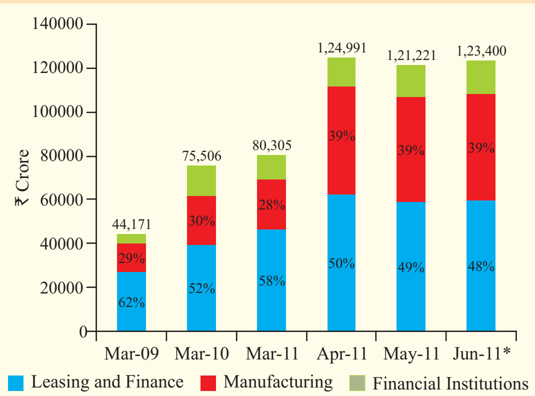
*: Outstanding position. @: Average daily outright trading volume in Central Government dated securities.
#: Volumes in BSE and NSE. ^: As at mid-June 2011. **: Up to June 24, 2011.
Note: In col. 2, (-) ve sign indicates injection of liquidity while (+) ve sign indicates absorption of liquidity.

whereas mutual funds (MFs) contributed nearly three-fourth of the total lending in CBLO, and more than half in market repo segment. The collateralised segment of the overnight money market remained dominant, accounting for more than 80 per cent of the total volume during Q1 of 2011-12.

V.10 With from strong growth in retail deposit mobilisation, banks offered a relatively lower rate of interest on CDs during 2011-12 so far (up to June 17) compared with the previous quarter. The CD issuance declined in Q1 of 2011-12. In contrast, the CP issuance increased. The 'leasing and finance' and 'manufacturing companies' were the major issuers of CPs (Chart V.2b, V.3).

V.11 Primary yields on Treasury Bills (TBs) firmed up during Q1 of 2011-12 in line with

Chart V.3: Major Issuers of Commercial Paper



Note: Data up to June 15, 2011.

the spike in short-term interest rates (Table V.4). The rise in yields reflected a sharp increase in Government short-term borrowing, through issuances of TBs over and above the amount as per the indicative calendar announced in March 2011 as also through issuances of Cash Management Bills (CMBs) to meet the unanticipated sharp cash flow mismatches, particularly, in the wake of large tax refunds.

Yield curve flattens with sharper rise at the short end

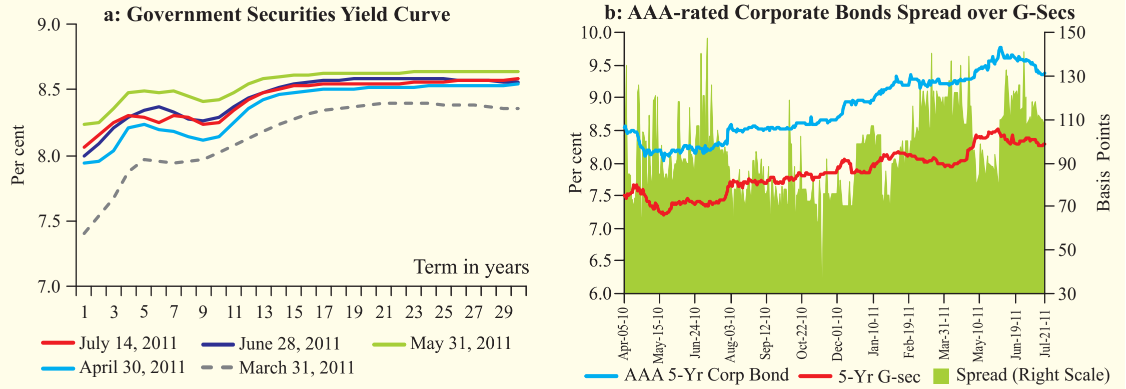
V.12 Reflecting the larger than anticipated issuances of TBs and CMBs by the Government, and the higher than expected hike in the Reserve Bank's policy rate in May 2011, the G-sec yield curve shifted up, particularly at the short end, flattening the yield curve. The rise in yields across the maturity spectrum also

Table V.4: Treasury Bills in the Primary Market

Year/ Month	Notified Amount (₹ crore)	Average Implicit Yield at Minimum Cut-off Price (Per cent)		
		91-day	182-day	364-day
1	2	3	4	5
2009-10	3,80,000	3.57	3.97	4.38
2010-11	3,03,000	6.18	6.48	6.56
Apr-11	30,000	7.32	7.60	7.65
May-11	44,000	8.05	8.24	8.25
Jun-11	53,000	8.21	8.19	8.32
Jul-11*	20,000	8.16	8.27	8.27

*: Up to July 15, 2011.

Chart V.4: Turnover and Yield in the Bond Market



Source: FIMMBA

Source: Bloomberg

reflected the increase in the global commodity prices, including crude oil, and persistent high inflation. The yield curve, however, moved downward thereafter in the wake of growth concerns and moderation in crude oil prices (Chart V.4a).

V.13 In the context of inflationary pressures and tight liquidity conditions, the primary market yields moved up. The weighted average yield in primary auctions firmed up during Q1 of 2011-12 (Table V.5). The investor sentiment, however, was largely sustained. The bid-cover ratio stood in the range of 1.39-3.20 during Q1 of 2011-12 as against 1.39-3.87 during the corresponding quarter of the previous year. In view of the flattening yield curve, more long dated securities were issued and accordingly, the weighted average maturity of the dated securities issued during Q1 of 2011-12 increased.

V.14 During 2011-12 so far (up to July 15, 2011), 13 States raised ₹31,773 crore on a gross basis as compared with ₹28,210 crore raised during the corresponding period of 2010-11.

V.15 The spreads of 5-year corporate bonds over comparable G-secs decreased during May 2011, reflecting the impact of unanticipated increase in Government short-term borrowing. The spreads increased in June mainly reflecting the hardening of corporate bond yields (Chart V.4b).

Monetary transmission strengthens with rates hardening in the credit market

V.16 Monetary policy transmission to credit market strengthened further during Q1 of 2011-12 as banks increased their deposit and lending rates in response to the increase in the policy rate by the Reserve Bank (Table V.6). During Q1 of 2011-12, deposit rates of banks were increased in the range of 10-300 basis points (bps) across all maturities. Twenty-three major banks accounting for around 65 per cent of the total bank deposits raised their deposit rates in the range of 25-175 bps. The rise in deposit rates was relatively sharper for maturities up to 1 year for all categories of banks. As savings account deposits constitute around a quarter of total deposits, the 50 bps hike in the savings deposit rate also increased the cost of funds for the banks. During the quarter, all scheduled

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

Item	2009-10	2010-11	2011-12*
1	2	3	4
Central Government			
Gross amount raised (₹crore)	4,51,000	4,37,000	1,59,000
Devolvement on Primary Dealers (₹crore)	7,219	5,773	1,506
Bid-cover ratio (range)	1.44-4.32	1.39-3.88	1.39-3.20
Weighted average maturity (years)	11.16	11.62	12.35
Weighted average yield (per cent)	7.23	7.92	8.38
State Governments			
Gross amount raised (₹crore)	1,31,122	1,04,039	31,773
Cut-off yield range (per cent)	7.04-8.58	8.05-8.58	8.36-8.69
Weighted average yield (per cent)	8.11	8.39	8.57

*: Up to July 15, 2011.

Table V.6: Deposit and Lending Rates of Banks

(Per cent)

	Sep-10	Dec-10	Mar-11	Jun-11
1	2	3	4	5
Domestic Deposit Rate (1-3 years tenor)				
(i) Public Sector Banks	6.75-7.75	7.00-8.50	8.00-9.75	8.25-9.75
(ii) Private Sector Banks	6.50-8.25	7.25-9.00	7.75-10.10	8.00-10.50
(iii) Foreign Banks	3.00-8.00	3.50-8.50	3.50-9.10	3.50-10.00
Base Rate				
(i) Public Sector Banks	7.50-8.25	7.60-9.00	8.25-9.50	9.25-10.00
(ii) Private Sector Banks	7.00-8.75	7.00-9.00	8.25-10.00	8.50-10.50
(iii) Foreign Banks	5.50-9.00	5.50-9.00	6.25-9.50	6.25-9.50
Median Lending Rate*				
(i) Public Sector Banks	7.75-13.50	8.75-13.50	8.88-14.00	-
(ii) Private Sector Banks	8.00-15.00	8.25-14.50	9.00-14.50	-
(iii) Foreign Banks	7.25-13.00	8.00-14.50	7.70-14.05	-

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

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

commercial banks increased their Base Rates in the range of 25-225 bps, of which 47 major banks with a credit share of around 98 per cent raised their Base Rates by 50-125 bps.

Exchange rate remains flexible with less volatility

V.17 During 2011-12 so far (up to July 20, 2011), the rupee appreciated marginally against all major currencies barring the Japanese Yen, reflecting in part the dollar's movement in the international currency markets due to uncertainty of growth prospects in the US (Chart V.5a). The average daily turnover in the interbank segment of the foreign exchange market was higher while it was lower in the merchant segment than that in the preceding quarter. The 1-month, 3-month as well as 6-month forward premia declined significantly during the quarter, reflecting an increased supply by exporters in the forward market. The Reserve Bank did not intervene in the forex market during 2011-12 so far.

V.18 The average daily turnover in the exchange traded currency derivatives grew by 1.7 per cent when compared with the negative growth of 2.8 per cent in the previous quarter (Chart V.5b). Options recorded a higher growth rate than futures. In the OTC currency derivatives, the swap segment continued to dominate. The average daily turnover in the

Chart V.5: Trends in Forex Market

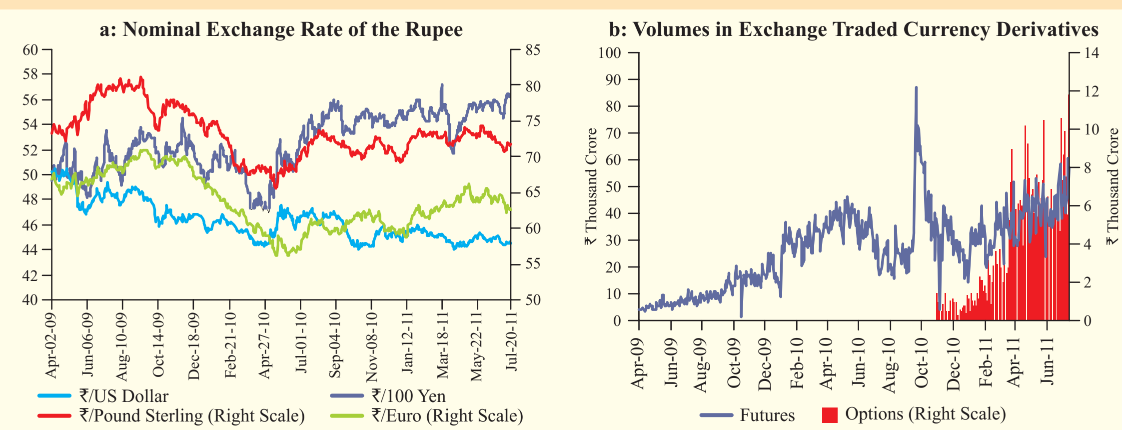


Table V.7: Key Stock Market Indicators

Indicator	BSE Sensex		NSE Nifty	
	2010-11	Apr-Jun 2011-12	2010-11	Apr-Jun 2011-12
1	2	3	4	5
BSE Sensex/NSE Nifty				
(i) End-period	19445.22	18845.87	5833.75	5647.40
(ii) Average	18605.18	18617.73	5583.54	5585.97
Coefficient of Variation	6.32	3.28	6.40	3.31
Price-Earning Ratio@	21.25	19.94	22.14	20.82
Price-Book Value Ratio	3.70	3.48	3.70	3.50
Market Capitalisation to GDP Ratio (per cent)@	86.80	74.90	85.10	73.20

@: As at end-period.
Source: Bombay Stock Exchange Ltd. (BSE) and National Stock Exchange of India Ltd. (NSE).

OTC market grew by around 14.8 per cent during Q1 of 2011-12 as compared with a negative growth of 3.7 per cent during the previous quarter.

Equity markets remained sluggish and less volatile

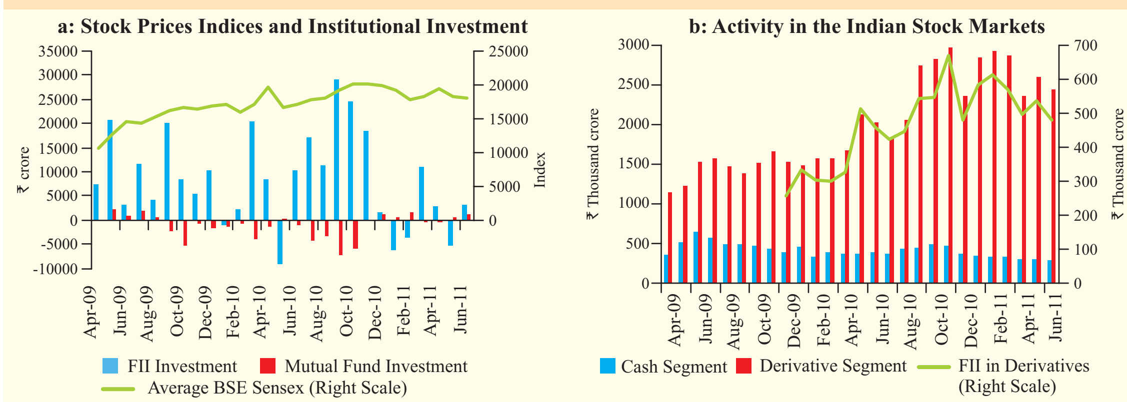
V.19 Volatility in equity markets declined substantially in the post-crisis period. This declining trend continued into Q1 of 2011-12. Although, in relative terms, the performance of the Indian equity markets was better than that of other BRIC nations during Q1, the two key indices, Sensex and Nifty, declined by about 3 per cent (Table V.7). Rising crude oil prices, persistently high inflation, successive policy rate hikes by the Reserve Bank, domestic political developments and the worsening Greek sovereign debt crisis affected market sentiment negatively. Net investment by FIIs in equity and debt segments was US$ 1.0 billion during Q1 of 2011-12, of which flows to equity market amounted to US$ 0.8 billion (Chart V.6). Equity markets, however, rallied towards end-June with a revival in FII investments.

V.20 Stock price returns are affected by stock return volatility, and the extent of impact depends crucially on the permanence of shocks to the variance in returns. An analysis of the returns from the broad based S&P CNX Nifty index against the backdrop of the financial crisis and monetary policy action demarcates the time varying volatility persistence in the returns data (Chart V.7 a and b). The variability in returns, controlling for all other past factors, shows a sharp decline from the crisis period and appears to be moderating.

V.21 Turnover in the equity derivatives segment constituting almost 90 per cent of the overall investments, witnessed some moderation during Q1 of 2011-12. Volatility in Nifty index options as measured by the India Volatility Index (VIX) was lower in Q1 of 2011-12 than Q4 of 2010-11.

V.22 The resource mobilisation in the primary segment of the domestic capital market through public issues was lower during Q1 of 2011-12 than the corresponding quarter of the previous year (Table V.8). Poor performance of the IPOs after their listing affected investor and promoter sentiments.

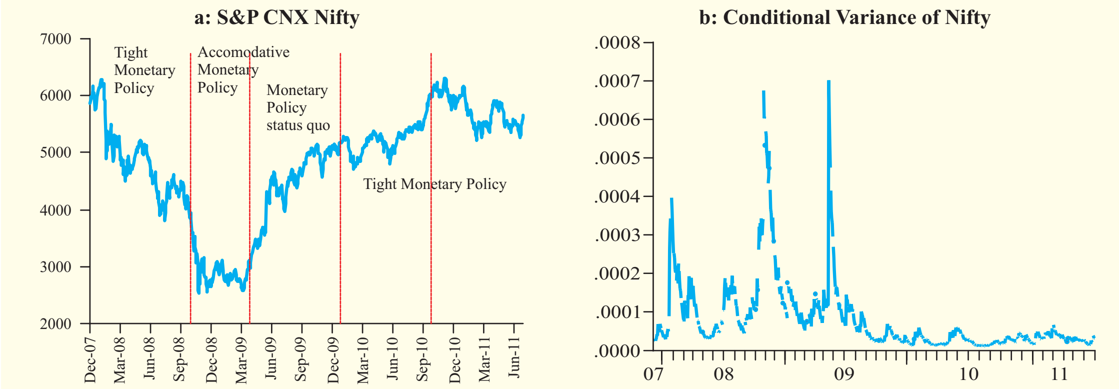
Chart V.6: Movement in Stock Prices and Turnover



Source: SEBI

Note: Data for FII investment in derivatives is available only from December 2009.

Chart V.7: Indian Stock Market Performance



Note: Variants of GARCH (Generalised Auto Regressive Conditional Heteroskedastic) models allow for effective modeling of conditional variance in returns.

V.23 Resource mobilisation by mutual funds during April-June 2011 was higher than that during the corresponding period of the previous year, although there were net outflows during May-June 2011, particularly in debt mutual funds. The increase in dividend distribution tax for non-retail investors in liquid/debt mutual funds effective from June 1, 2011 and the cap of 10 per cent of net worth placed on banks' investment in liquid/debt funds which will be made effective over a six-month period beginning July 5, 2011, could have affected flows into debt mutual funds.

Table V.8: Resource Mobilisation from Capital Market

(₹ crore)

Category	2010-11 (Apr-Mar)	2010-11 (Apr-Jun)	2011-12 (Apr-Jun)
1	2	3	4
Prospectus and Rights Issues*	37,620	7,737	7,000
1. Private Sector (a+b)	24,831	7,737	2,422
(i) Financial	4,335	2,550	901
(ii) Non-financial	20,496	5,187	1,521
2. Public Sector	12,790	0	4,578
Euro Issues	9,441	4,844	1,237
Mutual Fund Mobilisation(net)@	-49,406	3,547	73,039
1. Private Sector	-19,215	14,109	64,425
2. Public Sector#	-30,191	-10,562	8,614

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

Housing prices and transaction volumes rise in Q4 of 2010-11

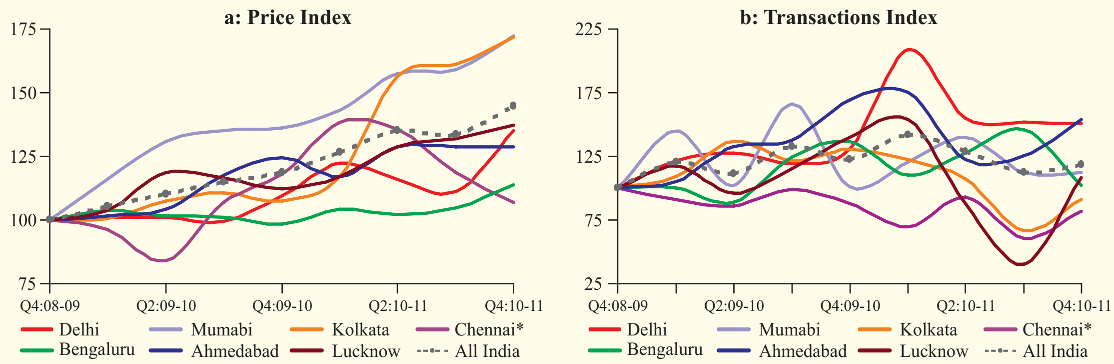
V.24 Property prices increased during 2010-11, despite firming up of mortgage rates. The Reserve Bank's Quarterly House Price Index (HPI) based on data in respect of seven cities collected from the Department of Registration and Stamps (DRS) of the respective State Governments show that house prices in five of the seven major cities were higher on a quarter-over-quarter basis in Q4 of 2010-11, but were flat in Ahmedabad and had continued to fall in Chennai (Chart V.8). The data on volume of transactions show that after stalling in Q3, transactions increased during Q4 of 2010-11. On a year-on-year basis, there has been an increase in housing prices in Q4 in six cities (*i.e.,* barring Chennai). Housing transactions, however, fell in five of the seven cities (*i.e.,* barring Delhi and Mumbai).

Market volatility could resurface if macro conditions deteriorate

V.25 The subdued current market volatility is no guidance for future. Financial market volatility can return if macro conditions worsen.

V.26 Indian financial markets would continue to be influenced by the global as well as domestic factors. Money market rates would continue to be conditioned by monetary policy

Chart V.8: Trends in Housing Indices



Note: 1. * Index for Chennai contains both residential and commercial properties.
2. All India Index is a weighted average of indices of 7 cities based on population.

actions. If prolonged inflation feeds into inflationary expectations, it would affect all segments of the markets, particularly the G-sec markets. A widening of the fiscal deficit leading to a higher than budgeted market borrowings could also exert upward pressure on G-sec yields. A slowdown in economic growth could affect corporate performance which, in turn, would weigh on equity markets.

VI. PRICE SITUATION

In line with the projection made in the Annual Policy statement, inflation remained high in Q1 of 2011-12. The revision in fuel prices effected in June 2011 was factored in the projected inflation path which reduces, but does not fully eliminate the suppressed inflation risks. Softening of global commodity prices may provide some respite in the short-run. The favourable impact of a near normal monsoon on food inflation, however, could be offset by hike in minimum support prices. Non-food manufactured products inflation remains significantly higher than the long-term average of about 4 per cent, and reflects the persistence of pricing power. Apart from supply-side factors, demand pressures need to soften further for containing inflation. Price pressures are expected to persist through Q2 as well and then moderate in the later part of 2011-12.

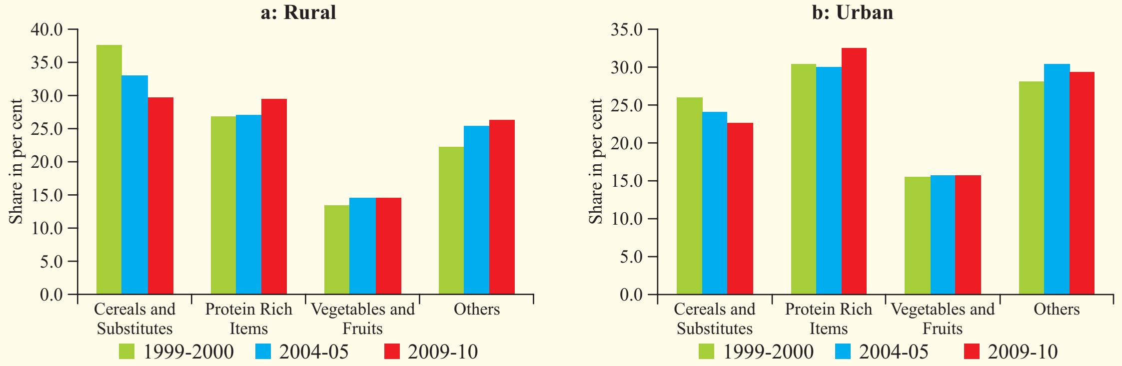
Near-term upside risks to inflation remain significant

VI.1 Inflationary pressures persisted during Q1 of 2011-12 (9.4 per cent y-o-y, provisional in June 2011), reflecting transmission of global commodity prices to domestic inflation as well as increase in manufactured product prices on account of sustained input cost pressures. Producers were able to considerably pass on high costs amidst strong consumption demand. Global commodity prices exhibited some moderation in the recent period. However, as administered fuel prices were not raised earlier when global prices had risen sharply, a revision of fuel prices became inevitable and was effected on June 25, 2011. Even after this revision the pass-through is incomplete and remains a source of upside risk during the year.

VI.2 For many other commodities pass-through remains incomplete, limiting the possibility of domestic prices falling in tandem with softening global prices. On the other hand, should global commodity prices start firming up again there will be further pressure on domestic prices. In any case, sticky administered prices pose a fiscal risk as they entail larger subsidies. They are also a source of inflation in the medium-to-long run as they dampen supply response by keeping interest rates high and resulting in a drag on investment. There are other sources of likely price pressures during the course of the year. Utility prices, especially electricity, may need to be revised up to cover costs. Domestic fertiliser prices still remain disconnected with higher prices of imported fertilisers and fertiliser inputs. Large discrete changes in administered prices also affect inflation expectations.

VI.3 Primary food articles inflation moderated to 9.1 per cent in Q1 of 2011-12 from over 20 per cent level seen in Q1 of 2010-11, largely reflecting base effect as index levels continued to increase reflecting the structural character of inflation especially in protein rich items. Latest data available from NSSO quinquennial consumer expenditure survey (2009-10) suggests that there has been a secular shift in dietary pattern towards protein rich food items, both in rural and urban areas. Price pressures in these items could continue in the absence of supply response, as was seen in recent years (Chart VI.1). Renewed pressures may also come from revision in Minimum Support Prices (MSP). Non-food manufactured products inflation persisted at very high levels compared to its historical average and may persist as cost pressures and pricing power remain significant.

Chart VI. 1: Changing Composition of Food Consumption



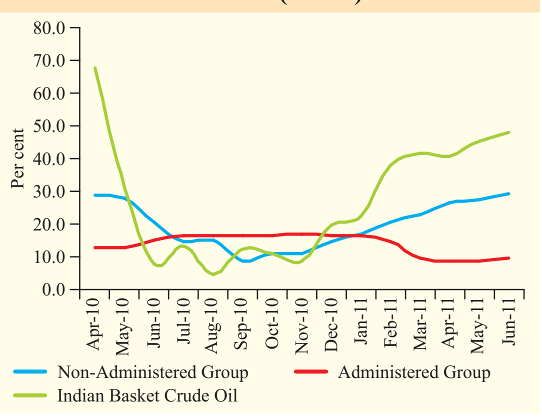
Note: Protein rich items include pulses, milk & products, egg fish and meat. Others include edible oil, sugar, salt & spices, beverages *etc.*
Source: NSSO, Key Indicators of Household Consumer Expenditure in India, 2009-10.

Administered price revisions and increase in freely priced fuel products keep fuel inflation high

VI.4 The suppressed inflation concern, expressed in this Report in the preceding quarter came to roost, but this price adjustment is a significant step forward in strengthening the macroeconomic position of the Indian economy. Pass-through of international crude prices to domestic inflation has been significant in the recent period with most of the items under the freely priced category registering increases (Chart VI.2). International crude oil prices, though registered some decline in recent months, remain elevated as compared to the previous year.

VI.5 As domestic administered prices of fuel products were kept unchanged for one year, this had led to substantial increase in the magnitude of under recoveries leading to corresponding large increase in fiscal burden. On June 25, 2011 the Government decided to increase the price of diesel by ₹3 per litre, PDS kerosene by ₹2 per litre and of domestic LPG by ₹50 per cylinder and reduce the excise as well as custom duties to partly address the issue of under recoveries. The direct impact of this increase on WPI inflation was 0.7 percentage points. Given that monthly WPI is an average of weeks, the full impact of this increase would be seen in the WPI for the month July 2011, as the price revision was effected in the last week of June 2011.

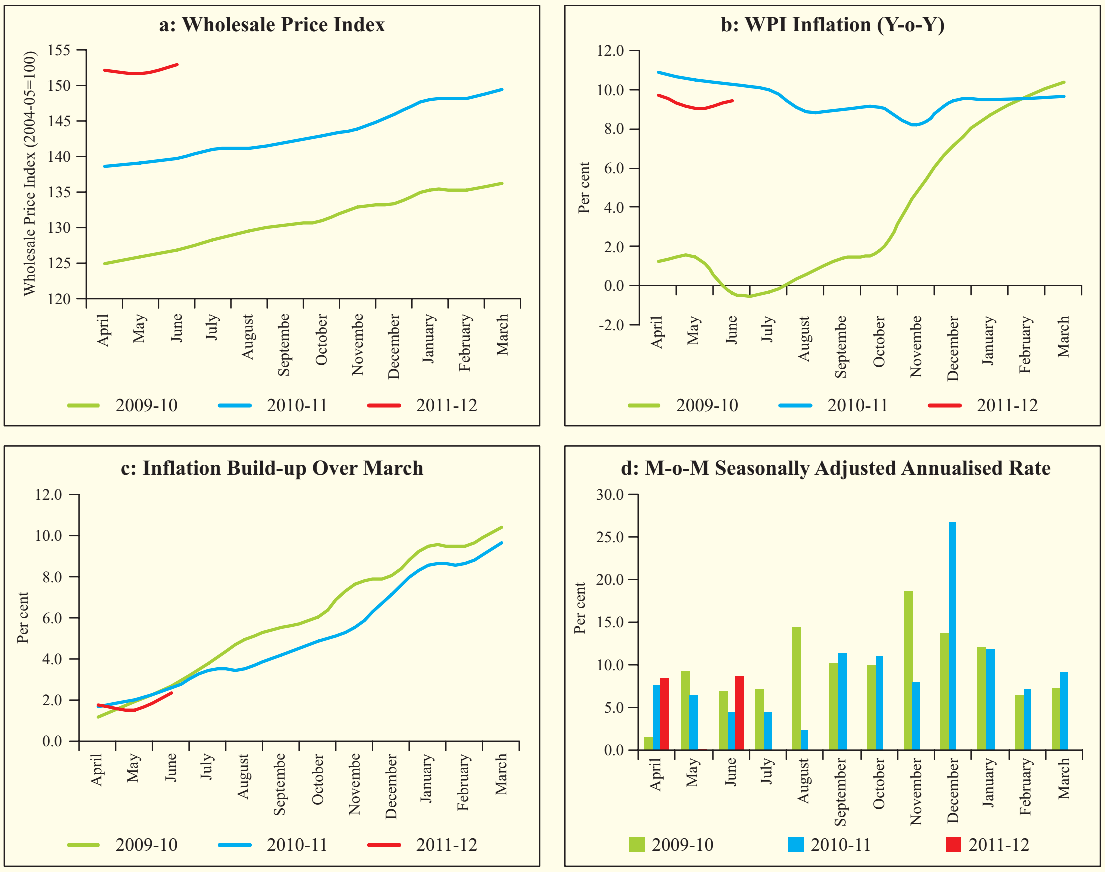
Chart VI.2: Global and Domestic Fuel Inflation (Y-o-Y)



Inflation still driven by both cost-push and demand-side pressures

VI.6 The generalisation of inflation with significant cost-push and demand side factors driving price changes in non-food manufacturing commodities has extended into Q1 of 2011-12. The wholesale price index (WPI) has continued its uptrend during 2011-12 so far even though year-on-year WPI inflation declined marginally in April 2011, owing to the high base. Inflation edged up in May and June 2011 reflecting continued price pressures. This was corroborated by the month over month seasonally adjusted changes which remained significantly positive during the recent period (Chart VI.3). The m-o-m rate of change in WPI

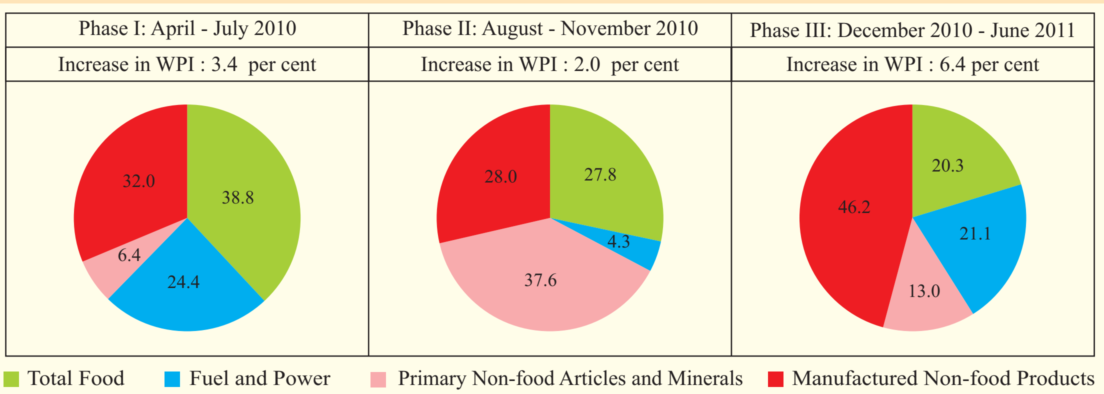
Chart VI.3: Trends in Wholesale Price Inflation



suggests that the build-up of price pressures has varied significantly over months, but remained positive in almost every successive month.

VI.7 Importantly, the underlying drivers of increase in WPI changed considerably over three phases since March 2010. Price rise since December 2010 reflects generalisation of the inflationary pressures as also the dominant contribution from non-food manufactured products inflation (Chart VI.4). The food group had the highest contribution to the increase in WPI during the first phase (between April and

Chart VI.4: Changing Weighted Contributions to Increase in WPI



Note: Pie Charts represent the contribution (in per cent) of different sub-groups to increase in WPI (adjusted for rounding up).

July 2010). Primary non-food articles, particularly fibres like raw cotton, raw jute and raw silk had the dominant contribution in the second phase (between August and November 2010). It may also be noted that, the contribution of food group to overall increase in WPI has declined over successive phases.

Non-food manufactured products inflation key to inflation concern

VI.8 The significant pick-up in non-food manufactured products inflation since December 2010 has been largely driven by pass-through of input cost pressures to output prices. Without the presence of demand pressures, the generalisation process would not have sustained over successive months. High month-over-month seasonally adjusted inflation indicates that the price pressures have been almost continuous (Chart VI.5).

VI.9 Textiles, chemicals and metals continue to contribute to most of the increase in manufactured non-food products (Chart VI.6). Input cost pressures have been significant for these products. Any moderation in manufactured non-food products inflation therefore would require both easing of pressures from input cost side as well as demand. Electricity price inflation remains moderate but given the increases in coal and mineral oils prices, electricity prices are likely to rise in the near-term.

Chart VI.5: Manufactured Non-food Products: Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes

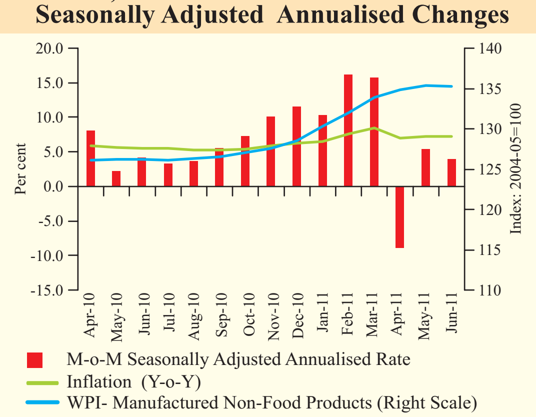
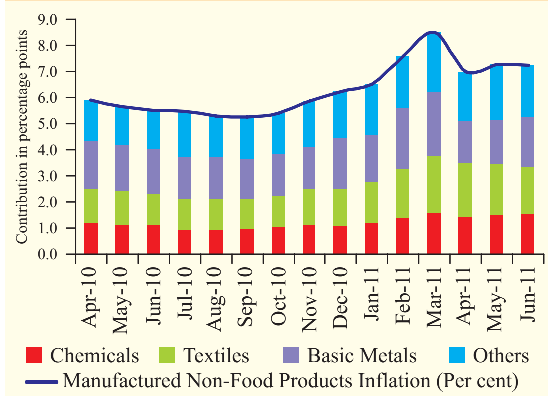


Chart VI.6: Major Contribution to Non-food Manufactured Products Inflation



Inflation surprise in advanced countries changes global inflation dynamics

VI.10 Inflation emerged as a key policy concern in the global economy in recent months as increase in commodity prices spilled over to headline inflation. The World Economic Outlook Update (June 2011) of the IMF revised upwards the projection of inflation for 2011 for advanced economies to 2.6 per cent (from 2.2 per cent earlier projected in April 2011) while for emerging economies it was kept unchanged (6.9 per cent). Though core inflation in advanced economies remains subdued indicating absence of significant pressures from domestic demand, headline inflation has exceeded the target level for most inflation targeting economies. The divergence in inflation between advanced and emerging economies is both on account of higher share of food and fuel in total consumption basket as well as buoyant demand due to faster recovery in EMEs. The increase in unit labour costs in EMEs is being seen as a risk to global price stability because of the growing internationalisation of supply chains.

VI.11 Subdued core inflation provided the space to most advanced economies to continue with accommodative monetary policy. The BIS, in its annual report 2010-11, however, cautions that the degree of global economic slack may be much less than what is generally believed and hence, inflationary pressures could stem from global recovery running into capacity constraints. Accommodative monetary policy conditions also entail the risk of adding to commodity price pressures. Most central banks of advanced economies continue to pursue policy rates at near zero/very low levels, while emerging economies have gradually tightened monetary policy to contain inflation pressures (Table VI.1).

Commodity prices ease with global growth weakening, unclear if this is transitory

VI.12 Global commodity prices have exhibited some decline in the Q1 of 2011-12, largely driven by improved supply prospects as well as some unwinding of investment positions in commodity futures market by financial investors. Crude oil prices moderated on the back of 28 International Energy Agency (IEA) member countries agreeing to release 60 million barrels of oil in July 2011 (Chart VI.7). Food prices have also moderated somewhat as supply response to high prices are expected to be good along with removal of trade restrictions by a number of countries. However, the prices continue to rule at significantly high levels.

VI.13 Declining stocks in many key commodities also indicate that the price decline seen recently may not sustain for a prolonged period of time. The FAO-OECD Agricultural outlook for 2011-20 indicates that short-term supply response may temporarily ease price pressures but food prices "... on an average are projected to remain on a higher plateau compared to the previous decade in both nominal and real terms." Rising income, diversification of dietary pattern to more protein-rich items as well as attraction of bio-

Table VI.1: Global Inflation Indicators

(Per cent)

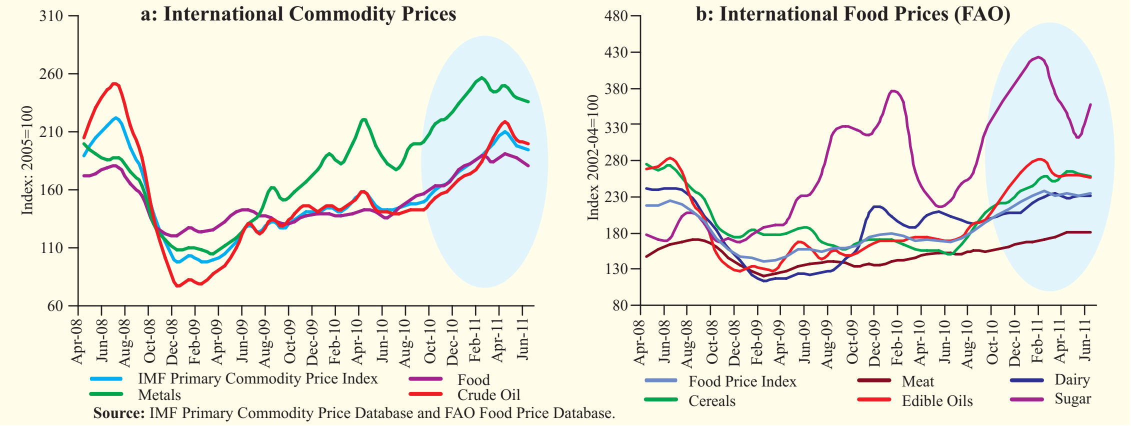
Country/ Region	Key Policy Rate	Policy Rate	(as on July 22, 2011)	Changes in Policy Rates (basis points)		CPI Inflation (y-o-y)	
				Sep, 15. 08 to Aug. 23, 09	Since Aug. 23, 09	June-10	June-11
1	2	3		4	5	6	7
Developed Economies							
Australia	Cash Rate	4.75	(Nov. 3, 2010)	(-) 400	175	2.9 ^	3.3 ^
Canada	Overnight Rate	1.00	(Sep. 8, 2010)	(-) 275	75	1.0	3.1
Euro area	Interest Rate on Main Refinancing Operations	1.50	(Jul. 13, 2011)	(-) 325	50	1.5	2.7
Japan	Uncollateralised Overnight Call Rate#	0.0 to 0.10	(Oct. 5, 2010)	(-) 40	(-) 10	-0.7*	0.3*
UK	Official Bank Rate	0.50	(Mar. 5,2009)	(-) 450	0	3.2	4.2
US	Federal Funds Rate#	0.0 to 0.25	(Dec.16,2008)	(-) 200	0	1.1	3.6
Developing Economies							
Brazil	Selic Rate	12.50	(Jul. 21, 2011)	(-) 500	375	4.8	6.7
India	Repo Rate	7.50	(Jun.16, 2011)	(-) 425	275	13.9*	8.7*
				(-400)	(100)		
China	Benchmark 1-year Deposit Rate	3.50	(Jul. 7, 2011)	(-) 214	125	2.9	6.4
	Benchmark 1-year Lending Rate	6.56	(Jul. 7, 2011)	(-) 241	125		
				(-200)	(600)		
Indonesia	BI Rate	6.75	(Feb. 4, 2011)	(-) 275	25	5.0	5.5
Israel	Key Rate	3.25	(Jun. 1, 2011)	(-) 375	275	2.4	4.2
Korea	Base Rate	3.25	(Jun. 10, 2011)	(-) 325	125	2.6	4.4
Philippines	Reverse Repo Rate	4.50	(May. 5, 2011)	(-) 200	50	3.6	5.2
	Repo Rate	6.50	(May. 5, 2011)	(-) 200	50		
Russia	Refinancing Rate	8.25	(May. 3, 2011)	(-) 25	(-) 250	5.8*	9.6*
South Africa	Repo Rate	5.50	(Nov. 19, 2010)	(-) 500	(-) 150	4.2	5.0
Thailand	1-day Repurchase Rate	3.25	(Jul. 13, 2011)	(-) 250	200	3.3	4.1

^ : Q4 of 2010-11. # : Change is worked out from the minimum point of target range. *: May.

Note: 1. For India, data on inflation pertain to CPI for Industrial Workers.
2. Figures in parentheses in column (3) indicate the effective dates when the policy rates were last revised.
3. Figures in parentheses in column (4 & 5) indicate the variation in the cash reserve ratio during the period.

Source: Websites of respective central banks/statistical agencies.

Chart VI.7: Trends in Global Commodity Prices



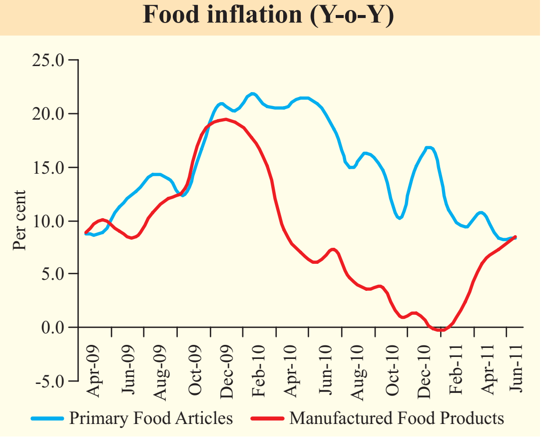
Source: IMF Primary Commodity Price Database and FAO Food Price Database.

fuel as an alternative source of energy could contribute to market tightness.

Food inflation declines significantly, but seasonal and structural factors still important

VI.14 Primary food articles inflation declined significantly over past few months, barring December 2010-January 2011 when the trend reversed temporarily (Chart VI.8). The decline, however, has not been significant enough to ease the concern on food inflation. Moreover, it largely reflects the base effect, since food price levels continue to be high (Chart VI.9). Moreover manufactured food products inflation, which declined sharply during 2010-11 has reversed course in recent months. This is mainly led by increase in prices of edible oils, milk products and tea & coffee indicating that the past increases in primary food prices are getting reflected in manufactured food price increases, with a lag.

Chart VI.8: Primary Food and Manufactured Food inflation (Y-o-Y)

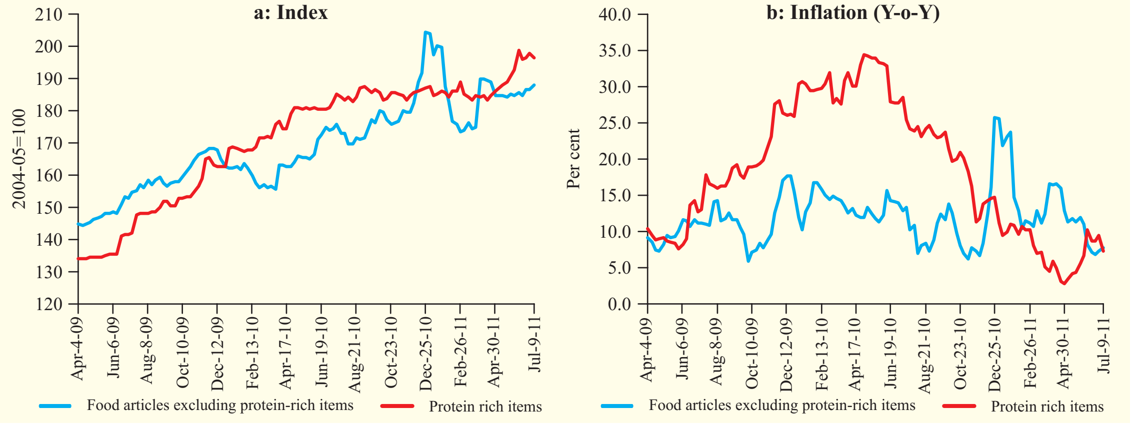


Near normal monsoon may not ease pressure on food inflation.

VI.15 A near normal monsoon is generally expected to have a softening impact on prices of food articles, but some risks to food inflation have emerged. The recent increases in Minimum Support Prices (MSPs) for key agricultural commodities, though it aims at protecting producers from price risk, could in turn have some inflationary impact. It has been observed that the trend in prices of food articles more or less follows the increase in MSPs, with MSPs providing the floor to market prices (Chart VI.10).

VI.16 Since a cost-plus pricing approach underpins revisions in MSPs, trends in input costs and rural wages provide lead information about expected path of food inflation. Increases in wages in rural areas could also put pressure on food prices both from demand and supply side. While increase in wages push up cost of production for agriculture, higher wage income is expected to provide purchasing power which could translate to higher demand, thereby pushing up prices. It has been observed that during 2010-11 the increase in wages for rural unskilled labourers have been on an average much higher than the increase in prices (state wise CPI- Rural Labourers inflation) indicating

Chart VI.9: Primary Food Articles: Index and Inflation



possibility of further pressure on prices going forward from higher wages (Chart VI.11).

VI.17 During Q1 of 2011-12, prices of non-food primary articles showed moderation as raw cotton prices declined significantly both on account of favourable production and decline in international prices. A major contributor to manufactured non-food products inflation in recent months has been textiles, tracking past increase in raw cotton and fibres prices. The recent trend of declining cotton prices, however, could lead to moderation in inflation for textiles too. Among the minerals group, the crude petroleum index was revised upwards significantly by 34.4 per cent effective second week of April 2011, reflecting lagged reporting of past increases in prices of domestic crude oil. This alone raised WPI inflation by about 0.4 percentage points.

CPI and WPI inflation converge with generalisation of price pressures

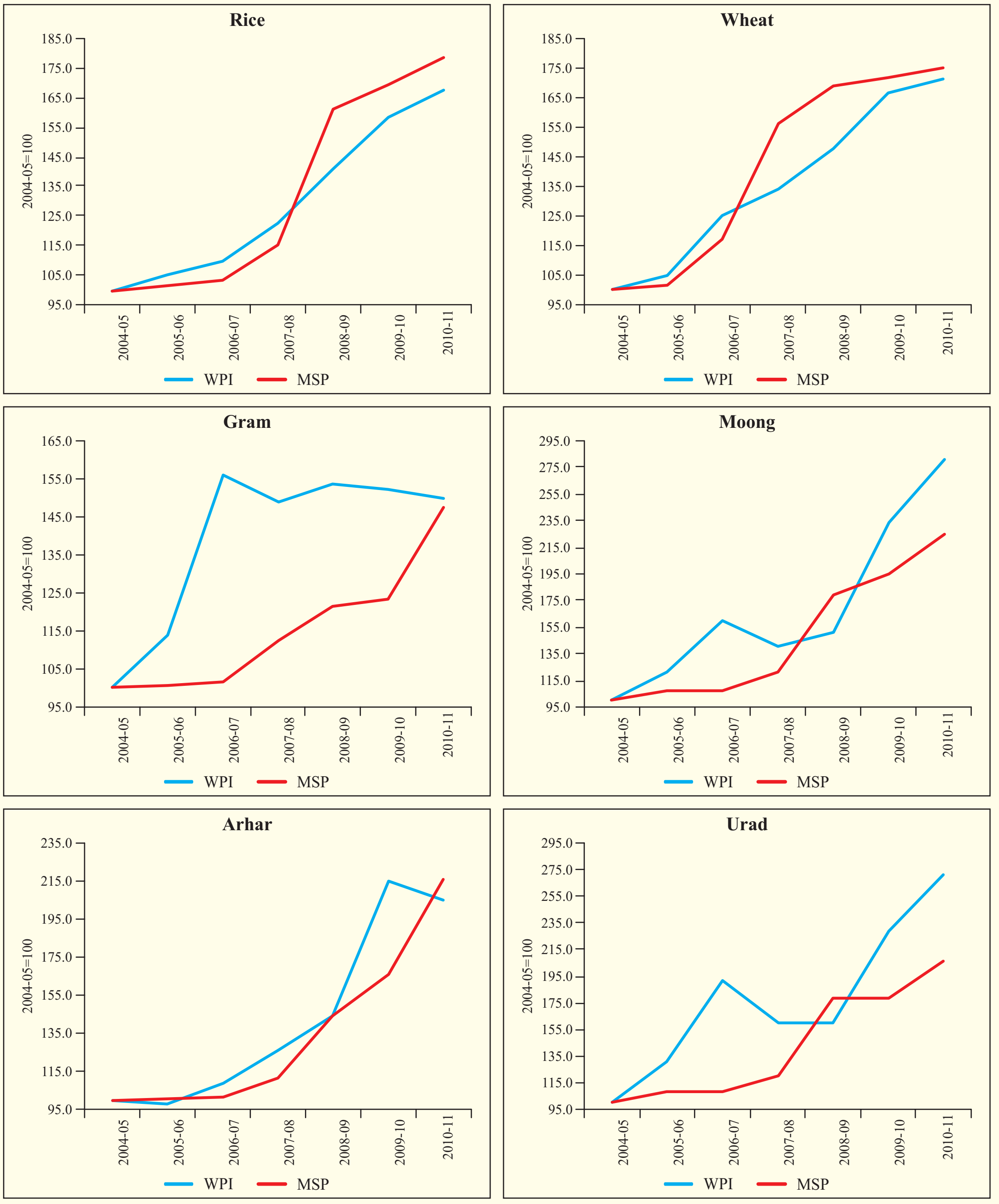
VI.18 Various measures of CPI inflation remained in the range of 8.7-9.3 per cent in May/June 2011. The convergence of various measures of CPI inflation with WPI inflation reflect moderation of food prices and increase in non-food manufactured products inflation (Chart VI.12).

VI.19 The new CPI introduced for urban and rural areas along with a composite All-India CPI suggest continued price pressures with the latest reading of 108.8 (provisional) for June 2011 (base: 2010=100). This new Consumer Price Index for 'rural', 'urban' and 'combined' introduced since January 2011 is a major initiative to improve price statistics. The introduction of new CPIs provides a nationwide price index which is more comprehensive in coverage across regions as well as commodity groups. A comparison of the new CPI series against the existing series suggests that while the weight of food group has declined significantly for both rural and urban groups, the miscellaneous group, largely services, has increased in share. As year-on-year inflation data based on the new CPI become available from January 2012, it will be closer to the measure of inflation that is being commonly used in other countries for the conduct of monetary policy. However, long time series data, especially for the back period would not be available for these new indices, which limits the suitability of the data for policy analysis in the near-term.

Inflation may moderate gradually due to structural constraints

VI.20 Responding to persistent high inflation and increasing generalisation of price pressures, the Reserve Bank has significantly raised its emphasis on containing inflation. The impact of the anti-inflationary measures through expected moderation in demand, however, faces resistance from commodity price and wage

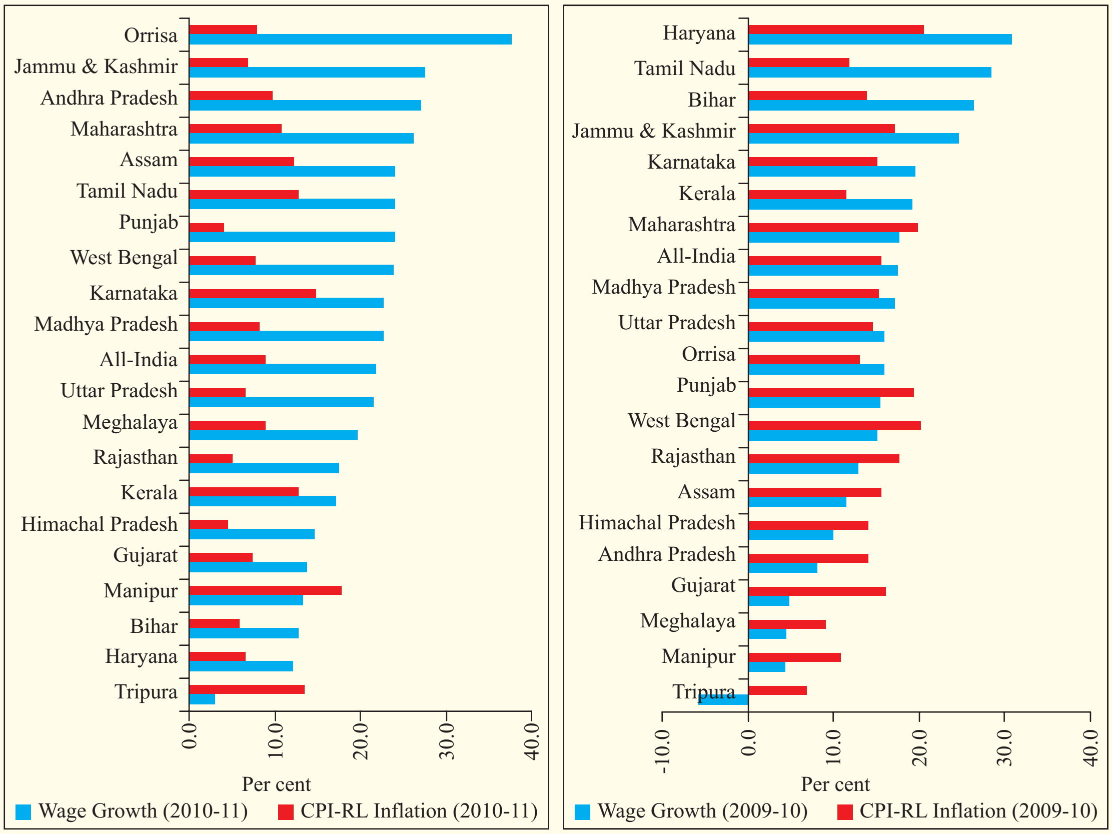
Chart VI.10: Minimum Support Prices and Wholesale Price Index



inflation, which constantly add to price pressures. The softening of global commodity prices could be temporary. If the accommodative monetary policy stance of advanced economies continues, commodity price pressures are likely to resurface. Recent trends in minimum support prices and rural wages suggest that given their conditioning influence on food inflation, a near normal monsoon may not ease food inflation significantly.

VI.21 With overshooting of the fiscal deficit target a possibility, its expansionary impact on demand could partly offset the moderation in

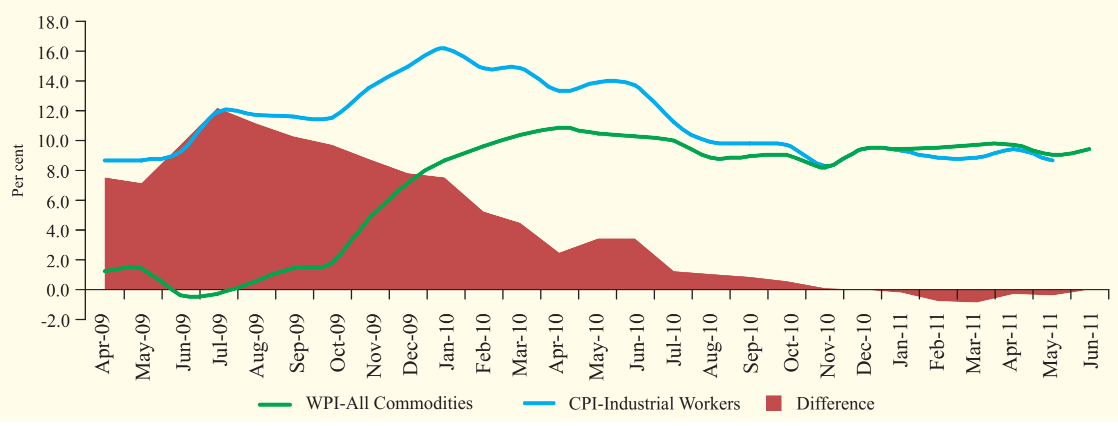
Chart VI.11: CPI-Rural Labourers Inflation and Wage Growth*



* Y-o-Y Growth in March; Rural Unskilled Labourer (Male) Wage.
Source: Labour Bureau, Ministry of Labour.

demand resulting from anti inflationary monetary actions and weaken monetary policy effectiveness. High inflation over several months has not led to price induced supply response in many critical commodities; in turn input cost pressures have spilled over to output prices. These trends necessitate structural reforms to enhance supply response while anti-inflationary bias of monetary policy anchors inflation expectations.

Chart VI.12: WPI and CPI Inflation (Y-o-Y)



VII. MACROECONOMIC OUTLOOK

Inflation has persisted at levels beyond Reserve Bank's comfort level which is inimical to growth. Inertial dynamics in wage and food prices have exacerbated the inflationary pressures. Inflation risks have stayed and high inflation is likely to persist during Q2 of 2011-12, though moderation in inflation is expected in the later part of the year. On the other hand, growth has showed signs of some moderation. Risk factors have emerged that could adversely impact aggregate demand. The business expectation surveys of various agencies, as well as the Reserve Bank's Industrial Outlook Survey suggest moderation due to higher input costs and rising interest rates. Professional forecasters' survey also supports the possibility of marginal moderation in economic activity. While monetary policy has been considerably tightened, the policy exigency at this juncture warrants continuation of anti-inflationary stance to tame inflation and anchor inflationary expectations.

Inflation risks stay, while growth showed signs of moderation

VII.1 In its Policy Statement of May 3, 2011, the Reserve Bank stated that inflation would stay at elevated level during the first half of 2011-12 before declining in the second half. Trends during Q1 of 2011-12 suggest that inflation trends have conformed with that assessment. Not only has the headline inflation stayed at around 9 per cent, non-food manufacturing inflation remains significantly high at above 7 per cent. On a sequential basis, the pace of price rise in this segment has stayed high since December 2010 on back of cost-push and demand-side factors. If the monsoon turns sub-normal, upside risks to the projected moderation in inflation during the second half would go up.

VII.2 On the other hand, there are signs of growth moderation during Q1 of 2011-12. On current reckoning, growth is likely to stay around trend during 2011-12 in line with the policy projection made in May. However, downside risks have increased. Challenges from the policy perspective have become even more stringent with increased risks to growth though inflation is likely to remain high in near term. The downside risks to growth emerge from uncertainties relating to South-West monsoon, likely moderation in private consumption and investment demand, high input costs, escalating cost of capital and uncertain global outlook which may impact the external demand and capital flows adversely. The overall assessment however suggests that agricultural growth may turn out to be lower on account of high growth last year.

VII.3 Notwithstanding the slowdown in growth, with high inflation, there are risks to growth sustainability that cannot be overlooked by monetary policy. It requires continued anti-inflationary bias with a close watch and nimble-footed calibration to new information. It is important to complete monetary transmission while it is also necessary that any possible turning points in cyclical conditions are not missed. There are upside risks to inflation from still incomplete pass-through of global commodity prices, downward stickiness of food prices, recent revisions in minimum support prices and evidence of wage price spiral. The inflation has proved to be stubborn so far and in view of the above factors may not subside in the second quarter of 2011-12. The challenge at this juncture is to contain inflationary pressures, while factoring in the lags in transmission of the monetary policy action. The task of monetary policy is made complex as these lags are often long and variable in length.

Table VII.1: Business Expectations Surveys

Period Index	NCAER-Business Confidence Index Apr. 2011	FICCI Overall Business Confidence Index Q3:2010-11	Dun & Bradstreet Business Optimism Index Q3: 2011	CII Business Confidence Index Apr.-Jun. 2011-12
1	2	3	4	5
Current level of the Index	145.2	63.8	143.6	62.5
Index as per previous survey	145.3	76.2	183.3	66.7
Index levels one year back	155.9	70.0	150.0	67.6
% change (q-o-q) sequential	-0.1	-16.3	-21.7	-6.3
% change (y-o-y)	-6.9	-8.9	-4.2	-7.5*

*: Percentage change over April-September 2010-11 survey.

Business expectations surveys indicate moderation

VII.4 Various business expectations surveys show moderation over the previous quarter and year, indicating a slowdown in overall economic activity. Persistent inflation appears to be the most important factor affecting the business expectations. Global uncertainty, higher input costs, higher interest rates and expectation of lower demand for finished goods are some of the other factors affecting the business sentiments of the Indian companies (Table VII.1).

VII.5 The seasonally adjusted HSBC Markit Manufacturing Purchasing Managers' Index (PMI) declined to its nine month low in June 2011, though it remained in expansionary mode. Sequential growth in output and new orders decelerated further. Rising input costs and borrowing costs have put further pressure on growth momentum. Seasonally adjusted PMI for services sector in June also remained in expansionary mode. It was marginally above May, though lower than that during January-April 2011.

Survey suggests Industrial Outlook has weakened

VII.6 The 54th round of the Industrial Outlook Survey of the Reserve Bank conducted during April-June 2011, based on a sample of 1,504 companies, showed moderation for the assessment quarter (April-June 2011) as well as for the expectation quarter (July-September 2011), but still remained in growth terrain (*i.e.* above 100, which is the mark that separates contraction from expansion) (Chart VII.1). The survey shows that the Indian manufacturing sector has moderated its view about demand conditions as net responses on production, order books, capacity utilisation, exports and imports showed lower optimism for the assessment quarter. In the expectation quarter however, slight improvement was visible.

VII.7 While outlook on availability of finance was less optimistic, the respondents expected cost of finance to rise further. A majority of respondents anticipated raw material costs to go up, which may affect profit margin adversely

Chart VII.1: Industrial Outlook Surveys

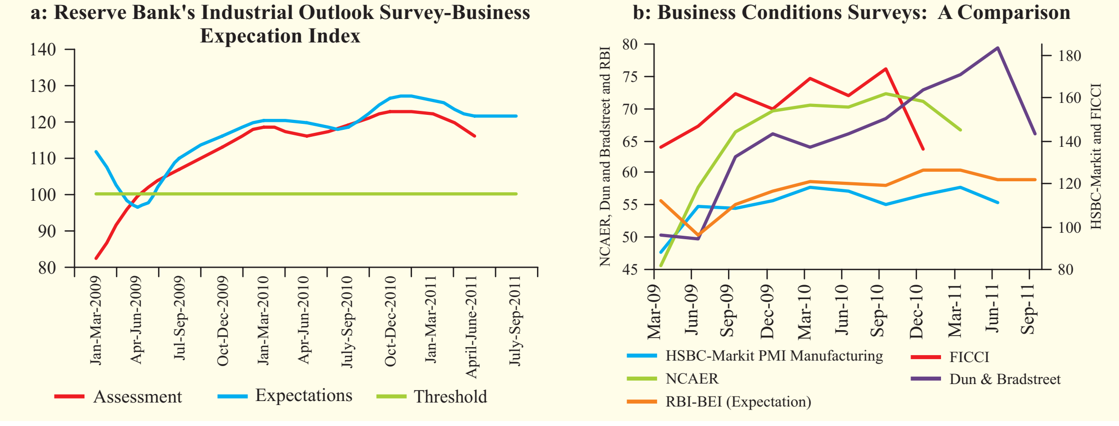


Table VII.2: Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response						
		October-December 2010		January-March 2011		April-June 2011		July-September 2011
		E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9
1. Overall Business Situation	Better	47.5	45.9	50.1	38.6	41.4	32.6	39.8
2. Overall Financial Situation	Better	39.6	37.1	41.1	27.1	33.4	24.1	30.6
3. Availability of Finance	Improve	31.3	30.3	32.3	23.8	27.3	21.5	24.2
4. Cost of External Finance	Decrease	-28.3	-33.9	-31.3	-42.5	-35.0	-49.0	-39.7
5. Production	Increase	49.1	43.9	48.6	41.4	40.0	32.1	40.6
6. Order Books	Increase	44.8	37.9	44.0	34.7	38.4	28.1	35.9
7. Level of Capacity Utilisation	Above Normal	7.2	5.6	9.5	4.9	4.4	17.2	25.0
8. Cost of Raw Material		-49.3	63.9	-53.6	-71.9	-57.0	-65.5	-51.7
9. Employment in the Company	Increase	21.0	19.4	20.6	18.7	17.4	18.2	19.4
10. Exports	Increase	26.1	23.1	26.3	18.9	24.0	18.2	25.8
11. Imports	Increase	22.2	20.9	21.3	19.9	18.9	17.6	19.0
12. Selling Price	Increase	17.0	20.2	18.6	26.5	23.7	21.5	18.3
13. Profit Margin	Increase	9.2	-0.4	8.3	-4.3	3.8	-9.9	2.5

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.

(Table VII.2). Overall, lower business optimism is seen in cement, textiles, basic metals, electrical machinery, transport equipment and fertiliser industry.

No significant downward revision in growth forecasts by other agencies

VII.8 Various international as well as domestic agencies have maintained their earlier forecasts, while OECD has revised it upwards. Only World Bank has revised the outlook downwards from the high of 9.0 per cent to 8.2 per cent, which in any case is in line with other forecasts (Table VII.3).

Survey of Professional Forecasters suggests moderation in activity[1]

VII.9 The results of the sixteenth round of 'Survey of Professional Forecasters' conducted by the Reserve Bank in June 2011 shows a downward revision in growth rate for 2011-12 as compared to the previous survey (Table VII.4). While the growth forecast for the agriculture sector was revised upwards, the forecast of industrial growth rate and services sector was revised downwards. Annual average WPI inflation forecast for the year 2011-12 was also revised upwards.

The troika that may alter baseline growth and inflation projections

VII.10 It is clear that there has been no significant alteration to the growth and inflation projections or the growth-inflation dynamics that were discussed in the 'Macroeconomic and Monetary Developments' released a quarter ago. However, at the margin, downside risks to

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	9.0 (+/-0.25)	Feb-11	-	-
Finance Ministry	9.0 (+/-0.25)	Feb-11	-	-
IMF#	8.0	Jun-11	8.0	Apr-11
OECD	8.5	May-11	8.2	Nov-10
World Bank	8.2	Jun-11	9.0	Feb-11
ADB	8.2	Apr-11	-	-
NCAER	8.5	Apr-11	-	-

#: IMFs′ forecast for growth is 8.2 per cent at market prices.

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

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

	Actual 2010-11	Annual Forecasts				Quarterly Forecast									
		2011-12		2012-13		2011-12								2012-13	
						Q1		Q2		Q3		Q4		Q1	
		E	L	E	L	E	L	E	L	E	L	E	L	E	L
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. Real GDP growth rate at factor cost (in per cent)	8.5#	8.2	7.9	-	8.3	8.3	7.7	8.1	7.7	8.2	8.1	8.5	8.2	-	8.1
a. Agriculture & Allied Activities	6.6#	3.1	3.5	-	3.6	3.8	4.8	3.1	3.5	3.0	2.2	3.0	3.0	-	3.8
b. Industry	7.8#	8.2	7.4	-	8.1	7.0	6.2	8.0	7.2	8.7	8.1	8.5	8.3	-	8.0
c. Services	9.2#	9.6	9.0	-	9.4	9.8	8.7	9.3	9.0	9.5	9.8	9.7	9.6	-	9.4
2. Gross Domestic Saving (per cent of GDP at current market price)	-	35.3	34.2	-	35.0	-	-	-	-	-	-	-	-	-	-
3. Gross Domestic Capital Formation (per cent of GDP at current market price)	-	37.5	35.5	-	36.4	36.5	34.0	37.3	35.0	37.8	35.0	38.5	36.0	-	37.0
4. Average WPI-Inflation	9.6	7.5	8.6	-	6.5	8.2	9.4&	7.8	10.0	7.5	8.8	6.7	6.9	-	6.8
5. Exchange Rate (INR/1USD end period)	44.65	44.5	44.5	-	43.5	44.5	44.7&	44.7	44.8	44.5	44.6	44.5	44.5	-	44.0
6. T-Bill 91 days Yield (per cent-end period)	7.31	7.5	8.0	-	7.6	-	-	-	-	-	-	-	-	-	-
7. 10-year Govt. Securities Yield (per cent-end period)	8.02	8.0	8.3	-	8.0	-	-	-	-	-	-	-	-	-	-
8. Export (growth rate in per cent)!	37.4	17.2	20.5	-	20.0	-	-	-	-	-	-	-	-	-	-
9. Import (growth rate in per cent)!	21.6	20.0	23.0	-	19.7	-	-	-	-	-	-	-	-	-	-
10. Trade Balance (US$ billion)	-104.9	-	-	-	-	-36.0	-35.5	-39.1	-39.4	-38.5	-34.3	-39.8	-35.0	-	-40.0

E: Previous Round Projection. L: Latest Round Projection. #: Revised Estimate. P: Provisional
- : Not Available. &: Actual !: US$ on BoP basis.

Note: The latest round refers to sixteenth round for the quarter ended June 2011, while previous round refers to fifteenth round for the quarter ended March 2011.

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

growth may have increased, while inflation stickiness is more evident.

VII.11 The three important factors that could significantly alter the baseline path of growth and inflation are: (1) significant departure of monsoon from 'normal', (2) a collapse or re-build of global commodity price bubble, and (3) Euro zone debt crisis assuming a full-blown proportion. Growth could slowdown and inflation pick up further if *kharif* crop is affected or global commodity prices surge again. Alternatively, normal monsoon or further softening of global commodity prices could be growth positive and bring about a faster fall in inflation. A full-scale Euro zone crisis could result in domestic inflation falling quickly, through a fall in external demand and international commodity prices. It could, however, also impact growth adversely through trade and capital flow channels. So how growth-inflation dynamics may play is a complex process, but clearly persistent high inflation remains a risk to growth sustainability. The risk of inflation persistence are also exacerbated by structural drivers of food inflation.

VII.12 The data from new IIP base has reconfirmed the Reserve Bank's view that there was no significant moderation in industrial production in H2 of 2010-11 and the deceleration in fourth quarter was exacerbated by a few volatile components. Similarly, the deceleration in industrial growth in April-May 2011 partly reflects subdued growth in some core industries along with base effect. Going forward, there is a possibility of some softening of industrial activity due to high input cost pressures and escalating cost of capital. In contrast to the likely subdued trend in agriculture and industrial sector, the services sector may continue to show a buoyant trend, which may support the growth process.

VII.13 On the expenditure side, the domestic demand conditions continue to receive support from strong growth in private demand so far. Even though exports are growing at a faster pace than imports, going forward, the outlook for exports remains uncertain given the subdued growth and employment trends in Euro zone countries and the US. On domestic front, the recent initiatives by the Central and State governments for fiscal consolidation has resulted in slowdown in government consumption expenditure. Though this growth driver, on expenditure side, has slowed down, the trend may not continue in 2011-12 unless more radical measures are implemented to contain subsidies expenditure so that private investment demand is not crowded out amidst monetary tightening.

VII.14 Corporate sales growth has remained robust indicating continuation of strong demand conditions so far. The profit margins have however, come under stress following higher input and interest costs. Going forward, some moderation in investment and consumption demand is likely, as high inflation may erode purchasing power. The anti-inflationary monetary policy stance is also likely to soften the demand. There is also a need for credit growth to decelerate further.

Breaking inertial dynamics of wage and food price rise important for arresting inflation

VII.15 The latest employment survey result of the NSSO indicates that the real wages of the casual labourers have been rising in recent years. This implies that on an average, the purchasing power of the poor may not have been dented by inflation. The Government's schemes such as MGNREGA to promote inclusive growth seem to have had a positive welfare impact. However, the faster increase in wages *vis-à-vis* inflation poses the risk of wage-price spiral, particularly for food inflation, as the revision in MSPs take into account wage cost escalation. Increase in demand for food as a result of higher wages, in the absence of adequate supply response, leads to higher food prices. Rise in wages in response to inflation could also become faster both on account of MGNREGA wages being indexed to inflation and increase in wage bargaining capacity in the casual labour market. This wage-price inertial movement could add to the structural pressure on food inflation.

VII.16 Evidence also suggests that resultant primary food inflation eventually gets reflected in manufactured food inflation. This, coupled with indications of downward stickiness of food prices, especially in the case of protein-rich items, gets translated into higher inflation. The capacity utilisation levels are also high which may put further pressure on manufacturing products inflation. Taking into account all these factors, it is important to break the inertial dynamics to contain the inflationary pressures.

Unfinished task of taming inflation warrants continuation of anti-inflationary monetary stance

VII.17 The emerging growth risks are likely to be factored in the policy reaction. However, inflation has stayed high for a year and a half now, averaging 9.5 per cent in this period. Amidst a wage-price spiral and continued cost-push and demand side pressures on domestic prices, monetary policy confronts two key questions. First, will the recent signs of weakening activity persist and restrain wage price and demand side pressures on manufacturing inflation? Second, are there other factors that might put further pressure on prices and wages and keep inflation high, thus feeding further on inflation expectations? A judgement on the answers to these questions will influence the calibration of the monetary policy stance. Monetary policy will have to preserve the broad thrust on tight monetary stance till there is credible evidence of inflation trending close to a level within the Reserve Bank's comfort zone.

JAYANT PRINTERY