RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments in 2010-11

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Reserve Bank of India
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MACROECONOMIC AND MONETARY DEVELOPMENTS IN 2010-11

Overview

Monetary policy was tightened in a calibrated manner through 2010-11 with transmission improving distinctly in Q4 on the back of liquidity deficit. While growth reverted to its recent trend, inflation remained above trend on the back of supply-side shocks. In the event, policy response focused on containing the spillover of supply side inflation and anchoring inflation expectations. This was important as cost-push pressures were significant and pricing power prevailed amidst strong aggregate demand.

2. Core inflationary pressures were effectively contained in the earlier part of the year but new shocks emerged: first in terms of vegetable prices spiking up in November and December 2010 and then spiraling up of global fuel and non-fuel prices. These supply-side shocks coming in quick succession elevated the path of inflation, and in the process price pressures became broad-based in the later part of the year.

Global Economic Conditions

Recovery outpacing expectations but oil, Euro zone risks remain

3. Even as recovery remains multi-speed, growth in both advanced economies and emerging/developing economies outpaced initial expectations. This raises hope for sustained, though moderately paced global recovery during 2011, with risks emerging from high oil prices. The Indian economy continued to outperform most emerging markets during 2010-11 retaining its position as the second fastest growing economy, after China, amongst the G-20 countries. China and India contributed nearly a quarter of the incremental world output.

4. The IMF World Economic Outlook of April 2011 has left its global growth forecast unaltered from its January 2011 estimate of 4.4 per cent for 2011 and 4.5 per cent for 2012. It has, however, projected a 36 per cent rise in global crude oil prices in 2011 and noted the potential of oil prices to surprise further on the upside. This is a key downside risk to growth. Sovereign balance sheet risks in the Euro zone and dormant real estate markets have also been cited as downside risks to growth in advanced economies (AEs).

Inflation risks on the rise, and not just in the emerging markets

5. Global inflation risks have risen significantly over the last quarter, not just in emerging markets but also in advanced economies. The pressures for rate cycle turning even in advanced countries can no longer be ignored with ECB raising its policy rates by 25 bps on April 7, 2011. Inflation in several emerging markets, especially in Asia, is now running above trend. As a result, central banks of several emerging markets have significantly tightened monetary policy. Besides India, these include China, Brazil, Israel, Thailand and Korea.

6. Notwithstanding the monetary tightening, risks to inflation in most countries are skewed on the upside. These risks emanate from commodity prices across food, fuel, and other industrial inputs that have firmed up significantly over the year.

Indian Economy: Developments and Outlook

Output

Activity levels remain strong

7. GDP growth during 2010-11 reverted to the high growth trajectory. Growth had moderated in the preceding two years as the global economy slowed down as a result of global financial crisis. The growth during 2010-11 reflects a rebound in agriculture and sustained levels of activity in industry and services.

8. Overall growth indicators are mixed. Prospects for agriculture appear encouraging, given IMD's forecast of a normal monsoon and a good outturn of Rabi in 2010-11. Industrial growth, however, moderated in the second half largely reflecting the waning of base effects and contraction in capital goods output. The deceleration has, however, been exacerbated by few items with volatile output. Other indicators, such as the Purchasing Managers' Index (PMI), direct and indirect tax collections, merchandise exports and bank credit suggest that the growth momentum persists. Indicators on services sector activity also remain robust, not withstanding some deceleration in the government-spending related services. However, high energy and commodity prices may impact output and investment climate, and pose a threat to maintaining high growth at a time when the investment momentum may be slowing down.

Aggregate Demand

Aggregate demand robust even as government spending decelerates on fiscal consolidation

9. Aggregate demand accelerated further in 2010-11 even as rebalancing took place from government consumption spending to private consumption and investment. Momentum in overall demand conditions was reflected in indicators like corporate sales growth, improving capacity utilisation, higher employment and pricing power with the producers. However, aggregate investment moderated somewhat in Q3 of 2010-11. This slackening was also reflected in the contraction in capital goods output and weaker new project investment indicated by banks. This process needs to be reversed to bolster the potential growth of the economy.

10. Though revenue buoyancy was witnessed in 2010-11, there are risks to the deficit projections of 2011-12 as subsidies are likely to exceed the budgetary provisions, given sharply higher international commodity prices. The process of fiscal consolidation needs to be carried forward on both revenue and expenditures sides, with a sharper focus on the latter. Containment of subsidies by raising domestic prices of petroleum products and fertilizers should be a building block of this strategy.

External Sector

CAD risks moderate, but have not dissipated

11. Improvement in exports during 2010-11 facilitated moderation of the current account deficit (CAD). However, if oil and other commodity prices stay elevated, CAD may widen in 2011-12. This will necessitate higher external financing. The dominance of more volatile portfolio equity flows requires that CAD be contained within prudent limits, especially as the net international liabilities and the debt creating flows have risen. Overall, diversification in exports and robust invisible earnings are expected to bulwark in any events of capital flow reversals.

12. While global recovery remains on course, the size and direction of capital flows can be impacted by the pace of US recovery, the reconstruction in Japan and the balance sheet risks in the Euro zone.

Monetary and Liquidity Conditions

Tightening helps keep stable monetary conditions

13. As inflation stayed above the indicated projections during 2010-11, monetary policy was continually tightened through the year. Monetary and liquidity conditions responded to the policy measures, though with a lag.

14. Even as reserve money growth remained strong, money supply growth stayed below indicative trajectory. Lower growth in aggregate deposits and reduction in money multiplier emanating from higher currency demand led to this divergent trend. Credit expansion was above the indicative trajectory for the year, though it moderated towards the later part. Deposit growth which lagged behind the credit expansion, picked up in Q4 of 2010-11, responding to the rise interest rates. Liquidity conditions were tight for most part of the year with some easing towards the last quarter.

Financial Markets

Stronger monetary transmission impacts interest rates

15. Interest rates firmed up responding to monetary policy signals. Banks progressively passed on the increased costs in the form of higher lending rates. Monetary transmission was observed to be strong particularly in the Q4 of 2010-11.

16. Conditions in various financial markets remained orderly. Asset prices generally remained range bound. Equity markets witnessed good buying interest from FIIs during July-November 2010 followed by some correction alongwith greater volatility. While price correction has not materialized, house price pressures remained moderate in Q3 of 2010-11.

Price Situation

Inflation persists with supply-side shocks and return of manufacturing inflation

17. Headline inflation exhibited strong persistence in 2010-11. It reflected both supply shocks and gradual generalisation of price pressures. The generalization was reflected in non-food manufacturing price pressures from December 2010 as producers were able to pass on cost increases amidst strong demand. Notwithstanding some moderation in food prices during Q4, hike in prices of a number of manufactured products following input cost pressures kept headline inflation firm and significantly above the medium-term trend. Inflation during 2011-12 is likely to moderate slowly but remain above the comfort level as the passthrough of international commodity prices is likely to continue.

Macroeconomic Outlook

Costly oil a risk to growth sustainability and inflation

18. High global crude oil and other commodity prices pose the biggest risk to India's growth and inflation. Persistently high inflation has kept inflation expectations elevated. Fresh pressures from commodity prices do make 2011-12 a challenging year for inflation management. Cross-country experience suggests that phases of high growth have generally been accompanied by low inflation. While growth risks are on the downside, emanating from high oil prices and some moderation in investment, GDP growth during 2011-12 is expected to stay close to the trend. However, the risks to inflation are on the upside and it may remain elevated for some more time despite the current anti-inflationary bias in the monetary stance.

I. OUTPUT

GDP growth, estimated at 8.6 per cent during 2010-11, reverted to its recent trend, aided by rebound in agricultural growth. Industrial growth moderated in the second half of the year reflecting the effect of higher base and some moderation in investment demand. The services sector maintained momentum in most of its segments. Buoyant overall agricultural performance and continued services sector growth momentum augur well for growth in 2011-12. However, risks to growth ahead arise from rising prices of oil and industrial raw materials, decelerating investment demand and high inflation.

Indian economy grew at around its trend rate in 2010-11

I.1 Real GDP growth in 2010-11 reverted to near trend growth rate, following two successive years of below trend growth (Chart I.1a). Non-agricultural GDP growth, however, was slightly below the trend (Chart I.1b). The main impetus to the growth in 2010-11 came from agriculture which benefited from a normal monsoon, while industry and services registered mild deceleration (Table I.1). This moderation was primarily during the second half of the year due to the waning of the favourable base effect as well as deceleration in Government-spending related services. Growth is expected to stay near its trend during 2011-12 with upside factors such as buoyant private consumption demand and improved external demand getting counter-balanced by likely adverse impact from high fuel and commodity prices and prevailing risks to global growth from the debt crisis in parts of the Euro zone. Demand conditions are discussed in Chapter II of this report.

Agriculture sector outlook remains strong

I.2 Agricultural production rebounded in 2010-11 after drought conditions in the preceding year caused a contraction. Foodgrain production reached a new record with both *Kharif* and *Rabi* crops turning out to be good. A satisfactory North-East monsoon following the normal South-West monsoon coupled with favourable sowing and reservoir positions improved the prospects for agricultural production during 2010-11. At 2 per cent and 21 per cent above their respective long period averages (LPA), this is the first time in the last ten years that both the South-West and

Chart I.1: GDP Growth and Trend

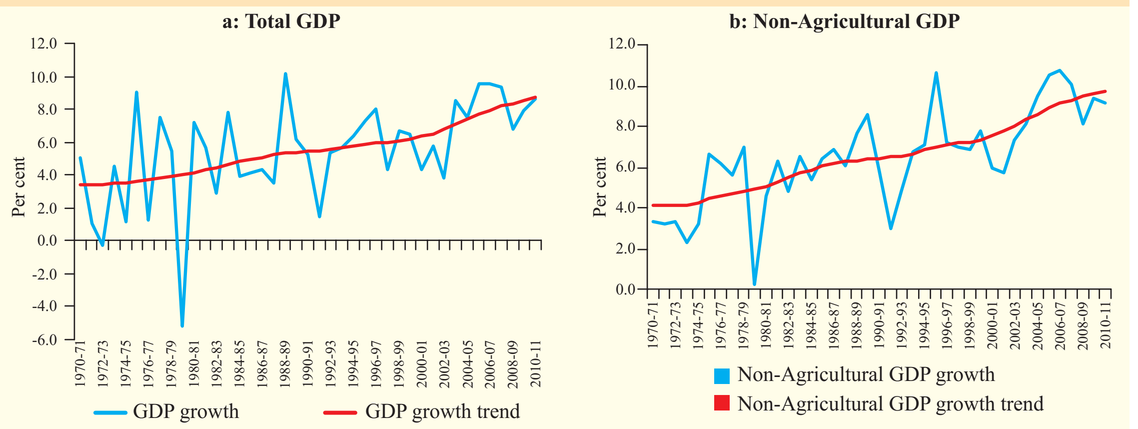


Table I.1 : Sectoral GDP Growth (Base: 2004-05)

(Per cent)

Item	2009-10*	2010-11#	2009-10 Q1	2009-10 Q2	2009-10 Q3	2010-11 Q1	2010-11 Q2	2010-11 Q3	2009-10 (Apr-Dec)	2010-11 (Apr-Dec)
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture and allied activities	**0.4**	**5.4**	**1.8**	**1.2**	**-1.6**	**2.5**	**4.4**	**8.9**	**0.2**	**5.7**
2. Industry	**8.3**	**8.2**	**2.9**	**6.3**	**10.0**	**11.7**	**8.9**	**5.7**	**6.4**	**8.7**
2.1 Mining and quarrying	6.9	6.2	6.9	6.6	5.2	8.4	7.9	6.0	6.2	7.4
2.2 Manufacturing	8.8	8.8	2.0	6.1	11.4	13.0	9.8	5.6	6.5	9.4
2.3 Electricity, gas and water supply	6.4	5.1	6.2	7.5	4.5	6.2	3.4	6.4	6.1	5.3
3. Services	**9.7**	**9.4**	**8.5**	**10.8**	**9.2**	**9.4**	**9.6**	**8.7**	**9.5**	**9.3**
3.1 Construction	7.0	8.0	5.4	5.1	8.3	10.3	8.7	8.0	6.2	9.0
3.2 Trade, hotels, restaurants, transport and communication, *etc.*	9.7	11.0	5.5	8.2	10.8	11.0	12.1	9.4	8.2	10.8
3.3 Financing, insurance, real estate and business services	9.2	10.6	11.5	10.9	8.5	7.9	8.2	11.2	10.3	9.1
3.4 Community, social and personal services	11.8	5.7	13.0	19.4	7.6	7.8	7.4	4.8	13.2	6.6
4. GDP at factor cost (total 1 to 3)	**8.0**	**8.6**	**6.3**	**8.6**	**7.3**	**8.9**	**8.9**	**8.2**	**7.4**	**8.6**

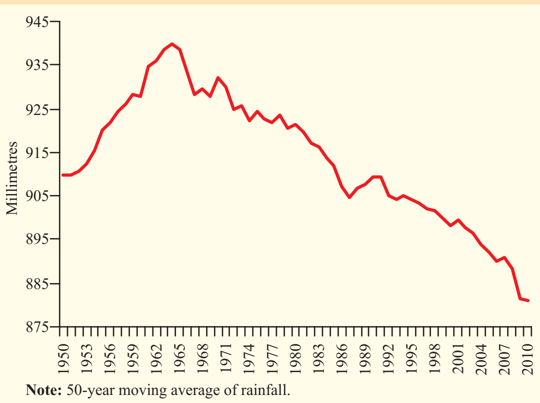
* : Quick Estimates. # : Advance Estimates.

Source: Central Statistics Office.

the North-East monsoons surpassed their respective LPAs. There has, however, been a secular decline in the long-term average rainfall during June-September over the years (Chart I.2). This reflects deterioration in climatic conditions that may have long-run detrimental consequences for agricultural output in India.

I.3 Area sown under major *Rabi* crops, in particular, wheat and pulses, have surpassed their respective normal areas sown and levels achieved in 2009-10 by significant margins. *Rabi* sowing of all crops as on April 15, 2011

Chart I.2: Long Period Average of Rainfall during June to September



Note: 50-year moving average of rainfall.

was 4 per cent higher than the level achieved during the previous year (Table I.2). The foodgrain production in 2010-11 is estimated to be the highest ever, surpassing the previous peak achieved in 2008-09. Significant increases in the outputs of key agricultural products would help in reducing the pressure on food prices. Agro-based industries could benefit from higher agricultural growth. Higher agricultural growth could also translate into better rural incomes which could help boost the demand for other sectors.

Record wheat production requires focus on food management

I.4 With record wheat production witnessed in 2010-11, there is need for focussed attention on food management. This is essential for building optimal food stocks while averting the problem of plenty caused by bumper harvests. The total stock of foodgrains with the Food Corporation of India (FCI) and other Government agencies declined to 44.4 million tonnes on March 31, 2011 (60.9 million tonnes on June 30, 2010) partly reflecting the

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

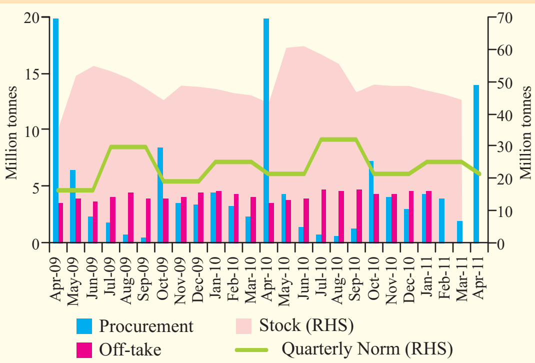
(Area in Million hectares; Production in Million tonnes)

Crop	Sowing				Production	
	Normal	2009-10	2010-11	Per cent of Normal 2010-11	Final 2009-10	3rd Advance Estimates 2010-11
1	2	3	4	5	6	7
Rice	4.26	4.43	4.45 (0.5)	104.5	89.09	94.11 (5.6)
Wheat	27.33	28.36	29.41 (3.7)	107.6	80.80	84.27 (4.3)
Total Coarse Cereals	6.32	6.58	6.19 (-6.0)	97.9	33.55	40.21 (19.9)
Total Cereals	**37.91**	**39.37**	**40.05 (1.7)**	**105.6**	**203.45**	**218.59 (7.4)**
Total Pulses	**12.02**	**14.30**	**15.75 (10.1)**	**131.0**	**14.66**	**17.29 (17.9)**
Total Foodgrains	**49.93**	**53.68**	**55.80 (4.0)**	**111.8**	**218.11**	**235.88 (8.1)**
Total Nine Oilseeds	**9.98**	**9.82**	**10.21 (3.9)**	**102.3**	**24.88**	**30.25 (21.6)**
Cotton #	-	-	-	-	**24.23**	**33.93**
Jute # #	-	-	-	-	**11.23**	**9.89**
Mesta # #	-	-	-	-	**0.59**	**0.59**
Sugarcane (Cane)	-	-	-	-	**292.3**	**340.55**
All Crops	**59.91**	**63.50**	**66.00 (4.0)**	**110.2**	-	-

-: 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.

Government's policy of faster release of foodgrains to the market to ease food inflation (Chart I.3). The Government has fast-tracked the process of creating new storage capacity of 150 lakh metric tonnes through private entrepreneurs and warehousing corporations while making capital investment in modern storage capacity eligible for viability gap funding. Going forward, the challenge for food management and procurement will be to ensure that the volatility in food prices does not get amplified.

Chart I.3: Food Stock and its Determinants



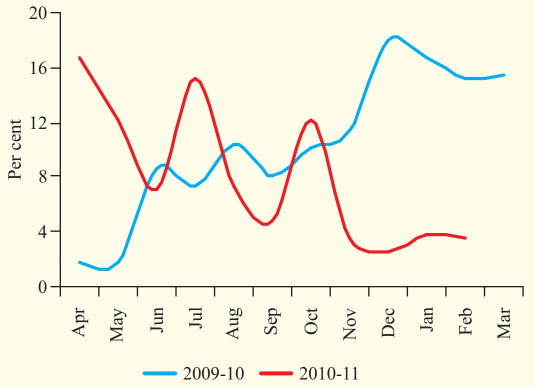
Note: 1. Data for off-take is up to January 2011 and stock up to March 2011.
2. Procurement and off-take data are monthly figures.
3. Procurement for April 2011 is as on April 25.

Industrial growth decelerates on account of high base effect and moderation in investment demand

I.5 During 2010-11 (data available up to February 2011), the industrial sector exhibited signs of slowdown as the IIP growth moderated with intermittent episodes of volatility mainly on account of the high base effect and sharp deceleration in capital and intermediate goods which could partly be attributed to the moderation in investment demand in Q3 of 2010-11 (Chart I.4).

I.6 The lower growth in IIP during April-February 2010-11 compared to the corresponding period of the previous year has been on account of the slowdown in growth of almost all the sectors except consumer goods (Table I.3). The contribution of intermediate and

Chart I.4: Growth in Index of Industrial Production (Y-o-Y)



capital goods to the overall IIP growth declined, reflecting some moderation in investment demand. The continued high growth of consumer durables segment reflects higher private consumption demand.

Amidst slowdown, manufacturing activity spread more evenly now

I.7 One notable feature of the pattern of IIP growth is that the activity in manufacturing sector has become more evenly spread with fifteen out of seventeen industries recording positive growth during April-February 2010-11. Moreover, the contribution of the bottom twelve industries to the overall IIP growth has increased (Chart I.5).

Recent IIP slowdown exacerbated by volatile components

I.8 The recent IIP slowdown during the period November 2010 to February 2011 has been exacerbated by a few industries. If IIP growth is calculated after excluding the top 10 and the bottom 10 items that tend to disproportionately impact the overall IIP on account of wide volatility, the growth in February 2011 would be close to 8.8 per cent *vis-à-vis* 8.7 per cent in January 2011 and 11.2 per cent in February 2010. This suggests that the deceleration is not as pronounced as it may appear from the headline numbers. Nevertheless, the risk to industrial growth remains with deceleration in output of capital goods (Chart I.6).

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 2009-10	Growth Rate Apr-Feb 2009-10	Growth Rate Apr-Feb 2010-11 P	Weighted Contribution# Apr-Mar 2009-10	Weighted Contribution# Apr-Feb 2009-10	Weighted Contribution# Apr-Feb 2010-11 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	10.5	9.9	9.6	6.5	6.0	6.1	5.3
Manufacturing	79.4	11.0	10.4	8.1	89.4	89.2	89.4
Electricity	10.2	6.0	5.8	5.4	4.6	4.6	5.3
Use-based							
Basic Goods	35.6	7.2	6.8	6.5	19.5	19.5	23.0
Capital Goods	9.3	19.2	19.0	8.7	29.4	27.4	17.4
Intermediate Goods	26.5	13.6	13.6	9.1	32.4	34.2	30.2
Consumer Goods (a+b)	28.7	6.2	5.9	7.5	18.7	18.8	29.3
a) Consumer Durables	5.4	24.6	23.8	21.8	17.9	18.2	24.0
b) Consumer Non-durables	23.3	0.4	0.3	1.9	0.9	0.7	5.3
General	**100.0**	**10.5**	**10.0**	**7.8**	**100.0**	**100.0**	**100.0**

: Figures may not add up to 100 due to rounding off. P : Provisional.

Source: Central Statistics Office.

Chart I.5: Growth Concentration in Manufacturing Sector

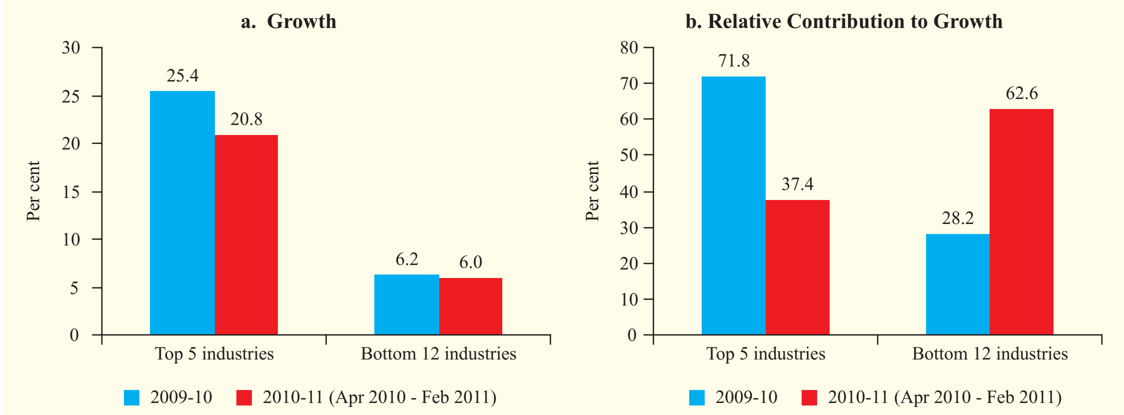
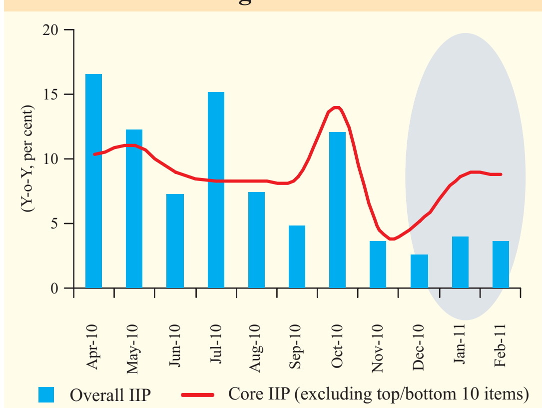


Chart I.6: Growth in IIP - Overall and Excluding Volatile Items



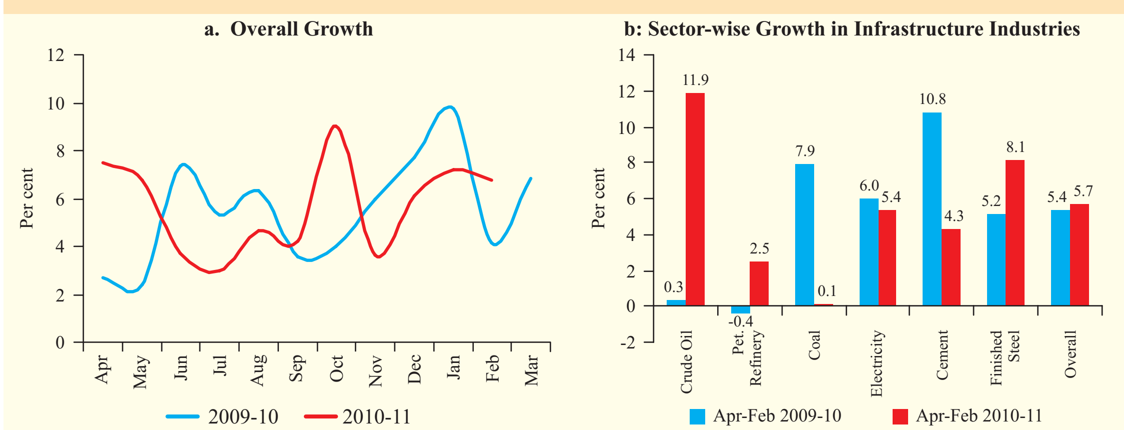
Growth of core infrastructure sector remains moderate

I.9 The six core industries (26.6 per cent of total weight in IIP) registered marginally higher growth during April-February 2010-11 as compared with the same period in the previous year while the year-on-year growth indicates some moderation in recent months (Chart I.7). Acute shortage of coal from domestic sources seems to have had some adverse impact on electricity generation. Growth in crude oil has been robust during the year partly due to base effect. Closer attention to investment in core infrastructure industries is necessary in view of likely energy deficits over the medium term.

High oil prices likely to affect near term growth

I.10 Uncertainty in the Middle East and North Africa (MENA) adds to upward risk in international oil prices. Analysis in the Indian context indicates likely adverse impact of rising input cost on GDP. Sectors such as surface and air transport, synthetic fibre and chemicals,

Chart I.7: Growth in Infrastructure Industries



cotton textiles, paper products, rubber and plastic, cement and foodgrains have high input linkages with oil.

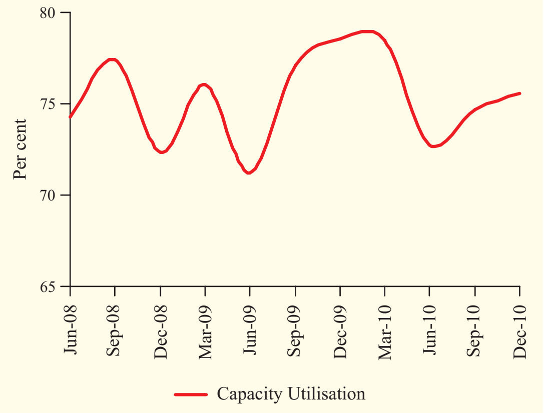
Capacity utilisation inching up

I.11 The evidence on capacity utilisation, order books and inventories provides a mixed picture on cyclical conditions in the industry. There has been some improvement in the overall capacity utilisation in Q3 of 2010-11 and order books improved during the quarter (Chart I.8). It still remains below the levels during the same period of the previous year. For the core industries, while capacity utilisation in petroleum refining and fertiliser remains stretched, that of cement and thermal power generation has eased in line with the production trend for these two industries.

Employment gaining traction supported by IT and automobiles industries

I.12 The ninth round of the series of "Quarterly Quick Employment Surveys" conducted by the Labour Bureau to assess the impact of the economic slowdown on employment in India for the quarter ended December 2010 indicates that the employment situation showed substantial improvement in major industries/groups led by the IT/BPO and the automobile industries (Table I.4).

Chart I.8: Capacity Utilisation



Services sector exhibits sustained momentum

I.13 The services sector growth moderated during Q3 of 2010-11 led by deceleration across all sub-sectors except 'financing, insurance, real estate and business services'. The 'community, social and personal services' sub-sector decelerated sharply in 2010-11 so far, reflecting the resumption of the fiscal consolidation process. Nevertheless, the outlook for services sector remains positive with lead indicators of services sector such as tourist arrivals and cell phone connections recording robust growth as per the data available so far for 2010-11. Commercial vehicles production, air cargo and passengers handled at domestic and

Table I.4: Changes in Estimated Employment

(in Thousands)

Industry/Group	Mar 2010 over Dec 2009	Jun 2010 over Mar 2010	Sep 2010 over Jun 2010	Dec 2010 over Sep 2010	Dec 2010 over Dec 2009
1	2	3	4	5	6
1. Textiles including apparels	-119	-63	245	40	103
2. Leather	0	21	4	16	41
3. Metals	4	45	27	0	76
4. Automobiles	29	51	29	18	127
5. Gems and jewellery	24	4	4	-10	22
6. Transport	-2	-21	13	-1	-7
7. IT/BPO	129	129	108	141	507
8. Handloom/powerloom	-5	-3	6	3	1
Overall	**61**	**162**	**435**	**207**	**870**

Source: Ninth Quarterly Quick Employment Survey, October 2010-December 2010, Labour Bureau.

Table I.5: Indicators of Services Sector Activity

(Growth in Per cent)

Services Sector Indicators	2008-09	2009-10	Apr-Feb 2009-10	Apr-Feb 2010-11
1	2	3	4	5
Tourist arrivals#	-3.3	4.5	4.5	9.0
Commercial vehicles production#	-24	35.9	35.9	32.6
Cement	7.2	10.5	10.8	4.3
Steel	1.6	4.9	5.2	8.1
Railway revenue earning freight traffic	4.9	6.6	6.9	3.6
Cell phone connections	80.9	47.3	49.8	20.2
Cargo handled at major ports	2.2	5.7	5.5	1.1
Civil aviation				
Export cargo handled	3.4	10.4	10.4	14.7
Import cargo handled	-5.7	7.9	5.5	22.1
Passengers handled at international terminals	3.8	5.7	5.1	11.7
Passengers handled at domestic terminals	-12.1	14.5	14.1	15.7

#: Data pertain to April-March.

Source: Ministry of Tourism, Ministry of Statistics and Programme Implementation and SIAM.

international terminals registered higher growth indicating buoyant transport sector. Leading indicators of construction activity show a mixed trend with improvement in growth of steel production and deceleration in cement (Table I.5).

Growth momentum likely to sustain at close to trend

I.14 Current growth conditions suggest that the Indian economy is neither overheated, nor does it face a slack. Growth conditions have shown slight moderation of late, but GDP is still likely to grow close to trend in 2011-12. The India Meteorological Department (IMD) has predicted a normal monsoon in 2011. Following a record *Rabi* outturn, this can bolster agricultural growth further. Manufacturing is expected to sustain the momentum as reflected in the strong private consumption demand and improvement in external demand. PMI for March 2011 also suggests sustained expansion. Monsoon turning out to be less than normal is a potential downside risk. If recent increases in crude oil and industrial raw material prices persist, they could weaken the growth momentum amidst high inflation. Downside risks to growth also arise from higher cost of capital and any weakening of consumer confidence as the cost of leverage goes up.

II. AGGREGATE DEMAND

Aggregate demand accelerated further in 2010-11. Private consumption and investment were the key drivers of growth in 2010-11, even though investment moderated somewhat in Q3. Government consumption expenditure has decelerated and this rebalancing should be maintained by focusing on fiscal consolidation. In this context, it is important to contain subsidies that are at risk of overshooting the budgetary provisions as global oil prices rise.*

Demand conditions remain supportive of growth

II.1 Aggregate expenditure, in real terms, accelerated in 2010-11 with private consumption as well as investment expenditure growing at a brisk pace (Table II.1). Going forward, private expenditure is likely to continue to be the main driver of growth, though some moderation can be expected in response to high inflation and demand-side policy measures. Government consumption expenditure has decelerated significantly in 2010-11 and this rebalancing could be maintained this year by staying on the path of fiscal consolidation. Investment expenditure is expected to remain moderate. Recovery in investment expenditure from the soft patch in Q3 of 2010-11 would depend on pick-up in execution of large infrastructure projects.

Saving rate driven up by public sector, investment rate by private corporates

II.2 Both saving and investment rates improved in 2009-10. Improvement in the overall saving rate has been led by the public sector while the investment rate has been boosted mainly by private corporate sector (Table II.2).

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

(Per cent)

	2009-10 Q.E.	2010-11 A.E.	2009-10			2010-11			2009-10	2010-11
			Q1	Q2	Q3	Q1	Q2	Q3	Apr-Dec	Apr-Dec
1	2	3	4	5	6	7	8	9	10	11
				Growth Rate						
Real GDP at market prices	9.1	9.7	6.5	7.6	9.2	10.2	10.4	9.7	7.8	10.1
Total final consumption expenditure	8.7	7.3	9.3	12.2	7.4	7.4	8.9	6.9	9.5	7.7
(i) Private	7.3	8.2	7.3	8.5	7.0	7.0	8.6	9.0	7.6	8.3
(ii) Government	16.4	2.6	21.3	37.5	9.6	9.1	10.4	-3.0	20.5	4.7
Gross fixed capital formation	7.3	8.4	-0.4	0.3	8.7	25.7	17.8	6.0	2.9	16.1
Changes in stocks	90.8	7.1	78.9	86.1	95.4	6.4	8.2	4.0	86.8	6.1
Net Exports	10.2	-9.5	11.1	-21.4	14.8	6.2	13.8	-59.4	-0.4	-18.4
				Relative Share						
Total final consumption expenditure	70.1	68.5	73.1	71.4	73.6	71.3	70.4	71.7	72.7	71.1
(i) Private	58.5	57.6	61.8	60.2	60.4	60.1	59.2	60.1	60.8	59.8
(ii) Government	11.6	10.8	11.3	11.2	13.1	11.2	11.2	11.6	11.9	11.3
Gross fixed capital formation	32.0	31.6	30.4	31.9	30.9	34.6	34.1	29.8	31.1	32.7
Changes in stocks	3.5	3.5	3.5	3.6	3.5	3.4	3.6	3.3	3.5	3.4
Net Exports	-7.2	-6.0	-6.6	-7.2	-8.7	-6.4	-7.5	-3.2	-7.6	-5.6
Memo:										₹ Crore
Real GDP at Market Prices	48,69,317	53,42,571	11,12,505	11,37,893	12,55,103	12,25,551	12,56,776	13,76,242	35,05,500	38,58,568

Q.E.: Quick Estimates. A.E.: Advance Estimates.

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

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

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

(Per cent to GDP at current market prices)

Item	2007-08	2008-09	2009-10 QE
1	2	3	4
1. Gross Domestic Saving	36.9	32.2	33.7
1.1 Household Sector	22.5	23.8	23.5
Financial saving	11.7	10.8	11.8
Saving in physical assets	10.8	13.1	11.7
1.2 Private Corporate Sector	9.4	7.9	8.1
1.3 Public Sector	5.0	0.5	2.1
2. Gross Domestic Capital Formation*	38.1	34.5	36.5
2.1 Household Sector	10.8	13.1	11.7
2.2 Private Corporate Sector	17.3	11.5	13.2
2.3 Public Sector	8.9	9.5	9.2

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

Key fiscal indicators budgeted to improve in 2011-12

II.3 The key fiscal indicators of the Central Government showed an improvement in 2010-11 (RE) attributable mainly to larger than expected proceeds from telecom spectrum auctions. The Government chose to utilise these excess receipts to increase allocations for rural infrastructure, implementation of Right to Education Act, plan assistance to States and recapitalisation of public sector banks. The Budget intends to carry forward the process of fiscal consolidation in 2011-12 through reduction in expenditure growth. Recognising that the windfall benefit of one-off non-tax revenues of 2010-11 would not be available during 2011-12, the revenue deficit as a ratio to GDP is budgeted to remain unchanged. Nonetheless, the gross fiscal deficit (GFD) as ratio to GDP is budgeted to decline reflecting compression in capital expenditure in 2011-12 (Table II.3).

Fiscal consolidation process to continue but quality and pace matter

II.4 Over the medium term, the Government has envisaged a gradual reduction in key deficit indicators in consonance with its macroeconomic projections and conservative stance on revenue collections. However, key deficit indicators are likely to remain higher than the prescribed path of the Thirteenth Finance Commission and accordingly, the Government would not be able to achieve revenue balance by 2013-14. Although the Government focuses

Table II.3: Key Fiscal Indicators of the Central Government

(Per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal deficit
1	2	3	4
2009-10	3.1	5.2	6.4
2010-11 BE	1.9	4.0	5.5
2010-11 RE	2.0	3.4 (2.3)	5.1
2011-12 BE	1.6	3.4 (1.8)	4.6
13th FC	-	2.3	4.8
2012-13 (Rolling targets)			
MTFP	-	2.7 (1.1)	4.1
13th FC	-	1.2	4.2
2013-14 (Rolling targets)			
MTFP	-	2.1 (0.5)	3.5
13th FC	-	0.0	3.0

BE: Budget Estimates. RE: Revised Estimates.
MTFP: Medium Term Fiscal Policy Statement. 13th FC: Thirteenth Finance Commission.
Note: Figures for 'effective revenue deficit' are indicated in brackets.
Source: Union Budget 2011-12 and 13th FC.

on reducing 'effective revenue deficit', which excludes capital grants to States, the headline revenue deficit, as a ratio to GFD, is expected to remain higher in 2011-12. This indicates that a larger portion of GFD would emanate from revenue deficit, reducing the availability of resources to undertake capital outlays.

Tax buoyancy helps though tax cut roll-back was partial

II.5 The Central Government is calibrating the roll-back of taxes/duties towards the pre-crisis levels recognising the emerging inflationary situation. The growth in gross tax revenues, however, is budgeted to be lower for 2011-12 as compared with 2010-11 (Table II.4). By keeping the standard rates for excise duty and service tax unchanged, the Government intends to stay on course towards introduction of goods and services tax. With the implementation of direct tax code in 2012-13, the tax buoyancy is expected to improve and raise the gross tax-GDP ratio gradually to 11.3 per cent by 2013-14, though lower than its pre-crisis peak of 11.9 per cent in 2007-08.

Focus on quality of expenditure important in fiscal consolidation

II.6 Sharp moderation in revenue expenditure growth and marginal decline in budgeted capital expenditure are expected to contain expenditure growth this year. The fiscal consolidation strategy for 2011-12 is primarily expenditure driven, reflecting the impact of lower growth in expenditure on salary and pensions and subsidies. While controlling non-plan revenue expenditure growth is a positive feature, the compression in capital expenditure poses concerns regarding the quality of fiscal consolidation.

Capping of expenditure on subsidies is subject to upside risks

II.7 The Budget's lower projection of subsidies for 2011-12 is subject to the underlying assumption of no major variation in international fertiliser and petroleum prices during the entire span of 2011-12, which may not hold (Table II.5). There is an upside risk in the case of fertiliser subsidy as fertiliser input prices have increased. Fertiliser subsidies are

Table II.4 : Central Government 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	15.9	18.7	3.4	15.6	15.4	14.0
2. Revenue Expenditure	14.9	15.6	4.1	13.9	13.4	12.2
3. Capital Expenditure	25.0	44.6	-1.4	1.7	2.1	1.8
4. Non-Developmental Expenditure	20.1	10.5	9.5	7.8	7.2	6.9
5. Development Expenditure	12.1	26.5	-0.9	8.1	8.5	7.4
4. Non-Plan Expenditure	18.5	13.9	-0.7	11.0	10.4	9.1
5. Plan Expenditure	10.2	30.2	11.8	4.6	5.0	4.9
6. Revenue Receipts	6.0	36.8	0.8	8.7	9.9	8.8
i) Tax Revenue (net)	3.0	23.5	17.9	7.0	7.2	7.4
ii) Non Tax Revenue	19.9	89.3	-43.0	1.8	2.8	1.4
7. Gross Tax Revenue	3.2	26.0	18.5	9.5	10.0	10.4
i) Direct Tax	13.1	18.1	19.4	5.8	5.7	5.9
ii) Indirect Tax	-9.0	38.0	17.3	3.8	4.3	4.5
Memo:						
Primary Deficit	41.9	-22.0	-9.6	3.1	2.0 (1.9)	1.6
Revenue Deficit	33.7	-20.4	13.9	5.2	3.4 (4.0)	3.4
Gross Fiscal Deficit	24.2	-4.2	2.9	6.4	5.1 (5.5)	4.6

Note: Figures in bracket are budget estimates for 2010-11 as per cent of GDP.
Source: Union Budget 2011-12.

Table II.5: Major Subsidies

(Amount in ₹ crore)

Items	2009-10 Amount	2009-10 per cent to GDP	2010-11 RE Amount	2010-11 RE per cent to GDP	2011-12 BE Amount	2011-12 BE per cent to GDP
1	2	3	4	5	6	7
Total Subsidies	1,41,351	2.2	1,64,153	2.1	1,43,570	1.6
of which:						
i. Food	58,443	0.9	60,600	0.8	60,573	0.7
ii. Fertiliser	61,264	0.9	54,976	0.7	49,998	0.6
iii. Petroleum	14,951	0.2	38,386	0.5	23,640	0.3
iv. Interest subsidy	2,687	0.0	5,223	0.1	6,869	0.1
v. Others	4,006	0.1	4,968	0.1	2,490	0.0

Source: Union Budget 2011-12.

likely to exceed budgetary provisions unless urea price is decontrolled or Nutrient-Based Fertiliser Subsidy scheme succeeds in effectively capping the total fertiliser subsidies. Further, the rising international oil prices may generate pressures on the fiscal situation in case there is a delay in the corresponding adjustment in domestic prices, leading to larger subsidy expenditure towards under-recoveries of downstream oil public sector units. Furthermore, the introduction of National Food Security Bill may also have additional expenditure implications.

Robust sales growth points to enduring demand conditions

II.8 Corporate sales growth remained robust during Q3 of 2010-11 and together with inventory movements signalled continued buoyancy in demand. However, profit margin came under pressure, on account of higher input and interest costs (Table II.6). All components

Table II.6: Corporate Sector-Financial Performance

Item	2009-10 Q1	2009-10 Q2	2009-10 Q3	2009-10 Q4	2010-11 Q1	2010-11 Q2	2010-11 Q3
1	2	3	4	5	6	7	8
							(Growth rates in per cent)
No. of Companies	2530	2531	2562	2565	2546	2586	2643
Sales	-0.9	0.1	22.5	29.1	24.2	18.7	17.6
Other Income*	50.2	6.0	7.4	10.3	-21.2	58.5	14.7
Expenditure	-4.4	-2.5	20.6	30.7	29.0	19.9	19.6
of which:							
Raw Material	-13.6	-4.0	34.2	44.0	37.8	21.6	19.9
Staff Cost	8.1	6.3	5.2	13.7	16.7	20.5	21.5
Power and Fuel	-13.2	-16.1	-5.1	10.7	15.3	12.1	17.3
Depreciation provision	21.5	20.7	21.6	20.1	19.9	16.8	13.6
Gross profits	5.8	10.9	60.0	36.7	8.2	10.3	11.0
Interest payments	3.7	-1.0	-12.3	-2.9	26.9	5.9	22.4
Profits after tax	5.5	12.0	99.3	44.0	2.4	10.8	10.3
							(Ratios in per cent)
Change in stock# to Sales	0.6	2.3	0.8	1.1	2.9	1.0	1.5
Gross Profits to Sales	15.7	14.9	14.3	14.6	13.9	13.6	13.6
Profits After Tax to Sales	10.2	9.4	8.8	9.0	8.6	8.5	8.3
Interest to Sales	2.8	3.1	2.7	2.4	2.9	2.7	2.8
Interest to Gross Profits	18.0	20.5	19.1	16.6	21.1	19.9	20.6
Interest Coverage (Times)	5.6	4.9	5.2	6.0	4.7	5.0	4.9

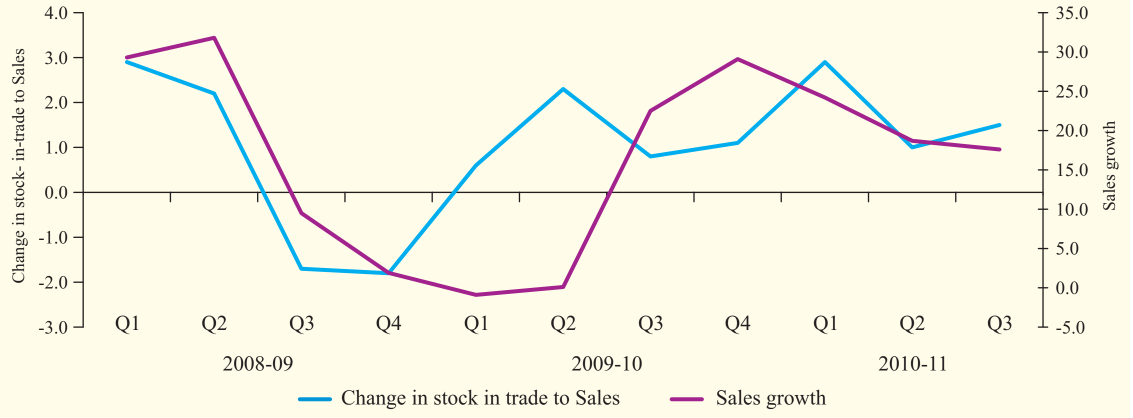
* : Other income excludes extraordinary income/expenditure if reported explicitly

: For companies reporting this item explicitly.

Note: 1. Data pertain to listed non-government non-financial companies.

2. 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 Change in Stock-in-Trade to Sales Ratio (%)



of input costs *viz*., expenses on raw materials, power & fuel and staff costs witnessed significant increase. Reflecting the tightening of monetary policy rates, interest payments have increased. Companies accumulated stocks as reflected in the rise in stock-in-trade to sales ratio. This may at the current juncture of cycle indicate that producers anticipate a pick-up in demand (Chart II.1). Early results for Q4 from a small sample of companies suggest that sales accelerated during the quarter.

Investment intentions of corporates moderate further in Q3 of 2010-11

II.9 Investment intentions of corporates witnessed a further slowdown in Q3 of 2010-11 after beginning to moderate from the previous quarter. Out of total costs of projects sanctioned in financial year 2010-11 (April-December), the largest share is envisaged to be invested in the power sector followed by the telecommunication sector and metal and metal products.

Demand conditions may soften a little, helping to rebalance growth

II.10 The pick-up in private spending in 2010-11 helped in sustaining growth recovery from the slowdown seen in the immediate aftermath of the global financial crisis. This was essential as the recovery in the initial phases was driven by fiscal stimulus that resulted in large government spending. Nevertheless, the pick-up in private consumption and fiscal consolidation has enabled rebalancing of demand. Restraint on subsidies in the wake of high global oil prices, and maintenance of investment demand are critical for sustaining private demand.

III. THE EXTERNAL SECTOR

Current account deficit (CAD) moderated in Q3 of 2010-11, reflecting significant acceleration in exports. While concerns on CAD in 2010-11 have receded, the spike in oil prices poses the risk of CAD widening in 2011-12. Capital flows are expected to improve financing the CAD comfortably. However, the dominance of portfolio equity flows and the decline in FDI raise concern over the stability of capital flows. While the earthquake in Japan is unlikely to significantly affect India, risk of further worsening of the geo-political situation in MENA and a possible turnaround in global interest rate cycle would have to be factored into macro-policies.

Concerns on CAD have receded, but have not dissipated

III.1 Current account deficit (CAD) that amounted to 3.7 per cent of GDP in H1 of 2010-11 moderated to 2.1 per cent of GDP in Q3 primarily reflecting pick up in exports. With this trend gaining further pace in Q4, the CAD for the full year may settle at around 2.5 per cent of GDP. However, the downward drift could reverse if the current spurt in global crude oil prices persists. With a larger CAD, any abrupt tightening of external financing could put pressure on the exchange rate, raise cost of capital and feed through into inflation. Developments in global economic and financial market conditions could impact the capital account, especially if the central banks in advanced economies (AEs) start withdrawing monetary accommodation. Such a withdrawal, however, is likely to raise global interest rates, reduce leveraged positions in global commodity markets and so help deflate global commodity prices.

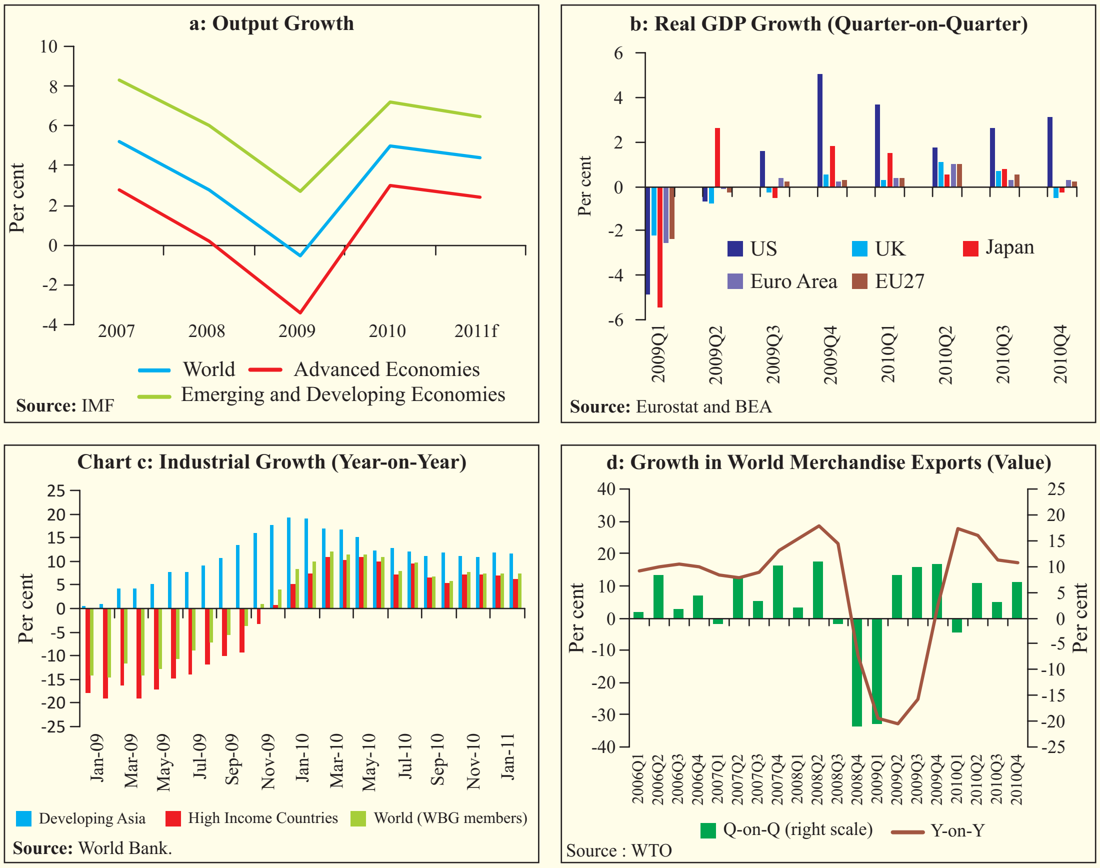
Global recovery advances but sovereign balance sheets pose risk

III.2 The global economic recovery is broadly on track. However, uncertainty remains with significant sovereign and banking sector default risks prevailing in parts of Europe. Furthermore, the recovery continues to move at multi-speed characterised by large output gaps in AEs and closing or closed gaps in emerging market and developing economies (EMDEs). More significantly, unemployment rates have begun to fall in US and Germany. The risk of double dip recession has receded. Nevertheless, still-stagnant real estate markets, stubbornly high unemployment and possibility of contagion from weak sovereign balance sheets of peripheral European countries continue to present major concerns in the AEs. IMF, in April 2011, has projected the world real GDP growth to slow down modestly to 4.4 per cent in 2011 from 5 per cent in 2010 (Chart III.1a). The key downside risk to global growth relates to the potential for oil prices to surprise further on the upside because of supply disruptions. Among the AEs, there was a diverging trend in growth during the fourth quarter *vis-à-vis* the previous quarter (Chart III.1b).

Outlook for capital flows to EMEs suggests risks from sudden reversals

III.3 While the capital flows to EMEs are likely to remain strong, they do run the risks of turning volatile, with possible episodes of sudden reversals. As strong capital flows in the first place were caused by the multi-speed recovery around the world and the consequent differential exit from accommodative monetary

Chart III.1: Key Global Indicators

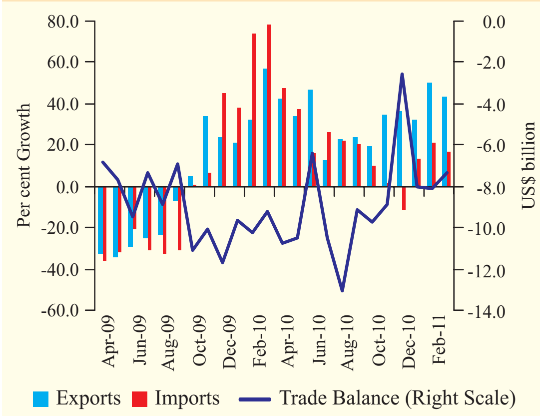


policy, the start of the exit in AEs can result in increased "home-bias" in investments and changes in portfolio allocations. US recovery and the need for massive reconstruction in Japan can bolster this trend. Net private capital flows to EMEs, according to the IIF, are estimated to increase by 6 per cent in 2011 to US $ 960 billion on top of an increase of 50 per cent during 2010 (IIF, January 2011). Net private financial flows to EMDEs, according to IMF's World Economic Outlook (April 2011), are projected at US $ 388 billion in 2011 as against US $ 470 billion in 2010.

World trade recovery continues, while industrial production regains speed after stagnation

III.4 World trade and industrial production slowed during the latter half of 2010, reflecting a global inventory cycle. Recent data show a mixed picture. Industrial production had begun to regain speed at the start of the calendar year (Chart III.1c). However, both the manufacturing and the services Purchasing Managers' Index had dipped in March 2011 in the aftermath of earthquake in Japan, though the index values suggest continued expansion. Global trade is recovering with the value of world merchandise trade, led by Asia, accelerating perceptibly in the fourth quarter of 2010 compared to the same period of 2009 (Chart III.1d). In volume terms, world trade expanded by 12 per cent in 2010. World imports of EMDEs are back to pre-crisis trends, but those of advanced economies continue to lag. Japan's disaster is likely to have some impact on East Asian economies, which have strong trade and financial links with Japan, before a reconstruction-led recovery starts.

Chart III.2: India's Merchandise Trade



Diversification in India's exports augurs well for trade balance

III.5 The robust growth in India's exports reflects diversification of products from labour intensive manufactures to higher value-added products in engineering and petroleum sectors and to destinations across emerging markets and developing economies which led to moderation in trade deficit during 2010-11(Charts III.2 and 3).

Impact of MENA unrest significant, that of Japan will be marginal

III.6 The ongoing political unrest in some of the Middle East and North African (MENA) countries and the natural disaster in Japan are not expected to directly affect India's trade position as these economies do not have a high share in India's international trade; there could, however, be significant indirect effects arising from the possible rise in oil prices and other commodity prices. Oil alone constitutes about one-third of India's total imports (Chart III.4 and Table III.1). Further, some transitory impact

Chart III.3a: Composition of India's Exports

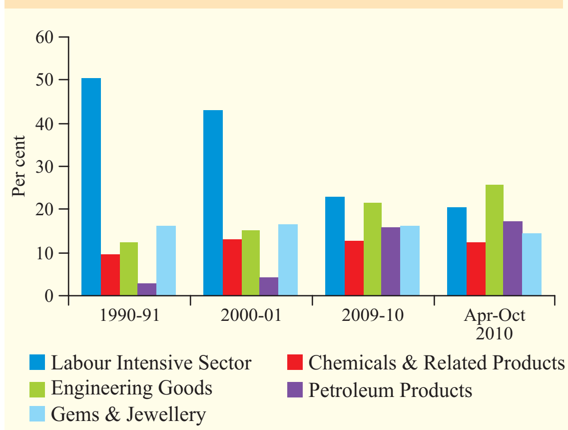


Chart III.3b: Destination of India's Exports

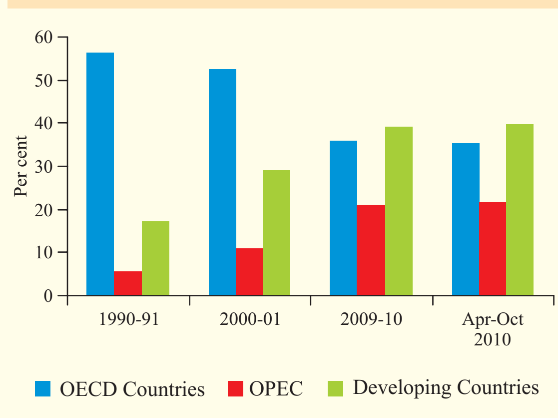


Chart III.4: India's POL Imports and International Crude Oil Prices

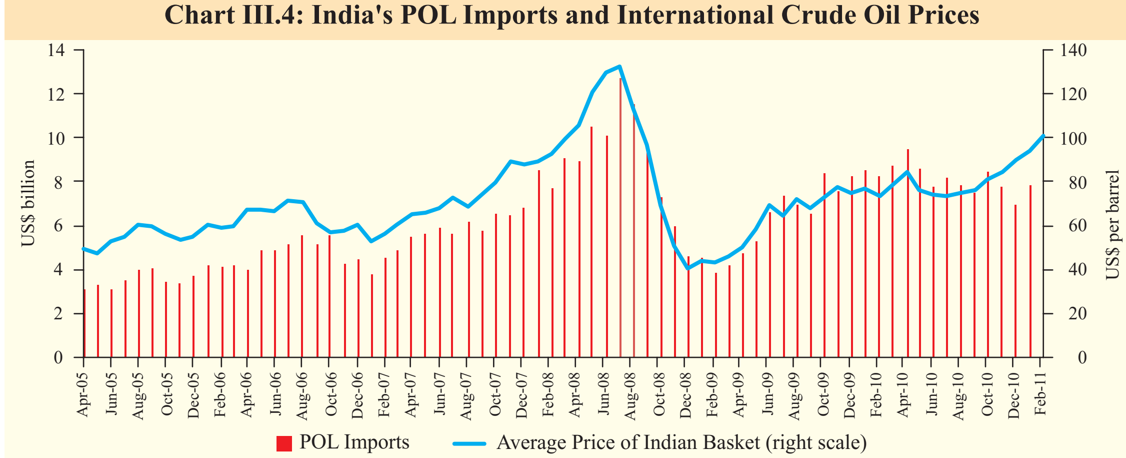


Table III.1: India's Merchandise Trade

(US$ billion)

Item	2009-10 (R) Absolute	2009-10 (R) Growth (%)	2010-11 (P)* Absolute	2010-11 (P)* Growth (%)
1	2	3	4	5
Exports	178.2	-2.5	245.9	37.6
Oil	28.1	2.1	42.5	51.2
Non-oil	150.1	-3.2	203.5	35.5
Imports	287.4	-3.8	350.3	21.9
Oil	86.8	-7.4	88.2	12.4
Non-oil	200.6	-2.2	217.1	20.4
Trade Balance	**-109.2**	**-5.7**	**-104.4**	**-4.4**
Non-Oil Trade Balance	**-50.5**	**1.2**	**-41.8**	**-6.9**

* : For oil and non-oil imports and non-oil trade balance data pertain to April-February.

R : Revised. P : Provisional.

Source: DGCI&S.

on investment flows and aid commitments from Japan may occur.

CAD moderation aided by net invisibles receipts too

III.7 Both the trade and invisible accounts contributed to the improvement in current account during Q3 of 2010-11. The higher invisibles surplus was mainly on account of an improvement in net services exports and private transfers (Table III.2). As a result, the CAD moderated from 3.7 per cent of GDP in H1 of 2010-11 to 3.1 per cent of GDP during April-December 2010 which was, however, higher than 2.6 per cent of GDP during April-December 2009.

III.8 Services exports recorded a strong growth during October-December 2010 over the corresponding quarter of the previous year led by travel, transportation, business, financial and software services. While net business services receipts gradually improved over the quarters, software exports rebounded strongly in Q3 of 2010-11. The robust growth in software exports could be attributed to the transformation in Indian information technology (IT) service offerings from application development and maintenance to provision of full services

Table III.2: India's Balance of Payments

(US $ billion)

Item	2009-10	2009-10 (PR) Q1	2009-10 (PR) Q2	2009-10 (PR) Q3	2009-10 (PR) Q4	2010-11 Q1 (PR)	2010-11 Q2 (PR)	2010-11 Q3 (P)
1	2	3	4	5	6	7	8	9
1. Exports	182.2	39.2	43.4	47.2	52.5	55.3	51.8	66.0
2. Imports	300.6	65.4	73.0	78.1	84.1	88.0	89.6	97.5
3. Trade Balance (1-2)	-118.4	-26.3	-29.6	-30.9	-31.6	-32.8	-37.8	-31.6
4. Net Invisibles	80.0	22.1	20.4	18.7	18.8	20.3	21.0	21.9
5. Current Account Balance (3+4)	-38.4	-4.2	-9.2	-12.2	-12.8	-12.5	-16.8	-9.7
6. Gross Capital Inflows	345.7	77.8	96.0	81.6	90.3	95.3	112.6	174.2
7. Gross Capital Outflows	292.3	74.2	76.7	66.9	74.5	78.8	91.3	159.3
8. Net Capital Account (6-7)	53.4	3.7	19.3	14.6	15.8	16.6	21.3	14.9
9. Overall Balance (5+8)#	13.4	0.1	9.4	1.8	2.1	3.7	3.3	4.0

: Overall balance also includes errors and omissions apart from items 5 and 8.

PR : Partially Revised. P : Provisional.

Table III.3: Net Invisibles

(US $ billion)

Item	October-December 2009-10 (PR)	October-December 2010-11 (P)	April-December 2009-10 (PR)	April-December 2010-11 (P)
1	2	3	4	5
1. Services	8.2	12.2	27.3	34.2
Of which:				
Travel	1.1	1.5	1.8	2.8
Transportation	-0.4	-0.3	-0.3	-0.5
Software Services	12.9	14.7	34.2	39.9
Business Services	-2.1	-0.9	-4.9	-3.1
Financial Services	-0.4	-0.1	-0.5	-0.4
2. Transfers (Private)	12.8	13.4	39.5	39.5
3. Income	-2.5	-3.9	-5.8	-10.6
Investment Income	-2.2	-3.6	-5.2	-9.9
Compensation of Employees	-0.3	-0.3	-0.5	-0.8
Total (1+2+3)	**18.5**	**21.7**	**61.0**	**63.1**

PR: Partially Revised. P: Preliminary.

comprising testing, infrastructure, consulting and system integration as well as the benefits of geographical diversification. Investment income receipts declined significantly over the corresponding period of the previous year, mainly due to the persistence of lower interest rates abroad. Private transfer receipts continued to be robust during the year so far. On the other hand, invisibles payments in Q3 were also higher due to larger payments under almost all components of invisibles, particularly investment income and business services. Net invisibles balance improved significantly in Q3 of 2010-11 over the corresponding quarter of the preceding year (Table III.3).

Composition and volatility in capital flows remain a concern

III.9 Although the net capital flows in Q3 of 2010-11 remained broadly the same as in the corresponding quarter of the preceding year, the composition and volatility of capital flows raised some concerns (Table III.4). For example, the FDI flows moderated. This was mainly on account of lower FDI inflows under services and 'construction, real estate and mining'. Though net FII flows were higher, they were volatile with several bouts of net outflows during the quarter.

III.10 Certain lead indicators of capital flows suggest that FDI inflows continued to be moderate during Q4 of 2010-11. FII flows also remained moderate being negative initially, but turned positive thereafter. ECB approvals increased on the back of strong domestic

Table III.4: Net Capital Flows

(US $ billion)

Item	October-December 2009-10 (PR)	October-December 2010-11 (P)	April-December 2009-10 (PR)	April-December 2010-11 (P)
1	2	3	4	5
Net Capital flows	14.6	14.9	37.6	52.7
Of which:				
1. Foreign Direct Investment (FDI)	3.0	2.1	15.4	7.6
Inward FDI	7.2	5.3	27.0	18.0
Outward FDI	-4.2	-3.2	-11.6	-10.4
2. Portfolio Investment	5.7	6.3	23.6	30.1
Of which:				
FIIs	5.3	7.2	20.5	29.5
ADR/GDRs	0.5	0.2	3.2	1.8
3. External Assistance	0.8	1.2	1.9	4.2
4. External Commercial Borrowings	1.7	3.6	2.4	9.3
5. NRI Deposits	0.6	0.2	3.5	2.3
6. Short-term Trade Credit	3.2	1.5	3.1	8.5

PR: Partially Revised. P: Preliminary.

Table III.5: Capital Flows in 2010-11 so far

(US $ billion)

Component	Period	2009-10	2010-11
1	2	3	4
FDI to India	April-February	33.8	25.9
FIIs (net)	April-March	29.0	29.4
ADRs/GDRs	April-March	3.3	2.0
ECB Approvals	April-March	20.7	25.6
NRI Deposits (net)	April-March	2.9	3.2

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

demand and interest rate differentials (Table III.5). Notwithstanding some easing of pressures with respect to financing of CAD, the moderation in equity inflows coupled with rising debt flows during 2010-11 so far poses risks to sustainability. Any unforeseen global developments may affect CAD and its financing and, therefore, warrant close monitoring of the evolving situation.

Higher absorption of capital inflows leaves modest reserve accretion

III.11 As net capital inflows were in excess of CAD, India's foreign exchange reserves increased modestly during Q3 of 2010-11. India's foreign exchange reserves stood at US$ 309.7 billion as on April 22, 2011. Net capital inflows, though relatively higher, were largely absorbed by higher CAD during April-December 2010 and did not complicate the monetary management.

Indicators of Real Effective Exchange Rate (REER) exhibit appreciation

III.12 The real effective exchange rate (REER) indices for 6-currency, 30-currency and 36-currency baskets exhibited appreciation of the Indian rupee during 2010-11. The 6-currency index showed maximum appreciation compared to other indices reflecting higher inflation differential with these countries

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

(Per cent, appreciation+/depreciation-)

	Index	Year-on-Year Variation (Average)		
	April 15 2011 P	2008-09	2009-10 P	2010-11 P
1	2	3	4	5
36-REER	102.3	-9.9	-3.1	7.7
36-NEER	92.8	-10.9	-2.6	2.9
30-REER	93.7	-10.2	-4.6	4.5
30-NEER	94.7	-8.3	-2.2	1.0
6-REER	115.8*	-9.3	-0.01	12.7
6-NEER	90.8*	-13.6	-3.4	5.7
Rs/USD	44.5	-12.5	-3.1	4.1
Rs/USD (end-March)	44.7	-21.5	12.9	1.1

NEER : Nominal Effective Exchange Rate.
REER : Real Effective Exchange Rate.
P : Provisional.
* : Data pertain to March 2011.
Note : Rise in indices indicates appreciation of the rupee and vice versa.

(Table III.6). The REER appreciation may not have implications for external sector competitiveness as there are a host of other factors such as global recovery leading to a pick-up in demand as well as diversification of the export basket and across destinations and various Government initiatives that have a bearing on the export performance.

External debt rises

III.13 External debt stock as at end-December 2010 showed an increase of around 14 per cent over the level of end-March 2010 reflecting increases in ECBs and short-term credit as well as valuation effects due to depreciation of the US dollar against other major currencies (Table III.7).

III.14 The debt sustainability indicators witnessed a modest deterioration at end-December 2010 on account of the continued dominance of debt creating flows (Table III.8).

Net international liabilities increase

III.15 Large increase in India's net international liabilities during the quarter,

Table III.7: India's External Debt

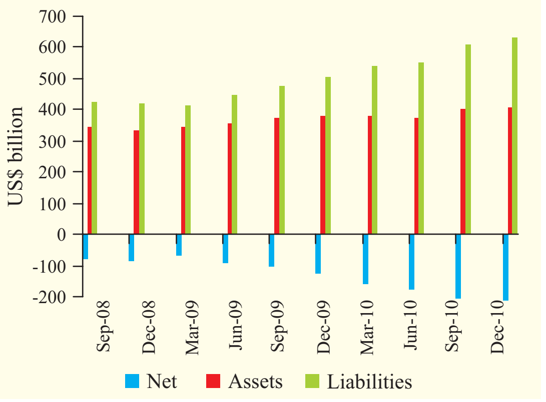
(US$ billion)

Item	External debt outstanding			Variation December 2010 over March 2010	
	End-March 2009	End-March 2010 (PR)	End-December 2010 (P)	Amount	Per cent
1	2	3	4	5	6
1. Multilateral	39.5	42.9	47.6	4.7	11.0
2. Bilateral	20.6	22.6	25.2	2.6	11.5
3. IMF	1.0	6.0	6.1	0.1	1.7
4. Trade Credit	14.5	16.9	19.0	2.1	12.4
5. Commercial Borrowings	62.4	70.9	84.7	13.8	19.5
6. NRI Deposits	41.6	47.9	50.7	2.8	5.8
7. Rupee Debt	1.5	1.7	1.6	-0.1	-5.9
8. Long-Term Debt (1 to 7)	**181.2**	**208.8**	**234.9**	**26.1**	**12.5**
9. Short-Term Debt	**43.4**	**52.3**	**62.6**	**10.3**	**19.7**
Total Debt (8+9)	**224.6**	**261.2**	**297.5**	**36.3**	**13.9**

PR : Partially Revised. P : Provisional.
Source: Ministry of Finance, Government of India and Reserve Bank of India.

despite moderation in CAD, mainly reflected the valuation effects due to exchange rate movements (Chart III.5).

Chart III.5: International Investment Position



Oil prices and capital flow volatility to shape external balance

III.16 Hardening of international crude oil prices on the back of geo-political concerns pose risks to current account balance during 2011-12. Higher growth in software exports and robust transfer receipts may provide some cushion. Financing of the current account, however, may not be a problem as capital flows are likely to improve considering India's long-run growth prospects and policies supporting FDI, as also larger FII investments in debt markets. Nonetheless, the composition and volatility of capital flows could have implications for external sector vulnerability, warranting close monitoring.

Table III.8: External Sector Vulnerability Indicators

(Per cent)

Indicator	End-December 2009	End-March 2010	End-September 2010	End-December 2010
1	2	3	4	5
1. Total Debt/GDP	-	18.0	-	-
2. Ratio of Short-term to Total Debt (Original Maturity)	18.0	20.0	20.9	21.0
3. Ratio of Short-term to Total Debt (Residual Maturity)	-	41.2	42.9	-
4. Ratio of Concessional Debt to Total Debt	17.7	16.8	16.0	15.6
5. Ratio of Reserves to Total Debt	112.8	106.8	101.4	99.9
6. Ratio of Short-term Debt to Reserves	15.7	18.8	20.6	21.1
7. Reserves Cover of Imports (in months)	12.4	11.1	10.3	9.9
8. Reserves Cover of Imports and Debt Service Payments (in months)	11.6	10.5	9.8	9.4
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	5.1	5.5	3.8	3.9

IV. MONETARY AND LIQUIDITY CONDITIONS

Tight liquidity conditions prevailing during the third quarter of 2010-11 eased somewhat during the fourth quarter mainly on account of softening of both structural and frictional stress factors. The deficit liquidity conditions strengthened monetary transmission, which was reflected in higher deposit as well as lending rates of banks, and in turn improved deposit growth and induced slight moderation in credit growth. The anti-inflationary thrust of monetary policy, however, continued to remain non-disruptive of the growth momentum.

Monetary conditions remain consistent with the anti-inflationary bias

IV.1 During 2010-11, the monetary and liquidity conditions remained consistent with the anti-inflationary stance. The monetary policy stance of the Reserve Bank shifted to tightening mode since October 2009 in response to rising inflationary pressures. The calibrated policy actions so far have not been disruptive to growth. The Reserve Bank increased cash reserve ratio by 100 basis points (bps), reverse repo rate by 250 bps, and the repo rate by 200 bps since February 2010 so far. A shift from absorption mode to injection mode in the liquidity adjustment facility (LAF) implies effective rise in policy rates by 350 bps since February 2010 (Table IV.1).

IV.2 During 2010-11, the Reserve Bank articulated a net liquidity level of ±1 per cent of net demand and time liabilities (NDTL) of banks as ideal for effective monetary transmission. The persistence of deficit liquidity conditions in Q4 of 2010-11 helped in further strengthening the monetary policy transmission. However, inflation continues to remain at elevated levels. The Reserve Bank strove to maintain the difficult balance between ensuring sufficient liquidity for smooth functioning of markets on the one hand and sustaining the anti-inflationary monetary policy stance on the other.

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
October 11, 2008	6.00	9.00	6.50 (–2.50)
October 20, 2008	6.00	8.00 (–1.00)	6.50
October 25, 2008	6.00	8.00	6.00 (–0.50)
November 3, 2008	6.00	7.50 (–0.50)	6.00
November 8, 2008	6.00	7.50	5.50 (–0.50)
December 8, 2008	5.00 (-1.00)	6.50 (–1.00)	5.50
January 5, 2009	4.00 (-1.00)	5.50 (–1.00)	5.50
January 17, 2009	4.00	5.50	5.00 (–0.50)
March 4, 2009	3.50 (-0.50)	5.00 (-0.50)	5.00
April 21, 2009	3.25 (-0.25)	4.75 (-0.25)	5.00
February 13, 2010	3.25	4.75	5.50 (+0.50)
February 27, 2010	3.25	4.75	5.75 (+0.25)
March 19, 2010	3.50 (+0.25)	5.00 (+0.25)	5.75
April 20, 2010	3.75 (+0.25)	5.25 (+0.25)	5.75
April 24, 2010	3.75	5.25	6.00 (+0.25)
July 2, 2010	4.00 (+0.25)	5.50 (+0.25)	6.00
July 27, 2010	4.50 (+0.50)	5.75 (+0.25)	6.00
September 16, 2010	5.00 (+0.50)	6.00 (+0.25)	6.00
November 2, 2010	5.25 (+0.25)	6.25 (+0.25)	6.00
January 25, 2011	5.50 (+0.25)	6.50 (+0.25)	6.00
March 17, 2011	5.75 (+0.25)	6.75 (+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.

Liquidity conditions soften as structural and frictional liquidity drivers ease

IV.3 After a phase of significant tightness, both structural and frictional drivers of deficit liquidity conditions softened relatively during the fourth quarter of 2010-11 (Table IV.2). Liquidity conditions had switched to deficit mode since end-May 2010, due to large increase in government balances with the Reserve Bank

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)
2009				
April	1,08,430	70,216	-40,412	1,38,234
May	1,10,685	39,890	-6,114	1,44,461
June	1,31,505	22,890	12,837	1,67,232
July	1,39,690	21,063	26,440	1,87,193
August	1,53,795	18,773	45,127	2,17,695
September	1,06,115	18,773	80,775	2,05,663
October	84,450	18,773	69,391	1,72,614
November	94,070	18,773	58,460	1,71,303
December	19,785	18,773	1,03,438	1,41,996
2010				
January	88,290	7,737	54,111	1,50,138
February	47,430	7,737	33,834	89,001
March*	990	2,737	18,182	21,909
April	35,720	2,737	-28,868	9,589
May	6,215	317	-7,531	-999
June	-74,795	317	76,431	1,953
July	1,775	0	16,688	18,463
August	11,815	0	20,054	31,869
September	-30,250	0	65,477	35,227
October	-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 22	-16,405	0	-48,401	-64,806

@ : Excludes minimum cash balances with the Reserve Bank in case of surplus.

* : Data pertain to March 31.

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.

(resulting from 3G/BWA auctions and the first installment of quarterly advance tax payments). The Reserve Bank initiated several policy measures to ease the liquidity pressure *viz.,* allowing SCBs to avail of additional liquidity support under the LAF and conducting second LAF (SLAF) on a daily basis.

IV.4 Liquidity conditions eased in August 2010, mainly on account of large pre-scheduled public debt redemptions. After a brief period of surplus liquidity, the LAF again switched to deficit mode from the second week of September 2010 on account of quarterly advance tax payments. Structural factors like imbalances between deposit and credit growth coupled with high currency demand added to the pressure on liquidity. During the third quarter, the Reserve Bank undertook open market operation (OMO) purchases and other measures to ease the liquidity pressures.

IV.5 Liquidity conditions eased marginally during the last quarter of 2010-11 due to pick-up in government spending and staggered OMOs carried out by the Reserve Bank since mid-December (Table IV.3). During 2010-11, the Reserve Bank purchased government securities of around ₹67,000 crore under OMO auctions. Notwithstanding the quarterly advance tax payouts in mid-March 2011, which again contributed to temporary tightness, the liquidity deficit remained capped on account of higher government expenditure during the month.

IV.6 During first week of April 2011, the LAF was in reverse repo mode, partly reflecting increased government spending. However, since April 11, it has reverted to deficit mode.

IV.7 The monetary transmission is usually substantially more effective in a deficit liquidity situation than in a surplus liquidity situation. An empirical exercise carried out by the Working Group on Operating Procedures of Monetary Policy (Chairman: Shri Deepak Mohanty) suggests that under deficit liquidity conditions, money market rates respond immediately to policy shock.

IV.8 The recent episodes of large government surplus cash balances emerging as a major autonomous factor influencing the liquidity points towards a need for better cash management by the government (Chart IV.1). In this context, the above Working Group suggested a scheme of auctioning of government surplus cash balances at the discretion of the Reserve Bank to be put in place in consultation with the government.

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

(₹ crore)

Item	2009-10				2010-11			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9
A. Drivers of Liquidity (1+2+3+4)	**-45,110**	**-44,513**	**-66,785**	**55,055**	**-1,05,124**	**26,981**	**-1,12,597**	**73,540**
1. RBI's net Purchase from Authorised Dealers	-15,874	2,523	436	910	816	751	5,991	0
2. Currency with the Public	-18,690	-9,020	-43,224	-31,109	-58,757	180	-42,613	-45,487
3. a. Centre's surplus balances with RBI	3,382	-67,938	-22,663	85,257	-58,249	10,953	-78,960	1,28,021
3. b. WMA and OD	0	0	0	0	0	0	0	0
4. Others (residual)	-13,928	29,922	-1,334	-3	-8,994	15,097	2,985	-8,994
B. Management of Liquidity (5+6+7+8)	**-21,674**	**62,376**	**89,870**	**1,618**	**67,255**	**-41,456**	**1,34,075**	**15,771**
5. Liquidity impact of LAF	-1,30,020	25,390	86,330	18,795	75,785	-44,545	83,165	-7,410
6. Liquidity impact of OMO* (net)	43,159	32,869	3,540	2,787	1,550	2,772	50,910	23,181
7. Liquidity impact of MSS	65,187	4,117	0	16,036	2,420	317	0	0
8. First round impact of CRR change	0	0	0	-36,000	-12,500	0	0	0
C. Bank Reserves # (A+B)	**-66,784**	**17,863**	**23,085**	**56,673**	**-37,869**	**-14,475**	**21,478**	**89,311**

(+) : 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.

Structural drivers respond to policy signals amidst tight liquidity

IV.9 The monetary policy transmission was weak till May 2010 due to overhang of large surplus liquidity that had to be infused following the global financial crisis. The anti-inflationary policy actions of the Reserve Bank that operated through raising the policy rates contributed to keeping liquidity and monetary conditions in line with the policy objective. In a tight liquidity environment, it was expected that higher deposit rates would improve the growth of deposits while higher lending rates would moderate the demand for credit. During Q4 of 2010-11, effective transmission of monetary policy was reflected in higher deposit as well as lending rates of banks and higher issuances of bulk deposits by way of CDs. As a result, credit growth decelerated, while deposit growth accelerated, thereby narrowing the divergence between credit and deposit growth rates (Chart IV.2). The easing

Chart IV.1: LAF Volumes and GoI Balances

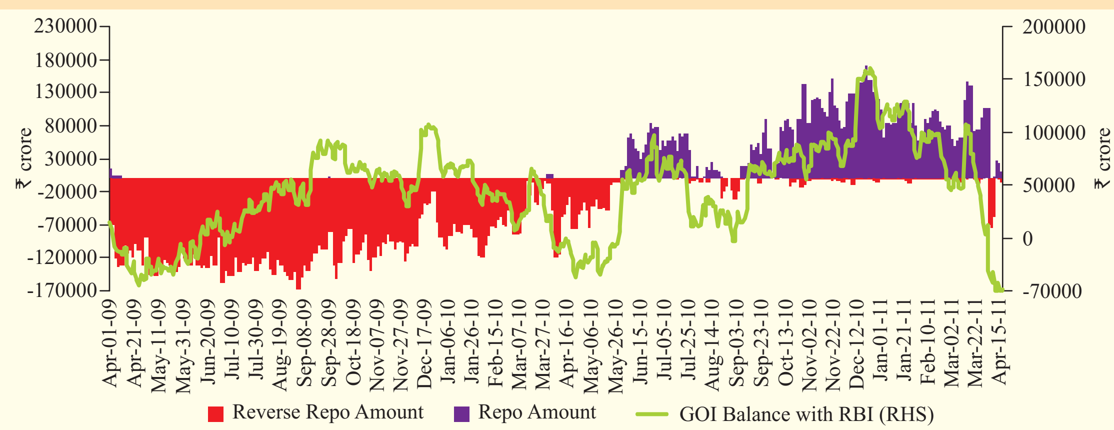
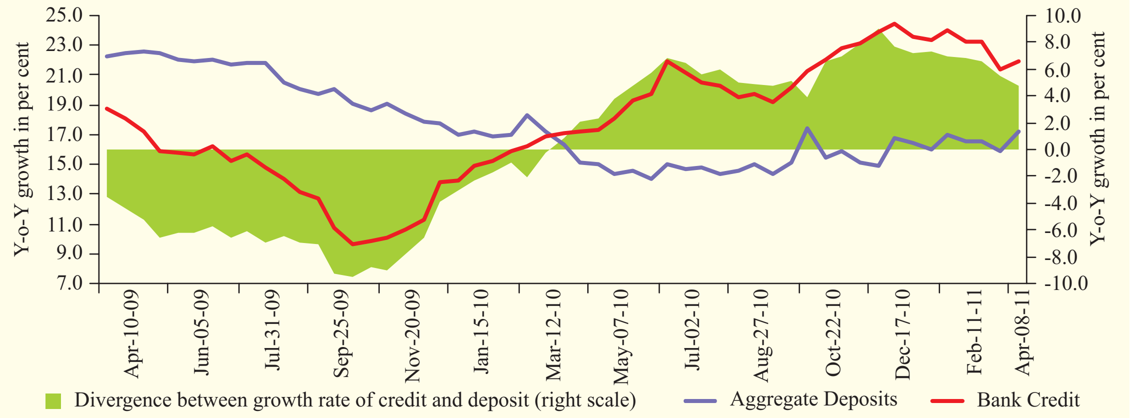


Chart IV.2: Aggregate Deposits and Bank Credit



of liquidity conditions was reflected in the decline in the LAF injection.

Money supply growth remains below the indicative trajectory

IV.10 Even as reserve money growth remained strong, the money supply (M_3) growth during 2010-11 generally remained below the indicative trajectory set out in the Annual Policy Statement for 2010-11 (Table IV.4). This was due to lower growth in aggregate deposits and reduction in money multiplier emanating from higher currency demand.

Table IV.4: Monetary Indicators

(Y-o-Y growth in per cent)

Item	2009-10	2010-11
1	2	3
Broad Money (M_3)	16.8	15.9
Narrow Money (M_1)	18.2	9.6
Main Components of M_3		
Currency with the Public	15.3	19.1
Aggregate Deposits	17.2	15.4
of which: Demand Deposits	22.0	-0.6
Time Deposits	16.4	18.2
Main Sources of M_3		
Net Bank Credit to the Government	30.7	18.2
Bank Credit to the Commercial Sector	15.8	20.6
Net Foreign Assets of the Banking Sector	-5.2	7.4
Reserve Money	17.0	19.1
Reserve Money adjusted for CRR changes	13.0	18.2
Scheduled Commercial Banks		
Non-food Credit	17.1	21.2
Aggregate Deposits	17.2	15.8

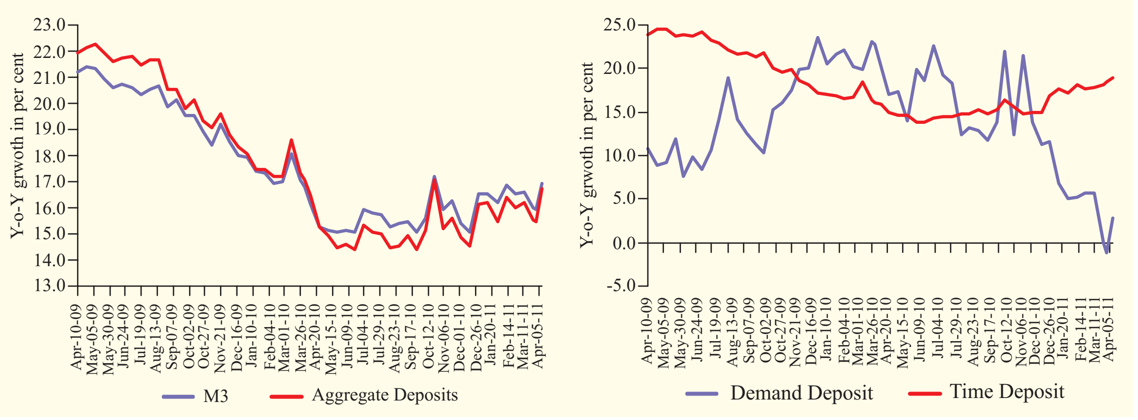
Note: 1. Data are provisional.
2. Data pertain to March 31, except for SCBs, which pertain to March 25 for 2010-11 and March 26 for 2009-10.

IV.11 Money supply growth is largely influenced by the trend in aggregate deposits, as these account for over 85 per cent of the money stock. During the first three quarters of 2010-11, term deposits appeared relatively unattractive as a store of value, in view of the modest rise in deposit rates relative to high inflationary expectations. During the last quarter of the year, however, as deposit rates were raised sharply, deposit mobilisation gathered momentum, which also helped in the pick-up in money supply growth. As a result of a sharper increase in deposit interest rates during the quarter as also the deceleration in industrial activity and the underperformance of equity market, a shift from low interest bearing demand deposits to more lucrative time deposits became evident (Chart IV.3).

Strong currency demand aided tight liquidity and decline in money multiplier

IV.12 Stronger growth in demand for currency during 2010-11 contributed to both tightness in liquidity and subdued growth in broad money. The growth in currency demand, which generally remains below money supply growth, witnessed a spurt in 2010-11 partly reflecting stronger GDP growth and persistent high inflation. During the year 2010-11, the

Chart IV.3: Money Supply and Deposits



real elasticity of demand for currency remained close to unity, indicating the predominant role that inflation played in generating high currency demand (Chart IV.4). The rise in currency demand, coupled with deceleration in the growth of aggregate deposits resulted in a higher currency-deposit ratio, and hence, a decline in the money multiplier. Consequently, even with high base money growth, due mainly to injection of primary liquidity through repo and OMOs, the money supply growth remained lower than the indicative trajectory (Chart IV.5).

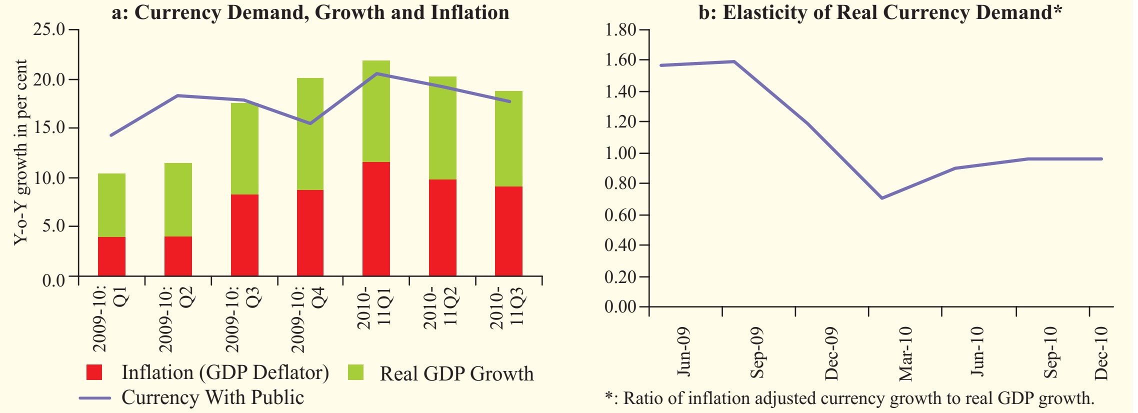
Income velocity of money recovers from the post-crisis dip

IV.13 There was a sharp fall in the velocity of money (M_3) during 2008-09 and 2009-10 reflecting post-global crisis uncertainties in the financial system. With consolidation of growth and normal financial conditions, the income velocity of money reverted to its long-term path, involving a pick-up in 2010-11 (Chart IV.6).

Credit growth remains above trajectory but has started moderating

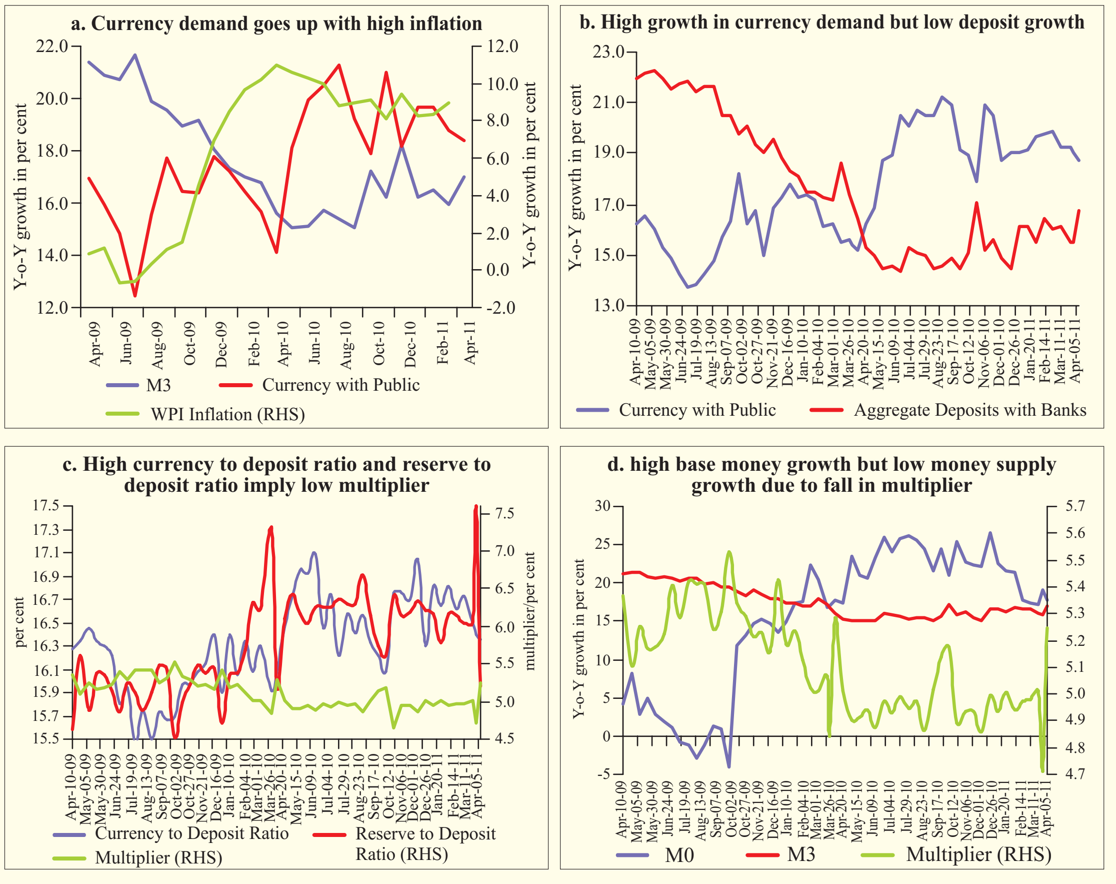
IV.14 Credit growth remained above the indicative trajectory, but with some moderation seen in the recent period. After witnessing an acceleration in non-food credit growth over the indicative trajectory of 20 per cent, there had been some moderation since the beginning of Q4 of 2010-11. In response to higher interest rates, the non-food credit growth decelerated and deposit growth accelerated. Consequently,

Chart IV.4: Trend in Currency Demand



*: Ratio of inflation adjusted currency growth to real GDP growth.

Chart IV.5: Decline In Money Multiplier Constrains Money Supply Growth



the incremental credit-deposit ratio moderated (Chart IV.7).

IV.15 The moderation in credit growth on a y-o-y basis was especially evident in the case of public sector banks, even though the credit conditions generally remained supportive of economic activity (Table IV.5).

IV.16 The sectoral deployment of credit continued to remain broad-based, with high growth in flow of credit to services and personal

Chart IV.6: Quarterly Trends in Velocity of Money

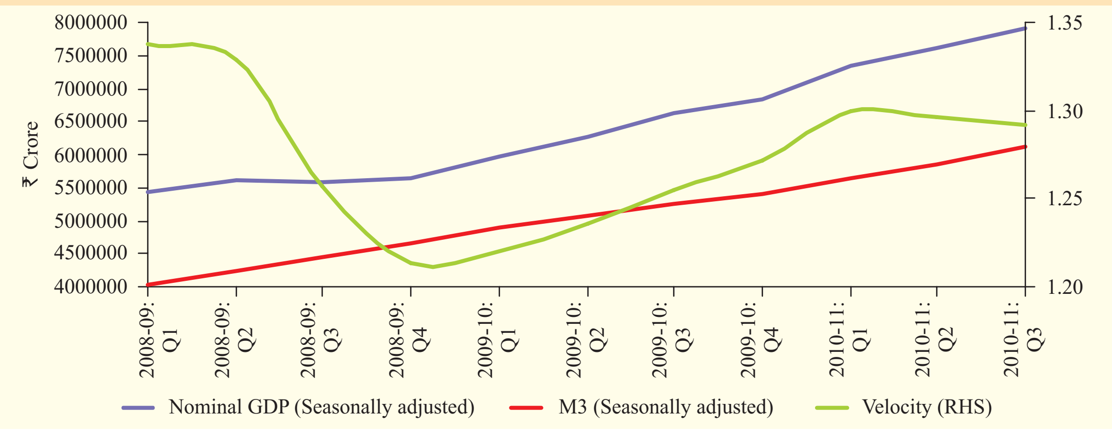
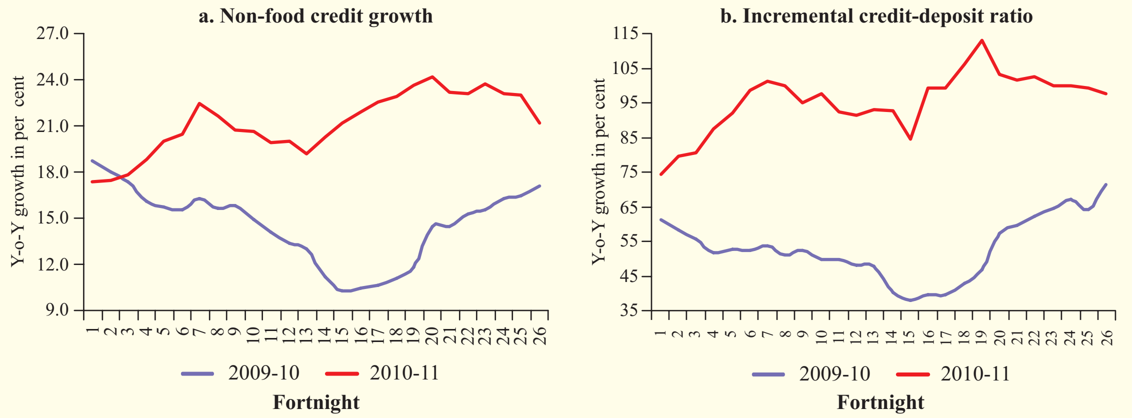


Chart IV.7: Credit Indicators



loans (Table IV.6). Disaggregated analysis suggests that credit to the industrial sector continued to be led by credit to infrastructure, metal and metal products, textiles, engineering, food processing and gems and jewellery. The high growth in credit to infrastructure is especially noteworthy as it is on a high base. The bank credit to NBFCs also witnessed a sharp rise.

IV.17 Banks continued to be the major source of finance for the commercial sector. During 2010-11, funding from non-bank sources registered a marginal decline as compared to the previous year (Table IV.7). In the case of foreign sources of funding, external commercial borrowings /FCCBs have registered robust rise, partly reflecting the soft interest rate regime prevalent in most of the advanced economies. The decline in foreign direct investment (FDI) was substantially offset by the rise in ECBs/ FCCBs.

Monetary policy to factor risks to growth from high inflation

IV.18 The Reserve Bank's anti-inflationary policy has been calibrated with a view to containing inflationary expectations, while being non-disruptive to the overall growth process. The deficit liquidity conditions helped in strengthening the monetary transmission further in Q4 of 2010-11 as reflected in higher deposit and lending rates, which helped in easing the structural stress on liquidity. The growth momentum has continued so far. However, inflation remains elevated, despite the 350 bps effective increase in policy rates. Risk to growth from sustained high inflation could condition the stance of the monetary policy in near-term. Since high inflation itself

Table IV.5: Credit Flow from Scheduled Commercial Banks

(Amount in ₹ crore)

Bank Groups	Outstanding as on Mar 25, 2011	Year-on-Year Variation as on Mar 26, 2010 Amount	Mar 26, 2010 Per cent	Mar 25, 2011 Amount	Mar 25, 2011 Per cent
1	2	3	4	5	6
1. Public Sector Banks	29,19,923	3,95,427	19.6	5,05,785	21.0
2. Foreign Banks	1,97,893	-2474	-1.5	31,032	18.6
3. Private Banks	7,28,029	61,212	11.7	1,43,325	24.5
4. All Scheduled Commercial Banks*	39,38,659	4,69,240	16.9	6,93,870	21.4

Note: 1. Data as on Mar 25, 2011 are provisional.
2. * Including Regional Rural Banks.

Table IV.6: Sectoral Deployment of Credit

(Per cent)

Sector	Q-o-Q Variation		Y-o-Y variation	
	Mar.26, 2010 over Dec. 18, 2009	Mar.25, 2011 over Dec. 17, 2010	Mar. 26, 2010 over Mar. 27, 2009	Mar. 25, 2011 over Mar. 26, 2010
1	2	3	4	5
Non-food credit	**10.4**	**8.1**	**16.8**	**20.6**
Agriculture and allied activities	**19.5**	**9.3**	**22.9**	**10.6**
Industry	**11.3**	**8.0**	**24.4**	**23.6**
of which, Infrastructure	11.8	8.3	40.7	38.6
Basic metal & metal products	8.5	8.7	26.5	28.8
Textiles,	9.0	11.1	18.2	19.2
Engineering	9.6	4.8	12.2	26.3
Food processing	18.0	15.0	22.1	29.3
Gems & Jewellery	5.9	8.6	11.3	24.2
Services	**9.8**	**8.9**	**12.5**	**23.9**
of which, tourism, hotels, restaurants	16.4	2.9	42.5	42.9
Professional services	2.6	7.1	-1.9	38.9
Commercial real estate	5.2	6.1	-0.3	21.4
NBFCs	10.2	22.9	14.8	54.8
Personal Loans	**3.4**	**6.8**	**4.1**	**17.0**
of which, consumer durables	5.2	12.4	1.3	22.4
Housing	2.5	4.1	7.7	15.0
Vehicle Loans	7.6	5.4	2.9	24.3

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 being disseminated every month from November 2010.

could disrupt growth, it is important for the monetary policy to ensure a low inflation environment as a pre-condition for sustained high growth.

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

(₹ crore)

Item	April-March		
	2008-09	2009-10	2010-11
1	2	3	4
A. Adjusted Non-food Bank Credit (NFC)	**4,21,921**	**4,78,614**	**7,06,949**
i) Non-Food Credit	4,11,824	4,66,960	6,78,078
of which petroleum and fertilizer credit	31,159	10,014	-24,236
ii) Non-SLR Investment by SCBs	10,097	11,654	28,871
B. Flow from Non-banks (B1+B2)	**4,51,399**	**6,04,303**	**5,09,432**
B1. Domestic Sources	**2,58,132**	**3,80,733**	**3,08,619**
1. Public issues by non-financial entities	14,205	31,956	28,520
2. Gross private placements by non-financial entities	77,856	1,41,964	63,874 #
3. Net issuance of CPs subscribed to by non-banks	4,936	41,667	33,546 *
4. Net credit by housing finance companies	25,876	28,485	35,325 +
5. Total gross accommodation by the four RBI regulated AIFIs - NABARD, NHB, SIDBI & EXIM Bank	31,408	33,783	40,007
6. Systemically important non-deposit taking NBFCs (net of bank credit)	42,277	60,663	71,267 +
7. LIC's gross investment in corporate debt, infrastructure and social sector	61,574	42,215	36,080
B2. Foreign Sources	**1,93,267**	**2,23,570**	**2,00,813**
1. External Commercial Borrowings / FCCBs	30,948	15,674	59,545
2. ADR/GDR Issues excluding banks and financial institutions	4,788	15,124	9,441
3. Short-term credit from abroad	-13,288	34,878	38,854 #
4. FDI to India	1,70,819	1,57,894	92,973 +
C. Total Flow of Resources (A+B)	**8,73,320**	**10,82,917**	**12,16,381**
Memo Item:			
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	-32,168	96,578	-36,707

*: Up to March 15, 2011 +: Up to February 2011 #: April-December 2010

Note: FDI data for April-February include equity capital for April-February and reinvested earnings, other capital and equity capital for unincorporated bodies for April-December.

V. FINANCIAL MARKETS

Monetary transmission strengthened during Q4 of 2010-11 with interest rates firming up gradually across the spectrum as liquidity remained in deficit mode. The policy transmission to deposit and lending rates is visible in the current base rate regime. Asset prices, including property prices, generally remained range bound. Equity markets experienced orderly correction in Q4 of 2010-11. The rupee exhibited two-way movements against the US dollar without any intervention or active capital account management. Going forward, the financial markets need to brace up to the geopolitical risks in MENA, default risks in the Euro zone and movements in cross-border capital flows.

Global portfolio rebalancing to impact domestic financial markets

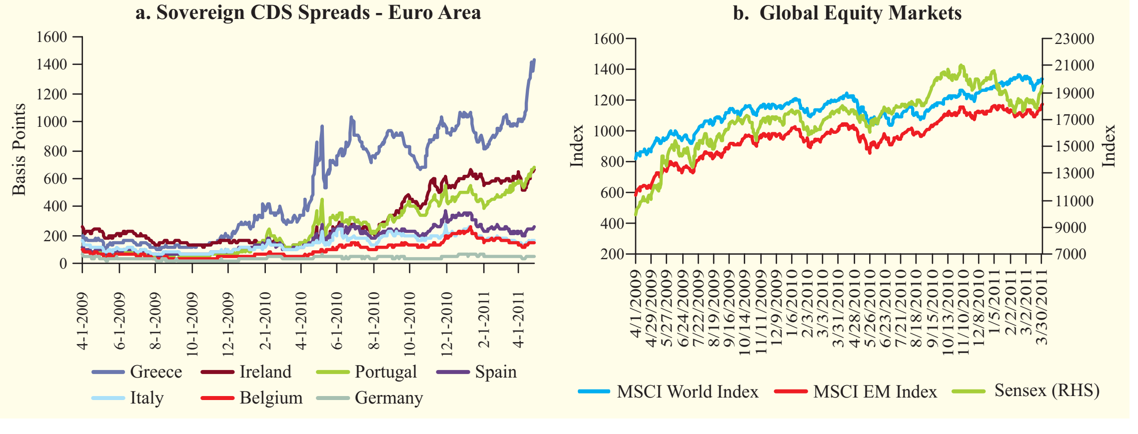
V.1 The year 2010-11 was marked by periods of volatility and tranquility in the Indian financial markets. With global uncertainties rising, volatility may aggravate further, partly from building up of speculative positions in global commodity markets. Portfolio choices are also governed by the geopolitical developments in the MENA region and availability of easy liquidity in certain advanced economies. An additional source of uncertainty for the global financial markets is the sovereign and banking sector default risks in parts of Europe (Chart V.1a) There could, however, be a rebalancing of investors' portfolio if economic recovery in major advanced economies gains traction and causes a quicker-than-anticipated withdrawal of monetary accommodation. With rise in global equity markets (Chart V.1b) there may be a shift in investors' preference away from the EME markets to those of the advanced economies, particularly the US.

V.2 While credit spreads shrank markedly during Q4 of 2010-11, bond yields in advanced economies firmed up reflecting the post-crisis rise in debt to GDP ratio as well as incipient signs of inflationary concerns. Apart from food prices, the rising expectations of increased crude oil prices following the geo-political risks in MENA raised inflationary expectations especially in EMEs. The initial reaction to the downside risks associated with the natural calamity hit Japanese economy has subsequently given rise to the expectations of boost in demand for its reconstruction.

Global uncertainties and anti-inflationary monetary policy stance impacting Indian markets, but orderly conditions prevail

V.3 Global uncertainties as well as domestic developments impacted Indian financial markets.

Chart V.1: Indicators of Global Financial Market Developments



The Indian markets, however, remained largely orderly, despite the challenges posed by persistent inflation and high current account deficit.

V.4 Call rate firmed up in step with the policy rates and remained above the upper bound of the LAF corridor for a major part of Q4 of 2010-11, due to frictions caused by skewed SLR holdings (Chart V.2a). While issuances and rates on certificates of deposits (CDs) continued to increase during the quarter reflecting banks' efforts to mobilise more funds, issuance of commercial paper (CP) moderated on account of the strong credit growth, even as the rates continued to be high reflecting general liquidity stress (Chart V.2b). The yield curve for government securities (G-sec) further flattened during Q4 in response to policy rate hike expectations and liquidity tightness.

V.5 The Indian rupee appreciated moderately against the US dollar. Stock markets remained volatile for the greater part of Q4, weighed by domestic and global concerns, but appreciated towards the close of the quarter on the back of strong foreign portfolio inflows. Returns in the Indian equity markets were relatively lower than most other EMEs (Table V.1). Prices in the housing market continued the rising trend during the third quarter of 2010-11.

Money market rates reflect liquidity conditions

V.6 The money market was generally orderly although liquidity conditions remained in deficit mode during the fourth quarter of 2010-11. Reflecting the high credit demand, high currency growth, and unspent surplus balance in the government account as also the hikes in policy rates by the Reserve Bank, the call rates mostly remained above the repo rate during Q4 (Chart V.2a, Table V.2). The rates in the collateralised segments also rose in line with the trend in the call money market.

V.7 Transaction volumes in the collateralised borrowing and lending obligation (CBLO) and market repo segments were higher during Q4 than Q3 of 2010-11 (Table V.3). The collateralised segment of the money market remained predominant, accounting for more than 80 per cent of the total volume of transactions during 2010-11.

V.8 With strong credit growth not matched by commensurate deposit growth, banks increasingly financed their advances by raising CDs at higher rates. During surplus liquidity situations, when the CP rates are lower than the Base Rates, corporates take greater recourse to the CPs. They, however, prefer bank financing,

Table V.1: Stock Price Movements and PE Ratios in EMEs

(Per cent)

Stock Price Variations				P/E Ratios			
Item	End-March 2010@	End-March 2011@	End-March 2011*	Item	End-March 2010	End-Dec. 2010	End-March 2011
1	2	3	4	5	6	7	8
Indonesia (Jakarta Composite)	93.7	32.5	-0.7	Indonesia (Jakarta Composite)	13.6	20.9	18.5
Brazil (Bovespa)	72.0	-2.5	-1.0	Brazil (Bovespa)	16.4	13.9	11.6
Thailand (SET Composite)	82.6	32.9	1.4	Thailand (SET Composite)	12.4	15.2	14.0
India (BSE Sensex)	80.5	10.9	-5.2	India (BSE Sensex)	17.7	18.7	17.3
South Korea (KOSPI)	40.3	24.4	2.7	South Korea (KOSPI)	12.2	16.0	12.9
China (Shanghai Composite)	31.0	-5.8	4.3	China (Shanghai Composite)	23.1	16.1	16.6
Taiwan (Taiwan Index)	52.0	9.6	-3.2	Taiwan (Taiwan Index)	19.1	15.4	14.7
Russia (RTS)	128.0	30.0	15.5	Russia (RTS)	9.8	8.6	9.6
Malaysia (KLCI)	51.4	17.0	1.7	Malaysia (KLCI)	18.9	17.4	17.0
Singapore (Straits Times)	69.9	7.6	-2.6	Singapore (Straits Times)	13.4	11.3	10.9

@ : Year-on-year variation. * : End-March 2011 over End-December 2010.
Source: Bloomberg.

Table V.2: Rates in Domestic Financial Markets

	Money Market					Bond Market		Forex Market	Stock Market Indices	
	Call Rate* (Per cent)	Market Repo Rate (Non-LAF) (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
Apr-10	3.49	3.04	2.95	5.37	5.56	8.01	8.37	44.50	5295	19679
May-10	3.83	3.79	3.67	6.85	5.17	7.56	8.15	45.81	5053	16845
Jun-10	5.16	5.29	5.21	6.82	6.37	7.59	8.21	46.57	5188	17300
Jul-10	5.54	5.37	5.25	6.93	6.69	7.69	8.27	46.84	5360	17848
Aug-10	5.17	5.12	5.01	7.32	7.17	7.93	8.52	46.57	5457	18177
Sep-10	5.50	5.35	5.24	7.82	7.34	7.96	8.52	46.06	5811	19353
Oct-10	6.39	5.96	5.88	12.15	7.67	7.68	8.58	44.41	6069	20250
Nov-10	6.81	6.42	6.14	12.22	8.16	8.03	8.64	45.02	6055	20126
Dec-10	6.67	6.27	6.20	10.10	9.15	8.03	8.89	45.16	5971	19228
Jan-11	6.54	6.21	6.20	8.81	9.42	8.15	9.05	45.39	5783	19289
Feb-11	6.69	6.45	6.43	9.05	10.04	8.12	9.25	45.44	5401	18037
Mar-11	7.15	6.56	6.46	10.40	9.96	8.00	9.23	44.99	5538	18457

*: Average of daily weighted call money rates. **: Average of daily closing indices.
WADR: Weighted Average Discount Rate. WAEIR: Weighted Average Effective Interest Rate.

once the CP rates rise above the Base Rate. Leasing-finance and manufacturing companies continue to be the major issuers of CPs (Table V.4).

V.9 The primary yields on Treasury Bills (TBs) firmed up during Q4 of 2010-11 in line with the spike in short-term interest rates (Table V.5).

V.10 Annualised volatility of one year interest rate swaps increased during Q4 of 2010-11 (Chart V.3). This may reflect market uncertainties on future short-term money market rates.

The yield curve responds to monetary actions and lower budgeted borrowings

V.11 Responding to the persistently high inflation and tightening liquidity conditions, G-sec yields, both in the primary and secondary markets, firmed up during January 2011, but moderated thereafter. A lower-than-expected fiscal deficit and market borrowing programme for the first half of 2011-12 improved market sentiments. Yields eased in March 2011 in response to announcement of auctioning

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

a: Policy Rates and Money Market Rates | **b. CP and CD outstanding *vis-a-vis* Non-food Credit Growth**

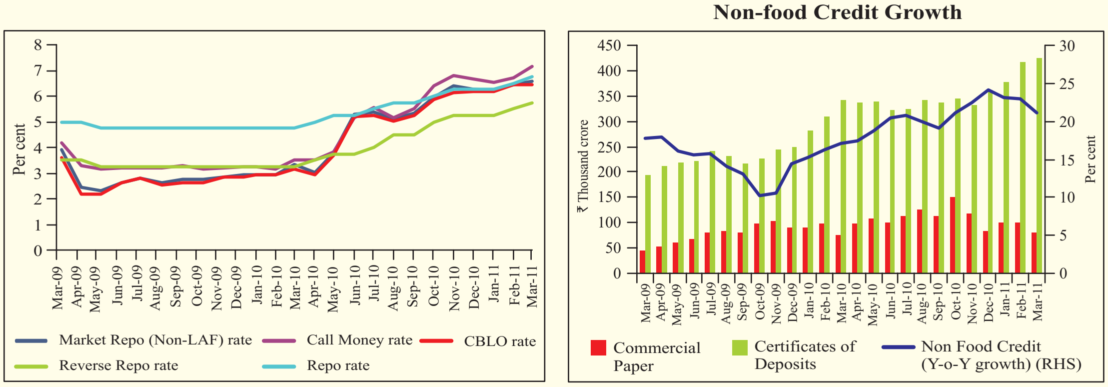


Table V.3: Average Daily Volumes in Domestic Financial Markets

(₹ 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	6,221	1598	16,378	9,191
Apr-10	57,150	8,187	20,319	50,891	98,769	3,36,807	10,682	1671	18,411	9,262
May-10	32,798	8,393	17,610	42,274	1,09,039	3,40,343	18,774	1653	20,122	8,836
Jun-10	-47,347	7,129	9,481	31,113	99,792	3,21,589	14,523	1236	18,476	8,605
Jul-10	-46,653	9,477	12,011	29,102	1,12,704	3,24,810	10,105	1450	17,126	8,443
Aug-10	-1,048	7,958	15,553	45,181	1,26,549	3,41,616	12,488	1146	18,476	9,656
Sep-10	-24,155	8,606	15,927	53,223	1,12,003	3,37,322	11,582	1254	18,787	10,446
Oct-10	-61,658	8,920	14,401	43,831	1,49,620	3,43,353	10,355	1151	25,053	11,404
Nov-10	-99,311	8,865	9,967	32,961	1,17,793	3,32,982	7,645	922	22,092	11,190
Dec-10	-1,20,495	9,436	12,989	43,784	82,542	3,61,408	6,939	830	17,737	8,574
Jan-11	-92,933	7,758	11,546	44,815	1,01,752	3,77,640	7,025	912	20,054 P	8,430
Feb-11	-78,639	10,356	13,150	42,292	1,01,291	4,18,524	6,994	863	19,673 P	8,011
Mar-11	-80,963	11,278	15,134	43,201	80,305	4,24,740	8,144	1314	22.211 P	7,458

*: Outstanding position P:Provisional. #: Comprises volumes in BSE and NSE.
@: Average daily outright trading volume in Central Government dated securities.
Note: In col. 2 (-) ve indicates injection of liquidity while (+) ve indicates absorption of liquidity.

of unutilised investment limits for FIIs for G-Sec and corporate debt. The flattening of yield curve despite inflationary pressures may have been aided by policy rate hikes and temporarily lower issuances (Chart V.4a).

V.12 In the primary market, investors' sentiment remained positive, as reflected in the lower bid-cover ratio, which stood in the range of 1.39-3.87 during the year and 1.69-3.25 during the fourth quarter. More long dated securities were issued to take advantage of the yield curve movements (Table V.6). The spreads on five-year corporate bonds over the corresponding government bond yield widened during the fourth quarter of 2010-11 on the back of tight liquidity conditions (Chart V.4b).

Table V.4: Major Issuers of Commercial Paper

(₹ crore)

End of Period	Leasing and Finance		Manufacturing		Financial Institutions		Total
	Amount	Share (%)	Amount	Share(%)	Amount	Share(%)	Outstanding
1	2	3	4	5	6	7	8
Mar-09	27,183	62	12,738	29	4,250	9	44,171
Jun-09	34,437	50	23,454	34	10,830	16	68,721
Sep-09	31,648	40	31,509	40	16,071	20	79,228
Dec-09	36,027	40	42,443	47	11,835	13	90,305
Mar-10	39,477	52	22,344	30	13,685	18	75,506
Jun-10	42,572	43	43330	43	13,890	14	99,792
Aug-10	57,161	45	55,933	44	13,455	11	1,26,549
Sep-10	58,098	52	40,485	36	13,420	12	1,12,003
Oct-10	80,306	54	54,894	37	14,420	9	1,49,620
Nov-10	58,871	50	45,457	39	13,465	11	1,17,793
Dec-10	49,282	60	24,960	30	8,300	10	82,542
Jan-11	55,591	55	35,601	35	10,560	10	1,01,752
Feb-11	51,339	51	40,262	39	9,690	10	1,01,291
Mar-11	46,350	58	22,695	28	11,260	14	80,305

Table V.5: Treasury Bills in the Primary Market

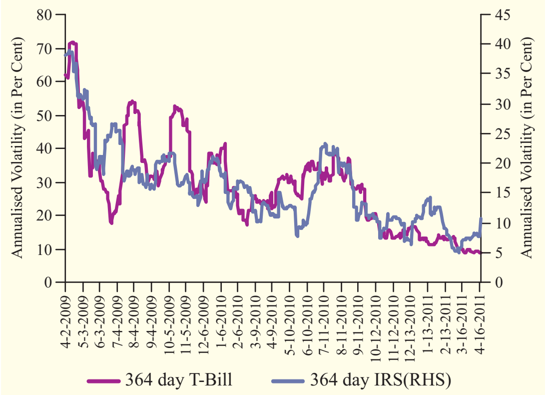
Year/ Month	Notified Amount (₹ crore)	Average Implicit Yield at Minimum Cut-off Price (Per cent)		
		91-day	182-day	364-day
1	2	3	4	5
2009-10	3,80,000	3.57	3.97	4.38
2010-11	3,03,000	6.04	6.47	6.66
Apr-10	36,000	4.14	4.64	5.07
May-10	36,000	4.39	4.76	4.92
Jun-10	12,000	5.29	5.31	5.41
Jul-10	16,000	5.51	5.86	5.88
Aug-10	33,000	6.15	6.41	6.48
Sep-10	13,000	6.11	6.41	6.59
Oct-10	26,500	6.57	6.82	6.97
Nov-10	24,000	6.82	7.15	7.14
Dec-10	19,000	7.14	7.29	7.37
Jan-11	21,000	7.17	7.37	7.55
Feb-11	29,500	7.15	7.51	7.68
Mar-11	37,000	7.23	7.49	7.61

V.13 Interest Rate Futures (IRF) on 91-day TBs were permitted by the Reserve Bank in March 2011. These futures will be cash settled with the final settlement price based on the weighted average price/yield obtained in the weekly auctions on the date of expiry of the contract. This is likely to enhance liquidity and also to provide more options for the financial markets to hedge interest rate risks through exchanges.

Deposit and lending rates transmit the anti-inflationary policy stance

V.14 Stronger transmission is evident as banks continued to increase both the lending rates and deposit rates across maturity spectrums. Deposit rates have risen rapidly to accommodate fast rise in credit and to offset the tight liquidity environment during 2010-11. Scheduled commercial banks (SCBs) raised their deposit rates in the range of 25-500 basis points between end-March 2010 and end-March 2011 across maturities. The deposit rates for 1-3 years maturity increased by 50-125 basis points during the fourth quarter (Table V.7). Several banks reviewed and increased their base rates by 75-125 basis points between July 2010 and March 2011. Base rates of 64 major banks with a credit share of around 98 per cent ruled in the range of 8.0-9.5 per cent in March 2011, reflecting greater convergence since base rates became operational effective July 1, 2010.

Chart V.3: Volatility in Treasury Bill and Interest Rate Swap



Exchange rate remains orderly and flexible

V.15 The rupee remained stable during the fourth quarter of 2010-11, without any

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

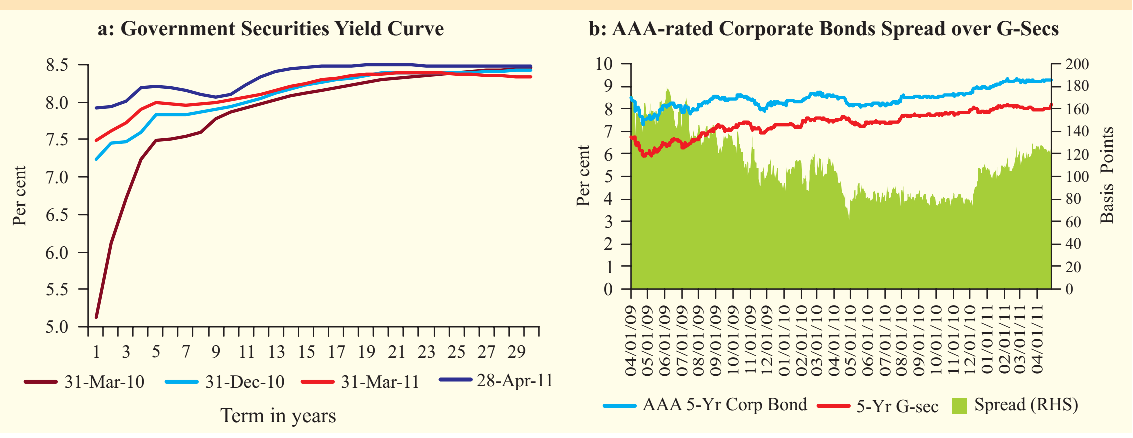


Table V.6: Issuances of Central and State Government Dated Securities

Item	2009-10	2010-11
1	2	3
Central Government		
Gross amount raised (₹crore)	4,51,000*	4,37,000
Devolvement on Primary Dealers (₹crore)	7,219	5,772
Bid-cover ratio (Range)	1.4-4.3	1.4-3.9
Weighted average maturity (years)	11.2	11.6
Weighted average yield (per cent)	7.2	7.9
State Governments		
Gross amount raised (₹crore)	1,31,122	1,04,039
Cut-off yield (Per cent)	7.0-8.6	8.1-8.6
Weighted average yield (per cent)	8.1	8.4

* : Inclusive of MSS desequestering of ₹33,000 crore.

intervention or active capital account management. It exhibited two-way movement against major international currencies except Euro. There was a modest appreciation against the US dollar since mid-February 2011 (Chart V.5a). While the turnover in inter-bank segment of the foreign exchange market remained volatile, the turnover in the merchant segment increased in Q4 of 2010-11.

V.16 Volumes in the exchange traded currency derivatives increased during Q4 of 2010-11 (Chart V.5b). The growth in volumes particularly for currency futures and options has been supported by retail participation and companies. In fact, the monthly trend of turnover in OTC forwards and swap involving rupee remained sluggish during this period. While turnover in the merchant segment decreased from USD 93 billion in October 2010 to USD 64 billion in March 2011 (up to March 25), the turnover in the inter-bank segment declined from USD 418 billion to USD 367 billion for the corresponding period.

Equity markets underperform, remain volatile

V.17 Reflecting several macroeconomic uncertainties, Indian equity markets underachieved and remained volatile during Q4 of 2010-11. Markets lost much of the valuation gains made during the last four months of 2010, when they outperformed most of the international markets. During Q4 of 2010-11, the BSE Sensex has been the worst performer amongst the major equity indices barring Nikkei. Slowdown of net equity investment by the FIIs in India largely contributed to the decline (Chart V.6a). In terms of the coefficient of variation, the volatility of Sensex between end-December 2010 and end-March 2011 at 3.95 per cent is much higher than the 2.0 per cent of the MSCI emerging market index and 1.9 per cent of the MSCI world index. The equity derivatives segment had gone up

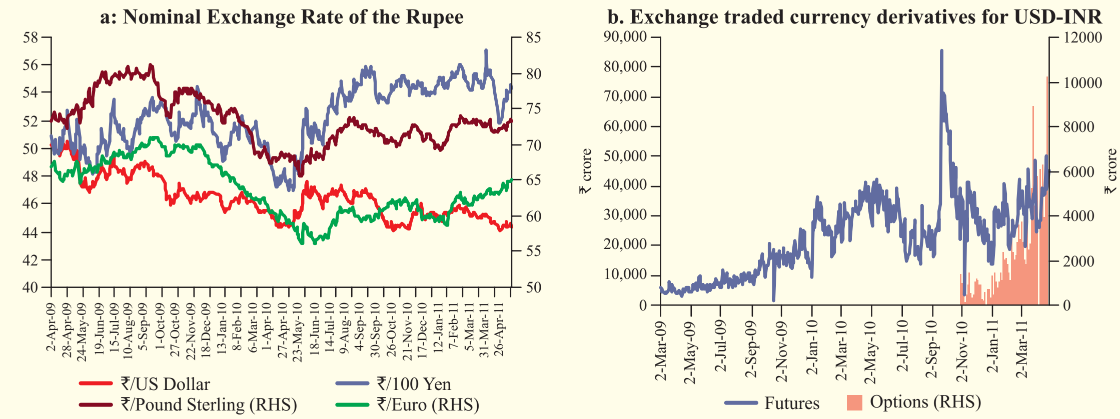
Table V.7: Deposit and Lending Rates of Banks

(Per cent)

	Sep-10	Dec-10	Mar-11
1	2	3	4
1. Domestic Deposit Rate (1-3 years tenor)			
a. Public Sector Banks	6.75-7.75	7.00-8.50	8.00-9.75
b. Private Sector Banks	6.50-8.25	7.25-9.00	7.75-10.10
c. Foreign Banks	3.00-8.00	3.50-8.50	3.50-9.10
2. Base Rate			
a. Public Sector Banks	7.50-8.25	7.60-9.00	8.25-9.50
b. Private Sector Banks	7.00-8.75	7.00-9.00	8.25-10.00
c. Foreign Banks	5.50-9.00	5.50-9.00	6.25-9.50
3. Median Lending Rate*			
a. Public Sector Banks	7.75-13.50	8.75-13.50	-
b. Private Sector Banks	8.00-15.00	8.25-14.50	-
c. Foreign Banks	7.25-13.00	8.00-14.50	-

* : Median range of interest rates at which at least 60 per cent of business has been contracted.

Chart V.5: Trends in Forex Market



substantially over the year and currently constitutes almost 90 per cent of the overall investments. FII investments accounted for 19.8 per cent of the total investments in derivatives (Chart V.6b)

V.18 The activity in the primary segment of the domestic capital market remained buoyant during the first three quarters of 2010-11, but moderated during Q4. However, resources raised through public issuances were higher during 2010-11 than the previous year (Table V.9). During the year, resource mobilisation by mutual funds turned negative, owing to high volatility in the market, surfacing of risks in the real sector, lower retail investments possibly on account of higher returns on competing instruments (bank deposits in particular) and also due to lower corporate support to the MFs.

Asset price concerns remain as housing prices remain firm

V.19 Property prices continued to rise in most cities during Q3 of 2010-11, as reflected in 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. However, the indices for Delhi and Chennai witnessed a decline during this period (Chart V.7).

Macro-factors may determine financial market movements ahead

V.20 Going forward, macroeconomic factors may dominate financial markets movements in 2011-12. Macro-risks are large and uncertainty abounds on how they might play out. Global commodity markets are witnessing firming up

Chart V.6: Movement in Stock Prices and Turnover

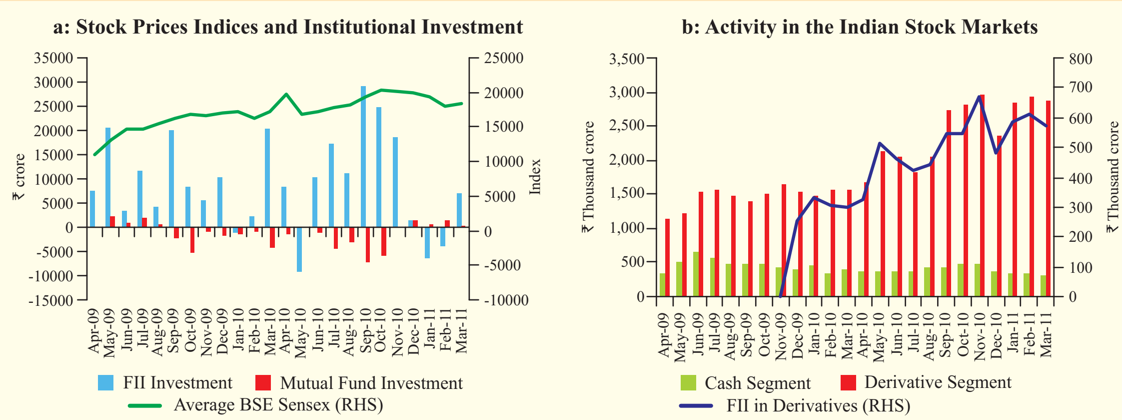
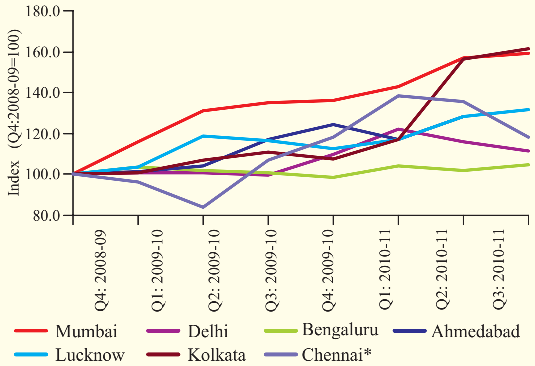


Table V.8: Key Stock Market Indicators

Indicator	BSE Sensex		NSE Nifty	
	2009-10	2010-11	2009-10	2010-11
1	2	3	4	5
1. BSE Sensex/S&PCNX Nifty				
(i) End-period	17527.77	19445.22	5249.1	5833.75
(ii) Average	15585.2	18605.18	4657.76	5583.54
2. Coefficient of Variation	11.88	6.32	11.33	6.4
3. Price-Earning Ratio @	21.32	21.15	22.33	22.14
4. Price-Book Value Ratio	3.9	3.7	3.7	3.7
5. Market Capitalisation to GDP Ratio (per cent)@	98.9	86.8	96.4	85.1

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

Chart V.7: Trends in House Price Index



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

of prices. Even though several hedge funds have booked profits in the global commodity markets in mid-March 2011 following the Japan earthquake, a fresh wave of speculation has arisen immediately after profit-booking as a result of MENA region event risk.

V.21 Domestic debt markets are likely to be conditioned by evolving fiscal and monetary policy considerations as well as possible hardening of global yields. However, the path of fiscal consolidation embarked upon by the Government could help to ease the pressure on long-term bond yields in the G-Sec market, if inflationary expectations are reined in. Sustained growth momentum could, however, continue to exert pressure on interest rates through high demand for credit. The risk of volatile portfolio flows impacting asset prices and exchange rate remains in the face of growing uncertainties in the global markets. The expected change in operating procedures could help improve the transmission of monetary policy on an enduring basis, enabling interest rate channel to work better.

Table V.9: Resource Mobilisation from Capital Market

(₹ crore)

Category	2008-09	2009-10	2010-11
1	2	3	4
A. Prospectus and Rights Issues*	14,671	32,607	37,620
1. Private Sector (a+b)	14,671	25,479	24,373
a) Financial	466	326	3,877
b) Non-financial	14,205	25,153	20,496
2. Public Sector	0	7,128	13,247
B. Euro Issues	4,788	15,967	9,441
C. Mutual Fund Mobilisation(net)@	-28,296	83,080	-49,406
1. Private Sector	-34,017	54,928	-19,215
2. Public Sector #	5,721	28,152	-30,191

* 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.

VI. PRICE SITUATION

The pick-up in inflation in March 2011 was contrary to general expectations of a gradual softening, as conditioned by decelerating industrial growth as well as sustained anti-inflationary monetary actions. Inflation in 2011-12 is likely to moderate slowly but remain above comfort levels reflecting strong persistence. The transmission of rising international commodity prices and spillover from past food and some wage price inflation in some sectors has been visible in recent months. Despite moderating food inflation, headline inflation remained firm in Q4 of 2010-11 as generalised price pressures emerged with rising input costs feeding into manufactured products inflation. Risks to inflation in 2011-12 have amplified from an uncertain outlook on international commodity prices, incomplete pass-through to domestic prices and possibility of prices of food, fuel, minerals and metals staying firm. Policy interventions are necessary to address near-term and structural imbalances to bring down inflation on an enduring basis.

Inflation stays elevated, while underlying drivers change

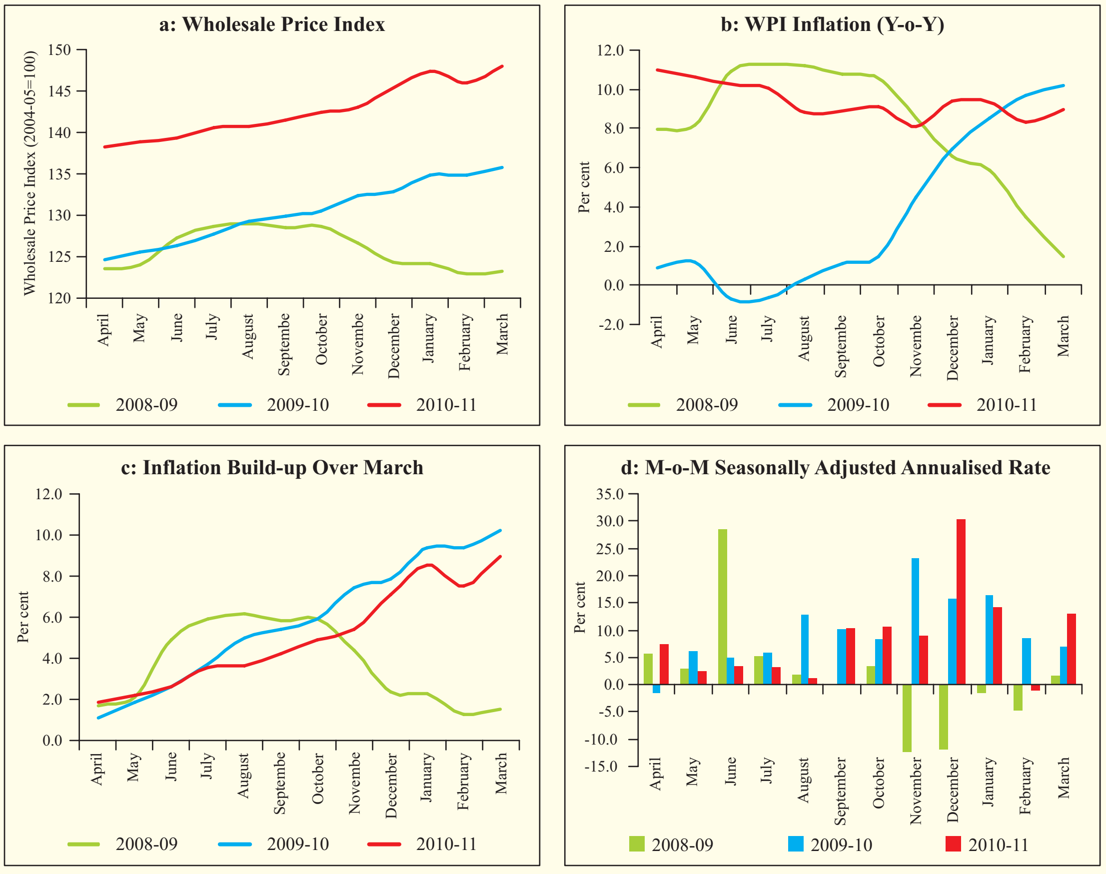
VI.1 Inflation remained elevated during 2010-11 driven by both supply shocks as well as gradual generalisation of price pressures. Though food inflation moderated during Q4 of 2010-11, increase in prices of a number of manufactured products and freely priced fuel items kept headline inflation firm at above the comfort level. Growing uncertainties in international commodity markets, continuing pressure on global commodity prices from newer shocks like the geo political tensions in MENA region and supply disruptions in primary commodity producing countries suggest increasing risks to the expected moderation in inflation. These developments necessitated continuation of the anti-inflationary monetary policy stance to control inflation and anchor inflationary expectations.

VI.2 One notable feature of inflation path during 2010-11 has been the repeated occurrence of a number of supply shocks which kept headline inflation stubbornly high. Subsequently, price pressures have passed through to other sectors in terms of significant increases in input prices. This was manifested in the secular increase in the Wholesale Price Index (WPI), prominently in the second half. The financial year build-up in inflation, however, has been lower than what was experienced during the previous year while month over month seasonally adjusted changes remained significantly positive indicating continued price pressures (Chart VI.1).

Return of global inflation adds to spillover risks

VI.3 The global inflation environment exhibited some turnaround in recent months as increase in commodity prices spilled over to headline inflation. Most inflation targeting countries currently have headline inflation above the target zone. In the case of advanced economies, core inflation remains subdued indicating absence of significant pressures from domestic demand. The rise in inflation, however, has been more pronounced in the EMEs. The higher share of food and fuel in total consumption basket explains a relatively larger influence of upward movement of international commodity prices on inflation in the EMEs.

Chart VI.1: Trends in Wholesale Price Inflation



VI.4 Most advanced economies continue to pursue accommodative monetary policies as core inflation remains subdued along with high unemployment levels and sluggish recovery in economic growth. However, as commodity price inflation feeds into inflation expectations and generalised inflation, advanced economies could face the policy challenge of containing inflation, even when recovery remains fragile. Even though the policy rates in most advanced economies remain very low, central banks have started to recognise the risks from commodity price spikes to inflation. The European Central Bank, on April 07, 2011, increased its policy rate by 25 basis points to 1.25 per cent after keeping it unchanged at historically low levels for almost two years (Table VI.1). Emerging market economies have continued with hikes in key policy rates as the balance of policy focus needed to be shifted towards controlling inflation. Given the recent increase in global commodity prices and its potential impact on generalised inflation going forward, EMEs are likely to persist with anti-inflationary monetary policy stance. Among the major EMEs, most central banks raised their key policy rates during the last quarter of 2010-11.

Risks from increase in global commodity prices to domestic inflation have increased significantly

VI.5 Global commodity prices have exhibited uptrend since mid-2010 fuelled by fresh concerns over supply prospects (Chart VI.2). Political tensions in the MENA region significantly impacted crude oil prices and

Table VI.1: Global Inflation Indicators

(Per cent)

Country/ Region	Key Policy Rate	Policy Rate	(as on April 28, 2011)	Changes in Policy Rates (basis points): Sep, 15. 08 to Aug. 23, 09	Changes in Policy Rates (basis points): Since Aug. 23, 09	CPI Inflation (y-o-y): Mar-10	CPI Inflation (y-o-y): Mar-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	1.4	3.3
Euro area	Interest Rate on Main Refinancing Operations	1.25	(Apr 13, 2011)	(-) 325	25	1.6	2.7
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10	(Oct. 5, 2010)*	(-) 40	(-) 10	-1.1	0.0
UK	Official Bank Rate	0.50	(Mar. 5,2009)	(-) 450	0	3.4	4.0
US	Federal Funds Rate	0.0 to 0.25	(Dec.16,2008)*	(-) 200	0	2.3	2.7
Developing Economies							
Brazil	Selic Rate	12.00	(Apr.21, 2011)	(-) 500	325	5.2	6.3
India	Reverse Repo Rate	5.75	(Mar 17, 2011)	(-) 275	250	14.9	8.8
	Repo Rate	6.75	(Mar. 17, 2011)	(-) 425	200		
				(-400)	(100)		
China	Benchmark 1-year Deposit Rate	3.25	(Apr. 6, 2011)	(-) 189	100	2.4	5.4
	Benchmark 1-year Lending Rate	6.31	(Apr. 6, 2011)	(-) 216	100		
				(- 200)	(500)		
Indonesia	BI Rate	6.75	(Feb. 4, 2011)	(-) 275	25	3.4	6.7
Israel	Key Rate	3.00	(Apr. 1, 2011)	(-) 375	250	3.2	4.3
Korea	Base Rate	3.00	(Mar.10, 2011)	(-) 325	100	2.3	4.7
Philippines	Reverse Repo Rate	4.25	(Mar. 24, 2011)	(-) 200	25	4.4	4.3
	Repo Rate	6.25	(Mar. 24, 2011)	(-) 200	25		
Russia	Refinancing Rate	8.00	(Feb. 28, 2011)	(-) 25	(-) 275	6.5	9.4
South Africa	Repo Rate	5.50	(Nov. 19, 2010)	(-) 500	(-) 150	5.1	4.1
Thailand	1-day Repurchase Rate	2.75	(Apr. 20, 2011)	(-) 250	125	3.4	3.1

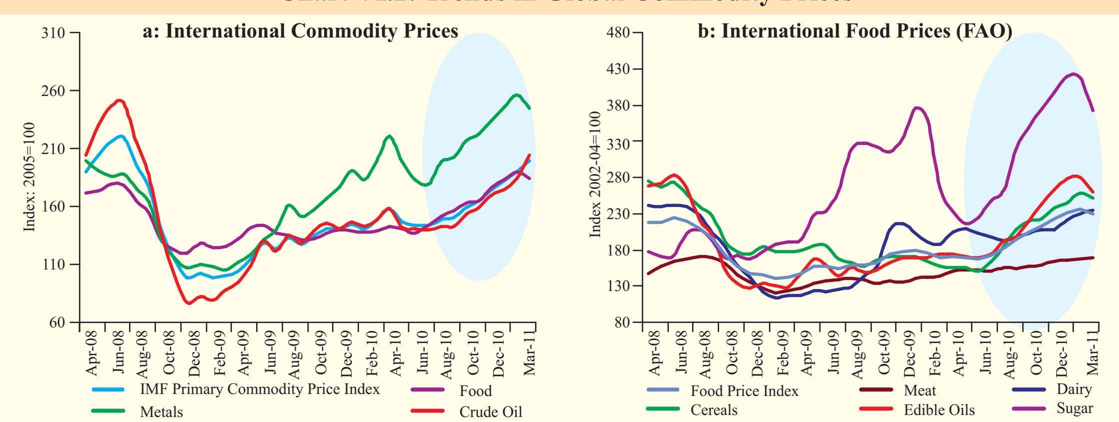
^ : Q4 of 2010-11 * : Change is worked out from the minimum point of target range.

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.

average crude oil prices were at US$ 114.4 per barrel for UK Brent category and US$ 108.6 per barrel for Dubai Fateh category during March 2011. Accordingly, the Indian basket crude oil price averaged US$110.4 per barrel in March 2011 given the composition of the Indian basket. Despite ample spare capacity with some OPEC member countries, crude oil

Chart VI.2: Trends in Global Commodity Prices



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

prices are likely to remain at higher levels during 2011-12 as compared with 2010-11 given the political uncertainties and tight demand-supply balance.

VI.6 The FAO food price index, which in March 2011 recorded its historical peak since inception in 1990, showed some moderation in April 2011. However, the FAO, in its latest World Food Outlook, indicated that increasing diversion to cash crops could limit the production capacity of individual food crops to respond to high prices adequately to levels that could be sufficient to alleviate market tightness. Against this backdrop, the FAO has warned that "…consumers may have little choice but to pay higher prices for their food. With the pressure on world prices of most commodities not abating, the international community must remain vigilant against further supply shocks in 2011 and be prepared". Apart from oil and food, metals and other primary products have also exhibited considerable increase in prices.

VI.7 The earthquake in Japan in March 2011 led to a temporary decline in commodity prices reflecting fears of a slowdown in demand from Japan. However, prices have rebounded since then and are likely to witness further pressure, especially in the case of metals and industrial raw materials as reconstruction efforts could lead to increased demand.

Pass-through of global inflation has been divergent and incomplete

VI.8 The impact of changes in global commodity prices on domestic inflation is dependent on a number of factors. In the case of fuel, where India is highly import dependent, any increase in global prices has a significant impact on domestic inflation. In the case of food items, the magnitude of the spillover impact of rising global food prices has been minimal, especially in the case of cereals (Table VI.2). This is mostly because prices of most food items in India are predominantly affected by domestic supply conditions as well as government's pricing policy rather than global trends. However, increasing global prices rule out the possibility of using imports as a measure for food price control. In the case of primary input commodities like cotton and rubber, global price changes have been largely reflected in Indian prices too, adding cost pressure on manufactured products. Thus, global price increases have both direct and indirect impact on domestic inflation conditions.

Table VI. 2: Movement in International and Domestic Commodity Prices

Per cent

Item	Annual Variation March 2011		Mar-11 over Dec-10	
	International Prices	Domestic Prices (WPI)	International Prices	Domestic Prices (WPI)
1	2	3	4	5
Rice	-1.9	2.7	-7.4	-2.0
Wheat	65.7	0.8	3.3	0.5
Maize	82.7	25.5	16.0	11.8
Soyabean oil	42.8	19.1	-1.1	10.7
Sugar	40.6	-7.5	-6.2	-1.7
Cotton	167.6	98.1	36.7	34.4
Rubber	63.8	49.1	19.3	11.6
Coal	35.6	15.9	8.2	15.9
Petroleum	37.0	6.3	20.7	0.0
Iron ore	21.2	29.7	3.8	1.4
Fertilizers	28.4	9.4	-1.2	3.1
Aluminium	15.8	1.8	8.7	-0.8
Copper	27.3	0.3	3.9	1.0
Gold	27.9	33.4	2.4	1.3
Silver	109.6	68.9	22.4	14.2

Source: World Bank and Ministry of Commerce and Industry, GOI.

Sources of price pressures shift over three distinct phases

VI.9 The nature of the inflation during 2010-11, in terms of contribution of specific groups items in the WPI basket, changed over three phases (Chart VI.3). In the first phase (between March and July 2010), food group had the highest contribution to the increase in WPI. In the second phase (between July and November 2010), primary non-food articles, particularly fibres like raw cotton, raw jute and raw silk had the dominant contribution. The major source of price pressures in the third phase (between November 2010 and March 2011) came from manufactured non-food products reflecting generalisation of inflation.

Food inflation declines but price levels remain firm reflecting structural imbalances

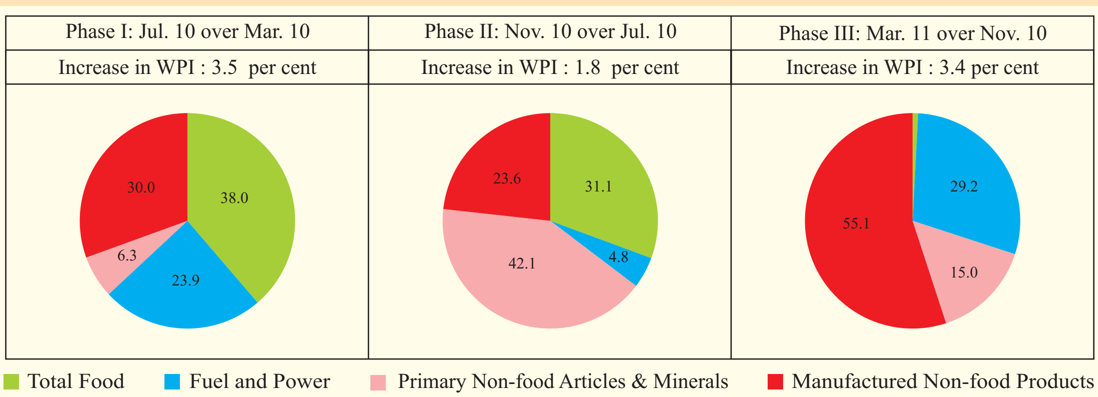
VI.10 The decline in primary food articles inflation on the expected lines with the arrival of fresh crops in the market and government interventions in the market has been one comfort factor during Q4 of 2010-11. The government has announced a number of measures in the Union Budget for 2011-12 to address the structural imbalances, especially in the case of protein-rich food items. These measures, however, could yield results only in the medium term.

VI.11 The decline in food inflation has not brought about significant decline in price levels as the prices are ruling at higher levels above the past trend, more so in the case of protein-rich items (Chart VI.4). These point towards weak supply response to both growing demand and increasing prices, leading to growing imbalances. Supply-augmenting measures as well as policies to create more efficient markets are critical to contain inflation at moderate levels. Such structural rigidities, unless addressed adequately, could lead to a situation of persistent high level of inflation which could constrain the efficacy of monetary policy.

Volatility in food prices has increased

VI.12 Along with increase in inflation in food articles in recent months, there has also been increase in volatility in food prices, especially in the case of vegetables, fruits and condiments and spices (Chart VI.5). Increased volatility in prices can influence inflation expectations adversely and also lead to inefficiencies in resource allocation as economic agents would find it difficult to distinguish between absolute and relative price changes. Also, the spike in vegetable prices during 2010-11 has been almost of the same magnitude as the previous shock of 1998-99 (Chart VI.6). However, the decline in prices following the spike has been lower during the current spike.

Chart VI.3: Changing Weighted Contributions to Increase in WPI During 2010-11



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

Chart VI.4: Trend in Primary Food Prices

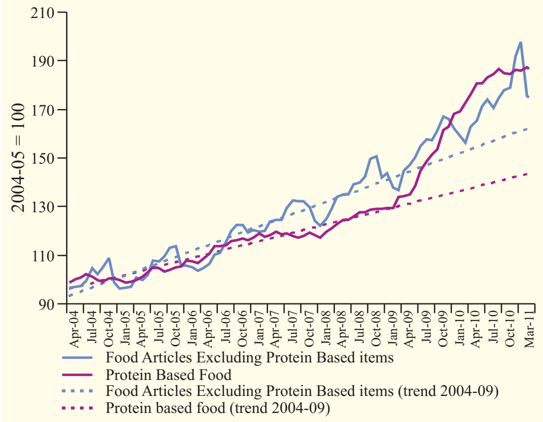
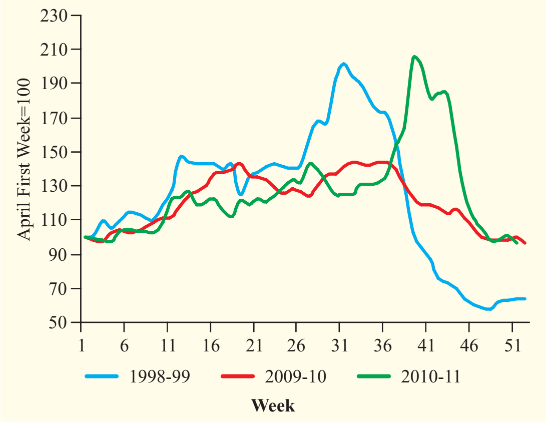


Chart VI.6: Vegetable Price Shocks

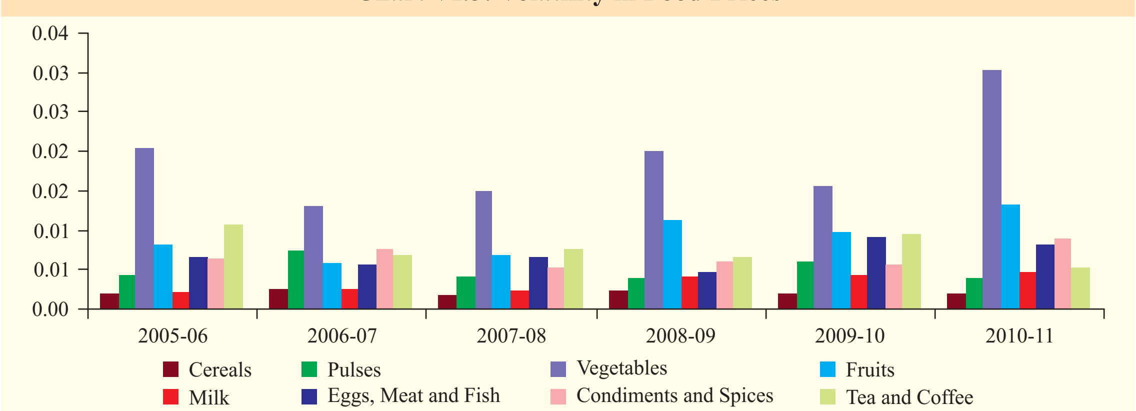


Partial pass-through of global fuel inflation increases medium-term risks

VI.13 Recent significant increases in international crude oil and coal prices have added further pressure on domestic inflation. In recent period, the full impact of increase in global oil price increases has been muted by the administered price intervention as the pass-through of increase in crude prices has been low in the items under administered prices (Chart VI.7). Empirical estimates show that every 10 per cent increase in global crude prices, if fully passed through to domestic prices, could have a direct impact of 1 percentage point increase in overall WPI inflation and the total impact could be about 2 percentage points over time as input cost increases translate to higher output prices across sectors.

VI.14 Administered price interventions could keep inflation low in the near-term, but with significant risks to medium-term inflation through the impact on higher fiscal deficit apart from its impact on efficiency concerns. Even in the case of freely priced products, the pass-through remains incomplete. As against an increase of 42 per cent y-o-y in March 2011 in the Indian basket crude oil price, the domestic price of non-administered fuels increased by only 23 per cent. This indicates that prices could increase going forward as domestic inflation catch up with global trends. It is also important to make further progress in deregulation of fuel prices, particularly diesel. This would enable demand to adjust appropriately to price signals, reduce fiscal deficit and make the inflation number more representative of underlying inflation conditions.

Chart VI.5: Volatility in Food Prices



Note: Volatility is measured as annual standard deviation of changes in log of price index (weekly).

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

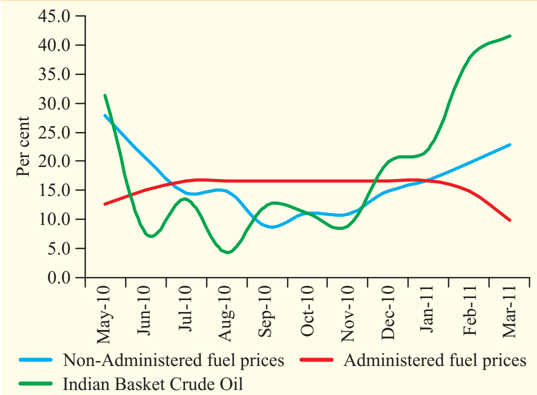
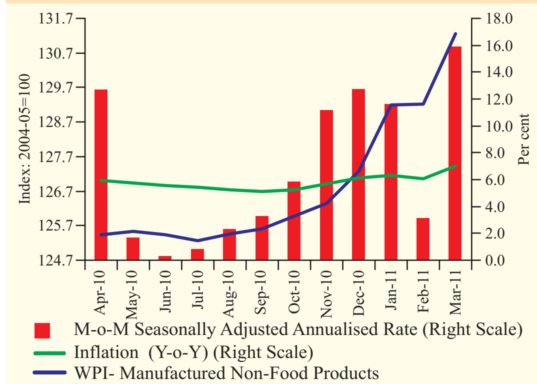


Chart VI.9: Manufactured Non-food Products: Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes



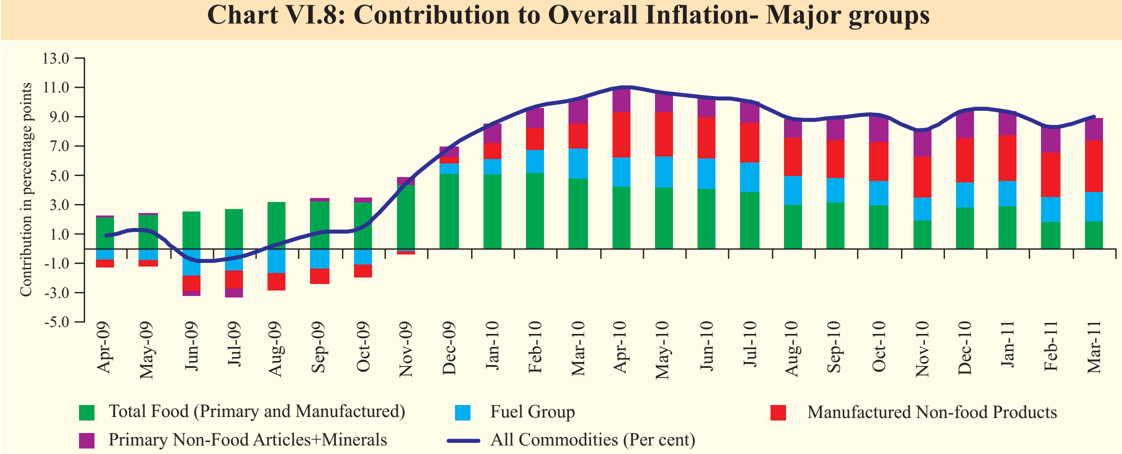
Contribution of non-food manufactured products to overall inflation increased with rising input cost pressures

VI.15 The underlying contributors to inflation have changed in recent months. The non-food manufactured products group, broadly seen as an indicator of demand-side and generalised pressures on inflation, has contributed to much of the high inflation in recent months even as the contribution of food inflation declined (Chart VI. 8). Fuel group and non-food primary articles also continue to contribute significantly to overall inflation, pointing towards persisting and generalised inflationary pressures.

VI.16 After exhibiting a near stable path up to the third quarter of 2010-11, manufactured non-food products inflation rose significantly in the last quarter with both the price index and month-over-month seasonally adjusted changes indicating significant build-up in price pressures (Chart VI.9). Currently, the y-o-y inflation in this group is at 7.0 per cent (March 2011), much above the medium term trend. The increasing price pressures in this category, is important consideration in the conduct of monetary policy. It indicates the spillover of supply shocks to generalised inflation through the input cost channel as well as the inflation expectations. It can also impact the core inflation through wage price spiral.

VI.17 The rise in non-food manufacturing prices reflects the presence of significant pricing power. In terms of the contribution to increase in non-food manufactured prices

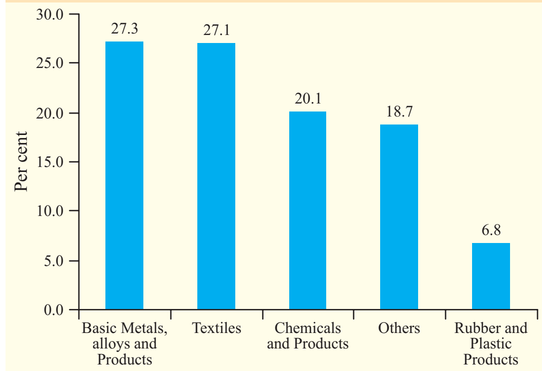
Chart VI.8: Contribution to Overall Inflation- Major groups



during 2010-11, about three fourth of the increase was driven by three major groups, *viz.*, textiles, chemicals and metals (Chart VI.10). Significant input cost pressures were visible in these groups as the global prices of cotton, petroleum products and metals had increased. The producers' ability to pass on these increases to output prices point towards prevalence of favourable demand conditions.

VI.18 During the last quarter of 2010-11, a number of product groups under the manufactured products group witnessed increase in prices (Table VI.3). As a result, the increase in price level during Q4 of 2010-11 was predominantly driven by non-food manufacturing, reflecting rise in input costs feeding into product prices.

Chart VI.10: Weighted Contribution to Manufactured Non-food Products Price Rise (March 2011, Year-on-Year)



VI.19 The divergence in inflation between major sub-groups in WPI continues to be large with primary articles and 'fuel and power' group exhibiting significantly high inflation as

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

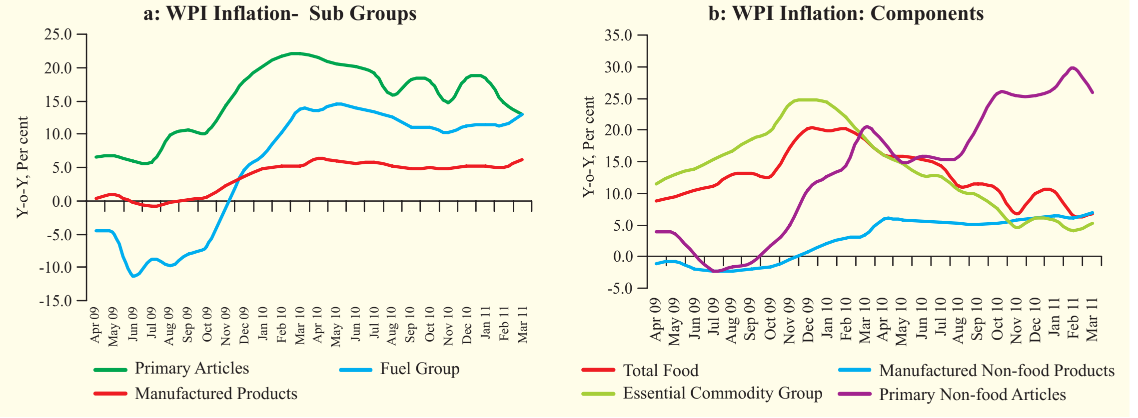
Per cent

Commodity	Weight	(Year on Year, March)				Quarterly Variation (Mar-11 over Dec-10)	
		2009-10		2010-11		Change in WPI	W.C.
		Inflation	W.C.	Inflation	W.C.		
1	2	3	4	5	6	7	8
All Commodities	100.0	10.2	100.0	9.0	100.0	1.8	100.0
1. Primary Articles	20.1	22.2	48.1	13.0	35.5	-2.4	-35.6
Food Articles	14.3	20.6	31.9	9.5	18.2	-5.4	-56.8
Non-Food Articles	4.3	20.4	8.6	25.9	13.6	7.5	21.6
Minerals	1.5	37.9	7.7	12.2	3.5	-0.5	-0.8
2. Fuel Group	14.9	13.8	20.1	12.9	22.1	5.3	45.9
i. Coal	2.1	7.9	2.0	15.9	4.4	15.9	20.9
ii. Mineral Oils	9.4	18.6	17.1	14.7	16.6	4.7	27.0
iii. Electricity	3.5	3.4	1.0	3.6	1.1	-1.3	-2.0
3. Manufactured Products	65.0	5.2	32.0	6.2	41.5	2.7	87.5
i. Food Products	10.0	15.1	14.7	2.4	2.8	0.6	3.5
ii. Beverages, Tobacco & Tobacco Products	1.8	8.1	1.5	7.3	1.5	5.2	5.1
iii. Textiles	7.3	9.1	5.4	15.6	10.5	6.9	23.4
iv. Wood & Wood Products	0.6	6.6	0.4	3.2	0.2	1.4	0.5
v. Paper & Paper Products	2.0	2.5	0.5	7.2	1.4	1.9	1.9
vi. Leather & Leather Products	0.8	2.5	0.2	-3.0	-0.3	-3.3	-1.3
vii. Rubber & Plastic Products	3.0	3.7	1.0	9.0	2.6	2.7	4.0
viii. Chemicals and Chemical Products	12.0	3.7	4.1	6.6	7.8	3.3	19.0
ix. Non-Metallic Mineral Products	2.6	3.2	0.9	3.2	1.0	2.8	3.9
x. Basic Metals, Alloys and Metal Products	10.7	1.4	1.5	9.3	10.6	4.1	23.1
xi. Machinery and Machine Tools	8.9	1.5	1.3	2.4	2.1	0.4	1.7
xii. Transport Equipment and Parts	5.2	1.2	0.6	3.3	1.7	1.8	4.2
Memo:							
Food Items (Composite)#	24.3	18.5	46.6	6.8	21.0	-3.3	-53.3
Food Items (Protein Based)$	6.4	28.7	19.5	7.5	6.7	-0.4	-2.0
Manufactured Non-food Products	55.0	3.3	17.2	7.0	38.8	3.1	84.0
WPI Excluding Food	75.7	7.4	53.4	9.8	79.0	3.8	153.3
WPI Excluding Fuel	85.1	9.6	79.9	8.3	77.9	1.1	54.1
Essential Commodities	14.4	18.6	28.3	5.2	9.8	-1.7	-15.8

W.C.: Weighted contribution to increase in WPI. #: Primary Food Articles + Manufactured Food Products.

$: Includes milk, 'eggs, meat and fish' and pulses.

Chart VI.11: Annual WPI Inflation



compared to manufactured products group (Chart VI.11.a). Manufactured products inflation, however, increased in recent months. Within the fuel group, coal prices increased significantly in March 2011, while increase in freely priced petroleum products prices led to higher inflation for mineral oils. Electricity price increases remained moderate during 2010-11 but given the increases in coal and mineral oils prices, electricity prices are likely to rise in the near-term. Among the major components, non-food primary articles inflation remained high driving input cost prices for manufactured products. Decline in food inflation has, however, been reflected in significant moderation in essential commodities inflation (Chart VI.11b).

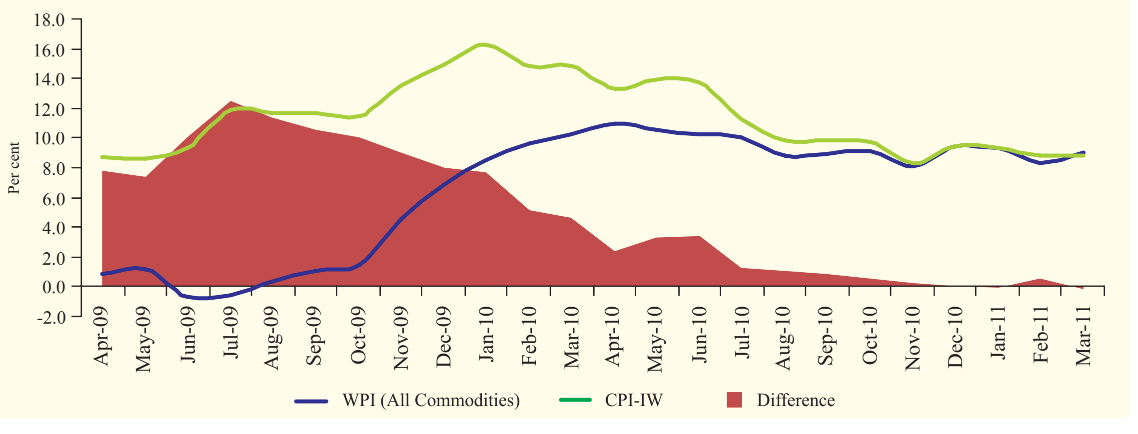
CPI and WPI inflation converge, but elevated levels point to generalised price pressures

VI.20 Inflation, as measured by various consumer price indices, moderated from the double digit levels, reaching single digit after more than a year, but still remain high. Various measures of inflation remained in the range of 8.8-9.1 per cent in March 2011. While the extent of divergence between WPI and CPI inflation narrowed significantly as food prices moderated, both remained elevated indicating generalisation of price pressures (Chart VI.12).

Inflation path remains sticky and risks abound

VI.21 With the likelihood of spillovers from past inflation and sustained impulses transmitting from rising global commodity

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



prices, the inflation path for 2011-12 looks sticky, characterised by nominal rigidities. Nominal rigidities mean that nominal prices of goods and wages are temporarily rigid due to price-setting behaviour and may not decline immediately after a rise in inflation. Headline inflation could remain elevated in the first half of 2011-12 before declining gradually in the second half but remain above the Reserve Bank's comfort level.

VI.22 Even as food inflation moderated, it has not led price levels returning to the trend, suggesting that even if the transient shocks abate price pressures may remain. The measures of the Government announced in the Union Budget, in terms of supply augmentation in key protein rich items can only be expected to yield results in the medium term. The impact of global price spurts in the case of crude oil on domestic inflation has so far been partial on account of incomplete pass-through reflecting administrative price interventions. However, if global prices remain firm at high levels, such measures could lead to a significant fiscal burden and thereby feed into medium term inflation. Allowing further pass-through especially for coal, where global prices have increased significantly, and electricity, where input costs have escalated, while raising inflation in the near term will help in medium-term inflation management through the impact on both demand adjustment and a favourable impact on the fiscal position.

VI.23 The spillover of supply-side led inflation on to generalised inflation appears to have been faster in recent months through input cost escalation. Given the risk that high and persistent inflation in itself could jeopardize the growth momentum and inclusive growth, policy has to focus on anchoring inflationary expectations as well as limiting the second-round impact of supply shocks.

VII. MACROECONOMIC OUTLOOK

While India's macroeconomic outlook for 2011-12 remains favourable, high oil prices pose the biggest risk to both growth and inflation. Forward-looking surveys indicate slight moderation in growth and business expectations. The pass-through from both fuel and non-fuel commodity prices remains as yet incomplete. As domestic prices adjust further to international commodity prices, inflation gap is likely to close only slowly. Persistent high inflation now poses risk to sustaining high growth.

Inflation risks significant, while growth risks emerge

VII.1 The baseline case is that the Indian economy may continue to grow at near its trend growth rate, while inflation may remain above comfort-levels. Risks to growth exist from persistence of current elevated crude oil prices as this can slow down the Indian economy. If global crude oil prices escalate further, growth could be significantly impacted given the inter-linkages amongst several macro-parameters and non-linearities coming into play. Inherent in these linkages is the likely adverse impact on growth from inflation staying high due to the energy price shock. Mitigating factors exist in form of strong private demand, prediction of normal monsoon, good pipeline investment and reduced energy intensity per unit of output, but some deceleration in growth can be anticipated. The forward looking surveys of various agencies as well as the Reserve Bank's industrial outlook survey also reflect some weakness. The professional forecasters and the inflation expectations surveys indicate that inflation expectations remain high.

Phillips curve relationship does not hold

VII.2 It is important to lower inflation as quickly and as decisively as possible because empirical evidence suggests that high growth on an average has coexisted with low inflation and that episodes of high inflation have typically been followed by slowdown in growth rates. The Phillips curve relationship suggesting trade-off between high growth (or low unemployment) and low inflation broke down with stagflation in the 'seventies and recent evidence suggests that while it may hold for very low levels of inflation, above a certain threshold, the Phillips curve is backward-bending or vertical. This implies that at high levels of inflation, growth could be lower coupled with higher unemployment. High inflation raises inflation expectations and causes wage inflation to rise, ultimately feeding on itself.

VII.3 Indeed, the more recent high growth phase of the Indian economy starting 2003-04 has been accompanied by low headline and core inflation. It shows that high growth does not warrant high inflation. The best way to catch up is to lower inflation differential with the other open economies so that sustainable growth is promoted by macroeconomic stability. Empirical analysis suggests that beyond a threshold level of inflation in the Indian economy, output gets sacrificed and inflation costs begin to rise sharply. These costs adversely affect the poor the most as relative prices move to their disadvantage. Balancing growth and inflation may be important in the short-run, but in the long-run, persistent inflation is a significant threat to growth.

Business expectations surveys generally exhibit moderation

VII.4 The more recent forward looking surveys conducted by various agencies indicate moderation in business expectations. Most notably, the NCAER and FICCI surveys have shown a substantial q-o-q decline indicating the possibility of a slowdown (Table VII.1).

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 Q2: 2011	CII Business Confidence Index Jan.-Mar. 2011
1	2	3	4	5
Current level of the Index	145.3	63.8	183.3	66.7
Index as per previous survey	158.5	76.2	171.2	66.2
Index levels one year back	156.8	70.0	142.8	66.1
% change (q-on-q) sequential	-8.3	-16.3	7.1	0.8
% change (y-on-y)	-7.3	-8.9	28.4	0.9 *

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

VII.5 High and persistent inflation appears to be the single most influential factor affecting the business confidence adversely through various channels (the Dun and Bradstreet Survey and NCAER Survey). These channels include slackening consumer demand (CII Survey) and input cost inflation (FICCI Survey). Apart from inflation, other factors affecting the business confidence adversely include currency risks, global economic instability (the CII Survey) and geopolitical uncertainty in the MENA region which may have implications for the petroleum prices (NCAER Survey).

VII.6 The seasonally adjusted HSBC Markit Manufacturing Purchasing Managers' Index (PMI) remained unchanged in March 2011 from its February 2011 level and indicated sustained expansion of the Indian manufacturing sector at a pace that is above the long-run series average. The HSBC Markit Services PMI for India slowed in March 2011 from the seven-month high in February 2011 but still reflected a strong expansion.

The Industrial Outlook Survey shows moderation

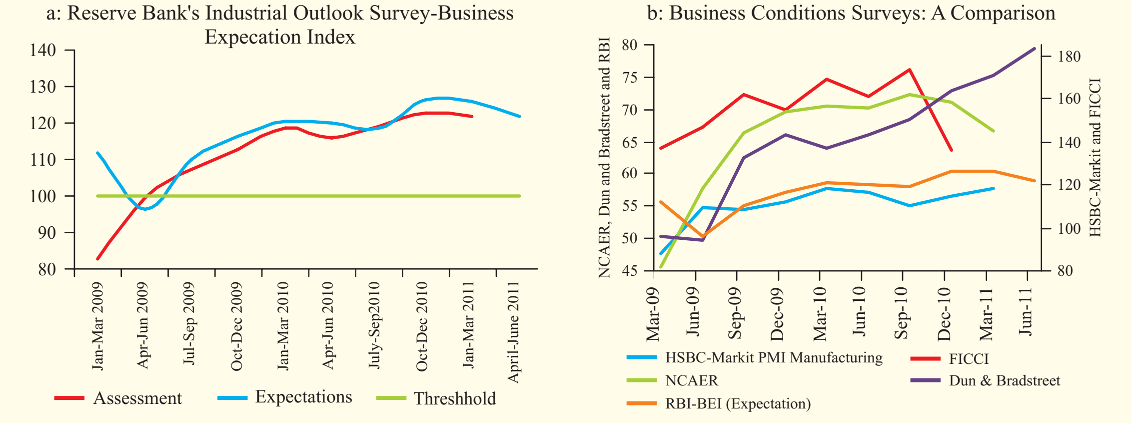
VII.7 The 53rd round of the Industrial Outlook Survey of the Reserve Bank conducted during January-March 2011, based on a sample of 1,524 companies, showed moderation for the assessment quarter (January-March 2011) as well as for the expectations quarter (April-June 2011) (Table VII.2 and Chart VII.1). The Business Expectations Index (BEI) remains in growth terrain (*i.e.* above 100, which is the threshold that separates contraction from

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

Parameter	Optimistic Response	Net Response						
		July-September 2010		October-December 2010		January-March 2011		April-June 2011
		E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9
1. Overall Business Situation	Better	41.5	38.7	47.5	45.9	50.1	38.6	41.4
2. Overall Financial Situation	Better	34.1	30.6	39.6	37.1	41.1	27.1	33.4
3. Availability Of Finance	Improve	28.5	26.6	31.3	30.3	32.3	23.8	27.3
4. Cost Of External Finance	Decrease	-23.3	-28.3	-28.3	-33.9	-31.3	-42.5	-35.0
5. Production	Increase	40.2	40.0	49.1	43.9	48.6	41.4	40.0
6. Order Books	Increase	36.3	36.1	44.8	37.9	44.0	34.7	38.4
7. Level Of Capacity Utilization	Above Normal	5.8	3.1	7.2	5.6	9.5	4.9	4.4
8. Employment In The Company	Increase	16.8	18.7	21.0	19.4	20.6	18.7	17.4
9. Exports	Increase	20.7	20.0	26.1	21.2	26.3	18.9	24.0
10. Imports	Increase	21.7	22.0	22.2	20.9	21.3	19.9	18.9
11. Selling Price	Increase	15.2	13.8	17.0	20.2	18.6	26.5	23.7
12. Profit Margin	Increase	3.1	-2.5	9.2	-0.4	8.3	-4.3	3.8

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

Chart VII.1: Industrial Outlook Surveys



expansion). The survey shows that the Indian manufacturing sector is concerned about slowdown in overall demand conditions as rising input costs may result in higher selling prices. The profits margins may also come under pressure with rising input costs. The overall financial situation, working capital finance requirement and availability of finance deteriorated for both the assessment and expectation quarters, there is also a strong perception of increase in the cost of external finance. On employment outlook, Indian manufacturers anticipate no change in the current situation.

Survey of Professional Forecasters[1] see weaker growth, firmer inflation

VII.8 The results of the fifteenth round of the Survey of Professional Forecasters conducted by the Reserve Bank in March 2011 show a downward revision in overall (median) GDP growth rate for 2011-12, mainly due to expectation of moderation in agricultural sector and industrial sector (Table VII.3). The inflation forecasts have been revised upwards.

VII.9 The growth outlook for 2011-12 looks positive though with some downside bias. The available projections for 2011-12 by various agencies give a mixed picture with some projecting a growth rate of 9 per cent while others within a range of 8.0 to 8.5 per cent, suggesting a moderation in the growth process (Table VII.4).

Downside risks to growth and upside risks to inflation have increased

VII.10 Going forward, policy trade-offs may arise as downside risks to growth and upside risks to inflation have increased. Threats to inflation from rising global commodity prices as well as domestic core inflationary pressures exist. Unless addressed, they have a potential to adversely impact the growth. Certain factors do provide support to the growth process. Improved *rabi* production that would be reflected in Q1 of 2011-12 and likely normal south-west monsoon as forecasted by IMD could boost rural demand. High top-line growth for firms indicates strong demand conditions. Continuation of fiscal consolidation process could provide support for private investment. Recent improvement in exports and decline in imports provides a good base for net external demand.

VII.11 However, external demand conditions can change ahead if commodity prices fuel import bill, while export demand gets impacted by lower demand from other oil-importing countries. At a time, when growth may decelerate from high base, risks to growth also stem from other factors. Global uncertainties can impinge upon recovery in the AEs and

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

	Actual 2009-10	Annual Forecasts				Quarterly Forecast									
		2010-11		2011-12		2010-11		2011-12							
						Q4		Q1		Q2		Q3		Q4	
		E	L	E	L	E	L	E	L	E	L	E	L	E	L
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. Real GDP growth rate at factor cost (in per cent)	8.0#	8.7	8.5	8.5	8.2	8.5	8.2	8.4	8.3	8.5	8.1	8.3	8.2	-	8.5
a. Agriculture & Allied Activities	0.4#	5.0	5.4	3.3	3.1	5.0	5.0	3.5	3.8	3.1	3.1	3.4	3.0	-	3.0
b. Industry	8.3#	9.0	8.1	8.7	8.2	7.3	6.2	7.6	7.0	8.1	8.0	8.8	8.7	-	8.5
c. Services	9.7#	9.6	9.5	9.5	9.6	9.6	9.8	9.5	9.8	9.5	9.3	9.6	9.5	-	9.7
2. Gross Domestic Saving (per cent of GDP at current market price)	33.7#	34.0	34.0	35.5	35.3	-	-	-	-	-	-	-	-	-	-
3. Gross Domestic Capital Formation (per cent of GDP at current market price)	36.5#	36.0	36.9	37.0	37.5	36.3	37.3	35.7	36.5	35.9	37.3	36.8	37.8	-	38.5
4. Corporate profit after tax (growth rate in percent)&	28.8	20.0	20.0	21.2	20.0	15.8	10.7	17.5	20.0	14.1	12.8	16.0	9.5	-	10.4
5. Inflation WPI (Avg.)	3.6	8.5	9.4*	6.6	7.5	6.6	8.9*	6.4	8.2	6.9	7.8	7.0	7.5	-	6.7
6. Exchange Rate (INR/1USD end period)	45.1	44.5	44.7*	43.5	44.5	44.5	44.7*	44.1	44.5	43.9	44.7	43.9	44.5	-	44.5
7. T-Bill 91 days Yield (per cent-end period)	4.4	6.8	7.3	6.9	7.5	-	-	-	-	-	-	-	-	-	-
8. 10-year Govt. Securities Yield (per cent-end period)	7.8	8.0	8.0	8.0	8.0	-	-	-	-	-	-	-	-	-	-
9. Export (growth rate in per cent)!	-3.6	18.0	28.7	17.8	17.2	-	-	-	-	-	-	-	-	-	-
10. Import (growth rate in per cent)!	-5.6	20.0	20.3	18.0	20.0	-	-	-	-	-	-	-	-	-	-
11. Trade Balance (US$ billion)	-108.2	-	-	-	-	-35.7	-26.1	-38.1	-36.0	-40.7	-39.1	-41.2	-38.5	-	-39.8

E: Previous Round Forecasts. L: Latest Round Forecasts. #: Quick Estimate P: Preliminary Value

-: Not Available. *: Actual &: BSE listed companies. !: US$ on BoP basis.

Note: The latest round refers to fifteenth round for the quarter ended March 2011, while previous round refers to fourteenth round for the quarter ended December 2010.

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

impact India's growth if the balance sheet risks in Euro zone precipitate. However, an offset would be available to India in such an event in the form of likely softer commodity prices. Though the IMD forecast suggests a normal south-west monsoon, the event risk of temporally deficient or spatially uneven rains exists. It constitutes a significant risk as food inflation has already been high for a long period and can add to generalised inflation. Spillover

Table VII.4: Agencies' Projections for 2011-12

Agency	Latest Projection	
	Real GDP Growth (Per cent)	Month
1	2	3
Economic Advisory Council to the PM	9.0 (+/-0.25)	Feb-11
Finance Ministry	9.0 (+/-0.25)	Feb-11
IMF #	8.0	Apr-11
OECD	8.2	Nov-10
World Bank	9.0	Feb-11
ADB	8.2	Apr-11
NCAER	8.5	Apr-11

#: IMF's forecast of growth for calendar year 2011 is 8.2 per cent at market price.

from food to manufacturing through higher input costs and wage spirals can occur in this case. This in turn could lower growth. Furthermore, some deceleration in investment has been seen in Q3 of 2010-11. If subsidies now overshoot the budgetary provision, it can crowd out private investment.

VII.12 The persistence of inflation at elevated levels and the generalisation of inflationary pressures to manufacturing products continue to be the major policy concern. Going forward, several factors may exert further upward pressure on inflation. Apart from the imported inflation through global commodity prices, especially of oil, increases in global food prices need to be watched and agricultural policy, food management and trade policy need to be flexibly and speedily used to curb any food price pressures. Structural measures may also need to be reinforced as one is observing downward stickiness in food prices, especially in case of protein-rich items.

VII.13 As monetary policy addresses inflation, it is also vital that price rigidities do not build up. On the one hand, these rigidities would spill into medium-term inflation through larger fiscal deficits. On the other hand, suppressed inflation arising from price controls can eventually force discrete price changes that have deleterious impact on actual and expected inflation. As such, raising administered fuel and fertiliser prices is necessary. A quick deregulation of diesel prices can help provide fiscal space. This in turn would enable fiscal policy to turn counter-cyclical in case output growth slackens. On the other hand, monetary policy could act more effectively in containing inflationary spillovers from supply-side disturbances.

Persistence of inflation warrants continuation of anti-inflationary monetary policy stance for sustaining growth

VII.14 Effective increase in policy rate by 350 basis points since March 2010 has been substantial and has resulted in a significant strengthening of transmission in Q4 of 2010-11. However, inflation is likely to remain high in near term as it has become generalized. Also, commodity price pressures persist and the pass-through as yet is incomplete. While inflationary pressures have accentuated, downside risks to growth have also emerged. On the one-side, with investment showing signs of deceleration, macroeconomic challenges have increased. On the other side, the high inflation now poses risk to faster growth in future. Experience suggests that more rapid growth phases have been typically accompanied by low inflation.

VII.15 In this scenario, while growth risks remain, persistence of high inflation warrants continuation of anti-inflationary monetary stance to sustain the growth momentum over the medium term.

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