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

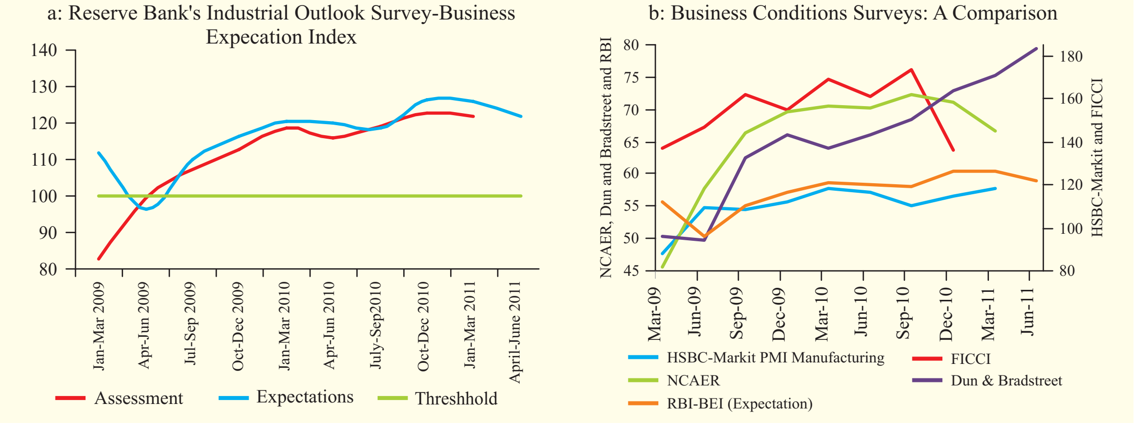
VII.7 The 53rd round of the Industrial Outlook Survey of the Reserve Bank conducted during January-March 2011, based on a sample of 1,524 companies, showed moderation for the assessment quarter (January-March 2011) as well as for the expectations quarter (April-June 2011) (Table VII.2 and Chart VII.1). 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

[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.