RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments in 2012-13

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Reserve Bank of India
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MACROECONOMIC AND MONETARY DEVELOPMENTS IN 2012-13

Overview

1. Monetary policy eased during 2012-13, in response to some softening of inflation and significant moderation in growth. However, monetary policy response to addressing growth concerns was constrained by inflation persistence and the twin deficit risks that prevailed for the most part of the year. Although fiscal risks were lowered during H2 of 2012-13, current account deficit (CAD) risks intensified during Q2 and Q3.

2. The impact of monetary policy in boosting GDP growth is contingent upon resolution of supply bottlenecks, governance issues impeding investments and the government's efforts towards fiscal consolidation. Domestic energy price adjustments, inadequate supply response and sustained wage pressures on inflation are expected to drag down growth for some more time. These factors, coupled with subdued domestic business confidence, are likely to keep recovery in 2013-14 modest. The challenge is to counter the growth slowdown by reviving investment while managing the trade-off between objectives of reviving demand and restraining the CAD.

3. While non-food manufactured products inflation has moderated, there is always the risk that the current high food inflation could spill over to broader price formation, undermining the efforts of monetary policy to contain inflation. In the long run, structural measures, including reforms, improved governance and increased government investment to crowd in private investment, would play the catalytic role in moving growth towards its potential levels.

Global Economic Conditions

Global growth likely to stay sluggish in 2013

4. Global growth turned weaker in 2012 and is expected to stay sluggish in 2013 as fiscal adjustments drag growth in advanced economies (AEs) and, in turn, delay cyclical recovery in emerging market and developing economies (EMDEs). The International Monetary Fund (IMF) in its World Economic Outlook has forecast global growth to stay sluggish at 3.3 per cent in 2013 before improving to 4.0 per cent in 2014. While downside tail risks have reduced in early 2013 because of the supportive policy action in the euro area and the measures to tackle the fiscal cliff in the US, risks to global recovery have increased consequent to the Chinese economy slowing down.

Global commodity price inflation likely to remain soft, although with some risks from QE

5. The outlook for global commodity prices during 2013 remains benign, with a further decline expected in metal and oil prices. This should help reduce imported inflation in the domestic economy, subject to prevalence of stable exchange rate movements. However, global commodity price inflation risks remain from the large and continuous doses of quantitative easing (QE).

Global financial markets bolstered by policy actions aimed at reducing tail risks

6. Notwithstanding weak global growth and austerity measures imposed in the

US and in the euro area, international financial markets gained traction following unconventional monetary easing. However, this has not translated into growth revival. Although the tail risks have reduced, they remain significant, calling for committed action to trim the balance sheet exposures and prepare adequate buffers against possible contagion effects.

Indian Economy: Developments and Outlook

Output

Slow-paced recovery likely to shape 2013-14

7. The Indian economy remained sluggish in Q3 of 2012-13, with slowdown turning visibly pervasive across most sectors. The deceleration in the services sector growth, which has been the mainstay of high growth in the recent period, had dragged down overall economic activity and employment creation. The agriculture output was dented by deficient rainfall that impacted kharif crop. Domestic policy uncertainties, governance concerns, the impact of earlier monetary tightening and the slacking of external demand continue to adversely impact growth.

Aggregate Demand

Resolving structural bottlenecks and providing public investment stimulus can turnaround falling investment

8. Aggregate demand remained sluggish during Q3 of 2012-13 with inflation impacting real consumption and cyclical and structural factors affecting investment. Corporate results suggest weak demand, with moderation in investment as well as consumption. Government consumption expenditure has decelerated, reflecting expenditure-cutting as part of its fiscal consolidation strategy. Corporate data on planned fixed investments indicate that investment slowed further during Q3 of 2012-13. Given the intensity of the slowdown, a public investment stimulus balanced with offsetting reductions in current expenditures, along with concerted action to remove supply-side bottlenecks, are needed to shape the revival of the economy.

External sector

Sustained efforts needed to reduce the CAD, though fall in global commodity prices brings temporary respite

9. External imbalances were in focus as the current account deficit (CAD) to GDP ratio reached a historic high of 6.7 per cent in Q3 of 2012-13. However, CAD in Q3 was adequately financed by capital inflows, without any reserve depletion. Current account in 2013-14 is likely to benefit from moderation in global commodity prices of oil, gold and other metals. Yet, sustainability of the CAD continues to face risk from event shocks that may cause a sudden stop or reversals of capital inflows. As such, there is need to initiate policy actions to bring structural improvements in the current account through productivity enhancements to boost competitiveness. Going forward, the government's recent initiatives to curtail the fiscal deficit, if pursued along the indicated path, are likely to reduce pressure on the CAD and lower twin deficit risks.

Monetary and Liquidity Conditions

Reserve Bank calibrated monetary policy easing to evolving growth-inflation dynamic and macroeconomic imbalances

10. The Reserve Bank eased monetary policy to revive investment and growth. It was guided by the imperative to optimally use the limited monetary space while balancing the concerns of persisting inflation and historically high CAD. In this vein, the Reserve Bank cumulatively reduced the repo rate by 100 bps in 2012-13. Furthermore, amidst increasing structural and frictional liquidity deficits, it injected `1.5 trillion of primary liquidity through outright open market operations

(OMOs). Also, `1.3 trillion of primary liquidity was infused through cuts in the Cash Reserve Ratio (CRR) since January 2012. Further liquidity requirements were met through LAF repos.

Financial Markets

Strong FII flows augured well for the Indian rupee and equity market

11. Policy actions, both domestic and global, augured well for the Indian financial markets in Q4. Nonetheless, limited policy space and political uncertainties continued to weigh down the markets. The easing trend in G-sec yields reversed at the end of the year due to same reasons. Primary equity markets remained subdued. Sustained commitment to reforms and policy action to reduce external sector risks, and improvement in the global economy are crucial to boosting market sentiments and support capital raising. On the asset price front, house price inflation remains high.

Price Situation

Headline inflation and demand side price pressures moderate, but suppressed inflation poses risks

12. Headline, and especially the non-food manufactured product inflation pressures, softened during 2012-13, even as consumer price inflation firmed up. The average headline WPI inflation during 2012-13 at 7.4 per cent was significantly lower than the 9.0 per cent recorded in the preceding year. The year-end inflation turned out to be even lower at 6.0 per cent. However, consumer price inflation stays in the double digits, reflecting substantially food inflation pressures. Headline inflation in 2013-14 is likely to exhibit a downward bias on account of expected lower global commodity prices, but face an upward bias from significant pass-through from suppressed inflation.

Macroeconomic Outlook

Slow-paced recovery, range-bound inflation and macro-financial risks require a cautious monetary policy response

13. Growth continued to slow down in 2012-13, but could witness a slow-paced recovery later this year, contingent on improved governance and concerted action to resolve structural bottlenecks. Subdued business and consumer confidence, reflected in various surveys, is expected to drag growth down. Headline inflation is likely to remain range-bound in 2013-14, with some further moderation in H1 but slight increase in H2 on account of strong base effects. Most surveys anticipate modest gains, both on growth and inflation. Currently, significant macro-financial risks prevail from slow growth, high CAD and inflation above the threshold over which it becomes inimical to growth sustainability. Therefore, monetary policy would need to be calibrated recognising the very limited policy space available to ease further.

I. OUTPUT

Growth decelerated further during Q3 of 2012-13, with the slowdown extending to services sector, which has been the mainstay of India's high growth. Mining and manufacturing activity continued to stall while agriculture output was impacted by deficient rainfall during the monsoon season. Domestic policy uncertainties, sluggish external demand and the lagged impact of the earlier monetary tightening policy reduced growth. Global growth decelerated during 2012 and is expected to remain weak during 2013 also. As business sentiments remain weak and structural impediments still constrain activity levels, recovery during 2013-14 may be modest.

Global growth likely to remain weak in 2013

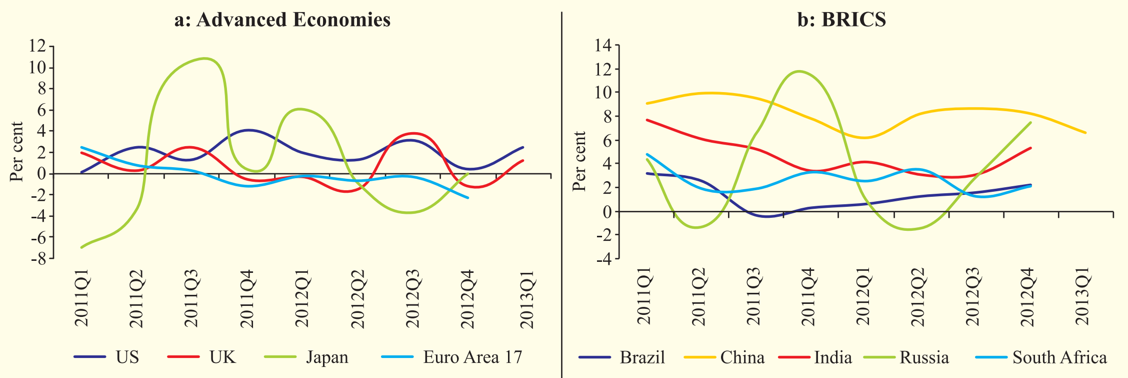
I.1 Global growth turned weaker in 2012 with slack external demand in advanced economies (AEs) adversely impacting growth in emerging market and developing economies (EMDEs). Activity levels are expected to stay weak in 2013 as fiscal adjustments drag growth in AEs and, in turn, delay cyclical recovery in EMDEs.

I.2 In its April 2013 World Economic Outlook (WEO), the IMF has forecasted global growth to stay subdued at 3.3 per cent in 2013, down by 0.2 percentage points from its January 2013 projections. The IMF expects global growth to pick up to 4.0 per cent in 2014 on the strength of the anticipated sharper recovery in the US.

I.3 Recent information suggest that global growth has stayed subdued although with slight improvement during Q1 of 2013. The US growth accelerated to 2.5 per cent (seasonally adjusted annualised quarter-on-quarter growth rate, q-o-q saar) in Q1 of 2013 from 0.4 per cent in Q4 of 2012, but was below market expectation. Japan's GDP remained flat in Q4 of 2012, after two quarters of contraction. The euro area remained in a contraction mode, with the pace of contraction increasing to 2.3 per cent (q-o-q, saar) in Q4 of 2012 from 0.3 per cent in Q3 (Chart I.1a). The UK narrowly avoided a triple dip recession in Q1 of 2013 by expanding at 1.2 per cent (q-o-q, saar) after contracting by the same rate in Q4 of 2012.

I.4 The expected loss of growth and employment in the US due to its budget sequestration may prove to be a drag on global economic expansion during 2013. According to the US Congressional Budget Office (CBO), fiscal tightening will knock out about 1.5 percentage points from US GDP growth in 2013.

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



Source Eurostat , European Commission

Source OECD, Stat Extracts

1.5 The US economy job gains have brought the unemployment rate to a four-year low of 7.6 per cent in March 2013, while euro area unemployment rate remained at a record level of 12 per cent in February 2013.

I.6 With the Chinese economy slowing down risks to global recovery have increased. Growth in China was around 7.8 per cent in 2012 and has declined to 6.6 per cent (q-o-q, saar) in Q1 of 2013. Brazil and South Africa have shown some improvement in their GDP growth in Q4 of 2012 (Chart I.1b).

I.7 Consequent to the slow global growth, world trade remained subdued for most of 2012 and in 2013 so far (see Chapter 3).

Slowdown of Indian economy persists

I.8 During 2012-13, the Indian economy continued to witness slowdown for the third quarter in succession (Table I.1). GDP growth in Q3 of 2012-13 at 4.5 per cent has been the lowest since Q4 of 2008-09 (3.5 per cent). The decline in the growth rate was seen in the agriculture and services sectors, while industrial growth remained listless. Overall, growth continued to remain below trend for the sixth consecutive quarter since Q2 of 2011-12 (Chart I.2). The momentum indicator corroborates the slowdown (Chart I.3).

I.9 While the moderation of growth in agriculture was largely on account of the rainfall deficiency, the slowdown in industry and services reflected several factors including domestic policy uncertainties, lagged impact of earlier monetary tightening and slackening of external demand. The sharp deterioration in the services sector in Q3 of 2012-13 over Q3 of the previous year was mainly reflected under 'trade, hotels, transport and communication' and 'financing, insurance, real estate and business services'. These sub-sectors slowed down in line with the slowdown of activity in industry and agriculture as also in the external sector. Sector-specific problems, such as those in communications, aggravated the slowdown.

I.10 The extension of the slowdown to the services sector, the main driver of India's high growth, merits close attention. The quarterly

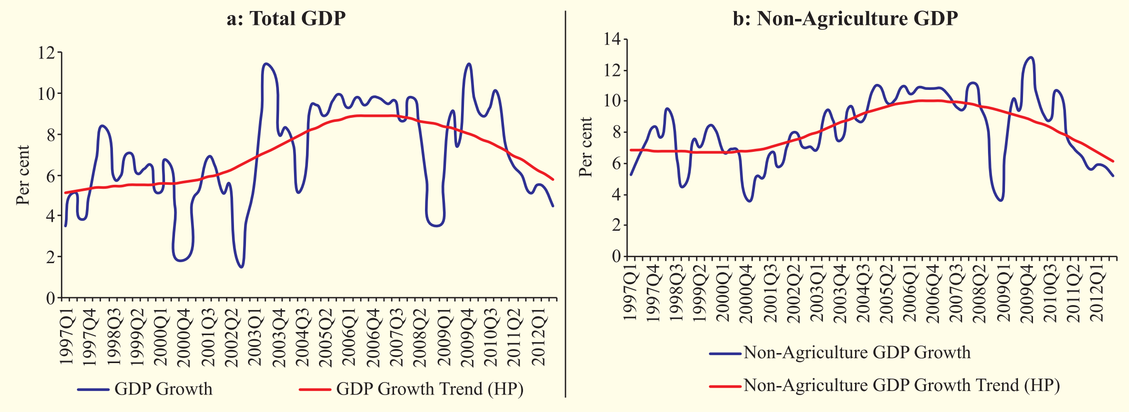
Table I.1 : Sector-wise Growth Rates of GDP (2004-05 prices)

(Per cent)

Item	2012-13 AE		2011-12				2012-13			Apr-Dec	
	Share	Growth	Q1	Q2	Q3	Q4	Q1	Q2	Q3	2011-12	2012-13
1	2	3	4	5	6	7	8	9	10	11	12
1. Agriculture, forestry & fishing	**13.7**	**1.8**	**5.4**	**3.2**	**4.1**	**2.0**	**2.9**	**1.2**	**1.1**	**4.3**	**1.7**
2. Industry	**19.1**	**2.0**	**6.5**	**2.7**	**0.9**	**1.0**	**0.8**	**1.1**	**2.3**	**3.3**	**1.4**
2.1 Mining & quarrying	2.0	0.4	-0.4	-5.3	-2.6	5.2	0.1	1.9	-1.4	-2.8	0.1
2.2 Manufacturing	15.2	1.9	7.4	3.1	0.7	0.1	0.2	0.8	2.5	3.6	1.2
2.3 Electricity, gas & water supply	1.9	4.9	6.6	8.4	7.7	3.5	6.3	3.4	4.5	7.6	4.7
3. Services	**67.2**	**6.5**	**8.3**	**8.2**	**8.1**	**7.0**	**7.4**	**7.1**	**6.0**	**8.2**	**6.8**
3.1 Construction	7.9	5.9	3.8	6.5	6.9	5.1	10.9	6.7	5.8	5.7	7.7
3.2 Trade, hotels, transport, storage and communication	27.5	5.2	9.5	7.0	6.9	5.1	4.0	5.5	5.1	7.8	4.9
3.3 Financing, insurance, real estate and business services	18.7	8.6	11.6	12.3	11.4	11.3	10.8	9.4	7.9	11.8	9.4
3.4 Community, social & personal services	13.0	6.8	3.5	6.5	6.8	6.8	7.9	7.5	5.4	5.7	6.9
IV. GDP at factor cost	**100.0**	**5.0**	**7.5**	**6.5**	**6.0**	**5.1**	**5.5**	**5.3**	**4.5**	**6.6**	**5.0**

AE: Advance Estimates.
Source: Central Statistics Office.

Chart I.2: GDP Growth



GDP of the services sector excluding community, social and personal services during the period 1997-98 to 2012-13 indicates two structural breaks in its growth series (Chart I.4). These breaks also indicate that current slowdown in the services sector starting since Q2 of 2008-09 has pulled down the sectors' mean growth to about the level prior to Q2 of 2003-04. Trade, telecommunications, transport by means other than railways and construction activity have been particularly impacted in the current cycle.

Deficient rainfall affects agricultural output

I.11 Deficiency and uneven distribution of rainfall during July-August 2012 dented *kharif* sowing in 2012 and impacted the production of foodgrains and commercial crops. The recovery of rainfall from September onward helped maintain soil moisture during the *rabi* season. The production of *rabi* oilseeds and coarse cereals has improved and *rabi* pulses are poised for record production during 2012-13. However, the production of wheat is expected to decline during 2012-13, mainly due to the smaller area covered under the crop. The decline in production of foodgrains during 2012-13 is estimated at only 3.5 per cent (Table I.2).

I.12 The current stock of foodgrains (59.7 million tonnes at end-March 2013) is sufficient to meet the buffer norms and requirements under the various poverty alleviation schemes. In view of the pace at which food stocks are building up, *i.e.*, around 27 per cent per annum in the

Chart I.3: Momentum Indicator of Growth

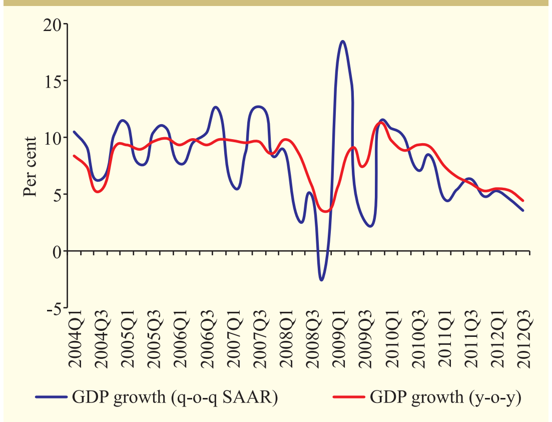


Chart I.4: Growth Rate of GDP-Services Excluding Community, Social Services *etc.*

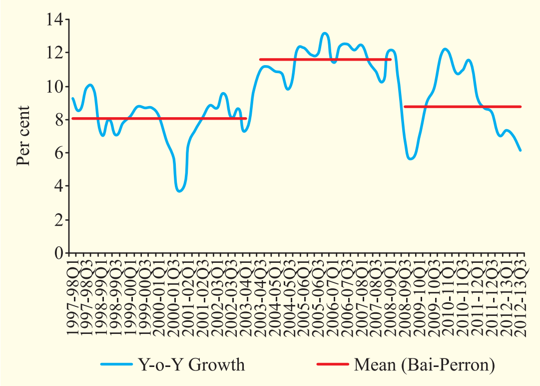


Table I.2: Agricultural Production – 2012-13

(Million tonnes)

Crop	2011-12 Final Estimates	2012-13 2nd Advance Estimates	Percentage Variations 2012-13
1	2	3	4
Foodgrains	259.3	250.1	-3.5
Rice	105.3	101.8	-3.3
Wheat	94.9	92.3	-2.7
Coarse Cereals	42.0	38.5	-8.3
Pulses	17.1	17.6	2.9
Oilseeds	3.0	2.9	-3.3
Cotton #	3.5	3.4	-2.9
Jute & Mesta # #	1.1	1.1	0.0
Sugarcane (Cane)	36.1	33.5	-7.2

#: Million bales of 170 kgs each.
#: Million bales of 180 kgs each.

past five years, there is a need for better management of the food stock in order to dampen cereal inflation.

Industrial growth is stagnating, but could improve ahead

I.13 Growth in the index of industrial production (IIP) witnessed a slowdown to 0.9 per cent during April-February 2012-13, largely due to infrastructure and input constraints, rising costs and moderation of external demand (Table I.3). Contraction in capital goods and the mining sector continue to affect the overall performance of the industrial sector (Chart I.5). Excluding the volatile items, the truncated IIP (96 per cent of IIP) growth in April-February 2012-13 is 1.5 per cent.

I.14 The growth of the manufacturing sector remained highly concentrated. Of the 22-major industry groups, the fastest growing top five manufacturing industries had the largest contribution of about 169 per cent to the overall growth of the manufacturing sector during April-February 2012-13 (Chart 1.6). Bottom 17 industries had a negative contribution of 72 per cent. Major industries that registered contraction in output included motor vehicles, electrical machinery & apparatus, machinery & equipment and fabricated metal products.

I.15 Shortage of power was a major constraining factor for the growth of the industrial sector. Growth in electricity generation decelerated during 2012-13 to 4.0 per cent from 8.2 per cent in the year before. The gap between requirement and availability of power increased to 8.7 per cent during the period. Shortages in

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

(Per cent)

Industry Group	Weight in the IIP	Growth Rate			Weighted Contribution#		
		April-March 2011-12	April-February		April-March 2011-12	April-February	
			2011-12	2012-13 P		2011-12	2012-13 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	14.2	-2.0	-2.1	-2.5	-7.6	-6.6	-29.3
Manufacturing	75.5	3.0	3.7	1.0	83.2	85.0	88.8
Electricity	10.3	8.2	8.7	4.0	24.3	21.5	41.1
Use-Based							
Basic Goods	45.7	5.5	5.9	2.3	74.5	66.7	103.0
Capital Goods	8.8	-4.0	-1.8	-7.6	-20.4	-7.5	-117.6
Intermediate Goods	15.7	-0.6	-0.7	1.5	-3.0	-2.7	23.2
Consumer Goods (a+b)	29.8	4.4	4.7	2.5	48.6	43.3	91.6
a) Consumer Durables	8.5	2.6	2.7	2.7	13.2	11.6	44.0
b) Consumer Non-durables	21.3	5.9	6.4	2.3	35.3	31.7	47.4
General	**100**	**2.9**	**3.5**	**0.9**	**100**	**100**	**100**

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

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

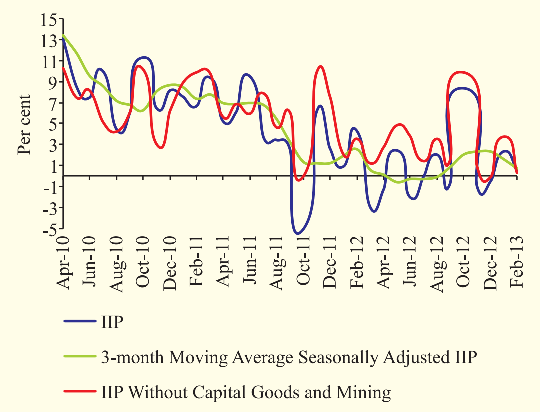
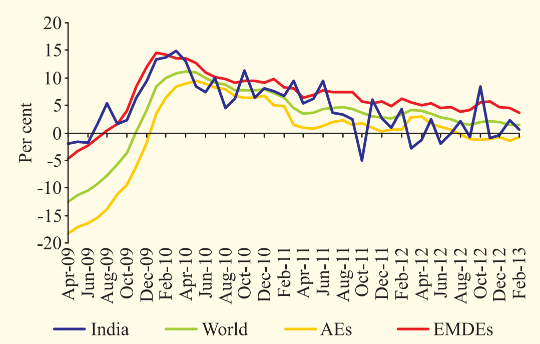


Chart I.7: Industrial growth – India and the World



Source: CPB World Trade Monitor

coal supply, delays in capacity addition and a delayed and skewed monsoon have contributed to the slower growth of power generation.

I.16 Capital goods output continued to contract, reflecting a subdued investment climate. The slowdown in economic activity and consumption demand has resulted in moderation in the growth of consumer goods.

I.17 Apart from domestic constraints, weak global growth was also responsible for the domestic industrial slowdown given the strong co-movement between the domestic and global IIP, with a statistically significant correlation coefficient of 0.7 for the period April 2008 to February 2013 (Chart 1.7).

Structural bottlenecks affect growth of core industries

I.18 Core industries are faced with various supply constraints, such as shortage of coal and natural gas, stoppage of mining in some states and delays in commissioning of large projects. Consequently, the growth of eight core industries decelerated to 2.6 per cent during April-February 2012-13 compared to 5.2 per cent during the corresponding period last year. The production of electricity and steel recorded sharp deceleration (Chart I.8). The pick-up in the industrial sector is contingent upon a tangible turnaround in the performance of the core industries.

Chart I.6: Growth Concentration in the Manufacturing Sector

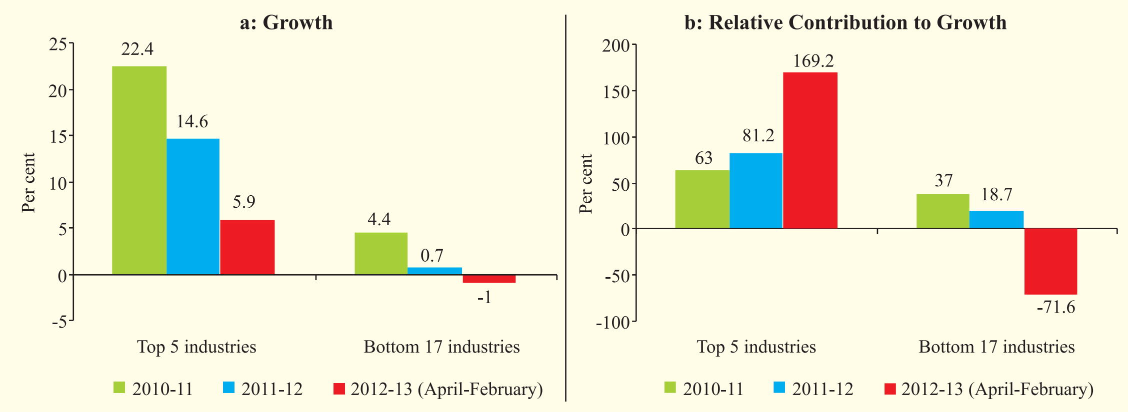
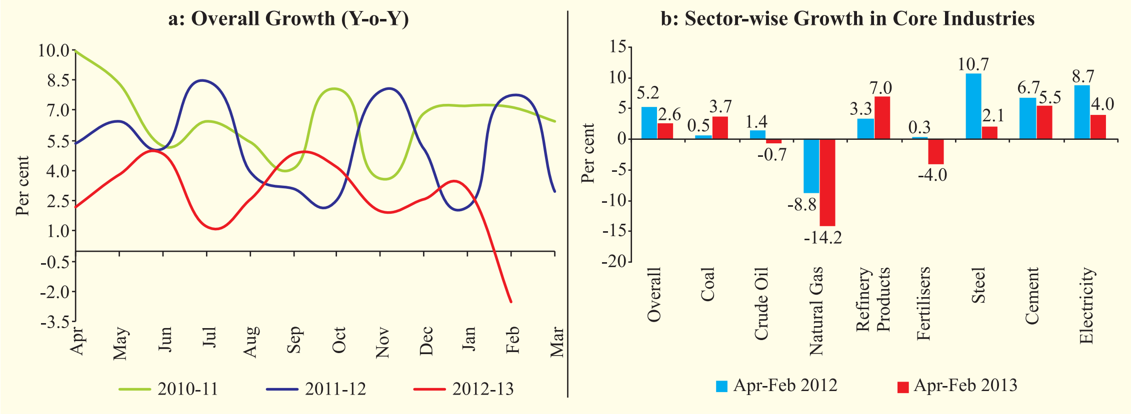


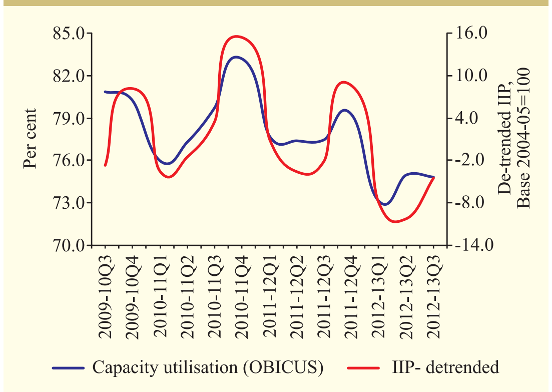
Chart I.8: Growth in Core Industries



Capacity Utilisation remained flat

I.19 Capacity utilisation, as measured by the 20th Round of the Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank, remained around the previous quarter's level during Q3 of 2012-13 (http://www.rbi.org.in/OBICUS20). There is broad co-movement between capacity utilisation and the de-trended IIP – Manufacturing (Chart I.9). After sequential lowering in the previous two quarters, new orders picked up marginally in Q3 of 2012-13; however, its growth remained lower than in the corresponding quarter of the previous year. The finished goods inventory to sales ratio reached its lowest level in the past five quarters, whereas the raw material inventory to sales ratio surged further to reach its highest level in five quarters.

Chart I.9: Capacity Utilisation and De-trended IIP (Manufacturing)



Services sector witnesses moderation in growth

I.20 Weak global growth coupled with the slowdown in domestic consumption has adversely affected the performance of the services sector. Several indicators of the services sector activity show a slowdown in their activity during April-February 2012-13 (Table I.4). The Reserve Bank's services sector composite indicator based on growth in indicators of construction, trade and transport and finance, showed a continuation of the downturn in services in Q3 of 2012-13, but indicated slight improvement during January-February of 2013 (Chart I.10).

Employment scenario remained weak during April-December 2012-13

I.21 The weak employment scenario that started from Q4 of 2011-12 still continues. As per the Labour Bureau survey, employment creation in the eight key sectors during 2012-13 (April-December) declined by 68 per cent over the corresponding period of the previous year, largely due to the IT/BPO sector, which is one of the main contributors to employment generation in the organised sector. Except for

Table I.4: Indicators of Services Sector Activity

(Growth in per cent)

Services Sector Indicators	2010-11	2011-12	2012-13
1	2	3	4
Tourist arrivals	10.0	9.7	2.9
Cement	4.5	6.7*	5.5*
Steel	13.2	10.7*	2.1*
Automobile Sales	16.8	11.1	2.6
Railway revenue-earning freight traffic	3.8	5.2	4.1
Cargo handled at major ports	1.5	-1.5	-2.6
Civil aviation			
Domestic Cargo Traffic	23.8	-4.9*	-3.0*
International Cargo Traffic	17.7	-1.3*	-4.7*
International Passenger Traffic	10.3	7.5*	4.8*
Domestic Passenger Traffic	18.1	16.7*	-5.2*

Note : *: Data refer to April-February.
Source: Ministry of Statistics and Programme Implementation, Ministry of Tourism, Press Information Bureau, Indian Ports Association, SIAM and CMIE.

textiles and leather, all other sectors have also shown a decline in the rate of employment generation (Table I.5).

Chart I.10: Services Sector Composite Indicator

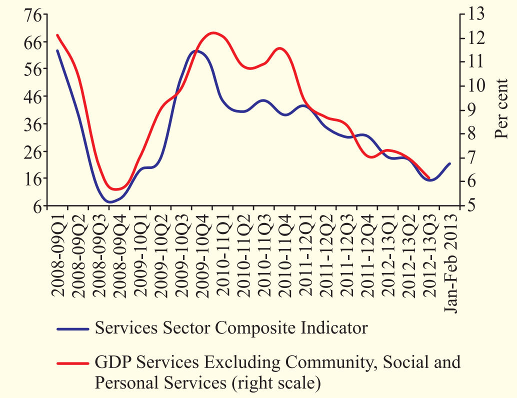


Table I.5: Changes in Employment

(million)

Industry/Group	2010-11	2011-12	2011-12 (Apr-Dec)	2012-13 (Apr-Dec)
1	2	3	4	5
Textiles including Apparel	0.10	0.09	0.09	0.10
Leather	0.03	-0.02	-0.01	0.01
Metals	0.09	0.08	0.09	0.03
Automobiles	0.11	0.03	0.03	0.01
Gems and Jewellery	0.00	0.03	0.03	0.00
Transport	0.00	0.04	0.02	0.00
IT/BPO	0.67	0.58	0.48	0.09
Handloom/Power loom	-0.01	0.00	0.02	0.00
Overall	**0.98**	**0.84**	**0.76**	**0.24**

Source: Employment Surveys, Labour Bureau.

Growth likely to have stayed low in Q4 of 2012-13, recovery in 2013-14 contingent on addressing supply bottlenecks

I.22 Given the continued dismal performance of industry and evidence of a slowdown in services, growth is likely to have remained subdued in Q4 of 2012-13. Going forward, sustained efforts by the government to expediting environmental clearances and land acquisition are needed to turnaround growth in core industries.

I.23 Constraints facing the infrastructure sector need to be addressed. The Reserve Bank, on its part, has also recently relaxed the norms for external commercial borrowings for infrastructural finance companies and has eased the norms for treating bank loans to public private partnership (PPP) projects as secured finance subject to conditions. On the global front, a meaningful recovery in euro area is likely to take somewhat longer. In this environment, growth in India is excepted to remain below potential for the third year in succession during 2013-14.

II. AGGREGATE DEMAND*

Aggregate demand in the economy remained sluggish during Q3 of 2012-13 with a prolongation of the investment cycle downturn and some weakness in consumption. Corporate results show that sales continued to decelerate suggesting slack in both inventory and consumption demand. Government consumption expenditure also decelerated in response to the fiscal consolidation plan. Going forward, some improvement in consumption demand is likely if inflation recedes further. Also, investment demand could turnaround if government initiatives to resolve structural bottlenecks that impede investment fructify. A public investment stimulus is needed to revive demand, but it is important to first create the fiscal space for it by cutting current expenditure.

Aggregate demand remained sluggish

II.1 Expenditure-side GDP data suggest that aggregate demand remained sluggish during Q3 of 2012-13, with weak expansion in private and government consumption expenditure. Corporate results reaffirm this, as sales growth continued to decelerate during Q3 of 2012-13, reflecting investment slack as well as some weakness in consumption demand. Further, planned corporate investments as gleaned from the phasing details of projects receiving financial assistance from banks and other financial institutions suggest that corporate fixed investments dropped in Q3 of 2012-13.

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

(Per cent)

Item	2011-12*	2012-13#	2011-12				2012-13			Apr-Dec	
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	2011-12	2012-13
1	2	3	4	5	6	7	8	9	10	11	12
Growth Rates											
GDP at market prices	6.3	3.3	8.3	6.4	5.8	5.2	3.8	2.7	4.1	6.8	3.6
Total Consumption Expenditure	8.1	4.1	6.9	7.0	9.0	9.3	2.9	2.9	4.2	7.6	3.4
(i) Private	8.0	4.1	6.6	6.3	9.2	9.7	2.0	2.0	4.6	7.4	2.9
(ii) Government	8.6	4.1	8.4	10.7	8.1	7.6	8.3	8.0	1.9	9.0	5.7
Gross Fixed Capital Formation	4.4	2.5	13.9	3.8	-1.7	2.6	-4.6	-1.0	6.0	5.0	0.1
Change in Stocks	-30.6	47.6	-27.5	-30.4	-32.0	-32.4	51.1	51.6	48.8	-30.0	50.5
Valuables	6.6	-18.1	16.1	-13.3	8.4	15.9	-57.6	-6.5	-13.4	3.5	-28.1
Net Exports	-42.5	-7.4	-14.8	-17.7	-82.1	-83.3	4.8	-36.7	-4.2	-33.7	-11.7
Discrepancies	-100.3	--	-13.8	-57.4	-92.0	127.1	-116.1	-162.1	283.9	-62.1	-97.8
Relative shares											
Total Consumption Expenditure	70.5	71.0	71.2	71.8	73.7	65.7	70.6	71.9	73.8	72.3	72.1
(i) Private	59.2	59.7	60.6	61.2	61.4	54.3	59.5	60.8	61.7	61.1	60.7
(ii) Government	11.3	11.4	10.6	10.5	12.3	11.5	11.1	11.1	12.1	11.2	11.4
Gross Fixed Capital Formation	33.7	33.4	35.7	35.1	31.8	32.5	32.8	33.8	32.4	34.1	33.0
Change in Stocks	2.3	3.3	2.4	2.4	2.2	2.2	3.5	3.5	3.1	2.3	3.4
Valuables	2.4	1.9	2.8	2.1	2.2	2.3	1.1	1.9	1.9	2.4	1.7
Net Exports	-8.8	-9.2	-9.3	-9.3	-9.5	-7.4	-8.5	-12.3	-9.6	-9.4	-10.1
Discrepancies	0.0	-0.4	-2.8	-2.1	-0.4	4.6	0.4	1.2	-1.6	-1.7	0.0
Memo:											
GDP at market prices (` billion)	56314	58183	13252	13207	14473	15382	13753	13568	15070	40932	42391

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

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

II.2 Growth in GDP at market prices remained low with notable deceleration in government consumption expenditure (Table II.1). The contribution to modest growth in Q3 largely came from private consumption and investment (Table II.2).

II.3 Revival of investment has become a major macro-economic challenge at the current juncture. Monetary policy easing in 2012-13 has not succeeded in turning around investment. The logjam associated with structural bottlenecks in the mining and infrastructure space persist and need to be resolved first. Otherwise, the limited available space for monetary policy could get quickly used up without stimulating aggregate demand and real activity.

Decline in saving and investment rates a concern

II.4 Both saving and investment rates declined in 2011-12 (Table II.3). All three sectors, *viz.*, households, private and public sectors have witnessed a slowdown in saving during this period. Within household saving, while the financial saving rate declined, physical saving rate increased as households turned to physical assets as inflation hedges. The persistence of inflation with average headline inflation of about 9 per cent during 2011-12 withered financial savings, as households attempted to stave off the downward pressure on their real consumption.

II.5 The decline in the rate of investment in 2011-12 was mainly due to decline in the investment rate of the private corporate sector

Table II.3: Saving and Capital Formation by Institutions

(per cent of GDP at current market prices)

Item	2009-10 TRE	2010-11 SRE	2011-12 FRE
1	2	3	4
1. Gross Domestic Saving	**33.7**	**34.0**	**30.8**
(i) Household Sector	25.2	23.5	22.3
(a) Financial Saving	12.0	10.4	8.0
(b) Physical Assets	13.2	13.1	14.3
(ii) Private Corporate Sector	8.4	7.9	7.2
(iii) Public Sector	0.2	2.6	1.3
2. Gross Capital Formation	**36.3**	**37.0**	**35.5**
(i) Household Sector	13.2	13.1	14.3
(ii) Private Corporate Sector	12.1	13.4	10.6
(iii) Public Sector	9.2	8.4	7.9
(iv) Valuables	1.8	2.1	2.7
3. Gross Capital Formation##	**36.5**	**36.8**	**35.0**

FRE : First Revised Estimates. SRE : Second Revised Estimates.
TRE: Third Revised Estimates.
##: Adjusted for errors and omissions.
Source: Central Statistics Office.

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

(per cent)

Item	2011-12				2012-13		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8
1. Private Final Consumption Expenditure	4.1	3.9	5.4	5.0	1.2	1.2	2.8
2. Government Final Consumption Expenditure	0.9	1.1	1.0	0.9	0.9	0.8	0.2
3. Gross Fixed Capital Formation	4.7	1.4	-0.6	0.9	-1.7	-0.4	1.9
4. Change in Stocks	-1.0	-1.1	-1.1	-1.1	1.2	1.2	1.1
5. Valuables	0.4	-0.3	0.2	0.3	-1.6	-0.1	-0.3
6. Net Exports	-1.3	-1.5	-4.6	-3.6	0.4	-3.4	-0.4
(i) Exports	4.3	4.3	2.4	3.1	1.7	1.3	-0.5
(ii) Imports	5.6	5.8	6.9	6.6	1.3	4.7	-0.1
7. Sum (1 to 6)	7.8	3.4	0.4	2.4	0.5	-0.6	5.4
8. Discrepancies	0.5	3.0	5.4	2.7	3.3	3.3	-1.3
9. GDP at Market Prices	8.3	6.4	5.8	5.2	3.8	2.7	4.1

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

followed by that of the public sector even as the household investment rate increased. The increase in investment in valuables continued in 2011-12 and exhibited a sharper rise, partly contributing to the high Current Account Deficit (CAD) in 2011-12.

Urgency of addressing infrastructural bottlenecks in various sectors to revive growth

II.6 As on January 1, 2013, nearly half of the 566 central sector projects (of `1.5 billion and above) are delayed and there have been cost overruns to the tune of 18 per cent. The sectors that have been affected by cost and time overruns are railways, water resources, petro chemicals, road transport & highways and power. Several factors that affect the progress of projects are delays in regulatory approvals, land acquisition, land/site handover, lack of strong rehabilitation and resettlement policies, delays in decision-making, weak/ineffective project planning and monitoring and contractual disputes.

II.7 The multiplicity of authorities involved in project clearances continue to constrain investment and, therefore, the numerous government initiatives have had limited benefits. Recognising this, several initiatives have been taken for speedy clearance of projects. These include setting up Standing Committees in the Ministries to fix responsibility for time and cost overruns, regular reviews of infrastructure projects by the concerned administrative Ministries and setting up Central Sector Project Co-ordination Committees in the States under the Chief Secretaries. A Cabinet Committee on Investment was also constituted in December 2012 to examine issues relating to clearances/approvals of major projects to ensure their accelerated and timely implementation.

II.8 The roads sector's progress has recently been tardy due to delays in pre-construction activities such as land acquisition, shifting of utilities and, forest and environment clearances. In fact, during 2012-13 only 1,933 km of road projects (6,491 km in 2011-12) were awarded by the government. Even the Engineering, Procurement and Construction (EPC) contracts, in which the government bears the cost of projects, have faced problems in attracting bids due to delays in procedural approvals. In this context, the Supreme Court judgement of March 2013 on delinking the environment from forest clearances for highway projects should come as a big boost to the sector. The Union Budget 2013-14 has also announced the setting up of a regulatory authority for the roads sector.

II.9 The power sector has been largely affected by the shortage of coal and gas, which led to cutbacks in electricity generation. The gap between demand and supply of coal continues to diverge and is likely to widen further during the Twelfth Plan, which in turn, may affect several power projects. On the one hand, more expensive imported coal may erode the profit margins of the producers, and on the other hand, several State Electricity Boards are supplying electricity at less than break-even price. Urgent policy intervention to augment coal supplies is necessary to sustain power sector investments.

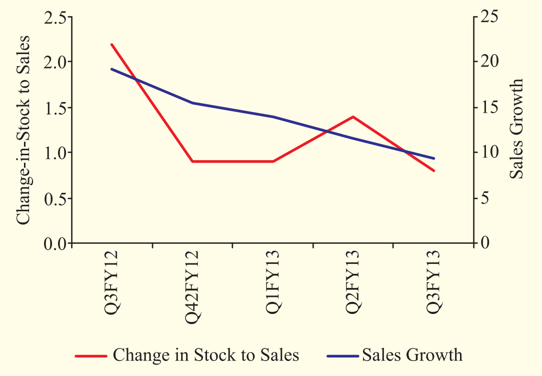
II.10 Private investments in railways have been low. A renewed focus on PPP could boost investment and help railways in furthering the rather challenging Twelfth Plan investment targets of `1 trillion through this route. Investment in near term can get kicked in from the Eastern Dedicated Freight Corridor.

II.11 Telecommunication, another key infrastructure sector, has also been struggling over the past few years due to various issues. The sector, which was growing at an average rate of 24 per cent during the 2000s, slowed to 8 per cent in 2011-12. Issues such as shortage of spectrum, its pricing and the principle underlying the auction process, changes in tax rules have dampened the outlook for the sector. Presently, almost all telecom operators are facing huge debt burden and cash flow issues.

Moderation in sales growth continued and profit margins were lower

II.12 Sales growth for listed Non-Government Non-Financial (NGNF) companies moderated in Q3 of 2012-13 to its lowest level since Q3 of 2009-10. Deceleration in sales was observed across manufacturing, IT and non-IT services sector, with a few exceptions such as jewellery, real estate, motor vehicles and other transport equipments. However, operating profit (EBITDA) grew at a positive rate for the second consecutive quarter, reversing the trend of the previous four quarters (Table II.4). Inventory accumulation, as reflected in the change in stock-in-trade to sales ratio was lower in Q3 of 2012-13, reversing the pick-up seen in Q2 of 2012-13 (Chart II.1). Net profit declined sharply during Q3 on a q-o-q basis (Table II.5). Analyst guidance for Q4 of 2012-13 suggests flat earnings growth and further deceleration in sales.

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



Fresh investment proposals declined further

II.13 Planned corporate investment, based on the total expenditure of projects for which assiatance was sanctioned by major banks/FIs,

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

	Q3FY12	Q4FY12	Q1FY13	Q2FY13	Q3FY13
1	2	3	4	5	6
No. of Companies			**2,473**		
			Growth Rates (y-o-y) in per cent		
Sales	19.2	15.5	13.9	11.6	9.3
Value of Production	20.0	14.1	13.3	12.3	8.0
Expenditure, of which	24.6	16.7	16.3	12.5	8.1
Raw Material	25.6	16.9	13.6	14.4	9.6
Staff Cost	17.6	14.4	17.7	15.2	13.1
Power & Fuel	37.2	30.7	26.2	20.8	10.8
Operating Profits (EBITDA)	-4.8	-0.5	-3.5	11.3	7.8
Other Income*	92.0	48.9	28.2	49.2	0.3
Depreciation	12.3	10.8	10.5	10.1	10.4
Gross Profits (EBIT)	0.8	4.1	-2.6	18.9	5.5
Interest**	58.8	39.9	38.6	11.5	17.4
Tax Provision	-2.6	2.4	-3.5	10.9	4.8
Net Profits (Without NOP)	-16.0	-6.9	-19.1	26.2	-1.2
Net Profits	-28.8	-7.0	-11.1	23.8	23.6
			Ratios in per cent		
Change in stock # to Sales	2.2	0.9	0.9	1.4	0.8
Interest Burden	30.2	27.0	33.0	27.6	33.6
EBITDA to Sales	12.8	13.3	12.9	13.2	12.6
EBIT to Sales	11.7	12.6	11.6	12.8	11.3
Net Profit to Sales	5.1	7.0	6.1	7.1	5.8

#: For companies reporting this item explicitly.
*: Other income excludes extraordinary income/expenditure if reported explicitly.
**: Some companies report interest on net basis.

Table II.5: Corporate Sector Financial Performance (Sequential Growth)

Indicator	Common Companies (q-o-q growth in per cent)				
	2011-12		2012-13		
	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6
No. of Companies			**2,473**		
Sales	6.1	9.6	-4.7	0.7	3.9
Value of Production	7.5	8.5	-4.8	1.2	3.4
Expenditure, *of which*	8.3	7.7	-4.4	0.8	4.0
Raw Material	8.9	10.2	-6.2	1.7	4.3
Staff Cost	3.3	2.3	5.6	3.3	1.4
Power & Fuel	9.0	4.5	9.7	-3.3	0.0
Operating Profits (EBITDA)	2.4	13.7	-7.5	3.5	-0.9
Other Income	7.1	27.3	-22.5	41.2	-28.0
Depreciation	3.5	6.3	-1.7	1.8	3.8
Gross Profits (EBIT)	2.9	18.5	-12.3	11.1	-8.7
Interest*	5.6	5.9	7.3	-7.0	11.2
Tax Provision	-6.2	15.3	-0.9	3.5	-11.4
Net Profits	-15.1	51.2	-17.9	17.4	-15.3

*: Some companies report interest on net basis.

Table II.6: Institutionally Assisted Projects and their Envisaged Cost (quarter-wise)

Financial Year		No. of Projects	Project Expenditure (₹ billion)
1		2	3
2010-11	Q1	181	1,250
	Q2	202	1,067
	Q3	160	787
	Q4	167	821
2011-12	Q1	154	787
	Q2	194	572
	Q3	151(133)	506(432)
	Q4	169	255
2012-13*	Q1	90	284
	Q2	124(109)	480(422)
	Q3**	63	147

Note: Based on data reported by 39 banks/FIs.
* : Data is provisional
** : Q3:2012-13 data is based on reported figures from 30 banks/FIs. Corresponding data for Q2:2012-13 and Q3: 2011-12 are given in parentheses.

moderated sharply in Q3 of 2012-13, reversing the increase observed in Q2 of 2012-13 (Table II.6). Most of the planned investements were in the power and cement sectors during Q3 of 2012-13 (Chart II.2).

Momentum towards fiscal consolidation continues

II.14 Faced with the challenge of twin deficits, the government embarked on a fiscal consolidation plan with mid-year correction in 2012-13. The containment of GFD at 5.2 per cent of GDP in 2012-13 (RE) in the face of shortfalls in tax revenues, telecommunication receipts and disinvestment proceeds was largely brought about by scaling down plan and capital expenditures. There was, however, a slippage in achieving the budgeted revenue deficit-GDP ratio of 3.4 per cent, reflecting the impact of a sharp rise in non-plan revenue expenditure, particularly subsidies, coupled with shortfall in revenue receipts (both tax and non-tax) during the year (Table II.7).

II.15 During 2013-14, the gross fiscal deficit-GDP ratio is budgeted to decline further to 4.8 per cent. Over the medium to long run, the continuation of fiscal consolidation efforts would significantly enhance sustainable growth and better balance the aggregate demand by helping to revive investment. Importantly, the envisaged fiscal correction is expected to be achieved through a reduction of 0.6 percentage points in the revenue deficit-GDP ratio. Notwithstanding the envisaged fiscal correction, the budgeted key fiscal deficits for 2013-14 are higher than the path set out by the Committee on Roadmap for Fiscal Consolidation (Chairman: Dr. Vijay L. Kelkar). As the fiscal consolidation efforts are primarily revenue-led, it is crucial for a revival in investment climate and growth to ensure the achievement of fiscal consolidation

Chart II.2: Share of Envisaged Investment in Major Industries in Aggregate Cost of Projects (per cent)

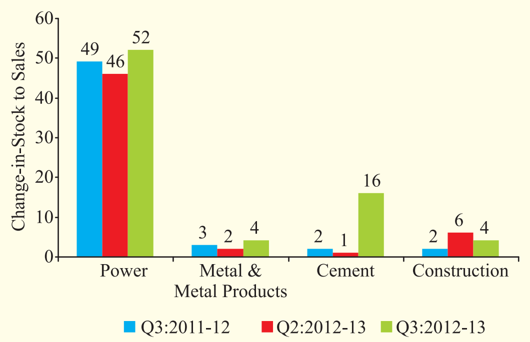


Table II.7: Key Deficit Indicators

(per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Effective Revenue Deficit	Gross Fiscal Deficit
1	2	3	4	5
		Centre		
2010-11	1.8	3.2	2.1	4.8
2011-12	2.7	4.4	2.9	5.7
2012-13 BE	1.9	3.4	1.8	5.1
2012-13 RE	2.0	3.9	2.7	5.2
2013-14 BE	1.5 (1.4)	3.3 (2.8)	1.8 (0.9)	4.8 (4.6)
2014-15 (Rolling targets)	- (0.9)	2.7 (2.0)	0.9 (0.0)	4.2 (3.9)
2015-16 (Rolling targets)	-	2.0	0.0	3.6
		States		
2010-11	0.5	0.0	-	2.1
2011-12 RE	0.8	-0.1	-	2.3
2012-13 BE	0.6	-0.4	-	2.1
		Combined		
2010-11	2.4	3.2		6.9
2011-12 RE	3.6	4.3		8.1
2012-13 BE	2.6	3.1		7.2

RE: Revised Estimates. BE: Budget Estimates.

Note: 1. Negative sign (-) indicates surplus in deficit indicators.
2. Figures in parentheses are Kelkar Committee's projections.

Source: Union Budget 2013-14 and Report of the Committee on Roadmap for Fiscal Consolidation-September 2012 (Chairman: Vijay Kelkar).

objectives without any sharp adjustment in productive public expenditure.

Tax-GDP ratio remains low in 2012-13, but expected to go up in 2013-14

II.16 Gross tax revenues in 2012-13 (RE) were lower than the budgeted level by 3.7 per cent because of decline in collection from Union excise duties, customs duties, corporation tax and wealth tax, although income tax and service tax collections showed an improvement. However, with the expected growth of 19.1 per cent in tax revenues, the gross tax-GDP ratio is estimated to improve by 0.5 percentage points to 10.9 per cent during 2013-14. The increase in tax revenues is sought to be achieved through higher excise and custom duties on certain products and the imposition of an additional surcharge on high-income individuals.

II.17 The growth in non-tax revenues is budgeted at 32.8 per cent, mainly on account of a substantial increase in dividends and profits from financial public sector undertakings (PSUs) and receipts from the telecommunications sector. Among non-debt capital receipts, disinvestment receipts are budgeted at a substantially higher level compared to the previous year.

Non-plan expenditure growth to moderate in 2013-14

II.18 During 2012-13 (RE), the total expenditure grew faster than the previous year (Table II.8). It is budgeted to accelerate further in 2013-14. Total budgeted expenditure at 14.6 per cent of GDP is higher than the Kelkar Committee target of 13.9 per cent. Among the expenditure components, the projected growth in capital expenditure at 36.6 per cent and plan expenditure at 29.4 per cent, if achieved,could help augment aggregate investment in the economy.

II.19 The growth in non-plan revenue expenditure is budgeted to be contained at 8.0 per cent as against a growth of 13.3 per cent in 2012-13. The restraint on non-plan revenue expenditure growth is critical to ensure that the fiscal consolidation is sustainable, and not excessively reliant on revenue augmentation. The expenditure on subsidies is budgeted at 2.0 per cent of GDP in 2013-14 as against 2.6 per cent of GDP in 2012-13 (Table II.9). The phased deregulation of diesel prices as announced by the Government would reduce petroleum subsidies and the softening of fertiliser prices in the international market together with urea price revisions, if any, may help to keep fertiliser subsidy bill under control. However, there could be a risk of slippage in adhering to the budget estimates of food subsidy expenditure.

II.20 Although plan expenditure has decelerated to 4.1 per cent in 2012-13 (RE), it is budgeted to register a significant increase of 29.4 per cent in 2013-14. Planned capital expenditure in 2012-13 was lower by 14.6 per cent over the budgeted amount and registered a 9.1 per cent y-o-y growth. On this low base, it is budgeted to expand by 30.6 per cent in 2013-14. The

Table II.8: Central Government Finances

Item	Growth rate (per cent)			Per cent to GDP		
	2011-12	2012-13 RE	2013-14 BE	2011-12	2012-13 RE	2013-14 BE
1	2	3	4	5	6	7
1. Total Expenditure	8.9	9.7	16.4	14.5	14.3	14.6
2. Revenue Expenditure	10.1	10.2	13.7	12.8	12.6	12.6
3. Capital Expenditure	1.3	5.8	36.6	1.8	1.7	2.0
4. Non-Developmental Expenditure	11.6	10.0	18.6	5.9	5.8	6.0
5. Development Expenditure	7.2	9.5	14.9	8.7	8.5	8.6
6. Non-Plan Expenditure	9.0	12.3	10.8	9.9	10.0	9.8
7. Plan Expenditure	8.8	4.1	29.4	4.6	4.3	4.9
8. Revenue Receipts	-4.7	16.0	21.2	8.4	8.7	9.3
i) Tax Revenue (net)	10.5	17.8	19.1	7.0	7.4	7.8
ii) Non Tax Revenue	-44.3	6.6	32.8	1.4	1.3	1.5
9. Gross Tax Revenue	12.1	16.7	19.1	9.9	10.4	10.9
i) Direct Tax	10.8	14.5	18.1	5.5	5.6	5.9
ii) Indirect Tax	13.9	19.5	20.2	4.4	4.7	5.0
Memo :						
10. Revenue Deficit	56.3	-0.8	-2.9	4.4	3.9	3.3
11. Effective Revenue Deficit	58.9	2.0	-23.1	2.9	2.7	1.8
12. Gross Fiscal Deficit	38.1	1.0	4.1	5.7	5.2	4.8
13. Gross Primary Deficit	74.0	-15.9	-15.9	2.7	2.0	1.5

BE: Budget Estimates. RE: Revised Estimates.
Source: Union Budget 2013-14.

re-prioritisation of expenditure in favour of capital expenditure is expected to increase the capital outlay-GFD ratio to 38.5 per cent in 2013-14 from 28.1 per cent in 2012-13 (RE).

Need to contain centre's market borrowing in 2013-14 as budgeted

II.21 The pattern of financing the fiscal deficit for 2013-14 shows continued reliance on market borrowings, which is budgeted to finance 89 per cent of the gross fiscal deficit (GFD). The recourse to short-term financing through treasury bills is budgeted at 3.7 per cent. If market borrowings are contained within the budgeted amount, it could provide some monetary space.

Table II.9: Total Subsidies

(Amount in ` billion)

Items	2011-12		2012-13 (RE)		2013-14 (BE)	
	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
1	2	3	4	5	6	7
Total Subsidies	**2,179.4**	**2.4**	**2,576.5**	**2.6**	**2,310.8**	**2.0**
i) Food	728.2	0.8	850.0	0.8	900.0	0.8
ii) Fertiliser	700.1	0.8	659.7	0.7	659.7	0.6
iii) Petroleum	684.8	0.8	968.8	1.0	650.0	0.6
iv) Interest subsidy	50.5	0.1	74.2	0.1	80.6	0.1
v) Other subsidies	15.7	0.0	23.8	0.0	20.5	0.0

RE: Revised Estimates. BE: Budget Estimates.
Source: Union Budget 2013-14.

Fiscal prudence may impart confidence in the economy

II.22 On the whole, the fiscal consolidation measures announced in the budget for 2013-14 may lay the foundation for a sustainable rebalancing of government finances. If budgetary targets are adhered to, it will enhance the credibility of the fiscal management, impart confidence among investors, lower risk premia on India and support growth revival. However, over the medium-term, the focus on eliminating the effective revenue deficit by 2015-16 would be critical to fiscal policy strategy as it could create space for counter-cyclical policies to support capital formation and growth.

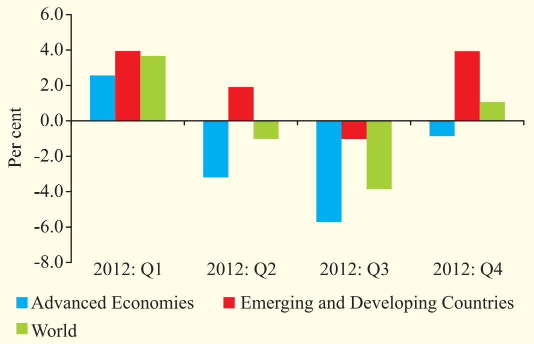
III. THE EXTERNAL SECTOR

External imbalances came to the fore during 2012-13 as the CAD-GDP ratio reached an all time high of 6.7 per cent in Q3 mainly on account of the growing trade deficit. Although non-oil non-gold imports have decelerated in recent months, the sticky oil and gold imports resulted in the widening of trade deficit. However, the overall balance of payments was in marginal surplus due to strong capital inflows, led by FII investments. In Q4 of 2012-13, CAD is expected to have narrowed on the back of a turnaround in export growth and stabilisation of import growth. The recent moderation in commodity prices, including oil and gold will also help reduce the pressure on the current account. Despite these factors, the CAD is likely to remain above sustainable level. This requires policy attention, as the lumpiness and volatility of capital flows expose CAD financing to risks of sudden stops and reversals in these flows.

No definitive signs of global recovery

III.1 During 2012, global trade expanded at its slowest pace since the mid-1990s with the exception of a large contraction in 2009. Slow growth in the advanced economies (AEs) continued to remain a weak link in global trade expansion, while emerging market and developing economies (EMDEs) seem to be contributing to global trade through increased intra-industry and South-South trade. The upturn in world exports in Q4 of 2012, though small, was largely supported by the relatively better growth performance in EMDEs, while exports from AEs showed contraction (Chart III.1). Going forward, the lower-than-expected growth in China in Q1 of 2013 comes as a dampener, and tilts towards downside the overall balance of risks to the global economic and trade outlook.

Chart III.1: Merchandise Export Growth in Advanced and Emerging Market Economies



Data Source: International Financial Statistics, IMF.

Exports pick-up in Q4 of 2012-13

III.2 Reflecting the modest increase in trade activities across EMDEs, India's merchandise exports showed a turnaround from December 2012 after a subdued performance in previous months (Table III.1 and Chart III.2a). In Q4 of 2012-13, export growth at 4.7 per cent was higher compared with 4.0 per cent in the corresponding period of 2011-12. While the recovery in exports in January 2013 was mainly due to higher demand from Saudi Arabia, Malaysia and a few African economies, the exports to China continued to contract. Commodity-wise data show that export pick-up was confined to a few sectors. Petroleum products, oil cakes, gems and jewellery, engineering goods and cotton yarn accounted for more than 75 per cent of the total rise in exports in Q4 of 2012-13.

III.3 Notwithstanding a modest increase in exports in recent months, the trade deficit remained significantly higher in 2012-13. In fact, the non-oil non-gold trade balance has shown an improvement since November 2012, turning mildly positive in February 2013 (Chart III.2b). Net imports of POL and gold accounted for nearly 82 per cent of India's trade deficit during 2012-13.

III.4 In the recent period, the government undertook a slew of measures to address the high trade deficit attributed to low exports and

Table III.1: India's Merchandise Trade

(US$ billion)

Item	April–March			
	2011-12 R		2012-13 P	
	Value	Growth (%)	Value	Growth (%)
1	2	3	4	5
Exports	306.0	21.8	300.6	-1.8
Of which: Oil	56.0	35.1	60.0	7.1
Non-oil	249.9	19.2	240.6	-3.7
Gold	6.7	10.8	6.5	-3.5
Non-Oil Non-Gold	243.2	19.5	234.1	-3.8
Imports	489.3	32.3	491.5	0.4
Of which: Oil	155.0	46.2	169.3	9.2
Non-oil	334.4	26.7	322.2	-3.6
Gold	56.5	38.9	54.0 @	-4.4
Non-Oil Non-Gold	277.9	24.5	268.3 @	-3.5
Trade Deficit	-183.4		-190.9	
Of which: Oil	-98.9		-109.3	
Non-oil	-84.4		-81.7	
Non-Oil Non-Gold	-34.7		-34.2	

@: Based on RBI estimates R: Revised P: Provisional

high POL and gold imports. In January 2013, the government authorised oil marketing companies to hike diesel prices on a monthly basis, thereby allowing gradual deregulation of diesel prices.

III.5 To curb the import demand for gold, the customs duty on gold import was raised further from 4 per cent to 6 per cent in January 2013. Under the Gold Deposit Scheme, the central government has allowed mutual funds / ETFs to deposit part of their gold with the banks. Recognising the concerns relating to high gold imports and its impact on India's CAD, the Union Budget 2013-14 emphasised that the household sector must be incentivised to save in financial instruments rather than buy gold and hence, proposed various measures including the introduction of inflation-indexed bonds.

CAD risks may moderate in the near term, though structural impediments remain

III.6 The current account deficit (CAD) rose to a historical high of 6.7 per cent of GDP in Q3 of 2012-13 (Table III.2). On BoP basis, merchandise exports remained almost stagnant at level achieved in Q3 of 2011-12. Though, sluggish global demand has largely been responsible for continued weak exports, there is a need to address domestic policy issues impeding export growth. For example, despite being one of the major coal producers in the world, India had to import 113 million tonnes during the period April 2012-January 2013, which is a jump of 29 per cent, on top of a rise of 47 per cent witnessed during the previous year. In 2012-13, diesel consumption increased by 6.8 per cent over 2011-12.

III.7 Other major sources of current receipts, *viz.*, exports of services, most notably software, and private transfers also decelerated and were thus inadequate to offset the impact of the high trade deficit on the current account balance. Non-oil non-gold imports have continued to decelerate, broadly tracking the slowdown in GDP growth (Chart III.3). In contrast, despite

Chart III.2: India's Merchandise Trade

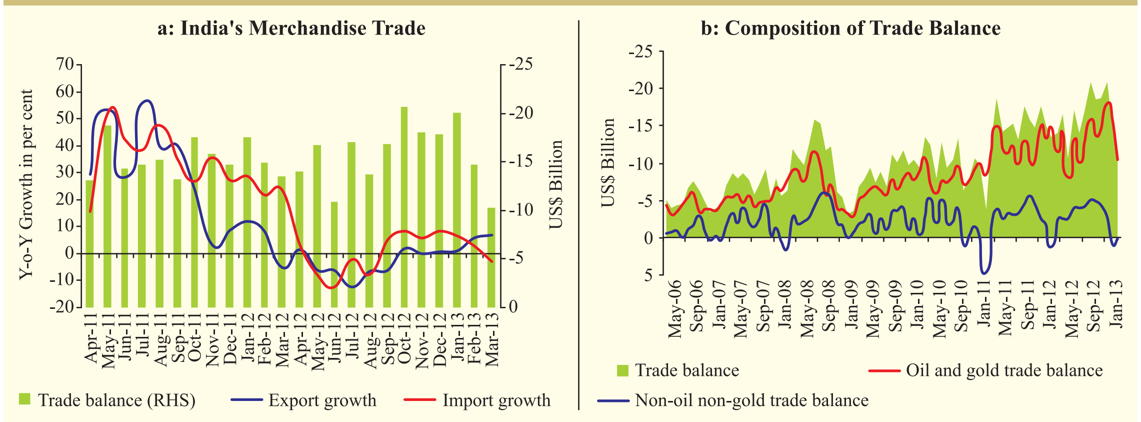


Table III.2: Major Items of India's Balance of Payments

(US $ billion)

	2011-12 (PR)	2011-12				2012-13		
		Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (PR)	Q1 (PR)	Q2 (PR)	Q3 (P)
1	2	3	4	5	6	7	8	9
1. Goods Exports	309.8	78.8	79.6	71.5	80.0	76.7	69.8	71.8
2. Goods Imports	499.5	123.7	124.1	120.1	131.7	119.1	118.1	131.4
3. Trade Balance (1-2)	-189.7	-44.9	-44.5	-48.6	-51.7	-42.4	-48.3	-59.6
4. Services Exports	140.9	33.7	32.3	37.3	37.7	34.8	34.6	36.5
5. Services Imports	76.9	17.4	18.3	21.1	20.0	20.7	19.4	18.9
6. Net Services (4-5)	64.0	16.3	14.0	16.1	17.7	14.1	15.2	17.6
7. Goods & Services Balances (3+6)	-125.7	-28.6	-30.5	-32.5	-34.0	-28.3	-33.1	-42.0
8. Primary Income (Net)	-16.0	-3.6	-4.0	-3.8	-4.6	-4.9	-5.6	-6.3
9. Secondary Income (Net)	63.5	14.8	15.6	16.2	16.9	16.8	16.1	15.7
10. Net Income (8+9)	47.5	11.2	11.6	12.4	12.3	11.9	10.5	9.4
11. Current Account Balance (7+10)	-78.2	-17.4	-18.9	-20.2	-21.7	-16.4	-22.6	-32.6
12. Capital Account Balance	-0.1	-0.3	0.2	0.1	-0.2	-0.3	-0.2	0.01
13. Financial Account Balance	80.7	18.7	19.0	20.6	22.4	15.8	23.9	31.1
of which: Change in Reserves*	12.8	-5.4	-0.3	12.8	5.7	-0.5	0.2	-0.8
14. Errors & Omissions (11+12-13)	-2.4	-0.9	-0.4	-0.5	-0.6	0.9	-1.0	1.6
Memo: As a ratio to GDP								
15. Trade Balance	-10.1	-9.7	-9.8	-10.6	-10.5	-9.9	-11.5	-12.3
16. Net Services	3.3	3.6	3.1	3.5	3.5	3.3	3.6	3.6
17. Net Income	2.5	2.4	2.6	2.7	2.5	2.8	2.5	1.9
18. Current Account Balance	-4.2	-3.8	-4.2	-4.3	-4.4	-3.9	-5.4	-6.7
19. Capital and Financial Account, Net (Excl. changes in reserves)	3.6	5.2	4.3	1.7	3.3	3.7	5.6	6.5

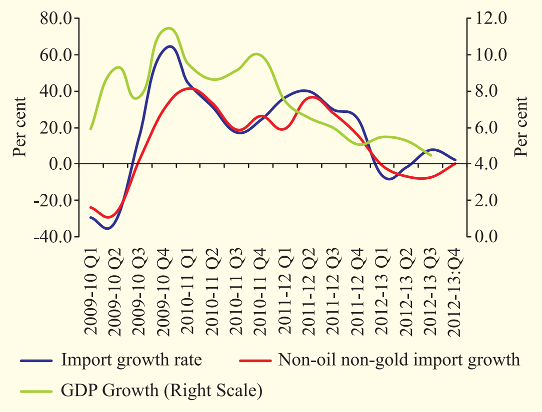
Notes: * : -/+ sign implies increase/decrease in reserves, respectively.
Total of subcomponents may not tally with aggregate due to rounding off.
P: Preliminary; PR: Partially Revised

various dampening factors such as slowdown in growth, depreciation of the rupee and policy measures like duty hike on gold, the demand for oil and gold imports has remained significant.

III.8 Global commodity prices, especially of oil and gold, have fallen recently. The softening of oil prices mainly reflects the subdued growth outlook for some advanced economies and also China. With the strengthening of US dollar, the role of gold as a safe haven asset may have weakened. Apart from that, the possibility of gold sale by some indebted euro area economies also appears to be the cause of fall in gold prices. Consequent to decline in oil and gold prices, pressures on the CAD in the short-run may have eased but there is hardly any space for complacency.

III.9 While the CAD, even at this large level, could be fully financed by capital inflows during 2012-13, volatility in such flows remains a risk. Given the slowing growth and attendant macro-

Chart III.3: GDP Growth and Import Growth



financial risks, as also the possibilities of global 'risk off' turning into global 'risk on' leading to reversal of capital flows from emerging markets, it is necessary to lower external sector risks by lowering the CAD to its sustainable level and not become complacent about external inflows. Overall, private sector external debt has become large and, going forward, some prudence may be necessary on external commercial borrowing (ECBs) and short-term trade credit.

Capital flows continue to be strong, enabling CAD financing

III.10 Even though the CAD rose sharply in Q3 of 2012-13, net capital flows were able to finance it fully and there was even a marginal accretion to foreign exchange reserves (Table III.3). While portfolio flows broadly tracked the global optimism in Q4 of 2012-13, domestic policy measures also served as pull factors to attract FII flows to India. In addition to increasing FII limits in debt securities (both corporate and government) in Q3, various policy announcements in Q4, *viz.*, (i) postponing the implementation of the General Anti-Avoidance Rule (GAAR) by two years, (ii) simplification of 'Know Your Customer' registration rules for overseas investors and (iii) removal of separate limits for FIIs on different types of corporate bonds may have improved the market sentiment. The recent fall in global commodity prices has somewhat alleviated CAD risks and thus attracted greater FII inflows, though its financing remains a challange.

III.11 While non-debt flows picked up in Q4, there was a mixed trend in the major components

Table III.3: Disaggregated Items of Financial Account

(US$ billion)

	2011-12 (PR)	2011-12				2012-13		
		Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (PR)	Q1 (PR)	Q2 (PR)	Q3 (P)
1	2	3	4	5	6	7	8	9
1. Direct Investment (net)	**22.1**	**9.3**	**6.5**	**5.0**	**1.4**	**3.9**	**8.9**	**2.5**
1.a Direct Investment to India	33.0	12.4	9.5	6.9	4.2	5.9	10.3	4.8
1.b Direct Investment by India	-10.9	-3.1	-3.0	-1.9	-2.9	-2.1	-1.4	-2.3
2. Portfolio Investment	**16.6**	**2.3**	**-1.4**	**1.8**	**13.9**	**-2.0**	**7.6**	**8.6**
2.a Portfolio Investment in India	16.8	2.5	-1.6	1.9	14.1	-1.7	7.9	9.8
2.b Portfolio Investment by India	-0.2	-0.2	0.2	-0.04	-0.2	-0.3	-0.3	-1.2
3. Financial Derivatives & Employee Stock Options	-	-	-	-	-	-0.6	-0.5	-0.4
4. Other Investment	**29.2**	**12.6**	**14.2**	**1.0**	**1.4**	**15.1**	**7.7**	**21.0**
4.a Other equity (ADRs/GDRs)	0.6	0.3	0.2	0.1	0.03	0.1	0.1	0.2
4.b Currency and deposits	12.1	1.2	3.1	3.2	4.6	6.4	3.5	2.6
Deposit-taking corporations, except the central bank: (NRI Deposits)	11.9	1.2	2.8	3.3	4.7	6.6	2.8	2.7
4.c Loans*	16.8	14.9	9.5	-7.7	-0.03	3.8	3.2	7.1
4.c.i Loans to India	15.7	14.9	8.9	-8.1	-0.02	3.7	3.5	7.2
Deposit-taking corporations, except the central bank	4.1	11.5	3.9	-8.7	-2.6	3.0	2.0	2.7
General government (External Assistance)	2.5	0.4	0.3	1.4	0.3	0.3	0.2	1.5
Other sectors (ECBs)	9.1	3.0	4.7	-0.8	2.3	0.4	1.2	3.1
4.c.ii Loans by India	1.0	-0.02	0.6	0.5	-0.01	0.1	-0.3	-0.1
General government (External Assistance)	-0.2	-0.04	-0.04	-0.04	-0.04	-0.1	-0.1	-0.1
Other sectors (ECBs)	1.2	0.02	0.6	0.5	0.03	0.1	-0.3	-0.1
4.d Trade credit and advances	6.7	3.1	2.9	0.6	0.2	5.4	4.1	6.2
4.e Other accounts receivable/payable – other	-6.9	-6.8	-1.5	4.8	-3.3	-0.6	-3.2	5.0
5. Reserve assets	**12.8**	**-5.4**	**-0.3**	**12.8**	**5.7**	**-0.5**	**0.2**	**-0.8**
Financial Account (1+2+3+4)	**80.7**	**18.7**	**19.0**	**20.6**	**22.4**	**15.8**	**23.9**	**31.1**

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

of debt-creating flows. While NRI deposits moderated in Q4, net flows in the form of ECBs showed an increase (Table III.4). Moderation in NRI deposits might be partly reflecting the subdued income growth conditions in major source countries. During Q4, ECBs have been raised mainly to fund the power sector, modernisation, import of capital goods and new projects. In view of rising private external debt, it is important to keep in view the end-use of ECBs.

Rupee remained range bound, supported by portfolio flows

III.12 The trend of a stronger rupee observed during December 2012 to early-February 2013 was mainly supported by portfolio capital flows and various reform measures announced during the period. Even though the rupee witnessed some weakness during the second week of February to early March, it remained largely range-bound with some subsequent appreciation during April 2013. In Q4, the level of the real effective exchange rate (*i.e.*, REER based on 6 and 36 currency baskets) remained almost at the level recorded in Q3 (average basis). REER witnessed some depreciation during 2012-13 (Table III.5).

External debt, particularly short-term debt, rose further in Q3

III.13 India's external debt increased to US$ 376 billion as at end-December 2012, reflecting continued dependence on ECBs and short-term borrowings to meet the widening CAD

Table III.4: Capital Flows

(US$ billion)

Component	2011-12				2012-13			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	Average of monthly flows							
1	2	3	4	5	6	7	8	9
FDI in India	4.1	3.1	2.3	1.5	2.0	3.4	1.8	2.9*
FDI by India	1.0	1.0	0.6	1.0	0.7	0.5	0.8	0.1
FIIs	0.8	-0.5	0.6	4.7	-0.6	2.6	3.3	3.8
ECB	1.0	1.6	-0.3	0.8	0.1	0.4	1.0	1.3
NRI	0.4	0.9	1.1	1.6	2.2	0.9	0.9	0.7*

*: January-February 2013.

(Table III.6). Short-term debt on a residual maturity basis has risen by about US$ 19 billion in the first three quarters of 2012-13.

Vulnerability indicators weakened further

III.14 India's external sector vulnerability indicators deteriorated further in Q3 of 2012-13 (Table III.7). Reflecting the sharper rise in external debt as compared to growth in nominal GDP (in rupee terms), the ratio of external debt to GDP increased in Q3. Similarly, the import cover declined marginally, as imports were spurred largely by oil and gold imports during the period. Reflecting the widening CAD, the net international investment liabilities-GDP ratio increased to 15.4 per cent at end-December 2012 from 15.1 per cent at end-September 2012.

Sustained efforts needed to bring the CAD to sustainable levels, though fall in commodity prices brings temporary respite

III.15 Export growth turned positive since December 2012 and this bodes well for narrowing the CAD in Q4 of 2012-13. Further, the recent fall in the prices of gold and POL, which constitute nearly 45 per cent of India's imports, may help alleviate the pressure on the trade deficit and, in turn, on the CAD. Even though the CAD-GDP ratio is likely to moderate from Q4 of 2012-13, it may still remain above the sustainable level in the short to medium

Table III.5: Nominal and Real Effective Exchange Rates: Trade-Based (Base: 2004-05=100)

	Index Mar 28, 2013 (P)	Y-o-Y Variation (Average) 2011-12	FY Variation (Mar 28, 2013 over-Mar 2012)
1	2	3	4
36- REER	95.8	-6.7	-2.7
36-NEER	79.1	-10.4	-5.9
6-REER	106.9	-5.9	-2.4
6-NEER	76.8	-10.3	-5.9
`/US$	54.4	-11.9	-7.5

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

Table III.6: India's External Debt

(US$ billion)

Indicator	End-Mar 2012 (PR)	End-Jun 2012 (PR)	End-Sep 2012 (QE)	End-Dec 2012 (QE)	Per cent Variation (end-Dec 2012 over end-Sep 2012)
1	2	3	4	5	6
1. Multilateral	50.5	49.7	50.7	51.6	1.8
2. Bilateral	26.9	27.4	27.9	26.3	-5.4
3. IMF	6.2	6.0	6.1	6.1	-0.3
4. Trade Credit (above 1 year)	19.0	19.1	19.1	18.5	-2.8
5. ECBs	104.8	104.3	108.8	113.0	3.8
6. NRI Deposits	58.6	60.9	67.0	67.6	0.9
7. Rupee Debt	1.4	1.2	1.3	1.3	-3.7
8. Long-term (1 to 7)	267.3	268.6	280.9	284.4	1.3
9. Short-term (Original Maturity)	78.2	80.5	84.7	91.9	8.5
10. Short-term (Residual Maturity) #	147.4	150.0	159.6	166.1	4.1
Total (8+9)	**345.5**	**349.1**	**365.6**	**376.3**	**2.9**

PR: Partially Revised. QE: Quick Estimates. #: RBI Estimate.
Note: Growth rates are based on data up to 3 decimal points.

Table III.7: External Sector Vulnerability Indicators

(per cent)

Indicator	End-Mar 2012	End-Sep 2012	End-Dec 2012
1	2	3	4
1. Ratio of Total Debt to GDP*	19.7	19.3	20.6
2. Ratio of Short-term to Total Debt (Original Maturity)	22.6	23.2	24.4
3. Ratio of Short-term to Total Debt (Residual Maturity)#	42.6	43.7	44.1
4. Ratio of Concessional Debt to Total Debt	13.9	13.2	12.5
5. Ratio of Reserves to Total Debt	85.2	80.7	78.6
6. Ratio of Short-term Debt to Reserves	26.6	28.7	31.1
7. Ratio of Short-term Debt (Residual Maturity) to Reserves#	50.1	54.1	56.2
8. Reserves Cover of Imports (in months)	7.1	7.2	7.1
9. Debt-Service Ratio (Debt Service Payments to Current Receipts)	6.0	6.0	5.8
10. Net International Investment Position (NIIP) (US$ billion)	-248.5	-271.5	-282.0
11. NIIP/GDP ratio	-13.3	-15.1	-15.4

* : Annualised GDP at current market prices.
- : Not available. #: RBI Estimate.

term. Capital flows, particularly equity flows, remain strong, mainly reflecting easy global liquidity (push factor) and market participants' expectations of higher returns from the Indian markets (pull factor). The reduced pressures on the trade deficit coupled with higher capital flows are likely to facilitate smooth financing of the CAD. Nonetheless, several risks remain, which require policy attention. First, even as POL and gold prices cool off, the moderation in CAD may still not be sufficient to bring it down to the sustainable level. Second, apart from POL and gold imports, there are also some other impediments to CAD reduction. Indian exports need to build productivity-based competitiveness and in this context, infrastructural constraints need to be addressed. It would be erroneous to take comfort from factors that are exogenous in nature, such as the fall in oil and gold prices, without addressing domestic structural problems. Third, even though FII flows remain strong at the moment, they may become volatile if global financial conditions turn adverse. Moreover, the continuation of these flows depends on the growth prospects of the Indian economy and any sign of uncertainty regarding these prospects may hamper these flows. Fourth, the global economic outlook is far from rosy and downside risks remain substantial. Thus, sustaining Indian export recovery in such an uncertain situation would be a challenge that needs domestic efforts to raise productivity-based competitiveness. To sum up, though the recent developments have given a temporary respite to CAD risks and have eased the pressure on its financing, policy efforts need to continue to bring it down to a sustainable level.

IV. MONETARY AND LIQUIDITY CONDITIONS

The combination of growth slowdown, persistence of inflation above the comfort level and a historically high CAD posed a special challenge for monetary policy making during 2012-13. The Reserve Bank addressed this with calibrated reductions in the policy rate and liquidity easing measures. Despite a large injection of durable liquidity through CRR cuts and OMOs, liquidity conditions tightened especially since November 2012, mainly due to large and persistent build-ups in government cash balances. Broad money growth was in line with the Reserve Bank's indicative trajectory for 2012-13. Going forward, while the asset quality of the banking sector remains a major concern, the Reserve Bank's monetary policy would strive to ensure adequate flow of credit to productive sectors, while keeping a vigil on inflation and working towards reducing macro-economic imbalances.

The Reserve Bank undertakes calibrated monetary policy easing

IV.1 The Reserve Bank has been managing the growth-inflation dynamics based on the tenet that low and stable inflation secures sustained high medium-term growth and facilitates consumers' and investors' decision-making. The macroeconomic priorities that have shaped recent monetary policy making include the need to address growth slowdown, restrain inflation pressures and mitigate vulnerabilities in the external sector. After a quick recovery in the post-crisis period, domestic economic growth significantly decelerated in 2011-12 and further during 2012-13 on account of both sluggish global growth and domestic bottlenecks.

IV.2 Taking cognizance of falling growth, the Reserve Bank lowered policy interest rate and the SLR by 100 bps each, and the CRR by 75 bps in 2012-13 on top of a 125 bps cut in the CRR in Q4 of 2011-12 (Table IV.1). It also undertook durable liquidity injections through outright purchases of G-secs as a part of open market operations (OMOs) totalling about `1.5 trillion during the year. After front-loading a 50 bps policy rate cut in April 2012, the Reserve

Table IV.1: Movements in Key Policy Variables

(Per cent)

Effective since	Repo Rate	Cash Reserve Ratio*	Statutory Liquidity Ratio*
1	2	3	4
May 3, 2011	7.25 (+0.50)	6.00	24
June 16, 2011	7.50 (+0.25)	6.00	24
July 26, 2011	8.00 (+0.50)	6.00	24
September 16, 2011	8.25 (+0.25)	6.00	24
October 25, 2011	8.50 (+0.25)	6.00	24
January 28, 2012	8.50	5.50 (-0.50)	24
March 10, 2012	8.50	4.75 (-0.75)	24
April 17, 2012	8.00 (-0.50)	4.75	24
August 11, 2012	8.00	4.75	23 (-1.00)
September 22, 2012	8.00	4.50 (-0.25)	23
November 3, 2012	8.00	4.25 (-0.25)	23
January 29,2013	7.75 (-0.25)	4.25	23
February 9,2013	7.75	4.00 (-0.25)	23
March 19, 2013	7.50 (-0.25)	4.00	23

Note: Since May 2011, the repo rate has been placed in the middle of the corridor, with the reverse repo rate 100 basis points below it and the MSF rate 100 basis points above it.

*: Percent of NDTL.

Bank had to hold rate in the absence of the expected momentum on fiscal consolidation and elevated inflation concerns. However, since September 2012, a renewed commitment to containing the fiscal deficit provided space to the Reserve Bank for further policy easing. In response, the policy rates were lowered further by 50 bps in Q4 of 2012-13. Rising CAD risks, however, prompted the Reserve Bank to exercise caution while easing.

Reserve Bank took measures to combat tight liquidity conditions

IV.3 Liquidity conditions exhibited mixed trends during 2012-13, with a generally comfortable liquidity situation interspersed with bouts of tightness, which can be divided into three broad phases. In the first phase, which was prolonged until June 2012, the liquidity deficit was broadly outside the Reserve Bank's comfort zone, largely due to the spillover of the tight liquidity conditions of Q4, 2011-12. Active liquidity-easing measures taken by the Reserve Bank that included CRR cuts and open market purchases resulted in a comfortable liquidity situation by July 2012, which marked the beginning of the second phase. This phase of comfortable liquidity lasted until mid-October 2012. The third phase began thereafter, when, despite easing measures followed by the Reserve Bank, persistently high government cash balances and strong currency demand kept the inter-bank liquidity deficit beyond the Reserve Bank's comfort zone. The Reserve Bank reduced the CRR in November 2012, and resumed outright OMOs on December 4, 2012 after a gap of more than five months (Chart IV.1).

IV.4 The third phase of liquidity deficit continued during Q4 of 2012-13. This period saw a large build-up of government cash balance. The Reserve Bank provided liquidity through LAF injections hovering around `1 trillion on a daily average basis during this period. In order to pre-empt end-quarter liquidity pressures, the Reserve Bank lowered the CRR of scheduled banks (SCBs) by 25 basis points to 4.0 per cent of their net demand and time liabilities (NDTL) effective from the fortnight beginning February 9, 2013. Additionally, the Reserve Bank conducted four outright OMO (purchase) auctions during Q4 and accepted bids amounting to `335 billion in these auctions, taking the total amount of liquidity injection to `1.5 trillion through these operations during the financial year, including `231 billion through anonymous trading platform (NDS-OM). Finally, in view of the anticipated large volume of banking transactions during the annual closing of accounts for 2012-13, the Reserve Bank conducted additional liquidity operations on March 28, 2013 (only Repo) and special LAF (Repo, Reverse repo and MSF) on March 30 and 31, 2013 (*i.e.* Saturday and Sunday, respectively), which

Chart IV.1: Inter-bank Liquidity and its Drivers

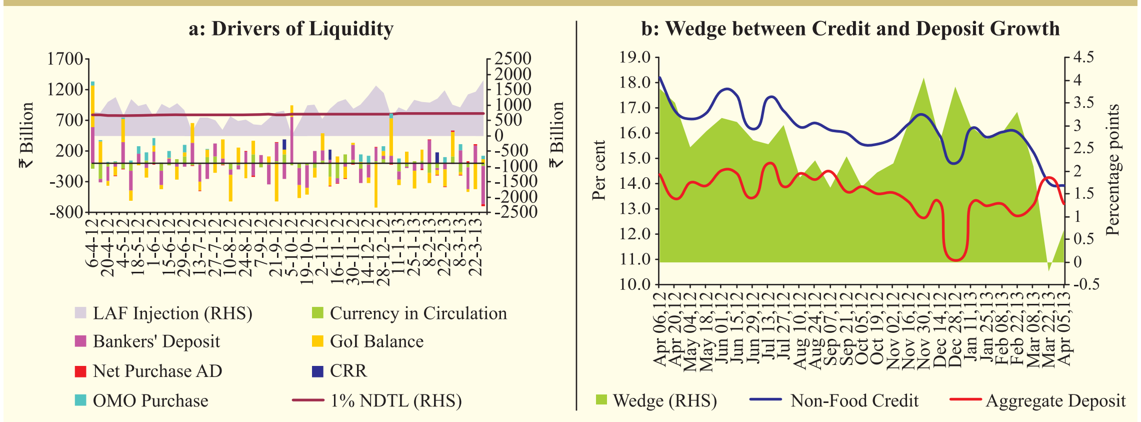
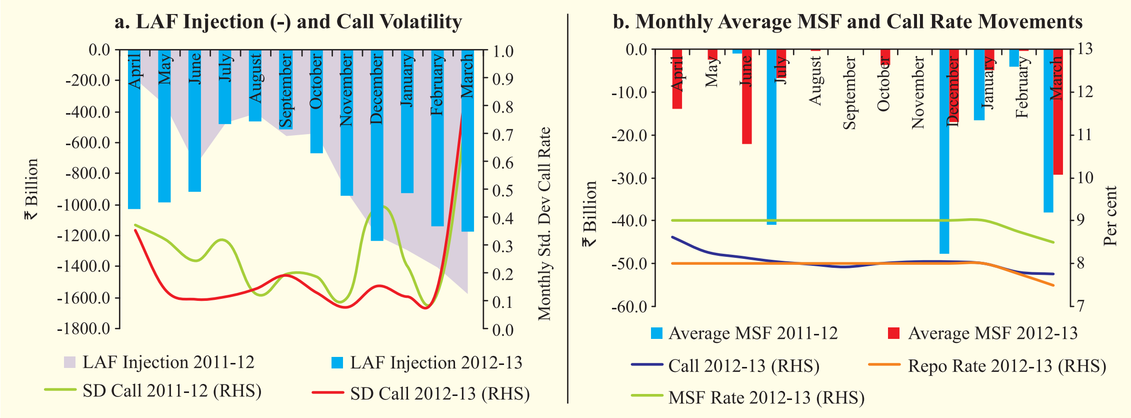


Chart IV.2: Liquidity Easing Measures and Movements in Operational Target



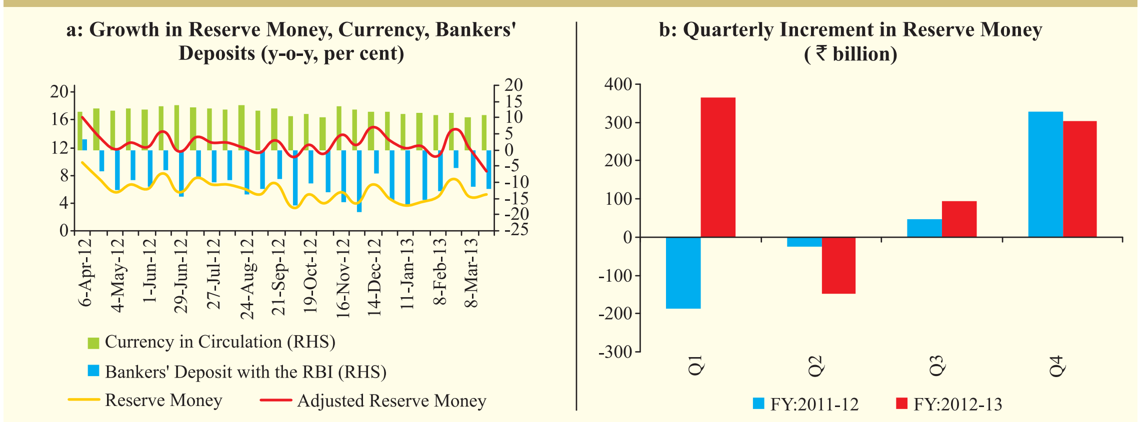
facilitated smooth and non-disruptive conduct of banking operations.

IV.5 During 2012-13, liquidity management encountered several challenges. However, the pre-emptive and calibrated use of varied instruments, which included reduction(s) in SLR and CRR, OMO purchases and additional LAF arrangements, had a positive impact on liquidity management, which got reflected in many of the market indicators. The call rate generally remained anchored close to the repo rate and below the MSF rate during 2012-13. The dependence on MSF was miniscule and clearly lower than in 2011-12, despite the Reserve Bank raising the borrowing limit of SCBs under the MSF to 2 per cent of their NDTL (Chart IV.2). Moreover, the volatility of the call rate, as indicated by its monthly standard deviation, generally declined in 2012-13. The call/notice rates generally remained within the corridor except on March 28, 2013. During April 2013 so far, liquidity conditions had eased following significant draw-down of government's cash balances.

Reserve money adjusted for CRR changes increased at a reasonable pace

IV.6 During 2012-13, the path of reserve money mainly reflected developments in the net domestic asset (NDA) during the year. On the components side, growth of currency in circulation marginally decelerated, reflecting the impact of the economic slowdown on currency demand. Bankers' deposits with the Reserve Bank recorded negative growth, mainly on account of policy-induced CRR cuts by the Reserve Bank. Since January 2012, the CRR has been reduced in stages by 200 bps to

Chart IV.3: Developments in Reserve Money



4 per cent, injecting around `1.3 trillion of primary liquidity into the banking system. Reserve money, adjusted for the CRR changes, however recorded a reasonable growth over the year (Chart IV.3).

IV.7 In Q4 of 2012-13, there was an increase in reserve money in absolute terms. This increase in reserve money was mainly driven by an increase in the currency in circulation. On the sources side, there has been a commensurate increase in the net Reserve Bank credit to the centre. The y-o-y CRR-adjusted reserve money growth remained stable at around 9.5 per cent in 2012-13, the same as in the previous year.

Broad money growth remained on the indicative trajectory

IV.8 Excess reserves created through cut(s) in the CRR generally lead to increase in money supply through the money multiplier process, which crucially depends on the credit appetite of the economy. In 2012-13, there was stagnation in aggregate deposits growth and deceleration in credit growth. The latter somewhat dampened the multiplier expansion (Chart IV.4). However, the M_3 remained on the indicative trajectory of the Reserve Bank during 2012-13 (Table IV.2).

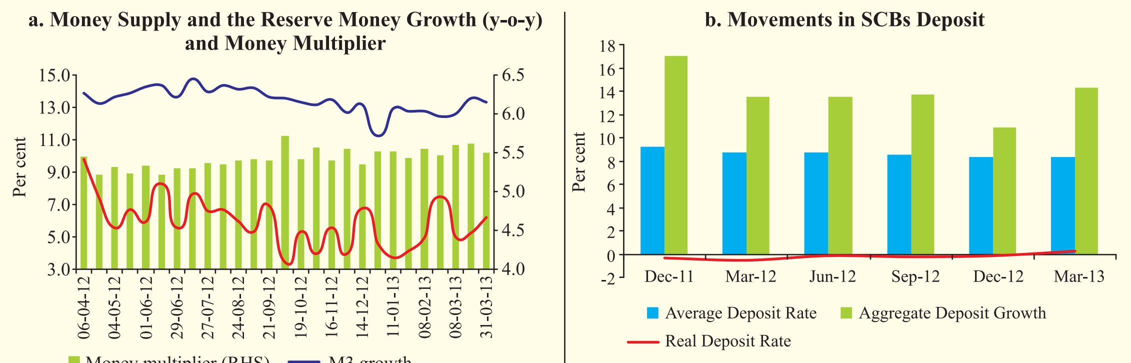
IV.9 On the component side, the muted aggregate deposit growth during 2012-13 at 13.5 per cent was mainly because of the deceleration in time-deposit growth. One major reason for the deceleration was the near-zero real interest rate on term deposits mainly due to high inflation. Although there was monetary policy easing over 2012-13, some banks raised their deposit rates, from mid-December 2012 in certain maturity buckets in view of the tight liquidity conditions, resulting in a marginal increase in the modal deposit rate by 2 bps during the second half of 2012-13 as against a decline of 13 bps during the first half of the year. During Q4 of 2012-13, although the

Table IV.2: Monetary Indicators

Item	Outstanding Amount (` billion) 31-Mar-13	Y-o-Y Variations (per cent) 31-Mar-12	31-Mar-13
1	2	3	4
Reserve Money (M_0)	**15,146.4**	**3.6**	**6.2**
Reserve Money (Adjusted)		**9.5**	**9.5**
Broad Money (M_3)	**83,444.9**	**13.2**	**13.3**
Main Components of M_3			
Currency with the Public	11,445.3	12.2	11.9
Aggregate Deposits	71,967.6	13.4	13.5
of which: Demand Deposits	7,420.9	-1.6	4.4
Time Deposits	64,546.7	15.7	14.7
Main Sources of M_3			
Net Bank Credit to Government	26,996.4	19.5	13.8
Bank Credit to Commercial Sector	56,405.5	17.0	13.8
Net Foreign Assets of the Banking Sector	15,991.4	10.8	3.6

Note: 1. Data are provisional.
2. Government balances as on March 31, 2013 are before closure of accounts.

Chart IV.4: Broad Money and Deposit Movements



Note: Data on deposit rates relate to average of 1-3 year deposit rate offered by banks.

Table IV.3:Asset Quality Indicator of the Banking Sector

	Mar-12					Dec-12				
	Gross NPA to Gross Advances (%)	Net NPAs to Net Advances (%)	Slippage Ratio #	Restructured Std. Asset to Gross Advances (%)	CRAR (%)	Gross NPA to Gross Advances (%)	Net NPAs to Net Advances (%)	Slippage Ratio #	Restructured Std. Asset to Gross Advances (%)	CRAR (%)
1	2	3	4	5	6	7	8	9	10	11
Public Sector Banks	3.17	1.47	2.95	5.74	13.23	4.18	2.10	3.28	7.41	12.00
Foreign Banks	2.68	0.61	2.31	0.10	16.75	2.96	1.02	1.92	0.18	17.17
New Private Sector Banks	2.18	0.44	1.17	1.06	16.66	2.02	0.45	1.36	1.07	17.11
Old Private Sector Banks	1.80	0.59	1.12	3.54	14.12	2.20	0.86	1.54	4.08	13.38
All Banks	2.94	1.24	2.55	4.69	14.24	3.69	1.73	2.86	5.92	13.50

Based on the data collected from banks for special analysis. Dec-12 figures of slippage are annualised.
Source: Latest updated OSMOS data.

deposit growth of SCBs continued to decelerate, going forward, the ebb in inflation and the consequent increase in the real interest rate are likely to boost deposit growth (Chart IV.4).

IV.10 Consequent to deceleration in domestic growth, the demand for credit in India was adversely affected. The deterioration in credit quality, on the other hand, impeded the supply of domestic credit. Notwithstanding the large injection of liquidity by the Reserve Bank, adverse sentiments emanating from global and domestic developments somewhat dampened credit expansion and the SCBs' non-food credit growth remained below the Reserve Bank's indicative trajectory. Despite low off-take, credit growth remained above deposit growth for most of 2012-13. However, the wedge between credit growth and deposit growth closed at the end of the year (Chart IV.1b). Preliminary data indicate that the weighted average lending rate on fresh rupee loans sanctioned by the reporting banks declined significantly during February 2013 compared with the previous month which was also reflected in the interest rates on fresh rupee loans sanctioned to housing and vehicle segments during that period.

Risk aversion impacting credit as asset quality concerns accentuate

IV.11 Besides sluggish demand, a major factor that led to the low credit growth of the banking sector over the past year is the deterioration in its asset quality. Asset quality indicators of the banking sector, which had deteriorated significantly during 2011-12, have further worsened in 2012-13 (Table IV.3). Although data indicate worsening asset quality across bank groups during Q3 of 2012-13, it continued to be led by PSBs, which account for the major portion of bank advances. Deterioration

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

Bank Credit	As on Apr 5, 2013 Outstanding Amount	Variation (y-o-y)			
		As on Apr 6, 2012		As on Apr 5,2013	
		Amount	Percent	Amount	Percent
1	2	3	4	5	6
1 Public Sector Banks*	39,089.9	5,254.8	17.9	4,410.1	12.7
2 Foreign Banks	2,651.6	367.9	18.8	328.9	14.2
3 Private Sector Banks	10,361.3	1,561.5	21.6	1,583.2	18.0
4 All Scheduled Com. Banks@	53,463.9	7,401.2	18.7	6,529.8	13.9

*: Excluding RRBs in public sector banks. @: including RRBs.
Note: Data as on April 5, 2013 are provisional.

in both asset quality and macroeconomic conditions resulted in increased risk aversion and consequent deceleration in credit growth across bank groups (Table IV.4).

IV.12 An analysis of the sectoral deployment of credit based on data from select banks (which cover 95 per cent of total non-food credit extended by all SCBs) for March 2013 reveals that non-food bank credit growth (y-o-y) to industries and services decelerated. The year-on-year bank credit growth to industry at 15.7 per cent in March 2013 moderated considerably, from 20.3 per cent in March 2012. Deceleration in credit growth to industry was observed in all the major sub-sectors, barring leather, chemicals, cement, wood products, food processing, textiles, glass and vehicles.

Flow of resources from banks to the commercial sector was significantly augmented by non-bank sources

IV.13 During 2012-13, non-banks continued to significantly contributed to the resource flow to the commercial sector in addition to the banks. The quantum flow of financial resources to the commercial sector increased during 2012-13 mainly due to an increase in non-SLR investment by SCBs and gross private placements by non-financial entities compared to the corresponding period last year. Among foreign sources, while there were increases in external commercial borrowings (ECBs) and short-term credit from abroad, foreign direct investment flows declined (Table IV.5).

Table IV.5: Resource Flow to the Commercial Sector

(` billion)

	April–March			April–March	
	2009-10	2010-11	2011-12	2011-12	2012-13
1	2	3	4	5	6
A. Adjusted Non-Food Bank Credit (NFC)	**4,786**	**7,110**	**6,773**	**6,773**	**6,839**
i) Non-Food Credit	4,670	6,815	6,527	6,527	6,359
of which: petroleum and fertiliser credit	*100*	*-243*	*171*	*101*	*38* *
ii) Non-SLR Investment by SCBs	117	295	246	246	481
B. Flow from Non-Banks (B1+B2)	**5,850**	**5,341**	**5,274**	**4,841**	**5,951**
B1. Domestic Sources	**3,652**	**3,011**	**2,970**	**2,033**	**2,772**
1. Public issues by non-financial entities	320	285	45	45	117
2. Gross private placements by non-financial entities	1,420	674	558	401	620 p*
3. Net issuance of CPs subscribed to by non-banks	261	68	36	36	55
4. Net Credit by housing finance companies	285	428	530	430	583 $
5. Total gross accommodation by 4 RBI-regulated AIFIs: NABARD, NHB, SIDBI & EXIM Bank	338	400	469	347	288 $
6. Systemically important non-deposit taking NBFCs (net of bank credit)	607	795	912	480	716 +
7. LIC's net investment in corporate debt, infrastructure and social sector	422	361	419	295	393 #
B2. Foreign Sources	**2,198**	**2,330**	**2,304**	**2,808**	**3,179**
1. External Commercial Borrowings/FCCBs	120	555	421	421	466
2. ADR/GDR Issues, excluding banks and financial institutions	151	92	27	27	10
3. Short-term credit from abroad	349	502	306	298	855 *
4. Foreign Direct Investment to India	1,578	1,181	1,550	2,062	1,848 $
C. Total Flow of Resources (A+B)	**10,636**	**12,451**	**12,047**	**11,615**	**12,791**
Memo:					
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	966	-367	-185	-185	830

$ Up to end-February 2013. P : Provisional. + Up to September 30, 2012. * Up to December 2012.

Monetary conditions may evolve with macroeconomic developments and shifting growth-inflation dynamics

IV.14 While the calibrated monetary policy and liquidity measures over the year have resulted in monetary growth in line with the indicative trajectory, the monetary policy stance in 2013-14 would be conditioned primarily by three macroeconomic challenges that need to be addressed. These challenges emanate from decelerating growth, comparatively high consumer price inflation and external vulnerability.

IV.15 At present, domestic inflation remains at a level that is above the Reserve Bank's comfort level. Furthermore, consumer price inflation is in double digits, in part driven by food inflation that gets a higher weight in CPI than headline inflation. The significant wedge between wholesale price and consumer price inflation is exacerbating the challenge for monetary management in anchoring inflationary expectations.

IV.16 In this context, it may be restated that the Reserve Bank looks at all types of inflation and inflation indices while framing its monetary policy. While communicating its inflation projections in terms of headline WPI inflation, to which it accords greater weight, it does take into account CPI inflation. The high CPI inflation and large food inflation in the WPI cannot be ignored, especially in view of the consumption patterns in India and the time-tested fact that high food inflation, if it persists, gets generalised and often requires a monetary policy response.

IV.17 Monetary policy reactions would need to keep in view the forward-looking expectations on inflation and the level of real interest rates. It is important to avoid financial disintermediation or financial repression if growth is to be revived on a sustainable footing. In a period of economic slowdown, a pro-growth monetary policy may push the interest rate down, but if the internal rate of return (IRR) falls at a faster rate due to depressed expected returns on investment, monetary policy stimulus may have limited effect. Factoring in these limitations and the three challenges enumerated above, monetary policy would need to be carefully calibrated to balance growth-inflation dynamics.

V. FINANCIAL MARKETS

Steady monetary easing in the face of fiscal austerity measures in advanced economies boosted global investor sentiments since Q4 of 2012. Notwithstanding the recent fallout of Cyprus, international financial markets posted significant gains, especially in Japan following its recent policy stimulus and in the US on the back of improved economic data. However, improved financial conditions are yet to translate into a sustained recovery in economic activity. Strong FII inflows, especially in H2 of 2012-13 augured well for the Indian equity market and the rupee, although the market movements were also conditioned by domestic slowdown and governance concerns. Primary equity market, however, remain subdued. Its recovery depends on improvement in macroeconomic fundamentals, continued fiscal consolidation and revival of global growth.

Global financial market conditions improve supported by receding tail risks

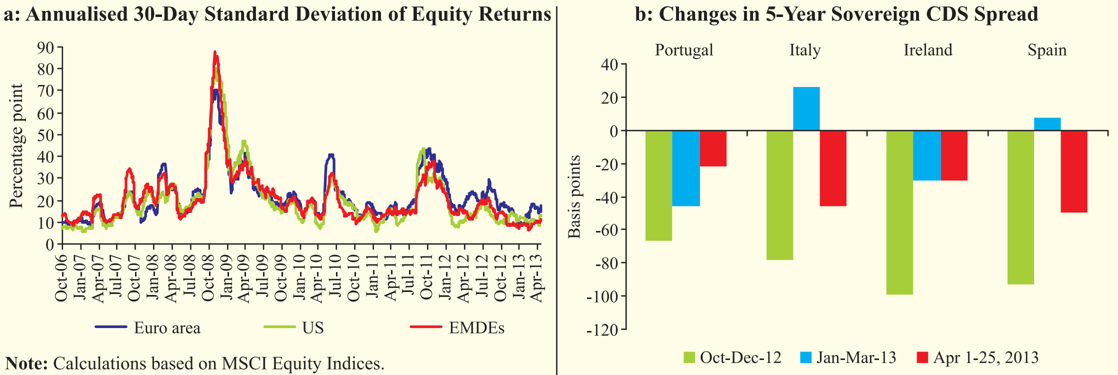
V.1 The easing of financial market tensions that began in Q3 of 2012 continued through March 2013 as policy actions contributed to reducing tail risks to the global economy, which still remain significant. Policy accommodation in the euro area through the launch of the European Central Bank (ECB) bond buying programme, the bailout of Greece and the unveiling of a road map for the euro area banking union have been instrumental in limiting the downside risks. The IMF's Global Financial Stability Report of April 2013 has noted that global financial and market conditions have improved appreciably in the past six months due to monetary stimulus and liquidity support. However, further actions and balance sheet repairs are necessary to entrench financial stability.

V.2 In the US, the fiscal cliff has kicked in with moderate intensity. It will lead to a large predicted reduction in the budget deficit and consequent slowdown of the US economy. The three main components of the fiscal cliff involve partial tax increases that became operational in January 2013, "sequestrations" or the spending reductions since March 2013 and the debt ceiling which would kick in from May 19, 2013 if no agreement is reached. Slowdown resulting from strong fiscal tightening could have ramifications for financial markets across the globe.

V.3 Financial markets are now pricing in the impact of large fiscal and monetary stimuli provided by the new Japanese government. This includes a stimulus package of 10 trillion yen to boost growth and overcome deflation. The Bank of Japan set a higher inflation target and committed to spend 60-70 trillion yen in each of the next two years to buy bonds and other assets, while doubling its monetary base in the same period. The large dose of quantitative easing (QE) in Japan that exceeds the size of the QE by the US Fed is impacting financial markets in several ways. In the currency market, yen depreciated sharply since the stimulus announcements. If it leads to sustained dollar appreciation, it can impact Indian markets through the exchange rate channel. Over time, the Japanese stimulus could impact global commodity prices upwards.

V.4 Following the above policy actions, financial market volatilities have been dampened and appear to be at the lowest levels since 2007 (Chart V.1a). Further, G-sec yields of troubled euro area economies have come down sharply and, as a result, the cost of borrowing has declined, which should facilitate the fiscal adjustments.

Chart V.1: Trends in Global Markets



Note: Calculations based on MSCI Equity Indices.
Source: Datastream.

Source: Bloomberg.

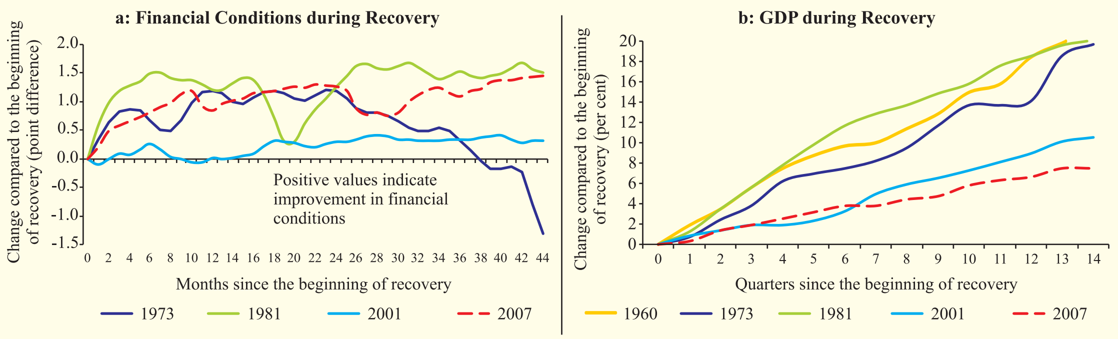
V.5 Credit default swap (CDS) spreads for troubled euro area economies declined notably since H2 of 2012 (Chart V.1b). Improved risk perceptions have translated into better market access. In January 2013, Portugal returned to the international long-term debt market for the first time since 2011. The improvement in bank funding conditions allowed hundreds of euro area banks to repay higher-than-expected long term refinancing operation (LTRO) funding to the ECB since January 2013.

V.6 Stress still remains in the euro area in some form, as was evident from the recent case of Cyprus, which became the fourth euro area member to receive a bailout after Greece, Ireland and Portugal (or the fifth, if the partial bailout for Spanish banks is also counted). The €10 billion bailout deal with international lenders on March 25, 2013 which avoided a controversial levy on bank accounts would force large losses on big deposits in Cyprus' two largest banks. Elsewhere in Europe, a banking crisis in Slovenia looms large.

Improved financial conditions slow to translate into real activity

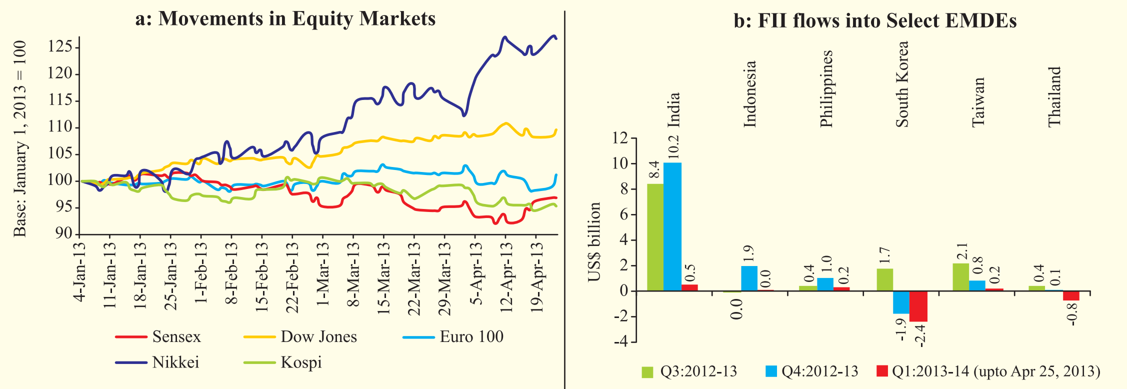
V.7 Notwithstanding the improvement in financial conditions, it remains to be seen whether it can translate into eventual real sector recovery. Current upturn in financial conditions in the US has been at par or better than the financial sector improvements seen in the previous recoveries. Yet, the current real sector expansion has remained relatively weak (Chart V.2). The main reason is the deleveraging by the financial and household sectors as the collapse in housing prices following the financial meltdown severely damaged their balance sheets.

Chart V.2: Current US Economic Recovery Compared with Previous Recoveries



Notes: 1: Years indicate years of start of recession. 2: Recovery month/quarter as officially announced by NBER. 3: Current recovery from 2007 recession started in June 2009 (Q2 2009). 4: FCI for 1960 is not available.
Source: Calculations based on data from Datastream, BEA, Minneapolis Fed, St. Louis Fed.

Chart V.3: Trends in Equity Indices and FII Flows



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

Policy interventions boost global equity markets; India weighed down by weak macroeconomic performance

V.8 The Japanese equity market posted the highest increase in Q4 of 2012-13 boosted by recent monetary easing. The US equity indices (both Dow Jones and S&P 500) rose to an all time high following improved economic data, such as employment, and some recovery in the housing sector. However, the European and emerging market and developing economies' (EMDEs) equity markets including that of India have underperformed. Domestic factors such as slowdown in economic growth, persistent inflationary pressures, and high current account deficit despite strong FII inflows added to the downward pressures on Indian markets (Chart V.3).

Money markets remained orderly, despite year-end liquidity pressures

V.9 Tight liquidity conditions caused marginal increase in the average call money rate to 8.03 per cent in Q3 of 2012-13. However, following the reduction in the policy (repo) rate in the Third Quarter Review of Monetary Policy Statement 2012-13 (January 29, 2013), the average call money rate declined to 7.91 per cent in Q4. The year-end scramble for funds by banks pushed the weighted average daily call rate above the formal corridor on March 28, 2013 to around 12 per cent (maximum rate was 18 per cent), and it has since reverted to hover around the repo rate (Chart V.4). The rates in the collateralised segments (*i.e.*, CBLO and market repo) moved in tandem with the call rate, but generally remained below it during 2012-13.

V.10 Against a backdrop of slow deposit mobilisation, the demand for certificates of deposit (CDs) persisted, with the average gross fortnightly issuance of CDs remaining high and aggregating to around `332 billion in 2012-13. The average gross fortnightly issuance of commercial paper (CP) stood higher at around `318 billion. The outstanding amount of CP issued by corporates increased from `0.9 trillion at end-March 2012 to around `1.1 trillion at end-March 2013 (Table V.1).

Primary yield on dated central G-sec declines, boosted by favourable market conditions

V.11 The gross market borrowing of the central government through dated securities

Chart V.4: Movement in Call Money Rate

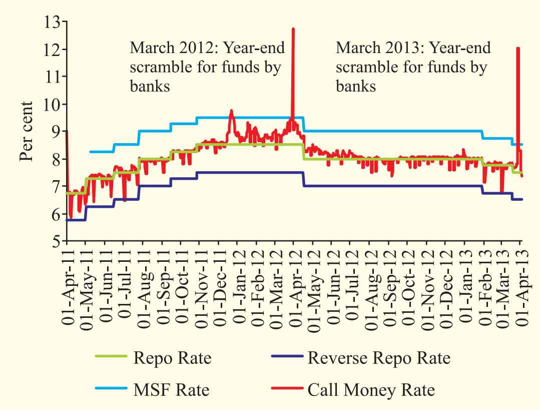


Table V.1: Average Daily Volume in Domestic Financial Markets

(in ` billion)

Month	Money Market						Bond Market		Forex Market inter-bank (US$ bn)	Stock Market ##
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificate of Deposits*	G-sec**	Corporate Bond#		
1	2	3	4	5	6	7	8	9	10	11
Mar-12	-1,574	175	112	380	912	4,195	99	26	21	152
Jun-12	-913	152	180	376	1,258	4,252	258	30	19	117
Sep-12	-517	143	185	502	1,706	3,572	260	36	21	143
Dec-12	-1,231	142	147	398	1,818	3,328	197	39	19	139
Jan-13	-930	170	192	456	1,998	3,251	466	25	20	128
Feb-13	-1,136	158	246	431	1,923	3,011	355	29	19	134
Mar-13	-1,093	194	216	480	1,093	3,896	307	43	23	133

*: Outstanding position. **: Average daily outright volume traded in central government dated securities.
#: Average daily trading in corporate bonds. ##: Average daily turnover in BSE and NSE.
Note: In column 2, (-) ve sign indicates injection of liquidity into the system.

during 2012-13 to the tune of `5.6 trillion was successfully completed, and that for 2013-14 has been budgeted slightly higher at `5.8 trillion. The weighted average maturity of the dated securities issued increased over the year, while the primary yields declined in view of the favourable market conditions and lower interest rate regime for long dated securities (Table V.2).

V.12 Also, 27 states and the Union Territory of Puducherry raised `1.8 trillion on a gross basis in 2012-13. The weighted average yield firmed mainly on account of increase in gross market borrowing by states. Consequently, the weighted average spreads for SDL issuances over the corresponding GoI security increased.

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

Item	2011-12	2012-13	2013-14*
1	2	3	4
Central Government			
Gross amount raised (` billion)	5,100	5,580	450
Devolvement on primary dealers (` billion)	121.13	18.28	-
Bid-cover ratio (range)	1.39-5.12	1.36-4.59	3.24-6.03
Weighted average maturity (years)	12.66	13.50	15.37
Weighted average yield (%)	8.52	8.36	7.95
State Government			
Gross amount raised (` billion)	1,586	1,773	82
Cut-off yield range (%)	8.36-9.49	8.42-9.31	8.24-8.51
Weighted average yield (%)	8.79	8.84	8.33
Weighted average spread (bps)	44	71	53

*: Data up to April 23, 2013.

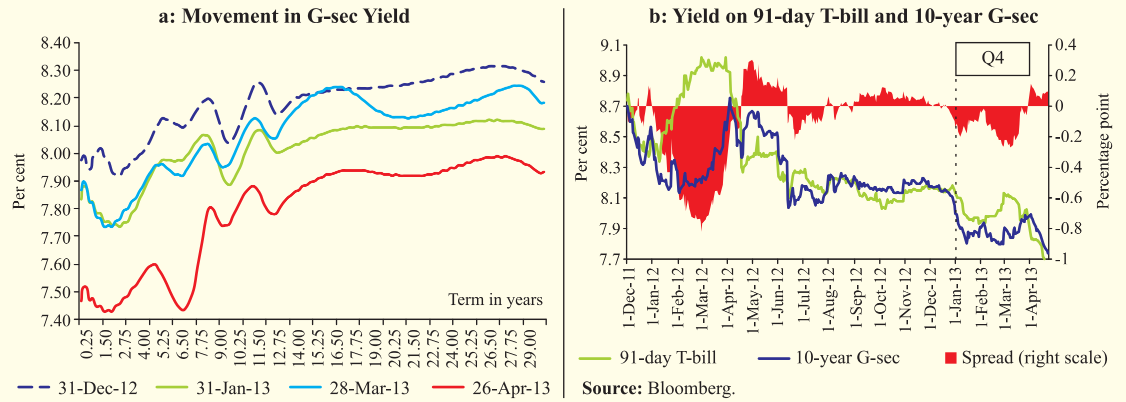
Easing trend in G-sec yield reversed at the year-end, reflecting limited policy space and tighter liquidity

V.13 Reflecting expectations of a reduction in policy rate, optimism about improvement in the fiscal situation, reduction in the primary issuances, and expectations of further measures from the government to rein in the fiscal deficit, G-sec yields eased in the beginning of Q4 of 2012-13. The continuation of OMO purchase auctions also added to the positive sentiment.

V.14 Nevertheless, yields hardened in Q4 of 2012-13, first in end-January after markets factored in limited space for monetary policy rate cuts and then in March due to tighter liquidity and fears that political uncertainty at the centre may impact capital inflows. The 10-year generic yield hardened from 7.86 per cent at end-February 2013 to 7.99 per cent at end-March 2013 (Chart V.5a).

V.15 G-sec yields have exhibited a softening bias in April 2013 on value buying, supported by lower reading of WPI inflation for March 2013, which aided market sentiment and strengthened the expectations of easing of policy rates. The softening of commodity prices also helped in easing of the yields. The ten year benchmark yield declined to 7.74 per cent on April 26, 2013. The traded volume in G-sec generally varied inversely with G-sec yields. Pricing in the weak macroeconomic

Chart V.5: Trend in G-sec Yield



Source: Bloomberg.

performance, Q4 saw short-term yields persisting at levels higher than the 10-year yield (Chart V.5b).

Equity market pared some gains in Q4; FII flows continue to be strong

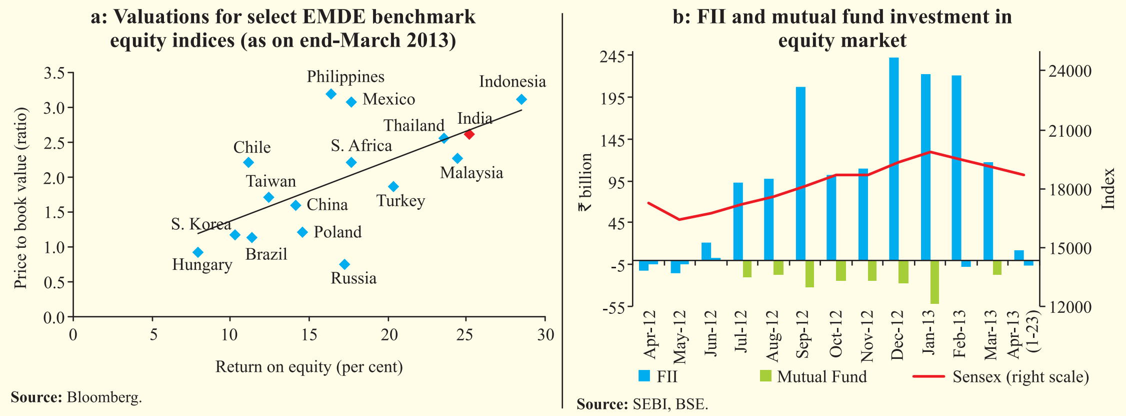
V.16 After witnessing a rally in Q3 of 2012-13, the domestic equity markets weakened during Q4, mainly on account of domestic political uncertainties at the centre in the wake of coalition politics process, slowdown in GDP growth and exports, and lower corporate earnings of some blue chip companies for Q3. During 2013-14 (up to April 26, 2013), BSE Sensex recorded gains of 2.4 per cent mainly on account of hopes of rate cut and fall in commodity prices.

V.17 Key stock market indicators show that price to earnings (PE) and price to book value (PB) ratios declined in 2012-13 in comparison with the past two years. However, end-March 2013 data indicate that India is reasonably priced in terms of return on equity (ROE) and PB ratio compared to most other EMDEs (Chart V.6a)

V.18 The Indian financial market, in February 2013, had a new entrant *viz.*, the MCX Stock Exchange Limited (MCX-SX). It officially commenced operations with the launch of its flagship index SX40 comprising 40 blue chip companies, and is yet to gain significant market share.

V.19 FIIs made net investments of `1.7 trillion in the capital market (both equity and debt) in 2012-13 compared with that of `0.9 trillion in the previous year. Their net investment in equity market was at `1.4 trillion compared with `0.4 trillion last year. Mutual funds (MFs) also made significantly higher net investments

Chart V.6: Trends in Indian Equity Markets



Source: Bloomberg.

Source: SEBI, BSE.

of `4.5 trillion in the capital market (both equity and debt) compared to `3.3 trillion last year (Chart V.6b).

IT outperformed Sensex in Q4 of 2012-13

V.20 The BSE IT, which represents the IT sector of India, recorded q-o-q gains of 21 per cent compared with losses of 3 per cent by the BSE Sensex in Q4 of 2012-13. The influential factors were strong and better-than-expected quarterly earning results of major IT companies and the announcement of measures to boost exports in the services sector in the Union Budget 2013-14. Going forward, global economic conditions would continue to primarily shape the demand for the domestic IT sector, thereby conditioning their performance.

Resource mobilisation through mutual funds and QIPs gathered momentum

V.21 While resource mobilisation through public issues in the debt market, ADR/GDR and IPOs remained muted, MFs posted a pick-up led by private sector MFs in 2012-13 (Table V.3). After a period of fewer mobilisations through Qualified Institutional Placement (QIP) (introduced in 2006) in the recent past, `149 billion was mobilised through 43 issues in 2012-13 (up to February). Guidelines issued by the SEBI that require listed companies to achieve and maintain public shareholding at 25 per cent by June 2013 may further encourage resource mobilisation through this route. Private placements of corporate debt increased to `3.2 trillion raised through 2,288 issues in 2012-13 (up to February).

Higher mobilisation achieved through disinvestment of PSEs

V.22 The disinvestment programme of the Union Government generated higher mobilisation of about `240 billion during 2012-13. Various public sector enterprises, *viz.*, NBCC, HCL, NMDC, OIL, NTPC, RCF, NALCO and SAIL, divested their stake, with NTPC mobilising the maximum amount of around `115 billion. The disinvestment programme for 2013-14 is budgeted higher at `400 billion.

Table V.3: Resource Mobilisation from the Primary Market

(` billion)

Category	2010-11	2011-12	2012-13
1	2	3	4
a. Public Issue (i) + (ii)	581	461	216*
i) Public Issue (Equity)	487	105	62*
of which: IPOs	356	59	62*
FPOs	131	46	0
ii) Public Issue (Debt)	95	356	154*
b. Rights Issue	95	24	82*
Total Equity Issues (i+b)	582	129	144*
c. Euro Issues (ADR/GDR)	94	27	10
d. Mutual Fund Mobilisation (net)	-494	-220	765
i) Private Sector	-192	-154	638
ii) Public Sector	-302	-66	127
e. Private Placement in Corporate Debt market	2,188	2,613	3,223*
f. QIP	259	22	149*
g. Disinvestment	221	139	240

*: Data up to February 2013.
Source: SEBI and Department of Disinvestment, Ministry of Finance.

Indian rupee remained range-bound in Q4 of 2012-13

V.23 Various reform measures, *inter alia*, postponement of GAAR (General Anti Avoidance Rules) by two years, partial deregulation of diesel prices, liberalised FDI limits for certain sectors, rise in FII limits in corporate debt and G-sec market and announcement of fiscal consolidation path, further boosted the confidence of global investors in the Indian economy. Reflecting these developments, the rupee showed a modest appreciation in January 2013 which, however,

Chart V.7: Movement of INR aginst Select Currencies, and Changes in Indices

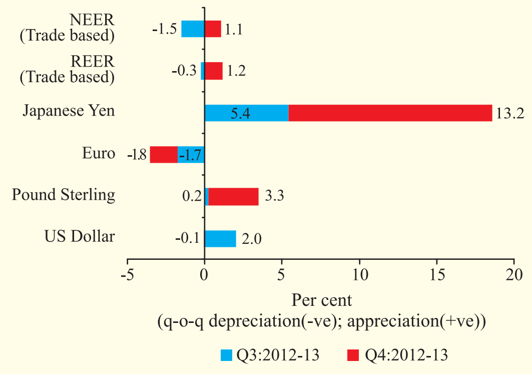


Table V.4: House Price and Transaction Volume Indices (Base Q4:2008-09 = 100)

Quarter	Mumbai	Delhi	Bengaluru	Ahmedabad	Lucknow	Kolkata	Chennai *	Jaipur	Kanpur	All India
1	2	3	4	5	6	7	8	9	10	11
House Price Index										
Q1:2012-13	231.8	217.3	140.2	176.6	179.4	204.2	133.9	171.9	144.9	188.6
Q2:2012-13	232.4	225.2	143.0	183.4	208.9	226.9	129.5	177.7	135.8	194.3
Q3:2012-13	248.5	247.8	147.9	187.8	221.6	247.3	149.2	179.4	117.0	206.8
Growth in per cent										
y-o-y	29.7	47.0	1.2	9.3	28.6	59.6	24.0	9.7	-16.4	26.0
q-o-q	6.9	10.1	3.4	2.4	6.0	9.0	15.2	1.0	-13.8	6.4
House Transactions Volume Index										
Q1:2012-13	153.2	133.6	81.6	140.1	151.9	98.2	80.9	296.7	154.9	134.6
Q2:2012-13	100.4	142.6	112.6	130.5	233.7	96.9	68.2	322.6	409.2	145.4
Q3:2012-13	96.3	128.2	119.4	172.4	113.3	88.8	79.6	354.8	495.9	147.2
Growth in per cent										
y-o-y	26.8	-34.5	41.2	31.4	-31.4	-18.4	-39.2	59.8	311.1	14.2
q-o-q	-4.1	-10.1	6.1	32.1	-51.5	-8.3	16.7	10.0	21.2	1.2

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

came under pressure thereafter partly due to dollar demand from oil importing companies (Chart V.7). Overall, the rupee remained stable against the dollar in Q4 of 2012-13 over Q3. The rupee has been gaining strength since the second week of April 2013 as concerns regarding the CAD seem to have somewhat diminished on account of fall in international prices of crude oil and gold and positive trend in export.

V.24 As at end-March 2013, the rupee showed lower depreciation (y-o-y) compared to some other major EMDEs, such as Brazil, South Africa and Argentina. However sustained efforts to control the widening current account are required to bolster global confidence in the Indian economy and attract stable capital flows to enable smooth CAD financing. In the interim, corporates need to factor in the risks of unexpected currency volatilities and appropriately hedge a larger proportion of their currency exposures.

House prices continue to rise with increasing volumes

V.25 The annual growth in the Reserve Bank's quarterly House Price Index at all-India level has hovered around 20 per cent for the past eight quarters, with all cities, except Kanpur, registering positive growth in Q3 of 2012-13. Transaction volumes also picked up, registering an annual growth of over 14 per cent in Q3 (Table V.4).

Near-term risks from euro area reduced, domestic reform initiatives to boost investor sentiment in 2013-14

V.26 Despite weak global growth, the start of sequestration in the US and concerns about Italy and Cyprus, the global financial condition improved during Q4, mainly on account of central banks' QE measures. Steady commitment to accommodative monetary policy in the face of fiscal austerity in advanced economies (AEs) is likely to support investor sentiments in the short-run. However, the persistence of exceptionally low interest rates over the medium-run poses risks of re-emergence of financial sector imbalances and vulnerabilities. It is, therefore, important for the AEs to clean up their bank balance sheets at the earliest and for EMDEs such as India to build liquidity buffers to meet any shocks from contagion from the AEs should the tail risks materialise.

V.27 On the domestic front, the slow recovery envisaged in 2013-14 may support the financial markets. However, macro-financial risks are rising as is evident from sub-par corporate earnings, deteriorating asset quality and stretched leverage in certain sectors, especially power and construction. However, sustained commitment to reforms and policy action could considerably lower this risk.

VI. PRICE SITUATION

Growth slowdown, softer commodity prices, range-bound exchange rate in recent months and past monetary policy actions contributed to the moderation of headline inflation to 6.0 per cent (provisional) in March 2013 from 7.7 per cent in March 2012. Inflation, however, continues to remain above comfort level. The divergence between WPI and CPI inflation widened, reflecting high food inflation, which is a source of concern. Headline inflation in 2013-14 is expected to remain range-bound around the current level. While sluggish global growth may dampen global inflation risks, domestically energy price adjustments, supply-side bottlenecks, including that of food, and sustained wage pressures may offset the moderation of inflation resulting from growth moderation and past monetary policy actions.

Global inflationary pressures remained muted in 2012-13

VI.1 Global inflation continued to remain muted against the backdrop of fragile and uneven global economic recovery. In advanced economies (AEs), weak demand pressure and high unemployment rate contributed to low inflation. The April 2013 World Economic Outlook (WEO) projected the consumer price inflation in the AEs to moderate to 1.7 per cent in 2013 from 2.0 per cent in 2012. In emerging market and developing economies (EMDEs), it is projected to remain at 5.9 per cent in 2013, same as in the previous year.

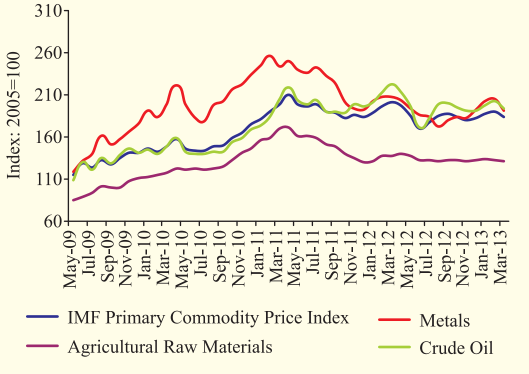
VI.2 Low inflation, even below the inflation targets in the case of several AEs, provided space to extend their monetary accommodation through unconventional monetary policies. Policy rates in several AEs remained at the zero lower bound, prompting them to undertake further doses of quantitative easing (QE) (Table VI.1). Some other AEs that had space lowered policy rates further. The central banks of AEs continue to stimulate protracted recovery along with well-anchored inflation expectations. While the immediate risk of global inflation resurgence remains low, once recovery shapes up, inflation concerns could resurface given the presence of excess global liquidity.

VI.3 Although consumer price inflation generally remained moderate in the case of EMDEs, some EMDEs, including India, the Middle East, Sub-Saharan Africa and some East European countries, faced high inflation in 2012. India emerged as an outlier among BRICS and the G-20 nations with double-digit CPI inflation (Table VI.1). India's high CPI inflation remains a worry in the context of its increased openness and on account of welfare implications.

Global commodity prices exhibit softening bias

VI.4 The year 2012-13 was marked by stable oil and food prices and softer prices for metals, beverages and agricultural raw materials. Metal prices, after falling until August 2012, witnessed an uptrend in subsequent months (Chart VI.1). However, global oil and non-oil commodity prices witnessed marked correction during April 2013, reflecting improved supply prospects

Chart VI.1: International Commodity Prices



Source: IMF

Table VI.1: Global Inflation and Policy Rates

Country/ Region	Key Policy Rate	Policy Rate (as on April 27, 2013)	Changes in Policy Rates (basis points)		CPI Inflation (y-o-y, Per cent)	
			Sep. 2009 to Dec. 2011	Jan. 2012 to Apr. 2013	Mar-12	Mar-13
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	3.00 (December 5, 2012)	125	(-) 125	1.6#	2.5#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	75	0	1.9	1.0
Euro area	Interest Rate on Main Refinancing Operations	0.75 (Jul. 11, 2012)	0	(-) 25	2.7	1.7
Israel	Key Rate	1.75 (Jan 1, 2013)	225	(-) 100	1.9	1.3
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10* (Oct. 5, 2010)	(-) 10	0	0.5	-0.9
Korea	Base Rate	2.75 (Oct. 11, 2012)	125	(-) 50	2.6	1.3
UK	Official Bank Rate	0.50 (Mar. 5, 2009)	0	0	3.5	2.8
US	Federal Funds Rate	0.0 to 0.25* (Dec. 16, 2008)	0	0	2.7	1.5
Emerging and Developing Economies						
Brazil	Selic Rate	7.50 (Apr. 18, 2013)	225	(-) 350	5.2	6.6
China	Benchmark 1-year Deposit Rate	3.00 (Jul. 6, 2012)	125	(-) 50	3.6	2.1
	Benchmark 1-year Lending Rate	6.00 (Jul. 6, 2012)	125 (600)	(-) 56 (-150)		
India	Repo Rate	7.5 (Mar. 19, 2013)	375 (100)	(-) 100 (-200)	9.4	10.4
Indonesia	BI Rate	5.75 (Feb. 9, 2012)	(-) 50	(-) 25	4.0	5.9
Philippines	Reverse Repurchase Rate	3.50 (Oct. 25, 2012)	50	(-) 100	2.6	3.2
	Repurchase Rate	5.50 (Oct. 25, 2012)	50	(-) 100		
Russia	Refinancing Rate	8.25 (Sep. 14, 2012)	(-) 275	25	3.7$	7.3$
South Africa	Repo Rate	5.00 (Jul. 20, 2012)	(-) 150	(-) 50	6.2	6.0
Thailand	1-day Repurchase Rate	2.75 (Oct. 17, 2012)	200	(-) 50	3.5	2.7

*: Change is worked out from the minimum point of target range. #: Q4 (Jan-Mar). $: February

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

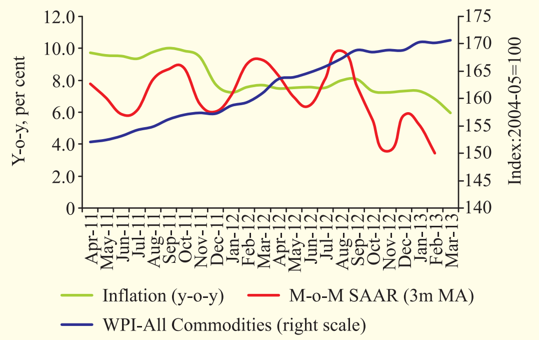
Source: Websites of respective central banks/statistical agencies.

and weaker global growth expectations. Global food prices continued to remain range-bound. Food and Agriculture Organisation (FAO) assessment indicate improved food supply outlook for 2013 on account of favourable production prospects.

Domestic headline inflation moderated as generalised inflationary pressures eased

VI.5 After remaining in the range of 7.5–8.1 per cent during H1 of 2012-13, wholesale price index (WPI) inflation (y-o-y) in India moderated gradually to 5.96 per cent, (provisional) in March 2013 (Chart VI.2). Moderation in headline inflation has been significant even as price pressures continued to persist from the food and fuel segments. This was facilitated by a decline in manufactured non-food products inflation, which came down sharply to 3.5 per cent (provisional) in March

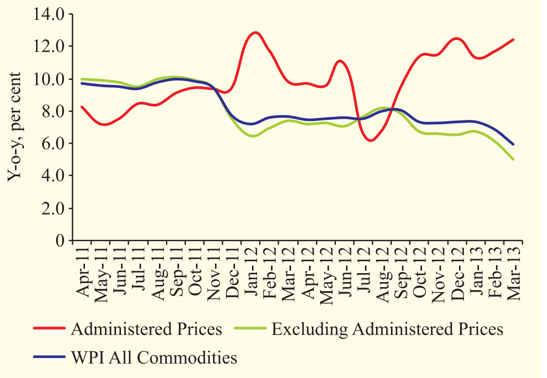
Chart VI.2: Wholesale Price Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes



2013, reaching its lowest level in the past three years. While subdued pressures from global commodity prices and the range-bound exchange rate helped the course of downward movement in the inflation trajectory, the decline in inflation also reflects the impact of growth moderation and the weak pricing power of firms as well as past monetary policy actions aimed at containing inflation and anchoring inflation expectations. The momentum of price changes, as indicated by 3-month moving average seasonally adjusted month-over-month changes, also moderated in H2 of 2012-13.

VI.6 Moderation in inflation has not been commensurate with the slowdown in growth, in part because structural factors are keeping prices up, and in part because price softening was offset by revisions in administered prices, especially in the fuel group (Chart VI.3). To the extent that administered price increases keep headline inflation above market-determined prices, it reflects the lagged pass-through.

Chart VI.3: Administered and Non-Administered Price Inflation in India



Cereals and pulses emerge as major pressure points for food inflation

VI.7 Food prices continued to increase during the Q4 of 2012-13. The contribution of different items to overall food inflation, however, changed during the year. After exhibiting moderate price increases in the previous year, the price increases in cereals and pulses became quite significant during the current year (Chart VI.4). The delayed and skewed south-west monsoon had a significant impact on the production of cereals and pulses, which triggered the initial price spurt. However, despite the presence of large buffer stocks, price increases continued to be persistent. It is observed that there has been a secular build-up in the stock of foodgrains in recent years that are much above the buffer norms (see Chapter I).

VI.8 The minimum support prices (MSP) of most cereals and pulses have increased significantly in recent years, which has emerged as an additional source of pressure. This is particularly true in the case of paddy (Table VI.2). However, total rice production fell during 2012-13, due mainly to drought conditions in parts of Tamil Nadu, Maharashtra and other rice-producing states.

Chart VI.4: Food Inflation Trends

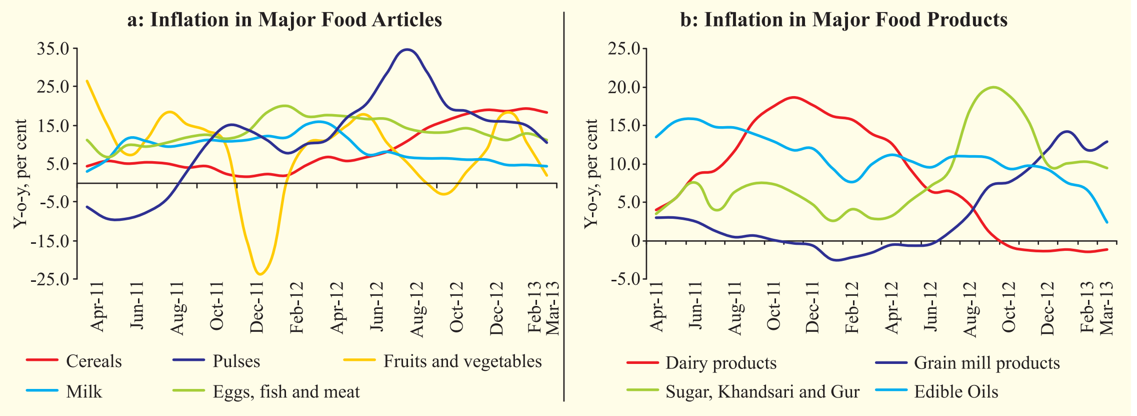


Table VI.2: Annual Average Percentage Increase in MSP and WPI

Commodity	2002-07		2007-13	
	MSP	WPI	MSP	WPI
1	2	3	4	5
Rice	1.8	2.1	14.0	10.0
Wheat	4.0	5.8	10.7	7.8

VI.9 Apart from cereals, volatility in prices of vegetables and fruits added to domestic price pressures. Also, inflation in protein-rich food items continued to remain elevated since, apart from pulses, price increases have been significant for eggs, fish and meat. Inflation in milk, however, moderated over the course of the year. Manufactured food products inflation also tracked the trends in primary food inflation.

VI.10 Persistent increases in domestic food prices during 2012-13, despite range-bound global food prices, calls for a relook at the overall agriculture price policy, where MSPs and large buffer stocks are the two major policy tools. While food security is of paramount importance in a country such as India, recent experience suggests that large buffer stocks have not been effective in dampening prices, even as the system is bearing large carrying costs and storage losses. Also, significant increases in the cost of production in agriculture, driven largely by the increase in wage costs, added to pressure on food prices. As has been highlighted in the past, the changing pattern of consumption in favour of protein-rich items has not been matched by supply elasticities, which added pressure from the demand side. Addressing these issues by augmenting supply capacities could be critical in achieving the goal of stable food prices.

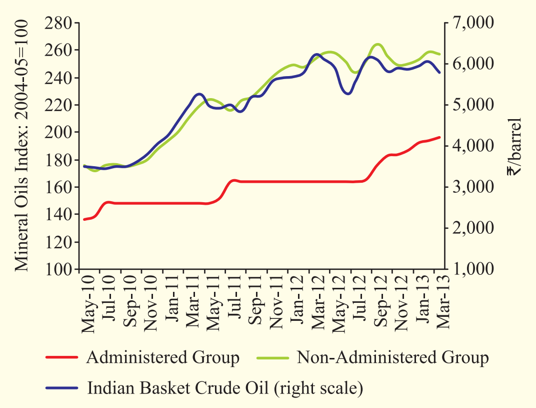
Administered price revisions keep fuel inflation high and persistent

VI.11 Revision in administered prices largely shaped the course of fuel inflation during the year. Given the unsustainable level of subsidy burden arising from administered prices, the price of diesel was raised by `5 per litre in September 2012. Also the number of subsidised LPG cylinders per consumer was capped at six (which was later raised to nine). In January 2013, the government allowed OMCs to raise the retail price of diesel in a staggered manner and to charge bulk consumers the market price of diesel.

VI.12 Although the revisions in administered fuel prices led to some decline in the extent of suppressed inflation, the gap still persists (Chart VI.5). This has resulted in a substantial build-up in the under-recoveries of the oil marketing companies (OMCs) to the tune of `1.61 trillion during 2012-13, of which 57 per cent was on account of diesel. The decision to allow small, step-wise increases in diesel prices could result in some persistence of fuel inflation during 2013-14. However, a gradual and calibrated increase in price to align it with international prices is desirable, since large discrete price changes often have a distortionary impact on inflation expectations.

VI.13 Although there was some moderation in international coal price, the gap between domestic and global prices persists. Of the total estimated domestic demand of about 770 MT during 2013-14, 21 per cent would have to be met through imports. Greater reliance on imports for bridging domestic demand-supply gap could lead to increase in costs which could reflect in prices.

Chart VI.5: Global and Domestic Fuel Prices



VI.14 The recent debt restructuring of most State Electricity Boards (SEBs) would lead to improved financial positions and, thereby, improve their sustainability. However, the debt restructuring is also conditional on significant increases in prices to make them financially viable. This is partly reflected in increases in electricity prices in June 2012, which exerted upward pressure on fuel inflation. Further increases can be expected in the near term. However, if the improved financial condition of the SEBs leads to better delivery, the reliance on more expensive sources of power such as gensets could decline, which could lead to a decline in the overall power cost for firms.

Generalised inflationary pressures ease as output gap remains negative

VI.15 The major development in inflation dynamics in recent months was the marked decline in non-food manufactured products inflation. The month-over-month seasonally adjusted annualised change (3-month moving average), which is an indicator of the momentum of price increases, also indicates significant moderation in price pressures in recent months (Chart VI.6).

VI.16 The decline in the contribution of the metals and chemicals group has been the major driver of the moderation in inflation within the non-food manufactured products group (Chart VI.7). As prices moderated in the international commodity markets and the rupee remained range-bound, the benefits got passed on to domestic inflation. This reaffirms the fact that in the absence of offsetting pressures, generalised inflation does moderate with a negative output gap.

Pattern of price changes points to significant moderation

VI.17 A look at the distribution of price changes within non-food manufactured products indicates that during 2012-13, the share of items exhibiting month-over-month increases in prices has gradually declined, while the share of items reporting price decreases has increased (Chart VI.8). This points to the presence of a strong disinflationary momentum, which further

Chart VI.7: Contributors to Non-food Manufactured Products Inflation

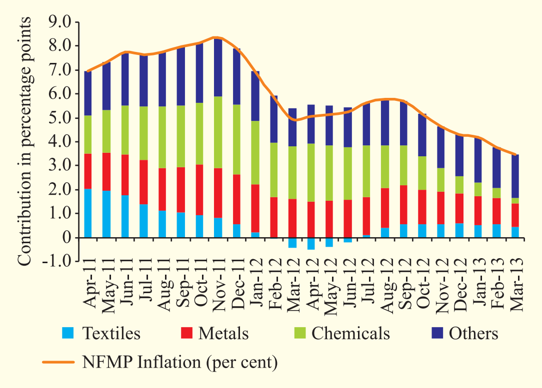


Chart VI.6: Manufactured Non-food Products: Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes

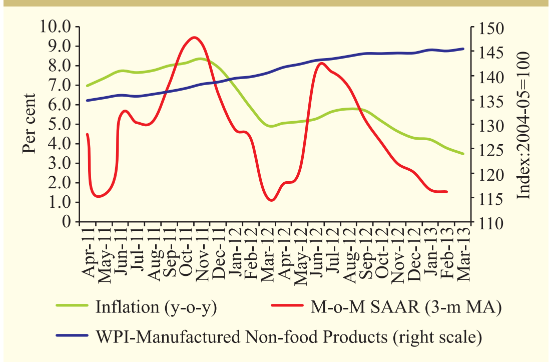


Chart VI.8: Price Changes Within Non-food Manufactured Products

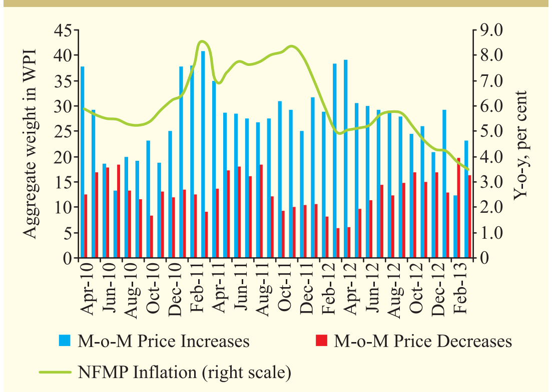
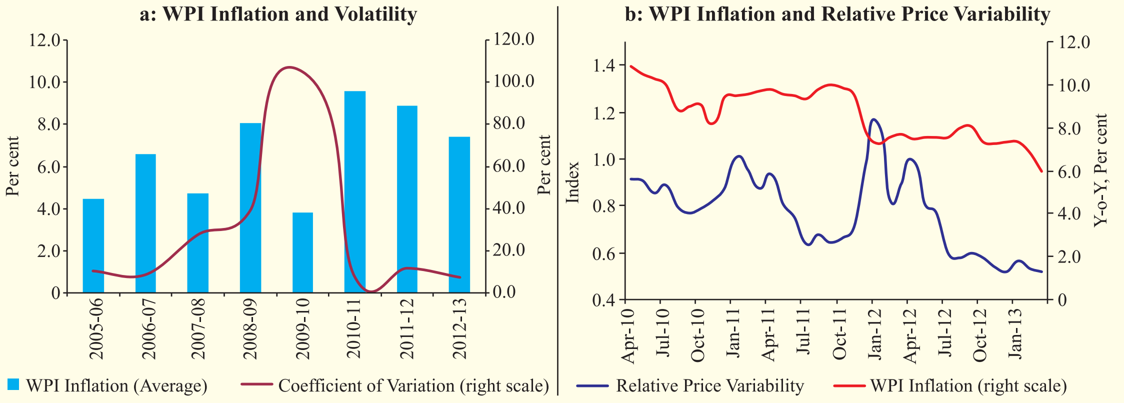


Chart VI.9: Variability and Volatility in WPI Inflation



- Volatility is defined as coefficient of variation of monthly inflation (y-o-y) during the year.
- The index of relative price variability (RPV) is measured as the weighted sum of deviations in commodity group inflation from overall inflation: $RPV_t = \sqrt{\sum_{i=1}^{n} w_{it}\,(\pi_{it} - \pi_t)^2}$ (where, π_{it} is the inflation in commodity sub group *i* at period *t*, π_t is the average rate of inflation at period *t* and w_{it} is the weight of commodity sub-group *i* in price index).

corroborates the weak pricing power. The PMI input and output price indices in recent months exhibited moderation, further pointing towards moderation of inflation pressures.

VI.18 During the three-year period of high inflation (2010-11 to 2012-13), the month-to-month volatility of all-commodities WPI inflation declined, reflecting its persistence. During 2012-13, the declining volatility reflects gradual moderation in overall inflation. The relative price variability across commodities, which was high in 2011-12, also declined during 2012-13, suggesting that softening of inflation has occurred in a generalised manner Chart VI.9 (a & b).

Wage growth pressures persist, although with some moderation

VI.19 Persistent pressure from wages remains a major risk to inflation moderation. Although the pace of increase of rural wages moderated, it continues to be in double digits. However, the sharp increase in inflation in rural areas in recent months led to significant moderation in real wage growth (Chart VI.10). State-specific factors continue to play a major role in wage-price dynamics, with significant variation in inflation and wage growth being observed across the major states (Chart VI.11).

VI.20 In the private corporate sector, the increase in staff costs remained significant, indicating persistent pressure from wage costs (see Chapter II). The results of the Annual Survey of Industries (available up to 2010-11) also show double-digit growth in wages in the factory sector, pointing towards pressure on industry from high wages.

Divergence between WPI and CPI inflation widened

VI.21 Since December 2012, inflation as measured by the all-India new Consumer Price Index (CPI-combined: rural + urban) remained in double digits even as WPI inflation moderated, leading to a widening of

Chart VI.10: Wages and Inflation in Rural Areas

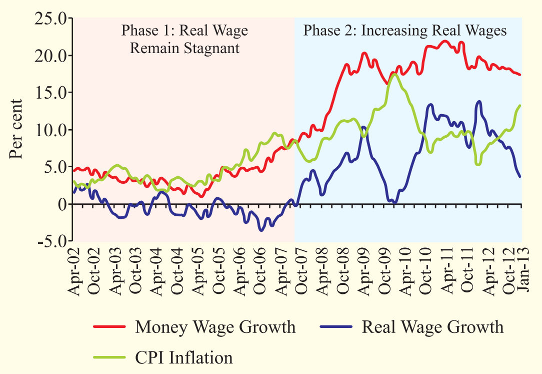
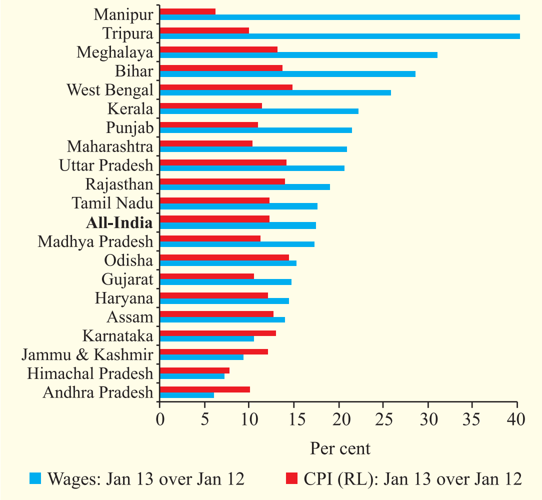
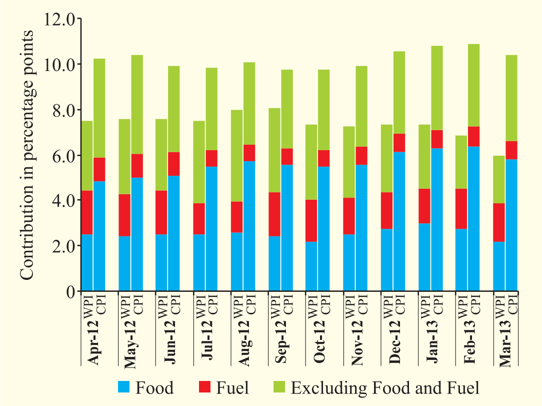


Chart VI.11: State-wise Inflation and Growth in Rural Wages



the gap between the two (10.4 per cent and 6.0 per cent in new CPI and WPI, respectively, in March 2013) (Chart VI.12). This divergence is on account of several factors. Both the higher weight of food in the new CPI (47.6 per cent) compared with the WPI (24.3 per cent), and higher food inflation in new CPI at 12.4 per cent compared with 8.1 per cent in WPI for March 2013 contributed to the divergence. In particular, new CPI inflation for vegetables, oils & fat, milk, sugar and eggs, fish & meat was higher than that in the WPI possibly reflecting trade and transport margins and other supply chain inefficiencies. Also, housing, which is only part of the new CPI, exhibited double-digit inflation.

Chart VI.12: WPI and New CPI Inflation



Consumer price inflation in some commodities diverges between rural and urban areas

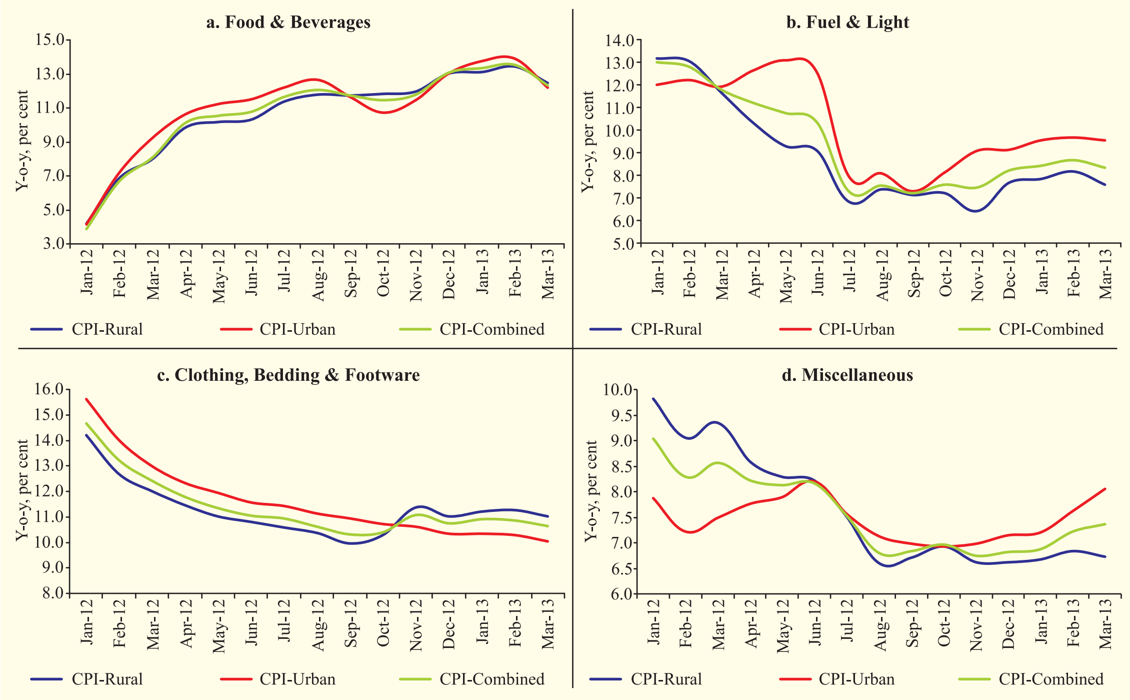
VI.22 There were large divergences in inflation by commodity groups in rural and urban areas (Chart VI.13). The fuel & light group witnessed higher inflation in urban areas. Inflation in clothing, bedding and footwear was higher in rural areas in recent months. While overall food inflation remained more or less the same between rural and urban areas. However, within food groups there was significant divergence in inflation trends. Inflation was higher in cereals, pulses, 'eggs, fish and meat' and prepared meals in urban areas, while 'milk & milk products', 'condiments & spices', sugar and edible oils recorded higher inflation in rural areas. These divergence in inflation may also in part reflect supply chain inefficiencies across various regions but it needs a thorough examination.

Regional variation in inflation remains significant

VI.23 Though starting at around the similar rate of 10 per cent in May 2012, CPI inflation across various regions of the country exhibited significant divergence in recent months. Notably, the north-eastern region witnessed lower inflation than the rest of the country (Chart VI.14). Inflation differential across regions could be due to region-specific factors, such as the composition of the consumption basket and transport costs. State-specific government policies, such as the availability of fair price shops and restrictions on inter-state movement of goods could also lead to the differences in inflation.

VI.24 Recent trends in the prices of selected food articles collected across various regions by the Reserve Bank indicate further firming up of the prices of cereals, both in the wholesale and retail markets, while prices of pulses showed some moderation. The average mark-up in the prices between retail and wholesale markets during Q4 of 2012-13 were sustained in the range of 7–20 per cent for cereals and

Chart VI.13: Commodity-group wise new CPI inflation

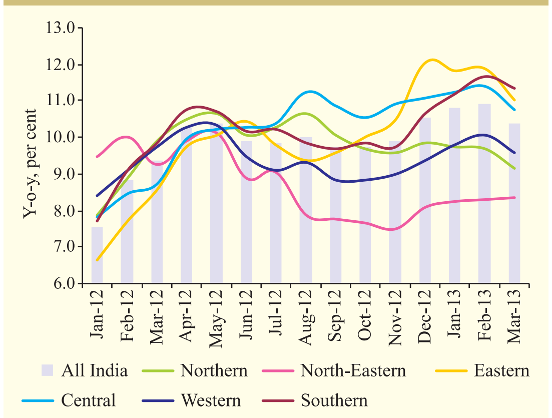


pulses, and it varied in the range of 22–45 per cent for perishable items, including vegetables, fruits and fish.

Headline inflation is expected to remain range-bound during 2013-14

VI.25 Going forward, the growth slowdown and the lagged impact of past monetary policy actions are expected to keep inflation moderate from the demand side. The recent fall in global commodity prices and subdued demand conditions may result in some further moderation in headline inflation in the coming months, but overall inflation is likely to stay range-bound. From the supply side, price adjustments in diesel, coal and electricity, when effected, may offset the inflation moderation due to slack demand. Moreover, food inflation remains a major pressure point accentuated by continuing supply bottlenecks. A sustained moderation in food inflation would entail greater emphasis on removing supply bottlenecks and raising agricultural productivity. The near-term path of food inflation, however, is also contingent upon the performance of the monsoon. The global environment remains uncertain, and despite the recent moderation, possible upswings in fuel prices or depreciation of the exchange rate pose further upside risks. Risks also stem from the possible wage-price spiral and high inflation expectations. In view of these factors, the monetary policy has to continue its close vigil on the inflation front while continuing to facilitate growth recovery.

Chart VI.14: Region-wise New CPI Inflation



VII. MACROECONOMIC OUTLOOK

The slowdown in the Indian economy persisted, with growth hobbled by structural bottlenecks and adverse global conditions. While demand-side inflation pressures reduced, high consumer price inflation along with the current account deficit (CAD) well above sustainable levels limits the space for monetary policy to support growth. Surveys show that business confidence remains subdued despite reforms and policy initiatives since September 2012. Against this backdrop, a recovery in 2013-14 is likely to be slow-paced. It would require further all-round efforts that includes initiatives to remove structural impediments and improve governance. Resolving outstanding issues that constrain infrastructure investment and a public investment stimulus rebalanced by revenue spending cuts holds the key to the economy's revival.

Growth slowdown, macroeconomic risks come to fore in 2012-13

VII.1 Growth slowdown, persistent inflation and the twin deficit risks came to the fore during 2012-13 and enervated the Indian economy endangering the reversal of its declining growth path. Amidst trade-offs, monetary policy factored in increased growth risks and shifted its stance to calibrated easing to address the growth slow down as headline inflation gradually moderated. The government also launched concerted policy action and reforms during H2 of 2012-13. These reforms, with fuller implementation, are expected to arrest the downward spiral and kick in a modest recovery in 2013-14.

VII.2 In the interim, growth impulses turned weaker in H2 of 2012-13 as mining and manufacturing activity remained subdued and slowdown spilled over to certain segments of the services sector, most notably 'trade, hotels, transport and communication'. Growth in Q3 of 2012-13 dropped to a 15-quarter low of 4.5 per cent, taking the growth during the first three quarters to 5.0 per cent. It looks probable that growth for 2012-13 may be at a 10-year low at about the CSO's Advance Estimates of 5.0 per cent.

VII.3 Part of the slowdown has been due to global factors with weak external demand impacting activity levels, especially that of the manufacturing sector. Growth in most emerging market and developing economies (EMDEs) slowed during 2012 and their growth is expected to stay low in 2013. On the domestic front, the services sector activity decelerated. The sector has been the mainstay of India's recent growth story. Industrial growth is now virtually facing stagnation resulting from a combination of factors, most notably the investment cycle downturn, supply-side bottlenecks, governance problems and weak external demand. Slowing private consumption demand is also dragging down growth, especially in the recent quarters.

VII.4 Macro-financial conditions worsened with slowing growth, widening current account deficit (CAD) and persistence of high consumer price inflation. The CAD/GDP ratio rose to a record 6.7 per cent in Q3 of 2012-13. Notwithstanding likely improvement in Q4, the CAD/GDP ratio is expected to be at a new high of around 5.0 per cent for the year 2012-13, which is about twice the sustainable level. Other indicators also suggest increased external sector vulnerabilities. Short-term debt on a residual maturity basis increased to 44.1 per cent of the total debt and 56.2 per cent of the foreign exchange reserves by end-December 2012. The economy has become vulnerable to any event shocks that might precipitate a sudden stop or a reversal of capital inflows. The recent fall in global commodity prices, especially of crude oil and gold, provide some much needed relief, but being complacent based on price movements that may not necessarily be enduring could be myopic since the CAD/GDP ratio could exceed sustainable levels for the third successive year in 2013-14.

Macro-financial risks start getting addressed, may pave the way for recovery

VII.5 The widening CAD was accompanied by an increasing fiscal deficit in H1 of 2012-13. With the emerging macroeconomic imbalance from the fiscal side that had accentuated the twin deficit risks, the government embraced a plan for fiscal consolidation following the recommendations of the Kelkar Committee. The Committee had projected the GFD/GDP ratio to touch 6.1 per cent for 2012-13 in the absence of corrective measures. However, binding itself to a credible commitment to lower fiscal deficits, the GFD/GDP ratio was lowered to 5.2 per cent in 2012-13. This correction has effectively lowered the twin deficit risks at a critical juncture. If the government stays on its fiscal plans in 2013-14 and rebalances spending from non-plan to planned expenditure, it would lay the foundation for a sustainable recovery.

VII.6 Monetary space in 2012-13 was constrained by twin deficits and elevated inflation. Headline inflation hovered in the 7-8 per cent band for most of the year before moderating to about 6.0 per cent by the end of 2012-13. However, a more perceptible fall in non-food manufactured product inflation along with marked progress in addressing fiscal risks provided headroom for monetary policy to start easing. Using the available space, it lowered policy rates cumulatively by 100 bps, CRR by 75 bps (on top of a 125 bps reduction in Q4 of 2011-12) and SLR by 100 bps.

VII.7 Recovery at the current juncture will critically depend on supply-side action to remove a host of micro-constraints and structural bottlenecks that impede production and investment, especially in growth-driving sectors such as road and power. The government has initiated action in this direction, but progress has been slow, making it imperative for decisive action to be taken quickly on the outstanding issues. Failure to do so could lead to multiple problems and cause further deterioration in the asset quality of bank finance, choke off flow of debt as well as equity finance to stressed firms and stall recovery in its tracks. In addition, a significant dose of public investment stimulus could crowd-in private investment, but such a stimulus needs to be financed within the budgetary constraints by downsizing its current spending.

Business expectations surveys show little improvement in sentiments

VII.8 The current growth slowdown has been amplified by the loss of business confidence. Confidence has been dented by macroeconomic deterioration, global macroeconomic and financial uncertainties and the perception of adverse and biased information, driven in part by recent experience during the global financial crisis. In this environment, expectations are being anchored around recent bad news.

VII.9 Various surveys on business expectations indicate that business confidence remains subdued despite policy action and reforms during H2 of 2012-13 (Table VII.1).

Table VII.1: Business Expectations Surveys

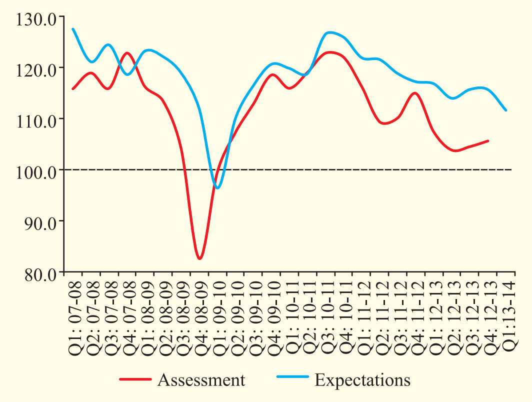
Period Index	NCAER- Business Confidence Index April 2013	FICCI Overall Business Confidence Index Q3:2012-13	Dun & Bradstreet Business Optimism Index Q2: 2013	CII Business Confidence Index Q4: 2012-13
1	2	3	4	5
Current level of the Index	114.1	61.2	141.6	51.3
Index as per previous survey	119.7	62.4	146.8	49.9
Index levels one year back	134.9	57.7	150.0	52.9
% change (q-o-q) sequential	-4.7	-1.9	-3.5	2.8
% change (y-o-y)	-15.4	6.1	-5.6	-3.0

Although the seasonally adjusted HSBC Markit Purchasing Managers' Indices (PMI) for manufacturing and services (March 2013) remained in expansion mode, they recorded the slowest pace of expansion in the last 16 and 17 months, respectively.

Industrial Outlook Survey reflects further weakening of business expectations in Q1 of 2013-14.

VII.10 The Reserve Bank's 61st Round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS61) conducted during Q4 of 2012-13 showed that the Business Expectation Index (BEI), a composite indicator based on several business parameters recorded marginal improvement for Q4 of 2012-13. However, index capturing expectations for Q1 of 2013-14 dropped significantly (Chart VII.1). These indices have persisted in the growth terrain (*i.e.* above 100, which is the threshold that separates contraction from expansion).

Chart VII.1: Business Expectation Index



VII.11 An analysis of the net responses among various components of demand conditions showed improved optimism on order books, capacity utilisation and exports during Q4 of 2012-13. However, their outlook for Q1 of 2013-14 showed significant moderation. The sentiments on the overall financial situation reflected lower optimism (Table VII.2).

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

Parameter	Optimistic Response	Net Response[1]										
		January-March 2012		April-June 2012		July-September 2012		October-December 2012		January-March 2013		April-June 2013
		E	A	E	A	E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9	10	11	12	13
1. Overall Business Situation	Better	33.6	26.5	34.9	18.3	30.6	16.1	32.2	17.2	37.5	18.4	29.6
2. Overall Financial Situation	Better	25.2	18.5	27.7	14.2	23.6	12.2	25.8	12.7	27.0	11.8	21.9
3. Production	Increase	40.4	33.1	34.7	20.3	33.6	18.8	35.7	18.6	37.1	18.6	24.4
4. Order Books	Increase	31.3	24.8	29.5	16.9	29.9	12.0	30.3	12.9	29.8	14.0	22.3
5. Capacity Utilisation	Increase	24.3	16.7	19.9	8.6	18.4	6.3	20.0	5.7	21.7	7.8	11.7
6. Exports	Increase	18.6	14.2	20.7	10.8	20.5	10.0	18.0	9.3	18.4	10.8	16.7
7. Imports	Increase	15.5	14.4	15.7	11.6	15.5	9.8	14.0	8.8	13.5	8.3	11.9
8. Employment in the Company	Increase	13.6	12.9	14.6	10.0	12.3	8.3	13.3	6.7	10.3	5.5	8.0
9. Availability of Finance (from internal accruals)*	Improve										12.1	18.7
10. Availability of Finance (form banks and other sources)*	Improve										13.4	15.3
11. Availability of Finance (form overseas)*	Improve										3.4	6.3
12. Cost of External Finance	Decrease	-38.8	-37.4	-22.7	-30.5	-24.0	-27.4	-20.6	-24.4	-18.1	-17.6	-14.3
13. Cost of Raw Material	Decrease	-50.1	-59.4	-49.0	-63.1	-51.4	-59.6	-48.6	-50.7	-45.0	-53.5	-45.6
14. Selling Price	Increase	14.7	13.5	19.0	17.5	18.8	18.5	17.3	10.2	15.8	9.1	14.9
15. Profit Margin	Increase	-2.9	-11.3	-1.2	-17.9	-3.6	-15.1	-1.3	-16.7	-2.0	-15.3	-4.9

E-Expectations and A- Assessment.

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

* These questions are new and have been added in the 61st Round (January-March 2013) by splitting the question on Availability of finance (both internal and external sources).

Further fall in consumer confidence

VII.12 The Reserve Bank's 12th Round of the Consumer Confidence Survey (http://www.rbi.org.in/CCS12), conducted in March 2013 indicates a declining trend in consumer confidence for the past one year (Chart VII.2).

External agencies expect revival in the economy

VII.13 Forecasts by various external agencies indicate a moderate recovery in the Indian economy during 2013-14. The projections for GDP growth range from 5.8 per cent to 6.7 per cent (Table VII.3). Current projections by these agencies are slightly lower than their earlier projections, indicating that they anticipate a weaker recovery.

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

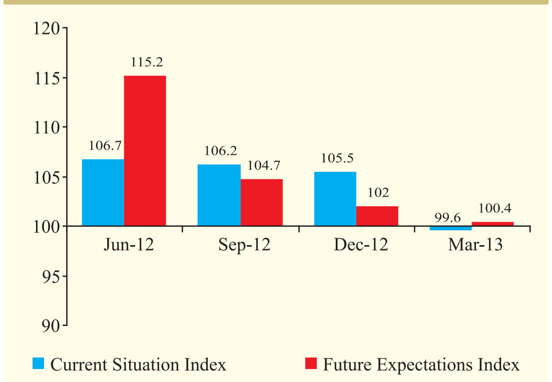
Agency	Latest Projection		Earlier Projection	
	Real GDP Growth (Per cent)	Month/ Year	Real GDP Growth (Per cent)	Month/ Year
1	2	3	4	5
Finance Ministry	6.1 to 6.7	Feb. 2013		
PMEAC	6.4	Apr. 2013		
IMF*	5.8	Apr. 2013	6.0	Jan. 2013
World Bank	6.4	Jan. 2013		
OECD**	5.9	Dec. 2012	6.5	Nov. 2012
ADB	6.0	Apr. 2013	6.5	Dec. 2012
NCAER	6.2	Jan. 2013		

* Corresponds to 5.7 per cent projection for growth in GDP at market prices for calendar year 2013 in the IMF's World Economic Outlook of April 2013;
** GDP at market prices.

Survey of Professional Forecasters anticipates modest recovery in growth[1]

VII.14 The Reserve Bank's 23rd Round of the Survey of Professional Forecasters outside the Reserve Bank (http://www.rbi.org.in/SPF23) shows anticipation of modest recovery in 2013-14 to 6.0 per cent from 5.0 per cent in the preceding year. Average WPI inflation is expected to moderate to 6.5 per cent from 7.3 per cent. 5-year ahead inflation expectations moderated slightly (Chart VII.3a) Both these latest growth and inflation projections are half a percentage downward revision from the earlier round. Forecasters expect the CAD to come down to 4.5 per cent of GDP in 2013-14 from a projected 5.1 per cent for 2012-13 (Table VII.4).

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



Modest decline observed in the households' inflation expectations

VII.15 The latest round of Inflation Expectations Survey of Households (IESH Round 31) (http://www.rbi.org.in/IESH31) indicates that the perception of current inflation as well as the mean and median expectations on future inflation, both at 3-month and 1-year ahead, has decreased in this quarter (*i.e.*, January-March 2013) as compared with the previous quarter (Chart VII.3b). Moreover, the percentage of respondents expecting price rise 'more than the current rate' in next quarter as well as next year has decreased as compared with the last round of the survey.

Slow-paced recovery likely in 2013-14 but negative output gap may persist

VII.16 Given the current state of the economy, the policy action taken so far and the expectations

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

Table VII.4: Median Forecasts of Select Macroeconomic Indicators by Professional Forecasters 2012-13 and 2013-14

	Actual 2011-12	Annual forecasts				Quarterly Forecast									
		2012-13		2013-14		2012-13		2013-14							
						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 (%)	6.2#	5.0^	5.0	6.5	6.0	6.0	5.0	6.1	5.5	6.5	5.8	6.6	6.2	-	6.4
a. Agriculture & Allied Activities	3.6#	1.8^	1.8	3.0	3.0	1.9	2.1	2.5	2.7	3.0	3.0	3.2	3.3	-	3.0
b. Industry	2.7#	2.0^	2.5	4.7	4.4	4.0	2.9	4.4	3.7	4.6	4.1	5.5	4.4	-	4.7
c. Services	7.9#	6.5^	6.6	7.8	7.1	7.8	6.3	7.6	6.8	7.7	7.0	7.9	7.4	-	7.7
2. Gross Domestic Saving (% of GDP at current market price)	30.8#	30.5	29.5	31.2	30.0	-	-	-	-	-	-	-	-	-	-
3. Average WPI-Inflation (%)	8.9	7.3*	7.3	7.0	6.5	6.7*	6.6	6.8	6.5	6.6	6.0	7.0	6.5	-	6.8
4. Exchange Rate (`/US$ end period)	51.2	54.4&	54.3	52.0	53.8	54.4&	54.3	53.0	54.5	52.5	54.8	51.5	54.4	-	54.0
5. 10-year Govt. Securities Yield (%-end period)	8.6	7.9	8.0	7.8	7.7	-	-	-	-	-	-	-	-	-	-
6. Export (growth rate in %)!	20.9*	-3.5	-4.1	11.2	8.7	-	-	-	-	-	-	-	-	-	-
7. Import (growth rate in %)!	30.3*	-1.4	0.0	8.6	7.4	-	-	-	-	-	-	-	-	-	-
8. Trade Balance (US$ billion)	-189.8*	-	-	-	-	-48.1	-51.2	-46.5	-48.6	-50.8	-52.0	-53.0	-59.6	-	-56.6
9. Current Account Deficit (% of GDP)	4.2*	4.2	5.1	3.5	4.5	-	-	-	-	-	-	-	-	-	-
10. Central Government Fiscal Deficit (% of GDP)	5.7&	5.7	5.2	5.3	5.0	-	-	-	-	-	-	-	-	-	-

E: Previous Round Projection. L: Latest Round Projection. #: 1st Revised Estimate. *: Preliminary.
- : Not Available. !: US$ on BoP basis. &: Actual ^ : Advance Estimate.

Note: The latest round refers to 23rd Round for the quarter ended March 2013, while previous round refers to 22nd Round for the quarter ended December 2012.

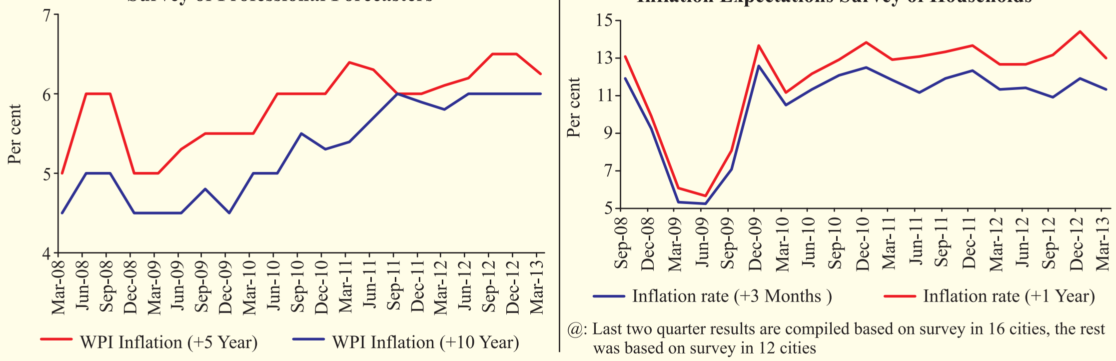
Source: Survey of Professional Forecasters, Q4 of 2012-13.

of various economic agents and factoring in a reasonable policy response ahead, the Reserve Bank's baseline assessment is that a recovery in 2013-14 is likely but would be contingent on

Chart VII.3: Inflation Expectations

a. 5-year and 10-year ahead median inflation forecasts - Survey of Professional Forecasters

b. 3-month and 1-year ahead median inflation expectations - Inflation Expectations Survey of Households@



@: Last two quarter results are compiled based on survey in 16 cities, the rest was based on survey in 12 cities further policy action to unwind the bottlenecks to productive activity. The output gap would still remain negative during 2013-14.

VII.17 India's sub-par economic activity over the past two years is not completely surprising given that growth has slowed down in most EMDEs. With the exception of China, India and Indonesia, growth in most EMDEs slipped to below 4 per cent in 2012. Deceleration in world trade played a major role in slowing down the growth of EMDEs. According to the IMF's WEO, the volume of world trade in goods and services expanded 2.5 per cent in 2012, which is a considerably slower pace than the average annual growth of 6.3 per cent during 1995-2011. If global trade in goods and services picks up on improved external demand, it would have a positive effect on domestic manufacturing activity that has high export intensity. Invisibles earnings could also improve with an acceleration in software exports. This would help in narrowing the CAD and reducing external sector risks to macroeconomic stability. However, the baseline projections in the WEO of April 2013 suggest that the volume of global trade in goods and services is likely expand at a slow pace of 3.6 per cent in 2013.

VII.18 Dependence on improved external demand to shape recovery in India could, therefore, be problematic. External uncertainties remain significant from euro area problems in Italy, Cyprus and Slovenia, the sequestration impact in the US and unconventional policies in Japan. How they ultimately shape global capital flows would have an impact on the rupee.

VII.19 As such, recovery crucially hinges on domestic action. Interest rates can play only a limited role in revival. Activity in the mining sector has been severely affected by legal enforcements on illegal mining, cancellation of inappropriate coal block auctions and law and order problems. Vexed issues have also cropped up on natural gas pricing and coal supply, which threaten the viability of the new power project investments. The telecom sector, which was a major driver of the investment boom in the past, is facing issues of regulation, besides penetration ratios plateauing out. Execution of road projects slowed down in 2012-13 despite record tendering in 2011-12, mainly on account of failures to meet environmental requirements and land acquisition issues, as also the rising leverage of the project executing firms (see Chapter 2 for more details). While appropriate regulatory and legal frameworks are necessary to ensure sustainable growth, transparency and the speedy redressal of issues would go a long way towards improving the business climate.

VII.20 Corporate investment has slowed down due to structural and cyclical factors after a capital expenditure boom during 2003-11, in which planned fixed investments of the corporates in large projects increased over 8.6 times in eight years. However, if structural issues of the kind mentioned above are quickly resolved, a turnaround in investment activity should be possible.

VII.21 The forecast by Indian Meteorological Department of a normal monsoon estimated at 98 $\pm$ 5 per cent of the Long Period Average (LPA) raises hope that consumption may improve. Some further moderation in headline inflation in H1 of 2013-14 from the current levels can also be expected to have a favourable impact on real private consumption. Therefore, the growth recovery process in the economy should kick-in later during 2013-14 but the pace of recovery is likely to remain slow.

Inflation likely to stay above comfort levels in 2013-14 and remain range-bound around current levels

VII.22 Average headline inflation declined from 9.6 per cent in 2010-11 to 8.9 per cent in 2011-12 and further to 7.3 per cent in 2012-13, with a low of 6.0 per cent in March 2013. As a baseline case, it is expected to see some further moderation in H1 of 2013-14 on the back of subdued pricing power of domestic producers and falling global commodity prices before it increases somewhat in H2 due to base effects and a reduction in the output gap. On the whole, inflation during 2013-14 is likely to remain range-bound around current levels, but stay above the Reserve Bank's comfort level. Significant suppressed inflation lingers in the system, despite the considerable pass-through that occurred during 2012-13. The proposed diesel price pass-through and the likely increase in electricity tariffs and coal prices, would exert some upward pressure on prices.

VII.23 An increase in coal prices would be necessitated, factoring in coal imports that would be needed to bridge the demand-supply gap. An increase in power tariffs is expected along the lines envisaged as part of the restructuring package for the distribution companies. Sticking to the envisaged path of diesel price hikes is necessary to create fiscal space for increasing public investments and for lowering the fiscal risks to macro-financial stability.

VII.24 As a baseline case, the outlook on global energy prices is benign. Supplies are expected to improve, in part by the exploitation of shale gas reserves in the US. Along with soft metal prices, it could contribute significantly to keeping the imported inflation component low during 2013-14, though its ultimate transmission would depend on the extent of correction in the CAD and the consequent rupee exchange rate movements.

Macro-financial risks require cautious monetary policy response ahead

VII.25 Even while macro-financial stability risks have started getting addressed, they stay significant at the current juncture. This necessitates careful calibration of monetary policy during 2013-14. While several risk factors impinge upon the likely growth and inflation outcomes for 2013-14, six factors may be highlighted in this context. First, if consumption decelerates markedly from here and impacts staples and not just discretionary items, it could delay the recovery process. However, given that CAD risks are still large, monetary stimulus from a consumption viewpoint needs to be restrained for some time to allow the trade account to adjust. Second, the risk of a sub-normal monsoon to growth and inflation cannot be ignored altogether for 2013-14 despite forecast of a normal monsoon. Third, the biggest risk to recovery comes from failure to effectively complete policy action to remove supply-side constraints that impede investments. This could bring to the fore both the growth and financial stability risks. With rising corporate leverage, especially in the infrastructure space, it is necessary to resolve the vexed structural issues that the sector faces. Fourth, while fiscal risks have been lowered, they have not waned. If growth slows down further it could result in revenue shortfalls that could lead to the resurgence of fiscal risks. Fifth, global risks still remain significant which could have an adverse impact in the form of sudden stop and reversal of capital inflows. Sixth, while global inflation is expected to stay muted in the near term, given the large doses of QE, liquidity could feed into long-term inflation expectations at some stage.

VII.26 In view of the above risks and the fact that headline inflation remains above the threshold over which it becomes inimical to growth sustainability, and consumer price inflation remains high, the monetary space for 2013-14 remains very limited. If some of the risks enumerated above come to the fore, policy-recalibration could become necessary in either direction as may be considered appropriate.