RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments Second Quarter Review 2011-12

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

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Reserve Bank of India
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MACROECONOMIC AND MONETARY DEVELOPMENTS SECOND QUARTER REVIEW 2011-12

Overview

During Q3 of 2011, global growth prospects further deteriorated, which may have an adverse impact on the Indian economy. The intensity of the impact will depend on how deep is the global downturn which, in turn, is related to how the current and future financial stress in global markets are addressed. In a baseline scenario, growth in India in 2011-12 is likely to be somewhat below trend.

2. Inflationary pressures are strong and persistent due to structural rigidities, continuing strong demand and the adaptive nature of inflation expectations. The path of inflation is sticky and remains broadly in line with earlier projections. With falling global commodity prices partly offset by rupee depreciation, the risks to inflation projections are now balanced.

3. Monetary policy has been tightened considerably with an effective 500 bps rate hike cumulatively and a 100 bps reserve requirement increase in a span of 20 months since February 2010. Monetary transmission has helped raise deposit and lending rates, correct the mismatch between deposit and credit growth and dampen aggregate demand. Though the risks to growth are becoming visible, the challenge of bringing down inflation to an acceptable level on a sustainable basis still remains significant.

Global Economic Conditions

Global growth risks intensify as debt crisis erodes confidence

4. Global growth prospects appear to be declining, even though recovery has not stalled. There have been significant downward revisions in growth projections for the advanced economies. Risks to global growth have amplified with business and consumer confidence dampening on the back of the deepening sovereign debt crisis in Europe. Private sector balance sheets are at risk and significant banking sector weakness is re-emerging as a result. Importantly, financial stress could extend beyond euro area boundaries. If the euro area slows down further, as currently expected, it may have a domino effect on the global economy with spillovers to emerging markets.

5. In its World Economic Outlook of September 2011, the International Monetary Fund (IMF) significantly lowered its global growth forecast by 0.3 percentage points for 2011 and 0.5 percentage points for 2012. The world economy is still expected to grow at 4.0 per cent in both these years. The cuts in growth projections were deeper for advanced economies (AEs), but were also pervasive among emerging and developing economies (EDEs). The IMF also lowered its growth forecast for India. Its current projections of 7.8 per cent for 2011 and 7.5 per cent for 2012 in market prices correspond to a projection of 7.6 per cent growth at factor cost for 2011-12 and 2012-13.

Global commodity prices softening, but consumer inflation persists

6. Global commodity prices, especially those of metals, have softened significantly. However, even after some correction, the current Brent crude oil price is still over 25 per cent higher than its average for 2010-11. The IMF has *revised upwards its consumer price inflation forecast for EDEs by 0.6 percentage point to 7.5 per cent for 2011, while leaving the projection for AEs unchanged at 2.6 per cent.*

7. The global inflation path remains unclear. A strong softening bias has been induced in by the impending global slowdown. Producers' pricing power remains low in AEs. Wage inflation is also likely to be restrained as unemployment still remains a significant challenge in these economies. However, this is counterbalanced by inflation persistence in EDEs backed by demand conditions. Also, there are upside risk to global commodity prices stemming from excessively accommodative monetary policy stance in AEs.

Indian Economy: Developments and Outlook

Output

Growth moderating below trend in 2011-12

8. Growth in 2011-12 is likely to moderate to below trend. Agriculture prospects remain encouraging with the likelihood of a record Kharif crop. However, moderation is visible in industrial activity and some services, mainly construction and community, social and personal services. Given the linkage of domestic industrial growth with global cycle, some further moderation is likely ahead given the weak global PMIs. Capacity constraints seem to be easing in some manufacturing activity, especially cement, fertilizers and steel. Construction activity has slowed and leading indicators suggest that services growth may slightly weaken ahead.

Aggregate demand

Investment slowdown may impact growth ahead

9. Indications are that investment demand is softening as a result of combination of factors including monetary tightening, hindrances to project execution and deteriorating business confidence. Planned corporate fixed investment in new projects declined significantly since the second half of 2010-11. Consequently, the pipeline of investment is likely to shrink, putting 2012-13 growth at risk. Private consumption is also starting to soften in parts, but it still remains robust as is evident from corporate sales performance. There are also risks to demand management if government consumption spending overshoots budget estimates. As such, a key to growth sustainability lies in supporting investment by rebalancing demand from government consumption to public and private investment.

External sector

Widening CAD poses risk if global trade and capital flows shrink

10. The Current Account Deficit (CAD) widened in Q1 of 2011-12. Exports are expected to decelerate in H2 of 2011-12. If global financial market stress increases further and affects capital flows to the emerging markets, financing of CAD could pose a challenge. The Indian rupee has seen significant nominal and real depreciation in Q2 of 2011-12. However, this trend has been in line with that of other emerging market currencies, which too depreciated significantly as US dollar appreciated with flight to safety amidst rising risk aversion.

Monetary and Liquidity Conditions

Liquidity conditions remain comfortable, credit growth stays above trajectory

11. Though during Q2 of 2011-12, liquidity conditions remained in deficit mode in line with the policy objective, it remained comfortable. Base money has decelerated as currency growth moderated. Money (M_3) growth, however, moderated less sharply as the money multiplier increased. Bank credit growth is also presently above the indicative trajectory. This has been supplemented by increased resource flows from non-banking sources. Going forward, credit growth is expected to moderate as growth slows down. Monetary transmission is still unfolding in response to significant monetary *tightening since February 2010. However, real interest rates are still low and supportive of growth.*

Financial Markets

Spillovers contained in domestic equity and currency markets as risk aversion and volatility is back in global markets

12. The US sovereign rating downgrade and the deteriorating sovereign debt situation in the euro area caused significant pressures in global financial markets during Q2 of 2011-12. Rising risk aversion caused credit spreads to widen, and most markets experienced increased volatility. Volatility spillovers impacted domestic equity and currency markets, but were contained by providing adequate rupee and forex liquidity. Rupee depreciation and the fall in equity indices in Q2 of 2011-12 were comparable to the patterns in most other emerging markets. Money market rates remained in line with policy signals, while G-sec yields hardened after the announcement of additional market borrowing.

Price Situation

High inflation likely to persist in near-term before moderating as falling global commodity prices provide limited comfort

13. Upside risks to inflation persist in EDEs which have experienced elevated inflation for more than a year. Global commodity prices have eased, but the levels remain high, especially for crude oil. Financialisation of commodities has made the future commodity price path uncertain. With incomplete pass-through of the earlier rise in global commodity prices, the favorable impact, arising from the transmission of falling global commodity prices is also likely to be limited. Moreover, the benefit from the recent fall in global oil prices has been offset by rupee depreciation. Domestic price pressures still remain significant and broad-based. Food price inflation remains high as a result of structural mismatches in non-cereal primary food articles and large MSP revisions. Real wage inflation has been significant in 2010-11 and the wedge between wage inflation and CPI inflation has increased further in Q1 of 2011-12. In sum, the inflation challenge remains significant.

Macroeconomic Outlook

Growth risks amplify while sticky inflation makes policy choices difficult

14. Growth risks have increased on account of global headwinds and domestic factors. The baseline inflation path still remains sticky and broadly unchanged from earlier projections. This has made policy choices more complex. Some sacrifice of growth is inevitable in the current milieu of high inflation. On the current assessment the growth in 2011-12 is likely to moderate slightly from that projected earlier. Various surveys conducted suggest that business expectations have suffered, while inflation expectations remain high. At the same time inflation risk persists. In this backdrop, the monetary policy trajectory will need to be guided by the emerging growth-inflation dynamics even as transmission of the past actions is still unfolding.

I. OUTPUT

Global recovery looked healthy till recently, but slowing momentum was witnessed in Q3 of 2011. Moderation in global growth is also expected ahead as a result of waning of business and consumer confidence. Risks to domestic growth have amplified because of these global headwinds. Notwithstanding a satisfactory monsoon and a possible record kharif crop output, overall growth in the second half of 2011-12 is likely to remain below trend. Moderation in activity is apparent in industry, though the fall is exacerbated by a few volatile components. The services sector has been resilient so far but construction, which is important for its large employment potential, is cooling off.

Global growth in siege from debt overhang

I.1 The global growth outlook has deteriorated significantly over the last quarter. Global recovery, which appeared healthy till recently, now appears to be in siege from the sovereign debt overhang. Financial instability arising from unresolved sovereign debt issues, especially in the euro area, is impacting business and consumer confidence, leading to risk aversion and dampening of demand and supply of credit. This, in turn, is acting as a drag on aggregate demand and choking recovery from the 2008 crisis in the advanced economies. Risks of spillovers from sovereign debt crisis to the global banking system remain large.

I.2 The US economy grew by 1.3 per cent in Q2 of 2011 (annualised q-o-q), after negligible growth in Q1 (Chart I.1). The picture ahead is not clear, as gauged from the October 2011 Beige Book of the Federal Reserve. The latest news flow suggests that the recovery, even though weak, is holding so far. The US Institute for Supply Management (ISM) manufacturing index that serves as a Purchasing Managers' Index (PMI) improved to 51.6 in September 2011 from 50.6 in August. However, its forward-looking new orders index remained in contraction mode. Non-manufacturing ISM for US slowed down marginally in September 2011 from the previous month, but still remains in expansion mode. Moreover its production component remained strongly expansionary and accelerated in September. In contrast to signs of a downturn, payrolls increased by 1,03,000 in September after rising by 57,000 in August, but the labour force also grew, leaving unemployment unchanged at 9.1 per cent.

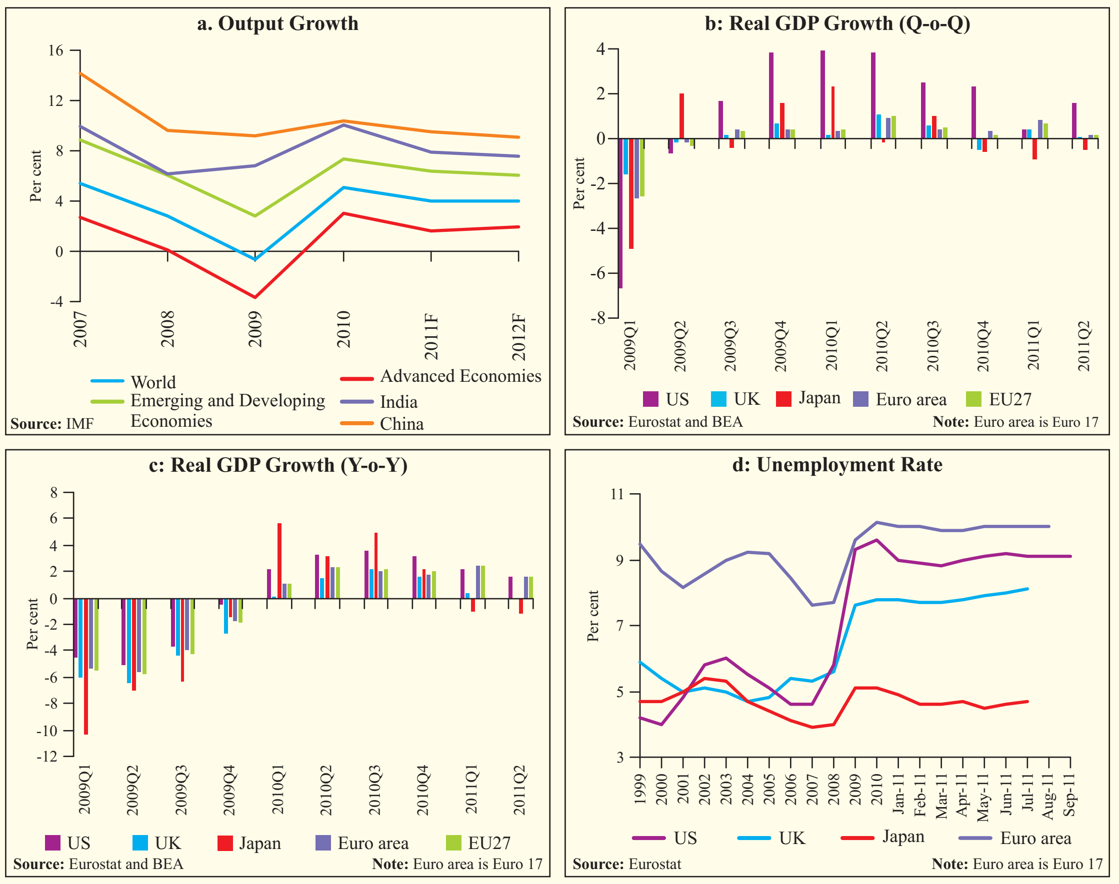
Euro area growth at heightened risk, emerging and developing economies may witness softening

I.3 Growth prospects for the euro area are at heightened risk, with moderation likely even for Germany, as external demand weakens. Euro area growth decelerated from 2.5 per cent y-o-y in Q1 of 2011 to 1.6 per cent in Q2 and is expected to decelerate further in the second half due to moderating global demand, falling consumer and business confidence and stressed financing conditions in the backdrop of the debt crisis. The Japanese economy is on a downswing, reflecting the impact of the earthquake/tsunami but may rebound going ahead as reconstruction accelerates.

I.4 Emerging and developing economies (EDEs) had experienced robust recovery from the crisis although their growth has also slightly moderated in recent quarters. There may be further slowing due to monetary tightening, weak external demand and volatile capital flows, yet the slowdown is expected to be less pronounced than in the advanced economies.

I.5 China may register some moderation in growth as a fallout of the slowdown in global growth, the impact of monetary tightening and emerging stress in financial markets on the back of ongoing asset price correction. China's GDP growth decelerated for the third consecutive

Chart I.1: Key Global Indicators



quarter with y-o-y growth recorded at 9.1 per cent in Q3 2011, the lowest in more than two years. Chinese exports have also slowed, recording only 17 per cent y-o-y rise in September 2011, the lowest in seven months due to dwindling growth in Europe, China's largest trading partner. However, a slowdown in Chinese economy may induce it to rebalance from external trade towards domestic consumption which may lead to adjustments in the countries that run a huge deficit with China.

Output gap widens marginally as growth moderates

I.6 During the first quarter of 2011-12, real GDP growth moderated to 7.7 per cent, decelerating for the third successive quarter and recording the lowest rate in the previous five quarters. While agriculture sector registered a considerably improved performance *vis-a-vis* the first quarter of the previous year, moderation was evident in the industry and services sectors (Table I.1). The deceleration was particularly marked for the industrial sector. However, despite some moderation, growth is only slightly below trend (Chart I.2).

I.7 At the sectoral level, agriculture growth was supported by improved *rabi* crop for 2010-11, while the slackening of industrial growth was reflected in the 'mining and quarrying' and 'manufacturing' sectors. The services sector witnessed moderation on account of a fall in growth rate of all its sub-components except 'trade, hotels, transport and communication'. The sharp deceleration in the growth of the construction sector, in particular, is likely to negatively impact capital formation, going forward.

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

(Per cent)

Item	2009-10*	2010-11#	2010-11 Q1	Q2	Q3	Q4	2011-12 Q1
1	2	3	4	5	6	7	8
1. Agriculture & allied activities	**0.4**	**6.6**	**2.4**	**5.4**	**9.9**	**7.5**	**3.9**
2. Industry	**8.3**	**7.8**	**9.7**	**9.0**	**6.2**	**5.3**	**6.7**
2.1 Mining & quarrying	6.9	5.8	7.4	8.2	6.9	1.7	1.8
2.2 Manufacturing	8.8	8.3	10.6	10	6.0	5.5	7.2
2.3 Electricity, gas & water supply	6.4	5.7	5.5	2.8	6.4	7.8	7.9
3. Services	**9.7**	**9.2**	**10.1**	**9.5**	**8.6**	**8.6**	**8.9**
3.1 Trade, hotels, transport and communication, *etc.*	9.7	10.3	12.1	10.9	8.6	9.3	12.8
3.2 Financing, insurance, real estate and business services	9.2	9.9	9.8	10.0	10.8	9.0	9.1
3.3 Community, social & personal services	11.8	7.0	8.2	7.9	5.1	7.0	5.6
3.4 Construction	7.0	8.1	7.7	6.7	9.7	8.2	1.2
4. GDP at factor cost (total 1 to 3)	**8.0**	**8.5**	**8.8**	**8.9**	**8.3**	**7.8**	**7.7**

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

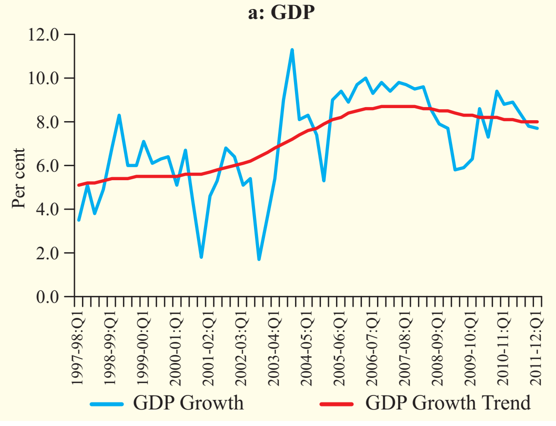
I.8 Downside risks to growth are likely to emanate from the impact of monetary policy in the context of high domestic inflationary pressures and the worsening global environment. These add further downside risk to growth projection of 8.0 per cent for 2011-12, the baseline scenario in the First Quarter Review of Monetary Policy of July 2011.

Agricultural prospects encouraging

I.9 The south-west monsoon in 2011-12 was 1 per cent above the long period average, with excess/normal in 92 per cent of the geographical area of the country. For the season as a whole (June-September 2011), the production weighted rainfall index (PRN) of the Reserve Bank and the area weighted rainfall index of the India Meteorological Department (IMD) were at 101 per cent (Chart I.3). The reservoir position as on October 20, 2011 was also much higher than during the corresponding period last year. The timely arrival and normal progress of the monsoon, combined with equitable spatial distribution, contributed favourably to *kharif* sowing. Till October 14, 2011, sowing under all *kharif* crops was 2.4 per cent higher than in 2010-11 and was also higher than the normal area sown (Table I.2).

I.10 As per the First Advance Estimates, production of major *kharif* crops in 2011-12 is

Chart I.2: GDP Growth and Trend



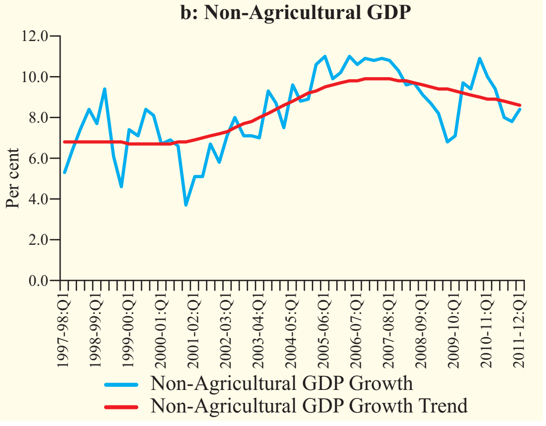
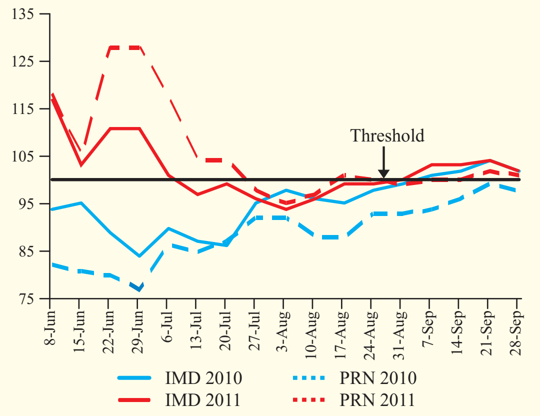


Chart I.3: PRN Index *vis-a-vis* IMD Index



expected to be higher than in the previous year. This is significant given the record production of foodgrains during 2010-11. The prospects of *rabi* crop are also perceived to be favourable due to the satisfactory performance of the monsoon. Thus, growth prospects of the agricultural sector in the current year appear to be good.

Improvement in productivity of major crops in recent years

I.11 The agricultural sector has witnessed resurgence in recent years. The sector was a key driver of growth during 2010-11. The increased agricultural production in recent years has been mainly due to improvement in productivity, while the area under cultivation has remained more or less constant for major crops (Chart I.4). With a view to ensuring food security to the growing population, productivity gains need to be consolidated and sustained.

Table I.2: *Kharif* 2011-12: Production and Area Sown

(Area in million hectares; Production in million tonnes)

Crops	Area sown as on October 14				Production	
	Normal	2010	2011	Per cent of Normal 2011	2010-11*	2011-12**
1	2	3	4	5	6	7
Total Foodgrains	**72.0**	**69.1**	**69.8**	**96.9**	**120.2**	**123.9**
of which			*(1.0)*			*(3.1)*
Rice	39.4	35.7	38.6	98.0	80.7	87.1
			(8.1)			*(7.9)*
Coarse Cereals	**22.0**	**21.2**	**20.0**	**90.9**	**32.4**	**30.4**
			(-5.7)			*(-6.2)*
Cereals	**61.3**	**56.9**	**58.6**	**95.6**	**113.1**	**117.5**
			(3.0)			*(3.9)*
Total Pulses	**10.6**	**12.2**	**11.2**	**105.7**	**7.1**	**6.4**
of which			*(-8.2)*			*(-9.9)*
Tur	3.5	4.6	3.9	111.4	2.9	2.9
Urad	2.2	2.5	2.3	104.5	1.4	1.2
Moong	2.6	2.8	2.4	92.3	1.5	1.2
Total Oilseeds	**17.7**	**17.5**	**18.1**	**102.3**	**20.8**	**20.9**
of which			*(3.4)*			*(0.5)*
Groundnut	5.1	5.0	4.3	84.3	5.7	5.6
Soyabean	8.8	9.3	10.3	117.0	12.7	12.6
Cotton#	**9.4**	**11.0**	**12.1**	**128.7**	**33.4**	**36.1**
			(10.0)			*(8.1)*
Jute & Mesta##	**0.9**	**0.9**	**0.9**	**100.0**	**10.6**	**11.2**
			(0.0)			*(5.7)*
Sugarcane (Cane)	**4.6**	**4.9**	**5.1**	**110.9**	**339.2**	**342.2**
			(4.1)			*(0.9)*
All Crops	**104.6**	**103.4**	**105.9**	**101.2**	-	-
			(2.4)			

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

Chart I.4: Average Growth in Yield - Major Crops

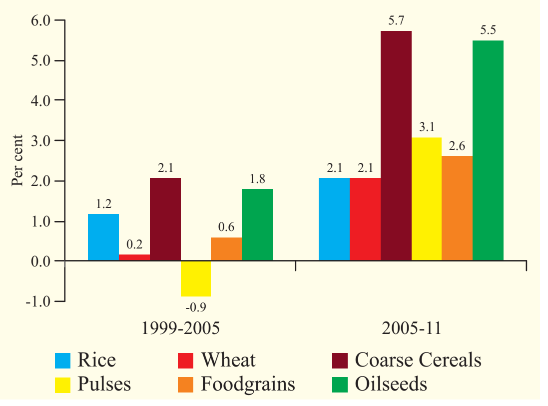
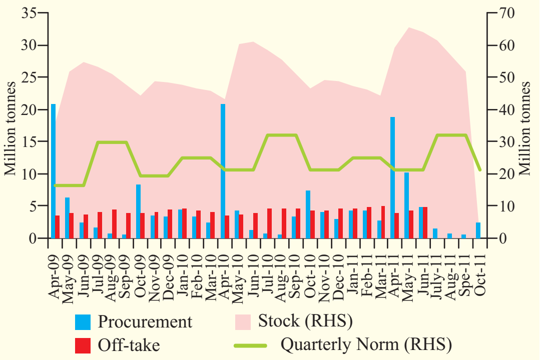


Chart I.5: Food Stock and its Determinants



Note: 1. Data for off-take is up to June 2011 and stock as on October 1, 2011.
2. Procurement and off-take data are monthly figures.
3. Procurement for October 2011 is as on October 13, 2011.

Food security and food stock management remain a challenge

I.12 The current stock of foodgrains, at around 52 million tonnes, is much higher than both the quarterly buffer and security reserve requirements (Chart I.5). This level of stocks is sufficient to meet the off-take required for various welfare schemes under the public distribution system (PDS). However, larger coverage and enhanced entitlement under the PDS, as envisaged under the proposed National Food Security Bill, may necessitate additional procurement. This would require creation of additional storage facilities.

I.13 Long term food security entails going beyond self-sufficiency to food surplus. The country is not yet self-sufficient in pulses and oilseeds. Latest data available from the consumer expenditure survey of 2009-10 conducted by the National Sample Survey Office (NSSO) suggests that there has been a structural change in food consumption pattern towards protein-rich food items, both in rural and urban areas. Simultaneously, the share of cereals in food has declined. A situation when the demand for high value items such as meat and fish, eggs, fruit and vegetables is rising faster than supply, calls for an overhaul of the entire supply chain mechanism. Development of vegetable clusters and terminal market complexes under the public-private partnership model is a significant step which holds immense potential for better post-harvest management and price discovery. The model Agriculture Produce Market Committee (APMC) Act allows for contract farming and markets in private/co-operative sectors. So far 17 States/Union Territories have amended their APMC Acts and the rest are in the process of doing so. Effective implementation of the model Act is necessary for developing a nation-wide agricultural market.

Industrial growth moderates amidst large volatility

I.14 The first five months of 2011-12 witnessed significant moderation in the growth of industrial production to 5.6 per cent from 8.7 per cent in the corresponding period of 2010-11. The slowdown in production was driven by manufacturing and mining, while electricity recorded robust growth (Table I.3).

I.15 Manufacturing sector growth decelerated significantly to 6.0 per cent during April-August 2011 from 9.2 per cent during the corresponding period of last year. The lower growth in manufacturing was on account of deceleration/negative growth in 14 out of 22 industry groups. As per use-based classification, moderation in growth was evident in all categories except basic goods and consumer non-durables.

I.16 The sharp moderation in manufacturing growth was reflective of deceleration in production of both capital and intermediate goods (Chart I.6). There has been significant volatility in the production of capital goods in the recent period. Volatility measured by standard deviation is 3.2 for IIP excluding

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

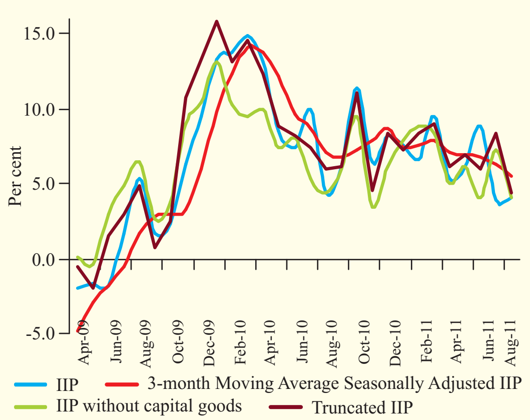
(Per cent)

Industry Group	Weight in the IIP	Growth Rate			Weighted Contribution#		
		Apr-Mar	Apr-Aug		Apr-Mar	Apr-Aug	
		2010-11	2010-11	2011-12 P	2010-11	2010-11	2011-12 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	14.2	5.2	7.7	0.2	7.3	10.1	0.2
Manufacturing	75.5	9.0	9.2	6.0	86.7	85.4	84.8
Electricity	10.3	5.5	4.1	9.5	5.9	4.5	15.0
Use-based							
Basic Goods	45.7	6.0	4.9	7.4	29.1	23.5	52.0
Capital Goods	8.8	14.8	18.9	7.2	25.1	28.2	18.0
Intermediate Goods	15.7	7.4	9.2	1.0	12.5	15.1	2.6
Consumer Goods (a+b)	29.8	8.6	8.9	4.8	33.3	33.2	27.4
a) Consumer Durables	8.5	14.2	16.3	4.3	24.0	26.1	11.4
b) Consumer Non-durables	21.3	4.3	3.4	5.1	9.3	7.1	16.0
General	**100.0**	**8.2**	**8.7**	**5.6**	**100.0**	**100.0**	**100.0**

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

capital goods, which is lower than 4.6 for the overall IIP during the period April 2009 to August 2011. The Reserve Bank's truncated measure of IIP (excluding volatile items) suggests stronger growth in 2011-12 so far than that suggested by general IIP.

Chart I.6: Industrial Growth (Y-o-Y)



I.17 The top five performing industries accounted for around 90 per cent of the growth in the manufacturing sector during April-August 2011 (Chart I.7).

Domestic industrial growth linked to global cycle

I.18 Going forward, in addition to the domestic factors, some adverse impact on domestic industrial growth may come from the slowing global manufacturing growth. Co-movement has been observed between the Indian and global industrial production in recent years

Chart I.7: Growth Concentration in Manufacturing Sector

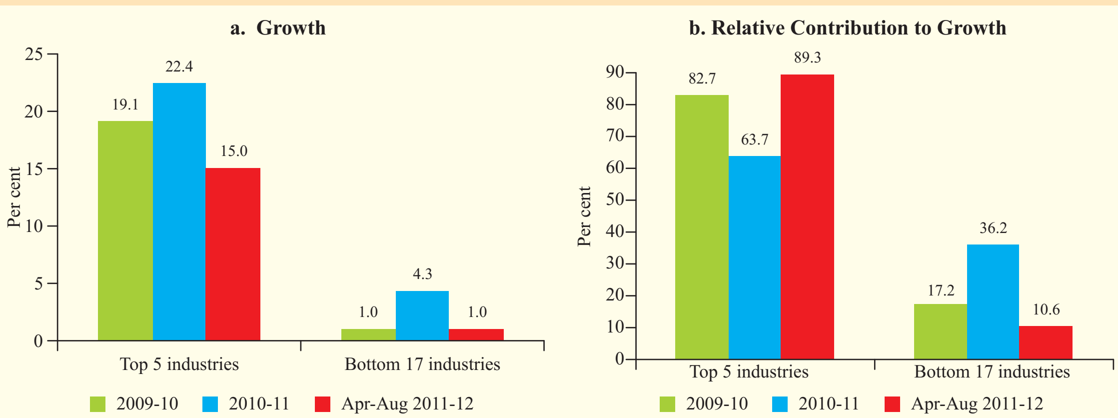
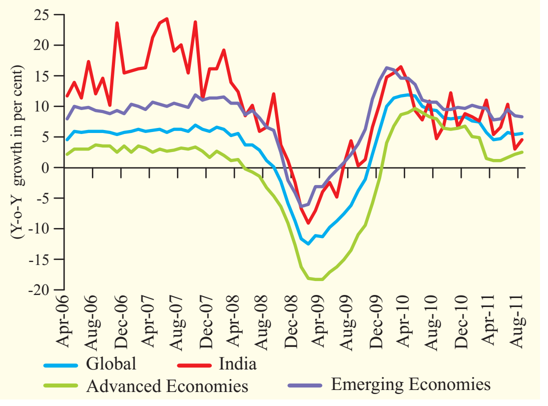


Chart I.8: Industrial Growth - India and the World



(Chart I.8). The correlation between the global and Indian industrial growth rates during October 2008-August 2011 is 0.91. The adverse impact may come mainly through trade channel as the global demand for intermediates and finished goods falls. However, some impact may also come through the capital flow channel as financing costs increase with risk aversion. Wealth effects from lower collateral valuations could also impact demand.

Growth in core industries remains subdued

I.19 The core infrastructure sector grew by 5.3 per cent during April-August 2011 compared with 6.1 per cent growth during the corresponding period of the previous year. The performance of core industries during the year is mainly supported by the robust performance of the electricity and steel sectors (Chart I.9).

Capacity utilisation eases

I.20 The Order Books, Inventories and Capacity Utilisation Survey (OBICUS) [http://www.rbi.org.in/OBICUS14] of the Reserve Bank shows a decline in new orders during the first quarter of 2011-12. This is reflected in lowering of capacity utilisation to 72.3 per cent in Q1 of 2011-12 from 77.8 per cent in Q4 of 2010-11, mainly due to seasonal factors (Chart I.10). New orders and capacity utilisation declined noticeably in basic metals, textiles, machinery and equipment, food products and beverages, and motor vehicles industries.

I.21 Capacity utilisation differed across various infrastructure industries during the first four months of 2011-12. While it was over stretched in petroleum refinery products; cement, fertiliser and finished steel industries showed lower capacity utilisation in relation to 2010-11 (Table I.4).

Chart I.10: OBICUS (Capacity Utilisation)

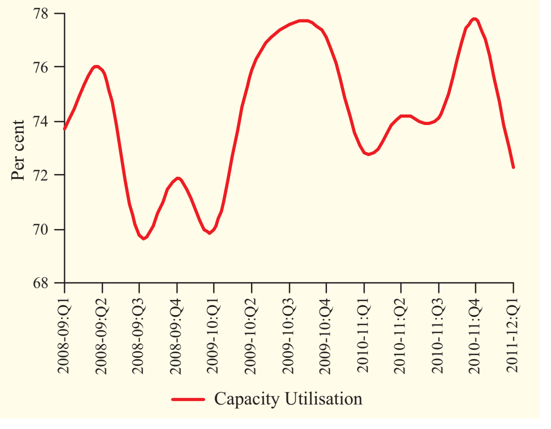


Chart 1.9: Growth in Infrastructure Industries

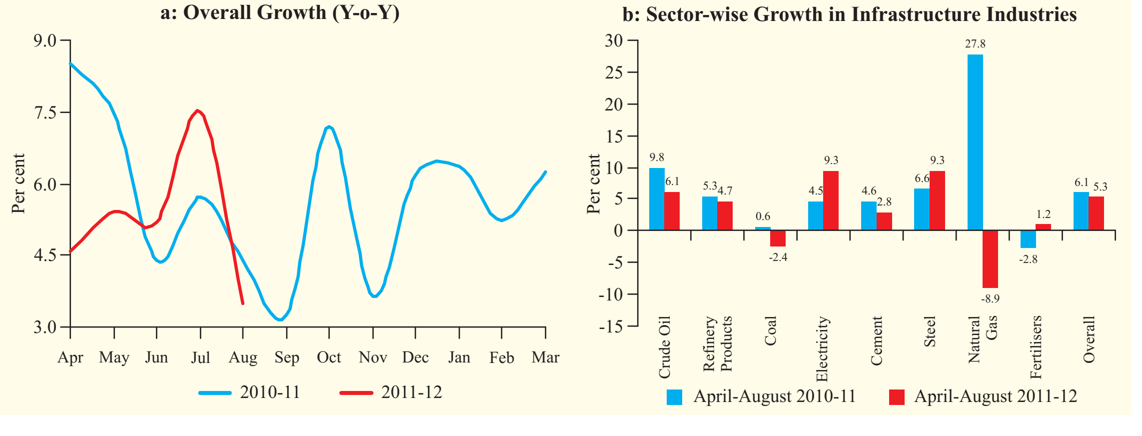


Table I. 4: Capacity Utilisation in Infrastructure Sector

(Per cent)

Sector	2009-10	2010-11	2011-12*
1	2	3	4
Finished Steel (SAIL+VSP+Tata Steel)	90.7	92.0	87.6
Cement	82.0	76.0	75.0
Fertilizer	93.6	94.5	91.9
Refinery Production-Petroleum	107.4	109.3	113.0
Thermal Power	77.7	75.1	75.1

*: Data pertain to April-July 2011.
Source: Capsule Report on Infrastructure Sector Performance, Ministry of Statistics and Programme Implementation, GoI.

Services sector growth also impacted but remains strong

I.22 The sharp moderation in construction and 'community, social and personal services' notwithstanding, the services sector grew by 8.9 per cent in Q1 of 2011-12, higher than the previous two quarters. The relatively better growth in 'trade, hotels, transport and communication' and 'financing, insurance, real estate and business services', contributed to the overall momentum in the sector. More recent data, however, indicates a deterioration in indicators for telecom and construction, which suggests that maintaining the momentum may be difficult (Table I.5).

Leading indicators suggest economy may be slowing down in 2011-12

I.23 Even though agriculture is poised to register good growth in 2011-12 and services sector continues to be robust, industrial growth during the year so far has been subdued. The PMI Index for September 2011 is just above the threshold level of 50, suggesting negligible expansion. This may partly reflect global factors, given the recent weak global manufacturing PMIs and the observed linkage between domestic and global industrial growth cycles. The mining sector, particularly coal, has been adversely affected. The sluggishness in core infrastructure sector growth could also pull down GDP growth in 2011-12. The under performance of the construction sector, which is the lead indicator of capital formation, suggests further weakening ahead. Capital goods production has shown considerable volatility since the previous year. Thus, lead indicators suggest the economy will experience moderation in growth during 2011-12.

Table I.5: Indicators of Services Sector Activity

(Growth in per cent)

Services Sector Indicators	2009-10	2010-11	April-July 2010	April-July 2011
1	2	3	4	5
Tourist arrivals	4.4	8.3	6.3$	9.3$
Cement	10.5	4.5	4.6#	2.8#
Steel	6.0	8.9	6.6#	9.3#
Railway revenue earning freight traffic	6.6	3.8	2.3#	6.1#
Cell phone connections	47.3	18.0	36.5	-31.3
Cargo handled at major ports	5.8	1.6	0.6#	4.5#
Civil aviation				
Domestic cargo traffic	24.3	23.7	33.6	-5.3
International cargo traffic	10.5	17.7	25.3	3.9
Domestic passenger traffic	15.6	18.1	21.2	17.9
International passenger traffic	8.8	10.3	12.6	8.8

#: Data pertain to April-August. $: Data pertain to April-September.
Source: Ministry of Tourism; Ministry of Statistics and Programme Implementation and CMIE.

II. AGGREGATE DEMAND*

Of late, there are signs of aggregate demand softening reflecting a combination of factors including monetary tightening, hindrances to execution of projects and deteriorating business confidence. Corporate investment intentions in new projects declined sharply since Q3 of 2010-11 and remain subdued. Private consumption has started to dampen with rising interest rates, but is still reasonably strong. However, risks to demand management persist from overshooting of government expenditures. With investment falling more than anticipated, and consumption responding less than intended, there is a need to rebalance private as well as government spending from consumption towards investment to sustain potential output growth.

Falling investment a concern as it lowers potential output

II.1 There is growing evidence of investment decelerating. Information from the corporate sector, the banking system's capex funding, housing transactions as well as falling construction activity suggest that investment has been adversely impacted. Project finance data received from 33 major banks/financial institutions also indicates a decline in investment intention in Q1 of 2011-12. During the quarter, 135 projects were sanctioned assistance amounting to about ₹80,300 crore as against 195 projects sanctioned assistance worth ₹1,42,800 crore during the corresponding quarter of the previous year. With corporate fixed investment having already declined in the second half of 2010-11, a further drop this year could reduce the pipeline investment in 2012-13 and impact potential growth ahead.

II.2 Some softening in investment demand was anticipated with significant monetary policy tightening since February 2010. However, the fall was aggravated by a combination of factors. Non-monetary factors, such as hindrances to execution and uncertainty about the global economy appear to have significantly impacted investment climate. There are risks of global factors causing further erosion in investment levels. Investment in the power sector has been impacted by concerns relating to coal supply and financials of State Electricity Boards. However, improvements in execution could see road investments pick up ahead as the National Highways Authority of India tendering is proceeding at an impressive rate in the current year.

External demand likely to weaken

II.3 Aggregate demand may remain weak in the second half of 2011-12 as external demand is likely to weaken as a result of slowing global economy. Despite an increase in the growth rate of net exports (as against a contraction in the previous two quarters), the contribution of net exports to aggregate demand reduced even further in the first quarter of 2011-12. The deterioration in the global economy in the recent period and the growing uncertainty in the euro area could adversely impact export demand going forward.

GDP growth improves even as private consumption growth moderates

II.4 Expenditure-side GDP estimates showed an improvement in growth during Q1 of 2011-12. Real GDP growth at market prices improved to 8.5 per cent during Q1 of 2011-12 compared with 7.7 per cent observed in the previous quarter, solely on account of the investment component. Even so, the growth rates of GDP at market prices and all its components were lower in Q1 of 2011-12 than in the

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

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

II.5 Private final consumption expenditure (PFCE), the largest component of aggregate demand, moderated during the first quarter of 2011-12. The moderation in PFCE growth is mainly due to tapering of demand in interest rate sensitive sectors. This is evident in the slackening of growth in the consumer durables segment of the IIP and, in particular, the dip in the sales of passenger cars in recent months, reflecting the combined impact of persistent inflationary pressures and monetary policy actions. These factors seemed to neutralise the impact of improved agriculture performance on rural demand. Government final consumption expenditure also moderated in Q1 of 2011-12.

Sales growth remains healthy though profits are under pressure

II.6 There was sustained growth in sales of select non-financial non-government companies in Q1 of 2011-12 reflecting strong demand, the deceleration in consumption notwithstanding. Also, accumulation of stock-in-trade as percentage of sales was lower in Q1 of 2011-12 as compared to that of the same period previous year and the preceding quarter (Table II.2 and Chart II.1). However, OBICUS showed that finished goods as well as raw material inventories increased during Q1 of 2011-12. Despite sustained growth in sales, there was lower growth in net profits compared with the previous three quarters, largely on account of higher input costs. Profit margins shrank and interest payments formed 2.8 per cent of sales and 21.7 per cent of gross profits in Q1 of 2011-12.

II.7 In Q1 of 2011-12, large companies (sales greater than ₹1,000 crore) reported the highest growth in sales at 24.8 per cent, while their net profits rose by 8.5 per cent. In contrast, small companies (sales less than ₹100 crore) registered decline in sales but registered 14.5 per cent growth in net profits. Profit margins of all companies – large, medium and small – dipped compared to the corresponding quarter of 2010-11.

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

(Per cent)

Item	2009-10 Q.E	2010-11 R.E.	2010-11 Q1	2010-11 Q2	2010-11 Q3	2010-11 Q4	2011-12 Q1
1	2	3	4	5	6	7	8
(Growth rate)							
Real GDP at Market Prices	9.1	8.8	9.1	9.1	9.2	7.7	8.5
Total Final Consumption Expenditure	8.7	8.0	9.1	8.5	7.4	7.5	5.7
Private	7.3	8.6	9.5	8.9	8.6	8.0	6.3
Government	16.4	4.8	6.7	6.4	1.9	4.9	2.1
Gross Fixed Capital Formation	7.3	8.6	11.1	11.9	7.8	0.4	7.9
Change in Stocks	90.8	7.4	9.3	9.0	5.1	4.6	4.7
Net Exports	10.2	-15.3	33.3	14.1	-52.6	-34.8	21.5
(Share in GDP)							
Total Final Consumption Expenditure	70.1	69.5	72.8	71.0	72.3	63.1	70.9
Private	58.5	58.3	61.7	60.1	60.1	52.6	60.5
Government	11.6	11.2	11.1	10.9	12.2	10.5	10.4
Gross Fixed Capital Formation	32.0	32.0	31.4	32.7	30.5	32.1	31.2
Change in Stocks	3.5	3.5	3.6	3.6	3.3	3.4	3.5
Net Exports	-7.2	-5.6	-7.7	-7.6	-3.8	-3.9	-8.6
Memo:							(₹ crore)
Real GDP at Market Prices	48,69,317	52,98,129	12,12,620	12,41,332	13,70,189	14,69,338	13,15,395

Q.E.: Quick Estimate. R.E.: Revised Estimate.
Note: As only major items are included in the table, data will not add up to 100.
Source: Central Statistics Office.

Table II.2: Corporate Sector- Financial Performance

(Per cent)

Item	2010-11 Q1	2010-11 Q2	2010-11 Q3	2010-11 Q4	2011-12 Q1
1	2	3	4	5	6
No. of Companies		2,426			
		(Growth rates in per cent)			
Sales	24.6	18.9	17.5	20.7	22.5
Expenditure	29.0	20.1	19.5	22.8	23.0
Raw Material	37.2	21.6	20.8	25.2	27.7
Staff Cost	16.4	20.2	21.1	20.4	19.9
Operating profits	15.6	7.4	10.9	16.8	12.4
Other Income*	-21.2	58.6	9.7	-20.8	40.8
Depreciation provision	19.8	17.2	14.3	14.8	9.8
Gross Profits	9.3	9.7	9.9	11.0	16.1
Interest payments	27.5	6.4	22.4	30.6	21.7
Profits after tax	3.8	39.0	9.6	14.0	6.2
		(Ratios in per cent)			
Change in stock# to Sales	2.6	0.8	1.4	2.3	1.3
Operating Profits to Sales	16.2	15.4	15.8	15.3	14.8
Gross Profits to Sales	13.7	13.5	13.5	13.4	13.0
Profits After Tax to Sales	8.6	10.9	8.4	8.6	7.4
Interest to Sales	2.8	2.6	2.6	2.5	2.8
Interest to Gross Profits	20.7	19.2	19.6	18.8	21.7
Interest Coverage (Times)	4.8	5.2	5.1	5.3	4.6

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

#: For companies reporting this item explicitly.

Note: Growth rates are percentage changes in the level for the period under reference over the corresponding period of the previous year for common set of companies.

II.8 In terms of sectoral breakdown, sales of manufacturing companies were higher at 25 per cent compared to those of IT companies (19 per cent) and companies in the services sector (14 per cent). While profit margins of manufacturing and non-IT services companies dipped in Q1 of 2011-12 compared with the corresponding quarter of last year, it remained the same for IT companies.

II.9 Early results of 161 companies for Q2 of 2011-12 suggest that sales growth remains healthy. With support from other income, the growth in net profits is maintained (Table II.3).

Fiscal slippages may complicate the task of aggregate demand management

II.10 The Central government's key deficit indicators have widened during 2011-12 (April-

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

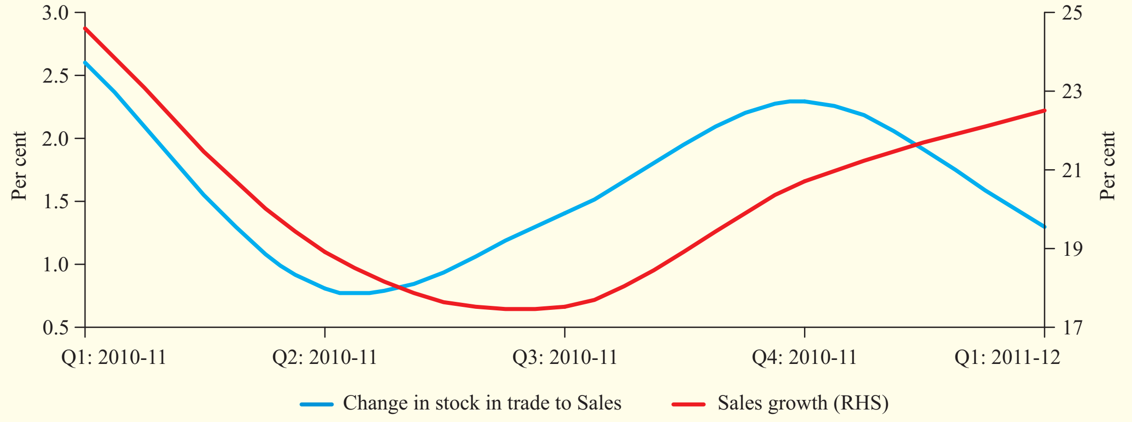


Table II.3: Early Results for Q2 of 2011-12

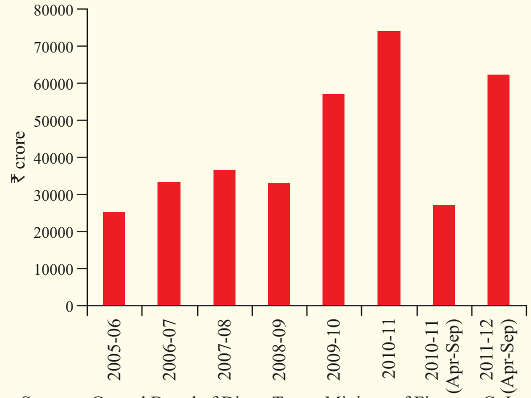
Indicator	2010-11 Q2	2011-12 Q1	2011-12 Q2
1	2	3	4
No. of companies		161*	
Growth rate (Y-o-Y) in per cent			
Sales	25.0	33.2	27.7
Expenditure	21.2	32.3	33.6
Raw Material	20.4	36.4	39.8
Staff Cost	23.7	29.7	21.3
Power and Fuel	41.3	45.9	22.5
Operating Profits	20.4	18.0	9.1
Other Income	28.3	55.0	113.3
Depreciation	29.5	4.4	1.0
Gross Profits	18.8	25.8	21.8
Interest	22.7	15.6	22.4
Tax Provision	24.6	40.6	33.1
Net Profits	19.2	23.4	22.7
Ratio in per cent			
Cost of raw material to Sales	65.2	68.5	68.9
Staff cost to Sales	8.8	8.3	8.5
Interest to Sales	1.2	1.0	1.2
Interest to Gross Profits	7.2	6.7	7.3
Interest Coverage	13.9	14.9	13.6
Operating Profits to Sales	19.4	17.0	16.6
Gross Profits to Sales	16.5	15.2	15.7
Net Profits to Sales	12.0	11.0	11.5

* : Of which 117 are manufacturing companies.

August) in comparison with the levels during the corresponding period of the previous year. The deficit continues to be higher during 2011-12 (April-August) even when adjusted for receipts from spectrum auctions during 2010-11 (April-August) in excess of the budgeted amount. The wider fiscal imbalances during the year so far reflect a sharp deceleration in tax revenues. The Centre's quarterly analysis of its own finances attributes the deceleration in tax revenue to frontloading of direct tax refunds, aimed at reducing the pendency of claims in the current year (Chart II.2). The higher recovery of loans and decline in capital expenditure, however, contained the deterioration in gross fiscal deficit (GFD) relative to that in revenue deficit (RD) (Table II.4).

II.11 Current indications are that the Central government's deficit targets for 2011-12 will be breached. The fiscal position during the course of the year will be shaped by the eventual growth outcome and its impact on tax revenues as well as the government's commitment towards controlling expenditure, especially non-plan revenue expenditure. Although total expenditure growth was lower during 2011-12 (April-August) than in the corresponding period of 2010-11, it remained above the budgeted growth. Furthermore, expenditure pressures from petroleum subsidies are yet to be fully accounted for in Central government finances during the year so far. The first instalment of supplementary demand for grants of the Central government presented in August 2011 did not provide for the additional allocation that may be required for petroleum subsidies.

Chart II.2: Direct Tax Refunds



Source : Central Board of Direct Taxes, Ministry of Finance, GoI.

II.12 These expenditure pressures, particularly on the revenue account, could partially offset the impact of demand compression. The previous quarter release of this Report had cautioned about the likelihood of fiscal slippage in 2011-12. There is a possibility of Central government missing its disinvestment target, which would add to the pressures of achieving the budgeted fiscal deficit for 2011-12. The Central government has announced an additional borrowing of nearly ₹53,000 crore in the second half of 2011-12, taking into account the shortfall in other sources of financing of fiscal deficit, mainly National Small Savings Fund (NSSF) and lower than budgeted opening cash balance.

Table II.4: Central Government Finances during April-August 2011

(₹ crore)

Item	2010-11 (RE)	2011-12 (BE)	April-August Amount		Percentage to Budget Estimates		Growth Rate (Per cent)	
	(Amount)		2010-11	2011-12	2010-11	2011-12	2010-11	2011-12
1	2	3	4	5	6	7	8	9
1. Revenue Receipts (i+ii)	7,83,833	7,89,892	2,90,799	1,88,550	42.6	23.9	85.0	-35.2
i) Tax Revenue (Net)	5,63,685	6,64,457	1,38,500	1,44,895	25.9	21.8	29.6	4.6
ii) Non-Tax Revenue	2,20,148	1,25,435	1,52,299	43,655	102.8	34.8	202.4	-71.3
2. Non-Debt Capital Receipts	31,745	55,020	5,479	10,144	12.1	18.4	42.9	85.1
3. Non-Plan Expenditure	8,21,552	8,16,182	3,11,249	3,40,215	42.3	41.7	26.9	9.3
of which								
i) Interest Payments	2,40,757	2,67,986	85,621	1,00,243	34.4	37.4	18.7	17.1
ii) Food Subsidies	60,600	60,573	31,953	28,216	57.5	46.6	21.9	-11.7
iii) Fertiliser Subsidies	54,976	49,998	21,927	26,308	43.9	52.6	-19.2	20.0
iv) Petroleum Subsidies*	3,386	3,640	858	1,034	27.6	28.4	4.5	20.5
	(3,85,21)	(2,36,76)	(14,866)	(21,043)				
4. Plan Expenditure	3,95,024	4,41,547	1,36,454	1,32,002	36.6	29.9	39.2	-3.3
5. Revenue Expenditure	10,53,677	10,97,162	3,91,151	4,18,550	40.8	38.1	25.3	7.0
6. Capital Expenditure	1,62,899	1,60,567	56,552	53,667	37.7	33.4	82.2	-5.1
7. Total Expenditure	12,16,576	12,57,729	4,47,703	4,72,217	40.4	37.5	30.4	5.5
8. Revenue Deficit	2,69,844	3,07,270	1,00,352	2,30,000	36.3	74.9	-35.3	129.2
			(1,71,614)		(62.1)		(10.7)	(34.0)
9. Gross Fiscal Deficit	4,00,998	4,12,817	1,51,425	2,73,523	39.7	66.3	-16.9	80.6
			(2,22,687)		(58.4)		(22.2)	(22.8)
10. Gross Primary Deficit	1,60,241	1,44,831	65,804	1,73,280	49.6	119.6	-40.3	163.3

***:** Figures in parentheses include primarily compensation to Oil Marketing Companies for under-recoveries and post Administered Pricing Mechanism subsidies.

Note: Figures in parentheses under items 8 and 9 are derived after adjusting for higher than budgeted one-off spectrum receipts during April-August 2010.

Source: Controller General of Accounts, Ministry of Finance.

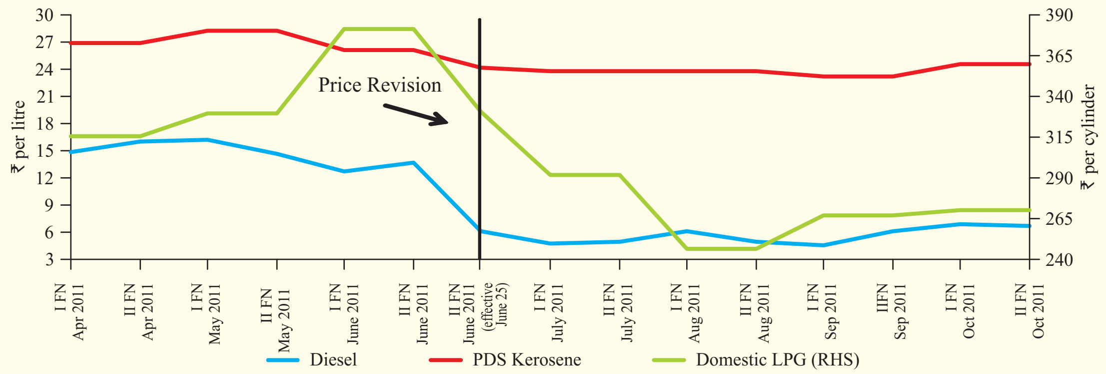
Subsidies likely to overshoot budget estimates

II.13 During 2011-12 (April-August), the growth in major subsidies, excluding compensation to Oil Marketing Companies (OMCs) for under-recoveries, was 1.5 per cent as against a decline budgeted for the year as a whole. Non-plan expenditure of the Ministry of Petroleum and Natural Gas which includes compensation to OMCs for under-recoveries registered y-o-y growth of 42 per cent during the period. According to the Petroleum Planning and Analysis Cell (PPAC), the under-recoveries reported by OMCs for the first half of 2011-12 amounted to ₹64,900 crore. The per unit under-recovery on sale of petroleum products has been firming up since mid-September 2011, in line with the weakening of the rupee notwithstanding some interim decline in global crude oil prices (Chart II.3).

II.14 Based on the current assessment of under-recoveries of OMCs for 2011-12 as a whole, expenditure on petroleum subsidies could range between 0.74 per cent and 0.87 per cent of GDP depending on the extent of burden sharing by the Central government as compared with the budget estimate of 0.26 per cent of GDP for 2011-12. The subdued growth in revenue receipts may pose a risk of spillover of the current year's petroleum subsidy burden to the next year. On the other hand, if the international crude oil prices decline in response to sluggish global demand, the under-recoveries may be contained, easing the petroleum subsidy burden.

II.15 There are further upside risks to GFD on account of revenue shortfall for the Centre of around 0.29 per cent of GDP due to changes in the duty structure of petroleum products. Similarly, there are signs of pressures emerging

Chart II.3: Under Recoveries of Oil Marketing Companies per Unit of Product



Note: I FN : First fortnight. **II FN:** Second fortnight.
Source : PPAC, Ministry of Petroleum and Natural Gas, GoI.

in respect of expenditures on fertiliser subsidies, evident from the data on Central government finances during April-August 2011.

State finances expected to remain on track

II.16 The States resumed fiscal consolidation in 2010-11 and have budgeted to carry it forward during 2011-12. At a consolidated level, the revenue account is budgeted to turn into surplus in the current year after remaining in deficit during the previous two years and the GFD-GDP ratio is expected to decline further (Table II.5). The fiscal correction in 2011-12 is expected primarily on the basis of budgeted decline in revenue expenditures. It may be noted that 12 States announced reduction in rates of value added tax (VAT) on petroleum products during June-July 2011 to provide relief to the consumers in the wake of upward revision in administered prices on select petroleum products. During 2011-12 (April-August), States received lower grants from the Centre than a year ago, even though tax devolution has been on track.

II.17 The small savings collections under NSSF witnessed a net outflow of ₹5,485 crore during April-August 2011 as against a net inflow of ₹25,291 crore during the corresponding period of the previous year. This has affected NSSF's

Table II.5 : Key Fiscal Indicators

(Per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal deficit	Outstanding Liabilities#
1	2	3	4	5
Centre				
2009-10	3.1	5.2	6.4	53.7
2010-11 RE	2.0	3.4	5.1	49.9
2011-12 BE	1.6	3.4	4.6	48.5
States*				
2009-10	1.2	0.5	2.9	25.0
2010-11 RE	1.0	0.3	2.6	23.0
2011-12 BE	0.7	-0.2	2.2	22.4
Combined				
2009-10	4.5	5.6	9.3	69.2
2010-11 RE	3.2	3.7	7.7	64.3
2011-12 BE	2.4	3.2	6.8	63.0

RE: Revised Estimates. BE: Budget Estimates.
#: Includes external liabilities of the Centre calculated at historical exchange rate.
*: Data are provisional and based on budgets of 28 State governments of which five are Vote on Account.
Source: Budget documents of the Central and State governments.

contribution to financing State governments' GFD. As a result, State governments' reliance on market borrowings during 2011-12 (April-September) was higher than a year ago. The surplus cash balances of State governments invested in the Central government's Treasury Bills as on October 14, 2011 were, however, higher than a year ago.

Need to rebalance government spending to support investment

II.18 The sharp slowdown in investment can affect growth going forward. Hindrances to execution of projects and problems relating to land acquisition seem to be affecting investor sentiments. Consumption demand has started to fall for interest rate sensitive sectors, but this is in line with the near-term policy objective of dampening inflation. Given the growth outlook, there is a risk of not meeting the tax collection target. With oil prices remaining at elevated levels, the subsidy burden of the Government is expected to be much higher than budgeted. Hence, the process of fiscal consolidation is likely to suffer a setback. Fiscal slippage would further complicate management of aggregate demand. A possible crowding out of private investment will pose stronger downside risks to growth. This can be addressed by rebalancing government spending from consumption to investment at this critical juncture and by putting in place complementary policies to support investment.

III. THE EXTERNAL SECTOR

Despite a surge in exports and higher net invisibles receipts, the current account deficit (CAD) increased during Q1 of 2011-12 reflecting strong import growth on account of higher oil prices and sharp increase in imports of gold & silver, machinery and electronics. The composition of capital inflows shifted with a sharp fall in FII inflows and rise in FDI. The uncertainties associated with the sovereign debt problem in the euro area and the slowdown in the US could pose challenges for India's external sector. The external sector outlook, though stable in the baseline scenario, will require close monitoring with a greater emphasis on encouraging FDI inflows.

Widening CAD poses risks amidst uncertain global conditions

III.1 Although merchandise export growth outpaced import growth, CAD surged during Q1 of 2011-12 in absolute terms, reflecting sharp increase in imports of oil, gold, silver, machinery and electronics. The wider CAD was financed comfortably with an improvement in capital flows, particularly on account of a marked increase in FDI inflows. Going forward, the external sector is expected to remain manageable although the upside risks to CAD have increased arising from slowing global economy and debt-related stress in euro area, in particular.

Trade deficit widened in spite of high export growth

III.2 Merchandise exports grew at a higher than anticipated rate during April-September 2011 reflecting continued diversification in terms of commodities as well as export destinations. The rise in exports was particularly on account of engineering goods (103 per cent) and petroleum & oil products (53 per cent). However, during this period, there was a sharp rise in imports as well, which led to the widening of the trade deficit. The high growth in imports stemmed from an increase in oil imports (42 per cent) and non-oil import items, *viz*., gold and silver (80 per cent), machinery (34 per cent), electronics (33 per cent) and organic and inorganic chemicals (26 per cent). Notably, non-oil trade deficit remained unchanged in nominal terms (Table III.1 and Chart III.1).

Exports may slowdown ahead in a tougher climate

III.3 India's export growth has shown unexpected buoyancy in recent months, despite the slowdown in advanced economies (AEs) and rising global uncertainty (Table III.2). This,

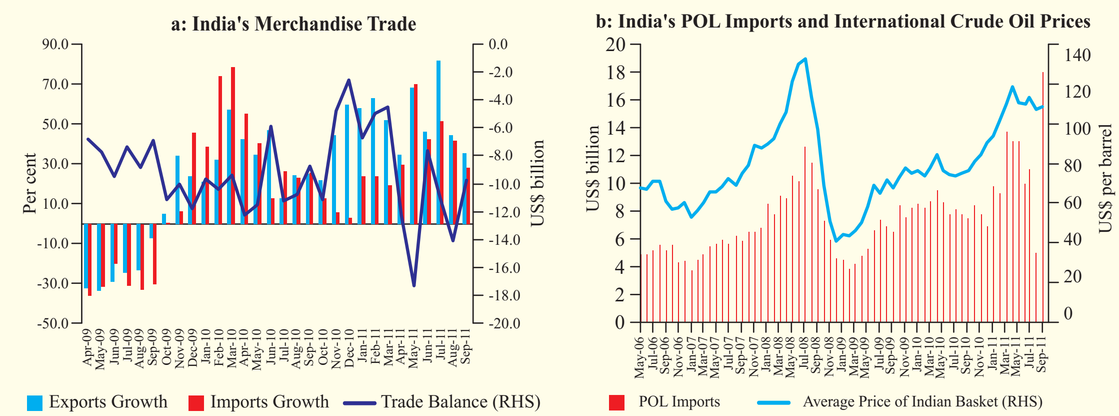
Table III.1: India's Merchandise Trade

(US$ billion)

Item	2009-10 (R)		2010-11 (P)		April-September (P)			
					2010-11		2011-12	
	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth (%)
1	2	3	4	5	6	7	8	9
Exports	178.8	-2.2	254.4	42.3	105.4	30.1	160.0	51.8
Oil	28.2	2.3	41.9	48.7	17.7	63.9	27.0	52.5
Non-oil	150.6	-3.0	212.5	41.1	87.7	24.9	133.0	51.7
Imports	288.4	-3.5	352.6	22.3	167.2	30.5	233.5	39.7
Oil	87.1	-7.0	106.1	21.7	49.4	31.7	70.4	42.5
Non-oil	201.3	-1.9	246.5	22.5	117.8	29.9	163.1	38.5
Trade Deficit	**-109.6**	**-5.5**	**-98.2**	**-10.4**	**-61.8**	**30.9**	**-73.5**	**18.9**
Non-oil Trade Deficit	**-50.6**	**1.4**	**-34.0**	**-32.8**	**-30.1**	**46.8**	**-30.1**	**0.0**

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

Chart III.1: India's Merchandise Trade



among others, was a reflection of the continued diversification of India's exports to other emerging and developing economies (EDEs) where growth buoyancy was still intact as also the domestic trade policies intended to support exports. However, the slowing of AEs, with some weakening of growth prospects of EDEs, may weigh on India's exports in subsequent months.

Global trade may decelerate on weakening global demand and rising risk aversion

III.4 The growth in global trade has remained volatile reflecting the uncertain global environment (Chart III.2). Both the IMF and the WTO have projected a lower growth in world trade volume reflecting weakening global demand. The IMF has reduced its earlier forecast for world goods and services trade from 8.2 per cent to 7.5 per cent for 2011 and further to 5.8 per cent for 2012. The WTO has lowered its forecast for merchandise trade volume growth to 5.8 per cent in 2011 from its previous estimate of 6.5 per cent.

Growth in services exports may also decelerate

III.5 The surplus on account of invisibles continued to finance around 60 per cent of the merchandise trade deficit in Q1 of 2011-12. Within services, export of software services continued to grow in Q1, though at a lower rate than during the previous quarter. Private transfers, representing workers' remittances from abroad, remained marginally higher in Q1 than in the corresponding quarter of the previous year despite uncertainties in source countries. The decline in investment income, reflecting lower interest rates abroad, also impacted the overall net receipts on account of invisibles

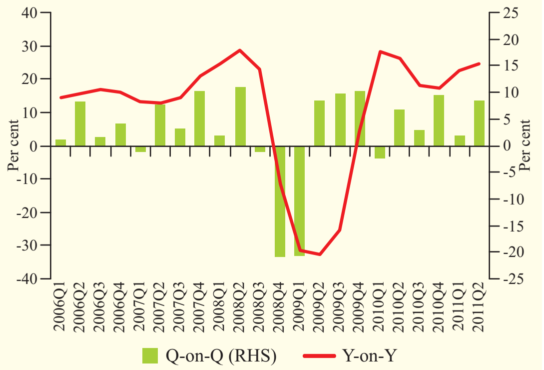
Table III.2: India's Balance of Payments

(US $ billion)

	2009-10 (PR)	2010-11 (P)	2010-11				2011-12
			Q1(PR)	Q2(PR)	Q3(PR)	Q4(PR)	Q1(P)
1	2	3	4	5	6	7	8
1. Exports	182.2	250.5	55.3	52.0	65.9	77.2	80.6
2. Imports	300.6	380.9	87.2	89.3	97.4	107.1	116.1
3. Trade Balance (1-2)	-118.4	-130.5	-31.9	-37.3	-31.5	-29.9	-35.5
4. Net Invisibles	80.0	86.2	19.8	20.5	21.5	24.5	21.3
5. Current Account Balance (3+4)	-38.4	-44.3	-12.1	-16.8	-10.0	-5.4	-14.2
6. Gross Capital Inflows	345.7	496.0	94.5	112.1	173.7	115.7	127.3
7. Gross Capital Outflows	292.3	436.3	77.7	90.8	160.3	107.5	106.4
8. Net Capital Account (6-7)	53.4	59.7	16.8	21.4	13.4	8.2	20.9
9. Overall Balance (5+8)#	**13.4**	**13.0**	**3.7**	**3.3**	**4.0**	**2.0**	**5.4**

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

Chart III.2: Growth in World Merchandise Exports (Value)



Source: WTO

(Table III.3). In the coming quarters, a slowdown in the US and the euro area may have some impact for exports of invisibles, particularly software services, as was evident during Q4 of 2008-09 to Q2 of 2009-10.

Sharp decline in FII flows largely offset by strong FDI flows in Q2 of 2011-12

III.6 So far in 2011-12, capital inflows have exhibited an uptrend, mainly on account of robust FDI inflows and rise in external commercial borrowings (ECBs) and trade credit. FDI inflows were almost double the level recorded during the corresponding period of 2010-11 while ECBs also registered healthy growth (Table III.4). However, net FII inflows have not only been volatile but also significantly

Table III.3: Net Invisibles

(US $ billion)

Item	April-March		April-June	
	2009-10 (PR)	2010-11 (P)	2010-11 (PR)	2011-12 (P)
1	2	3	4	5
A. Services	35.7	47.7	9.6	12.1
Of which				
Travel	2.5	4.0	0.6	0.1
Transportation	-0.8	0.4	0.0	0.1
Software	48.2	56.8	12.5	14.2
Business Services	-6.7	-3.8	-1.1	-1.0
Financial Services	-0.9	-1.0	-0.2	-0.5
B. Transfers (Private)	52.1	53.4	13.1	13.7
C. Income	-8.0	-14.9	-2.9	-4.3
Investment Income	-7.2	-13.9	-2.6	-4.2
Compensation of employee	-0.8	-1.0	-0.3	-0.1
Invisibles (A+B+C)	**80.0**	**86.2**	**19.8**	**21.3**

P: Provisional. PR: Partially Revised.

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

(US $ billion)

Component	Period	2010-11	2011-12
1	2	3	4
FDI to India	April-August	11.7	21.0
FIIs (net)	April-Oct. 14	27.5	0.6
ADRs/GDRs	April-August	1.5	0.3
ECB Approvals	April-August	7.5	15.9
NRI Deposits (net)	April-August	1.9	2.1

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

low up to October 14, 2011. Volatility in FII inflows witnessed in Q2 mainly reflected concerns of a double-dip recession in the US and a worsening debt crisis in the euro area. During Q1 of 2011-12, the surplus on capital account at US$ 20.9 billion was more than adequate for financing the higher CAD at US$ 14.5 billion (Table III.5).

Overall capital flows to emerging markets entering an uncertain phase

III.7 EDEs are facing a general rise in volatility of capital flows with resurfacing of global downside risks and even the possibility of a reversal of such flows under extreme circumstances cannot be ruled out. The possibility of contagion from the euro area banking system to the EDEs remains high. This can operate through adverse impact on the balance sheets of the subsidiaries of European banks operating in the EDEs and due to investment funds liquidating their positions because of any losses on assets in AEs. Going forward, in context of India, buoyancy in FDI inflows may continue during the second half of 2011-12, as projects attracting significant FDI are already in the pipeline. Uncertainty remains, however, regarding portfolio flows, which are by nature volatile.

Debt creating capital flows also uncertain in spite of widening interest rate differential

III.8 During 2011-12 so far, ECBs registered healthy growth and NRI deposits also showed

Table III.5: Net Capital Flows

(US $ billion)

Item	April-March 2009-10 (PR)	April-March 2010-11 (P)	April-June 2010-11 (P)	April-June 2011-12 (P)
1	2	3	4	5
Net Capital flows	**53.4**	**59.7**	**16.8**	**20.9**
Of which				
1. Foreign Direct Investment	18.8	7.1	2.9	7.2
Inward FDI	33.1	23.4	6.1	12.9
Outward FDI	-14.4	-16.2	-3.2	-5.7
2. Portfolio Investment	32.4	30.3	4.6	2.5
Of which:				
FIIs	29.0	29.4	3.5	2.5
ADR/GDRs	3.3	2.0	1.1	0.3
3. External Assistance	2.9	4.9	2.5	0.4
4. External Commercial Borrowings	2.8	11.9	2.2	2.9
5. NRI Deposits	2.9	3.2	1.1	1.2
6. Short-term Trade Credit	7.6	11.0	4.3	3.1

P: Preliminary. PR: Partially Revised.

marginal increase. The ECB policy was further rationalised and liberalised in September 2011. The increase in the annual limit for eligible borrowers under the automatic route may help in sustaining the uptrend in ECBs in the coming quarters of 2011-12. However, euro imbroglio, if continues, may affect the availability and cost of debt creating flows.

Rupee sees significant nominal and real depreciation in Q2 of 2011-12

III.9 Based on narrow as well as broad currency baskets (*i.e.*, 6, 30 and 36 currency baskets), the Indian rupee depreciated sharply over end-March 2011 both in nominal and real terms (Table III.6).

External vulnerability indicators portray a mixed picture

III.10 India's external debt stock as at end-June 2011 showed an increase of US$10.4 billion over the level as at end-March 2011 mainly on account of ECBs reflecting interest rate differential and short-term trade credit reflecting surge in imports (Table III.7).

III.11 The key debt sustainability indicators, such as ratio of short-term debt to total external debt, ratio of short-term debt to reserves, and debt service ratio marginally worsened due to the continued dominance of debt creating flows. However, other indicators, *viz*., reserves cover for imports and debt service payments improved

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

(Per cent, appreciation+/depreciation-)

	Index Oct. 14, 2011 P	Year-on-Year Variation (Average) 2008-09	2009 10 P	2010- 11 P	2011-12 (P) (Oct. 14 over end-Mar.)
1	2	3	4	5	6
36-REER	99.5	-9.9	-3.1	7.9	-4.1
36-NEER	85.5	-10.9	-2.6	2.9	-8.0
30-REER	92.4	-10.2	-4.6	4.5	-2.0
30-NEER	87.9	-8.4	-2.2	1.1	-7.1
6-REER	109.7	-9.3	-0.3	13.0	-6.3
6-NEER	82.7	-13.6	-3.7	5.6	-9.0
₹/USD (Average)	45.3	-12.4	-3.2	4.0	1.7#
₹/USD (end-March)	49.1*	-21.5	12.9	1.1	-9.1

NEER: Nominal Effective Exchange Rate. REER: Real Effective Exchange Rate. P: Provisional.
*: As on October 18, 2011. #: Apr. – Sept. 2011 over Apr. – Sept. 2010.
Note: Rise in indices indicates appreciation of the rupee and *vice versa*.

Table III.7: India's External Debt

(US$ billion)

Item	End-March 2010 PR	End-March 2011 P	End-June 2011 P	Variation (End-June 2011 over End-March 2011)	
				Amount	Per cent
1	2	3	4	5	6
1. Multilateral	42.9	48.5	49.4	0.9	1.9
2. Bilateral	22.6	25.8	26.3	0.5	1.9
3. International Monetary Fund	6.0	6.3	6.4	0.1	0.9
4. Trade Credit (above 1 year)	16.9	18.6	18.7	0.1	0.3
5. External Commercial Borrowings	70.8	88.9	93.2	4.3	4.8
6. NRI Deposits	47.9	51.7	52.9	1.2	2.4
7. Rupee Debt	1.7	1.6	1.6	0.0	-2.1
8. Long-term (1 to 7)	208.7	241.5	248.4	6.9	2.9
9. Short-term	52.3	65.0	68.5	3.5	5.4
Total (8+9)	**261.0**	**306.4**	**316.9**	**10.5**	**3.4**

P: Provisional. PR: Partially Revised.

during Q1 of 2011-12 (Table III.8). Going forward, debt flows may increase further due to persistence of interest rate differentials, higher annual ceiling for ECBs under the automatic route for corporates in specified sectors and liberalisation of investment by FIIs in corporate bonds for the infrastructure sector.

External sector outlook, although stable, warrants close monitoring

III.12 With progressive diversification both in terms of commodities as well as destinations, exports during the year so far (up to September 2011) have grown faster than imports and net services also continue to grow albeit at moderate pace. However, owing to increasing uncertainty in growth prospects of US and European economies, the growth momentum in exports seen so far may not be sustained and growth in services exports may also remain moderate in the coming months. While uncertain global economic and financial prospects underpinned volatile international price of crude oil, some moderation in prices due to downward revision in global oil demand in coming period may provide some relief.

III.13 Trends in capital inflows so far suggest that the economy has received sufficient flows to finance CAD during the first half of 2011-12. Although there has been a marked decline in net FII flows, a significant pick up in FDI inflows augurs well from the sustainability point of view. Going forward, capital flows into India will depend on how the economic and financial conditions in AEs, particularly the US and the euro area, evolve during the second half and whether relative growth and interest rate differential would suffice to outweigh the general risk perception among foreign investors. It is, therefore, important to encourage FDI inflows to impart stability to India's capital account. Overall, the balance of payments outlook for 2011-12, although stable, warrants close monitoring.

Table III.8: External Sector Vulnerability Indicators

(Per cent)

Indicator	End-March 2010	End-June 2010	End-March 2011	End-June 2011
1	2	3	4	5
1. Ratio of Total Debt to GDP	18.0	–	17.4	–
2. Ratio of Short-term to Total Debt (Original Maturity)	20.0	21.2	21.2	21.6
3. Ratio of Short-term to Total Debt (Residual Maturity)	41.2	42.5	42.2	43.3
4. Ratio of Concessional Debt to Total Debt	16.8	15.9	15.5	15.1
5. Ratio of Reserves to Total Debt	106.9	98.0	99.5	99.6
6. Ratio of Short-term Debt to Reserves	18.8	21.0	21.3	21.7
7. Reserves Cover for Imports (in months)	11.1	10.7	9.6	10.0
8. Reserves Cover for Imports and Debt Service Payments (in months)	10.5	10.1	9.2	9.5
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	5.5	4.2	4.2	4.6

IV. MONETARY AND LIQUIDITY CONDITIONS

In the Q2 of 2011-12, liquidity conditions continued to remain in deficit mode, in line with the policy objective of the Reserve Bank. Base money decelerated as currency growth moderated. Money (M_3) growth, however, accelerated moderately as the money multiplier increased. While credit growth is above the indicative trajectory, it will moderate as growth decelerates. Going forward, the global uncertainty and fiscal pressures pose challenges to effective monetary policy management.

Significant monetary tightening in the face of high inflation

IV.1 The Reserve Bank has been pursuing a tight monetary policy stance since early 2010 in response to sustained inflationary pressures. Inflation, which initially emerged from supply side constraints, increasingly became generalised and the Reserve Bank had to calibrate its policy response to anchor inflation expectations, while at the same time ensuring that the growth impulses of the economy were not hampered. In continuation of this policy stance, the Reserve Bank raised the policy repo rate by 50 bps in July 2011 and again by 25 bps in September 2011 (Table IV. 1). The level of policy rate and inflation presently are broadly comparable to the levels prevailing in September 2008 (Chart IV.1).

Liquidity remained in deficit mode

IV.2 The average LAF injection, which was around ₹49,000 crore in the first quarter of 2011-12, dropped marginally to around ₹47,000 crore in the second quarter of 2011-12 mirroring the increase in centre's cash deficit. Liquidity deficit largely remained within (+/-) 1 per cent of NDTL of the banks, in line with the stated policy objective of the Reserve Bank. The liquidity deficit, which had witnessed some stress in June 2011 due to quarterly advance tax payouts, eased in early July 2011, reflecting

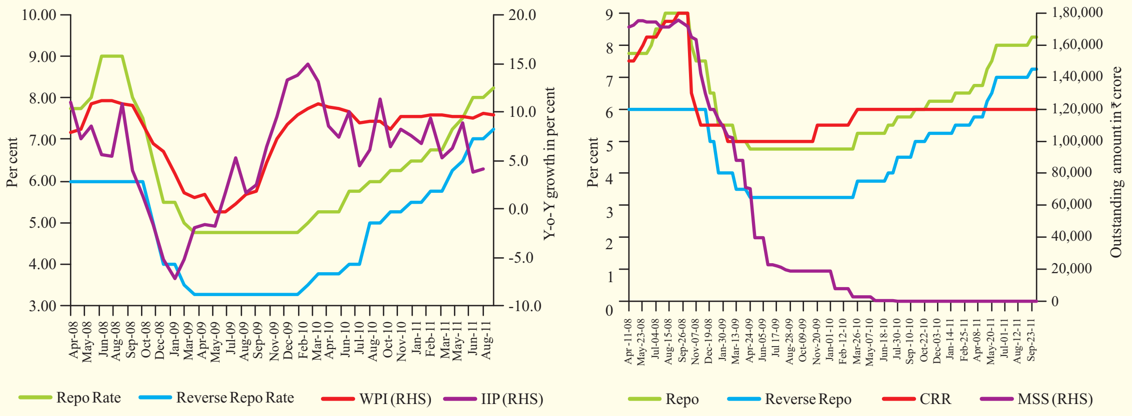
Table IV.1: Movements in Key Rates in India

(Per cent)

Effective Since	Reverse Repo Rate	Repo Rate	Marginal Standing Facility Rate	Cash Reserve Ratio
1	2	3	4	5
Apr. 21, 2009	3.25 (-0.25)	4.75 (-0.25)		5.00
Feb. 13, 2010	3.25	4.75		5.50 (+0.50)
Feb.27, 2010	3.25	4.75		5.75 (+0.25)
Mar. 19, 2010	3.50 (+0.25)	5.00 (+0.25)		5.75
Apr. 20, 2010	3.75 (+0.25)	5.25 (+0.25)		5.75
Apr. 24, 2010	3.75	5.25		6.00 (+0.25)
Jul. 2, 2010	4.00 (+0.25)	5.50 (+0.25)		6.00
Jul. 27, 2010	4.50 (+0.50)	5.75 (+0.25)		6.00
Sept. 16, 2010	5.00 (+0.50)	6.00 (+0.25)		6.00
Nov. 2, 2010	5.25 (+0.25)	6.25 (+0.25)		6.00
Jan. 25, 2011	5.50 (+0.25)	6.50 (+0.25)		6.00
Mar. 17, 2011	5.75 (+0.25)	6.75 (+0.25)		6.00
May 3, 2011	6.25 (+0.50)	7.25 (+0.50)		6.00
May 9, 2011	6.25	7.25	8.25	6.00
Jun 16, 2011	6.50 (+0.25)	7.50 (+0.25)	8.50 (+0.25)	6.00
July 26, 2011	7.00 (+0.50)	8.00 (+0.50)	9.00 (+0.50)	6.00
Sept. 16, 2011	7.25 (+0.25)	8.25 (+0.25)	9.25 (+0.25)	6.00

Note : 1. Reverse repo indicates absorption of liquidity and repo indicates injection of liquidity.
2. As announced in Monetary Policy Statement 2011-12, the Marginal Standing Facility came into effect from May 9, 2011.
3. Figures in parentheses indicate change in policy rates in percentage points.

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



the drawdown of Central Government cash balances and transition to WMA/OD (Chart IV.2 and Table IV.2). Since the introduction of the new operating procedures of monetary policy in May 2011, injection of liquidity under the marginal standing facility (MSF) has been limited to two occasions (₹100 crore on June 10 and ₹4,105 crore on July 15, 2011), which is indicative of the liquidity position not getting over tight.

IV.3 While repo auctions under LAF continued to be conducted between 9.30 am and 10.30 am, the Reserve Bank decided to shift the reverse repo auctions under LAF and MSF operations to the afternoon time slot of 4.30 pm to 5.00 pm on all working days (excluding Saturdays) with effect from August 16, 2011. The prime reason for shifting the reverse repo window to the afternoon slot is to encourage the market participants to trade amongst themselves and to park any surplus with the Reserve Bank only after exhausting all other avenues to deploy the funds in the money market.

Base money growth slows, reflects moderation in currency expansion

IV.4 The decelerating trend of base money since December 2010 continued during the second quarter of 2011-12 mainly on account of an absence of significant injection of primary liquidity by the Reserve Bank. While moderate amount of liquidity was injected through LAF operations, no significant primary liquidity was injected either by way of outright purchases of G-Sec or forex operations. In addition, currency growth, which had witnessed significant acceleration and remained above money supply

Chart IV.2: LAF Volumes and GoI Surplus

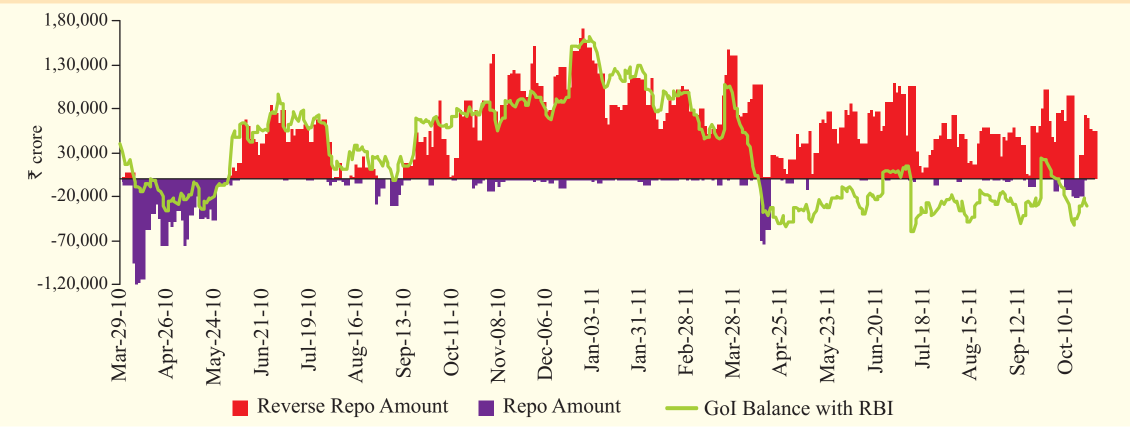


Table IV.2: Liquidity Position

(₹ crore)

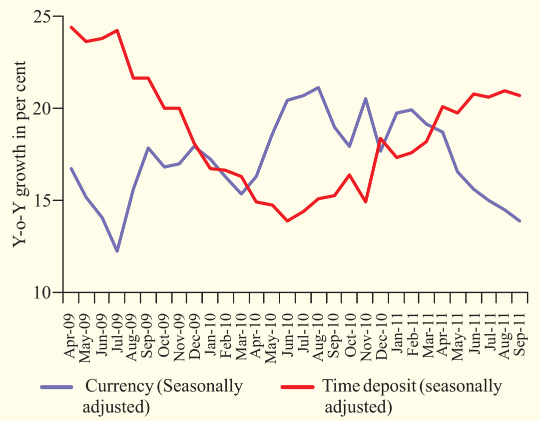
Outstanding as on last Friday	LAF	MSS	Centre's Surplus@	Total
1	2	3	4	5=(2+3+4)
2010				
April	35,720	2,737	-28,868	9,589
May	6,215	317	-7,531	-999
June	-74,795	317	76,431	1,953
July	1,775	0	16,688	18,463
August	11,815	0	20,054	31,869
September	-30,250	0	65,477	35,227
October	-1,17,660	0	86,459	-31,201
November	-1,03,090	0	93,425	-9,665
December	-1,13,415	0	1,44,437	31,022
2011				
January	-76,730	0	1,18,371	41,641
February	-72,005	0	77,397	5,392
March*	-1,06,005	0	16,416	-89,589
April	-39,605	0	-35,399	-75,004
May	-75,795	0	-9,544	-85,339
June	-96,205	0	8,339	-87,866
July	-48,555	0	-25,983	-74,538
August	-49,215	0	-21,192	-70,407
September	-82,645	0	-24,387	-1,07,032
October (on 14th)	-54,270	0	-32,883	-87,153

@ : Excludes minimum cash balances with the Reserve Bank in case of surplus.
* : Data pertain to March 31

Note: 1. Negative sign in column 2 indicates injection of liquidity through LAF.
2. Negative sign in column 4 indicates WMA /OD availed by the Central Government.

growth for most part of 2010-11, has also been decelerating since the first quarter of 2011-12 which moderated the base money expansion. The increase in term deposit interest rates since September 2010 prompted a switch from currency holdings and demand deposits to time deposits (Chart IV.3).

Chart IV.3: Currency Growth



Growing endogeneity of money keeps money supply above trajectory

IV.5 While the base money growth has decelerated sharply, the money supply growth accelerated moderately as the money multiplier rose (Table IV.3 and Chart IV.4). This divergent trend in base money and broad money arises out of increasing endogeneity of money supply as banks respond to strong credit demand, which is met through recourse to additional borrowings, including that from the central bank.

Robust deposit growth

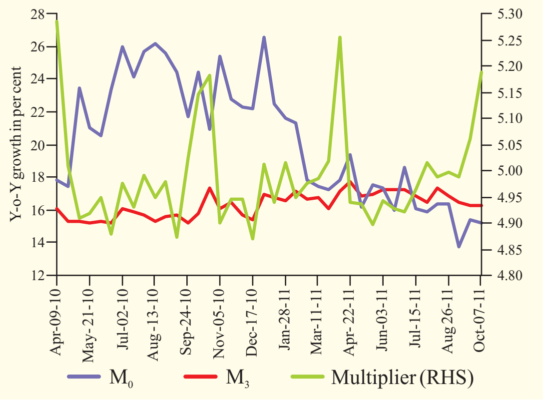
IV.6 Deposits registered robust growth since December 2010 due to successive hikes in

Table IV.3: Monetary Indicators

Item	Outstanding Amount (₹ crore)	FY variations (per cent)		Y-o-Y Variations (per cent)	
	Oct. 07, 2011	2010-11	2011-12	Oct. 08, 2010	Oct. 07, 2011
1	2	3	4	5	6
Reserve Money (M_0)*	**13,84,833**	**6.2**	**0.6**	**21.4**	**12.8**
Broad Money (M_3)	**69,62,822**	**6.9**	**7.1**	**15.8**	**16.2**
Main Components of M_3					
Currency with the Public	9,49,232	8.6	3.8	18.9	13.8
Aggregate Deposits	60,11,223	6.6	7.7	15.3	16.7
of which: Demand Deposits	6,51,919	-5.9	-9.2	14.3	-3.5
Time Deposits	53,59,304	8.8	10.2	15.5	19.7
Main Sources of M_3					
Net Bank Credit to Govt.	21,57,973	5.2	8.8	22.5	22.9
Bank Credit to Commercial Sector	44,44,825	7.3	4.9	19.8	18.7
Net Foreign Assets of the Banking Sector	15,42,066	5.1	10.7	1.1	14.5

Note: 1. Data are provisional.
2. * : Data pertain to October 14, 2011.

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



interest rates. The opportunity cost of saving in lower interest bearing instruments like small savings increased, resulting in a shift from small savings to term deposits (Chart IV.5).

IV.7 During 2011-12 so far, banks' investment in government securities has accelerated (Chart IV.6 a). However, no sharp rise in SLR maintenance is observed as NDTL has increased at a higher rate (Chart IV.6 b).

Credit expansion still above indicative trajectory but may correct ahead

IV.8 Credit growth, which had witnessed a sharp deceleration in the first quarter of 2011-12, continued the trend in the initial period of the second quarter, partly reflecting high base of last year (Chart IV.7). Notwithstanding this deceleration, credit growth remained above the indicative trajectory of 18 per cent set out by the Reserve Bank in the July 2011 review, mainly due to high nominal GDP growth.

IV.9 During the first three quarters of 2010-11, the divergence between credit growth and deposit growth was high and growing. As the cost of funds under LAF increased progressively with the rise in the repo rate, banks raised their deposit and lending rates. This stronger transmission of monetary policy helped in narrowing the divergence between deposit and credit growth. The gap between the two declined from 9 percentage points in mid-December 2010 to 5.6 percentage points in March 2011 and further to 2.1 percentage points in October 2011(Chart IV.8).

Non-banking sources dominate credit expansion

IV.10 The non-bank sources have occupied the space that was vacated by banks in meeting the credit requirements of the economy during 2011-12 so far (up to September 2011) (Table IV.4). This is reflected in the increase in the share of non-bank sources in total flow of financial resources from about 46 per cent in April-September 2010 to 54 per cent in April-September 2011, with both domestic and foreign funding sources showing significant increase. Within domestic sources, net issuance under CPs, NBFCs-ND-SI and housing finance companies (HFCs) increased. The resource flow from external sources rose on account of higher mobilisation through FDI and ECBs.

Chart IV.5: Behaviour of Time Deposits

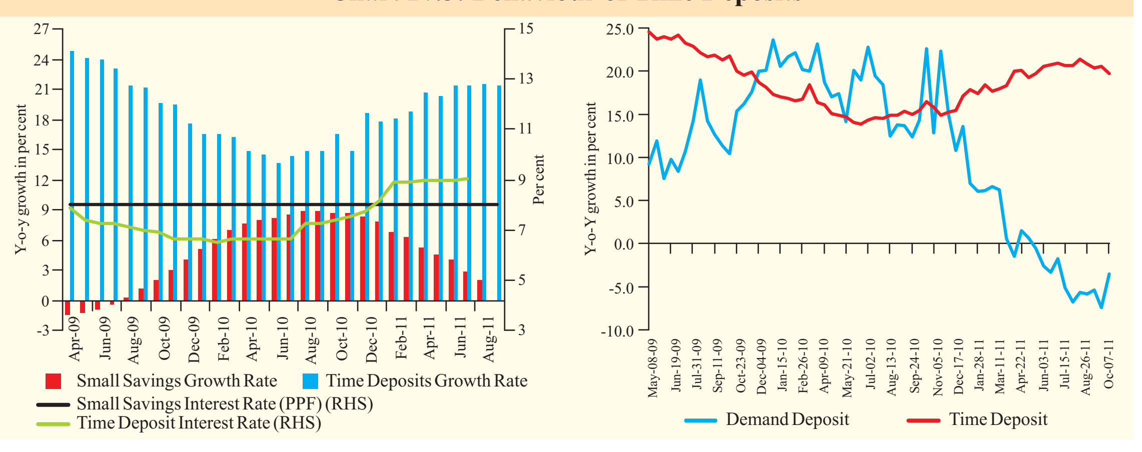
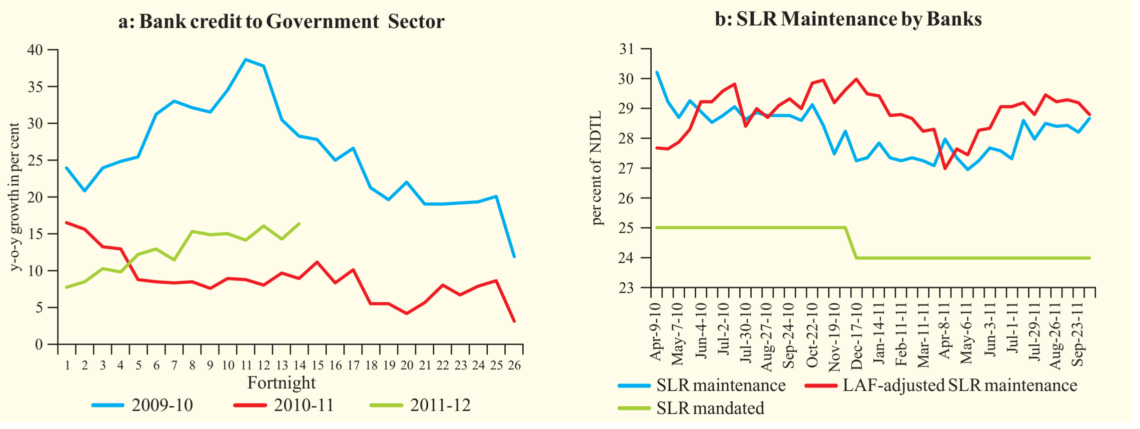


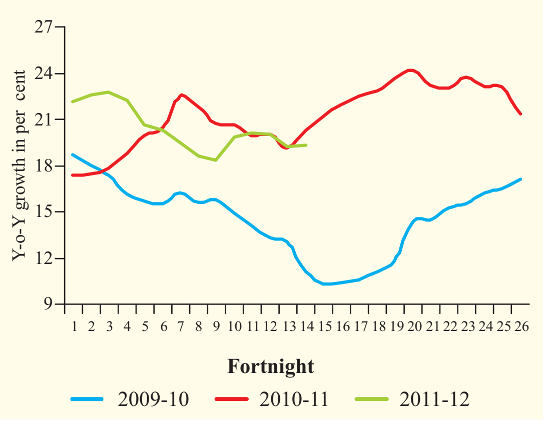
Chart IV.6: Banks' Investment in Government Securities



Credit expansion not broad-based

IV.11 The credit growth of foreign banks registered a sharp rise, while that of public sector banks continued to witness a deceleration in continuation of the trend observed in first quarter of 2010-11. As public sector banks continued to be the largest lenders, the overall credit growth decelerated (Table IV.5).

Chart IV.7 : Non-food Credit Growth



IV.12 The credit deceleration has been diffused over a wide range of sectors that include chemical and chemical products, engineering, power, telecommunications and consumer durables (Table IV.6). The slowdown in credit growth may have been prompted by deceleration in investment demand that could have impacted term loans. Further, the top rated corporates resorted to relatively cheaper sources of borrowings including ECBs and CPs.

Real interest rates low and non-disruptive to growth

IV.13 Real lending interest rates have remained positive, but low and supportive of growth in the recent period (Chart IV.9). Despite monetary

Chart IV.8 : Aggregate Deposits and Bank Credit

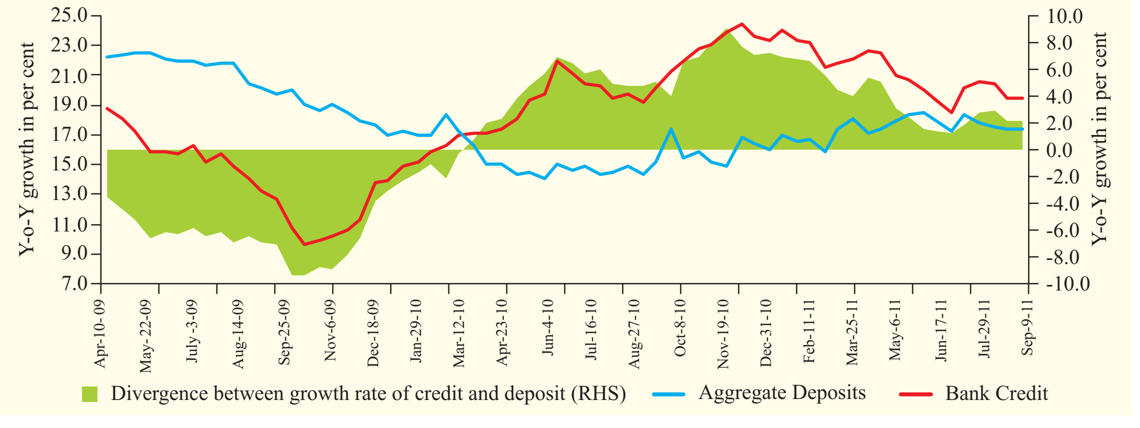


Table IV.4: Flow of Financial Resources to the Commercial Sector

(₹ crore)

Item	April-March		April-September	
	2009-10	2010-11	2010-11	2011-12
1	2	3	4	5
A. Adjusted Non-Food Bank Credit (NFC)	**4,78,614**	**7,11,031**	**2,59,692**	**2,29,157 +**
i) Non-Food Credit	4,66,960	6,81,501	2,27,006	2,07,483 +
of which: petroleum and fertilizer credit	10,014	-24,236	-24,130	1,573&
ii) Non-SLR Investment by SCBs	11,654	29,530	32,686	21,674 +
B. Flow from Non-banks (B1+B2)	**5,88,784**	**5,14,495**	**2,20,690**	**2,70,441**
B1. Domestic Sources	**3,65,214**	**2,95,573**	**1,23,652**	**1,37,838**
1 Public issues by non-financial entities	31,956	28,520	10,054	6,205
2 Gross private placements by non-financial entities	1,41,964	67,436	-	-
3 Net issuance of CPs subscribed to by non-banks	26,148	17,207	41,875	59,693 *
4 Net Credit by housing finance companies	28,485	38,386	8,775	11,110&
5 Total gross accommodation by 4 RBI regulated AIFIs - NABARD, NHB, SIDBI & EXIM Bank	33,783	40,007	15,282	8,558
6 Systematically important non-deposit taking NBFCs (net of bank credit)	60,663	67,937	35,209	39,784 $
7 LIC's net investment in corporate debt, infrastructure and Social Sector	42,215	36,080	12,457	12,488&
B2. Foreign Sources	**2,23,570**	**2,18,922**	**97,038**	**1,32,603**
1 External Commercial Borrowings / FCCB	15,674	52,899	27,635	41,809
2 ADR/GDR Issues excluding banks and financial institutions	15,124	9,248	7,250	1,783
3 Short-term Credit from abroad	34,878	50,177	19,707	13,721 #
4 Foreign Direct Investment to India	1,57,894	1,06,598	42,446	75,290&
C. Total Flow of Resources (A+B)	**10,67,398**	**12,25,526**	**4,80,382**	**4,99,598**
Memo:				
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes	96,578	-36,707	3,266	3,426

+: up to October 7, 2011 *: up to August 15, 2011 $: up to July 2011 #: up to June 2011 &: up to August 2011 -: Not available

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

tightening, real interest rates have fallen due to high inflation.

Monetary overshooting a risk in the face of fiscal pressures

IV.14 Credit growth has remained strong notwithstanding the successive interest rate hikes. As a result, even though there has been only moderate injection of primary liquidity through LAF transactions, broad money growth has stayed above the indicative trajectory, operating on the impetus provided by the endogenous factors like strong credit growth and high deposit growth, bolstered by substitution from currency to deposits. Going forward however, credit growth could moderate as growth decelerates and inflation moderates. However,

Table IV.5: Credit Flow from Scheduled Commercial Banks

(Amount in Rupees crore)

Item	Outstanding as on October 7, 2011	Variation (y-o-y)			
		As on Oct 8, 2010		As on Oct 7, 2011	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1. Public Sector Banks	30,38,986	4,24,615	19.8	4,70,704	18.3
2. Foreign Banks	2,21,422	17,923	11.4	45,898	26.1
3. Private Banks	7,86,334	1,25,973	24.5	1,45,213	22.6
4. All Scheduled Commercial Banks*	41,48,598	5,84,064	20.2	6,75,538	19.5

Note: 1. Data as on October 7,2011 are provisional.
2. *Including Regional Rural Banks.

Table IV.6: Sectoral Deployment of Credit

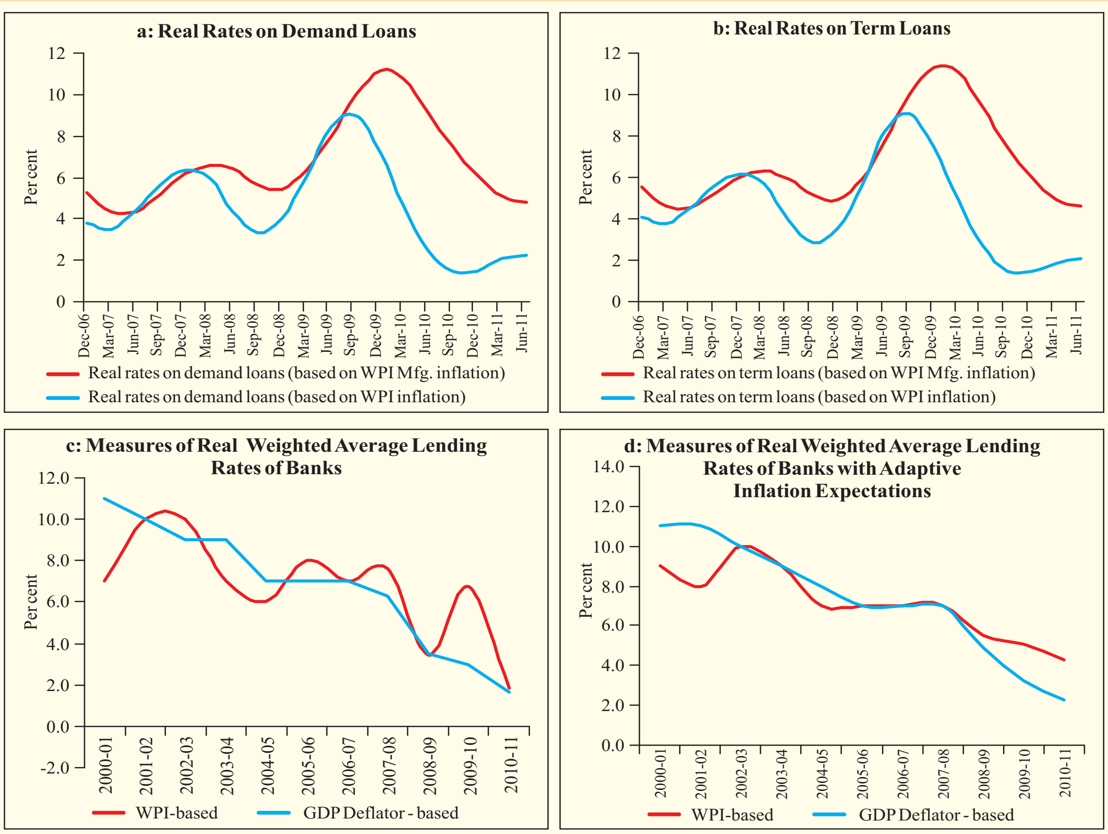
(Per cent)

Sector	Outstanding Credit as on Sept. 23, 2011 (₹ crore)	Y-o-Y Variation: Sept. 24, 2010 over Sept. 25, 2009	Y-o-Y Variation: Sept. 23, 2011 over Sept. 24, 2010	Financial Year Variation: Sept. 24, 2010 over Mar. 26, 2010	Financial Year Variation: Sept. 23, 2011 over Mar. 25, 2011
1	2	3	4	5	6
Non-food credit	**37,96,893**	**18.7**	**18.7**	**5.2**	**3.5**
Agriculture and allied activities	**4,33,791**	**19.3**	**7.9**	**-3.4**	**-5.8**
Industry	**17,42,163**	**24.4**	**22.9**	**8.1**	**7.5**
of which, Chemical & chemical products	96,670	15.3	9.4	3.1	2.3
All engineering	1,01,632	27.8	22.5	12.4	8.9
Infrastructure	5,64,958	47.4	20.3	23.6	7.3
of which, Power	3,00,752	46.9	32.2	21.1	11.7
Telecommunications	89,964	94.7	-10.2	68.8	-10.4
Roads	1,03,545	28.3	31.9	6.7	11.9
Services	**9,12,413**	**17.4**	**19.3**	**5.2**	**1.3**
of which, Commercial Real Estate	1,14,459	7.9	12.6	10.3	2.3
NBFCs	1,83,761	18.5	46.2	10.8	4.7
Personal Loans	**7,08,526**	**8.6**	**15.2**	**5.0**	**3.4**
of which, Consumer durables	8,492	12.5	-6.5	9.5	-16.4
Housing (incl. Priority sector)	3,66,889	10.4	15.7	5.4	6.0
Education	48,339	23.6	18.1	11.1	10.6
Vehicle loans	83,981	16.1	19.3	10.3	5.9

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

even with some deceleration expected in credit growth, containing monetary growth remains a challenge in face of large market borrowing.

Chart IV.9 : Real Rate of Interest on Demand Loans and Term Loans



V. FINANCIAL MARKETS

Indian equity and foreign exchange markets, unlike the debt and money markets, showed greater volatility in Q2 of 2011-12 than in the previous quarter. This mainly reflected risk aversion arising out of the deepening euro area sovereign debt crisis. Going forward, domestic growth and inflation outlook, resilience of the banking sector and the nature and depth of global uncertainty will shape the developments in the financial markets. The global markets will primarily track the international policy actions to address the problem of euro area sovereign debt crisis and slowdown in advanced economies (AEs).

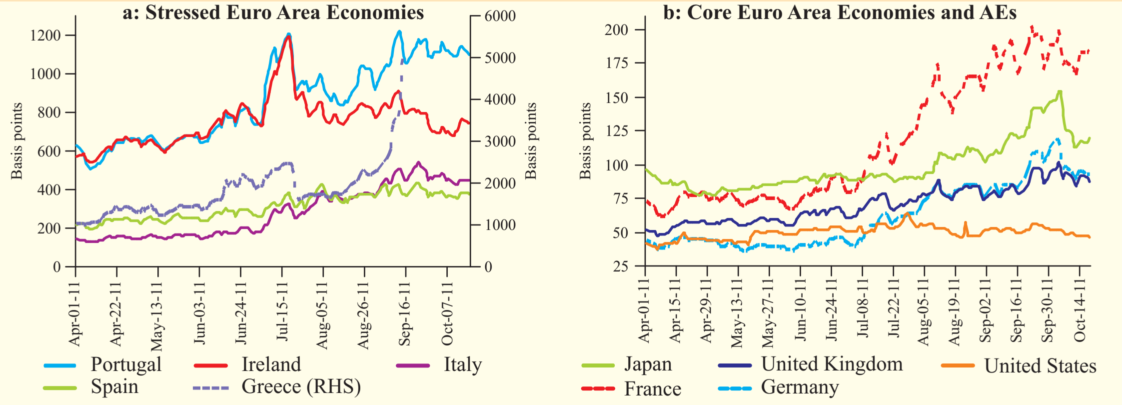
Risk aversion, volatility back in global markets driven by sovereign debt crisis

V.1 The downgrade of US sovereign debt rating by S&P and deteriorating sovereign debt problems in the euro area resulted in renewed volatility in global financial markets during Q2 of 2011-12. The credit default swaps (CDS) spreads of stressed euro area economies like Portugal, Italy and Greece widened since August 2011, reflecting market perception of worsening sovereign debt sustainability of these economies. AAA rated sovereigns, such as Germany and France, were also impacted in the absence of credible measures to contain the pervasive impact of the worsening sovereign crisis (Chart V.1). Several periphery and core European countries including Italy and Spain were downgraded by the credit rating agencies following the debt concerns, slackening economic activity and weakening financial systems.

Debt overhang causing significant spillover risks

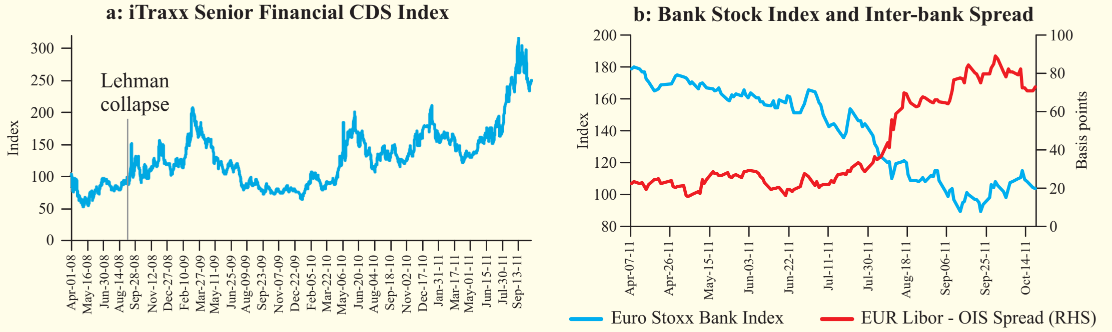
V.2 There is a growing threat that financial stability concerns would get transmitted to the real economy as sovereign debt problems translate into a deterioration of the balance sheets of banks holding these sovereign bonds, mainly in Europe. The stocks of European banks, particularly those with high exposure to the sovereign debt issued by the periphery countries, faced broad-based sell-offs. The CDS spreads of banks widened to levels higher than those during the US sub-prime crisis, partly reflecting the risk perception arising from lack of progress in deleveraging in euro area banks (Chart V.2).

Chart V.1: Sovereign Spreads – Euro Area and AEs



Source: Bloomberg.

Chart V.2: Movement in Bank CDS Spreads and Stocks



Note: 1. The markit iTraxx Europe Senior financial index comprises 25 equally weighted credit default swaps on investment grade European entities.
2. The Euro Stoxx Banks Index is a capitalisation weighted index, which includes countries participating in the European Monetary Union that are involved in the banking sector.

Source: Bloomberg.

Debt resolution deadlock adds to market uncertainties

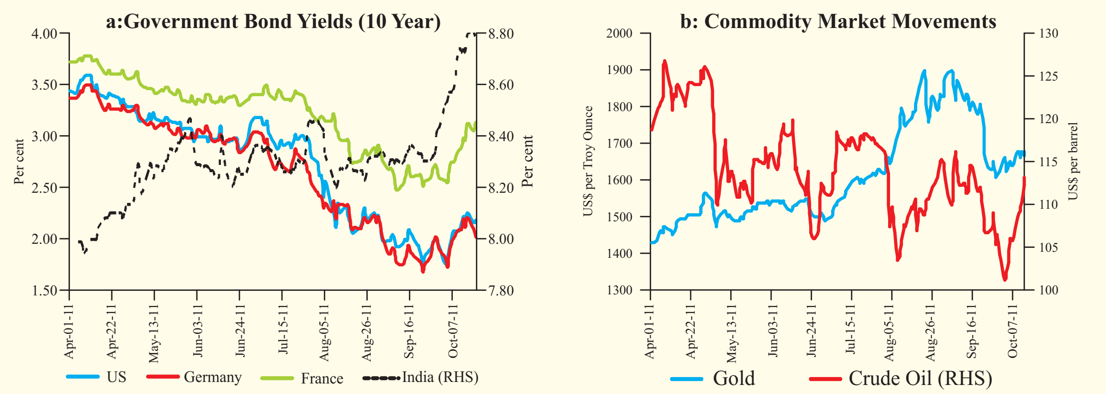
V.3 One of the main policy tools to deal with the 2008 crisis was fiscal stimulus. AEs raised public expenditure and pared down some tax burden expecting thereby to boost private demand. Nonetheless, reflecting deleveraging by households, tight bank lending and deflation in house prices, private demand decelerated, muting the fiscal multiplier. Presently, while unemployment continues to remain at elevated levels, the option of fiscal stimulus is largely unavailable on account of concerns over debt sustainability. The governments of AEs are striving to find a balance between the need for a fiscal stimulus in the short-term against sustainable fiscal adjustment in the medium-term.

V.4 Reacting to the growing uncertainties in the policy outlook, global financial markets declined despite an assurance in the euro area summit (July 2011) to increase the flexibility of the European Financial Stability Facility (EFSF). That assurance failed to inspire confidence underlining the challenge of keeping a monetary union intact even without a fiscal union. The policy announcement by the US Fed to keep the longer-term interest rates low through its maturity extension programme ("operation twist") on September 21, 2011 has received limited response so far.

Search for safe heaven assets continues

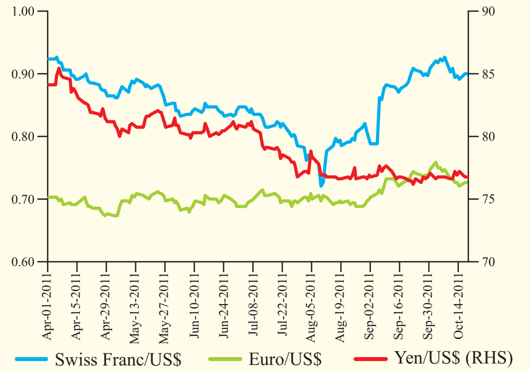
V.5 There has been a shift in investor preference towards perceived safe haven assets (Chart V.3). This has triggered global selloffs

Chart V.3: Flight from Stocks to Sovereign Bonds and Safe Assets



Source: Bloomberg.

Chart V.4: Movements in Global Currencies against the US dollar



Source: Bloomberg.

in the equity markets and portfolio rebalancing in favour of gold as a safe asset has caused gold prices to touch a historical high of US $1900 per troy ounce on September 5, 2011. The slowdown in growth of AEs led to the decline in the crude oil prices in the quarter.

V.6 International currency markets turned volatile during Q2 of 2011-12. The US dollar appreciated *vis-a-vis* the euro (Chart V.4).

Spillover pressures witnessed in Indian equity and currency markets

V.7 Taking cues from the global turmoil, Indian financial market segments that have a high degree of cross-border linkages turned volatile, while the other segments without strong linkages remained orderly. As a result, increased volatility was evidenced in the equity and currency markets since September 2011 (Chart V.5a).

V.8 In line with the global markets, the Indian equity prices continued their declining trend in Q2 of 2011-12. The rise in equity indices at the beginning of Q2 due to FII inflows could not sustain the momentum owing to global developments and net sales by FIIs ensued. The two key Indian equity indices, Sensex and Nifty, declined (y-o-y) by about 14.5 per cent and 14.7 per cent, respectively, as on October 19, 2011. Nonetheless, the decline in Indian equity markets was relatively less than that in many emerging and developing economies (EDEs). P-E ratio of Indian equities remained higher than other EDEs as at end September 2011 (Table V.1, V.2 and Chart V.5b).

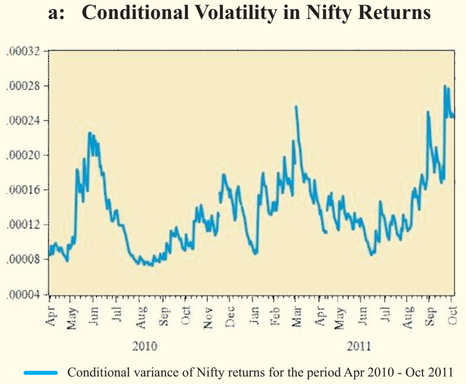
Table V.1: Stock Price Movement and P/E Ratios in EDEs and AEs

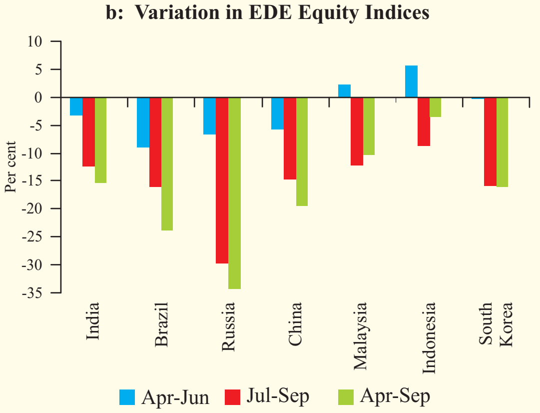
Items	Stock Price Variations (Per cent)			P/E- Ratios		
	End-Mar 2010@	End-Mar 2011@	End-Sep 2011*	End-Mar 2010	End-Mar 2011	End-Sep 2011
1	2	3	4	5	6	7
Brazil (Bovespa)	72.0	-2.5	-23.7	16.4	10.9	8.0
China (Shanghai Composite)	31.0	-5.8	-19.4	23.1	16.3	12.6
India (BSE Sensex)	**80.5**	**10.9**	**-15.4**	**17.7**	**17.6**	**17.9**
Indonesia (Jakarta Composite)	93.7	32.5	-3.5	13.6	16.9	16.1
Malaysia (KLCI)	51.4	17.0	-10.2	18.9	17.0	14.8
Russia (RTS)	128.0	30.0	-34.4	9.8	8.4	5.1
Singapore (Straits Times)	69.9	7.6	-13.9	13.4	10.3	7.4
South Korea (KOSPI)	40.3	24.4	-16.0	12.2	13.8	12.3
Taiwan (Taiwan Index)	52.0	9.6	-16.8	19.1	15.7	13.8
Thailand (SET Composite)	82.6	32.9	-12.5	12.4	13.3	11.1
France (CAC 40)	41.6	0.4	-25.3	15.2	11.9	8.6
FTSE 100	44.7	4.0	-13.2	15.6	14.4	10.0
FTSE EUROTOP 100	44.8	13.3	-17.3	14.2	12.6	9.7
Germany (DAX)	50.6	14.4	-21.9	17.5	12.8	9.8
Hong Kong (Hang Seng)	56.5	10.8	-25.2	15.2	12.0	8.1
Japan (Nikkei)	36.8	-12.0	-10.8	39.1	17.9	16.3
United States of America (S&P 500)	46.6	13.4	-14.7	17.1	15.1	12.4

@: Year-on-year variation. *: Variation over end-March 2011.

Source: Bloomberg.

Chart V.5: Increasing Volatility in Equity Markets





Source: NSE, Bloomberg, IMF.

FII investments decline

V.9 FII investments declined during Q2 of 2011-12. FIIs made net sales in the equity segment while making net purchases in the debt segment. Mutual funds (MFs) made net purchases in both equity and debt segments. The turnover in equity derivatives segment increased substantially over the year. FII investments in equity derivatives increased significantly during Q2 as compared to the previous quarter (Chart V.6).

V.10 Resource mobilisation in the primary segment of the domestic capital market was lower during 2011-12 (up to September) (Table V.3). Dampened secondary market conditions and poor performance of the IPOs after their listing also affected investor and promoter sentiment. Resource mobilisation by MFs, however, improved.

Bank CDS spreads widen following the downgrade of the largest PSB

V.11 Credit rating agency Moody's downgraded the largest public sector bank (PSB) on October 4, 2011 on account of the asset quality and capital adequacy concerns. CDS spreads of that bank, which had started to widen sharply from early August, widened further by 10 bps that day. The difference in spreads between the largest private and public sector banks, which had seen range bound movements for most part of the previous quarter, widened in September 2011, partly reflecting investor concerns about contagion risk (Chart V.7).

Money market tracks monetary policy signals

V.12 The monetary policy stance continued to favour deficit liquidity conditions in Q2 of 2011-

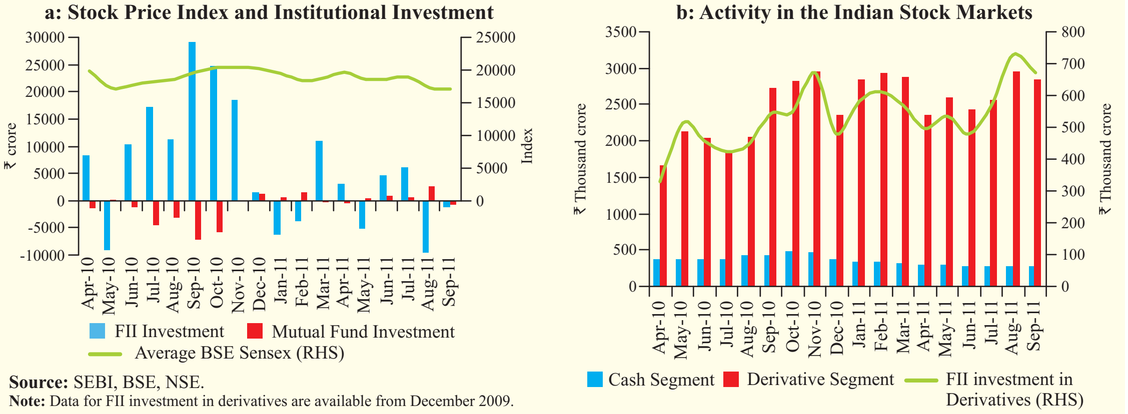
Table V.2: Key Stock Market Indicators

Indicator	BSE Sensex			NSE Nifty		
	2010-11	Apr-Sep 2010-11	Apr-Sep 2011-12	2010-11	Apr-Sep 2010-11	Apr-Sep 2011-12
1	2	3	4	5	6	7
1. BSE Sensex/S&P CNX Nifty						
(i) End-period	19445.22	20069.12	16453.76	5833.75	6029.95	4943.25
(ii) Average	18605.18	17866.06	18003.77	5583.54	5360.57	5406.38
2. Coefficient of Variation(%)	6.32	4.88	5.64	6.40	4.92	5.62
3. Price-Earning Ratio @	21.25	22.99	18.35	22.14	25.46	17.85
4. Price-Book Value Ratio	3.70	3.70	3.40	3.70	3.80	2.90
5. Market Capitalisation to GDP Ratio (per cent)@	86.80	90.45	66.28	85.10	88.36	64.81

@: As at end-period.

Source: Bombay Stock Exchange Ltd. (BSE) and National Stock Exchange of India Ltd. (NSE).

Chart V.6: Movement in Stock Prices and Turnover

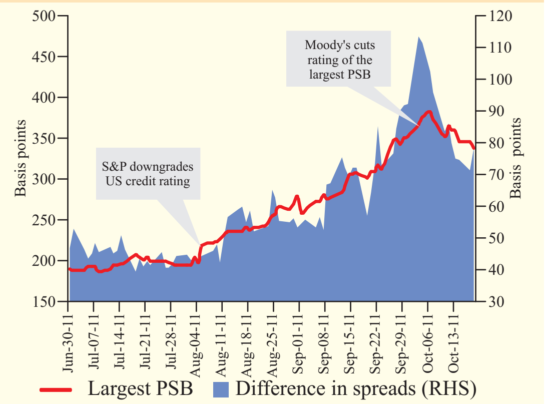


Source: SEBI, BSE, NSE.
Note: Data for FII investment in derivatives are available from December 2009.

12 for effective monetary policy transmission. Against the backdrop of tight liquidity conditions in the system, the call rate rose at the beginning of Q2 and firmed up thereafter, in line with the 75 bps hike in the policy rate. The call rate generally hovered around the policy (repo) rate during Q2. The money market remained orderly without exhibiting signs of stress (Chart V.8, Tables V.4 and V.5).

V.13 The collateralised segment (*i.e.* CBLO and market repo) accounts for more than 80 per cent of the overnight money market volume and constitutes the bulk of money market. Reflecting active market conditions, the transaction volumes in this segment remained high. Banks and primary dealers continued to

Chart V.7: Movements in Bank CDS spreads



Source: Bloomberg.

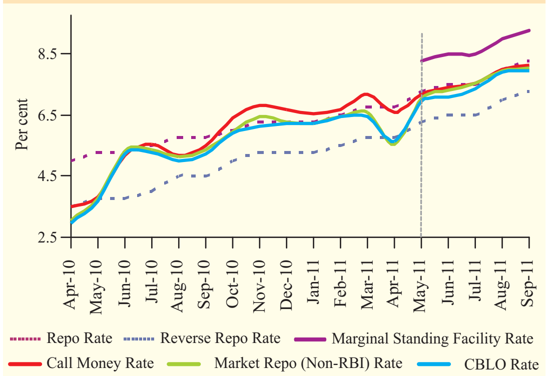
Table V.3: Resource Mobilisation from Capital Market

(₹ crore)

Category	2010-11 (Apr-Mar)	2010-11 (Apr-Sep)	2011-12 (Apr-Sep)
1	2	3	4
A. Prospectus and Rights Issues*	37,620	14,057	11,684P
1. Private Sector (a+b)	24,373	13,475	7,106
a) Financial	3,877	3,420	901
b) Non-financial	20,496	10,054	6,205
2. Public Sector	13,247	583	4,578
B. Euro Issues	9,441	7,443	1,783
C. Mutual Fund Mobilisation(net)@	-49,406	-452	55,280
1. Private Sector	-19,215	18,744	52,451
2. Public Sector #	-30,191	-19,196	2,829

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

Chart V.8: Movements in Money Market Rates



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

Table V.4: Rates in Domestic Financial Markets at a Glance

	Money Market					Bond Market		Forex Market	Stock Market Indices	
	Call Rate* (Per cent)	Market Repo Rate (Non-RBI) (Per cent)	CBLO Rate (Per cent)	Commercial Paper WADR (Per cent)	Certificates of Deposit WAEIR (Per cent)	G-Sec 10-year Yield@ (Per cent)	Corporate Bonds Yield AAA 5-Yr bond (Per cent)	Exchange Rate@@ (₹/US$)	CNX Nifty#	BSE Sensex#
1	2	3	4	5	6	7	8	9	10	11
Mar-10	3.51	3.32	3.15	6.29	6.07	7.94	8.61	45.50	5178	17303
Mar-11	7.15	6.56	6.46	10.40	9.96	8.00	9.23	44.99	5538	18457
Apr-11	6.58	5.55	5.63	8.62	8.66	8.02	9.25	44.37	5839	19450
May-11	7.15	7.05	6.94	9.49	9.30	8.31	9.48	44.90	5492	18325
Jun-11	7.38	7.30	7.06	9.71	9.61	8.28	9.63	44.85	5473	18229
Jul-11	7.51	7.53	7.33	9.33	9.19	8.34	9.44	44.42	5597	18616
Aug-11	7.97	7.95	7.87	9.56	9.19	8.32	9.38	45.28	5077	16888
Sep-11	8.11	8.04	7.95		9.14 $	8.35	9.44	47.64	5016	16695

*: Weighted average of daily call money borrowing rates. @: Average of daily FIMMDA closing rates.
@@: Average of daily RBI reference rate. #: Average of daily closing indices. $: As on Sep 9, 2011.
WADR: Weighted Average Discount Rate. WAEIR: Weighted Average Effective Interest Rate.

be the most significant borrowers, while the MFs continued as the major group of lenders followed by banks in this segment. However, the share of MFs in the total lending declined significantly to below 50 per cent in Q2.

V.14 In the absence of credit funding pressures and given reasonable retail deposit mobilisation in Q2, banks' issuance of certificates of deposits (CDs) declined. Consequently the rate of interest on CDs declined.

V.15 The average fortnightly issuance of commercial paper (CP) declined in Q2 of 2011-12 (up to August) as compared to that of the previous quarter. 'Leasing and finance' and 'manufacturing companies' continued to be the major issuers of CPs.

V.16 Primary yields on Treasury Bills (TBs) firmed up consistent with the spurt in overnight rates during Q2 of 2011-12 (Table V.6). The upward movement in rates reflected the marked increase in Government short-term borrowing through issuance of TBs and cash management bills (CMBs) to finance unanticipated cash-flow mismatches coupled with tight liquidity conditions.

Table V.5: Average Daily Volumes in Domestic Financial Markets

(₹ crore)

	Money Market						Bond Market		Forex Market	Stock Market#
	LAF	Call Money	Market Repo	CBLO	Commercial Paper*	Certificates of Deposit*	G-Sec@	Corporate Bond	Inter-bank (US$ mn)	
1	2	3	4	5	6	7	8	9	10	11
Mar-10	37,640	8,812	19,150	60,006	75,506	3,41,054	6,621	1,598	16,082	9,191
Mar-11	-80,963	11,278	15,134	43,201	80,305	4,24,740	8,144	1,314	22,211	7,276
Apr-11	-18,809	13,383	14,448	56,160	1,24,991	4,47,354	6,928	1,053	25,793	8,277
May-11	-54,643	10,973	15,897	40,925	1,21,221	4,33,287	7,356	691	24,167	6,668
Jun-11	-74,125	11,562	16,650	41,313	1,04,689	4,23,767	12,844	1,168	24,047	6,404
Jul-11	-43,759	11,513	11,748	41,006	1,33,691	4,12,189	10,560	1,208	22,525	6,889
Aug-11	-40,712	11,290	14,793	39,131	1,48,812	4,05,685	15,737	1,266	23,279	6,870
Sep-11	-55,920	13,782	13,893	45,119		3,86,470$	12,320P	1,069	22,384	6,896

*: Outstanding position. @: Average daily outright trading volume in Central Government dated securities.
#: Volumes in BSE and NSE (cash segment). $: As on Sep 9, 2011. P: Provisional.
Note: In col. 2, (-) ve sign indicates injection of liquidity while (+) ve sign indicates absorption of liquidity.

Table V.6: Treasury Bills in the Primary Market

Year/ Month	Notified Amount (₹ crore)	Average Implicit Yield at Minimum Cut-off Price (Per cent)		
		91-day	182-day	364-day
1	2	3	4	5
2009-10	3,80,000	3.57	3.97	4.38
2010-11	3,03,000	6.18	6.48	6.56
Apr-11	30,000	7.32	7.60	7.65
May-11	44,000	8.05	8.24	8.25
Jun-11	53,000	8.21	8.19	8.32
Jul-11	40,000	8.21	8.23	8.34
Aug-11	40,000	8.35	8.43	8.24
Sep-11	50,000	8.41	8.42	8.40
Oct-11*	16,000	8.46	8.62	8.52

*: Up to October 18, 2011.

Table V.7: Issuances of Central and State Government Dated Securities

Item	2009-10	2010-11	2011-12*
1	2	3	4
Central Government			
Gross amount raised (₹ crore)	4,51,000	4,37,000	2,78,000
Devolvement on Primary Dealers (₹ crore)	7,219	5,773	7,168
Bid-cover ratio (range)	1.44-4.32	1.39-3.88	1.39-3.20
Weighted average maturity (years)	11.16	11.62	12.20
Weighted average yield (per cent)	7.23	7.92	8.40
State Governments			
Gross amount raised (₹ crore)	1,31,122	1,04,039	76,956
Cut-off yield range (per cent)	7.04-8.58	8.05-8.58	8.36-9.09
Weighted average yield (per cent)	8.11	8.39	8.67

*: Up to October 18, 2011.

Additional market borrowing puts pressure on yields

V.17 Yield movements, which remained generally range bound during July 1-September 28, 2011 rose thereafter, factoring in the announced increase in the Government's market borrowings by ₹52,872 crore over and above the amount budgeted for 2011-12 (Chart V.9a). The hardening of primary yields was associated with an increase in the weighted average maturity during 2011-12 so far (Table V.7).

V.18 Reflecting the impact of the unanticipated increase in Government market borrowing, the spread of 5-year corporate bonds over comparable G-secs decreased (Chart V.9b).

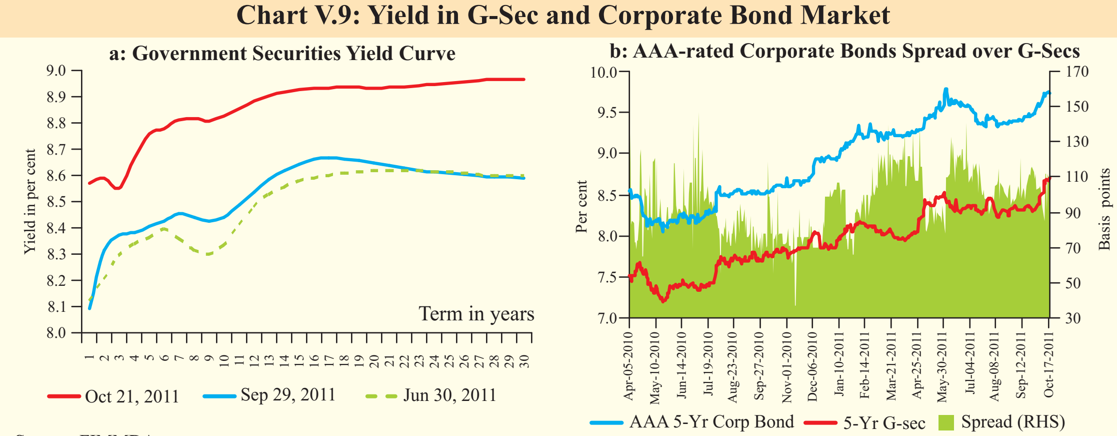
Monetary transmission strengthens with rates hardening in the credit market

V.19 During Q2 of 2011-12, banks increased their deposit rates across all maturities, with the sharpest rise in maturities up to 1 year for all categories of banks. The increase in modal deposit and base rates for the quarter was about 40 bps and 75 bps, respectively (Table V.8).

The rupee depreciated significantly reflecting global uncertainty

V.20 During April-July 2011, the Indian rupee exhibited two-way movement. However, since August 2011, it witnessed depreciation against all four major international currencies, reflecting prevailing global market sentiment led FII-sell-offs (Chart V.10a). Nevertheless,

Chart V.9: Yield in G-Sec and Corporate Bond Market



Source: FIMMDA.

Source: Bloomberg.

Table V.8: Deposit and Lending Rates of Banks

(Per cent)

Items	Sep-10	Dec-10	Mar-11	Jun-2011	Sept-11
1	2	3	4	5	6
Domestic Deposit Rates (1-3 years tenor)					
(i) Public Sector Banks	6.75-7.75	7.00-8.50	8.00-9.75	8.25-9.75	8.55-9.75
(ii) Private Sector Banks	6.50-8.25	7.25-9.00	7.75-10.10	8.00-10.50	8.00-10.50
(iii) Foreign Banks	3.00-8.00	3.50-8.50	3.50-9.10	3.50-10.00	3.50-9.75
Base Rate					
(i) Public Sector Banks	7.50-8.25	7.60-9.00	8.25-9.50	9.25-10.00	10.00-10.75
(ii) Private Sector Banks	7.00-8.75	7.00-9.00	8.25-10.00	8.50-10.50	9.75-11.00
(iii) Foreign Banks	5.50-9.00	5.50-9.00	6.25-9.50	6.25-9.50	6.25-10.75
Median Lending Rate*					
(i) Public Sector Banks	7.75-13.50	8.75-13.50	8.88-14.00	9.50-14.50	-
(ii) Private Sector Banks	8.00-15.00	8.25-14.50	9.00-14.50	9.25-15.00	-
(iii) Foreign Banks	7.25-13.00	8.00-14.50	7.70-14.05	7.70-14.50	-

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

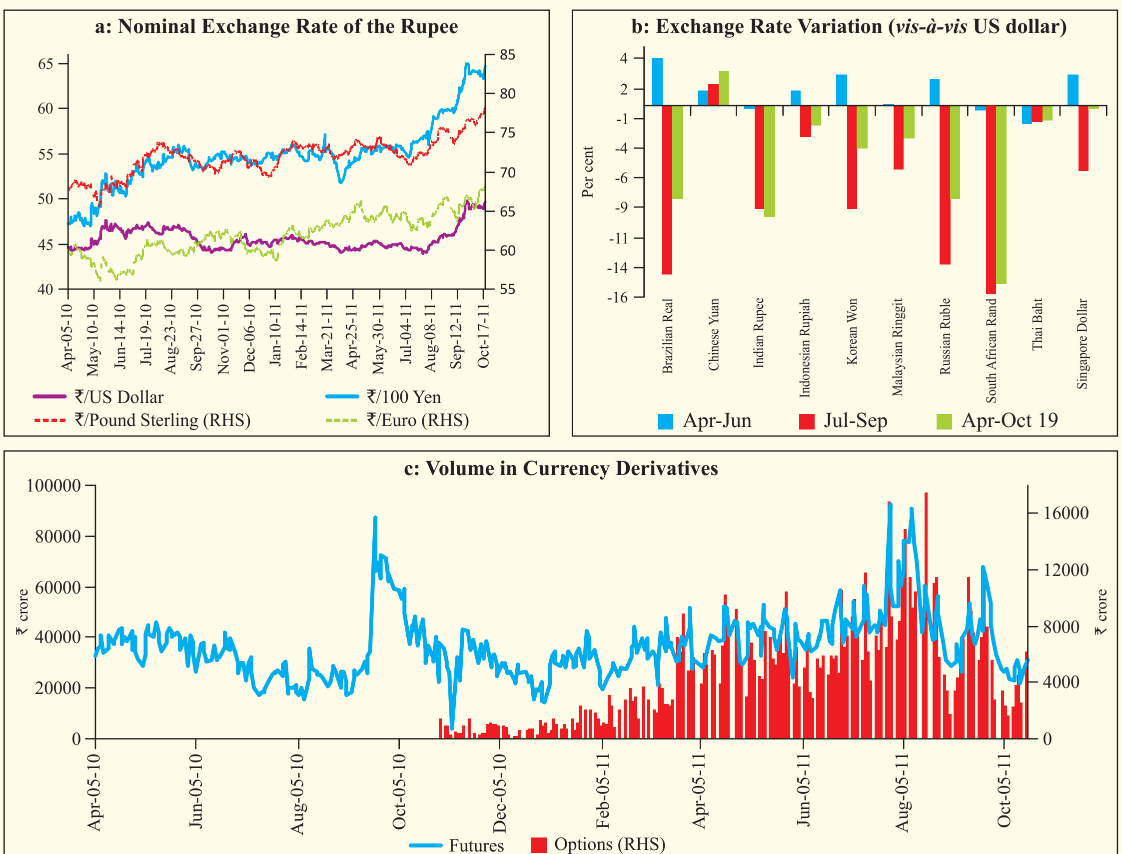
\- : Not available.

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

in comparison to some of the EDEs, the depreciation in the Indian rupee during Q2 of 2011-12 has been less stark (Chart V.10b).

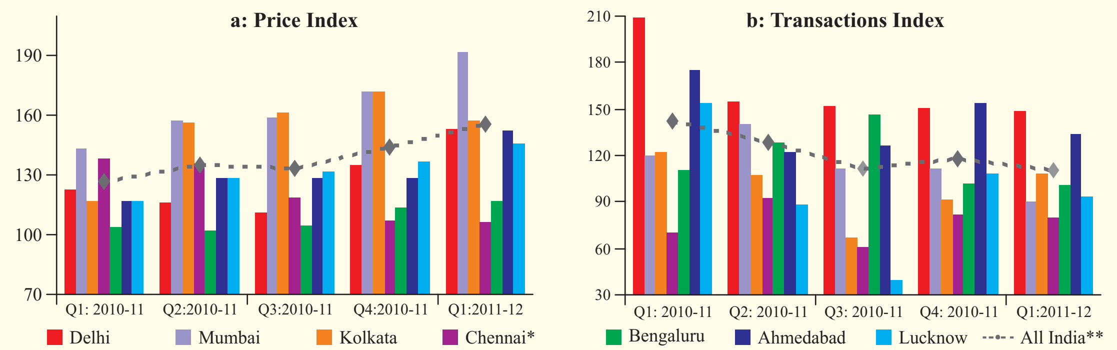
V.21 The average daily turnover in the merchant segment as well as interbank segment of the forex market was lower than that in the preceding quarter. The volume in value terms

Chart V.10: Trends in Forex Market



Source: RBI, IMF, FEDAI, Bloomberg, NSE, USE, MCX-SX.

Chart V.11: Trends in Housing Indices (Base: Q4 of 2008-09=100)



* : Chennai indices comprise of both residential and commercial properties.

** : All India index is weighted average of city indices, weights based on population proportion.

Source: Department of Registration and Stamps (DRS) of the respective State governments.

in the currency derivative market - both options and futures - which increased up to August 2011, showed some deceleration in September 2011 (Chart V.10c).

Housing prices rise amidst falling transaction volumes in Q1 of 2011-12

V.22 Despite falling volumes, property prices, as captured by the Reserve Bank's Quarterly House Price Index (HPI), firmed up in Q1 of 2011-12. The price index increased by about 8 per cent for the second successive quarter at an all-India level, while the transactions volume index that had fallen sharply in Q2 and Q3 of 2010-11 dipped by about 7 per cent in Q1 of 2011-12 negating the increase in the preceding quarter.

V.23 House prices increased in five of the seven major cities on a quarter-over-quarter basis in Q1 of 2011-12, but declined in Kolkata and remained flat in Chennai (Chart V.11a). On the other hand, the data on volume of transactions show that the number of transactions have fallen in six cities, except Kolkata (Chart V.11b). On a y-o-y basis, there has been a rise in housing prices and fall in housing transactions in Q1 of 2011-12 in six cities, barring Chennai.

More financial volatility likely ahead

V.24 The Indian financial markets will continue to be conditioned by the evolving macroeconomic developments, both global and domestic. Weak outlook for the US economy, and possible spillover effect from global contagion of the euro area crisis through the extremely interconnected European banking and financial market channel, among others, pose near-term risks to the financial markets. Persistence of domestic inflation with a plausible moderation in growth could impact corporate earnings, which may affect equity valuations. On the other hand, with substantial correction having occurred and limited investment opportunities globally, markets could see a recovery. However, the asset quality of Indian banking sector, the risk exposure and the challenge of public sector bank recapitalisation in the face of fiscal pressures are issues which require attention.

VI. PRICE SITUATION

Inflation continued to be high, generalised and above the comfort level of the Reserve Bank in the first half of 2011-12. Upside risks to inflation path could result from exchange rate pass-through of recent rupee depreciation and incomplete transmission of earlier rise in global commodity prices. Persistent supply shocks in an environment of buoyant demand have contributed to both generalisation of the inflation process and the sticky inflation path. The impact of anti-inflationary monetary policy measures taken so far may moderate domestic demand thereby reducing the upside risks to inflation.

Upside risks to global inflation persist despite weaker global growth outlook

VI.1 The substantial increase in commodity prices witnessed since early 2009 has fed into domestic inflation of major economies and inflation exhibited uptrend across both developed and emerging economies. The recent moderation in commodity prices on the back of weakening global growth prospects is expected to have limited softening impact on inflationary pressures, especially in emerging and developing economies (EDEs). In September 2011, the IMF revised upwards the projection of inflation for EDEs to 7.5 per cent for 2011 (from 6.9 per cent earlier projected in June 2011), while for advanced economies (AEs) it was kept unchanged at 2.6 per cent.

VI.2 AEs largely persist with their expansionary stance of monetary policy, with the US Fed providing clear guidance on the future stance of monetary policy up to 2013. Renewed concerns over the sluggishness of global recovery has led to most central banks of advanced economies keeping their policy rates at near zero/very low levels, while EDEs have gradually tightened monetary policy to contain inflationary pressures (Table VI.1). However, some of the EDEs which faced a surge in capital inflows due to higher interest rates responded by lowering policy rates as excessive capital inflows also entailed the risk of inflation.

Global commodity prices ease but levels remain high

VI.3 Global commodity prices have softened somewhat during 2011-12 from the high levels reached towards the end of 2010-11. This has been driven by concerns over sustainability of demand in the wake of sovereign debt concerns in the advanced economies as well as improved supply prospects in key agricultural products. Crude oil prices moderated on the back of International Energy Agency (IEA) member countries agreeing to release 60 million barrels of oil in July 2011 and projected moderation in demand growth (Chart VI.1). Global metal prices have also declined somewhat in recent months due to increasing worries about the impact of slowing economic growth on metal demand.

VI.4 Global food prices reached their historical peak in early 2011 and have moderated somewhat during recent months as global supply prospects have improved in key agricultural commodities. However, the prices continue to rule at significantly high levels. Rising income, diversification of dietary patterns, attraction of bio-fuel as an alternative source of energy and weather disturbances impacting supply situation are the major factors that contribute to market tightness.

VI.5 The World Bank projections on commodity prices for the 2011 and 2012 indicate that despite softening, prices could be significantly higher in 2011 and 2012 as

Table VI.1 : Global Inflation Indicators

(Per cent)

Country/ Region	Key Policy Rate	Policy Rate (as on Oct. 21, 2011)		Changes in Policy Rates (basis points)		CPI Inflation (y-o-y)	
				Sep. 15, 2008 to Aug. 23, 2009	Since Aug. 23, 2009	Sep-2010	Sep-2011
1	2	3		4	5	6	7
Developed Economies							
Australia	Cash Rate	4.75	(Nov. 3, 2010)	(-) 400	175	3.1	3.6 ^
Canada	Overnight Rate	1.00	(Sep. 8, 2010)	(-) 275	75	1.9	3.2
Euro area	Interest Rate on Main Refinancing Operations	1.50	(Jul 13, 2011)	(-) 325	50	1.9	3.0
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10	(Oct. 5, 2010)*	(-) 40	(-) 10	-1.1 #	0.2 #
UK	Official Bank Rate	0.50	(Mar. 5,2009)	(-) 450	0	3.1	5.2
US	Federal Funds Rate	0.0 to 0.25	(Dec.16,2008)*	(-) 200	0	1.1	3.9
Developing Economies							
Brazil	Selic Rate	11.50	(Oct. 19, 2011)	(-) 500	275	4.7	7.3
India	Repo Rate	8.25	(Sep.16, 2011)	(-) 425	350	9.9 #	9.0 #
				(-400)	(100)		
China	Benchmark 1-year Deposit Rate	3.50	(Jul. 7, 2011)	(-) 214	100	3.6	6.1
	Benchmark 1-year Lending Rate	6.56	(Jul. 7, 2011)	(-) 241	100		
				(-200)	(600)		
Indonesia	BI Rate	6.50	(Oct.11, 2011)	(-) 275	0	5.8	4.6
Israel	Key Rate	3.25	(Jun. 1, 2011)	(-) 375	275	2.4	2.9
Korea	Base Rate	3.25	(Jun 10, 2011)	(-) 325	125	3.6	4.3
Philippines	Reverse Repo Rate	4.50	(May. 5, 2011)	(-) 200	25	3.9	4.8
	Repo Rate	6.50	(May. 5, 2011)	(-) 200	25		
Russia	Refinancing Rate	8.25	(May. 3, 2011)	(-) 25	(-) 250	7.0	7.2
South Africa	Repo Rate	5.50	(Nov. 19, 2010)	(-) 500	(-) 150	3.1	5.7
Thailand	1-day Repurchase Rate	3.50	(Aug. 24, 2011)	(-) 250	225	3.0	4.0

^: Q1 of 2011-12 #: August. *: Change is worked out from the minimum point of target range.

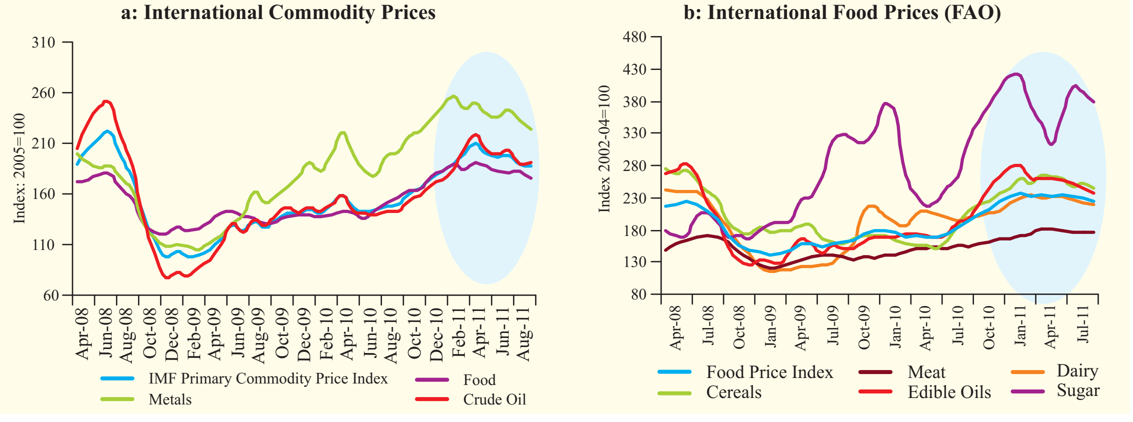
Note: 1. For India, data on inflation pertain to CPI for Industrial Workers.
2. Figures in parentheses in column (3) indicate the effective dates when the policy rates were last revised.
3. Figures in parentheses in column (5) indicate the variation in the cash reserve ratio during the period.

Source: Websites of respective central banks/statistical agencies.

compared to 2010 levels and the projected levels are almost closer to the peaks seen in 2008. This indicates that the pressure from global commodity prices may persist and the recent marginal softening of prices could only dampen the magnitude of price pressures.

VI.6 As yet, incomplete pass through of past price increases is another important risk factor from imported inflation. A comparative position of the movement of different commodity prices since the trough they hit during early 2009 indicates that the domestic

Chart VI.1: Trends in Global Commodity Prices



price increases in most commodities have been much lower than for the global price increases. This again limits the possibility of domestic prices falling in tandem with softening global prices.

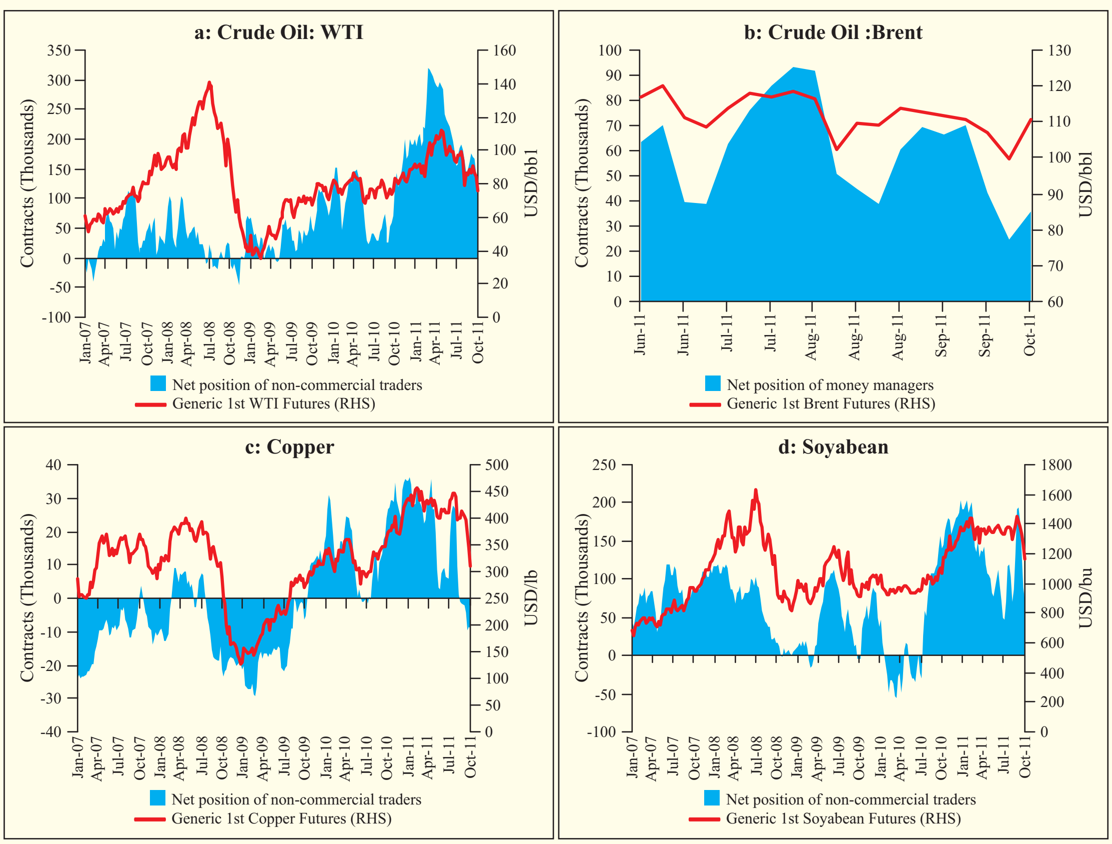
Financialisation of commodities adds to price volatility

VI.7 There is growing evidence of financialisation of commodities, which has been seen in some quarters as a source of upward pressure on global commodity prices. Net non-commercial positions in commodity futures and the futures prices for several commodities have remained significantly volatile (Chart VI.2). Unwinding of positions have generally coincided with softening of commodity prices in the futures market.

Generalised inflation persisted at much above the comfort level

VI.8 Domestically, inflationary pressures still persist and Wholesale Price Index (WPI) y-o-y inflation was at 9.7 per cent (provisional) for the month of September 2011. Inflation remained at above 9 per cent over successive months in the first half of the year, and price pressures persisted across the range of commodities covered in the WPI. Inflation in non-food manufactured products remained at or above 7 per cent over eight successive months. While high food and fuel price inflation contributed to the persistence of headline inflation, the generalised nature of the inflation warranted monetary policy measures to soften the demand pressures. The anti-inflationary thrust of monetary policy recognised the risk of near-term modest sacrifice of growth

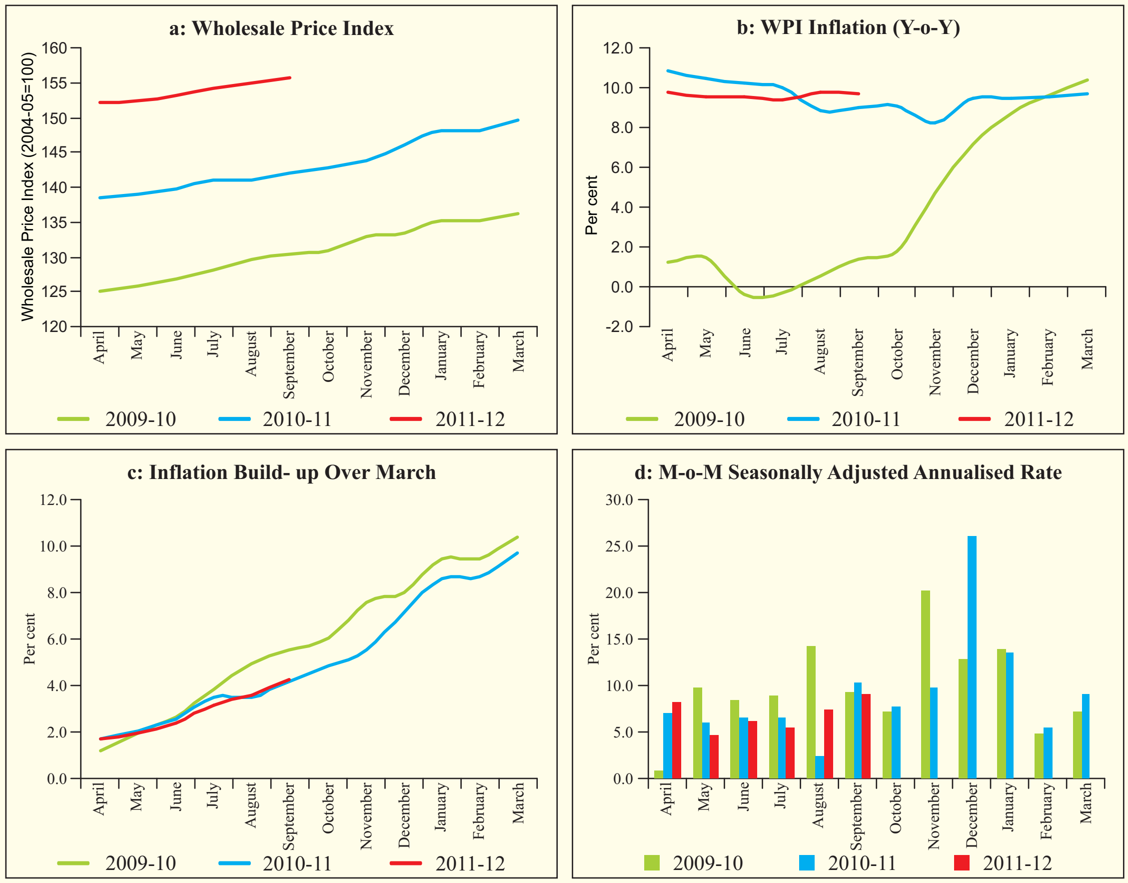
Chart VI.2: Net Position by Non-commercial Traders in Commodity Futures Market and Futures Prices



Note : Net non-commercial position includes net non-commercial as well as net non-reportable positions. Net long (+) , net short (-).

Source : Commitments of Traders Report by CFTC and ICE . Futures price based on COMEX, NYMEX, CBOT and ICE markets. Data extracted from Bloomberg.

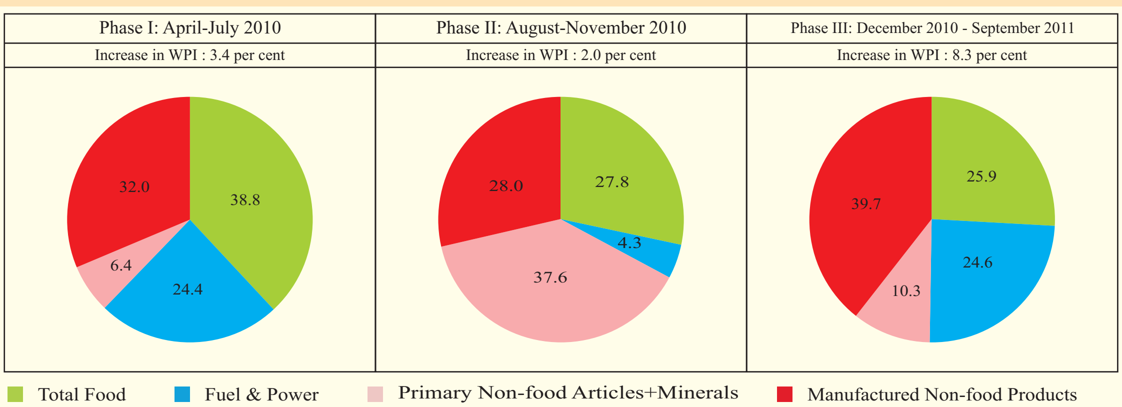
Chart VI.3 : Trends in Wholesale Price Inflation



momentum, while emphasizing the critical importance of a low inflation environment as a pre-condition to sustainable and inclusive growth.

VI.9 The month over month (m-o-m) seasonally adjusted changes in the price level, though volatile, remained significantly positive (Chart VI.3). Since December 2010, the major contributor to price rise has been non-food manufactured products reflecting generalisation of the inflationary pressures (Chart VI.4). It may be noted that the second round and indirect

Chart VI.4 : Changing Contributors to Increase in WPI



Note: Pie Chart Represents the Percentage Contribution of Different sub-groups to increase in WPI.

impact of past increases in food, fuel and non-food primary articles prices transmitted to non-food manufactured products in an environment of buoyant demand conditions.

Food inflation remains elevated despite record food production

VI.10 Though primary food articles inflation moderated from the levels of over 20 per cent witnessed in Q1 of 2010-11, it still remains high with the average inflation during 2011-12 so far (up to September) at 8.9 per cent. A decomposition of food articles inflation indicates that the price pressures have been moderate for cereals whereas increases have been significant in the case of protein-rich items (Chart VI.5). Demand has been growing in these items in recent years with rising income and changes in dietary pattern in favour of protein-rich items. Price pressures in these items could continue in the absence of supply response. Significant increase in nominal wages in rural areas (Chart VI.9) in recent years and successive increases in Minimum Support Prices (MSP) have weakened considerably the expected favourable impact of a normal monsoon this year and record food production.

Non-food articles prices remain moderate

VI.11 During 2011-12 (up to October 8, 2011), non-food articles prices have moderated somewhat, largely driven by decline in raw cotton prices in line with declining global prices. On the other hand, oilseeds prices have firmed up in recent months. As the area sown under both cotton and oilseeds have increased in the current year as compared with the previous year levels and also that the global prices have declined, non-food primary articles inflation may remain moderate in the near-term.

Increase in freely priced fuel products and revision in administered prices keep fuel inflation high

VI.12 Increase in administered prices of fuel products effected in June 2011 led to firming up of fuel inflation. Since then, prices of freely priced mineral oil products have increased partly on account of the recent depreciation of the rupee. Notwithstanding recent increases, the pass-through of global inflation to domestic inflation remains incomplete (Chart VI.6a).

VI.13 Domestic coal prices have remained unchanged in 2011-12 so far and given the incomplete pass-through of past increases in global coal prices, an upward revision in coal prices may become necessary going forward. Electricity prices increased by about 4 per cent in September 2011, partly reflecting the increase in input costs. The increase in electricity prices has been much less as compared with the increases in other energy prices as well as coal prices (Chart VI.6b). Given this, electricity prices are likely to be revised upwards in many states.

Chart VI.5: Primary Food Articles: Index and Inflation

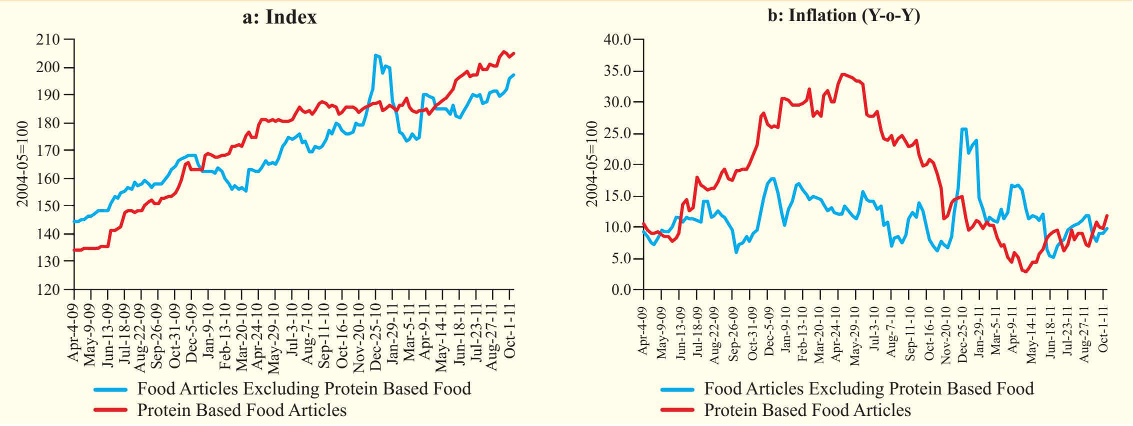
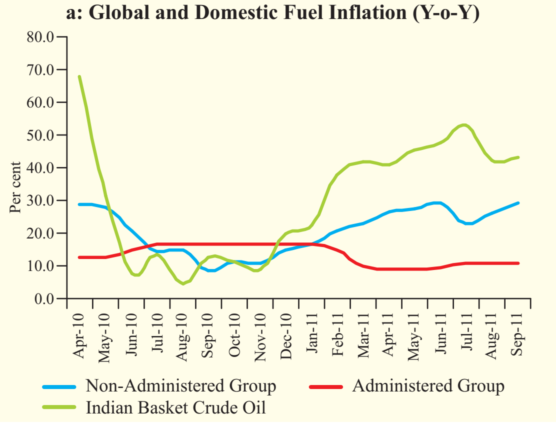
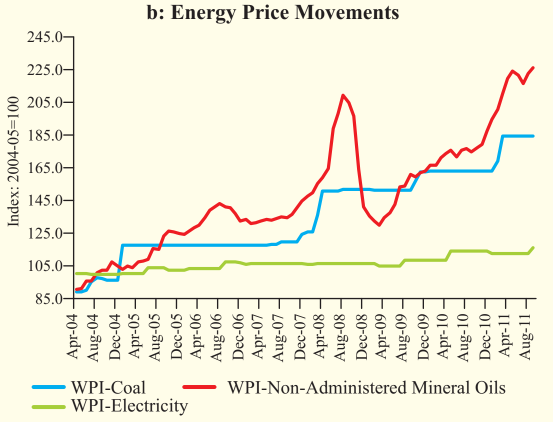


Chart VI.6: Trends in Fuel Inflation





Depreciation of the Rupee emerges as a new source of price pressures

VI.14 The rupee has depreciated by about 11 per cent against the US dollar during 2011-12 so far. India's imports account for about 22 per cent of GDP, and depreciation of the rupee raises the risk of imported inflation. Many of the commodities having large combined weights in the WPI also constitute jointly a significant proportion of total imports (Table VI.2). This is particularly evident from the trends in the price of the Indian Basket Crude Oil during 2011-12 so far. While in dollar terms the Indian Basket Crude Oil has declined since July 2011, in rupee terms it has increased owing to the rupee depreciation (Table VI.3).

Non-food manufactured products inflation remains significantly high.

VI.15 Sustained high inflation in manufactured non-food products reflects a combination of high input costs and buoyant demand. Even with modest moderation in demand in response to past monetary policy actions and the weakening of global growth outlook, as long as growth in demand remains significantly positive, input cost pressures can still be passed on in the form of higher wholesale and retail prices. Month-over-month seasonally adjusted inflation indicates that the price pressures have been almost continuous in 2011-12 so far, though relatively moderate as compared to the Q4 of 2010-11(Chart VI.7).

Table VI.2 Imports and WPI - Risk of Depreciation Induced Price Pressures

Items	Weight of the Item in WPI (2004-05=100)	Share of the Imported Item in Total Imports	
		2010-11	2011-12 (April-May)
1	2	3	4
Petroleum, crude & products	10.26	30.07	32.16
Machine tools	8.93	0.63	0.60
Iron & steel	6.36	2.73	1.94
Transport equipments	5.21	3.12	1.95
Vegetable oils fixed (edible)	3.04	1.83	1.45
Fertilizers	2.66	1.92	0.89
Coal, coke & briquittes *etc.*	2.09	2.74	3.02
Organic chemicals	1.95	3.17	2.70
Artficial resins, plastic materials *etc.*	1.86	1.95	1.41
Manufactures of metals	1.31	0.92	0.78
Inorganic chemicals	1.19	1.01	0.88
Pulp and waste paper	1.02	0.32	0.27
Non-ferrous metals	1.00	1.14	1.09
Electronic goods	0.96	6.10	6.15
Pulses	0.72	0.43	0.28
Gold	0.36	9.61	14.67

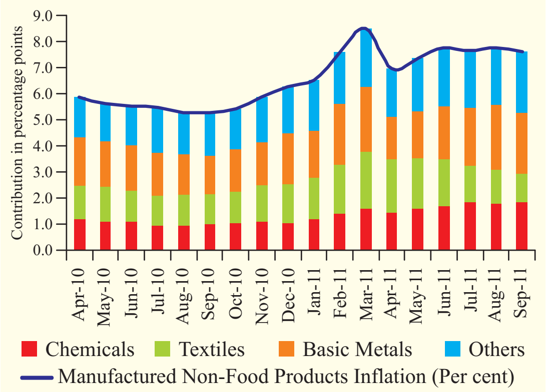
Note: The items presented in col. 2 and 3 & 4 may not exactly correspond, given differences in classification of items in WPI and Imports

Table VI.3: Comparative Movement of Oil Price and Exchange Rate Since July 2011

	July-11	October-11 (Average for First Fortnight)	Change in Per cent
1	2	3	4
Crude Indian Basket (US$)	112.5	103.6	-7.9
Exchange Rate (Rupee/Dollar)	44.4	49.2	10.7
Crude Indian Basket (Rupee)	4995.8	5094.1	2.0

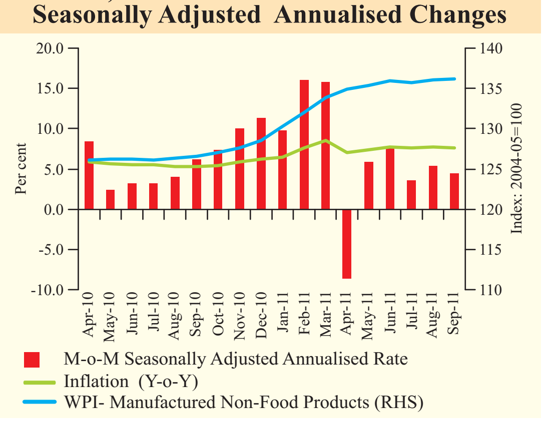
Note : The composition of Indian Basket of Crude Oil represents Average of Oman & Dubai for sour grades and Brent (Dated) for sweet grade in the ratio of 67.6:32.4.

Chart VI.8: Major Contributors to Non-food Manufactured Products Inflation



VI.16 Among non-food manufactured products, textiles, chemicals and metals continue to contribute the most to the increase in prices of manufactured non-food products (*i.e.,* about 69 per cent in September 2011) (Chart VI.8). Input cost pressures have been significant for these products in the recent past. While the recent moderation in cotton prices could be reflected in textile prices with a lag, depreciation of the rupee would offset the impact of any softening of global commodity prices on the price outlook for metals and chemicals significantly. Inflation in non-food manufactured products is also driven by a few items with low weights in WPI relative to the high weighted contribution. 24 out of 498 items under the manufactured non-food products, with a combined weight of 14.4 per cent in overall WPI accounted for as high as 51.2 per cent of the inflation in manufactured non-food products in September 2011.

Chart VI.7: Manufactured Non-food Products: Index, Inflation and Month-over-Month Seasonally Adjusted Annualised Changes



Input cost pressures alongside steady demand underpin the generalised inflation

VI.17 While supply shocks are often presumed to be temporary, at times, they could be repeated and thereby cause high inflation over a sustained period. In the absence of demand, however, even repeated supply shocks cannot cause a generalised inflation. If prices of commodities experiencing supply shock go up, prices of other commodities must decline in the absence of demand. Thus, high inflation that is broad based across a whole range of items covered in the price index is only feasible with the support of buoyant demand.

VI.18 Information on recent trends in expenditure patterns as available from the 66th round of NSSO consumption expenditure survey corroborates the role of demand. Growth in monthly per capita expenditure has been stronger in the second half of 2000s as compared with the first half (Table VI.4).

VI.19 Wage growth has been significant both in the formal and informal sectors relative to the inflation facilitating generalisation of supply side induced inflation shocks. Increase in rural wages has been in excess of the level of inflation experienced in rural areas (Chart VI.9). In the formal sector, Reserve Bank's company finance data suggest that the staff costs have risen at a faster rate since the middle of 2009-10 (Chart VI.10).

Table VI.4: Monthly Per Capita Expenditure Growth

(Annual Compound Growth, Mixed Reference Period Basis)

	1999-2000 to 2004-05	2004-05 to 2009-10
1	2	3
Nominal Growth		
Rural	3.6	10.5
Urban	5.3	10.9

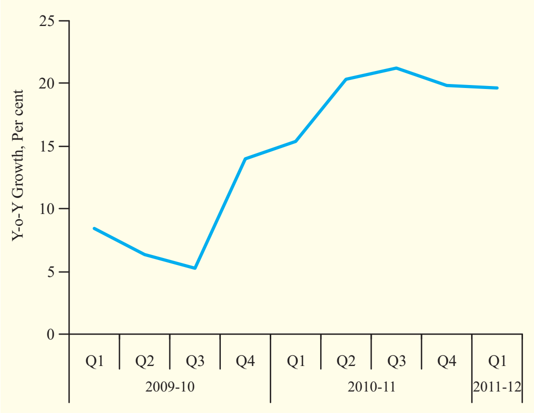
VI.20 Despite significant monetary tightening, inflation remains stubbornly high, reflecting partly the greater role of other input costs relative to interest costs in the corporate sector. The relative share of interest costs in total costs has remained largely unchanged over recent quarters, that too at a low level (Chart VI.11).

CPI and WPI inflation converge reflecting broad based price pressures

VI.21 Various measures of CPI inflation remained in the range of 9.0-9.4 per cent in August/September 2011. The convergence of various measures of CPI inflation with WPI inflation reflects broad based price pressures (Chart VI.12).

VI.22 The new CPI introduced for urban and rural areas along with a composite All-India CPI also suggest the build-up in price pressures (Chart VI.13). Trends in these indices since inception in January 2011 indicate that the price pressures have been relatively more in rural areas as compared to the urban areas. Also among the major groups, price increases have been more significant in textiles and fuel.

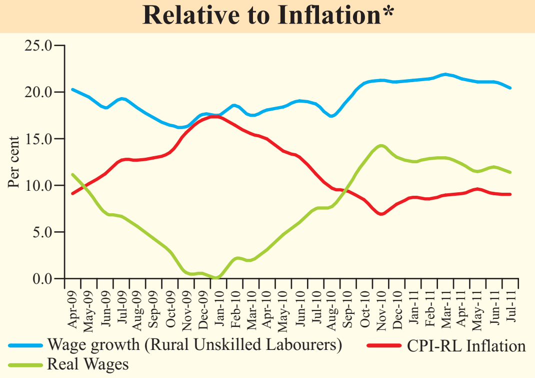
Chart VI.10: Staff Costs in the Corporate Sector



Inflation softening expected in the later part of the year, but risks remain

VI.23 The inflation path so far has been sticky and may remain so over the next few months. In the absence of significant anti-inflationary monetary policy actions, inflationary pressures could have been higher. Despite a normal monsoon this year and record production of foodgrains last year, food price inflation may not moderate much in an environment of increase in rural wages, significant increase in MSPs and persistent input cost pressures in the farm sector. Moderation in international crude prices may not translate into lower inflation in the fuel group, due to incomplete pass-through in the past as also the inflationary impact of rupee depreciation given the high import dependence in oil.

Chart VI.9: Increase in Rural Wages Relative to Inflation*



*: Y-o-Y Growth in Rural Unskilled Labourer (Male) wage and CPI-Rural Labourers inflation (Y-o-Y).

Source: Labour Bureau, Ministry of Labour

Chart VI.11: Interest as a Share of Sales and Costs

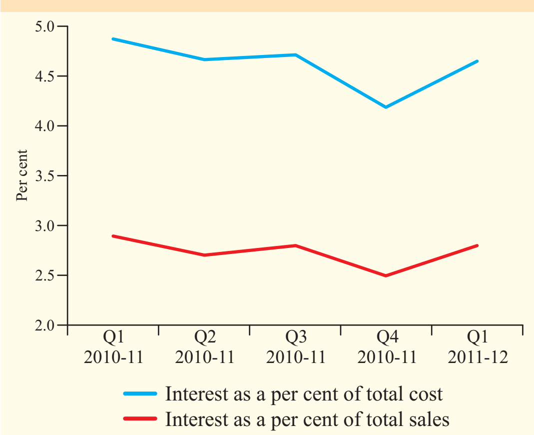
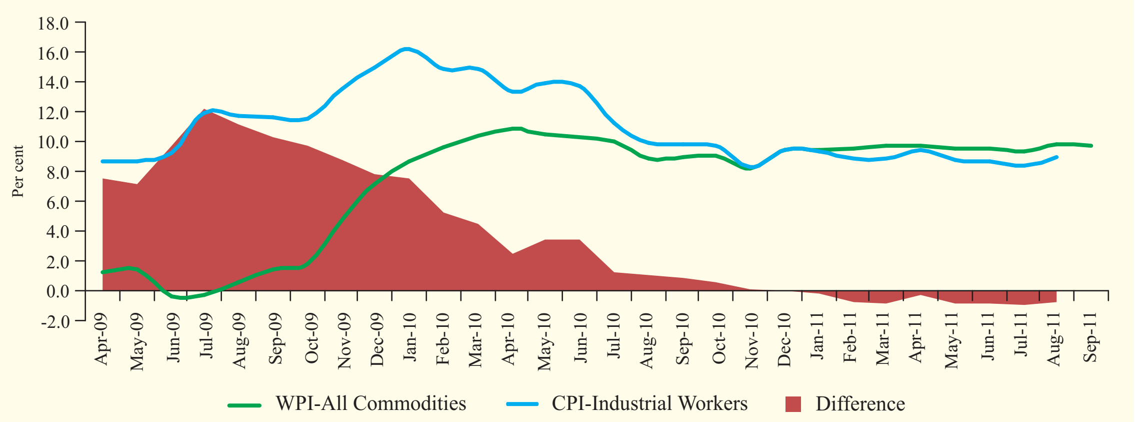
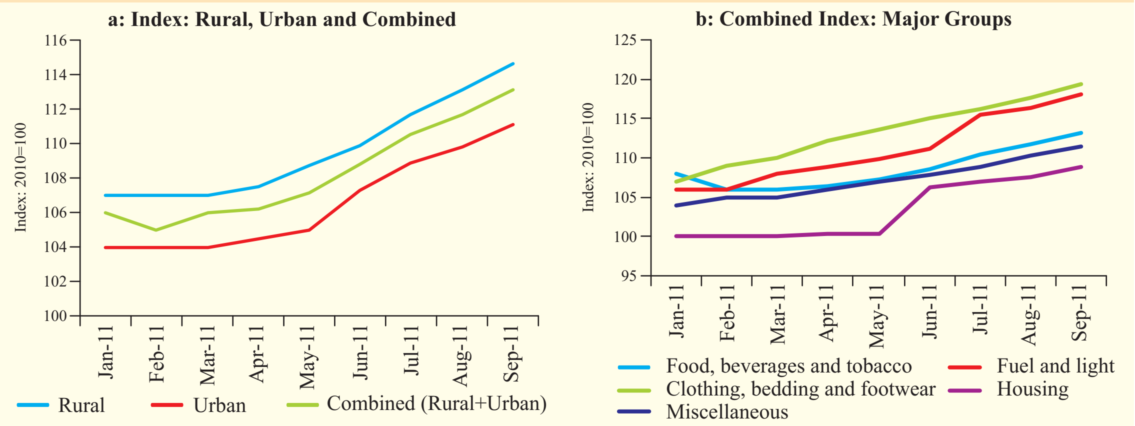


Chart VI.12: WPI and CPI Inflation (Y-o-Y)



VI.24 Moderation in non-food manufactured products inflation in the second half could be conditioned by softening of demand resulting from past monetary policy actions as also the spillover from weaker global growth momentum. While softening of input cost pressures could imply weaker transmission to non-food manufactured products, exchange rate depreciation would partly offset the magnitude of softening. For the conduct of monetary policy the outlook for inflation as also private consumption and investment demand would be critical. Current assessment of drivers of inflation suggests moderation of inflation in the later part of 2011-12.

Chart VI.13: Price Trends in New CPI



VII. MACROECONOMIC OUTLOOK

Inflation continues to be sticky while growth risks have increased. The business expectation surveys of various agencies, as well as the Reserve Bank's Industrial Outlook Survey suggest a weakening of business climate. The professional forecasters' survey show that forecasts for growth have been revised downwards while those for inflation have been marginally increased.

Growth risks increase on global headwinds while sticky inflation adds to complexity

VII.1 Growth risks have increased on global headwinds, while inflation continues to be sticky adding to the complexity for monetary policy. Should global downturn accentuate, monetary and fiscal policy space exists, though the current high inflation reduces the degrees of freedom somewhat. The IMF's baseline projections suggest that global economy would continue to grow at a moderate pace ahead. Recovery is unlikely to peter out even in the case of advanced economies. Nevertheless, in a financial world several outcomes are possible as perceptions of economic agents can shift fast impacting their economic behaviour. It would, therefore, be necessary for all stakeholders - private or government - to quickly build upon the liquidity buffers and hedge against financial risks.

VII.2 Even as the global growth cycle seems to be turning, persistence of inflation at high levels would continue to need to be factored in the policy. The baseline projection for WPI inflation for March 2012 was placed at 7.0 per cent at the time of the First Quarter Review of Monetary Policy on July 26, 2011 anticipating some moderation in the later part of the year. Forward-looking assessment suggests that inflation will play out broadly in line with the earlier anticipated path and the risks to the baseline projection are now balanced.

VII.3 Generalised inflationary pressures were still in evidence till September 2011. Inflation in non-food manufactured products remained high. Food inflation has surprised on the upside in the recent period in spite of favourable monsoon and likelihood of record *kharif* output, partly reflecting the large increase in MSPs.

VII.4 The benefits of the recent fall in global commodity prices have been largely offset by the rupee depreciation. The benefit from any further fall may also remain limited as a result of the incomplete passthrough of the earlier increase in global commodity prices, as was explained earlier in the RBI Annual Report 2010-11. Since then, suppressed inflation has been partly tackled through revisions in petroleum and electricity prices, but further upward revision cannot be ruled out.

VII.5 On the other hand, with weakening economic activity levels, the economy may grow at a rate somewhat lower than what was anticipated earlier. Indicators suggest that growth moderation has continued into Q2 of 2011-12. Growth is also likely to stay weak in the second half of 2011-12, especially if the global downturn continues. As such, challenges from the policy perspective have become even more complex with persistent inflation and increased risks to growth.

VII.6 The IMF's baseline scenario is that the dip in global growth this time around would be far muted than during 2008-09. Yet, it is important for the policymakers to be prepared for tail risk events. In such an event, some room for counter-cyclical action may be generated with a further fall in commodity prices. Yet, it is important to note in this context that inflation may turn out to be stickier than before due to structural impediments. Further room for front-loaded action may be limited. Headline inflation has now stayed in 8-11 per cent range for the past 21 months. Non-food manufacturing inflation has been more than 7 per cent for the past eight months against a long-term average of 4.4 per cent.

Monetary and fiscal policy space exists but inflation constraints important

VII.7 Fiscal policy space may be constrained if inflation stays elevated. Currently, government spending is adversely impacting the objective of containment of aggregate demand. On current assessment, the Government is unlikely to meet its deficit targets for 2011-12. A slowdown is likely to impact revenues and tax cuts will be difficult. The fiscal position has macro-economic consequences through its impact on interest rates, exchange rates and price level and is also an important determinant of the costs of overseas borrowings. It is, therefore, important to create fiscal space within the framework of fiscal rules.

VII.8 There are upside risks to inflation from still incomplete pass-through of global commodity prices, downward stickiness of food prices, recent revisions in minimum support prices and evidence of wage price spiral. In view of this, the inflation has proved to be stubborn and may subside only slowly in the rest of 2011-12. The challenge at this juncture is to contain inflationary pressures, while factoring in the lags in monetary transmission, which are long and variable and, therefore, difficult to assess.

Leading indicators suggest growth may moderate slowly

VII.9 Current assessment is that growth may moderate slowly and not fall to the levels seen during the post-Lehman crisis. As such, existing space for monetary management can tackle the growth-inflation challenge along with complimentary demand management and structural policies.

Business expectations surveys indicate moderation

VII.10 A comparative study of business expectations surveys, conducted by different agencies, indicates stiff moderation in business climate. Both global and domestic factors seem to have weakened the perception about the performance of the economy. The CII and FICCI business confidence indices have shown significant decline over the previous quarter and year too. The CII index stands lower than the index value recorded during the period October-March 2008-09, following the global financial crises. The top two concerns, according to CII Business Outlook Survey are high interest rates and high raw material costs. The latest survey of NCAER on business confidence recorded significant decline in index on both q-o-q and y-o-y basis (Table VII.1). Dun & Bradstreet Business Optimism Index is at the second lowest since September 2010 (Chart VII.1a). Persistent high inflation, weakening demand, lower availability of credit and prevailing global uncertainties appear to be affecting the business sentiments of the Indian companies.

VII.11 The seasonally adjusted HSBC Markit Purchasing Managers' Indices (PMI) for September 2011 indicate the economic activity may be slowing down. Manufacturing PMI registered the weakest expansion in the last two-and-a-half years. While the services PMI pointed towards a stagnation in activity.

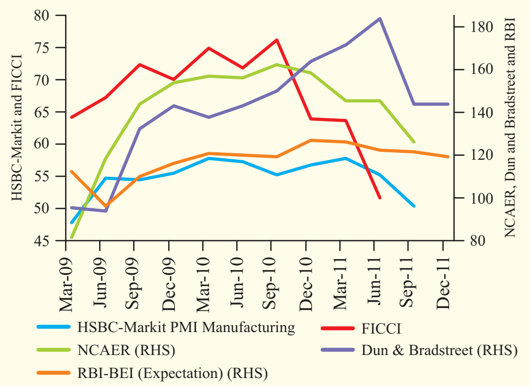
Table VII.1 : Business Expectations Survey

Period Index	NCAER-Business Confidence Index Sep. 2011	FICCI Overall Business Confidence Index Q1:2011-12	Dun & Bradstreet Business Optimism Index Q4: 2011	CII Business Confidence Index Q2: 2011-12
1	2	3	4	5
Current level of the Index	125.7	51.6	143.7	53.6
Index as per previous survey	145.2	63.7	143.6	62.5
Index levels one year back	162.1	71.9	163.5	67.6
Per cent change (q-o-q) sequential	-13.4	-19.0	0.1	-14.2
Per cent change (y-o-y)	-22.5	-28.2	-12.1	-20.7*

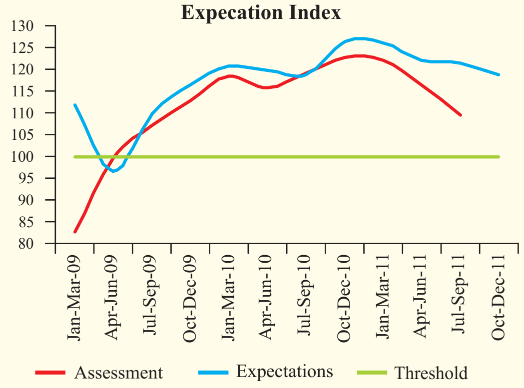
*: Percentage change over April-September 2010-11 survey.

Chart VII.1: Industrial Outlook Surveys

a: Business Conditions Surveys: A Comparison



b: Reserve Bank's Industrial Outlook Survey-Business Expecation Index



Survey suggests Industrial Outlook has weakened

VII.12 The 55th round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS55) of the Reserve Bank conducted during July-September 2011, showed further decline in Business Expectation Index (BEI). The index is a composite indicator based on assessment of several business related parameters for the assessment quarter (July-September 2011) as well as for the expectation quarter (October-December 2011). However, BEI still remained in growth terrain (i.e. above 100, which is the mark that separates contraction from expansion) (Chart VII.1b). The demand conditions of the Indian manufacturing sector continued to moderate as net responses on production, order books and exports declined for the assessment as well as expectation quarters. Most industry groups reported lower optimism on demand and financial conditions.

VII.13 The outlook on availability of finance was also less optimistic while the respondents expected cost of finance to rise further. A sizeable proportion of respondents anticipated continued increase in raw material costs, which may affect profit margins adversely (Table VII.2).

Downward Revision in growth forecast by other agencies

VII.14 Various agencies have revised downwards their earlier growth forecasts for

TableVII.2 : Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response								
		Oct-Dec 2010		Jan-Mar 2011		Apr-Jun 2011		July-Sept 2011		Oct-Dec 2011
		E	A	E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9	10	11
1. Overall Business Situation	Better	47.5	45.9	50.1	38.6	41.4	32.6	39.8	18.7	35.2
2. Overall Financial Situation	Better	39.6	37.1	41.1	27.1	33.4	24.1	30.6	11.7	26.3
3. Availability Of Finance	Improve	31.3	30.3	32.3	23.8	27.3	21.5	24.2	12.1	20.2
4. Cost Of External Finance	Decrease	-28.3	-33.9	-31.3	-42.5	-35.0	-49.0	-39.7	-50.2	-41.0
5. Production	Increase	49.1	43.9	48.6	41.4	40.0	32.1	40.6	22.6	39.9
6. Order Books	Increase	44.8	37.9	44.0	34.7	38.4	28.1	35.9	20.3	33.4
7. Level Of Capacity Utilisation	Above Normal	7.2	5.6	9.5	4.9	4.4	-0.7	4.3	-6.4	0.3
8. Cost of Raw Material	Decrease	-49.3	-63.9	-53.6	-71.9	-57.0	-65.5	-51.7	-58.1	-49.7
9. Employment in the Company	Increase	21.0	19.4	20.6	18.7	17.4	18.2	19.4	15.6	16.5
10. Exports	Increase	26.1	23.1	26.3	18.9	24.0	18.2	25.8	13.1	22.1
11. Imports	Increase	22.2	20.9	21.3	19.9	18.9	17.6	19.0	15.7	16.9
12. Selling Price	Increase	17.0	20.2	18.6	26.5	23.7	21.5	18.3	10.7	16.0
13. Profit Margin	Increase	9.2	-0.4	8.3	-4.3	3.8	-9.9	2.5	-17.1	-1.6

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

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

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

* : IMF's forecast is 7.7 per cent for GDP at market prices for 2011-12.

India for 2011-12, with some even projecting the growth to be below 8.0 per cent (Table VII.3).

VII.15 Going forward, there are significant downside risks to growth during 2011-12. GDP data for Q1 2011-12 and various lead indicators are indicative of further moderation in growth. The buoyant export growth observed up to August 2011 may not hold out on account of the sluggish growth in the advanced economies and further deepening of global uncertainties mainly because of euro area crisis, downward revision of US's credit rating by S&P and lowered debt ratings for several banks. Furthermore, domestic industry is exhibiting signs of slowdown on account of the lagged effects of past monetary policy actions. Risks to growth also emerge from the worsening global environment, volatility in international crude oil prices and high inflation.

Survey of Professional Forecasters[1] suggest lower growth, higher inflation

VII.16 In the 17th round of 'Survey of Professional Forecasters' (http://www.rbi.org.in/SPF17), conducted by the Reserve Bank, growth forecasts for 2011-12 have been slightly revised downward as compare to previous survey (Table VII.4). At sectoral level growth forecasts

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

	Actual 2010-11	Annual Forecasts				Quarterly Forecasts									
		2011-12		2012-13		2011-12						2012-13			
						Q2		Q3		Q4		Q1		Q2	
		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 at factor cost@	8.5#	7.9	7.6	8.3	7.7	7.7	7.5	8.1	7.7	8.2	7.8	8.1	7.6	-	7.6
a. Agriculture & Allied Activities@	6.6#	3.5	3.2	3.6	3.0	3.5	3.8	2.2	2.7	3.0	3.1	3.8	3.0	-	3.2
b. Industry@	7.8#	7.4	6.4	8.1	6.9	7.2	6.0	8.1	7.1	8.3	7.6	8.0	7.2	-	6.8
c. Services@	9.2#	9.0	9.1	9.4	9.0	9.0	9.0	9.8	9.2	9.6	9.1	9.4	8.9	-	9.1
2. Gross Domestic Saving*	-	34.2	34.0	35.0	34.6	-	-	-	-	-	-	-	-	-	-
3. Gross Domestic Capital Formation*	-	35.5	34.5	36.4	35.0	35.0	34.2	35.0	34.5	36.0	34.8	37.0	35.0	-	35.0
4. Average WPI-Inflation	9.6	8.6	8.8	6.5	6.7	10.0	9.6&	8.8	8.8	6.9	7.0	6.8	6.6	-	6.6
5. Exchange Rate (INR/1USD end period)	44.65	44.5	47.0	43.5	45.0	44.8	48.9&	44.6	48.0	44.5	47.0	44.0	46.1	-	45.8
6. T-Bill 91 days Yield^	7.31	8.0	8.3	7.6	7.7	-	-	-	-	-	-	-	-	-	-
7. 10-year Govt. securities Yield^	8.02	8.3	8.3	8.0	8.0	-	-	-	-	-	-	-	-	-	-
8. Export @ !	42.3	20.5	19.5	20.0	20.0	-	-	-	-	-	-	-	-	-	-
9. Import@ !	22.3	23.0	24.4	19.7	18.0	-	-	-	-	-	-	-	-	-	-
10. Trade Balance (US$ bn)	-98.2	-	-	-	-	-39.4	-34.8	-34.3	-37.7	-35.0	-39.0	-40.0	-38.0	-	-38.0

E: Previous Round Projection. L: Latest Round Projection. @: Growth rate in per cent. #: Revised Estimates.
*: Per cent of GDP at current market price. -: Not available. &: Actual. ^: Per cent end period. ! : In US$ on BoP basis.
Source: 17th round of Survey of Professional Forecasters, Q2: 2011-12.

[1] The forecast reflects the views of professional forecasters and not of the Reserve Bank.

are revised downward for 'agriculture and allied activities' and industry, whereas that for services has been revised upward marginally. Annual average inflation forecast for the year 2011-12 is revised marginally upward as compared to previous survey round, though it is expected to decline gradually over the quarters. The survey results are in consonance with the view that inflation may moderate slowly.

Inflation Expectation Survey indicates higher perceived and expected inflation

VII.17 The latest round of Inflation Expectation Survey of Households (http://www.rbi.org.in/IESH25) conducted in July-September 2011, exhibits marginal increase in both perceived and expected inflation. Households anticipate higher inflation in current and next one quarter. The survey was conducted by the Reserve Bank and covered 4000 household from seven different occupational classes.

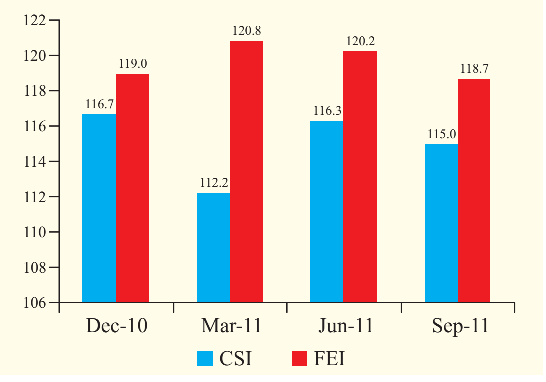
Consumer Confidence Survey indicates decline in index but remain positive

VII.18 The 6th round Consumer Confidence Survey (http://www.rbi.org.in/CCS6), conducted by the Reserve Bank in September 2011, indicates decline in positive perceptions of the household. Though the net response for one year outlook has declined as compared to the last three quarters yet optimism regarding improvement in future income remains. The overall 'future expectation index' is marginally down as inflation continues to have a pull down effect on the consumer confidence (Chart VII.2).

Inflation challenges and risks to growth to set policy responses

VII.19 While persistent high inflation is impacting growth, investment is slowing. This will have an adverse impact on potential growth. The investment cycle appears to be turning for the first time after 2003-04. The May issue of this report had stated that investment had entered into a soft patch. The soft patch has now extended beyond what was anticipated as in

Chart VII.2: Net Response to Current Situation Index (CSI) and the Future Expectations Index (FEI)



addition to the impact of monetary tightening, other factors have impacted business sentiments. First, with signs of global and domestic economy slowing down, firms are reluctant to expand capacities. Second, the impact of perceived governance issues have lingered, even though significant steps have been taken towards expediting road-project tendering and towards improving coal supplies for power projects. Third, business confidence has weakened due to wealth effects of the correction in equity prices. Fourth, along with the correction in the equity markets, the embedded valuations for planned investment have turned lower than the irrational pricing seen in the past. This has also contributed to new corporate fixed investment falling.

VII.20 The fall in new investment since the second half of 2010-11 has been significant and can impact the pipeline investment in coming years. Consumer demand is still robust, but some impact is likely ahead as a result of higher interest rates and changing business conditions. External demand is also expected to fall ahead if global slowdown persists. Even as growth moderates, inflation risks still prevail. Inflation remains a concern and will continue to occupy an important space in monetary policy setting. Monetary policy trajectory will need to be guided by the emerging growth-inflation dynamics, factoring in the transmission of past actions, that is still unfolding.

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