RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments Second Quarter Review 2013-14

Issued with the Second Quarter Review of Monetary Policy 2013-14

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Reserve Bank of India
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MACROECONOMIC AND MONETARY DEVELOPMENTS SECOND QUARTER REVIEW 2013-14

Overview

1. With improved stability in the foreign exchange market, the marginal standing facility (MSF) rate, which had become the effective anchor for money market rates, was reduced by 75 bps in the Mid-Quarter Review on September 20 and further by 50 bps on October 7 to 9.0 per cent. The Reserve Bank further introduced 7-day and 14-day variable rate term repos to provide additional liquidity up to 0.25 per cent of net demand and time liabilities (NDTL) of banks.

2. Given the tight liquidity conditions in line with the policy intent, the MSF rate had served as the effective policy rate in the short-run. So the effective cost of funds in the money market was reduced by lowering the MSF rate. However, keeping in view the concerns emanating from high and persistent consumer price index (CPI) inflation and some rise in the wholesale price index (WPI) inflation, as also the impact of low real interest rates on saving behaviour, the Reserve Bank hiked the repo rate by 25 bps on September 20. This signalled that the policy rate needed to respond to inflation risks so as to secure macroeconomic stability, even as the process of normalisation of monetary policy with a rollback of exceptional measures proceeds.

3. The Reserve Bank has been adopting a judicious mix of policy under a difficult macroeconomic scenario of high inflation, low growth and financial fragilities. Unlike countries which could go for quantitative easing to support growth on the back of deflation or very low inflation, India has faced markedly higher inflation even when compared to its emerging market peers in recent years. This makes it important to keep liquidity under check and the policy rate at a reasonable level to anchor inflation expectations, with a view to ensuring stable macro-financial conditions and positive real returns to savers. As the exceptional measures are rolled back with the improvement in exchange market conditions, it is important to keep this balance in view.

Global Economic Conditions

Sluggish global growth continues to be a drag on the domestic economy

4. Global growth continues to be sluggish, as reflected in the downward revisions in projections by various international agencies. Notwithstanding a distinct improvement in growth in the advanced economies, as also some key emerging market and developing economies (EMDEs), new risks to global recovery have arisen from fiscal discord in the US and uncertainties arising from expectations related to withdrawal from unconventional monetary easing by advanced economies.

5. The global inflation remains benign with slack in labour markets, expected stable commodity prices on the back of improved capacities and receding geo-political risks.

6. Global financial markets got a breather with the Fed decision to maintain *the pace of its bond purchases and its signal that the withdrawal of QE may take longer. However, financial markets could be disrupted again when the extraordinary monetary accommodation in the advanced economies is withdrawn.*

Indian Economy: Developments and Outlook

Output

Moderate recovery expected during H2 on the back of a rebound in agriculture and an improvement in exports

7. The slowdown facing the Indian economy extended into 2013-14 with growth in Q1 falling to a 17-quarter low. The growth slowdown was broad-based reflecting moderation in the services and agriculture sectors, and contraction in the industrial sector. Modest improvement in growth is likely in H2 of 2013-14 on the back of a good monsoon and some improvements in industrial growth. A fuller recovery is likely to start taking shape towards the end of the fiscal year when current steps to clear the logjams constraining economic activity seep through the various inter-sectoral linkages in the economy.

Aggregate Demand

Demand management requires balancing fiscal consolidation with investment support

8. The aggregate demand of the economy remained weak during Q1 of 2013-14 despite government final consumption expenditure increasing sharply. Private consumption decelerated, while fixed investment contracted. There was a sharp fall in fresh investment proposals from the private corporate sector. Weak demand conditions were also reflected in decelerating corporate sales. However, a good monsoon this year and consequent encouraging crop prospects are expected to shore up rural demand. The recent uptick in exports, if sustained, could provide added momentum. Revival of investment demand will take some more time. Meanwhile, further measures are needed to avert fiscal slippage by reduction in revenue spending, especially poorly targeted subsidies. At the same time, public investments need to be boosted to crowd-in private investment with a view to supporting a revival in the economy.

External sector

External sector risks lowered as CAD likely to moderate since Q2

9. The current account deficit (CAD) which widened again in Q1 of 2013-14, is likely to moderate in Q2, broadly in line with the narrower trade deficit. The trade balance has responded to the policy measures taken, especially as gold imports declined and exports picked up. While external risks have lowered somewhat, it is important to build on the recent CAD improvement through further structural adjustments. Focus will also be needed to encourage stable long-term capital inflows and to exercise caution with regard to private external debt that has been rising in recent years.

Monetary and Liquidity Conditions

Growth-inflation dynamics to shape monetary policy as normalisation of exceptional liquidity measures make headway

10. Since mid-July 2013, exceptional measures were put in place by the Reserve Bank to maintain liquidity conditions such that volatility in the forex market is contained. The policy rate was effectively recalibrated to the MSF rate, leading to the hardening of money market rates. However, to facilitate adequate credit to productive sectors, significant primary liquidity injection was provided via LAF, MSF, OMOs and standing facilities. Notable pick-up in credit off-take since mid-July has occurred as corporates have *substituted costlier money market sources by bank credit. As such, monetary and liquidity conditions are evolving broadly in sync with the policy. Further monetary policy actions would have to be recalibrated keeping in mind the growth-inflation dynamics, going forward.*

Financial Markets

Near-term uncertainties remain a lingering concern

11. Forward guidance by the Fed in September 2013 appears to have calmed near-term market uncertainties to a significant extent. Equity markets have rallied, currencies have appreciated and bond yields appear to have stabilised after a spell of volatility. The Indian financial markets also reacted positively to these developments. With a hesitant global recovery still unfolding, the challenge would be to put the domestic economy back on track quickly before a new world of less abundant liquidity becomes a reality.

Price Situation

Risks to inflation in H2 of 2013-14 broadly in balance, but persistence in CPI inflation remains a concern

12. The trajectory of softening WPI inflation reversed in Q2 of 2013-14 mainly due to an increase in food and fuel inflation. Vegetable prices increased sharply, impacting food inflation, while exchange rate depreciation and rise in crude oil prices led to a rebound in fuel inflation. However, manufactured non-food inflation remained subdued. While food inflation pressures could recede somewhat on the back of a normal south-west monsoon, upside risks exist. These stem largely from second-round effects of high food and fuel inflation. This, to an extent, is already reflected in the stubborn non-food and non-fuel component of CPI inflation. Risks also arise from high wage growth and rising costs of transport, education and health services. Besides, structural elements and the ratchet effect may check the fall in food inflation arising from good harvest.

Macroeconomic Outlook

Macro risks and inflationary pressures to underpin policy actions

13. A modest improvement in growth is anticipated in H2 of 2013-14. Both WPI and CPI inflation may stay range-bound around the current levels that remain above comfort levels. Various surveys, including those by the Reserve Bank show that business confidence remains weak, while inflation expectations have risen again. In this milieu, monetary and fiscal policies will have to be crafted so as to allow structural policy measures and ground-level actions to shape a sustainable recovery by next year. The monetary policy will need to aim at anchoring inflation expectations, while appropriately addressing growth risks.

I. OUTPUT

Growth in India, like in many other EMDEs, has slowed for over two years. The slowdown in India was led by domestic structural constraints, while global cyclical conditions added to the drag. However, as some of the structural constraints are starting to get addressed, activity levels could improve in H2 of 2013-14 and a moderate-paced economic recovery could start taking shape towards the end of the year. Better crop prospects due to a good monsoon, initiatives by the government to speed up project implementation and a pick-up in exports, along with a reduction in external imbalances has set the stage for recovery but sustained ground-level action, especially in expediting project implementation is needed to achieve a sustainable turnaround.

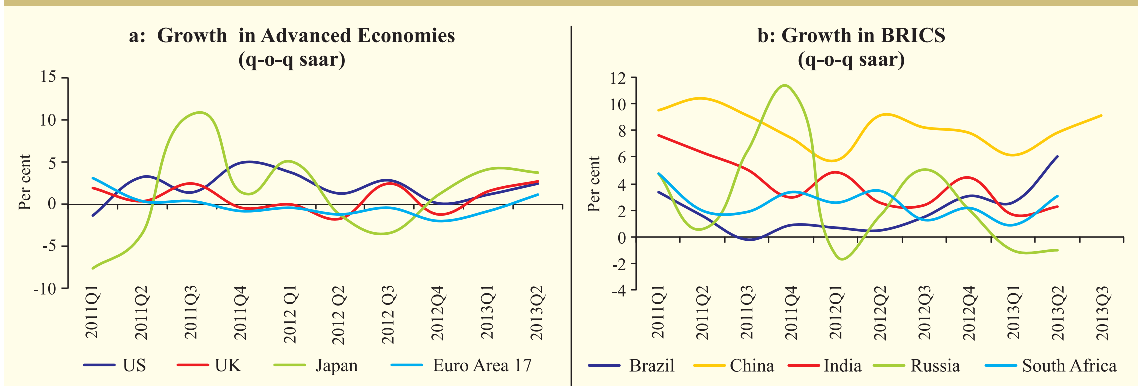
Global growth likely to remain sluggish in the near term

I.1 Global growth appears to be on a sluggish trail despite an improvement in Q2 of 2013 . The International Monetary Fund (IMF) in its World Economic Outlook in October 2013 revised global growth for 2013 downwards by 0.3 percentage points to 2.9 per cent. This downward revision is on account of slower growth in Emerging Market and Developing Economies (EMDEs), including in China and India. EMDEs growth projections have been lowered by 0.5 percentage points to 4.5 per cent, while the projections for Advanced Economies (AEs) stays at 1.2 per cent.

I.2 Although both advanced and emerging economies face the challenge of slower growth, there was a distinct improvement in growth in the major advanced economies during Q2 of 2013. In Q2 of 2013, the US GDP grew at 2.5 per cent (seasonally adjusted annualised quarter-on-quarter growth rate, q-o-q saar), higher than 1.1 per cent in Q1 (Chart I.1a), due mainly to growth in exports and non-residential fixed investments on the one hand and a smaller decrease in federal government spending on the other. But the US shutdown for sixteen days might get reflected in lower GDP growth in Q4 of 2013. The imminent risks to the global economy from a possible US debt default have been deferred with the US Government signing a debt deal on October 17, 2013. However, issues for the sustainability of the US recovery going forward remained with headwinds to investment, slack labour market conditions and a possible rise in mortgage rates.

I.3 Japan's economy expanded for the third straight quarter in Q2 of 2013 at 3.8 per cent. UK showed improvements for the second consecutive quarter in Q2 of 2013, growing by 2.7 per cent as against 1.5 per cent in Q1. The euro area grew by 1.1 per cent (q-o-q saar) in

Chart I.1: Global growth remains slow despite some recent improvement



Source: Eurostat

Source: OECD, Stat Extracts

Table I.1: Slowdown in growth has been broad-based

Sector-wise growth rates of GDP (2004-05 prices)

(Per cent)

Industry	2011-12*	2012-13#	2012-13				2013-14
			Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7	8
1. Agriculture, forestry & fishing	**3.6**	**1.9**	**2.9**	**1.7**	**1.8**	**1.4**	**2.7**
2. Industry	**2.7**	**1.2**	**-0.2**	**0.5**	**2.3**	**2.0**	**-0.9**
2.1 Mining & quarrying	-0.6	-0.6	0.4	1.7	-0.7	-3.1	-2.8
2.2 Manufacturing	2.7	1.0	-1.0	0.1	2.5	2.6	-1.2
2.3 Electricity, gas & water supply	6.5	4.2	6.2	3.2	4.5	2.8	3.7
3. Services	**7.9**	**6.8**	**7.6**	**7.1**	**6.2**	**6.3**	**6.2**
3.1 Trade, hotels, transport & communication	7.0	6.4	6.1	6.8	6.4	6.2	3.9
3.2 Financing, insurance, real estate and business services	11.7	8.6	9.3	8.3	7.8	9.1	8.9
3.3 Community, social & personal services	6.0	6.6	8.9	8.4	5.6	4.0	9.4
3.4 Construction	5.6	4.3	7.0	3.1	2.9	4.4	2.8
4. GDP at factor cost	**6.2**	**5.0**	**5.4**	**5.2**	**4.7**	**4.8**	**4.4**

*: First Revised Estimates. #: Provisional Estimates.
Source: Central Statistics Office (CSO)

the second quarter of 2013, helped by stronger growth in the two largest economies, Germany and France.

I.4 Among the EMDEs, China's GDP in Q3 of 2013 went up by 9.1 per cent (q-o-q saar) as compared to 7.8 per cent in Q2 and 6.1 per cent in Q1. Brazil's GDP growth at 6.0 per cent (q-o-q saar) for Q2 of 2013 turned out to be better than expected (Chart I.1b). With the Fed tapering plans getting delayed, the EMDEs need to prepare themselves in the interim for the challenges that may arise.

I.5 The US labour market conditions still remain weak with unemployment rate dropped to 7.2 per cent in September 2013, though additional non-farm payroll employment at 148,000 was also weak. UK labour markets witnessed unemployment rate of 7.7 per cent during June-August, down by 0.1 percentage points from March-May 2013. In case of Japan, the unemployment rate increased to 4.1 per cent in August 2013 from 3.8 per cent in July 2013. The unemployment rate in the euro area also remained high and unchanged at 12.0 per cent in August 2013.

The Indian economy faced broad-based slowdown during Q1 of 2013-14

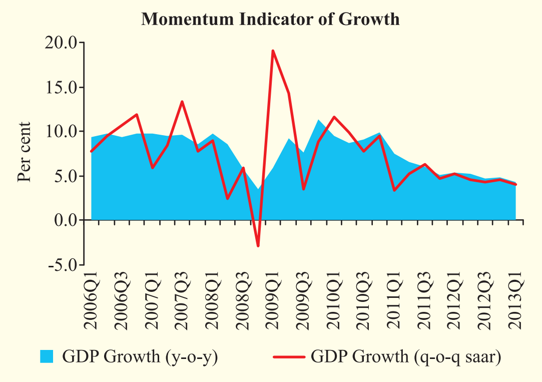
I.6 The slowdown facing the Indian economy extended into 2013-14 with growth in Q1 of 2013-14 falling to a 17- quarter low of 4.4 per cent (Table I.1). The growth slowdown was broad-based reflecting moderation in the services and agricultural sectors, and contraction in the industrial sector.

I.7 Since H2 of 2011-12, the seasonally adjusted annualised q-o-q saar growth rate has moved in line with declining trends in the year-on-year (y-o-y) GDP growth rate, confirming the downward momentum in the real economy (Chart I.2). The output gap also continued to be negative (Chart I.3). Supply constraints, high inflation, cyclical factors and low external demand contributed to this slowdown.

Agriculture growth expected to be buoyant

I.8 Agricultural production during 2013-14 is expected to record an above-trend growth (Table I.2). The first advance estimates of production of foodgrains have placed *kharif* foodgrains at 129.3 million tonnes, a 10.3 per

Chart I.2: Downward momentum of the real economy



cent jump over the first advance estimates of the previous year and 0.9 per cent growth over the fourth advance estimate. Oilseeds too are expected to show a substantial increase.

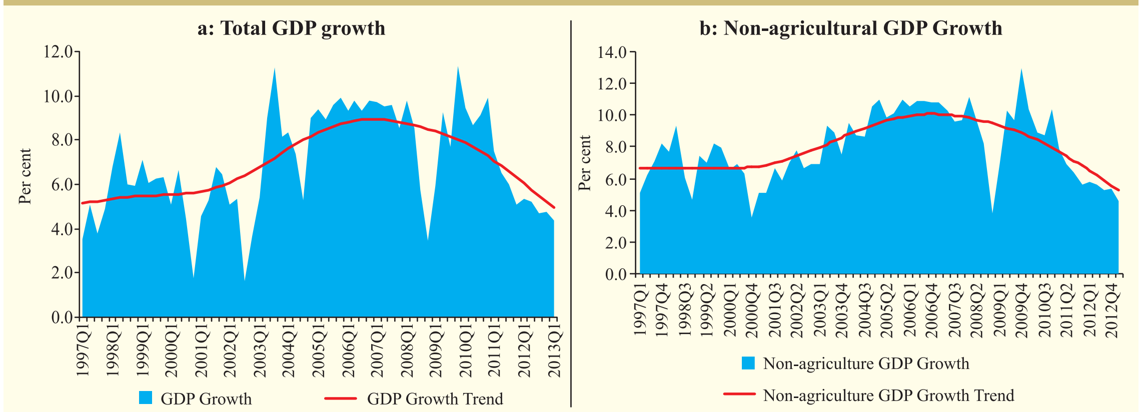
I.9 A normal and evenly distributed south-west monsoon reinforced the possibility of a good crop. Rainfall during June-September 2013 was 6 per cent above normal. Thirty out of the 36 meteorological sub-divisions that constitute 86 per cent of the country's area received normal or excess rainfall. Deficiency in rainfall was limited to areas in the East and North-East and in Haryana. Prospects for *rabi* crops are also good with water storage in the 85 major reservoirs as of October 17, 2013 being 16.3 per cent higher than last year's level. The Reserve Bank's production weighted rainfall index for foodgrains for the period stood at 102 per cent of the normal as compared to 87 per cent last year (Chart I.4). The same index for oilseeds (125), sugarcane (109) and cotton (126) was also higher. An improved *kharif* harvest is expected to help ease food price pressure.

I.10 The current stock of rice and wheat at 53 million tonnes (mid-October 2013) is sufficient to meet buffer norms and requirements under the various poverty alleviation schemes (Chart I.5). These stocks can be utilised better in the short-run for price management keeping in view storage constraints that may emerge following another bumper crop. However, over the medium-term a reassessment of the food management strategy may be required keeping in view the expected higher off-take with the phased implementation of the National Food Security Act at the all-India level.

Industrial activity continues to be constrained by supply bottlenecks

I.11 The index of industrial production (IIP) for April-August 2013 grew marginally by 0.1 per cent. Contraction of the mining and manufacturing sectors has been the main factor in dampening the overall performance of industrial growth. Excluding capital goods and the mining sector, IIP grew by 0.5 per cent

Chart I.3: Output gap continued to be negative



Note: Trend is based on Hodrick - Prescott filter

Table I.2: Initial estimates suggest jump in *Kharif* production

Progress of Kharif sowing and production

(Area in million hectares and production in million tonnes)

Crops	Sowing October 25			Production			Percentage Change		
	Normal as on Date	2013	2012	2013-14*	2012-13*	2012-13@	Sowing 2013 (col 3/col 4)	Production 2013-14 (col 5/col 6)	Production 2013-14 (col 5/col 7)
1	2	3	4	5	6	7	8	9	10
Foodgrains	**67.6**	**68.7**	**65.6**	**129.3**	**117.2**	**128.2**	**4.7**	**10.3**	**0.9**
Rice	36.6	38.4	37.5	92.3	85.6	92.8	2.4	7.8	-0.5
Coarse Cereals	20.1	19.6	17.8	31.0	26.3	29.5	10.1	17.9	5.1
Maize	7.3	8.2	7.5	17.8	14.9	16.0	9.3	19.5	11.3
Pulses	10.9	10.7	10.3	6.0	5.3	5.9	3.9	13.2	1.7
Tur	3.8	4.0	3.7	3.0	2.8	3.1	8.1	7.1	-3.2
Urad	2.4	2.6	2.5	1.3	1.1	1.4	4.0	18.2	-7.1
Oilseeds	17.8	19.5	17.7	24.0	18.8	20.9	10.2	27.7	14.8
Groundnut	4.6	4.3	3.9	5.6	3.8	3.1	10.3	47.4	80.6
Soyabean	9.5	12.2	10.7	15.7	12.6	14.7	14.0	24.6	6.8
Sugarcane	4.7	4.9	5.0	341.8	335.3	339.0	-2.0	1.9	0.8
Cotton#	11.6	11.5	11.7	35.3	33.4	34.0	-1.7	5.7	3.8
Jute & Mesta##	0.9	0.9	0.9	11.2	11.3	11.3	0.0	-0.9	-0.9
All Crops	**102.5**	**105.5**	**100.9**	-	-	-	**4.6**	-	-

#: Million bales of 170 kgs each. ##: Million bales of 180 kgs each. -: Not Available.
*: First Advance Estimates. @: Fourth Advance Estimates
Source: Ministry of Agriculture, GoI.

during the period (Chart I.6). Excluding volatile items such as 'cable, rubber insulated', 'atrazin', 'vitamins', 'food processing machinery', *etc.* truncated IIP (96 per cent of IIP) growth in April-August 2013 was negative at 0.9 per cent (Chart I.7).

I.12 While the mining sector has been declining since 2011-12, the contraction in the manufacturing sector during April-August 2013 was driven primarily by declining outputs of industries like machinery and equipments; accounting and computing machinery; basic metals; fabricated metal products; radio, TV, communication equipments; and motor vehicles.

Chart I.4: The Reserve Bank's production weighted rainfall index indicates normal monsoon

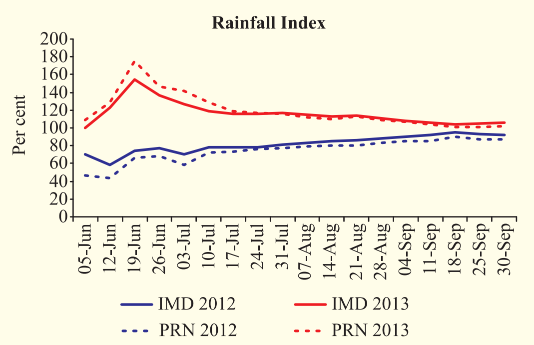
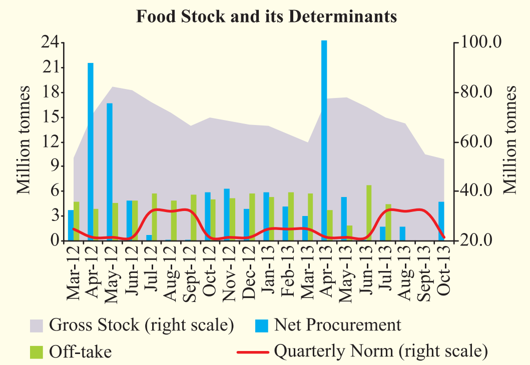
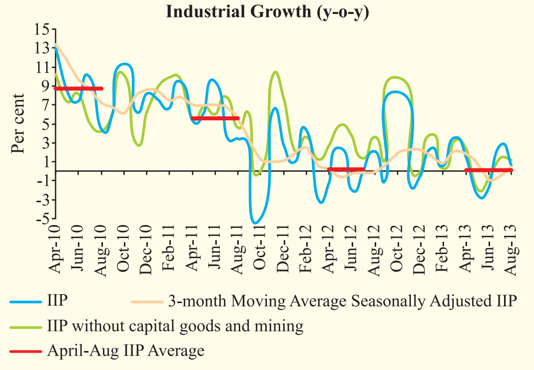


Chart I.5: Stock of foodgrains is sufficient to meet buffer norms



Note: 1. Data for off-take is up to July 2013 and stock as at mid-October 2013.
2. Procurement and off-take data are monthly figures.
3. Data for procurement is up to October 19, 2013.

Chart I.6: Subdued performance of the industrial sector



The decline in the mining sector's output, particularly coal, affected thermal power generation which decelerated to 1.8 per cent during April-August 2013 from 8.6 per cent last year. However, hydro-electricity generation is expected to be distinctly better this year with the replenishment of water in reservoirs. Hydro-power has grown by 20.2 per cent y-o-y during April-August 2013.

I.13 In terms of use-based industries, consumer durables and basic goods, which together have a 54 per cent weight in IIP, dragged its overall growth down (Table I.3).

Core industries show some improvement over last two months

I.14 Output of eight core industries improved consecutively for two months with a 3.7 per cent y-o-y growth in August 2013. The latest data shows a pick-up in core industries' output led by steel, cement and electricity. However, on a year-to-date (YTD) basis, the growth of eight core industries decelerated to 2.3 per cent during April-August 2013 from 6.3 per cent in the corresponding period last year (Chart I.8). The deceleration in thermal electricity during April-August 2013 was reflected in a reduction in the all-India plant load factor (PLF) to 64.1 per cent from 69.8 per cent last year.

Chart I.7: Truncated IIP shows contraction

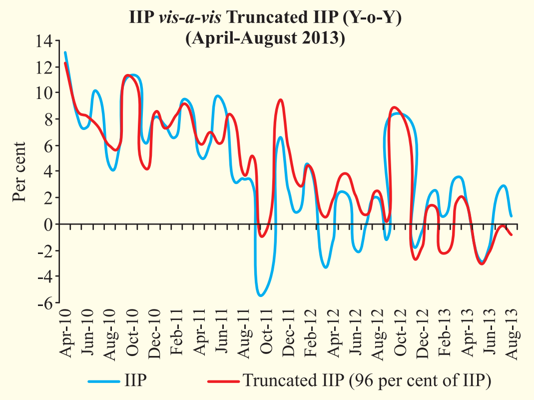


Table I.3: Broad-based industrial slowdown led by contraction in consumer durables

Sectoral and use-based classification of IIP

(Per cent)

Industry Group	Weight in the IIP	Growth Rate		
		Apr-Mar 2012-13	April-August 2012-13	April-August 2013-14P
1	2	3	4	5
Sectoral				
Mining	14.2	-2.3	-1.8	-3.4
Manufacturing	75.5	1.3	0.0	-0.1
Electricity	10.3	4.0	4.8	4.5
Use-Based				
Basic Goods	45.7	2.5	2.7	0.5
Capital Goods	8.8	-6.0	-14.4	0.8
Intermediate Goods	15.7	1.6	1.0	2.3
Consumer Goods (a+b)	29.8	2.4	3.2	-1.6
a) Consumer Durables	8.5	2.0	5.1	-11.0
b) Consumer Non-durables	21.3	2.8	1.6	6.6
General	**100**	**1.1**	**0.2**	**0.1**

P: Provisional
Source: Central Statistics Office.

Moderation in Capacity Utilisation

I.15 Capacity utilisation (CU), as measured by the 22nd round of the Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank, recorded seasonal decline in Q1 of 2013-14 over the previous quarter (http://www.rbi.org.in/OBICUS22). There is a broad co-movement between CU and de-trended Index of Industrial Production (IIP) (Chart I.9).

Chart I.8: Growth of core industries decelerated in 2013-14 so far

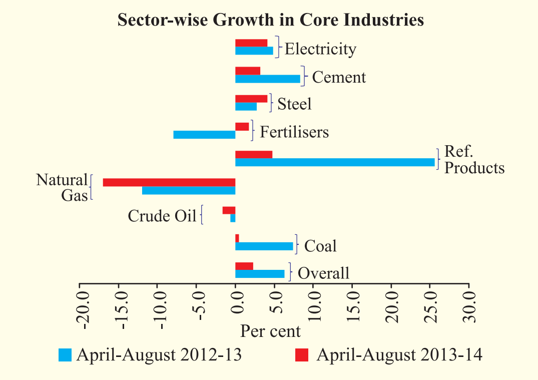
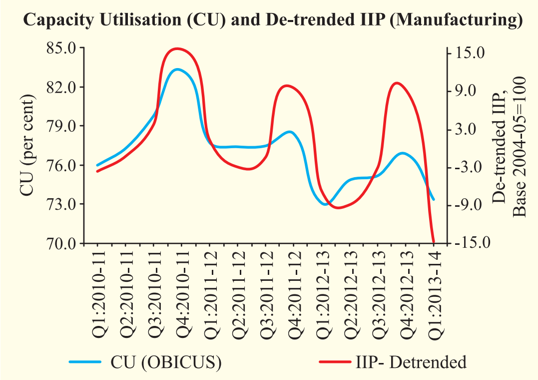


Chart I.9: Capacity utilisation (CU) recorded seasonal decline in Q1 of 2013-14



After a sequential increase in the previous two quarters, new orders declined in Q1 of 2013-14 both on a q-o-q sequential basis as well as on a y-o-y basis. Finished goods inventory to sales and raw material inventory to sales ratios increased in Q1 of 2013-14 and were higher than the previous year.

Lead indicators portray a mixed picture on service sector growth

I.16 The services sector grew at 6.2 per cent during Q1 of 2013-14 compared to 7.6 per cent during the same period last year. This was largely due to moderation in the growth of 'construction' and 'trade, hotels, restaurant, transport and communication' sectors. Developments in lead indicators of the services sector portray a mixed picture. Passenger and commercial vehicles sales and some segments of the aviation industry contracted even though indicators like tourist arrivals, railway freight revenue and steel production showed signs of improvement (Table I.4). The Reserve Bank's services sector composite indicator, which is based on growth in indicators of construction, trade and transport and finance, showed a

Table I.4: Lead indicators point towards subdued services sector activity

Indicators of services sector activity

(Growth in per cent)

Services Sector Indicators	2010-11	2011-12	2012-13	April-September 2012-13	April-September 2013-14
1	2	3	4	5	6
Tourist arrivals	10.0	9.7	2.1	1.7	4.3
Cement	4.5	6.7	8.4	8.3#	3.2#
Steel	13.2	10.3	2.5	2.8#	4.1#
Automobile Sales	16.8	11.1	2.6	3.5	1.2
Railway revenue earning freight traffic	3.8	5.2	4.1	4.8	6.2
Cargo handled at major ports	1.5	-1.6	-2.5	-3.3	2.3
Civil aviation					
Domestic cargo Traffic	23.8	-4.8	-3.4	3.8*	-3.0*
International cargo Traffic	17.7	-1.9	-4.2	-4.2*	-1.7*
International Passenger Traffic	10.3	7.6	5.5	3.2*	11.0*
Domestic Passenger Traffic	18.1	15.1	-4.3	-0.8*	2.3*

#: Data refers to April-August 2013; *: Data refers to April-July 2013.
Source: Ministry of Statistics and Programme Implementation, Ministry of Tourism, SIAM and CMIE

Chart I.10: Services sector composite indicator showed a modest pickup in July-August 2013

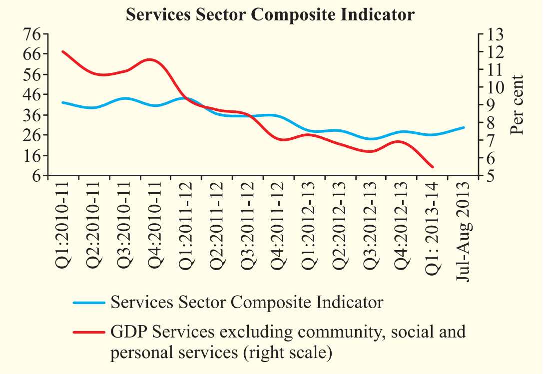
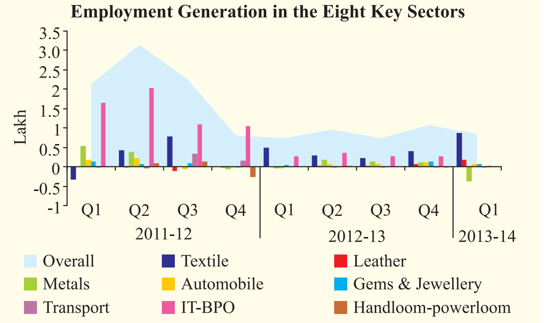


Chart I.11: Moderation in employment generation in eight key sectors continued in Q1 of 2013-14



Note: 1 Figures are absolute change in employment over the previous period.

2. July-December 2012 being a half-yearly survey, data for Q2 and Q3 2012-13 have been computed by taking the average proportions for the period 2009-11.

downturn in Q1 of 2013-14, but a modest pickup in July-August (Chart I.10).

Employment Scenario remains weak in Q1 of 2013-14

I.17 As per the Labour Bureau survey in eight key sectors, moderation in employment generation that started in 2012 continued in Q1 of 2013-14 (Chart I.11). The decline in employment generation was particularly sharp for the IT/BPO sector, reflecting the global slowdown and rising protectionism. Sector-wise, except textiles and leather, no other sector showed any perceptible improvement in employment generation during Q1 of 2013 on a sequential basis.

Moderate recovery expected during H2 mainly backed by pick-up in agriculture and exports

I.18 The Indian economy is expected to perform better during H2 of 2013-14 on the back of a good monsoon which has boosted the *kharif* prospects. A good crop will have a positive impact on rural demand, which in turn may help in improving the subdued industrial and services sectors. Further, improved *kharif* harvest is also expected to help ease supply-side constraints and hence food price pressure. Exports have picked up with exchange rate adjustment though global growth remains slow. On the policy front, the government has started taking several policy initiatives in certain sectors, especially infrastructure, which are expected to improve the overall investment climate. However, these actions will take some time to translate into activity at the ground-level. Therefore, improvements in activity levels during H2 of 2013-14 are expected to stay modest though recovery could start shaping towards the end of the year if the current positive momentum is sustained.

II. AGGREGATE DEMAND*

Notwithstanding a sharp rise in the government's final consumption expenditure, aggregate demand in the economy remained weak during Q1 of 2013-14 because of deceleration in private consumption and contraction in fixed investments. Persisting consumer price inflation impacted private consumption expenditure, while structural impediments and general uncertainty regarding the policy environment weighed down on investment activities. There was a sharp fall in fresh investment proposals from the private corporate sector during the quarter, reflecting the prevalence of overall negative business sentiments. However, a good monsoon this year and the pick-up in exports could boost aggregate demand.

Private consumption weakened, fixed investment contracted in Q1 of 2013-14

II.1 Expenditure-side GDP continued to weaken during Q1 of 2013-14 mainly on account of a deceleration in private final consumption expenditure and a contraction in fixed investments, even as the government's final consumption expenditure showed a sharp increase (Table II.1).

Table II.1: Aggregate demand continues to weaken mainly on account of deceleration in private consumption and contraction in fixed investment

Expenditure Side GDP (2004-05 prices)

(Per cent)

Item	2011-12*	2012-13#	2012-13				2013-14
			Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6	7	8
Growth Rates (y-o-y)							
GDP at Market Prices	6.3	3.2	3.4	2.5	4.1	3.0	2.4
Total Final Expenditure	8.1	3.9	4.7	4.0	3.8	3.3	3.0
(i) Private	8.0	4.0	4.3	3.5	4.2	3.8	1.6
(ii) Government	8.6	3.9	7.2	6.9	2.2	0.6	10.5
Gross Fixed Capital Formation	4.4	1.7	-2.2	1.1	4.5	3.4	-1.2
Change in Stocks	-30.6	73.4	69.8	71.7	75.8	76.0	-0.4
Valuables	6.6	-12.0	-20.9	4.3	-6.9	-20.2	92.5
Net Exports	-42.5	-17.3	-6.7	-21.4	-23.7	-16.4	-6.0
Discrepancies	-100.3	152.0	-12.9	28.6	-128.5	-6.3	29.1
Relative Shares							
Total Final Expenditure	70.5	71.0	72.1	72.8	73.5	65.9	72.5
(i) Private	59.2	59.6	61.1	61.8	61.4	54.7	60.6
(ii) Government	11.3	11.3	11.0	11.0	12.1	11.2	11.9
Gross Fixed Capital Formation	33.7	33.2	33.8	34.6	32.0	32.6	32.6
Change in Stocks	2.3	3.8	3.9	4.0	3.7	3.8	3.8
Valuables	2.4	2.0	2.1	2.2	2.0	1.8	4.0
Net Exports	-8.8	-10.0	-9.6	-11.0	-11.3	-8.4	-9.9
Discrepancies	0.0	0.0	-2.4	-2.6	0.1	4.2	-3.0
Memo:							
GDP at market prices (₹ Billion)	56314	58137	13702	13536	15062	15836	14034

*: First Revised Estimates; #: Provisional Estimates.
Source: Central Statistics Office.

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

II.2 Slowdown in income growth and persistence of a high consumer price inflation impacted private consumption expenditure while structural impediments and general uncertainty regarding the policy environment weighed down on investment activities. Investment in valuables, however, increased sharply on the back of high inflation and expected relative returns. In fact, among all the components of aggregate demand, the contribution of valuables to overall growth was the highest during Q1 of 2013-14 (Table II.2). At the same time, while exports continued to contract for the third successive quarter, imports also slackened in line with overall domestic activity and consequently, net exports posted a smaller contraction in Q1 of 2013-14 *vis-a-vis* previous quarters.

Table II.2: Valuables and government consumption supported overall growth

Contribution-weighted growth rates of expenditure-side GDP (2004-05 Prices)*

(Per cent)

Item	2012-13				2013-14
	Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6
1. Private Final Consumption Expenditure	2.6	2.2	2.6	2.1	1.0
2. Government Final Consumption Expenditure	0.8	0.7	0.3	0.1	1.2
3. Gross Fixed Capital Formation	-0.8	0.4	1.4	1.1	-0.4
4. Change in Stocks	1.7	1.7	1.7	1.7	0.0
5. Valuables	-0.6	0.1	-0.2	-0.5	2.0
6. Net Exports	-0.6	-2.0	-2.3	-1.2	-0.6
(i) Exports	3.0	1.2	-0.9	-0.2	-0.3
(ii) Less Imports	3.6	3.2	1.4	1.1	0.3
7. Sum 1 to 6	**3.0**	**3.1**	**3.5**	**3.2**	**3.1**
8. Discrepancies	0.4	-0.6	0.6	-0.3	-0.7
9. GDP at Market Prices (7+8)	**3.4**	**2.5**	**4.1**	**3.0**	**2.4**

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

Source: Central Statistics Office.

Persistent efforts to address infrastructure bottlenecks will help turnaround investment demand, boost market confidence

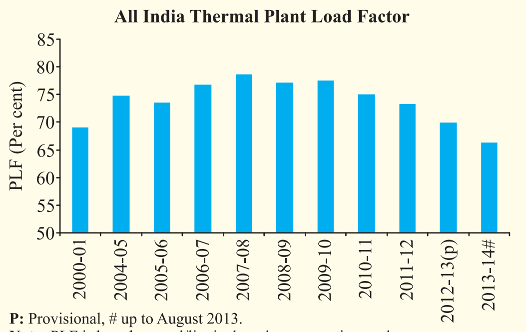
II.3 Persistent policy logjams, particularly those associated with delayed clearances on the part of the government; aggressive bidding on the part of private developers during the high growth phase; and inadequate appraisal mechanisms on the part of financiers, brought the infrastructure sector to a standstill. Consequently project delays have been slowing India's growth in a big way. As of June 2013, about 50 per cent of central sector projects (of ₹1.5 billion and above) were delayed, up from 44 per cent in June 2008, for which the cost overruns rose from 12 to 20 per cent during the last five-year period. Delayed projects were high in sectors, such as roads, followed by power, petroleum and railway.

II.4 Furthermore, leverage of the firms operating in infrastructure sector for a sample of 50 BSE 500 companies has risen over the years. Total borrowing to equity has increased from 111.3 per cent in 2009-10 to 217.2 per cent in 2012-13. Raising fresh equity in this sector has been difficult of late.

II.5 However, efforts at addressing the problems have begun to unlock the potential in this area. The Cabinet Committee on Investments (CII) was constituted to expedite the clearance of projects; CCI has cleared about 209 projects till mid-September 2013. A Project Monitoring Group was also set up in the Prime Minister's Office which has finalised deadlines for the intermediate steps to be taken to accelerate key mega infrastructure projects. While the impact is not immediately seen, concerted efforts over the next six months could bring about a turnaround in investment demand.

II.6 Amongst the infrastructure industry, the power sector was crippled by the poor performance of thermal power, with the plant load factor (PLF) declining continuously to almost early 2000 levels (Chart II.1). Estimates suggest that loss of power generation due to shortage of coal and gas amounted to around 50 billion units (BU) in 2012-13 and about 11.4

Chart II.1: Thermal power generation continues to remain well below capacity



P: Provisional, # up to August 2013.
Note: PLF is based on coal/lignite based power stations only,
Source: Central Electricity Authority

BU during the first four months of 2013-14. Though directives to sign fuel supply agreements (FSAs) have been given, the issue of demand-supply imbalance for coal is yet to be resolved.

II.7 Activity in the roads sector was also at a low ebb, as projects awaited forest, environmental and land acquisition clearances. During April-June 2013, National Highways Authority of India (NHAI) constructed/widened and strengthened 568 km of National Highways, recording a negative growth of around 7 per cent over the same period previous year. The government and the Reserve Bank have taken several steps to remove constraints facing the sector including delinking environment from forest clearances, treatment of lenders' debt exposure as secured loans, substitution policy for concessionaires and significant stepping up of efforts on NHAI's part to fast-track land acquisition. Over the last few months, the government has also been engaging with financial institutions and other stakeholders to infuse greater funds in highway projects. However, with large number of tendered projects remaining uninitiated, cancellation of bids and re-biding need to be speedily undertaken. Besides, pushing engineering, procurement and construction (EPC) projects can partially offset the low interest in tendering for public-private partnership (PPP) based road projects. The PPP mode is expected to pick up again in the next 1-2 years once the measures adopted by the government fructify and as investors' risk appetite improves.

II.8 In the telecommunications sector, balance sheets of major private service providers have been under pressure for quite some time, with operating margins having shrunk. In order to revive the sector, the government took some measures including announcing the National Telecom Policy 2012 and increasing the FDI cap in the sector from 74 to 100 per cent. While Telecom Regulatory Authority of India (TRAI) made various recommendations, spectrum pricing remains a vexed issue.

Corporate investment intentions continued to moderate

II.9 Corporate investment intentions remained subdued. The envisaged cost of projects for which institutional assistance was sanctioned during Q1 of 2013-14 aggregated ₹220 billion, which was significantly lower than the quarterly average for the previous two years (Table II.3). A sharp fall in fresh investment

Table II.3: Institutionally assisted project investment witness decline

Institutionally assisted projects and their envisaged expenditure (Quarter-wise)*

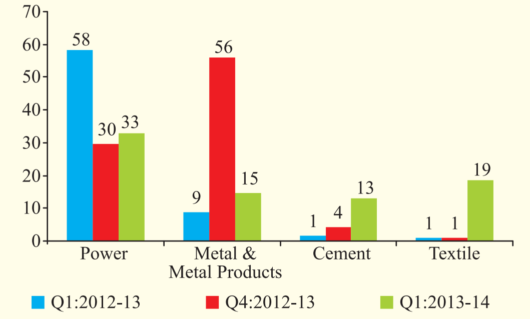
(₹ billion)

Financial Year		No. of Projects	Total Envisaged Expenditure	*of which*	
				Power industries	Metal & metal products industries
1		2	3	4	5
2011-12	Q1	147	749	284	231
	Q2	184	452	218	23
	Q3	137	462	242	14
	Q4	168	253	69	46
2012-13	Q1	110	413	240	36
	Q2	132	666	207	145
	Q3	89	256	157	15
	Q4	94	629	187	352
2013-14	Q1	82	220	72	32

*: Data are provisional and may undergo change due to modification/ cancellation of projects if reported subsequently.
Note: Based on data reported by 39 banks/FIs usually active in project finance.

Chart II.2: Power and metal industry largely driving new investments

Share of envisaged investment in major industries in aggregate cost of institutionally assisted projects (per cent)



proposals in metal and metal products and power industries mainly contributed to this decline. An industry-wise analysis indicates that during Q1 of 2013-14, the share of envisaged expenditure on new projects was the highest in the power industry followed by the textile industry (Chart II.2).

Sales growth decelerated, while net profits declined

II.10 Sales growth (y-o-y) of non-government non-financial listed companies continued to decelerate and reached a low of 2.5 per cent in Q1 of 2013-14 (Table II.4). The decline in sales was more distinct in the case of motor vehicles, medical precision and other scientific equipments, electrical machinery and apparatus, cement and cement products, iron and steel and real estate. The deceleration was most prominent for the manufacturing sector followed by the non-IT services sector. Sequentially, sales fell by 6.5 per cent in Q1 of 2013-14. While operating profits registered marginal growth, contraction in net profits was recorded for the second successive quarter. Further, profitability in terms of the EBITDA margin improved marginally in Q1 as compared to the previous quarter. The net profit margin, however, recorded a marginal decline.

II.11 Early results of 194 listed non-government non-financial companies for Q2 of 2013-14 show y-o-y sales growth and operating profits have improved.

Table: II.4: Corporate sales decelerate faster in Q1 of 2013-14

Performance of non-government non-financial companies

(Per cent)

	2012-13				2013-14
	Q1	Q2	Q3	Q4	Q1
1	2	3	4	5	6
No. of Companies			**2,446**		
			Growth Rates (y-o-y)		
Sales	14.3	12.0	9.6	4.3	2.5
Value of Production	13.7	12.6	8.4	4.3	1.9
Expenditure, *of which*	16.7	12.8	8.5	5.1	2.0
Raw Materials	14.0	14.9	9.5	2.9	-3.0
Staff Cost	17.8	15.4	13.4	13.6	13.9
Power & Fuel	25.9	21.3	11.1	3.6	1.1
Operating Profits (EBITDA)	-3.3	11.3	7.8	-0.9	1.2
Other Income*	27.6	49.6	0.3	2.0	28.7
Depreciation	10.4	10.1	10.4	8.8	9.5
Gross Profits (EBIT)	-2.4	18.9	5.5	-2.9	4.1
Interest	38.8	11.4	17.3	11.6	12.2
Tax Provision	-3.7	11.1	4.9	-3.9	0.7
Net Profits (PAT)	-13.0	22.0	21.3	-16.2	-10.4
			Ratios in per cent		
Change in stock to Sales #	0.9	1.4	0.8	0.9	0.2
Interest Burden	32.3	26.9	32.8	30.4	34.8
EBITDA to Sales	12.9	13.3	12.7	12.7	12.8
EBIT to Sales	11.6	12.9	11.3	11.8	11.9
Net Profit to Sales	6.1	7.1	5.8	5.8	5.3

#: For companies reporting this item explicitly.

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

The central government's key deficit indicators widened; risks for fiscal slippage in 2013-14

II.12 The deficit indicators of the central government widened significantly during the first five months of 2013-14. Low growth of the centre's net tax revenue on the one hand and a significant increase in revenue expenditure on the other increased the revenue deficit of the central government, which has already reached 87.4 per cent of budget estimates. The widening of revenue deficit coupled with higher capital expenditure resulted in a gross fiscal deficit of 74.6 per cent of budget estimates during the 5-month period. This is the highest in the last five years.

Growth slowdown weighs on tax collections

II.13 During the current fiscal so far, gross tax revenue (as a per cent of budget estimates) has been lower than the previous year due to moderation under the major tax heads. Based on latest data for April-September 2013, gross direct tax revenue was higher by 10.7 per cent (5.9 per cent a year ago), with an improvement in both corporation as well personal income tax collections. However, net of refunds, growth in direct tax collections decelerated considerably during the same period to 10.7 per cent as compared to 16.3 per cent last year and 19.5 per cent budgeted for 2013-14.

II.14 On the indirect taxes front, excise duty collections recorded a decline during April-August 2013, reflecting the impact of continued industrial slowdown (Chart II.3). The growth in services tax also witnessed deceleration in tandem with a moderation of India's services sector growth. However, collections from custom duties were higher than the previous year, reflecting the impact of rupee depreciation.

II.15 There are also risks to budgetary targets arising from the slow pace of disinvestment this year. Proceeds from disinvestment programmes for 2013-14 were meagre at ₹14.3 billion as against ₹400 billion targeted in the budget. On the non-tax revenue side, the Reserve Bank's record surplus transfer of ₹330 billion in August 2013 has already contributed to nearly one-fifth of the budgeted non-tax revenue of the central government. There is scope to offset the possible shortfall in disinvestment proceeds through payment of higher dividends by cash-rich public sector units (PSUs). Some of this cash can also be utilised by public sector units to boost public investments in their areas of operations depending on capacity creation needs and expected rate of returns.

Restraining expenditure is necessary for fiscal consolidation

II.16 The government's total expenditure during April-August 2013 as percentage of budget estimates was higher both in the revenue and capital accounts. Though, on the non-plan front, expenditure has been lower (Chart II.4), the spending on major subsidies during the period accounted for 62.3 per cent of budget estimates. Although the government has taken several steps to contain expenditure on subsidies through various reform measures, including phased deregulation of diesel prices and restrictions on subsidised LPG cylinders, the sharp depreciation of the rupee and increase in international prices of petroleum products increased the under-recoveries of the oil marketing companies (OMCs). OMCs reported under-recoveries of ₹256 billion in Q1 of 2013-14 and are currently incurring a daily under-recovery of ₹4.42 billion per day. There is a need to raise diesel prices further given an under-recovery of ₹10.24 per litre (effective October 16, 2013); on current reckoning, given the spillover from the previous year's under-

Chart II.3: Growth in gross tax revenue has been lower under all major heads of taxes except custom duty

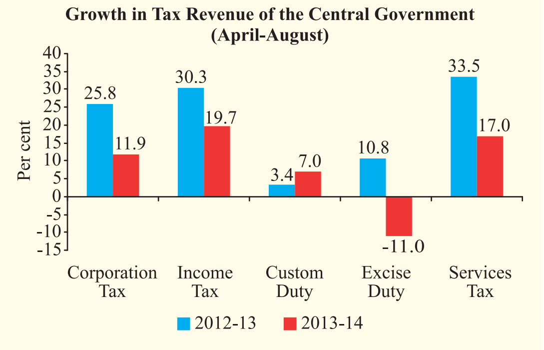
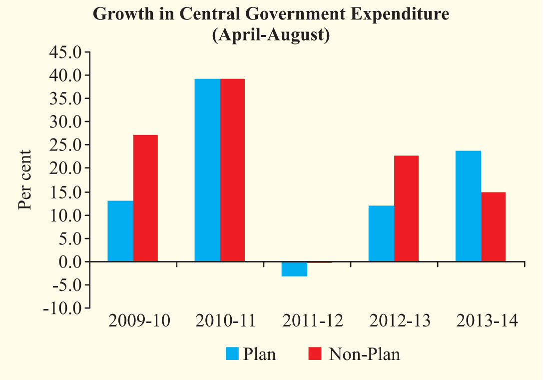


Chart II.4: Increase in plan expenditure is expected to boost the sluggish economy



recovery compensation, fuel subsidies could significantly overshoot budgetary provisions.

II.17 On the food subsidy front, although the recently enacted National Food Security (NFS) Act, 2013 may not lead to a breach in the budgetary provision of ₹100 billion for NFS, the overall food subsidy provision of ₹900 billion for the current year may not be adequate to meet the requirements of the existing targeted public distribution system. In subsequent years, implementation of the NFS Act could lead to increase the food subsidies depending on how it is rolled out and how other food-related schemes are merged with it.

State finances are budgeted to improve in 2013-14, although fiscal concerns remain

II.18 The consolidated fiscal position of state governments for 2013-14, based on their budget estimates, shows a continuance in fiscal consolidation, with an increase in revenue surplus and a reduction in the GFD-GDP ratio (Table II.5). Revenue surplus will be generated primarily through a reduction in the revenue expenditure-GDP ratio by 0.2 percentage points. On the expenditure side, although the capital outlay-GDP ratio is budgeted to marginally increase in 2013-14, the development expenditure-GDP ratio is budgeted to decline by 0.3 percentage points over the previous year, raising concerns about the quality of expenditure.

Table II.5: Gross Fiscal Deficit Budgeted to Improve in 2013-14

Key Deficit Indicators

(As per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal deficit	Outstanding Liabilities
1	2	3	4	5
Centre				
2011-12	2.7	4.4	5.7	51.9
2012-13 (Provisional Accounts)	1.8	3.6	4.9	51.9*
2013-14 BE	1.5	3.3	4.8	51.1
States				
2011-12	0.4	-0.3	1.9	22.2
2012-13 RE	0.8	-0.2	2.3	21.7
2013-14 BE	0.6	-0.4	2.2	21.4
Combined				
2011-12	3.2	4.1	7.6	65.4
2012-13 RE	2.9	3.7	7.5	65.5
2013-14 BE	2.2	2.9	6.9	65.8

* Revised Estimates

Note: 1. Minus (-) sign indicates surplus.

2. Outstanding liabilities of Centre and combined government includes external liabilities of the Centre calculated at current exchange rate as on March 31, 2013.

3. Combined liabilities of 2013-14 are adjusted for States' investment in Centre's treasury bills as on October 24, 2013.

Source: Budget documents of the Central and State governments.

Demand management requires balancing fiscal consolidation with investment support

II.19 Containing the fiscal deficit in 2013-14 within the budgetary limit could be a challenge for the government, given the level of gross fiscal deficit during the current fiscal so far. The government has started putting some correctives, such as austerity measures including a mandatory 10 per cent cut in non-Plan expenditures excluding certain identified expenditures. The government has also been making efforts to improve tax compliance through a combination of administrative steps as well as incentives, such as the Service Tax Voluntary Compliance Encouragement Scheme. More such measures are needed to avert fiscal slippage. Fiscal multipliers for capital outlay are found to be significantly higher than that for revenue expenditure. Hence, fiscal consolidation with a re-orientation in expenditure from revenue expenditure to investment spending could be growth supportive as it will also crowd in private investment.

III. THE EXTERNAL SECTOR

Though the CAD widened again in Q1 of 2013-14, it is likely to moderate in Q2, broadly in line with the narrowing trade deficit. While re-pricing of risk and anticipated dollar liquidity shortage in view of the Fed's May 2013 statement on asset purchase tapering led to the depreciation of the rupee and capital outflows from India in line with other EMDEs, this trend reversed in early September following additional policy measures and improvements in global sentiments. Consequently, external sector risks have somewhat receded. However, the window of opportunity so created needs to be used to bring about further durable adjustment to lower CAD and encourage its financing through long-term capital inflows, so as to impart greater resilience to large shocks.

World trade prospects remain weak

III.1 India's export performance over the last two years has been affected by continued sluggishness in global trade and an overvalued exchange rate for a prolonged period. Judging by the trends so far, global trade volumes in 2013 are expected to expand at roughly the same rate as last year, which was the slowest pace in the last 12 years, except for the contraction in 2009 in the wake of the global financial crisis. A slowdown in growth in key emerging markets and developing economies (EMDEs) has further affected exports from these countries, which turned negative in Q2 of 2013 (Chart III.1a). However, there have been divergent trends in these countries in the recent period (Chart III.1b), including pick-up in India's exports in Q2 of 2013-14 (July-September). The depreciation in the exchange rate, both in nominal and real terms, appears to have helped improve India's export competitiveness in recent months.

Trade deficit narrowed with pick-up in exports and fall in imports in Q2 of 2013-14

III.2 Amidst an adverse external environment, policy interventions helped India to reduce its trade deficit by about 38.7 per cent in Q2 of 2013-14 (y-o-y basis) (Chart III.2a). This was on account of both a sharp pick-up in exports and some moderation in imports.

III.3 Export recoveries were evident in sectors, such as petroleum products, rice, readymade garments, marine products and other chemicals. Moderation in imports was largely led by a sharp decline in gold and silver import and a slowdown in imports of machinery, fertiliser, project goods, coal, vegetable oil and

Chart III.1 : Global slowdown continues to affect EMDEs' exports but with divergent recent trends

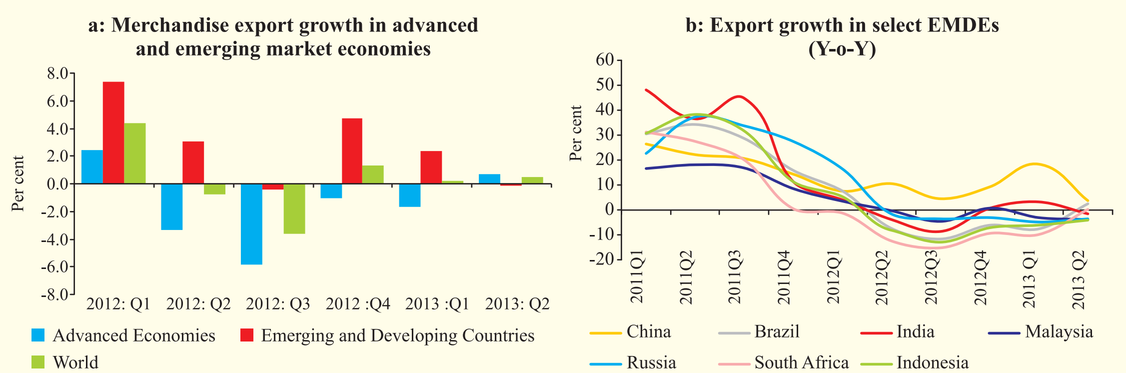
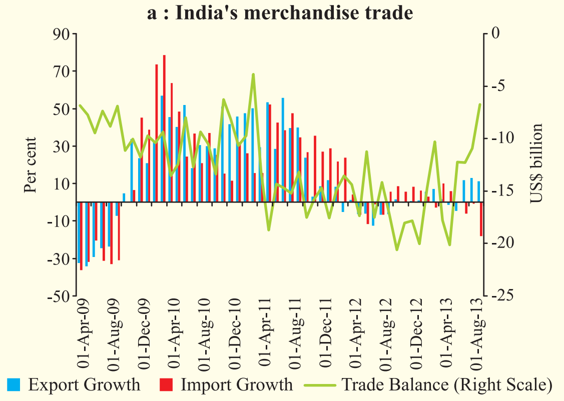
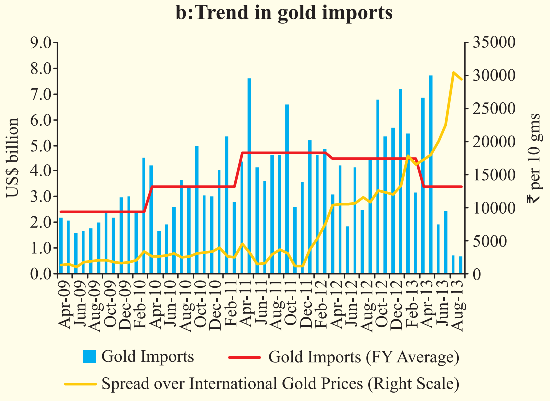


Chart III.2: India's trade balance improves, led by clampdown on gold imports





iron and steel. Subsequent to various measures undertaken by the Reserve Bank and the government to curb gold imports and a sharp depreciation in the rupee, gold imports declined by about 65 per cent in Q2 of 2013-14 (y-o-y) compared to an increase of 80.5 per cent in Q1 (Chart III.2b and Table III.1). During Q2, decline in value of gold imports was on account of both softening of international gold price and moderation in quantum of gold imports (by about 55 per cent). Accordingly, the merchandise trade deficit in Q2 of 2013-14 was significantly lower than that in the corresponding period in the previous year. Sustained improvements in the trade balance will, however, require a gradual recovery in trade partner economies and lower international prices of key import items (*e.g.* crude oil) as well as greater domestic production of commodities such as coal and iron ore.

Table III.1: Trade deficit narrowed significantly in H1 of 2013-14 reflecting turnaround in Q2 of 2013-14

India's Merchandise Trade

(US$ billion)

Item	April–March				April-September			
	2011-12		2012-13 P		2012-13		2013-14	
	Value	Growth	Value	Growth	Value	Growth	Value	Growth
1	2	3	4	5	6	7	8	9
Exports	306.0	21.8	300.4	-1.8	144.7	-6.2	152.1	5.1
Of which: Oil	56.0	35.1	60.9	8.6	27.5	-6.2	31.2	13.5
Non-oil	249.9	19.2	239.5	-4.2	117.2	-6.2	120.9	3.2
Gold	6.7	10.8	6.5	-3.2	3.3	-4.3	3.1	-6.7
Non-Oil Non-Gold	243.2	19.5	233.0	-4.2	113.9	-6.3	117.8	3.5
Imports	489.3	32.3	490.7	0.3	236.5	-2.9	232.2	-1.8
Of which: Oil	155.0	46.2	164.0	5.9	80.0	5.8	83.0	3.7
Non-oil	334.4	26.7	326.7	-2.3	156.5	-6.8	149.3	-4.6
Gold	56.3	38.9	53.7	-4.7	20.2	-30.2	20.4	0.6
Non-Oil Non-Gold	278.0	24.5	273.0	-1.8	136.3	-1.9	128.9	-5.4
Trade Deficit	-183.4		-190.3		-91.8		-80.1	
Of which: Oil	-98.9		-103.2		-52.5		-51.8	
Non-oil	-84.4		-87.2		-39.3		-28.4	
Non-Oil Non-Gold	-34.8		-40.0		-22.4		-11.1	

Source: DGCI&S.

Table III.2: CAD widened in Q1 of 2013-14, reflecting a worsening trade deficit

Major items of India's balance of payments

(US $ billion)

	2011-12 (PR)	2012-13 (PR)	2012-13		2013-14
			Q1 (PR)	Q4 (PR)	Q1 (P)
1	2	3	4	5	6
1. Goods Exports	309.8	306.6	75.0	84.8	73.9
of which: Oil	56.0	60.9	13.3	16.1	14.1
Gold	6.7	6.5	1.6	1.8	1.5
2. Goods Imports	499.5	502.2	118.9	130.4	124.4
of which: Oil	155.0	164.0	39.4	42.2	41.1
Gold	56.3	53.7	9.1	15.8	16.5
3. Trade Balance (1-2)	-189.7	-195.7	-43.8	-45.6	-50.5
of which: Non-oil non-gold trade balance	-41.1	-45.4	-10.2	-5.5	-7.7
4. Services Exports	140.9	145.7	35.8	37.8	36.5
5. Services Imports	76.9	80.8	20.8	20.9	19.7
6. Net Services (4-5)	64.0	64.9	15.0	17.0	16.9
7. Goods & Services Balances (3+6)	-125.7	-130.7	-28.9	-28.7	-33.6
8. Primary Income (Net)	-16.0	-21.5	-4.9	-5.2	-4.8
9. Secondary Income (Net)	63.5	64.4	16.8	15.8	16.7
10. Net Income (8+9)	47.5	42.9	11.9	10.6	11.9
11. Current Account Balance (7+10)	-78.2	-87.8	-16.9	-18.1	-21.8
12. Capital and Financial Account Balance	80.6	85.1	15.9	17.8	20.9
of which: Change in Reserves	12.8	-3.8	-0.5	-2.7	0.3
13. Errors & Omissions -(11+12+13)	-2.4	2.7	1.1	0.3	0.9
Memo: As a ratio to GDP					
14. Trade Balance	-10.1	-10.6	-10.2	-9.0	-11.3
15. Net Services	3.4	3.5	3.5	3.3	3.8
16. Net Income	2.5	2.3	2.8	2.1	2.6
17. Current Account Balance	-4.2	-4.8	-4.0	-3.6	-4.9
18. Capital and Financial Account, Net (Excl. changes in reserves)	3.6	4.8	3.8	4.0	4.6

Note: Total of subcomponents may not tally with aggregate due to rounding off.
P: Preliminary. PR: Partially Revised.

CAD, though widened in Q1 is likely to moderate in Q2

III.4 India's current account deficit (CAD) widened from 3.6 per cent of GDP in Q4 of 2012-13 to 4.9 per cent of GDP in Q1 of 2013-14 (Table III.2). With some visible improvement in the trade balance in Q2 of 2013-14, CAD is likely to show a significant correction in Q2.

FII flows, which had turned negative since end-May 2013, reversed in September

III.5 Notwithstanding a higher CAD in Q1 of 2013-14, capital inflows were broadly adequate to finance the current account gap, requiring only a marginal drawdown of foreign exchange reserves (Table III.3). While the net inflows under foreign direct investment (FDI) increased marginally, a significant rise was evident in NRI deposits over the previous quarter. Besides, there was a significant drawdown of assets held by banks under Nostro balances. Net foreign institutional investment (FII) flows remained buoyant in the first two months of Q1. However, amid concerns about the gradual withdrawal of the quantitative easing (QE) programme, as indicated by the US Fed on May 22, 2013, there was re-pricing of risk and concomitant capital outflows from EMDEs, including India. Since then, there has been a net outflow of FII investments of US$ 16.6 billion up to September 6, 2013 before resumption of inflows in subsequent weeks. On average, there was a net FII outflow of US$ 2.2 billion in each month of Q2 (Table III.4).

III.6 Recognising the risks to capital flows emanating from global financial conditions,

Table III.3: Net capital inflows almost entirely financed CAD in Q1 of 2013-14

Disaggregated Items of Financial Account

(US$ billion)

	2011-12 (P)	2012-13 (PR)	2012-13 Q1 (PR)	2012-13 Q4 (PR)	2013-14 Q1 (P)
1	2	3	4	5	6
1. Direct Investment (net)	**22.1**	**19.8**	**3.8**	**5.7**	**6.5**
1.a Direct Investment to India	33	26.9	5.9	7.2	6.5
1.b Direct Investment by India	-10.9	-7.1	-2.1	-1.4	0
2. Portfolio Investment	**16.6**	**26.7**	**-2**	**11.3**	**-0.2**
2.a Portfolio Investment in India	16.8	27.6	-1.7	11.5	-0.5
2.b Portfolio Investment by India	-0.2	-0.9	-0.3	-0.2	0.2
3. Financial Derivatives & Employee Stock Options	**-**	**-2.3**	**-0.6**	**-0.9**	**-0.5**
4. Other Investment	**29.2**	**45.2**	**15.4**	**4.2**	**14.1**
4.a Other equity (ADRs/GDRs)	0.6	0.2	0.1	0	0
4.b Currency and deposits	12.1	15.3	6.4	2.8	5.6
Deposit-taking corporations, except the central bank: (NRI Deposits)	11.9	14.8	6.6	2.8	5.5
4.c Loans*	16.8	10.7	3.5	-1.6	5.9
4.c.i Loans to India	15.7	11.1	3.5	-1.6	5.4
Deposit-taking corporations, except the central bank	4.1	1.3	3.0	-6.3	4.7
General government (External Assistance)	2.5	1.3	0.1	0.6	0.3
Other sectors (ECBs)	9.1	8.6	0.4	4.1	0.4
4.c.ii Loans by India	1	-0.4	0.1	0	0.4
General government (External Assistance)	-0.2	-0.3	-0.1	-0.1	-0.1
Other sectors (ECBs)	1.2	-0.1	0.1	0.1	0.5
4.d Trade credit and advances	6.7	21.7	5.4	4.5	2.5
4.e Other accounts receivable/payable - other	-6.9	-2.7	-0.1	-1.5	0.2
5. Reserve assets	**12.8**	**-3.8**	**-0.5**	**-2.7**	**0.3**
Financial Account (1+2+3+4+5)	**80.7**	**85.4**	**16.1**	**17.6**	**20.1**

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

the government and the Reserve Bank undertook various measures to facilitate capital inflows in the recent period, including (i) liberalised FDI norms through review of limits and (or) routes for select sectors *viz.*, telecom, asset reconstruction companies, credit information companies, petroleum and natural gas, courier services, commodity exchanges, infrastructure companies in the securities market and power exchanges, (ii) offering a window for the banks to swap the fresh FCNR(B) dollar funds with the Reserve Bank, (iii) increase in the overseas borrowing limit from 50 to 100 per cent of the unimpaired Tier I capital of banks (with the option of swap with the Reserve Bank, and (iv) permission to avail of ECB under the approval route from their foreign equity holder company for general corporate purposes. Since the introduction on September 10, 2013 of swap facility for FCNR(B) deposits and bank overseas

Table III.4: Portfolio capital outflows increased during 2013-14 so far

Trend in capital flows

(US$ billion)

Monthly Average	2012-13 Q1	2012-13 Q2	2012-13 Q3	2012-13 Q4	2013-14 Q1	2013-14 Jul-Aug.
1	2	3	4	5	6	7
FDI in India	2.0	3.2	1.4	2.4	2.2	2.0
FDI by India	0.7	0.5	0.7	0.5	0.0	0.3
FIIs	-0.6	2.6	3.3	3.8	-0.2	-2.2*
ADRs/GDRs	0.03	0.03	0.0	0.0	0.0	0.0
ECB	0.1	0.4	1.0	1.4	0.8	0.8
NRI	2.2	0.9	0.9	0.9	1.8	1.2

*: July-Sep.
Source: RBI Bulletin, September 2013.

Table III.5: Exchange rate depreciated in real terms

Average nominal and real effective exchange rates: trade-based (Base: 2004-05=100)

	36-REER	36-NEER	6-REER	6-NEER	Rs/US$*
1	2	3	4	5	6
2009-10	95.7	90.9	102.0	87.1	47.4
2010-11	103.9	93.5	114.9	91.8	45.6
2011-12	101.4	87.4	111.5	84.4	47.9
2012-13	94.6	78.3	105.0	75.6	54.4
2013-14 (Oct.18)	85.8	69.8	92.6	65.9	61.6#
Y-o-Y Variation in 2012-13 over 2011-12 (%)	-6.7	-10.4	-5.9	-10.5	-11.9
FY Variation (Oct. 18) over Mar. 2013 (%)	-9.8	-11.3	-13.0	-13.2	-11.7#

* : end - March. #: Pertains to exchange rate as on October 25, 2013.

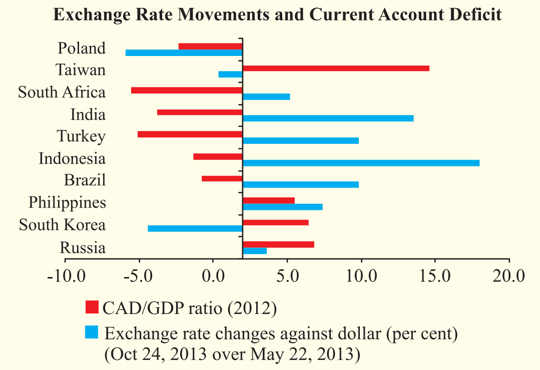
borrowings, US$ 6.9 billion and US$ 4.4 billion had been received under the respective schemes until October 25, 2013.

Exchange rate pressures abate after a spell of sharp depreciation

III.7 Amid heightened volatility in global and Indian currency markets, the Indian rupee depreciated speedily by 17.7 per cent against the US dollar during mid-May to end-August 2013. However, the rupee reversed the trend in September 2013 and appreciated by 6.0 per cent and further by 1.9 per cent up to October 25, 2013 as market sentiments improved on the back of various policy measures announced by the Reserve Bank and the government and the Fed's decision later in the month to maintain the pace of its QE. The opening of a forex swap window for the public sector oil marketing companies played an important role in stabilising rupee. Earlier, exchange rate pressures were evident in most EMDEs, particularly for current account deficit countries like India, where portfolio flows were severely affected due to the anticipation of a rollback of the bond purchase programme by the US Fed (Chart III.3).

III.8 In terms of the real exchange rate, as on October 18, 2013, the 6-currency and 36-currency REER showed a depreciation of 13.0 and 9.8 per cent respectively, over March 2013 (Table III.5).

Chart III.3: Currency depreciation pronounced for current account deficit countries



Net international investment position improves

III.9 Notwithstanding a decline in absolute terms, India's external debt as a ratio to GDP increased in Q1 of 2013-14. Decline in the level of external debt was mainly attributed to a fall in rupee denominated debt led by depreciation in the rupee and outflows from the debt segment of FIIs. While reserve adequacy indicators deteriorated further in Q1, India's reserves remained adequate to meet exigencies. India's net international investment position (IIP) as a ratio to GDP, improved from (-) 16.8 per cent at end-March 2013 to (-) 15.9 per cent at end-June 2013 (Tables III.6 and III.7).

Table III.6: India's external debt reduced in Q1 of 2013-14

(US$ billion)

Item	End-Mar 2012 (PR)	End-Jun 2012 (PR)	End-Mar 2013 (PR)	End-Jun 2013 (QE)	Per cent Variation (5) over (4)
1	2	3	4	5	6
1. Multilateral	50.5	49.7	51.6	51.7	0.3
2. Bilateral	26.9	27.4	25.2	24.8	-1.5
3. IMF	6.2	6.0	6.0	6.0	0.3
4. Trade Credit (above 1 year)	19.1	19.2	17.9	17.5	-2.3
5. ECBs	105.1	104.5	122.7	119.4	-2.7
6. NRI Deposits	58.6	60.9	70.8	71.1	0.4
7. Rupee Debt	1.4	1.2	1.3	1.2	-0.7
8. Long-term (1 to 7)	268	269	295	292	-1.2
9. Short-term	78.2	80.5	96.7	96.8	0.1
Total (8+9)	**345.8**	**349.4**	**392.1**	**388.5**	**-0.9**

PR: Partially Revised. QE: Quick Estimates.

External risks somewhat declined, but need to build upon recent gains

III.10 Since 2008-09, in the wake of the global financial crisis, India's external sector's weakness has come to the fore in several dimensions. First, CAD widened as a result of cyclical and structural factors. The CAD/GDP ratio averaged 3.4 per cent during the five-year period 2008-09 to 2012-13 after having averaged just 0.6 per cent in the preceding 16 years after the 1991-92 balance of payment crisis. Second, there has been a surge in imports over the last nine years, as a result of which imports as a ratio of GDP almost doubled to 22.3 per cent from 11.8 per cent during the preceding 12-year period of 1992-93 to 2003-04. The exports to GDP ratio also improved, but roughly at half the pace at which the imports increased. Improved foreign investment inflows helped finance the growing trade imbalance, but capital flow reversals post-Lehman crisis and again after the tapering indication this year exposed the growing imbalance making financing of CAD difficult. Consequently, the rupee came under pressure.

Table III.7: External sector vulnerability indicators showed a mixed trend

(Ratios in per cent)

Indicator	End-Mar 2012	End-Mar 2013	End-Jun 2013
1	2	3	4
1. Ratio of Total Debt to GDP	19.7	21.3	22.7
2. Ratio of Short-term to Total Debt (Original Maturity)	22.6	24.7	24.9
3. Ratio of Short-term to Total Debt (Residual Maturity)#	42.7	44.2	43.8
4. Ratio of Concessional Debt to Total Debt	13.8	11.6	11.6
5. Ratio of Reserves to Total Debt	85.1	74.5	72.7
6. Ratio of Short-term Debt to Reserves (Original Maturity)	26.6	33.1	34.3
7. Ratio of Short-term Debt to Reserves (Residual Maturity)#	50.1	59.0	60.2
8. Reserves Cover of Imports (in months)	7.1	7.0	6.7
9. Reserves Cover of Imports and Debt Service Payments (in months)	6.7	6.6	6.3
10. Debt-Service Ratio (Debt Service Payments to Current Receipts)	6.0	5.9	6.2
11. External Debt (US$ billion)	345.8	392.1	388.5
12. Net International Investment Position (IIP)	-249.8	-309.4	-296.9
13. Net IIP/GDP Ratio	-13.3	-16.8	-15.9

#: RBI Estimate.

III.11 In face of these pressures, the Reserve Bank and the government adopted a judicious approach that encompassed trade, monetary, fiscal and exchange rate policies to bring about a macroeconomic adjustment. Consequently, external sector risks have receded somewhat. However, uncertainties about future event shocks remain. It is, therefore, important to build on the recent gains by aiming at structural adjustments to further reduce CAD over the medium-term and encourage its financing through stable capital inflows.

IV. MONETARY AND LIQUIDITY CONDITIONS

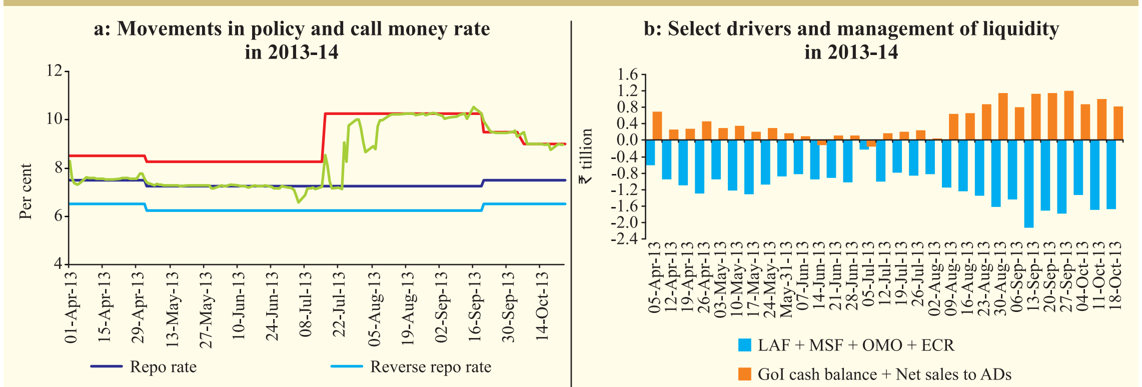
Monetary and liquidity conditions were tightened through exceptional liquidity measures in order to contain exchange market pressures and dampen volatility in the forex market. The MSF rate which was raised by 200 bps in July 2013, became the effective policy rate. With the ebbing of exchange market pressures, these measures are being rolled back in a calibrated manner. Notwithstanding the tightening, significant primary liquidity injection was done through LAF, MSF and OMO, besides increase in recourse to standing re-finance facilities. Money supply growth has been largely in line with the indicative trajectory. Credit growth has accelerated since mid-July, partly due to the substitution of costlier money market sources of finance by corporates with bank credit. Going forward, with the normalisation of exceptional monetary measures under way, incremental calibration will be shaped by changes in the growth-inflation balance, keeping macroeconomic stability in consideration.

The Reserve Bank tightened liquidity during Q2 of 2013-14, raising rupee funding costs to curb forex volatility

IV.1 Faced with a sharp depreciation of the rupee consequent on the sudden surge in capital outflows following indications of tapering of the US Fed's quantitative easing programme, the Reserve Bank hiked short-term interest rates and compressed domestic money market liquidity as a first line of defence. The measures taken included a 200 basis points (bps) hike in the marginal standing facility (MSF) rate to 10.25 per cent; a cap on daily LAF borrowing to 0.5 per cent of NDTL of respective banks as against the earlier practice of unlimited access against excess SLR holdings; and a hike in the minimum daily cash reserve ratio (CRR) requirement to 99 per cent from 70 per cent of the requirement. Weekly auctions of cash management bills (CMBs) were also conducted to drain out the liquidity. These measures moved up the call rate to the MSF rate, making the latter the effective policy rate in line with policy intent (Chart IV.1a).

IV.2 With tighter liquidity, the average daily liquidity injection under LAF (including MSF) increased from ₹526 billion in July 2013 to ₹1,131 billion in September 2013. The increase in government cash balances with the Reserve Bank and advance tax outflows also contributed towards the tightening of liquidity in September 2013. The liquidity tightening measures shifted the entire yield curve upwards with inversion visible at the short-end in line with the policy

Chart IV.1: MSF rate became the effective policy rate as liquidity tightened



Note: -ve (+ve) indicate injection (absorption) of liquidity into (from) the banking system.

objective. It also led to a sizeable increase in corporate bond yields and commercial paper (CP) discount rates. In order to prevent liquidity conditions from becoming too tight, which would have excessively impacted financing conditions, the Reserve Bank undertook two OMO purchase auctions in August 2013 injecting primary liquidity of ₹125 billion (Chart IV.1b). Additional liquidity of ₹247 billion was also injected on a temporary basis by providing two-day funds to banks through the MSF on Saturday (September 14, 2013) to counter the effect of advance tax outflows.

Exceptional liquidity measures being rolled back in a calibrated manner as exchange rate pressures ease

IV.3 Taking into account the easing of the exchange rate pressures since September 2013 and evolving macroeconomic conditions, the Reserve Bank in its Mid-Quarter Monetary Policy Review (September 20, 2013) moved towards normalising monetary measures. In order to reduce the costs of funds, it reduced the MSF rate by 75 bps to 9.5 per cent. The minimum daily CRR balance maintained by the banks was reduced to 95 per cent of the requirement from 99 per cent to provide banks with the flexibility to better manage their liquidity situation. However, considering inflation risks, the repo rate was increased by 25 bps to 7.5 per cent. The Reserve Bank also signalled its intention to normalise the conduct and operations of monetary policy and to revert to the LAF repo rate as the operational policy interest rate.

IV.4 As stable financial market conditions persisted, the MSF rate was further lowered by 50 bps to 9.0 per cent with effect from October 7, 2013. In continuation of the Reserve Bank's assurance on adequate liquidity, an OMO purchase auction was conducted on October 7, 2013 injecting liquidity of around ₹100 billion. As an additional liquidity enhancing measure and for developing the term money market, the Reserve Bank introduced weekly variable rate term repos of 7-day and 14-day tenors for an amount equivalent to 0.25 per cent of the NDTL of the banking system. As a result, total access to funds from the Reserve Bank augmented to 1.25 per cent of NDTL (*i.e.,* about ₹ 1 trillion) consisting of 0.5 per cent of NDTL under the overnight repo, about 0.5 per cent of NDTL under export credit re-finance (ECR) facility and 0.25 per cent of NDTL under term repo. The banks can also meet any further demand for liquidity through MSF. The first round of 7-day term repo was conducted on October 11, 2013 (₹190 billion) followed by 14-day term repo on October 18, 2013 (₹195 billion). As a result of these measures, the liquidity situation eased in October 2013.

Reserve money growth boosted by primary liquidity injection

IV.5 Reserve money growth picked up in recent months to 8 per cent y-o-y as at mid-October, while the same adjusted for CRR

Chart IV.2: Reserve money growth driven by expansion in domestic assets

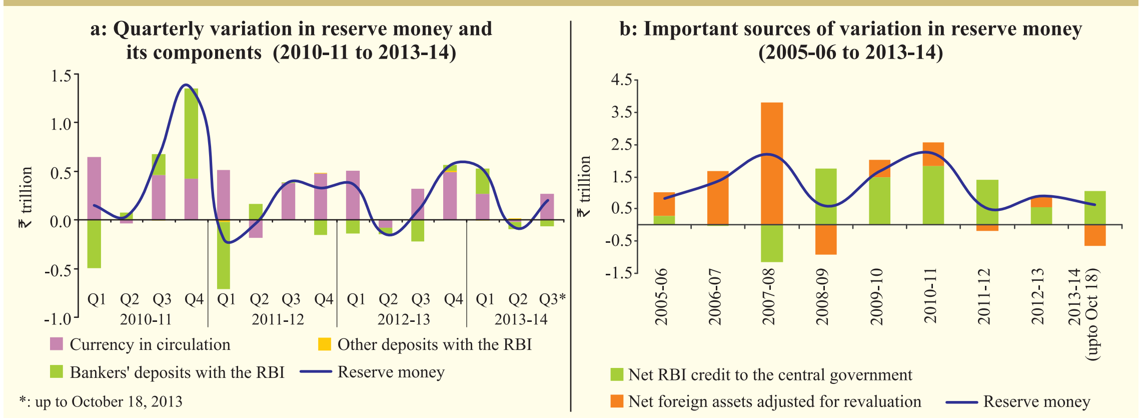
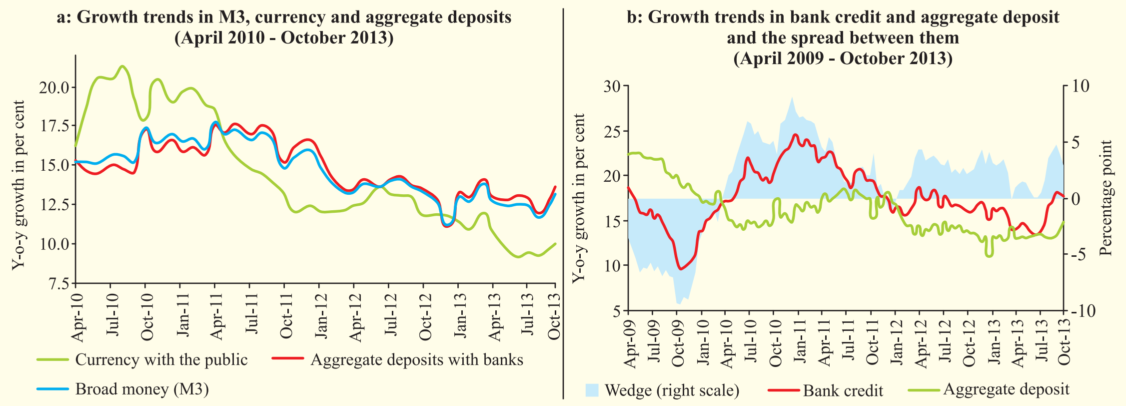


Chart IV.3: Money supply broadly in line with indicative trajectory



changes was around 10 per cent. Liquidity injections through LAF, MSF and OMOs have aided the increase in Reserve Bank's net credit to the central government. Though net foreign assets (adjusted for revaluation) on the sources side registered a decline during the year, it was more than offset by the increase in the Reserve Bank's net credit to the centre (Chart IV.2).

Broad money growth is in line with trajectory

IV.6 Money supply growth hovered around 12.5 per cent y-o-y during H1 of 2012-13, broadly in line with the indicative trajectory of 13 per cent for 2013-14, and is currently at 13.2 per cent (October 4, 2013). Currency expansion that had been lower in H1 of 2013-14 has picked up in October reflecting festive demand (Chart IV.3a). On the sources side, bank credit to the commercial sector has picked-up since middle of Q2 (Table IV.1). Consequently, the wedge between the growth in bank credit and aggregate deposit of scheduled commercial banks (SCBs) widened to about 4 percentage points at the end of Q2 (Chart IV.3b).

Credit off-take accelerates with greater recourse to bank finance by corporates

IV.7 Non-food credit growth increased from 14.0 per cent y-o-y on July 12, 2013 to 17.9 per cent on October 4, 2013, markedly higher than the indicative trajectory of 15 per cent. In part, this trend was supported by corporate firms substituting their market borrowings, especially

Table IV.1: Monetary Indicators

Item	Outstanding amount (₹ billion) 04-Oct-13	FY variations (per cent)		Y-o-Y variations (per cent)	
		2012-13	2013-14	05-Oct-12	04-Oct-13
1	2	3	4	5	6
Reserve Money (M_0)	**15,793.3**	**2.5**	**4.3**	**5.3**	**8.0**
Reserve Money (Adjusted)		**3.6**	**4.0**	**12.4**	**9.9**
Broad Money (M_3)	**89,748.7**	**7.7**	**7.1**	**13.6**	**13.2**
Main Components of M_3					
Currency with the Public	11,602.9	3.1	1.4	11.1	10.1
Aggregate Deposits	78,108.7	8.4	8.0	14.0	13.7
of which: Demand Deposits	7,605.0	-2.5	1.8	5.5	9.7
Time Deposits	70,503.7	9.8	8.7	15.0	14.1
Main Sources of M_3					
Net Bank Credit to Government	29,518.3	9.0	9.0	19.0	14.2
Bank Credit to Commercial Sector	60,468.6	4.8	6.7	16.2	16.4
Net Foreign Assets of the Banking Sector	16,936.9	-0.2	3.5	-0.4	9.9

Note: 1. Data are provisional.
2. Data for reserve money pertain to October 18, 2013.

Table IV.2: Banking sources dominate resource flow to the commercial sector

(₹ billion)

	April-March		April 1 - October 4	
	2011-12	2012-13	2012-13	2013-14
1	2	3	4	5
A. Adjusted Non-Food Bank Credit (NFC)	**6,773**	**6,849**	**2,177**	**3,905**
i) Non-food credit	6,527	6,335	1,919	4,036
of which: petroleum and fertiliser credit	*116*	*141*	*-88*	*-111 $*
ii) Non-SLR investment by SCBs	246	514	257	-131
B. Flow from Non-Banks (B1+B2)	**5,383**	**7,335**	**3,267**	**2,365**
B1. Domestic Sources	**3,079**	**4,212**	**2,289**	**1,440**
1. Public issues by non-financial entities	145	119	63	32 ^
2. Gross private placements by non-financial entities	558	1,038	268	305 *
3. Net issuance of CPs subscribed to by non-banks	36	52	898	147 &
4. Net Credit by housing finance companies	539	859	230	267 $
5. Total gross accommodation by 4 RBI-regulated AIFIs – NABARD, NHB, SIDBI & EXIM Bank	469	515	71	116 ^
6. Systemically important non-deposit taking NBFCs (net of bank credit)	912	1,188	618	484 #
7. LIC's net investment in corporate debt, infrastructure and social sector	419	441	141	89 $
B2. Foreign Sources	**2,304**	**3,123**	**978**	**925**
1. External commercial borrowings/FCCBs	421	466	88	181 ^
2. ADR/GDR issues, excluding banks and financial institutions	27	10	10	1 ^
3. Short-term credit from abroad	306	1,177	291	137 *
4. Foreign direct investment to India	1,550	1,470	589	606 $
C. Total Flow of Resources (A+B)	**12,156**	**14,184**	**5,443**	**6,270**
Memo: *Net resource mobilisation by mutual funds through debt (non-gilt) schemes*	-185	830	500	230 ^

$: Up to August 2013 ^:Up to September 2013 *: Up to June 2013 &: Up to mid-September 2013 #: Up to July 2013

through CPs, by bank borrowings (Table IV.2). This substitution occurred as money market rates, including discount rates on CPs firmed up and primary market conditions remained subdued.

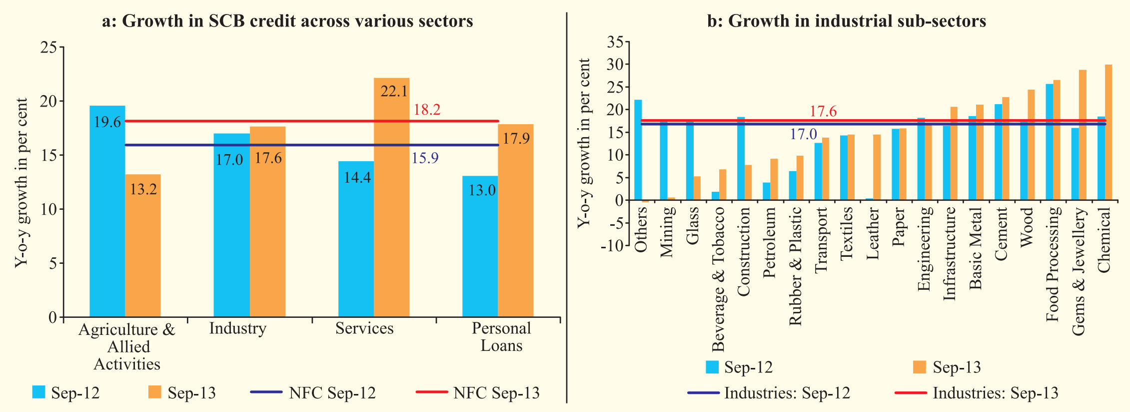
IV.8 Given the lacklustre domestic environment, banks need to ensure better credit management practices when extending loans, keeping a careful watch on their asset quality. The Reserve Bank's initiative to collate large common exposures across banks and make available the credit registry data is expected to help mitigate this problem.

Credit growth broad-based, uptick across sectors

IV.9 Data on sector-wise deployment of gross non-food bank credit of select SCBs indicate a build-up in credit to industries, services and also personal loan category (especially, housing) (Chart IV.4a). Overall industrial credit growth (y-o-y) was at 17.6 per cent in end-September 2013, with sectors such as basic metals, chemicals, infrastructure, cement, gems and jewellery, wood and food processing registering an above industry-average growth (Chart IV.4b).

IV.10 With the Reserve Bank increasing the cost of borrowing under MSF, even while restricting the availability of accommodation under the LAF repo, the modal deposit rate increased by 20 bps (q-o-q) during Q2 (Table IV.3). This rise was mainly with respect to short-term maturities of up to 180 days reflecting the tightening of liquidity conditions. Although the modal base rate remained unchanged at 10.25 per cent during Q2, the weighted average lending rate (WALR) on the outstanding bank loans increased marginally by 4 bps (q-o-q) to 12.15 per cent in August 2013. The WALR on fresh rupee loans sanctioned by banks increased sharply by 42 bps to 12.04 per cent in August 2013 from 11.62 per cent in June 2013.

Chart IV.4: Credit off-take picks-up significantly since mid-July 2013



Normalisation of exceptional measures underway, changes ahead will be conditioned by high inflation and low growth challenges

IV.11 The exceptional liquidity and monetary policy measures taken in the face of unprecedented exchange rate pressures were partially rolled back in the Mid-Quarter Monetary Policy Review on September 20 and further on October 7, 2013. Both these moves have lowered the effective policy rate by 125 bps. The Reserve Bank has also ensured sufficient liquidity in the system through LAF, MSF and OMO over a period of time in line with its assurances. Consequently, base money growth has picked up. Credit growth has also accelerated. With the process of normalisation of monetary measures making headway, monetary policy ahead would depend on how growth-inflation dynamics evolve. Liquidity conditions will have to be maintained at an appropriate level keeping in view the persistence in CPI inflation as also the slack growth conditions.

Table IV.3: Deposit and lending rates of banks registered an increase in Q2 of 2013-14

(Per cent)

Items	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13#
1	2	3	4	5	6	7	8
1. Domestic Deposit Rate (1-3 year tenor)							
i) Public Sector Banks	9.00-9.75	8.75-9.50	8.50-9.30	8.50-9.10	8.75-9.10	8.00-9.10	8.00-9.50
ii) Private Sector Banks	8.00-10.50	8.00-10.00	8.00-9.75	8.00-9.75	8.00-9.65	8.50-9.50	8.50-10.00
iii) Foreign Banks	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.75	3.50-9.60	3.60-9.88	3.50-11.00
Modal Deposit Rate of SCBs (all tenors)	***7.42***	***7.40***	***7.29***	***7.33***	***7.31***	***7.26***	***7.46***
2. Base Rate							
i) Public Sector Banks	10.00-10.75	10.00-10.50	9.75-10.50	9.75-10.50	9.70-10.25	9.70-10.25	9.80-10.25
ii) Private Sector Banks	10.00-11.25	9.75-11.25	9.75-11.25	9.70-11.25	9.70-11.25	9.60-11.25	9.80-11.50
iii) Foreign Banks	7.38-11.85	7.38-11.85	7.25-11.75	7.20-11.75	7.20-14.50	7.20-14.00	6.70-14.00
Modal Base Rate of SCBs	***10.75***	***10.50***	***10.50***	***10.50***	***10.25***	***10.25***	***10.25***
3. Weighted Average Lending Rate (WALR)*							
i) Public Sector Banks	12.70	12.41	12.34	12.23	12.18	12.10	12.10
ii) Private Sector Banks	12.31	12.42	12.32	12.14	12.13	12.10	12.17
iii) Foreign Banks	11.86	12.00	11.64	11.51	12.10	12.24	12.66
WALR of SCBs	***12.58***	***12.39***	***12.30***	***12.18***	***12.16***	***12.11***	***12.15***

#: Data on WALR pertain to August 2013. *: Based on loan outstanding as at end-quarter.
Note: Data on WALR are provisional.

V. FINANCIAL MARKETS

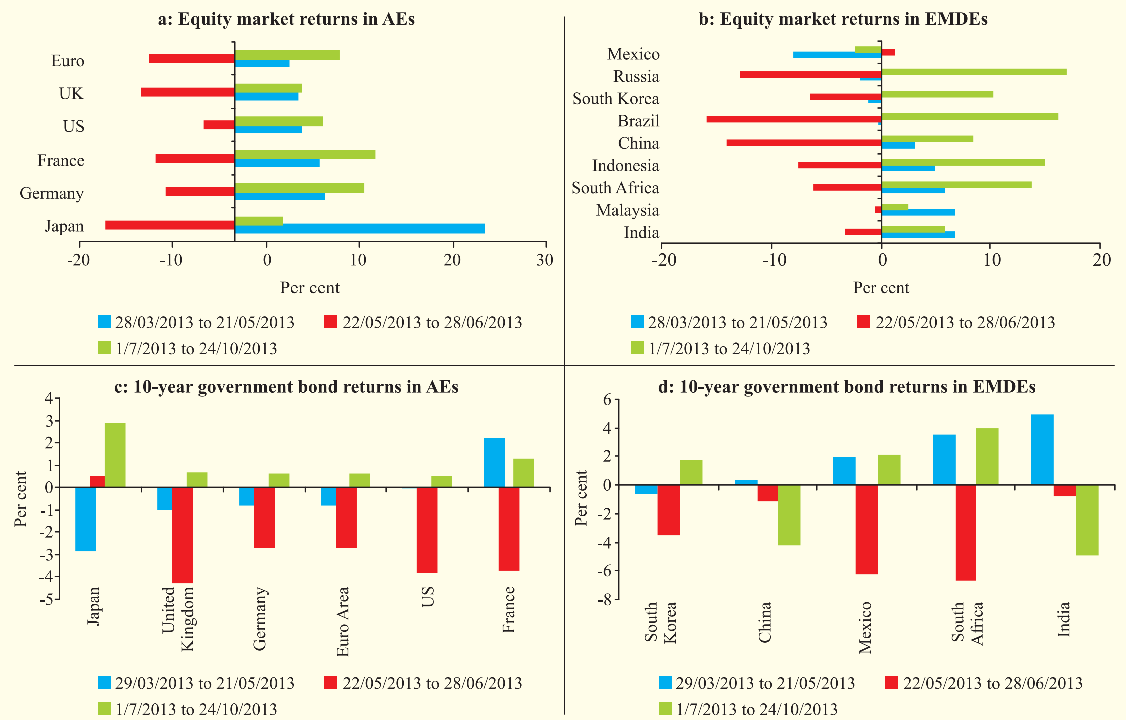
The decision by US Fed in September 2013 to maintain its pace of bond purchases appears to have considerably calmed markets. Since then, EMDE equity markets and currencies have rallied. Pressures in bond markets have also slackened. Tracking these global developments and significant policy actions by the Government and the Reserve Bank, Indian stock markets turned around in September 2013 after the slump in the preceding two months. The Rupee also strengthened in response to improved trade flows and return of equity inflows. While markets have got a temporary breather, near-term uncertainties remain and steps need to be taken to build buffers to manage contingent risks.

Fed announcement lowers near-term uncertainties

V.1 Although the exact timing of a possible tapering by the Fed remains unclear at present, what is obvious is that market participants have been making adjustments to a new world of potentially less liquidity. In the aftermath of the Fed indication on May 22, equity, bond and currency markets across countries and especially in emerging markets had experienced significant losses. Unsettled geo-political environment in some Middle East countries which raised crude oil prices had further added to the selling pressures.

V.2 In the H1 of 2013 till mid-May, equities had experienced significant rally, aided, among others, by accommodative monetary policies by central banks of the advanced economies. US bonds also rallied in April 2013. However, the Fed's communication about exit from QE led to sharp fall in the prices of these risky assets for both advanced and emerging market and developing economies (EMDEs) (Charts V.1).

Chart V.1: Global financial markets rally after tapering deferment



Source: Bloomberg and Thomson Reuters Datastream.

V.3 In the start of Q3 of 2013, global financial markets witnessed volatility on the back of speculation over the timing of tapering off of QE by the Fed. In general, there was an outflow of capital from EMDEs, especially to the US. This reversal prompted a spike in the Emerging Market Bond Index (EMBI) spread to nearly 375 basis points (bps) by end-August from around 278 bps on the eve of the Fed tapering off statement; EMDE stocks declined and their currencies also depreciated. Country-specific issues such as weaknesses in the current account, subdued export growth and infrastructural bottlenecks aggravated their concerns.

V.4 The Fed's decision on September 18 to continue with the monthly quantum of asset purchase, stating that they will await more evidence of an enduring economic recovery before adjusting their pace, brought significant improvement in market sentiments. Equity markets in advanced economies and EMDE equity markets surged, government bond yields moderated and currencies appreciated against the US dollar. Although the signing of the fiscal deal on October 17 has avoided potential debt default by the US, concerns remain since the deal only funds the US government through January 15, 2014 and raises the debt ceiling through February 7, 2014. Further contentious debate over spending cuts and entitlement programmes seem likely to ensue over the next several months. In October so far (up to October 24, 2013), the equity markets in select EMDEs increased by 5.7 per cent on an average.

Pressure on Rupee appears to be abating

V.5 Subsequent to the Fed's 'announcement effect', downward pressure on the local currencies along with considerable volatility was discernible across major EMDEs. This permeated both countries with CAD as well as those with current account surpluses. Among the former, the volatility was particularly high in the case of South Africa, India and Brazil. After touching a historical low of 68.36 per dollar on August 28, 2013, the spate of policy initiatives enabled the Rupee to recover (as on October 24, 2013) by almost 10 per cent (Chart V.2).

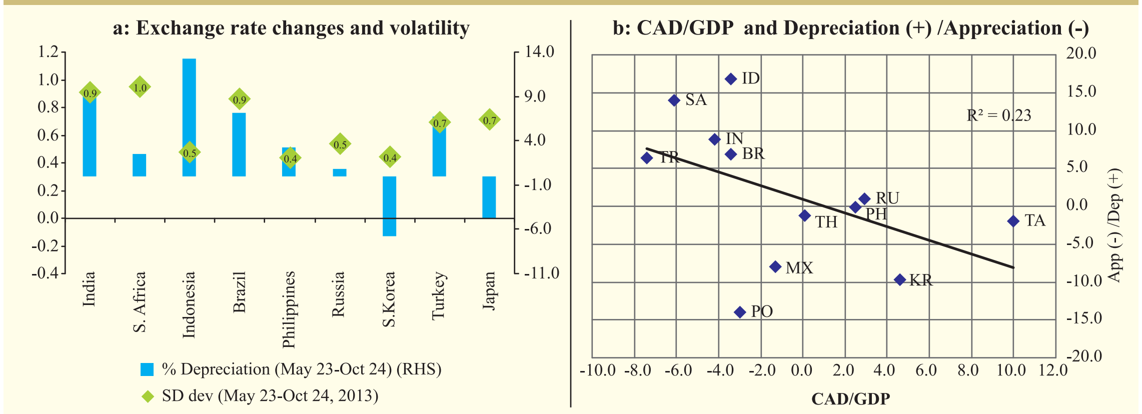
Currency derivatives activity subdued

V.6 The impact of the regulatory measures announced by the Reserve Bank and SEBI against the backdrop of heightened exchange rate volatility, were manifest in the derivatives market wherein activity in the currency derivatives declined in Q2 of 2013-14 (Chart V.3).

Initial money market upheavals and subsequent moderation

V.7 The situation in the money market was comfortable during the first half of July 2013. However, the exceptional measures taken by

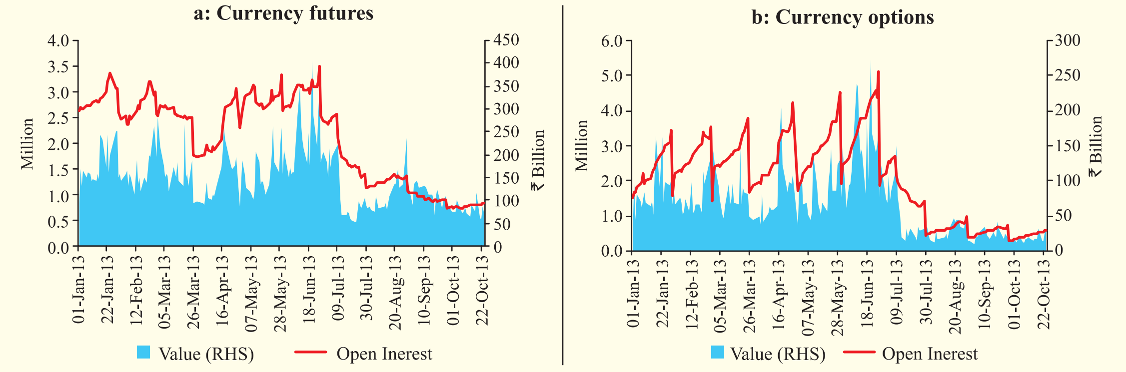
Chart V.2: EMDEs, especially those with CAD, face currency pressures



Turkey= TR, South Africa =SA, India= IN, Poland =PO, Brazil =BR, Indonesia =ID, Mexico =MX, Thailand =TH, South Korea =KR, Philippines =PH, Russia =RU, Taiwan =TA

[1] : CAD/GDP data pertains to 2013, sourced from WEO October 2013 except India where actual data points for the period of 2013 (January-June) is given.

Chart V.3: Subdued activity in the currency derivatives segment of NSE



Source: NSE.

the Reserve Bank during July and August 2013 impacted the money market. The weighted average call and CBLO rates increased to 9.97 per cent and 9.90 per cent, respectively, in September 2013 (Chart V.4). In continuation of its move towards calibrated withdrawal of the exceptional measures, the Reserve Bank on October 7, 2013 lowered the MSF rate by 50 bps to 9.0 per cent and announced additional liquidity measures in the form of term repos of 7-day and 14-day tenor for the amount equivalent to 0.25 per cent of banking system NDTL through variable rate auctions every Friday beginning October 11, 2013. As a result, the money market rates softened with the average call and CBLO rates standing at 8.92 per cent and 8.97 per cent, respectively on October 25, 2013.

Decline in CD issuance

V.8 The measures by the Reserve Bank aimed at tightening liquidity appears to have impacted this segment, with the weighted average effective interest rate (WAEIR) of CDs increasing to 11.20 per cent on September 6, 2013 from 8.19 per cent as at end-June 2013 (Chart V.5). The average gross fortnightly issuance of CDs declined to ₹96 billion during Q2 of 2013-14 (up to September 6, 2013) from ₹340 billion during Q1 of 2013-14. The outstanding amount of CDs also declined to ₹3,011 billion as on September 6, 2013 from ₹3,645 billion at end-June 2013.

Appetite for CP lacklustre

V.9 With rise in discount rates, the appetite for CP issuance has fallen markedly and corporates are substituting funding through the

Chart V.4: Temporary volatility in money markets and subsequent moderation

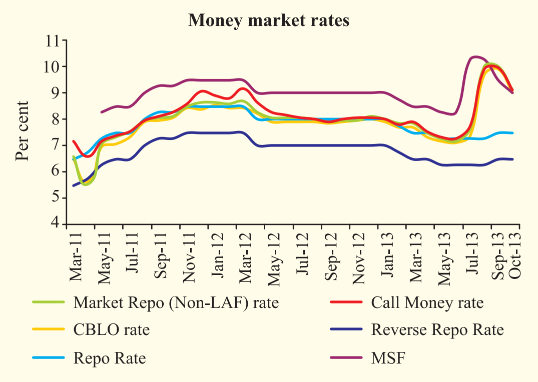


Chart V.5: CD issuances fall as money market rates rise

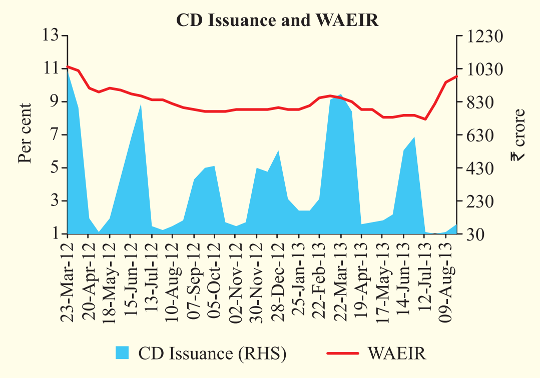
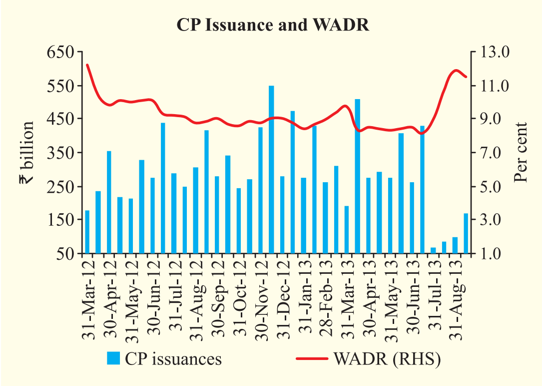


Chart V.6: Lacklustre appetite for CPs as corporates switch to bank funding



instrument with alternative financing sources, especially bank credit. The weighted average discount rate (WADR) of CPs increased to 11.53 per cent as on September 15, 2013 from 8.54 per cent at end-June 2013 (Chart V.6).

G-secs yields moderate

V.10 The 'announcement effect' on May 22, 2013 and subsequent measures by the Reserve Bank led to a significant hardening of G-sec yields. Generic yields on 10-year G-secs peaked to 9.27 per cent on August 19, 2013, after which it softened on announcement of OMO purchase auction on August 20, 2013. The yields hardened to 8.83 per cent on September 30, 2013 after a hike in the repo rate in the mid-quarter monetary policy review (Chart V.7). However, the markets rallied and yields softened after the Reserve Bank announced an OMO purchase auction of ₹100 billion on September 30, and reduced the MSF rate by 50 bps to 9.0 per cent on October 7, 2013. The 10-year generic G-sec yield closed at 8.65 per cent on October 25, 2013.

V.11 The average daily trading volume of central government securities remained low (Chart V.8).

Despite rising yield environment, cost of borrowing for government falls

V.12 The gross market borrowings of the Central Government through dated securities during 2013-14 (up to October 21, 2013) stood at ₹3,890 billion (net borrowings of ₹3,143 billion) as compared with ₹4,090 billion (net borrowings of ₹3,234 billion) during the corresponding period of the previous year (Table V.1). The weighted average maturity of the dated securities improved to 14.40 years. The benchmark 10-year yield in the primary auctions eased during early 2013-14 touching a low of 7.16 per cent on May 21, 2013 and remained subdued. The yields increased significantly post July 15, 2013 due to liquidity tightness. Despite this, the weighted average cost of borrowing so far has remained much below that in the corresponding period of the previous year. However, the quantum of devolvement till October 24, 2013 increased to ₹163.76 billion as compared to ₹18.28 billion in the corresponding period of the previous year.

V.13 During 2013-14 (up to October 24, 2013), 24 states raised ₹970 billion on a gross basis (net amount of ₹654 billion) as compared

Chart V.7: Yield curve shifts up on liquidity tightening, but eases on rollback

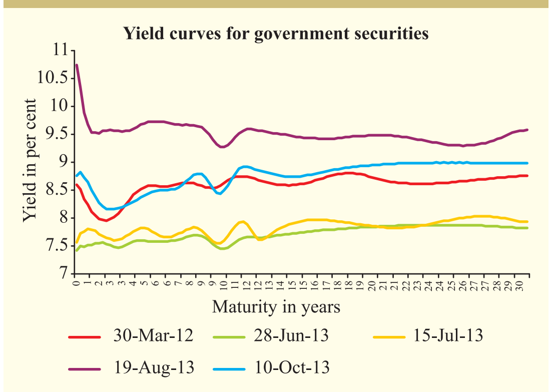


Chart V.8: Volumes in G-secs decline on higher yields

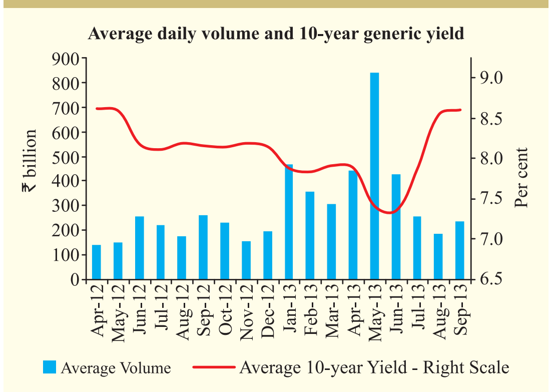


Table V.1: Weighted average yield of primary issuances fall in 2013-14

Item	2011-12	2012-13	2013-14*
1	2	3	4
Central Government			
Gross amount raised (₹ billion)	5,100	5,580	3,890
Bid-cover ratio (Range)	1.39-5.12	1.47-3.59	1.33-6.09
Weighted average maturity (years)	12.66	13.52	14.40
Weighted average yield (per cent)	8.52	8.60	8.17
State Governments			
Gross amount raised (₹ billion)	**1,586.3**	**1593.4**	**970**
Cut-off yield range (Per cent)	8.36-9.49	8.67-9.31	7.57-9.94
Weighted average yield (per cent)	8.79	8.97	8.88

* Up to October 24, 2013

with ₹966 billion (net amount of ₹862 billion) raised by 25 states in the corresponding period of the previous year. In the corresponding period, the weighted average yield eased to 8.88 per cent up to October 24, 2013 from 8.93 per cent during the corresponding period last year.

Equity market responds to measures and taper deferment to register gains

V.14 During the financial year 2013-14 (till October 25, 2013), the stock markets have gained 9.8 per cent (Sensex) and 8.1 per cent (Nifty). This movement, however, masks wide gyrations over the period (Chart V.9a). After initial gains, the announcement effect of May 22 put the global stock markets into a tail spin. Between May 22 - August 30, the Sensex and Nifty declined by 7 per cent and 10 per cent, respectively, as FIIs disinvested US$ 13 billion in domestic markets during this period. However, the equity market recovered after the Reserve Bank announced a slew of measures on September 4, 2013. The positive feel-good impact of the Fed's September 18, 2013 announcements also boosted markets. The momentum continued in October as well with the BSE Sensex and Nifty gaining 11 per cent and 13 per cent, respectively till October 25, 2013 over September 4, 2013. Confidence also returned, with FIIs investing US$ 1.0 billion in equity and debt segments during September-October (upto October 24, 2013). Equity market volatility, measured by NSE's VIX index heightened during Q2 of 2013-14 (Chart V.9b).

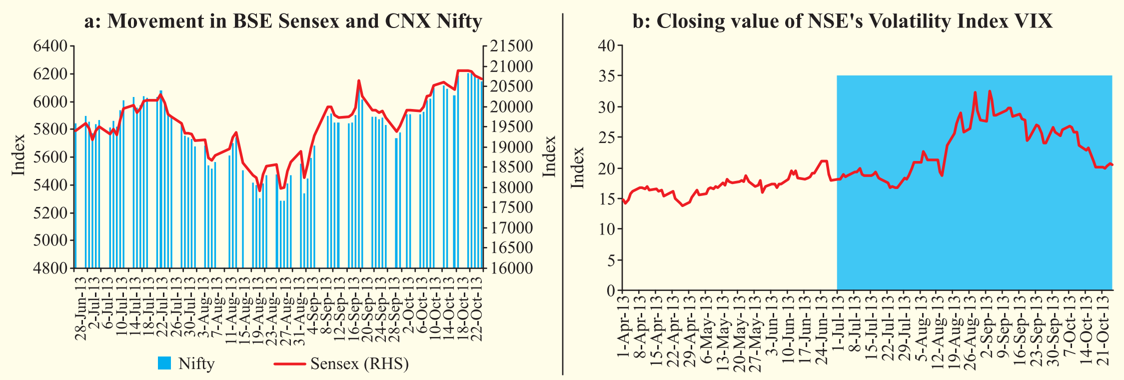
Primary capital market remained lacklustre

V.15 During H1 of 2013-14, an amount of about ₹32 billion was raised from the primary equity market through 24 issues. Resource mobilisation *via* private placements declined sharply. Resources mobilised by mutual funds during H1 of 2013-14 also declined drastically, mainly on account of heavy redemptions recorded in debt-oriented funds, especially during June-July and September 2013. Resources mobilised through ADR/GDR also fell substantially (Table V.2).

Turnover in the equity derivatives segment surges

V.16 During April-August 2013, the turnover in equity derivative segment increased by

Chart V.9: Deferment of taper lifts up equities, although they remained volatile



Source: BSE, NSE and Bloomberg.

Table V.2: Primary capital market mobilisation remained lacklustre

(₹ billion)

Category	2012-13 (Apr-Mar)	2012-13 (Apr-Sep)	2013-14 (Apr-Sep
1	2	3	4
a. Public Issue (i) + (ii)	**219.2**	**27.3**	**68.2**
i) Public Issue (Equity)	49.4	5.1	10.6
of which: IPOs*	49.4	5.1	10.6
FPOs	0.0	0.0	0.0
ii) Public Issue (Debt)	169.8	22.2	57.6
b. Rights Issue	89.4	67.5	21.7
Total Equity Issues (i+b)	**138.8**	**72.6**	**32.2**
c. ADR/GDR	10.4	9.9	1.2
d. Mutual Fund Mobilisation (net)	765.4	1018.7	353.4
i) Private Sector	637.9	841.3	248.2
ii) Public Sector	127.5	177.5	105.3
e. Private Placement in corporate debt market	3614.6	1808.2	1428.2
f. QIP	160.0	46.5#	52.0#

*: Does not include offer for sale. #: Up to August.
Source: SEBI.

29.0 per cent to ₹206.7 trillion from ₹160.3 trillion in the corresponding period last year. Trading volume also increased by 15.3 per cent to 716.3 million contracts during April-August 2013 from 621.1 million contracts in April-August 2012.

Crisis of NSEL exposes regulatory gaps prevailing in systemic institutions

V.17 Consequent to the directions of the Ministry of Consumer Affairs (MCA) to the National Spot Exchange Ltd (NSEL), NSEL decided to suspend trading of all contracts, including e-contracts as well and settle all one day forward contracts under the supervision of the Forward Market Commission (FMC).

V.18 This crisis in NSEL has raised the issue of inter-connectedness of financial institutions. Many brokerage firms are active in multiple segments, including equity, commodity and forex. A loss in one segment of their operations can have a cascading effect on other segments, in turn, propagating contagion effects throughout the market.

V.19 The Union Government has taken several policy initiatives to plug regulatory deficiencies. It has transferred the administrative control of FMC to the Ministry of Finance and constituted two committees, one under RBI Deputy Governor, Dr. K. C. Chakrabarty and the other under the Secretary, Department of Economic Affairs, Shri Arvind Mayaram, to look into various aspects relating to this crisis. These committees have since submitted their reports to the Central Government.

House price increases abated in Q1 of 2013-14

V.20 The q-o-q growth in the Reserve Bank house price index (Base year:2010-11) at the all-India level was lower at 0.89 per cent in Q1 of 2013-14 (latest available quarter) as compared to 2.46 per cent in the previous quarter. The increase was the highest for Lucknow, followed by Ahmedabad and Kochi (Table V.3).

Table V.3: House price growth moderates, with city-specific variations

City	Q-o-Q (Q1 of 2013-14)	Q-o-Q (Q4 of 2012-13)	Y-o-Y (Q1 of 2013-14)	Y-o-Y (2012-13)
1	2	3	4	5
Ahmedabad	4.47	2.90	15.05	11.87
Bengaluru	0.23	0.54	6.70	12.76
Chennai*	0.61	-0.09	15.98	18.95
Delhi	0.79	6.18	21.15	41.66
Jaipur	0.00	8.78	14.10	10.71
Kanpur	-9.35	-2.11	-28.00	-7.08
Kochi	2.28	-8.98	28.55	14.13
Kolkata	1.42	4.25	27.06	47.66
Lucknow	4.66	-1.82	27.56	25.06
Mumbai	0.28	0.36	8.38	18.15
All India #	**0.89**	**2.46**	**13.75**	**22.73**

*: Index is based on both residential and commercial properties.
#: Index is a weighted average of city indices, weights based on population proportion.

Near-term uncertainties remain a lingering concern

V.21 The Fed has decided to wait for more convincing evidence prior to initiating a graduated withdrawal of its bond buying programme. This has provided markets with much-needed breathing space. However, market uncertainties remain associated with how the debt ceiling issues will play out over the next several months and whether the incipient signs of recovery in the euro area sustain. Markets in India also face domestic uncertainties stemming from protracted slowdown, falling corporate earnings and rising leverage, besides risks of political uncertainties associated with the electoral cycle.

VI. PRICE SITUATION

On an average basis, headline WPI inflation has declined significantly over the past two years, though it has edged up since May 2013. Food articles inflation reached a three-year high largely due to a sharp rise in vegetable prices. Exchange rate depreciation and the rise in crude oil prices led to a rebound in fuel inflation to double-digit levels. As a result, headline inflation increased even though manufactured non-food inflation remained subdued. Going forward, the good monsoon should have a salutary effect on food inflation, but second-round effects from already high food and fuel inflation could impart upside pressures on prices of other commodities and services. Concerns about inflation emanate not just from high and persistent CPI inflation but also from rising WPI inflation.

Inflation and exchange market pressures prompted many EMDEs to tighten their monetary policies while inflation remained benign in Advanced Economies

VI.1 Owing to weak demand conditions and benign inflation, Advanced Economies (AEs) persisted with their exceptionally accommodative unconventional monetary policies (Table VI.1). Consumer price inflation in the OECD area was 1.7 per cent, year-on-year, in August 2013, down from the 2.0 per cent recorded in July. As inflation in AEs is likely to remain moderate in

Table VI.1:EMDEs Hike Policy Rates in Face of Inflation and Exchange Rate Pressures

Global Inflation and Policy Rates

Country/ Region	Key Policy Rate	Policy Rate (as on October 25, 2013)	Changes in Policy Rates (basis points)		CPI Inflation (Y-o-Y, per cent)	
			Sep 2009 to Dec 2011	Jan 2012 to Sep 2013	Sep-12	Sep-13
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	2.50 (Aug 7, 2013)	125	(-) 175	2.0#	2.2#
Canada	Overnight Rate	1.00 (Sep. 8, 2010)	75	0	1.2	1.1
Euro area	Interest Rate on Main Refinancing Operations	0.50 (May. 08, 2013)	0	(-) 50	2.6	1.1
Israel	Key Rate	1.00 (Oct 1, 2013)	225	(-) 175	2.1	1.3
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10@(Oct. 5, 2010)	(-) 10	0	(-) 0.3	1.1
Korea	Base Rate	2.50 (May 9, 2013)	125	(-) 75	2.0	0.8
UK	Official Bank Rate	0.50 (Mar. 5, 2009)	0	0	2.2	2.7
US	Federal Funds Rate	0.0 to 0.25@ (Dec. 16, 2008)	0	0	1.7*	1.5*
Emerging and Developing Economies						
Brazil	Selic Rate	9.50 (Oct 10, 2013)	225	(-) 150	5.3	5.9
China	Benchmark 1-year Deposit Rate	3.00 (Jul. 6, 2012)	125	(-) 50	1.9	3.1
	Benchmark 1-year Lending Rate	6.00 (Jul. 6, 2012)	125 (600)	(-) 56 (-150)		
India	Repo Rate	7.50 (Sep. 20, 2013)	375 (100)	(-) 100 (-200)	9.7	9.8
Indonesia	BI Rate	7.25 (Sep.12, 2013)	(-) 50	125	4.3	8.4
Philippines	Reverse Repurchase Rate	3.50 (Oct. 25, 2012)	50	(-) 100	3.7	2.7
	Repurchase Rate	5.50 (Oct. 25, 2012)	50	(-) 100		
Russia	Refinancing Rate	8.25 (Sep. 14, 2012)	(-) 275	25	6.6	6.1
South Africa	Repo Rate	5.00 (Jul. 20, 2012)	(-) 150	(-) 50	5.5	6.0
Thailand	1-day Repurchase Rate	2.50 (May 29, 2013)	200	(-) 75	3.4	1.4

@: Change is worked out from the minimum point of target range. #: Q3 (Jul-Sep). * August.

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

Source: Websites of respective central banks/statistical agencies.

the near-term given the current commodity price cycle and slack labour market conditions, normalising monetary policy in AEs may take a long time.

VI.2 In contrast, monetary policy was tightened in many key Emerging Markets and Developing Economies (EMDEs), such as Brazil, India and Indonesia during Q3 of 2013 as they faced inflation and exchange rate pressures, amidst large and volatile capital outflows following the Fed's indication on May 22, 2013 that prompted expectations about the global interest rate cycle reversing. Inflation risk for some EMDEs is likely to persist from exchange rate pass-through given that the pace and timing of withdrawal of monetary accommodation in AEs could keep capital flows volatile.

Global commodity price inflation likely to stay subdued in the near term

VI.3 Global commodity price increases have been moderate for some time now though their levels continue to remain elevated in relation to the demand-supply balance. The IMF's primary commodity price index for Q3 of 2013 was 3.2 per cent higher than the level in Q2 (Chart V1.1). Prices, especially of crude oil have not declined commensurate with improved supply prospects, due to abundant global liquidity and geo-political uncertainties in the Middle-East region. At the same time, the growth deceleration in EMDEs has led to some correction in global metal prices. With prospects of a strong recovery in global growth remaining dim in the near-term, the global commodity price inflation may stay subdued for now. Risks to global commodity prices, however, remain from volatile exchange rate movements and supply disruptions.

Domestic WPI headline inflation rebounded driven by food and fuel segments

VI.4 Headline inflation in India, measured by year-on-year (y-o-y) changes in the wholesale price index (WPI), which had declined to a 42 month low of 4.6 per cent in May 2013 increased to 6.5 per cent (provisional) in September 2013 driven by a rebound in food and fuel prices (Chart VI.2). The average inflation during H1 of 2013-14 at 5.5 per cent, however, remained considerably lower than 7.7 per cent during the corresponding period of the previous year.

VI.5 So far, the build-up of inflation during 2013-14 has been dominated by the food and fuel group which together contributed to about 87 per cent of the increase in the index during April-September 2013 (Chart VI.3).

Vegetable price shock took food inflation to a three-year high

VI.6 Food articles inflation was largely driven by significant increases in vegetable prices (Chart VI.4). Excluding vegetables, WPI

Chart VI.1: Global commodity prices largely remained range-bound

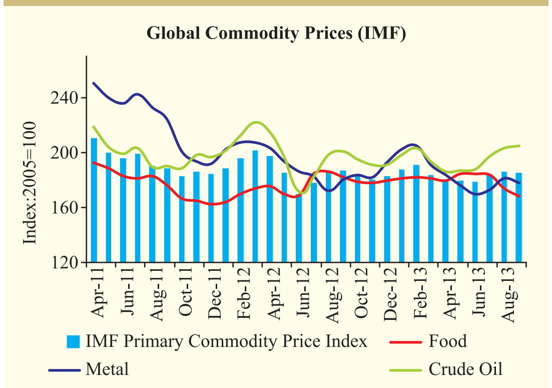


Chart VI.2: WPI inflation rebounded driven by food and fuel prices

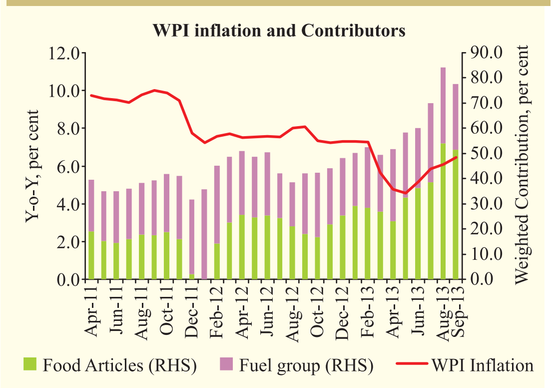
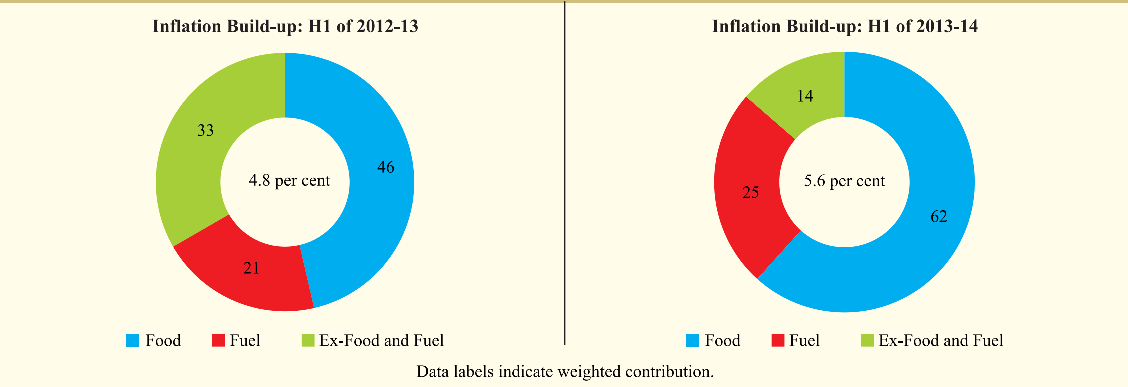


Chart VI.3: Build-up of inflation during 2013-14 so far has been dominated by the food and fuel segment



inflation was at 4.7 per cent in September. High food inflation on account of a number of factors, including high input costs, rising wages and inelastic supply responses could have a destabilising impact on overall inflation expectations.

VI.7 Despite a significant increase in the prices of primary food articles, inflation in manufactured food products declined to a low of 1.6 per cent in September 2013. This could be attributed to negative inflation in sugar and edible oils which together account for about half of the weight in the manufactured food products group. For over a year now, there has been a significant decline in global prices for both these products (Chart VI.5). The decline has been significant enough to exert a downward pressure on domestic prices despite depreciation of the rupee.

Rupee depreciation pass-through and higher global crude prices pushed up fuel price inflation

VI.8 Rupee depreciation and an increase in crude oil prices led to a rebound of fuel inflation to double-digit levels. Apart from the increase in prices of freely priced products, administered price revisions also contributed to an increase in fuel prices. However, the increase in administered prices did not keep pace with the rise in crude oil prices (in rupee terms) leading to greater suppressed inflation (Chart VI.6). The Indian basket's crude oil prices in rupee terms reached a record high of ₹7,263 per barrel during the first fortnight of September 2013, which was about

Chart VI.4: Vegetable price shock pushed up food inflation

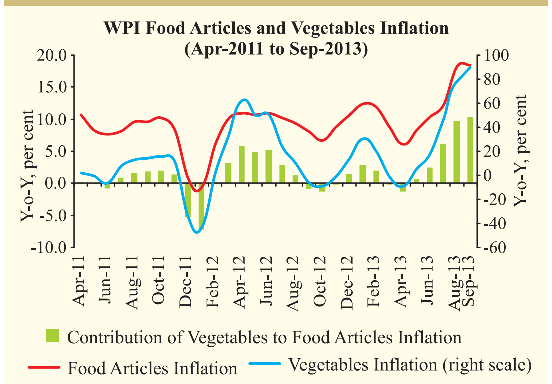


Chart VI.5: Prices of sugar and edible oils decline in line with falling global prices

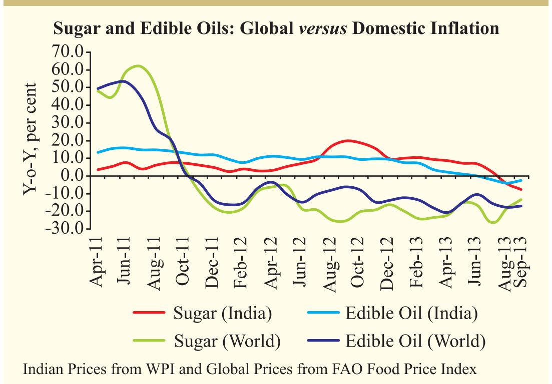


Chart VI.6: Fuel price increases driven by rising global prices and rupee depreciation

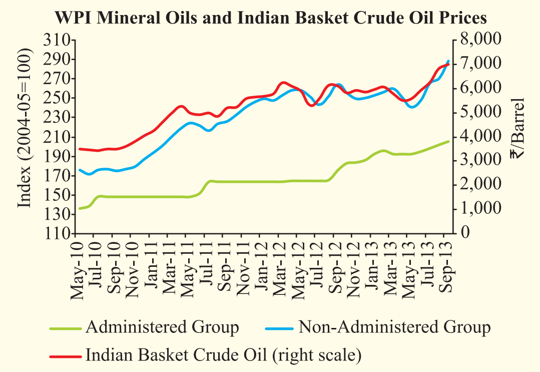
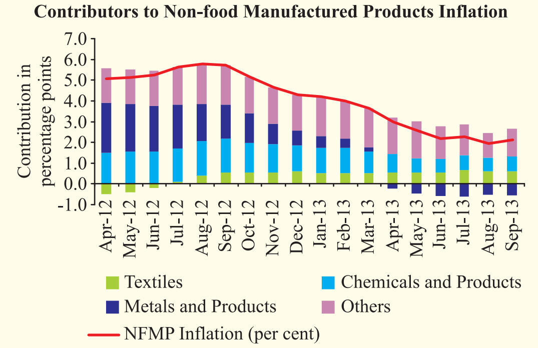


Chart VI.8: Declining metal prices pulled down manufactured non-food products' inflation



35 per cent higher than the low levels recorded during the second fortnight of April 2013. Some decline in global crude prices in recent weeks as well as the reversal in the trend of rupee movement helped ease part of the pressure. The price of crude oil consequently declined to ₹6,544 per barrel as on October 24, 2013.

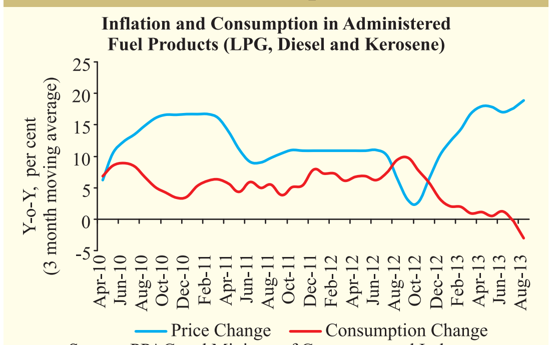
Further hike in fuel prices needed; may help dampen demand

VI.9 There have been concerted efforts to reduce the extent of suppressed inflation in the fuel segment. With the increase in fuel prices, there has been a significant slowdown in consumption in the recent period (Chart VI.7). Given the still large under-recoveries, there is need for further upward adjustment in fuel prices which would also dampen demand and restrain the twin deficits-fiscal and external. Such demand adjustments are also desirable for energy conservation and efficiency in the use of a scarce and costly resource.

Inflation in non-food manufactured products continued to moderate amidst slack demand

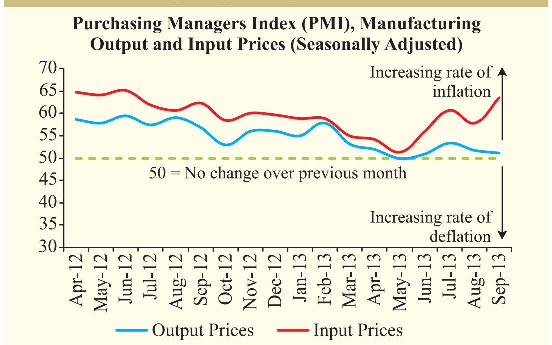
VI.10 Non-food manufactured products inflation at 2.1 per cent (y-o-y) in September 2013 continued to remain muted (Chart VI.8). Three product groups *viz.*, of chemicals, metals and machinery and machine tools, which account for about 58 per cent of the non-food manufactured products group, exhibited significantly lower inflation as compared to the rest. Negative inflation in metals during the current financial year so far, which is in line with declining global metal prices, was one of

Chart VI.7: Consumption of petroleum products slow down significantly with increase in prices



Source: PPAC and Ministry of Commerce and Industry.

Chart VI.9: Pricing power weakened further with firms unable to pass-on input price pressures



Source: HSBC Markit.

the key factors pulling down overall inflation in this segment.

VI.11 The slowdown in growth has led to a significant decline in pricing power as is evident from the trend available from purchasing manager index (PMI) (Chart VI.9). Though there was a pick-up in both input and output price indices in PMI in recent months, the gap between the two widened indicating that the firms are unable to pass on the full increase in input prices to output prices.

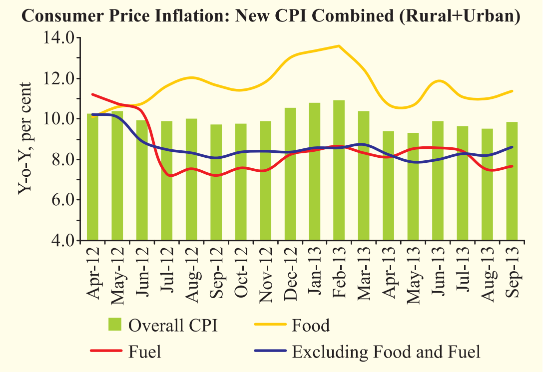
Real rural wage growth moderated due to higher inflation

VI.12 Though the growth in wages in rural areas declined in recent months, it continued to remain high in nominal terms and was in double-digits (Chart VI.10). High inflation, however, resulted in significant moderation of real wage growth. The level of real wages remained stagnant during the first eight months of calendar year 2013.

Rising food prices caused persistent high CPI inflation

VI.13 Though WPI inflation has moderated in 2013-14 so far, CPI inflation, as per the new CPI, continued to remain near double-digit levels driven by high food inflation (Chart VI.11). Given the higher weight of food in CPI as compared with WPI, the food group contributed significantly to overall CPI inflation and divergence between WPI and CPI inflation. The food group, which has a weight of 47.6 per cent in the new CPI (combined) contributed about 56 per cent of the inflation in September 2013.

Chart VI.11: High food inflation kept CPI inflation persistent near double digits



VI.14 Food prices increased at a faster rate in urban areas as compared to rural areas in recent months, driven largely by higher inflation in vegetables in urban areas (Chart VI.12). It is also seen that vegetable prices are more volatile in urban areas as compared to rural areas. While trade and transport costs could explain part of the divergence in inflation between rural and urban areas, such large swings in prices could also indicate that the supply chain is not efficiently integrated.

VI.15 Excluding food and fuel, the new CPI inflation remained high at 8.6 per cent in

Chart VI.10: Growth in real wages moderated in rural areas driven by higher inflation

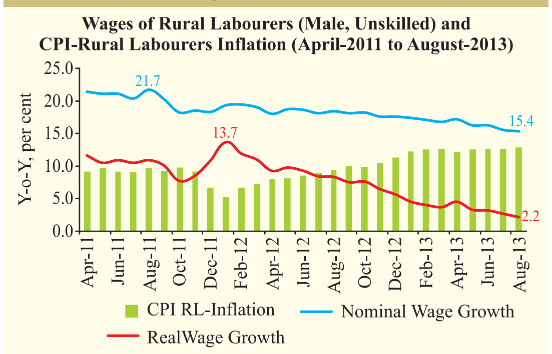


Chart VI.12: Food prices increased at a faster pace in urban areas

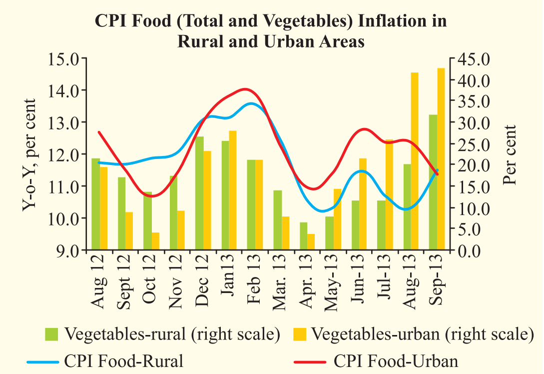
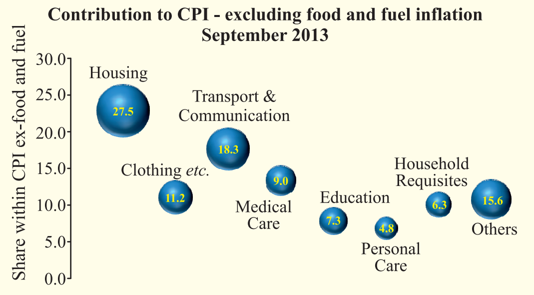


Chart VI.13: Inflation in CPI-excluding food and fuel was driven by housing and transport & communication



Note: Figures within the spheres indicate the contribution to CPI- excluding food and fuel inflation.

September 2013 as compared to 2.3 per cent in WPI. The composition of the basket for excluding food and fuel differs significantly across CPI and WPI. CPI includes housing for which inflation is in double-digits. It also includes a miscellaneous group comprising of a number of services. The contribution of housing and transport communication has been significant in CPI-excluding food and fuel inflation (Chart VI.13). High inflation in transport and communication reflect pass-through of increase in fuel prices to transport costs. Persistent contribution from services, such as education and medical care, which are more labour-intensive, also indicate that sustained increases in wages (both in nominal and real terms) in the recent period fed into generalised inflation. This could partly explain the sticky inflation at the consumer level even in the midst of a growth slowdown.

Risks to inflation largely in balance, though second-round effects may come into play

VI.16 Risks to inflation ahead are largely in balance from here on, though second-round effects from already high food and fuel inflation in CPI inflation could continue. A good *kharif* crop could partly mitigate the pressure on food prices, both at the wholesale and retail levels. Still, upside risks remain from short-term domestic supply-side disturbances, the possibility of unforeseen global oil price spikes and possible adverse currency movements.

VII. MACROECONOMIC OUTLOOK

After two years of growth deceleration, the slowdown extended into 2013-14 amid domestic structural constraints, dampened global cyclical conditions and dented business confidence. Growth forecasts by external agencies and professional forecasters have been revised downwards. Inflation expectations and inflation have begun to edge up again as the second round impact of already high food and fuel prices has come into play. In these circumstances, the revival in growth will require complementary monetary, fiscal and regulatory policies. At this juncture, it is important to maintain macroeconomic stability so as to allow further impetus to growth to come from productivity enhancing structural reforms, addressing supply constraints and ensuring quick project implementation.

Modest improvement in growth possible in H2 of 2013-14

VII.1 Indian economy has continued to slowdown for the third year in succession. In part, the slowdown is the result of global cyclical conditions that have resulted in most emerging markets and developing economies (EMDEs) slowing down. However, the slowdown has been exacerbated by domestic factors, a large part of which can be addressed through concerted policy actions and their implementation. Small but sustained policy steps can deliver growth back to the economy. Further productivity enhancements and containment of high wage inflation are possible by making labour markets more flexible and by improving human capital formation given the abundant labour supplies.

VII.2 To recoup India's potential growth, first and foremost it will be necessary to secure macroeconomic stability as failure to do so can result in a lasting growth collapse. High persistent inflation is inimical to growth. Inflation based on CPI-IW has averaged 9.5 per cent for the last six years and the headline WPI inflation has averaged 8.6 per cent during the last three years. Such high inflation eroded real consumption, lowered savings, caused financial disintermediation, widened the current account gap and placed additional pressures for subsidised safety nets for the vulnerable population. Against this backdrop, monetary policy will have to tread a carefully charted course to support reasonable real interest rates and avert financial repression.

VII.3 Growth has slackened to a 17-quarter low of 4.4 per cent during Q1 of 2013-14. On current reckoning, growth in 2013-14 is likely to stay at about the level of last year. After a slower H1, a modest recovery is likely in H2 of 2013-14. This is expected to come from a rebound in agricultural growth backed by a better than normal south-west monsoon and a pick-up in exports.

VII.4 While the current account deficit (CAD) risks have receded somewhat, what is important for now is that monetary and fiscal policies retain focus on maintaining macroeconomic stability. Meanwhile, structural policy measures and ground-level actions could work to boost growth over the medium-term.

Inflation may remain range-bound in H2 of 2013-14 but disinflation process is incomplete

VII.5 The WPI inflation trajectory changed in Q2 of 2013-14 with a turnaround since July 2013. On the current assessment, WPI inflation may remain range bound around the current level during H2 of 2013-14. This indicates persistence of inflation at levels distinctly above what was indicated by the Reserve Bank earlier in the year. Even though non-food manufactured products inflation remains low at present due to dampened demand-side factors and lower commodity prices, persistence of inflation in H2 can arise as high food and fuel inflation exert some cost push pressures on manufactured product prices and as high wage inflation feeds through to general level of prices.

VII.6 An important element in shaping the inflation outcome during 2013-14 will be inflation in primary food articles that rose to 18.4 per cent in September 2013 mainly due to a significant escalation in vegetable prices during H1 of 2013-14. As a base case, food inflation should soften during H2 on the back of possible bumper foodgrains and oilseeds output. However, the degree of fall in food inflation will be conditioned by food management, the extent of ratchet effect in vegetable prices and supply responses in protein-rich products.

VII.7 A fall in food inflation is a prerequisite to bring CPI inflation to a more reasonable level in line with the trends in emerging markets. However, pending sufficient supply responses, it is important that monetary policy keeps a tight leash to prevent relative price shocks in the current year from getting generalised. While the negative output gap is likely to have a disinflationary impact, supply constraints and the absence of a sufficiently competitive industrial structure can moderate its effect. Persistence of CPI inflation could also come from the second round effects of exchange rate pass-through and administered price revisions that can impact prices across a wide range through transportation costs. Also, inflation expectations and demand factors can keep price pressures elevated in services segments like education and health.

Surveys show business confidence continues to weaken

VII.8 The confidence channel has played an important role in the current growth slowdown. However, business confidence shows little improvement and continues to remain weak. This is indicated by moderation on a y-o-y and q-o-q basis in key indices of various surveys (Table VII.1). According to FICCI, weak demand, cost and availability of credit continue to be concerns. While the Dun and Bradstreet Business Confidence Index showed moderate improvement over the previous quarter, it remained below the level registered in Q4 of 2012-13.

VII.9 The seasonally adjusted HSBC Markit Purchasing Managers' Index (PMI) for both manufacturing and services contracted in September 2013. The index for output prices decelerated for both manufacturing and services while input prices for manufacturing accelerated during the month.

Industrial Outlook Survey reflects weak business sentiment, moderation expected ahead

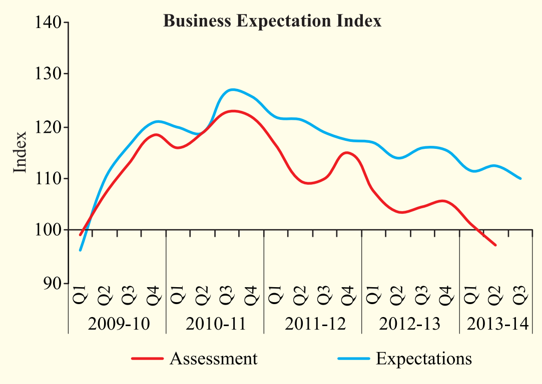
VII.10 The Reserve Bank's 63rd round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS63) conducted during August-September

Table VII.1: Expectations surveys indicate weak optimism

Business Expectations Surveys

Index/Period	NCAER- Business Confidence Index Oct 2013	FICCI Overall Business Confidence Index Q1:2013-14	Dun & Bradstreet Business Optimism Index Q4 : 2013	CII Business Confidence Index Q1: 2013-14
1	2	3	4	5
Current level of the Index	100.4	49.0	134.9	51.2
Index as per previous survey	117.7	57.4	130.6	51.3
Index level one year back	125.4	51.8	140.8	55.0
% change (q-on-q) sequential	-14.7	-14.6	3.3	-0.2
% change (y-on-y)	-19.9	-5.4	-4.2	-6.9

Chart VII.1: Decline witnessed in business expectation



2013, showed that in terms of assessment, the Business Expectation Index (BEI) dropped significantly for Q2 of 2013-14, falling below the threshold level of 100, separating contraction from expansion, and touching the lowest point since Q1 of 2009-10. For Q3 of 2013-14, expectations remained well above the threshold level (Chart VII.1).

VII.11 Analysis of the net responses among various components of demand conditions shows that while the sentiments on production remained broadly unchanged, the sentiments on order books, capacity utilisation, exports and imports dropped substantially for Q2 of 2013-14. The outlook for Q3 of 2013-14 also shows similar sentiments.

VII.12 Perceptions on overall financial situation dropped substantially for Q3 of 2013-14. The cost of external finance is perceived to rise, and the percentage of respondents expecting this to rise has increased for the first time since Q4 of 2011-12. Cost of raw material and selling price are expected to increase in Q3 of 2013-14. The perception on profit margins continues to remain in the negative terrain and

Table VII.2: Business confidence continues to weaken

Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response[1]										
		July-September 2012		October-December 2012		January-March 2013		April-June 2013		July-September 2013		October-December 2013
		E	A	E	A	E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9	10	11	12	13
1. Overall Business Situation	Better	30.6	16.1	32.2	17.2	37.5	18.4	29.6	12.8	30.0	7.4	25.7
2. Overall Financial Situation	Better	23.6	12.2	25.8	12.7	27.0	11.8	21.9	9.5	24.1	1.8	17.3
3. Production	Increase	33.6	18.8	35.7	18.6	37.1	18.6	24.4	9.8	28.5	10.8	28.9
4. Order Books	Increase	29.9	12.0	30.3	12.9	29.8	14.0	22.3	9.7	25.3	5.5	21.0
5. Capacity Utilisation	Increase	18.4	6.3	20.0	5.7	21.7	7.8	11.7	2.3	15.9	0.0	14.2
6. Exports	Increase	20.5	10.0	18.0	9.3	18.4	10.8	16.7	8.6	18.6	7.8	16.5
7. Imports	Increase	15.5	9.8	14.0	8.8	13.5	8.3	11.9	8.0	11.2	3.6	7.7
8. Employment in the Company	Increase	12.3	8.3	13.3	6.7	10.3	5.5	8.0	3.2	7.7	-0.2	4.5
9. Availability of Finance (from internal accruals)*	Improve						12.1	18.7	10.8	17.2	3.1	14.0
10. Availability of finance (from banks and other sources)*	Improve						13.4	15.3	12.1	15.2	3.9	12.0
11. Availability of finance (from overseas)*	Improve						3.4	6.3	5.0	7.0	-0.1	2.9
12. Cost of External Finance	Decrease	-24.0	-27.4	-20.6	-24.4	-18.1	-17.6	-14.3	-14.5	-12.4	-32.7	-28.3
13. Cost of Raw Material	Decrease	-51.4	-59.6	-48.6	-50.7	-45.0	-53.5	-45.6	-49.9	-43.4	-62.2	-51.5
14. Selling Price	Increase	18.8	18.5	17.3	10.2	15.8	9.1	14.9	7.3	12.1	11.3	13.9
15. Profit Margin	Increase	-3.6	-15.1	-1.3	-16.7	-2.0	-15.3	-4.9	-18.4	-3.7	-24.1	-9.3

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

E: Expectations. A: Assessment.

*: These questions are newly added by splitting the question on Availability of Finance (both internal and external sources) in the 61st round (Jan-March 2013).

is expected to deteriorate further in Q3 of 2013-14 (Table VII.2).

Consumer confidence declines

VII.13 The Reserve Bank's 14th round of the Consumer Confidence Survey (http://www.rbi.org.in/CCS14), conducted during September 2013 shows a decline in consumer confidence as indicated by the Current Situation Index (CSI) and Future Expectations Index (FEI) on account of decrease in positive perceptions of household circumstances, income, spending and employment (Chart VII.2).

Further downward revision in India's growth projections by external agencies

VII.14 Various external agencies have reduced India's growth projections. The external agencies' growth projections range between 4.3 to 5.9 per cent (Table VII.3).

Survey of Professional Forecasters[1]

VII.15 The Reserve Bank's 25th round of the Survey of Professional Forecasters outside the Reserve Bank (http://www.rbi.org.in/SPF25) also indicated a slowdown in growth. The median growth forecast for 2013-14 was revised downwards to 4.8 per cent from 5.7 per cent in the previous round, which is lower than the growth of 5.0 per cent registered during 2012-13. Average WPI inflation is expected to remain 6.0 per cent during the current year. Professional forecasters anticipated a reduction in the current account deficit (CAD) with a median forecast at 3.5 per cent of GDP in 2013-14. The survey indicated moderate slippage in fiscal deficit (Table VII.4).

Chart VII.2: Consumer confidence weakens

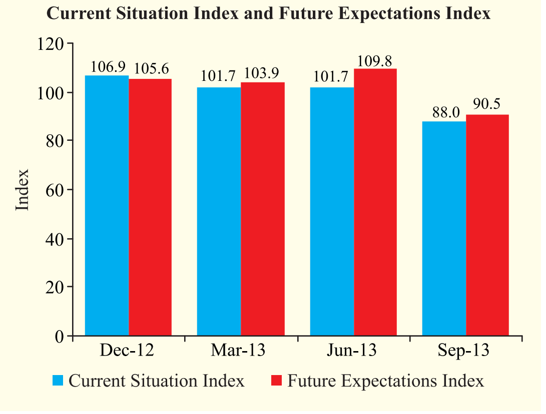


Table VII.3: Growth projections revised downwards

Agencies' projections for 2013-14

Agency	Latest Projection		Earlier Projection	
	Real GDP Growth (Per cent)	Month/ Year	Real GDP Growth (Per cent)	Month/ Year
1	2	3	4	5
Finance Ministry	5.0 to 5.5	Sept. 2013	6.1 to 6.7	Feb. 2013
PMEAC	5.3	Sept. 2013	6.4	Apr. 2013
IMF*	4.3	Oct. 2013	5.6	Jul. 2013
World Bank	4.7	Oct. 2013	5.7	Jun. 2013
OECD**	5.3	May 2013	5.9	Dec. 2012
ADB	4.7	Oct. 2013	6.0	Jul. 2013
NCAER	5.9	Aug. 2013	6.2	May 2013

*: IMF's projection in factor cost corresponding to 3.8 per cent in market prices.
**: GDP at market prices.

Households' inflation expectations move up

VII.16 The latest round of the Inflation Expectations Survey of Households (IESH Round 33) (http://www.rbi.org.in/IESH33) indicates that three-month ahead and one-year ahead median inflation expectations of households moved up in this quarter (July-September 2013) as compared with the previous quarter. The qualitative responses indicate that majority of the respondents expect price increases at 'more than current rate' (Chart VII.3).

Macro risks and inflationary pressures to underpin policy actions

VII.17 Macroeconomic risks diminished in the recent months, in part, due to domestic policy actions and in part due to exogenous factors. However, macroeconomic risks still exist with some upward pressure on inflation

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

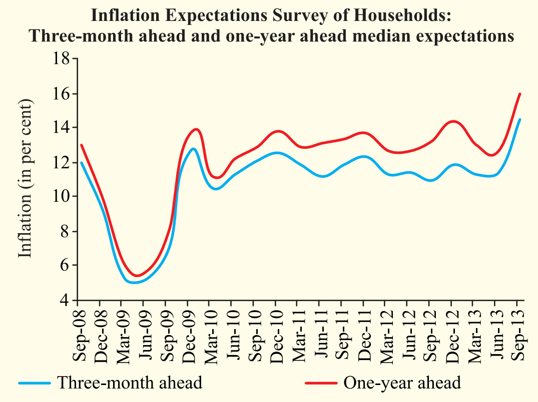
Table VII.4: Growth expectations decline, inflation expectations rise
Median Forecasts of Select Macroeconomic Indicators by
Professional Forecasters 2013-14 and 2014-15

	Actual 2012-13	Annual forecasts				Quarterly Forecast									
		2013-14		2014-15		2013-14						2014-15			
						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 growth rate at factor cost (%)	5.0	5.7	4.8	6.5	5.8	5.4	4.7	6.1	5.0	6.2	5.0	6.1	5.6	-	5.8
a. Agriculture & Allied Activities	1.9	3.0	3.7	3.0	3.0	3.1	3.3	3.5	4.1	3.3	4.4	3.0	3.0	-	3.0
b. Industry	1.2	3.6	1.3	5.5	3.8	3.7	1.2	4.0	1.4	3.8	2.1	4.6	3.4	-	3.3
c. Services	6.8	7.1	6.2	7.6	7.0	6.8	6.1	7.2	6.5	7.4	6.5	7.5	6.9	-	7.0
2. Gross Domestic Saving (% of GDP at current market price)	-	30.3	30.0	31.3	31.0	-	-	-	-	-	-	-	-	-	-
3. Average WPI-Inflation	7.4	5.3	6.0	5.7	5.5	-	-	5.4	6.5	5.5	6.5	5.6	6.5	-	5.8
4. Exchange Rate (₹/US$ end period)	54.4	-	-	-	-	-	-	59.5	62.0	59.5	60.8	59.5	60.9	-	61.0
5. 10-year Central Govt. Securities Yield (%-end period)	8.0	7.4	8.3	7.0	7.9	-	-	-	-	-	-	-	-	-	-
6. Export (growth rate in %)!	-1.0	4.4	3.8	9.0	8.9	-	-	-	-	-	-	-	-	-	-
7. Import (growth rate in %)!	0.5	3.9	-1.9	7.0	6.4	-	-	-	-	-	-	-	-	-	-
8. Trade Balance (US$ billions)	-195.7	-	-	-	-	-50.0	-39.0	-55.2	-45.6	-47.6	-42.5	-55.0	-46.0	-	-47.6
9. Current Account Deficit (% of GDP)	4.8	4.4	3.5	3.9	3.3	-	-	-	-	-	-	-	-	-	-
10. Central Government Fiscal Deficit (% of GDP)	4.9	4.8	5.0	4.7	4.7	-	-	-	-	-	-	-	-	-	-

E: Previous Round Projection. L: Latest Round Projection. - : Not Available. !: US$ on BoP basis.
Note: The latest round refers to 25th round for the quarter ended September 2013, while the previous round refers to 24th round for the quarter ended June 2013.
Source: Survey of Professional Forecasters, Second Quarter 2013-14.

and the possibility of fiscal slippage, thus posing new challenges. Despite the recent exchange rate stability, the external environment for the country is still fragile and buffers need to be rebuilt, including those by private agents. There is little scope for complacency at this stage, even though the rupee has gained strength.

Chart VII.3: Inflation expectations firm up



VII.18 At the present juncture, monetary policy faces an unenviable task of anchoring inflation expectations, even while growth remains tepid. It is, therefore, important to craft policy responses so that growth concerns are addressed in an environment of stable prices without endangering macroeconomic stability. For supporting growth, complementary action will be necessary aiming at productivity-enhancing structural reforms, addressing supply constraints and ensuring quick project implementation.

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