VII. Macroeconomic Outlook

Inflation has persisted at levels beyond Reserve Bank's comfort level which is inimical to growth. Inertial dynamics in wage and food prices have exacerbated the inflationary pressures. Inflation risks have stayed and high inflation is likely to persist during Q2 of 2011-12, though moderation in inflation is expected in the later part of the year. On the other hand, growth has showed signs of some moderation. Risk factors have emerged that could adversely impact aggregate demand. The business expectation surveys of various agencies, as well as the Reserve Bank's Industrial Outlook Survey suggest moderation due to higher input costs and rising interest rates. Professional forecasters' survey also supports the possibility of marginal moderation in economic activity. While monetary policy has been considerably tightened, the policy exigency at this juncture warrants continuation of anti-inflationary stance to tame inflation and anchor inflationary expectations.

Inflation risks stay, while growth showed signs of moderation

VII.1 In its Policy Statement of May 3, 2011, the Reserve Bank stated that inflation would stay at elevated level during the first half of 2011-12 before declining in the second half. Trends during Q1 of 2011-12 suggest that inflation trends have conformed with that assessment. Not only has the headline inflation stayed at around 9 per cent, non-food manufacturing inflation remains significantly high at above 7 per cent. On a sequential basis, the pace of price rise in this segment has stayed high since December 2010 on back of cost-push and demand-side factors. If the monsoon turns sub-normal, upside risks to the projected moderation in inflation during the second half would go up.

VII.2 On the other hand, there are signs of growth moderation during Q1 of 2011-12. On current reckoning, growth is likely to stay around trend during 2011-12 in line with the policy projection made in May. However, downside risks have increased. Challenges from the policy perspective have become even more stringent with increased risks to growth though inflation is likely to remain high in near term. The downside risks to growth emerge from uncertainties relating to South-West monsoon, likely moderation in private consumption and investment demand, high input costs, escalating cost of capital and uncertain global outlook which may impact the external demand and capital flows adversely. The overall assessment however suggests that agricultural growth may turn out to be lower on account of high growth last year.

VII.3 Notwithstanding the slowdown in growth, with high inflation, there are risks to growth sustainability that cannot be overlooked by monetary policy. It requires continued anti-inflationary bias with a close watch and nimble-footed calibration to new information. It is important to complete monetary transmission while it is also necessary that any possible turning points in cyclical conditions are not missed. There are upside risks to inflation from still incomplete pass-through of global commodity prices, downward stickiness of food prices, recent revisions in minimum support prices and evidence of wage price spiral. The inflation has proved to be stubborn so far and in view of the above factors may not subside in the second quarter of 2011-12. The challenge at this juncture is to contain inflationary pressures, while factoring in the lags in transmission of the monetary policy action. The task of monetary policy is made complex as these lags are often long and variable in length.

Business expectations surveys indicate moderation

VII.4 Various business expectations surveys show moderation over the previous quarter and year, indicating a slowdown in overall economic activity. Persistent inflation appears to be the most important factor affecting the business expectations. Global uncertainty, higher input costs, higher interest rates and expectation of lower demand for finished goods are some of the other factors affecting the business sentiments of the Indian companies (Table VII.1).

VII.5 The seasonally adjusted HSBC Markit Manufacturing Purchasing Managers' Index (PMI) declined to its nine month low in June 2011, though it

Table VII.1: Business Expectations Surveys

Period Index	NCAER-Business Confidence Index Apr. 2011	FICCI Overall Business Confidence Index Q3:2010-11	Dun & Bradstreet Business Optimism Index Q3: 2011	CII Business Confidence Index Apr.-Jun. 2011-12
1	2	3	4	5
Current level of the Index	145.2	63.8	143.6	62.5
Index as per previous survey	145.3	76.2	183.3	66.7
Index levels one year back	155.9	70.0	150.0	67.6
% change (q-o-q) sequential	-0.1	-16.3	-21.7	-6.3
% change (y-o-y)	-6.9	-8.9	-4.2	-7.5*

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

remained in expansionary mode. Sequential growth in output and new orders decelerated further. Rising input costs and borrowing costs have put further pressure on growth momentum. Seasonally adjusted PMI for services sector in June also remained in expansionary mode. It was marginally above May, though lower than that during January-April 2011.

Survey suggests Industrial Outlook has weakened

VII.6 The 54th round of the Industrial Outlook Survey of the Reserve Bank conducted during April-June 2011, based on a sample of 1,504 companies, showed moderation for the assessment quarter (April-June 2011) as well as for the expectation quarter (July-September 2011), but still remained in growth terrain (*i.e.* above 100, which is the mark that separates contraction from expansion) (Chart VII.1). The survey shows that the Indian manufacturing sector has moderated its view about demand conditions as net responses on production, order books, capacity utilisation, exports and imports showed lower optimism for the assessment quarter. In the expectation quarter however, slight improvement was visible.

VII.7 While outlook on availability of finance was less optimistic, the respondents expected cost of finance to rise further. A majority of respondents anticipated raw material costs to go up, which may affect profit margin adversely (Table VII.2). Overall, lower business optimism is seen in cement, textiles, basic metals, electrical machinery, transport equipment and fertiliser industry.

No significant downward revision in growth forecasts by other agencies

VII.8 Various international as well as domestic agencies have maintained their earlier forecasts, while

Chart VII.1: Industrial Outlook Surveys

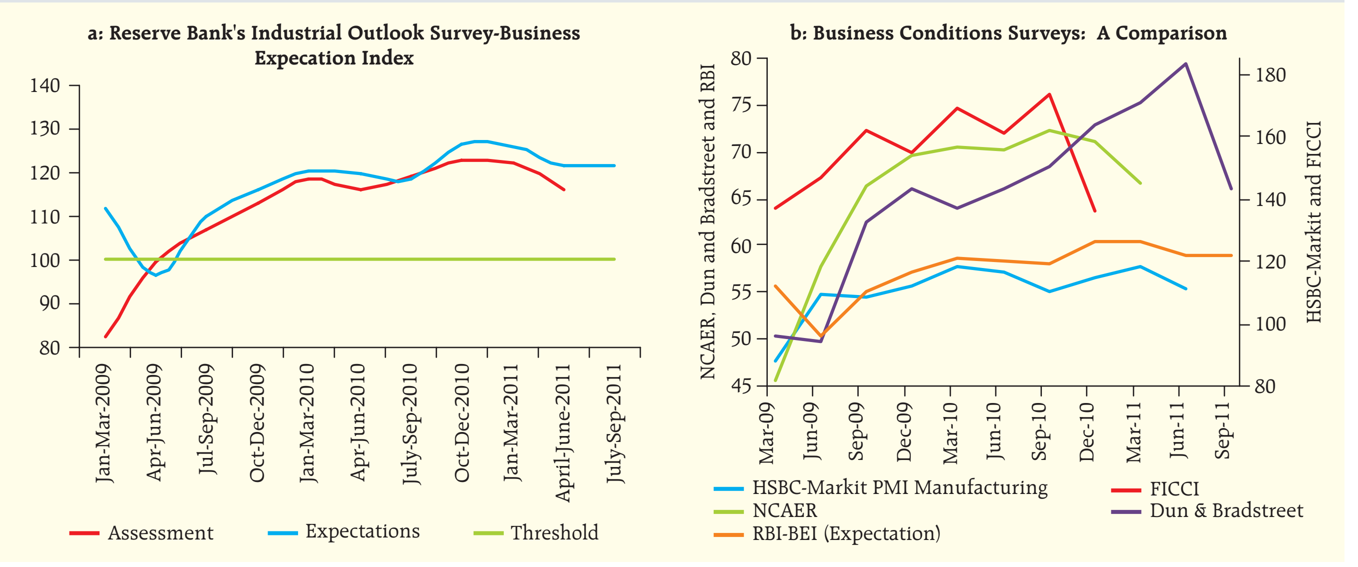

Table VII.2: Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response						
		October-December 2010		January-March 2011		April-June 2011		July-September 2011
		E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9
1. Overall Business Situation	Better	47.5	45.9	50.1	38.6	41.4	32.6	39.8
2. Overall Financial Situation	Better	39.6	37.1	41.1	27.1	33.4	24.1	30.6
3. Availability of Finance	Improve	31.3	30.3	32.3	23.8	27.3	21.5	24.2
4. Cost of External Finance	Decrease	-28.3	-33.9	-31.3	-42.5	-35.0	-49.0	-39.7
5. Production	Increase	49.1	43.9	48.6	41.4	40.0	32.1	40.6
6. Order Books	Increase	44.8	37.9	44.0	34.7	38.4	28.1	35.9
7. Level of Capacity Utilisation	Above Normal	7.2	5.6	9.5	4.9	4.4	17.2	25.0
8. Cost of Raw Material		-49.3	63.9	-53.6	-71.9	-57.0	-65.5	-51.7
9. Employment in the Company	Increase	21.0	19.4	20.6	18.7	17.4	18.2	19.4
10. Exports	Increase	26.1	23.1	26.3	18.9	24.0	18.2	25.8
11. Imports	Increase	22.2	20.9	21.3	19.9	18.9	17.6	19.0
12. Selling Price	Increase	17.0	20.2	18.6	26.5	23.7	21.5	18.3
13. Profit Margin	Increase	9.2	-0.4	8.3	-4.3	3.8	-9.9	2.5

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

OECD has revised it upwards. Only World Bank has revised the outlook downwards from the high of 9.0 per cent to 8.2 per cent, which in any case is in line with other forecasts (Table VII.3).

Survey of Professional Forecasters suggests moderation in activity[1]

VII.9 The results of the sixteenth round of 'Survey of Professional Forecasters' conducted by the Reserve Bank in June 2011 shows a downward revision in growth rate for 2011-12 as compared to the previous survey (Table VII.4). While the growth forecast for the agriculture sector was revised upwards, the forecast of industrial growth rate and services sector was revised downwards. Annual average WPI inflation forecast for the year 2011-12 was also revised upwards.

The troika that may alter baseline growth and inflation projections

VII.10 It is clear that there has been no significant alteration to the growth and inflation projections or the growth-inflation dynamics that were discussed in the 'Macroeconomic and Monetary Developments' released a quarter ago. However, at the margin, downside risks to growth may have increased, while inflation stickiness is more evident.

VII.11 The three important factors that could significantly alter the baseline path of growth and inflation are: (1) significant departure of monsoon from 'normal', (2) a collapse or re-build of global commodity price bubble, and (3) Euro zone debt crisis assuming a full-blown proportion. Growth could slowdown and inflation pick up further if *kharif* crop is affected or

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

Agency	Latest Projection		Earlier Projection	
	Real GDP Growth (Per cent)	Month	Real GDP Growth (Per cent)	Month
1	2	3	4	5
Economic Advisory Council to the PM	9.0 (+/-0.25)	Feb-11	-	-
Finance Ministry	9.0 (+/-0.25)	Feb-11	-	-
IMF#	8.0	Jun-11	8.0	Apr-11
OECD	8.5	May-11	8.2	Nov-10
World Bank	8.2	Jun-11	9.0	Feb-11
ADB	8.2	Apr-11	-	-
NCAER	8.5	Apr-11	-	-

#: IMFs' forecast for growth is 8.2 per cent at market prices.

[1] Introduced by the Reserve Bank from the quarter ended September 2007. The forecasts reflect the views of external professional forecasters and not of the Reserve Bank.

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

	Actual 2010-11	Annual Forecasts				Quarterly Forecast									
		2011-12		2012-13		2011-12								2012-13	
						Q1		Q2		Q3		Q4		Q1	
		E	L	E	L	E	L	E	L	E	L	E	L	E	L
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. Real GDP growth rate at factor cost (in per cent)	8.5#	8.2	7.9	-	8.3	8.3	7.7	8.1	7.7	8.2	8.1	8.5	8.2	-	8.1
a. Agriculture & Allied Activities	6.6#	3.1	3.5	-	3.6	3.8	4.8	3.1	3.5	3.0	2.2	3.0	3.0	-	3.8
b. Industry	7.8#	8.2	7.4	-	8.1	7.0	6.2	8.0	7.2	8.7	8.1	8.5	8.3	-	8.0
c. Services	9.2#	9.6	9.0	-	9.4	9.8	8.7	9.3	9.0	9.5	9.8	9.7	9.6	-	9.4
2. Gross Domestic Saving (per cent of GDP at current market price)	-	35.3	34.2	-	35.0	-	-	-	-	-	-	-	-	-	-
3. Gross Domestic Capital Formation (per cent of GDP at current market price)	-	37.5	35.5	-	36.4	36.5	34.0	37.3	35.0	37.8	35.0	38.5	36.0	-	37.0
4. Average WPI-Inflation	9.6	7.5	8.6	-	6.5	8.2	9.4&	7.8	10.0	7.5	8.8	6.7	6.9	-	6.8
5. Exchange Rate (INR/1USD end period)	44.65	44.5	44.5	-	43.5	44.5	44.7&	44.7	44.8	44.5	44.6	44.5	44.5	-	44.0
6. T-Bill 91 days Yield (per cent-end period)	7.31	7.5	8.0	-	7.6	-	-	-	-	-	-	-	-	-	-
7. 10-year Govt. Securities Yield (per cent-end period)	8.02	8.0	8.3	-	8.0	-	-	-	-	-	-	-	-	-	-
8. Export (growth rate in per cent)!	37.4	17.2	20.5	-	20.0	-	-	-	-	-	-	-	-	-	-
9. Import (growth rate in per cent)!	21.6	20.0	23.0	-	19.7	-	-	-	-	-	-	-	-	-	-
10. Trade Balance (US$ billion)	-104.9	-	-	-	-	-36.0	-35.5	-39.1	-39.4	-38.5	-34.3	-39.8	-35.0	-	-40.0

E: Previous Round Projection. L: Latest Round Projection. #: Revised Estimate. P: Provisional
- : Not Available. &: Actual !: US$ on BoP basis.

Note: The latest round refers to sixteenth round for the quarter ended June 2011, while previous round refers to fifteenth round for the quarter ended March 2011.

Source: Survey of Professional Forecasters, First Quarter 2011-12.

global commodity prices surge again. Alternatively, normal monsoon or further softening of global commodity prices could be growth positive and bring about a faster fall in inflation. A full-scale Euro zone crisis could result in domestic inflation falling quickly, through a fall in external demand and international commodity prices. It could, however, also impact growth adversely through trade and capital flow channels. So how growth-inflation dynamics may play is a complex process, but clearly persistent high inflation remains a risk to growth sustainability. The risk of inflation persistence are also exacerbated by structural drivers of food inflation.

VII.12 The data from new IIP base has reconfirmed the Reserve Bank's view that there was no significant moderation in industrial production in H2 of 2010-11 and the deceleration in fourth quarter was exacerbated by a few volatile components. Similarly, the deceleration in industrial growth in April-May 2011 partly reflects subdued growth in some core industries along with base effect. Going forward, there is a possibility of some softening of industrial activity due to high input cost pressures and escalating cost of capital. In contrast to the likely subdued trend in agriculture and industrial sector, the services sector may continue to show a buoyant trend, which may support the growth process.

VII.13 On the expenditure side, the domestic demand conditions continue to receive support from strong growth in private demand so far. Even though exports are growing at a faster pace than imports, going forward, the outlook for exports remains uncertain given the subdued growth and employment trends in Euro zone countries and the US. On domestic front, the recent initiatives by the Central and State governments for fiscal consolidation has resulted in slowdown in government consumption expenditure. Though this growth driver, on expenditure side, has slowed down, the trend may not continue in 2011-12 unless more radical measures are implemented to contain subsidies expenditure so that private investment demand is not crowded out amidst monetary tightening.

VII.14 Corporate sales growth has remained robust indicating continuation of strong demand conditions so far. The profit margins have however, come under stress following higher input and interest costs. Going forward, some moderation in investment and consumption demand is likely, as high inflation may erode purchasing power. The anti-inflationary monetary policy stance is also likely to soften the demand. There is also a need for credit growth to decelerate further.

Breaking inertial dynamics of wage and food price rise important for arresting inflation

VII.15 The latest employment survey result of the NSSO indicates that the real wages of the casual labourers have been rising in recent years. This implies that on an average, the purchasing power of the poor may not have been dented by inflation. The Government's schemes such as MGNREGA to promote inclusive growth seem to have had a positive welfare impact. However, the faster increase in wages *vis-à-vis* inflation poses the risk of wage-price spiral, particularly for food inflation, as the revision in MSPs take into account wage cost escalation. Increase in demand for food as a result of higher wages, in the absence of adequate supply response, leads to higher food prices. Rise in wages in response to inflation could also become faster both on account of MGNREGA wages being indexed to inflation and increase in wage bargaining capacity in the casual labour market. This wage-price inertial movement could add to the structural pressure on food inflation.

VII.16 Evidence also suggests that resultant primary food inflation eventually gets reflected in manufactured food inflation. This, coupled with indications of downward stickiness of food prices, especially in the case of protein-rich items, gets translated into higher inflation. The capacity utilisation levels are also high which may put further pressure on manufacturing products inflation. Taking into account all these factors, it is important to break the inertial dynamics to contain the inflationary pressures.

Unfinished task of taming inflation warrants continuation of anti-inflationary monetary stance

VII.17 The emerging growth risks are likely to be factored in the policy reaction. However, inflation has stayed high for a year and a half now, averaging 9.5 per cent in this period. Amidst a wage-price spiral and continued cost-push and demand side pressures on domestic prices, monetary policy confronts two key questions. First, will the recent signs of weakening activity persist and restrain wage price and demand side pressures on manufacturing inflation? Second, are there other factors that might put further pressure on prices and wages and keep inflation high, thus feeding further on inflation expectations? A judgement on the answers to these questions will influence the calibration of the monetary policy stance. Monetary policy will have to preserve the broad thrust on tight monetary stance till there is credible evidence of inflation trending close to a level within the Reserve Bank's comfort zone.