RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments Third Quarter Review 2010-11

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Monetary Policy 2010-11

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Macroeconomic and Monetary Developments Third Quarter Review 2010-11

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MACROECONOMIC AND MONETARY DEVELOPMENTS THIRD QUARTER REVIEW 2010-11

Overview

Global Economic Conditions

While the outlook for recovery in advanced economies has improved, concerns persist over the durability of the momentum

1. Global economic activity in the second half of 2010 turned out to be stronger than earlier expectations. However, the uneven pace of growth across regions and uncertainty about the durability of recovery in the advanced economies persist. The positive sentiments arising from the growth momentum in major advanced economies was neutralised by the persistence of high unemployment and downside risks from weak housing markets and unfinished deleveraging. The combination of developments resulted in additional policy stimulus. While in the US the second dose of quantitative easing (QE2) was followed up with extension of fiscal stimulus, other advanced economies faced a difficult choice between delaying fiscal exit to support growth on the one hand and early exit to contain the sovereign debt concerns on the other. The risk of sovereign debt crisis spreading from the Euro-zone periphery has resurfaced in recent months.

EMEs face the risk of inflation from potential overheating and hardening of commodity prices

2. Emerging Market Economies (EMEs), which had recovered ahead of the advanced economies, exhibited robust growth momentum driven by domestic demand. Inflation and overheating risks have, however, prompted monetary tightening at varied pace. Commodity prices also firmed up, largely reflecting easy liquidity conditions in advanced economies, as well as growing demand pressures in EMEs.

3. The asymmetry in monetary and liquidity conditions between the advanced and the emerging economies and the imbalance in their growth outlook have led to larger capital inflows to EMEs. The familiar policy challenges of asset price inflation and upward pressure on exchange rates have re-emerged. A number of EMEs resorted to soft capital controls and exchange market intervention to limit the adverse impact of excess capital inflows on their economies.

Indian Economy: Developments and Outlook

Output

Robust broad-based growth puts the economy back on its earlier high growth trajectory but sectoral imbalances pose risks to inflation

4. The robust GDP growth in the first half of 2010-11 suggests that the economy has returned to its earlier high growth path. Satisfactory kharif production and higher rabi sowing point to stronger contribution of the agriculture sector to overall GDP growth in 2010-11. Industrial production has exhibited near double digit growth but the significant volatility adds uncertainty to the outlook. Lead indicators of the services sector show sustained buoyancy. In certain sectors, particularly non-cereal food items, however, the supply response to market signals in the form of higher prices has been weak,

thereby exerting upward pressures on inflation. Core infrastructure sector has grown slower than both the overall GDP and the industrial sector, suggesting that it remains a constraint to higher growth. Capacity utilisation levels have generally remained steady, which juxtaposed with high growth suggests that capacity addition is keeping pace with growth in demand.

Aggregate Demand

Private consumption expenditure and gross capital formation emerge as the key growth drivers

5. Growth in private consumption expenditure, after remaining subdued over several quarters, exhibited significant acceleration in the first half of 2010-11. As per trends in the growth of gross fixed capital formation, the recovery in investment demand that had started in the last quarter of the previous year, has consolidated and remained strong. Fiscal trends during the year to date suggest that the fiscal deficit could remain within the budgeted level, but high growth in capital expenditure would add to the overall growth momentum from private demand. Lead indicators of private demand, such as corporate sales, capital expenditure plans, non-oil imports and credit demand point to sustained momentum in growth. Weak demand conditions in advanced economies have not affected the domestic growth momentum much in 2010-11 so far, even though global uncertainty remains a downside risk to the growth process.

External Sector

Higher current account deficit remains fully buffered by higher capital inflows, but sustainability concerns could stem from the composition of capital flows

6. As expected, the current account deficit widened significantly in the second quarter of the year. Even as exports expanded faster than imports, the trade deficit widened. From the current account perspective, the cushion to a widening trade deficit from net invisibles declined. While higher net capital inflows did not pose any immediate challenge, unlike in many other EMEs, because of the widening deficit in the current account, the shift in the composition of capital flows, particularly the sharp jump in portfolio inflows and significant decline in net FDI inflows raises questions about the sustainability of the external sector in the medium-term.

Monetary and Liquidity Conditions

Large primary liquidity injected by the Reserve Bank eased the liquidity pressures without diluting its anti-inflationary focus

7. The liquidity conditions had started to tighten by mid-2010 reflecting the normalisation of monetary policy and large increase in Government's surplus balances with the Reserve Bank due to revenues generated through 3G/BWA spectrum auctions. While sustained deficit liquidity conditions were consistent with the anti-inflationary monetary policy stance of the Reserve Bank during the year, the magnitude of the deficit widened significantly in the terminal months of 2010 to the point of posing concerns for growth. The severe tightness in liquidity was caused by both frictional factors associated with unusually large surplus balances of the Government and structural factors as reflected in stronger credit growth relative to deposit growth as well as higher demand for currency. The Reserve Bank introduced a number of measures with the aim of limiting the scale of the deficit, including reduction in SLR by 1 per cent of NDTL accompanied by a roughly equivalent amount of OMOs, which remained consistent with its anti-inflationary policy stance. The magnitude of liquidity deficit has moderated in recent weeks.

8. The growth in non-food credit has remained above the indicative trajectory of the Reserve Bank since October 2010, reflecting

growing credit demand associated with robust economic growth. Flow of financing from non-banking sources lagged behind the incremental flow of bank credit. Money supply (M_3) growth, however, was slightly below the projected level on account of sluggish deposit growth as well as some moderation in money multiplier resulting from higher growth in currency.

Financial Markets

Deficit liquidity conditions strengthened the transmission of policy rate actions to deposit and lending rates

9. The global financial markets continued to reflect the uncertainty about sovereign debt sustainability and the changing growth outlook of advanced economies. Markets in EMEs, including India, were influenced more by the domestic growth outlook, normalisation of monetary policy, corporate earnings prospects and the portfolio capital inflows that entailed a potential source of pressure on exchange rate and asset prices. In India, reflecting the tight liquidity conditions, interest rates in the money market, particularly in CBLO, T-bill, CP and CD segments hardened significantly. Recognising the structural imbalance between deposit growth and credit growth as well as the underlying signals of the anti-inflationary monetary policy stance, banks raised their deposit rates to improve deposit mobilisation while also raising the lending rates, which could be expected to moderate the aggregate demand, going forward. Asset prices generally remained firm, notwithstanding some correction in equity prices that partly reflected expectations about monetary policy actions associated with the abrupt reversal in the inflation path. The pace of increase in housing prices varied across cities. The Reserve Bank has recently used macroprudential measures to restrain the role of excessive leverage in asset price build-up.

Inflation

Upside risks from structural demand supply imbalance in certain sectors and firming global commodity prices have increased

10. WPI inflation had witnessed modest softening during August-November 2010 after remaining in double digits for five consecutive months. In December 2010, however, renewed price pressures surfaced, driven by factors that were largely unanticipated. Food inflation exhibited a strong rebound, led by onion and other vegetables, largely due to unseasonal rains and supply chain frictions. The Reserve Bank has already recognised the upside risks to inflation from higher global commodity prices, but this hardening happened sooner than anticipated. The pace of moderation in WPI inflation over a few months prior to December 2010 was also weak due to persistent elevated levels of food and fuel inflation, which are largely insensitive to anti-inflationary monetary policy measures. The expected significant softening of food inflation after a normal monsoon did not materialise, reflecting the impact of growing structural imbalances in certain sectors, particularly non-cereal food items. While the high growth in per capita income and the shift in the composition of demand have led to stronger growth in demand for items such as vegetables, fruits, pulses, eggs and meat, the supply response has generally lagged behind. The impact of this imbalance on food inflation has been magnified by rigidities in the supply chain management.

11. Non-food manufactured inflation, which is a broad indicator of generalised and demand side price pressures, has remained stable in the range of 5.1 to 5.9 per cent so far in the year. Besides the expected better supply response in non-food manufactured items to price signals and the pressure of imports, normalisation of the policy rate would have contributed to this trend. High month-over-month (annualised) inflation in recent months as also the rising price

index of the non-food manufactured group, however, suggest the combined impact of both input costs and demand pressures. The factors underlying the inflation process pose a major challenge for monetary policy since the impact of anti-inflationary monetary policy measures on inflation expectations and core inflation could be weakened considerably by structural factors, particularly in an environment of firming global commodity prices.

Growth and Inflation Outlook

Robust broad-based growth is expected to coexist with elevated inflation in the near-term

12. The return to the high growth path in 2010-11 materialised despite an uncertain global environment. Though the overall global outlook suggests some moderation in growth in both advanced and emerging economies in 2011, downside risks to India's growth momentum have receded considerably. The inflation outlook, which is being conditioned by both demand side and supply side factors, suggests slow paced moderation in inflation, with the possibility of rigidity at above the comfort level in the near-term. Recognising the need to firmly anchor inflationary expectations and contain inflation, the Reserve Bank has raised policy rates six times since the beginning of March 2010. As a result, along with the impact of the shift in the LAF mode from reverse repo to repo, the effective increase in policy rate has been 300 basis points.

13. Going forward, the Reserve Bank's monetary policy measures would have to be guided by not only the anti-inflationary thrust that is necessary in an environment of persistent high inflation, but also their expected effectiveness in a condition of entrenched supply side pressures on inflation. Oil prices moving permanently to a higher trading range looks more probable now. Moreover, sectoral imbalances in several non-cereal food items that reflect weak supply side adjustments in response to rising demand could persist in the near-term, and higher policy rates may not ensure the desirable degree of demand adjustment, even with the usual transmission lags, given the nature of the items in which the imbalances are growing. Aggregate demand side pressures on inflation, however, would have to be contained in a forward looking manner. Recent trends in sales growth and earnings of corporates point to their improving pricing power. MGNREGS, in turn, has the potential to raise the wage bargaining power even in the unorganised sector, particularly in the agriculture and construction sectors, besides raising rural demand at a faster pace relative to production of cereals and non-cereal food items. The demand side risks are also visible in the growing size of the current account deficit, and high inflation differential is a potential factor for eroding export competitiveness.

14. Thus, given the fact that elevated inflation and current account deficit are the two major macroeconomic concerns at the current juncture, demand management measures need to acquire centre stage in the near-term, with structural measures in the medium-run addressing sectoral imbalances and export competitiveness. The anti-inflationary focus of monetary policy would have to continue, recognising though the limits of monetary policy in dealing with structural pressures on inflation, and the need for forward looking response to demand side pressures. Since a lower inflation regime is essential for sustainable high growth, containing inflation becomes the dominant policy objective in the current environment.

I. OUTPUT

GDP growth is reverting to its earlier high growth trajectory led by broad-based growth momentum. Services sector growth and enhanced agricultural output supported the strengthening of the growth process. Industrial growth was robust, albeit with greater volatility. With both services sector and agriculture performing well, sustainability of growth requires continued buoyancy in the industrial sector. Robust growth has coincided with growing sectoral imbalances, particularly in some items where demand is growing faster than capacity, thereby exerting pressure on inflation. For high growth to coexist with a low inflation regime, structural policy measures to limit the magnitude of imbalances would be critical.

As downside risks recede, economy is back on the high growth trajectory

I.1 With 8.9 per cent growth in the first half of 2010-11, India continues to be one of the fastest growing economies in the world. The uncertainty about the durability of the robust growth seen in Q1 of 2010-11 waned significantly with the momentum continuing in Q2. Notwithstanding the impact of a lower base, the first half GDP growth suggests return to the high growth path (Table I.1). The robust growth momentum in Q2 reflected the continued buoyancy of services sector and further pick-up in agricultural performance due to a normal South-West monsoon. Industrial growth, though moderated on account of the base effect, remained on the higher side, but volatile.

Rabi outlook suggests continuation of the growth momentum in agriculture sector

I.2 Normal rainfall during South-West monsoon and satisfactory progress of North-East monsoon (121 per cent of long period average as on December 31, 2010) have brightened the prospects of agricultural performance during 2010-11. While, the area sown during *kharif* 2010-11 was 7 per cent higher than that in last year, the area sown during *rabi* season so far (January 14, 2011) with respect to major *rabi* crops, namely –

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

(Per cent)

Item	2008-09*	2009-10#	2009-10				2010-11		2009-10	2010-11
			Q1	Q2	Q3	Q4	Q1	Q2	H1	H1
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture & allied activities	**1.6**	**0.2**	**1.9**	**0.9**	**-1.8**	**0.7**	**2.5**	**4.4**	**1.0**	**3.8**
2. Industry	**3.1**	**10.4**	**4.6**	**8.5**	**12.3**	**15.1**	**11.7**	**9.0**	**6.5**	**10.3**
2.1 Mining & quarrying	1.6	10.6	8.2	10.1	9.6	14.0	8.4	8.0	9.1	8.2
2.2 Manufacturing	3.2	10.8	3.8	8.4	13.8	16.3	13.0	9.8	6.1	11.3
2.3 Electricity, gas & water supply	3.9	6.5	6.4	7.7	4.7	7.1	6.2	3.4	7.1	4.8
3. Services	**9.3**	**8.3**	**8.0**	**10.2**	**7.3**	**8.5**	**9.4**	**9.7**	**9.1**	**9.6**
3.1 Construction	5.9	6.5	8.4	8.3	8.1	8.7	10.3	8.8	8.4	9.6
3.2 Trade, hotels, restaurants, transport & communication, *etc.*	7.6	9.3	5.6	8.2	10.2	12.4	10.9	12.1	6.9	11.5
3.3 Financing, insurance, real estate & business services	10.1	9.7	11.7	11.3	7.9	7.9	7.9	8.3	11.5	8.1
3.4 Community, social & personal services	13.9	5.6	7.6	14.0	0.8	1.6	7.9	7.3	11.0	7.6
4. GDP at factor cost	**6.7**	**7.4**	**6.3**	**8.7**	**6.5**	**8.6**	**8.9**	**8.9**	**7.5**	**8.9**

* : Quick Estimates. # : Revised Estimates.

Source: Central Statistics Office.

wheat and pulses - had surpassed the levels achieved during the corresponding period of last year as well as the normal area sown for the respective crops (Table I.2). Improved sowing positions due to satisfactory monsoon along with improved reservoir positions indicate promising progress for *rabi* crop.

I.3 As per the First Advance Estimates for *kharif* production, total *kharif* foodgrain production during 2010-11 is estimated to be 10.4 per cent higher than the previous year. As regards *rabi* crop, based on rainfall pattern, higher sowing and improved reservoir positions, production of wheat, *rabi* pulses (which accounted for around 70 per cent of the overall pulses production in 2009-10) and oilseeds is expected to be higher than the previous year. The year on year growth over a very low base, however, masks the stagnation in per capita availability of food grains. As a result, strong growth in the agriculture sector and a normal monsoon have not eased the pressure on food inflation.

Table I.2: *Rabi* Area Sown

(Million hectares)

Crop	Normal Area	Sowing* 2008-09	2009-10	2010-11
1	2	3	4	5
Wheat	27.33	27.41	27.91 (1.9)	28.84 (3.3)
Rice	4.25	1.02	1.27 (23.9)	0.92 (-27.3)
Total Coarse Cereals	6.32	6.74	6.36 (-5.7)	5.88 (-7.4)
Total Cereals	37.91	35.17	35.54 (1.0)	35.65 (0.3)
Total Pulses	12.02	13.46	13.69 (1.8)	14.53 (6.1)
Total Foodgrains	49.93	48.62	49.23 (1.2)	50.18 (1.9)
Total Oilseeds	9.98	9.10	8.73 (-4.1)	8.94 (2.4)
All Crops	59.91	57.73	57.96 (0.4)	59.12 (2.0)

* : As on January 14.

Note: Figures in parentheses are percentage change over previous year.

Source: Ministry of Agriculture, Government of India.

Widening demand-supply gaps in some sectors exerting sustained pressures on food inflation

I.4 Notwithstanding stronger growth outlook for the agriculture sector, prices of several agricultural commodities continue to remain downward sticky, reflecting structural imbalances. The Eleventh Plan Document estimates the demand-supply gap to be around 13.4 per cent in oilseeds, 18.7 per cent in pulses and around 2.0 per cent in food grains during 2009-10[1].

I.5 Average growth rate of foodgrains production, at 1.6 per cent during 1990-2010, trailed behind the average population growth of 1.9 per cent. With robust growth, the pace of increase in per capita disposable income has far exceeded the rate at which supply is growing. The per capita net availability of foodgrains per day has declined from 510 grams in 1991 to 436 grams in 2008. Supply of major agricultural crops has not kept pace with demand on account of lower rate of increase in yield, inadequate irrigation coverage and excessive dependence on monsoon.

While low yield and increased cost of inputs have pushed dairy prices up, untimely and erratic rainfall affected supply of onions and vegetables in markets

I.6 Growing population coupled with rising income levels has altered dietary habits causing substantial increase in demand for various agricultural products, particularly pulses and vegetables as well as other protein-based products like meat, eggs, milk and fish.

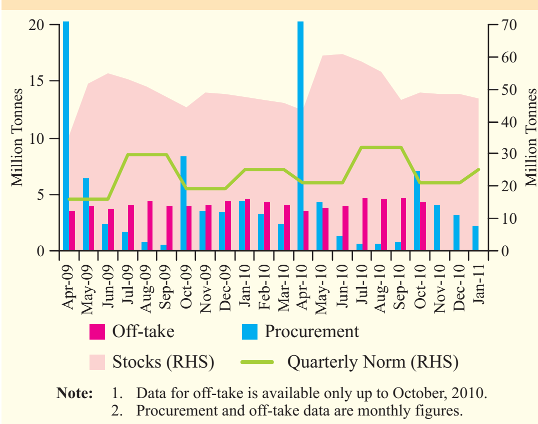
[1]Report of the Working Group for the Eleventh Five Year Plan (2007-12) on Crop Husbandry, Agricultural Inputs, Demand and Supply Projections and Agricultural Statistics. Supply pertains to actual domestic production based on Fourth Advance Estimates, while demand estimates in case of oilseeds is based on normative approach, and as regard pulses and foodgrains, the estimates are based on behavioural approach.

Inadequate response of production to structural changes in demand pattern continues to fuel demand-supply mismatch in these products. In the case of milk, supply side constraints have put pressure on prices. Also, the rise in input prices of items such as feedstock, labour and fuel have contributed to further pressure on prices. For poultry products like eggs and chicken, a rise in poultry feed prices resulted in higher prices. Excess rainfall in various parts of the country led to damage to crops like onion, potato and tomato, as well as various fruit items. The onion crop was affected in Andhra Pradesh and Karnataka due to cyclonic rainfall in October 2010 and in other states such as Maharashtra, Madhya Pradesh, Gujarat and Rajasthan due to untimely and erratic rainfall in November 2010. Pest infestation has also been a major cause of shortfall in supply of onions.

Ample food stocks provide food security, but do not ease pressure on food inflation, partly due to the nature of items driving food inflation which lie beyond the ambit of food security

I.7 Food stocks with public procurement agencies, though declining in recent months, continued to remain much higher than their respective buffer stock norms and food security reserve requirements. Lower monthly average procurement of food grains, *viz*., rice and wheat (up to January 14, 2011) coupled with higher monthly average off-take (up to October 2010) resulted in a decline in food stocks in recent months. The total stock of food grains with the Food Corporation of India (FCI) and other government agencies, which stood at 60.9 million tonnes on June 1, 2010 came down to 47.3 million tonnes on January 1, 2011 (Chart I.1). The policy on food management has to focus on better supply

Chart I.1: Food Stocks and its Determinants



Note: 1. Data for off-take is available only up to October, 2010.
2. Procurement and off-take data are monthly figures.

management in relation to demand, besides addressing the structural capacity constraints in food items.

Industrial growth has been robust, but also volatile

I.8 The industrial sector recorded a growth of 9.5 per cent during April-November 2010, mainly driven by the performance of the manufacturing and mining sectors (Table I.3). The growth pattern has, however, been volatile through the months of the current year (Chart I.2).

I.9 Growth in electricity generation remained modest. Acceleration in manufacturing sector growth was driven by the production of capital goods and consumer durables. Consumer non-durables continued to remain subdued,

Chart I.2: Growth in Index of Industrial Production (Y-o-Y)

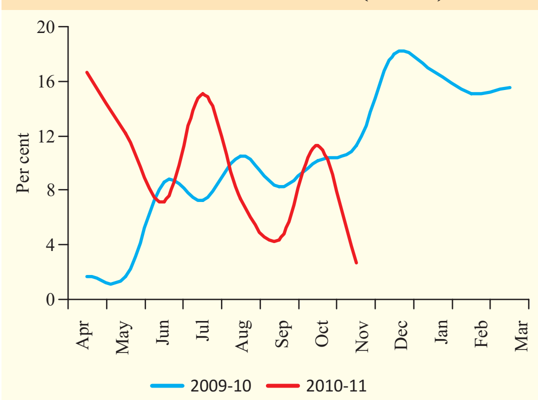


Table I.3: Index of Industrial Production: Sectoral and Use-Based Classification of Industries

(Per cent)

Industry Group	Weight in IIP	Growth Rate			Weighted Contribution#		
		Apr-Mar	Apr-Nov		Apr-Mar	Apr-Nov	
		2009-10	2009-10	2010-11 P	2009-10	2009-10	2010-11 P
1	2	3	4	5	6	7	8
Sectoral							
Mining	10.5	9.9	8.4	8.0	6.0	7.2	5.4
Manufacturing	79.4	11.0	7.5	10.0	89.4	86.5	90.8
Electricity	10.2	6.0	5.7	4.5	4.6	6.3	3.9
Use-Based							
Basic Goods	35.6	7.2	5.8	5.8	19.5	22.6	17.5
Capital Goods	9.3	20.9	6.6	22.5	29.4	12.8	33.7
Intermediate Goods	26.5	13.6	11.2	9.6	32.4	39.0	26.9
Consumer Goods (a+b)	28.7	6.2	6.1	6.8	18.7	25.5	21.9
a) Consumer Durables	5.4	24.6	20.6	21.7	17.9	21.8	20.2
b) Consumer Non-durables	23.3	0.4	1.2	0.7	0.9	3.7	1.7
General	**100.0**	**10.5**	**7.4**	**9.5**	**100.0**	**100.0**	**100.0**

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

primarily on account of deceleration in growth of industries such as wheat flour/*maida*, rice bran oil, coffee, hair oil, hsl lamps, fluorescent tubes and rubber foot wear.

Manufacturing sector growth yet to become broad-based

I.10 During April-November 2010, despite nine out of seventeen industries (contributing to about 36 per cent of the weight in the IIP) exhibiting higher growth than last year, manufacturing sector growth is yet to become broad-based. Nearly 73 per cent of the overall growth during the period was contributed by the top five manufacturing industries, with a combined weight of 24.6 per cent in IIP (Chart I.3).

Capacity utilisation in core sector remains broadly unchanged, but robust growth entails the risk of capacity pressures

I.11 During April-October 2010, capacity utilisation levels in the infrastructure sector did not stretch much relative to last year (Table I.4). The lower capacity utilisation in the cement sector partly reflects larger capacity addition relative to demand.

Chart I.3 : Growth Concentration in Manufacturing Sector

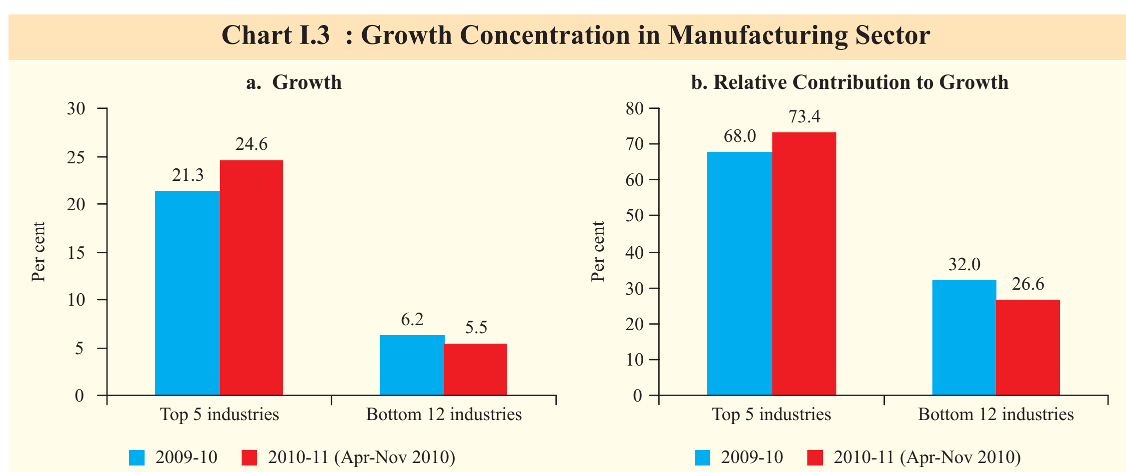


Table I.4: Capacity Utilisation in Infrastructure Sector

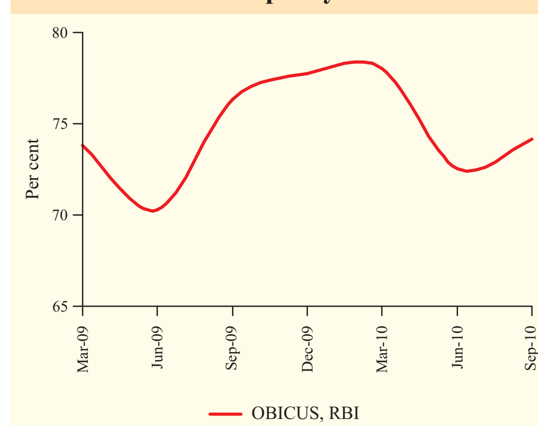
(Per cent)

Sector	Apr-Oct	
	2009-10	2010-11
1	2	3
Finished Steel (SAIL+VSP+ Tata Steel)	87.7	88.9
Cement	80.0	75.0
Fertilizer	94.1	94.2
Refinery Production-Petroleum	101.3	102.7
Thermal Power*	72.9	76.2

*: Data represent plant load factor and pertain to April-December.

Source: Capsule Report on Infrastructure Sector Performance (April 2010-October 2010), Ministry of Statistics and Programme Implementation, GoI and Central Electricity Authority.

Chart I.4: Capacity Utilisation



I.12 The Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank indicates that capacity utilisation increased during Q2 of 2010-11 but remained below the previous peak (Chart 1.4).

I.13 During the second quarter of 2010-11 employment growth situation improved as compared with the previous quarter as well as the corresponding quarter of last year (Table I.5).

Growth in core infrastructure lags behind both GDP and industrial sector growth

I.14 The six core industries (26.6 per cent of the total weight in IIP) recorded a moderate 5 per cent growth during April-November 2010 over that of the preceding year (Chart I.5). Electricity generation exhibited subdued growth, primarily due to under performance of thermal power generation constrained by negative or very low growth in each type of fossil fuel, especially coal. Coal production, which remained subdued during the current financial year, may continue to fall short of target on account of increasing sensitivity to environmental norms.

Services sector, which has the dominant share in GDP, exhibits sustained momentum

I.15 Led by "trade, hotel, restaurant, transport, storage and communication" and "financing,

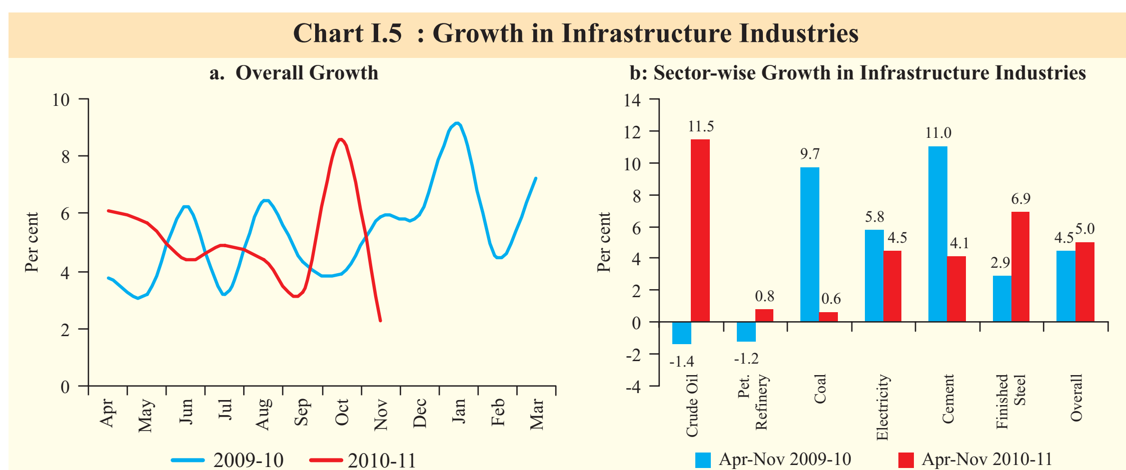
Table I.5: Changes in Estimated Employment

(in '000s)

Industry/ Group	Mar 2010 over Dec 2009	Jun 2010 over Mar 2010	Sep 2010 over Jun 2010	Sep 2010 over Sep 2009
1	2	3	4	5
1. Textiles including apparels	-119	-63	245	79
2. Leather	0	21	4	34
3. Metals	4	45	27	99
4. Automobiles	29	51	29	115
5. Gems and jewellery	24	4	4	39
6. Transport	-2	-21	13	-12
7. IT/BPO	129	129	108	936
8. Handloom/Powerloom	-5	-3	6	7
Overall	**61**	**162**	**435**	**1296**

Source: Eighth Quarterly Quick Employment Survey, July–September, 2010; Ministry of Labour and Employment, Labour Bureau, GoI.

Chart I.5 : Growth in Infrastructure Industries



insurance, real estate and business services", service sector growth during Q2 of 2010-11 showed gradual acceleration over the previous three quarters. The strong growth of various lead indicators, including commercial vehicles production, cell phone connections, air cargo and passengers handled at domestic and international terminals during the year so far, suggest continuation of the recent growth pattern (Table I.6).

Table I.6: Indicators of Services Sector Activity

(Growth in Per cent)

Services Sector Indicators	2008-09	2009-10	Apr-Oct 2009-10	Apr-Oct 2010-11
1	2	3	4	5
Tourist arrivals $	-3.3	3.5	0.2	8.5
Commercial vehicles production $	-24	35.9	15.1	41.3
Cement*	7.2	10.5	11	4.1
Steel*	1.6	4.9	2.9	6.9
Railway revenue earning freight traffic $	4.9	6.6	8.8	7.7
Cell phone connections	80.9	47.3	49.5	26.6
Cargo handled at major ports	2.2	5.7	3.6	1.7
Civil aviation				
Export cargo handled	3.4	10.4	5.2	20.5
Import cargo handled	-5.7	7.9	-6.9	27.4
Passengers handled at international terminals	3.8	5.7	2.7	12.7
Passengers handled at domestic terminals	-12.1	14.5	8.7	14.8

$: Data pertains to April-December.
* : Data pertains to April-November.
Source: Ministry of Tourism; Ministry of Statistics and Programme Implementation and SIAM.

For growth momentum to become sustainable, risks to inflation from structural imbalances needs priority attention

I.16 The improved *kharif* production thus far, favourable prospects for *rabi* production on account of the satisfactory progress of the North-East monsoon and the resultant increase in area coverage under *rabi* crop in 2010-11 would, going forward, sustain the growth momentum of the agriculture sector. Serious disruptions to supply of agricultural products due to temporary as well as structural shocks call for immediate focus on removal of bottlenecks, minimisation of post-harvest losses, reduction in transaction costs, improvement in cold storage and warehouse facilities and promotion of coordinated supply chains. Services sector growth momentum could continue, as reflected by its various lead indicators. Industrial production, however, is expected to moderate on account of the base effect. The deceleration in the growth of core infrastructure during November 2010 and slowdown in Manufacturing PMI during December 2010 indicate uncertainty about the course of IIP growth in the near term. Downside risks to growth from global uncertainty and increase in oil and commodity prices remain, though a major disruption to growth from these risks appears unlikely.

II. AGGREGATE DEMAND

The domestic demand[*] led growth process continued and was characterised by stronger growth in private consumption expenditure and higher contribution of fixed capital formation to growth. Reflecting fiscal consolidation and slowdown in government expenditure in recent few months, contribution of government consumption expenditure to growth moderated. Corporate sales growth remained high while earnings improved, suggesting buoyancy in demand. As the external sector outlook broadly suggests widening of current account deficit, the contribution of net exports to growth could remain negligible.

Private consumption expenditure and government capital expenditure have been the major growth drivers in the first half of the year

II.1 During the first half of 2010-11, the growth impulse from the expenditure side of GDP emanated predominantly from the acceleration in private consumption expenditure and gross fixed capital formation (Table II.1 and Chart II.1). Private final consumption expenditure gathered pace reflecting partly the pick-up in agricultural growth. Gross fixed capital formation also showed higher growth supported by robust corporate sector performance and strong growth in capital expenditure by the Government. Overall, real GDP at market prices increased by 10.4 per cent during the first half of 2010-11, which was

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

(Per cent)

	2008-09@	2009-10#	2009-10				2010-11		2009-10	2010-11
			Q1	Q2	Q3	Q4	Q1	Q2	H1	H1
1	2	3	4	5	6	7	8	9	10	11
					Growth Rate					
Real GDP at market prices	5.1	7.7	5.6	6.6	7.3	11.2	10.3	10.6	6.1	10.4
Total final consumption expenditure	8.3	5.3	5.9	9.8	4.8	2.6	8.0	9.3	7.8	8.7
(i) Private	6.8	4.3	4.3	6.7	5.3	2.6	7.8	9.3	5.5	8.6
(ii) Government	16.7	10.5	15.4	30.2	2.5	2.1	9.0	9.2	22.4	9.1
Gross fixed capital formation	4.0	7.2	3.1	4.0	8.8	17.7	19.0	11.1	3.6	14.9
Changes in stocks	-61.2	5.9	-0.8	3.5	8.7	11.1	15.3	12.4	1.4	13.8
Net Exports	40.2	-9.7	13.2	-7.6	-0.3	-113.4	12.2	-2.9	0.1	3.4
					Relative Share					
Total final consumption expenditure	70.9	69.4	73.1	72.6	73.4	62.3	71.6	71.7	72.8	71.6
(i) Private	59.5	57.6	61.6	61.3	60.4	51.1	60.3	60.6	61.4	60.4
(ii) Government	11.5	11.8	11.4	11.3	13.1	11.2	11.3	11.2	11.4	11.2
Gross fixed capital formation	32.9	32.8	32.4	34.3	31.9	34.6	35.0	34.4	33.4	34.7
Changes in stocks	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.4	1.3	1.3
Net Exports	-6.1	-5.1	-5.7	-7.8	-6.7	0.4	-5.8	-6.8	-6.7	-6.3
Memo:										₹ Crore
Real GDP at Market Prices	44,65,360	48,07,222	10,85,993	11,08,537	12,42,858	13,39,454	11,97,587	12,25,554	21,94,530	24,23,141

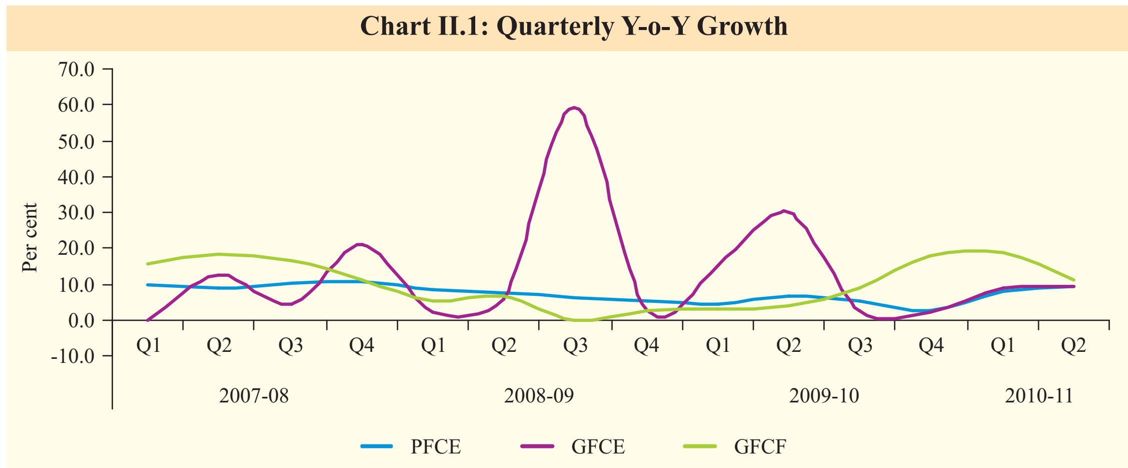
@ : Quick Estimates # : Revised Estimates.

Note: As only major items are included in the table, data will not add up to 100.

Source: Central Statistics Office.

* Demand as measured by expenditure side GDP data

Chart II.1: Quarterly Y-o-Y Growth



higher than the growth of 8.9 per cent in real GDP at factor cost. The differential in growth rates reflected higher net indirect taxes accruing to the government from stronger overall and industrial sector growth in the year. Furthermore, with substantial revision in expenditure side data for the first quarter of 2010-11, the trends in gross fixed capital formation and capital goods segment in IIP are now better aligned for the first half of the current fiscal.

Contribution of government final consumption expenditure and net exports to overall growth reflects fiscal consolidation and widening current account deficit

II.2 Government final consumption expenditure continued to grow at a robust pace but showed noticeable slackening relative to higher growth of last year, reflecting the impact of the resumption of the fiscal consolidation process (Table II.1).

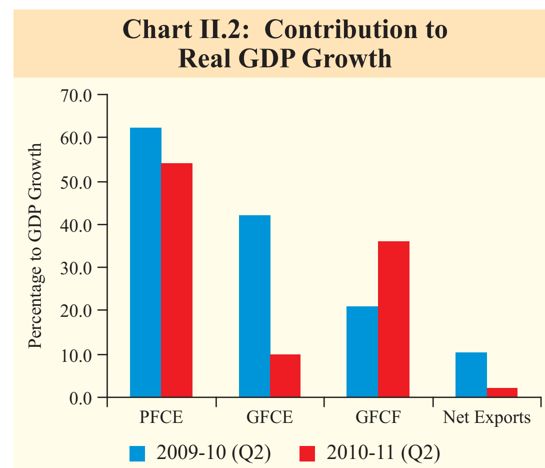
II.3 The contribution of net exports fell for the second successive quarter, though it still remained positive, even as the deficit in the goods and services account persisted (Chart II.2).

The composition of government expenditure has shifted towards capital expenditure

II.4 The Centre had budgeted a sharp reduction in expenditure growth for 2010-11 as a part of its gradual exit from the crisis-driven expansionary fiscal policy stance. However, the progress during 2010-11 (April-November) indicates a higher than budgeted growth in expenditure. The capital component of expenditure exhibited strong growth, which needs to be continued to address the growing infrastructure gap. Total expenditure growth, however, was substantially lower than the growth recorded during the corresponding period of 2009-10, as the Government lowered its expenditure since August 2010. The government intends to boost its expenditure in priority sectors, given the fiscal space available on account of higher than budgeted revenue receipts, which potentially could exert demand pressures.

II.5 The higher than budgeted revenue receipts during 2010-11 (April-November) resulted from

Chart II.2: Contribution to Real GDP Growth



better than expected tax and non-tax collections. Apart from substantial non-tax revenues in the form of receipts through the 3G and broadband wireless access (BWA) spectrum auctions, gross tax revenue increased strongly (26.8 per cent) as against a decline (7.8 per cent) in 2009-10 (April-November). There have been significant increases in revenues from customs duty (64.2 per cent) and union excise duty (37.3 per cent) along with high growth in personal income tax collections (11.8 per cent) and corporate tax collections (19.9 per cent), reflecting mainly the buoyancy in domestic economic activity and international trade as well as the partial rollback of indirect tax rate reductions as part of the fiscal exit.

II.6 The Government is on track in anchoring its fiscal deficit to 5.5 per cent of GDP in 2010-11. The mid-year targets for its key fiscal indicators were met for the first time since the enactment of Fiscal Responsibility and Budget Management (FRBM) Rules, 2004, benefiting from strong buoyancy in its revenue receipts. The progress in Central Government finances during 2010-11 (April-November) shows a lower growth in expenditure as compared to 2009-10, along with strong growth observed in tax and non-tax revenues. Consequently, revenue deficit (RD) and gross fiscal deficit (GFD) during 2010-11 (April-November) were substantially lower in absolute terms and as proportions of budget estimates, than those during the corresponding period of the previous year (Table II.2).

Higher development expenditure necessary for inclusive growth

II.7 Sector-wise profile of Government expenditure shows higher than budgeted growth in expenditure during 2010-11 (April-November) in agriculture, rural development, education and health, reflecting the Government's commitment to inclusive and sustainable growth. The higher resource availability from excess revenues has created fiscal space for allocating higher outlays to these priority sectors, which was reflected in the Government's additional supplementary demand for grants. Since lower inflation is a key factor to promote inclusive growth, the higher demand resulting from social expenditure also suggests the need to step up the rate of growth of essential items on the supply side.

Table II.2: Central Government Finances: April-November

Items	Amount (₹ crore)		Percentages to Budget Estimates for		Growth Rate (Per cent)	
	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11
1	2	3	4	5	6	7
1. Revenue Receipts	3,07,125	4,76,716	50.0	69.9	-2.5	55.2
i) Tax Revenue (Net)	2,32,873	2,96,634	49.1	55.5	-8.2	27.4
ii) Non-tax Revenue	74,252	1,80,082	52.9	121.6	20.9	142.5
2. Non-Debt Capital Receipts	8,326	27,449	155.8	60.8	215.4	229.7
3. Non-Plan Expenditure	4,47,995	4,79,771	64.4	65.2	25.1	7.1
of which:						
i) Interest Payments	1,19,504	1,34,544	53.0	54.1	7.0	12.6
ii) Defence	78,955	86,404	55.7	58.6	50.2	9.4
iii) Major Subsidies	90,766	90,137	85.6	82.6	-8.1	-0.7
4. Plan Expenditure	1,73,677	2,10,916	53.4	56.5	27.6	21.4
5. Revenue Expenditure	5,65,027	6,16,874	63.0	64.3	23.8	9.2
6. Capital Expenditure	56,645	73,813	45.8	49.2	49.9	30.3
7. Total Expenditure	6,21,672	6,90,687	60.9	62.3	25.8	11.1
8. Revenue Deficit	2,57,902	1,40,158	91.2	50.7	82.4	-45.7
9. Gross Fiscal Deficit	3,06,221	1,86,522	76.4	48.9	73.5	-39.1
10. Gross Primary Deficit	1,86,717	51,978	106.4	39.2	188.0	-72.2

Source: Controller General of Accounts, Ministry of Finance.

Risks to fiscal consolidation over the medium term and quality of fiscal consolidation are important concerns

II.8 Although Central Government finances are in line with the Medium Term Fiscal Policy Statement (MTFPS) roadmap, in order to meet the Thirteenth Finance Commission (TFC) target for RD and GFD (zero per cent and 3.0 per cent of GDP, respectively), steeper corrections would be necessary by 2013-14. The Government recognises that the envisaged elimination of RD by 2013-14 would be difficult. Furthermore, an abiding medium-term objective is to use borrowings for financing capital expenditure as indicated by the Government in its Mid-Year Analysis, 2010-11. As per the economic and functional classification, expenditure of Central Government administration and departmental commercial undertakings in gross capital formation was budgeted to remain low (1.0 per cent of GDP) during 2010-11. Moreover, there is a likelihood of further increase in subsidies, in view of the rising international oil and fertiliser prices. Finally, global uncertainty, especially in Europe, continues to be a key downside risk to fiscal consolidation.

II.9 The emphasis in the current phase of consolidation should be on the quality of adjustment, while also building adequate fiscal space to deal with future adverse shocks to growth and inflation. The fiscal correction envisaged during 2010-11 seems to rely significantly on one-off items (such as receipts from telecom spectrum auction and disinvestment proceeds). Furthermore, substantial proportion of the budgeted fiscal correction in 2010-11 is to be realised from the savings on account of lower than expected expenditure in respect of pay and pension arrears and loan waiver scheme. Durable fiscal consolidation, however, would require measures to augment revenue collection on a sustainable basis and rationalisation of recurring expenditure, with a focus on curtailing non-plan revenue expenditure.

Combined fiscal gap likely to moderate as state government finances show improvement

II.10 After witnessing deterioration in the previous two years, consolidated revenue deficit and gross fiscal deficit of State governments are estimated to fall in 2010-11 (BE) (Table II.3). The correction in the revenue account in 2010-11 is expected to come

Table II.3: Key Fiscal Indicators

(Per cent to GDP)

Year	Primary Deficit	Revenue Deficit	Gross Fiscal Deficit	Outstanding Liabilities*
1	2	3	4	5
		Centre		
2008-09	2.6	4.5	6.0	59.2
2009-10 RE	3.2	5.3	6.7	58.2
2010-11 BE	1.9	4.0	5.5	57.8
		States #		
2008-09	0.6	-0.2	2.4	26.2
2009-10 RE	1.6	0.8	3.4	26.2
2010-11 BE	1.0	0.4	2.9	25.8
		Combined		
2008-09	3.4	4.3	8.5	74.5
2009-10 RE	4.8	6.0	10.0	74.3
2010-11 BE	3.0	4.4	8.3	74.3

RE : Revised Estimates. BE : Budget Estimates.

* : Includes external liabilities at current exchange rates based on the report, *Government Debt Status and Road Ahead*, Ministry of Finance, Government of India, November 2010.

\# : Data pertain to 27 State governments.

Note: Negative sign indicates surplus.

through increase in revenue receipts as well as compression in revenue expenditure (as ratio to GDP) and thus appears to be more balanced. Lower consolidated revenue deficit of State governments along with lower capital outlay as ratio to GDP is likely to result in lower GFD-GDP ratio.

II.11 Combined finances of the Central and State governments budgeted for 2010-11 indicate that the key deficit indicators as per cent of GDP would moderate compared to the elevated levels of 2009-10 (Table II.3).

Corporate sales growth remained high suggesting buoyancy in demand

II.12 The private corporate sector contributed to the robust economic activity, and in turn, benefited from strong sales growth during the second quarter of 2010-11 (Table II.4). However, the build-up in inventory accumulation relative to sales moderated during the second quarter of 2010-11 compared to the recent peak observed during the first quarter of the financial year (Chart II.3). Compared to moderate growth in PAT of the private corporate sector, Government non-financial companies witnessed a noticeable rise driven by the robust performance of oil companies.

II.13 Strong investment intentions, as reflected in higher envisaged capital expenditure of companies which approached banks/FIs for financial assistance during April-September 2010, indicate optimistic outlook for fixed capital formation. In the first half of 2010-11, 338 projects were sanctioned assistance by banks/FIs involving about ₹2,42,000 crore as against 251 projects worth ₹2,31,000 crore during the corresponding period of the previous year.

Sectoral imbalances require structural policies

II.14 The rebound in private consumption partly reflected the low base effect, and hence, does not signal any broad based demand side pressure as yet. Sectoral demand-supply imbalances require structural policy intervention to improve the supply situation

Table II.4: Private Corporate Sector- Financial Performance

(Growth rates/Ratios in per cent)

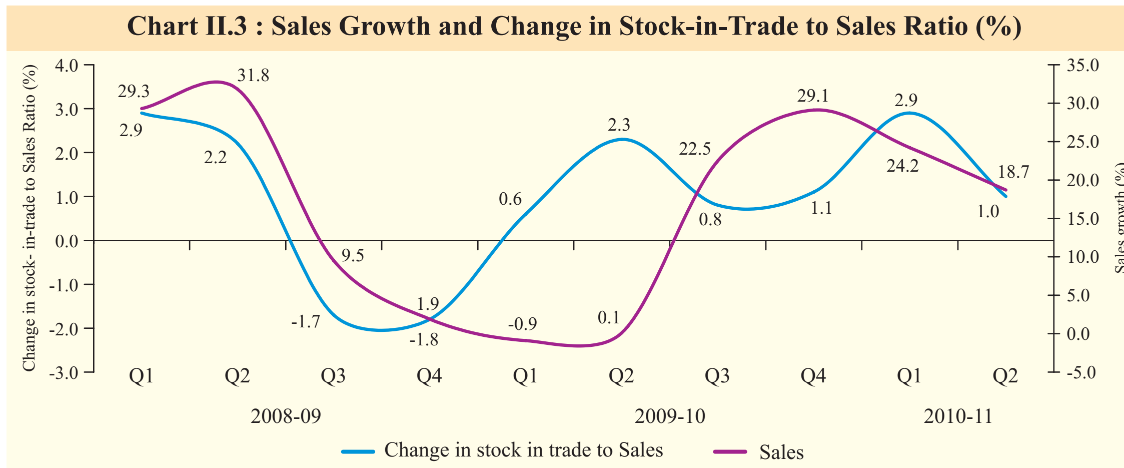
Item	2008-09				2009-10				2010-11	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6	7	8	9	10	11
No. of Companies	2500	2386	2486	2561	2530	2531	2562	2565	2546	2586
Sales	29.3	31.8	9.5	1.9	-0.9	0.1	22.5	29.1	24.2	18.7
Other Income*	-8.4	-0.6	-4.8	39.4	50.2	6.0	7.4	10.3	-21.2	58.5
Expenditure	33.5	37.5	12.6	-0.5	-4.4	-2.5	20.6	30.7	29.0	19.9
Depreciation provision	15.3	16.5	16.8	19.6	21.5	20.7	21.6	20.1	19.9	16.8
Gross profits (PBIT)	11.9	8.7	-26.7	-8.8	5.8	10.9	60.0	36.7	8.2	10.3
Interest payments	58.1	85.3	62.9	36.5	3.7	-1.0	-12.3	-2.9	26.9	5.9
Profits after tax	6.9	-2.6	-53.4	-19.9	5.5	12.0	99.3	44.0	2.4	10.8
Select Ratios										
Change in stock-in-trade to Sales#	2.9	2.2	-1.7	-1.8	0.6	2.3	0.8	1.1	2.9	1.0
Gross Profits to Sales	14.5	13.5	11.0	13.7	15.7	14.9	14.3	14.6	13.9	13.6
Profits After Tax to Sales	9.7	8.6	5.3	8.1	10.2	9.4	8.8	9.0	8.6	8.5
Interest to Sales	2.4	2.9	3.8	3.2	2.8	3.1	2.7	2.4	2.9	2.7
Interest to Gross Profits	16.8	21.5	34.6	23.3	18.0	20.5	19.1	16.6	21.1	19.9
Interest Coverage (Times)	6.0	4.6	2.9	4.3	5.6	4.9	5.2	6.0	4.7	5.0

#: 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.

Chart II.3 : Sales Growth and Change in Stock-in-Trade to Sales Ratio (%)



more than any demand compressing measures at the aggregate level. The stronger growth in private consumption expenditure partly reflects the change in terms-of-trade in favour of agriculture in view of the supply side constraints and the Government's commitment towards its flagship programmes, such as MGNREGA. With the waning of the base effect, the recent momentum in sales growth of corporates, however, would be contingent, *inter alia*, on the sustained growth in final consumption expenditure. Fiscal consolidation ushered in by the Government is expected to further lower the relative contribution of government final consumption expenditure to growth even though the share of government fixed capital formation may increase. Fiscal consolidation, if sustained, can contribute to a low inflation regime to coexist with high growth. In the near-term, India's policy option could be to pursue further diversification of exports in the fast growing emerging market economies to increase the contribution of the external sector to overall economic growth.

III. THE EXTERNAL SECTOR

India's external sector situation was characterised by a higher level of current account deficit and dominance of portfolio flows in Q2 of 2010-11. This may pose policy concerns going forward. Higher trade deficit and lower support from net invisibles led to a higher current account deficit. Even though export growth remained reasonably strong, robust import demand resulting from high domestic growth led to a large expansion in the size of the trade deficit. Higher net capital flows were better absorbed by the widening current account deficit, leading to a moderate accretion to reserves. External liabilities, however, increased at a faster pace than external assets. The composition of capital flows also changed considerably, with large increase in portfolio flows and lower FDI inflows. India's export growth remained strong in Q3 of 2010-11 notwithstanding persisting positive inflation differential. Ongoing developments such as volatility in the exchange rate of key currencies and pressure on commodity prices could have implications for India.

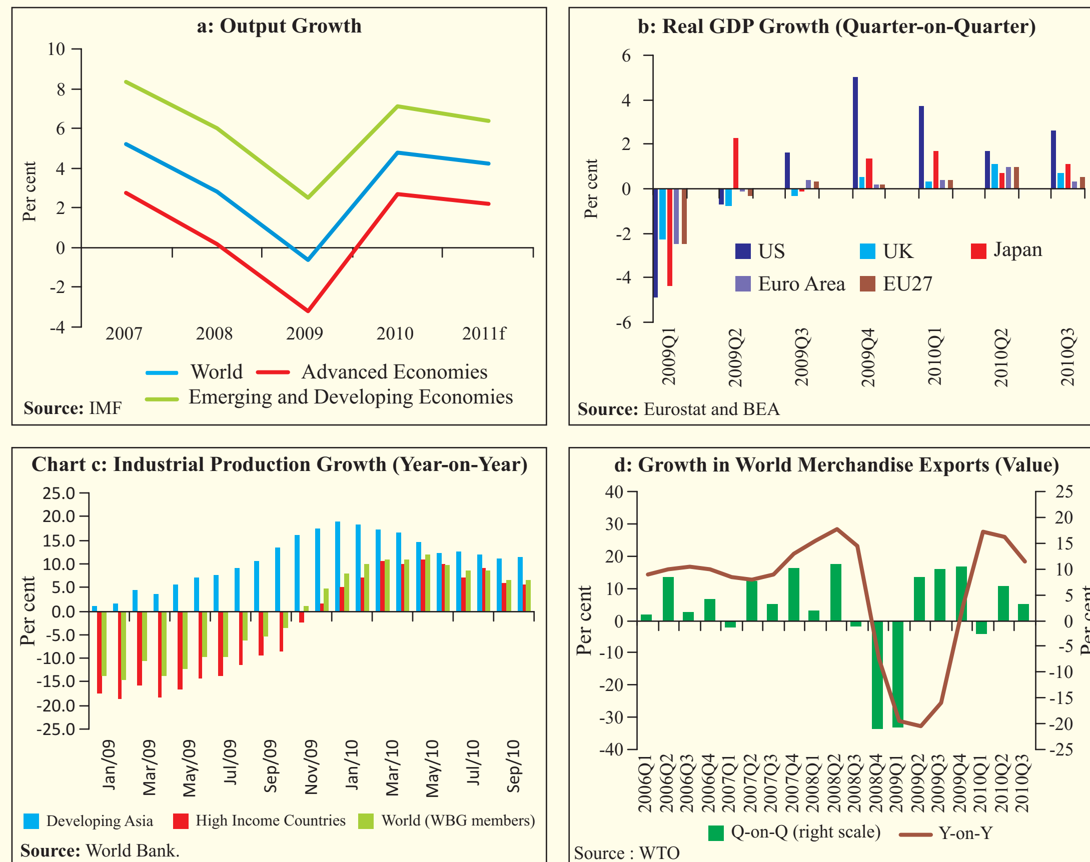
Uneven pace of growth across regions continues, though the recent performance of advanced economies has been better than earlier expected

III.1 The multi-speed recovery in the global economy that was observed in the first half of 2010 became more entrenched in the second half, as the advanced economies faced greater uncertainty while the emerging market economies (EMEs) experienced consolidation of growth around trend. The advanced economies which faced the prospect of double-dip recession, have in fact outperformed GDP growth forecasts made a year ago. The sovereign debt crises of Greece in May 2010 and Ireland in November 2010 and the evolving fiscal situation in Portugal, Italy and Spain added to the uncertainty regarding global recovery. EMEs, led by China and India, continue to grow at a faster rate compared to the advanced economies. In December 2010, OECD projected world real GDP growth at 4.6 per cent. In October 2010, IMF had projected world real GDP growth at 4.8 per cent (Chart III.Ia). Among advanced economies, there was a divergent trend in growth during the third quarter *vis-a-vis* the previous quarter (Chart III.1b). Apart from the possibility of sovereign debt crisis spreading to other advanced economies, the downside risks to growth projections for advanced economies could stem from the vulnerabilities related to continued weakness in financial systems, ongoing household balance sheet deleveraging and tensions that may arise from country specific response to global imbalances. The ILO expects the employment situation in advanced economies to reach the pre-crisis level only by 2015. Persistent high unemployment and uncertain growth outlook have complicated decisions on policy exit.

World trade recovery continues, though industrial output growth decelerates

III.2 Growth in world industrial production exhibited signs of deceleration after attaining a peak in May 2010, partly reflecting the base effect (Chart III.1c). Trade activities, however, have sustained the momentum of a strong recovery, prompting the WTO in December 2010 to retain its September 2010 estimates for growth in merchandise trade volume at 13.5 per cent for 2010 (Chart III.1d). This high growth, however, needs to be seen against the low base that resulted from the sharp 12.2 per cent

Chart III.1: Key Global Indicators

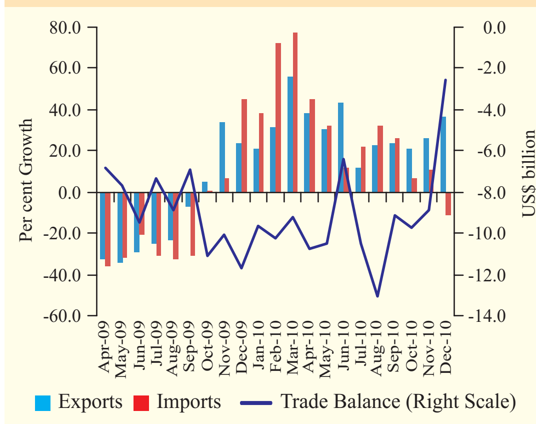


contraction experienced in 2009. In value terms, even after expanding by 23 per cent during the first three quarters of 2010, world merchandise trade remained below the peak level attained before the financial crisis. At 30 per cent, Asian exports increased at a significantly faster rate during the third quarter of 2010 on a year-on-year basis than the 18 per cent growth for world merchandise trade. With deficient domestic demand and high unemployment rate in advanced economies, protectionism remains a possible response, which could hinder overall global recovery.

Emerging Asia exhibits robust growth but rising inflation and larger capital flows pose policy dilemma for central banks

III.3 In December 2010, the ADB revised upward its assessment of growth of developing Asia to 8.5 per cent for 2010 from 8.2 per cent made in September, to reflect the robust expansion of the third quarter, mainly in Eastern and Central Asian countries. Recent data, however, point to some deceleration in economic activity and accordingly, real GDP growth for the region is projected at 7.3 per cent for 2011. IMF projections made in January 2011 also suggest real GDP growth of 7 per cent for 2011 for Asia, down from 8 per cent in 2010. Going forward, emerging inflationary pressures reflecting the shrinking output gap and firming global commodity prices could prompt monetary tightening. Sensitivity of capital inflows to such actions and policy options to deal with larger inflows that, at times, could be distortive, will complicate policy decisions.

Chart III.2: India's Merchandise Trade



India's export growth has remained strong but trade deficit for the year so far has widened

III.4 After witnessing a turnaround in October 2009, India's export growth maintained the momentum despite the fading out of the base effect (Chart III.2). India's export growth has also been better than the global recovery in exports, reflecting the diversification of the export basket as well as the export destinations. Since October 2009, imports have also registered strong growth. During October and November 2010, however, there was a slowdown followed by a decline during December. The growth in imports has primarily been led by oil, pearls and semi precious stones. Rising crude oil prices along with growth in quantity of oil imports has led to the higher oil import bill (Chart III.3). Though the growth of exports has outpaced imports growth during April-December 2010, the trade deficit has widened in absolute terms (Table III.1). In Q3 of 2010-11, with export growth significantly exceeding the import growth, the trade balance improved relative to the first two quarters.

Current account deficit widened significantly reflecting larger trade deficit and subdued net invisibles surplus

III.5 The rise in trade deficit (on BoP basis) led to a further widening of the current account deficit during the second quarter of 2010-11, on the back of stagnation in net invisibles surplus, partly due to the continuing growth imbalance between India and the rest of the world (Table III.2).

III.6 The moderation in net invisibles surplus during the quarter relative to the corresponding quarter of the previous year was mainly on account of decline in net investment income and private transfers, which offset the increase in net services (Table III.3). The decline in net income was mainly on account of decline in investment income receipts by 62.0 per cent during the quarter (as against an increase of 17.9 per cent a year ago), reflecting the persistence of lower interest rates abroad. Within services, software exports continued to be robust reflecting geographical diversification as well

Chart III.3: India's POL Imports and International Crude Oil Prices

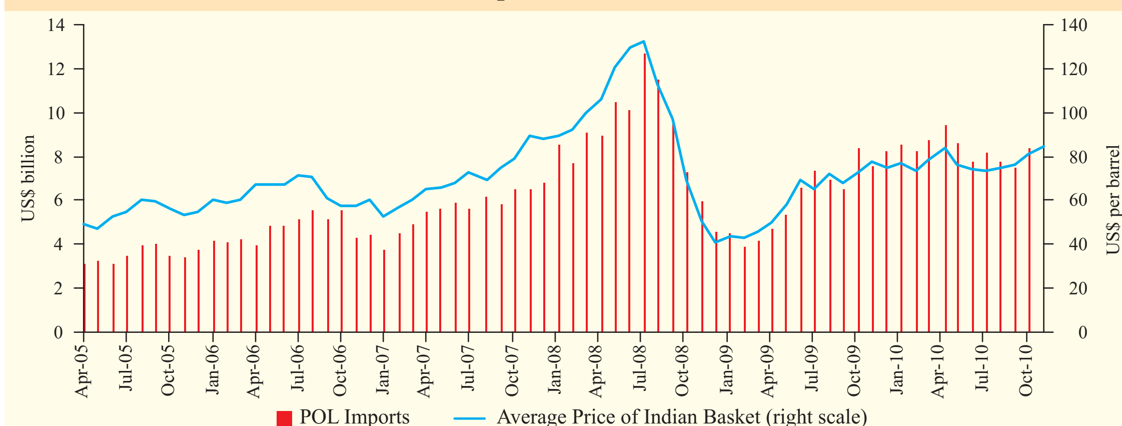


Table III.1: India's Merchandise Trade

(US$ billion)

Item	April-March		April-December			
	2009-10 (P)		2009-10 (R)		2010-11 (P)	
	Absolute	Growth (%)	Absolute	Growth (%)	Absolute	Growth (%)
1	2	3	4	5	6	7
Exports	178.7	-3.6	127.2	-13.8	164.7	29.5
Oil	28.1	2.1	19.5	-16.8	..	..
Non-oil	150.5	-4.6	107.7	-13.2	..	..
Imports	286.8	-5.6	206.2	-18.8	247.1	19.0
Oil	87.1	-7.0	61.6	-24.0	64.8*	21.4
Non-oil	199.7	-4.9	144.6	-16.3	157.1*	25.0
Trade Balance	**-108.2**	**-8.6**	**-79.0**	**-25.6**	**-82.4**	**4.3**
Non-Oil Trade Balance	**-49.2**	**-5.9**	**-36.9**	**-24.1**	**..**	**..**

* : Figures pertain to April-November. R : Revised. P : Provisional. .. Not Available.

Source: Directorate General of Commercial Intelligence & Statistics.

as enhanced operational efficiencies. Business services (mainly covering trade related, business & management consultancy, architectural & engineering services as well as maintenance of offices abroad) recorded lower net outflows mainly on account of robust recovery in receipts.

Larger net capital inflows were absorbed in financing the higher current account deficit, but the composition of capital flows poses sustainability risks

III.7 The buoyancy in capital inflows continued during the second quarter of 2010-11 driven by large inflows under FII investments along with steady inflows under short-term trade credits and external commercial borrowings (ECBs) (Table III.4). FDI, however, moderated mainly on account of lower FDI inflows under construction, real estate, business and financial services. Equity flows accounted for about 79 per cent of net capital flows during the first half of 2010-11, of which the share of FII investment was 77 per cent. Net inflows under ECBs and short-term trade credits reflected improved access to global financial markets and the need for financing higher demand for imports. Non-resident Indian (NRI) deposits continued to be steady, largely reflecting the interest rate differentials.

III.8 Latest available information on certain lead indicators of capital flows suggests continued buoyancy (Table III.5). However, FII inflows have exhibited large volatility during

Table III.2: India's Balance of Payments

(US$ billion)

Item	2009-10	2009-10 (PR)				2010-11	
		Q1	Q2	Q3	Q4	Q1 (PR)	Q2 (P)
1	2	3	4	5	6	7	8
1. Exports	182.2	39.2	43.4	47.2	52.5	56.3	54.3
2. Imports	300.6	65.4	73.0	78.1	84.1	87.8	89.6
3. Trade Balance (1-2)	-118.4	-26.3	-29.6	-30.9	-31.6	-31.6	-35.4
4. Net Invisibles	80.0	22.1	20.4	18.7	18.8	19.4	19.6
5. Current Account Balance (3+4)	-38.4	-4.2	-9.2	-12.2	-12.8	-12.1	-15.8
6. Gross Capital Inflows	345.7	77.8	96.0	81.6	90.3	95.0	112.8
7. Gross Capital Outflows	292.3	74.2	76.7	66.9	74.5	78.8	92.3
8. Net Capital Account (6-7)	53.4	3.7	19.3	14.6	15.8	16.2	20.5
9. Overall Balance (5+8)#	13.4	0.1	9.4	1.8	2.1	3.7	3.3

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

Table III.3: Net Invisibles

(US $ billion)

Item	July-September 2009-10 (PR)	July-September 2010-11 (P)	April-September 2009-10 (PR)	April-September 2010-11 (P)
1	2	3	4	5
1 Services	7.7	10.5	19.1	19.5
Of which:				
Travel	0.4	0.6	0.6	1.3
Transportation	0.3	-0.2	0.1	-0.2
Software Services	10.7	12.2	21.4	24.3
Business Services	-2.1	-1.0	-2.8	-2.1
Financial Services	-0.4	-0.1	-0.1	-0.3
2 Transfers (Private)	13.8	13.0	26.7	26.1
3 Income	-1.1	-3.9	-3.3	-6.5
Investment Income	-0.9	-3.7	-3.0	-6.1
Compensation of Employees	-0.1	-0.2	-0.3	-0.5
Total (1+2+3)	**20.4**	**19.6**	**42.5**	**39.1**

PR: Partially Revised. P: Preliminary.

the year so far. This pattern has contributed to the volatility in equity prices and the exchange rate. Moderation in FDI inflows has continued, which needs to be reversed (Chart III.4). ECB approvals, however, continue to increase on the back of strong domestic demand and interest rate differentials.

Moderation in FDI flows needs policy attention

III.9 The recent moderation in FDI flows to India has to be seen in the context of overall global trends, particularly, flows to other EMEs. During 2009-10, the decline in net FDI flows to India was relatively moderate (12 per cent) compared to EMEs (estimated to be 33 per cent in 2009), which partly reflected subdued cross-border merger and acquisition (M&A) activities and weaker return prospects for foreign affiliates. Subsequently, FDI flows to EMEs recovered modestly on the back of improved corporate profitability and some improvement in M&A activities. However, net FDI flows to India declined by almost 36 per cent, year-on-year, during April-September 2010. According to the latest estimates of UNCTAD (January 2011), FDI flows to major EMEs like China, Brazil, Mexico and Thailand recorded increases in the range of 6-53 per cent in 2010. Notably, Indonesia recorded about a three-fold rise in FDI inflows.

III.10 The moderation in FDI inflows to India during April-November 2010 has been driven by sectors such as construction, mining and business services. A major reason for the decline in inward FDI is reported to have been the environment sensitive policies pursued, as manifested in the recent episodes in the mining sector, integrated township projects and construction of ports, which appear to have affected the investors' sentiments. Added to this are the persistent procedural delays, land acquisition issues and availability of quality

Table III.4: Net Capital Flows

(US $ billion)

Item	July-September 2009-10 (PR)	July-September 2010-11 (P)	April-September 2009-10 (PR)	April-September 2010-11 (P)
1	2	3	4	5
Net Capital flows	19.3	20.5	23.0	36.7
Of which:				
1. Foreign Direct Investment (FDI)	7.5	2.5	12.3	5.3
Inward FDI	10.9	6.7	19.8	12.6
Outward FDI	3.4	4.2	7.4	7.2
2. Portfolio Investment	9.7	19.2	17.9	23.8
FIIs	7.0	18.8	15.3	22.3
ADR/GDRs	2.7	0.5	2.7	1.6
3. External Assistance	0.7	0.6	1.0	3.0
4. ECBs	1.2	3.7	0.7	6.0
5. NRI Deposits	1.0	1.0	2.9	2.2
6. Short-term Trade Credits	1.2	2.6	0.0	6.7

PR: Partially Revised. P: Preliminary.

Table III.5: Capital Flows in 2010-11 so far

(US $ billion)

Component	Period	2009-10	2010-11
1	2	3	4
FDI to India	April-November	25.3	19.0
FIIs (net)	April-January 14	24.7	31.6
ADRs/GDRs	April-December	3.2	1.8
ECB Approvals	April-December	13.1	16.0
NRI Deposits (Net)	April-December	3.5	2.3

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

infrastructure, which remain at the centre of the Government's policy focus. These factors, which are more structural in nature, if addressed expeditiously, could raise the share of India in the projected FDI flows to EMEs in the near future. According to the IIF, net FDI flows to EMEs are forecast to increase by 11 per cent in 2011.

Reserve accretion during the year so far has been moderate as, despite higher net capital inflows, the financing need in the current account increased

III.11 As the surplus in the capital account exceeded the financing gap in the current account, India's foreign exchange reserves (excluding valuation effects) increased by US$ 7.0 billion during the first half of 2010-11. Inclusive of valuation effects, the foreign exchange reserves increased by US$ 13.8 billion. Foreign exchange reserves as on January 14, 2011 stood at US$ 297.4 billion.

Indicators of Real Effective Exchange Rate (REER) showed a divergence reflecting inflation differential

III.12 There has been a distinct divergence between the movements of 6-currency and 36-currency REER indices during the year so far. While the 6-currency REER remained above the base level by 16 to 20 per cent, signifying higher inflation differentials with these economies, the 36 country REER largely remained below or around the base level, implying that inflation in India has been comparable or below the level prevailing in its trading partners in the developing world. The magnitude of nominal exchange rate appreciation/depreciation of the currencies of these countries also differed. This is reflected in the 30-currency REER (which is derived after the exclusion of 6-currency index from the 36-currency index) (Chart III.5).

Some external debt parameters have deteriorated

III.13 External debt stock as at end-September 2010 increased by 12.8 per cent to US$ 295.8 billion from US$ 262.3 billion at end-March 2010, with ECBs and short-term debt contributing around 71 per cent of the total

Chart III.4: Recent Trends in Foreign Investment Flows

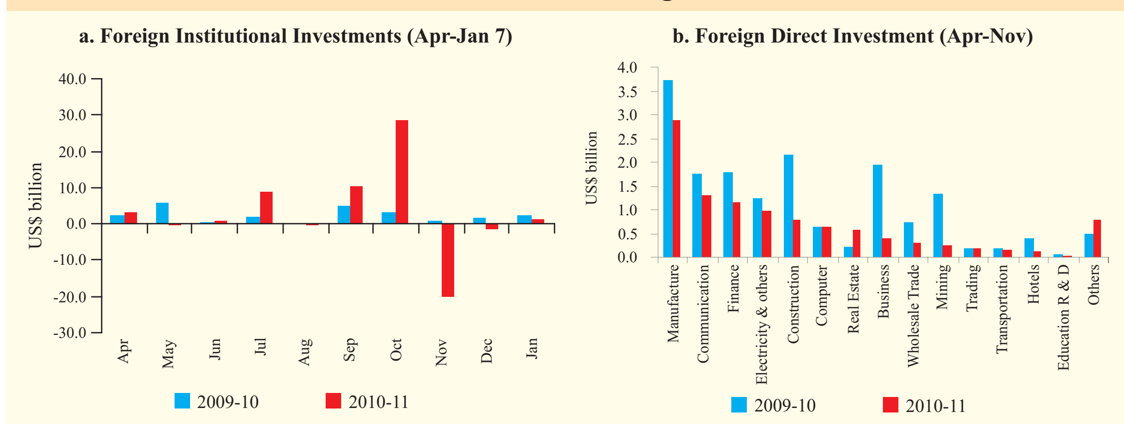
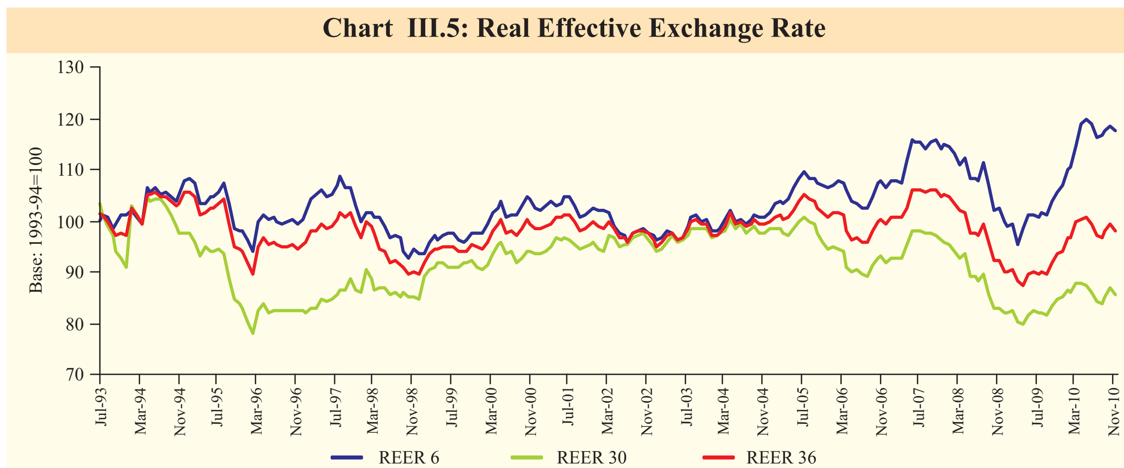


Chart III.5: Real Effective Exchange Rate



increase (Table III.6). Valuation effects due to depreciation of the US dollar against other major currencies accounted for nearly 19 per cent of the rise in external debt during this period. With higher private debt flows, there has been some worsening of debt parameters during the first half of 2010-11, though still very much within the comfort zone.

International Investment Position (IIP) shows deterioration

III.14 Incremental liabilities outpaced incremental assets in the IIP in the second quarter of 2010-11. Net international liabilities increased by US$ 33.2 billion during the second quarter to US$ 211.1 billion at end-September 2010 (Chart III.6).

Significant widening of current account deficit would necessitate larger and stable long-term capital flows to limit risks to medium-term sustainability

III.15 Recent trends in export growth suggest the possibility of exports surpassing the annual target for the current year. It is, however, imperative to diversify the exports further in terms of commodities and destinations, given the weak and uncertain demand conditions in advanced economies. Higher global crude oil prices and non-oil commodity prices

Table III.6: India's External Debt

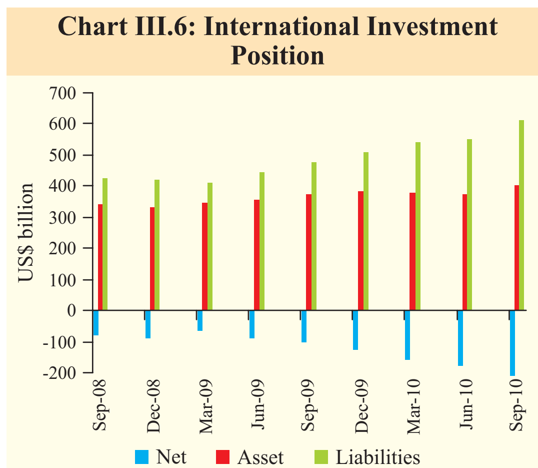
(US$ billion)

Item	Outstanding			Variation	
	End-March 2009	End-March 2010 PR	End-September 2010 P	September 2010 over March 2010	
				Amount	Per cent
1	2	3	4	5	6
1. Multilateral	39.5	42.8	46.8	3.9	9.1
2. Bilateral	20.6	22.6	24.7	2.1	9.2
3. IMF	1.0	6.0	6.2	0.1	2.5
4. Trade Credit (above 1 year)	14.5	16.9	18.5	1.6	9.3
5. ECBs	62.5	71.9	82.2	10.3	14.3
6. NRI Deposits	41.6	47.9	49.9	2.0	4.2
7. Rupee Debt	1.5	1.7	1.6	0.0	-1.0
8 Long-Term Debt (1 to 7)	**181.2**	**209.8**	**229.8**	**20.0**	**9.5**
9. Short-Term Debt	**43.4**	**52.5**	**66.0**	**13.5**	**25.8**
Total Debt (8+9)	**224.6**	**262.3**	**295.8**	**33.5**	**12.8**
Memo Item					
Total Debt/GDP (in per cent)	20.5	19.0			

PR: Partially Revised. P: Provisional.

Source: Ministry of Finance, Government of India and Reserve Bank of India.

Chart III.6: International Investment Position



accompanied by stronger domestic economic activity could raise India's import growth trajectory. If the improvement in the trade deficit witnessed in Q3 of 2010-11 continues, there may be some moderation in CAD from the high levels seen during the first two quarters. The upbeat growth outlook of India and rising interest rate differentials could be expected to attract even larger net capital inflows. A higher level of CAD along with the dominance of volatile and short-term debt creating flows could, however, pose some sustainability risks. A low inflation regime is also necessary so that any real appreciation of the exchange rate does not erode the competiveness of Indian exports. It is important to monitor the magnitude and composition of capital flows in the near term, given its potential implications for asset prices, exchange rate and the overall sustainability of the external sector.

Changing dynamics of BoP suggests the need to guard against vulnerabilities

III.16 The dynamics of the balance of payments altered significantly in 2010-11. A higher current account deficit, compositional shifts in capital flows in favour of short-term debt and portfolio flows, lower order of reserve accretion and faster increase in external liabilities of the country relative to external assets are some key areas of concerns surfacing in the external sector. The BoP data released by the Reserve Bank report a CAD of 3.7 per cent of GDP during April-September 2010, which is higher than the sustainable level of around 3 per cent in the medium-term. Although financing of such a deficit has not been a problem so far, the changing composition of capital flows for financing the deficit calls for an assessment of the external sector vulnerability indicators.

III.17 Reflecting the dominance of debt creating flows during April-September 2010 (almost 50 per cent compared to the average share of about 44 per cent during the last one decade), debt sustainability indicators witnessed some deterioration at end-September 2010 (Table III.7). The debt service ratio, however, remained at a comfortable level. Given the dominance of debt creating flows and volatile FII flows, any unforeseen adverse global developments may pose risks and this warrants close monitoring of the evolving situation.

Table III.7: External Sector Vulnerability Indicators

(Per cent)

	Indicator	End-September 2009	End-March 2010	End-September 2010
	1	2	3	4
1.	Ratio of Short-term to Total Debt (Original Maturity)	17.5	20.0	22.3
2.	Ratio of Short-term to Total Debt (Residual Maturity)	38.4	41.2	42.9
3.	Ratio of Concessional Debt to Total Debt	18.4	16.7	15.6
4.	Ratio of Reserves to Total Debt	115.9	106.4	99.0
5.	Ratio of Short-term Debt to Reserves	15.1	18.8	22.5
6.	Import Cover of Reserves (in months)	12.4	11.1	10.3
7.	Reserves Cover of Imports and Debt Service Payments (in months)	11.7	10.5	9.8
8.	Debt Service Ratio (Debt Service Payments to Current Receipts)	5.1	5.5	4.0

III.18 Widening of CAD and deterioration in vulnerability indicators are a result of several factors: First, lower growth in services receipts relative to payments reflecting the uneven pace of global recovery. Second, significant increase in imports relative to exports reflecting the steep rise in international crude oil prices, though in recent months trade balance has improved. Third, moderation in FDI inflows that was reported to have occurred on account of environment sensitive policies, land acquisition issues and availability of quality infrastructure. While the subdued growth of services receipts is cyclical in nature and can be expected to resolve with the global recovery becoming more broad-based and robust, the rise in crude oil prices and reasons for moderation in FDI are more structural in nature. Since supply of crude oil is relatively inelastic, the economy needs to adjust itself in the medium-term by investing in the use of non-conventional sources of energy. As regards FDI flows, the reform process needs to be expedited to address the impediments.

III.19 The above assessment suggests that going forward, the external sector needs to be monitored closely. The economy is very well poised to absorb a higher current account deficit for a couple of years but this cannot remain a persisting trend. The challenge in this regard is to reduce the current account deficit in the medium-term and readjust its financing in the short term. The prospects for the medium-term adjustment will improve with the global recovery consolidating, FDI flows to India strengthening on the promise of growth prospects and the reform process being accelerated.

IV. MONETARY AND LIQUIDITY CONDITIONS

Liquidity conditions remained tight during the third quarter of 2010-11, warranting liquidity easing measures by the Reserve Bank. The normalisation of monetary policy during the year, as intended, has been non-disruptive. Conditions for enhancing the effectiveness of monetary policy, however, improved in the third quarter of the year, as the tightness in liquidity prompted competition among banks, leading to higher deposit and lending rates. The Reserve Bank injected large primary liquidity through repo and open market operations, which was reflected in the high growth of base money. This was necessary to avoid the risk of liquidity stress adversely impacting the real economy, even though the overall anti-inflationary stance was sustained throughout.

While the goal of non-disruptive normalisation of monetary stance has been achieved with the return of robust growth, persistent high inflation has emerged as the key challenge for monetary policy

IV.1 The Reserve Bank achieved non-disruptive normalisation between March and November 2010 through calibrated tightening of the policy interest rates and liquidity conditions. The predominant objective behind adopting such an approach to normalisation was to gradually raise the anti-inflationary accent of the policy without disrupting growth. While growth has firmly consolidated around the trend now, inflation remains elevated with significant downward inflexibility. The interest rate and liquidity conditions altered significantly during the course of the year on the back of policy normalisation. In the terminal months of 2010, liquidity conditions tightened beyond the comfort level, driven by both frictional and structural factors, and interest rate transmission also strengthened as banks responded to the liquidity deficit by raising deposit and lending rates. The Reserve Bank undertook measures to ease the liquidity pressures to avoid the risk of liquidity stress affecting the flow of credit to productive activities. The anti-inflationary stance of monetary policy, however, continued.

Liquidity conditions started to tighten on the back of policy, but got exacerbated by autonomous factors

IV.2 In 2010, the repo and the reverse repo rates were raised by 150 basis points and 200 basis points, respectively, as part of the normalisation of policy (Table IV.1). With repo rate emerging as the operative policy rate, there was an effective tightening of policy rate by 300

Table IV.1: Movements in Key Policy Rates in India

(Per cent)

Effective Since	Reverse Repo Rate	Repo Rate	Cash Reserve Ratio
1	2	3	4
October 11, 2008	6.00	9.00	6.50 (–2.50)
October 20, 2008	6.00	8.00 (–1.00)	6.50
October 25, 2008	6.00	8.00	6.00 (–0.50)
November 3, 2008	6.00	7.50 (–0.50)	6.00
November 8, 2008	6.00	7.50	5.50 (–0.50)
December 8, 2008	5.00 (-1.00)	6.50 (–1.00)	5.50
January 5, 2009	4.00 (-1.00)	5.50 (–1.00)	5.50
January 17, 2009	4.00	5.50	5.00 (–0.50)
March 4, 2009	3.50 (-0.50)	5.00 (-0.50)	5.00
April 21, 2009	3.25 (-0.25)	4.75 (-0.25)	5.00
February 13, 2010	3.25	4.75	5.50 (+0.50)
February 27, 2010	3.25	4.75	5.75 (+0.25)
March 19, 2010	3.50 (+0.25)	5.00 (+0.25)	5.75
April 20, 2010	3.75 (+0.25)	5.25 (+0.25)	5.75
April 24, 2010	3.75	5.25	6.00 (+0.25)
July 2, 2010	4.00 (+0.25)	5.50 (+0.25)	6.00
July 27, 2010	4.50 (+0.50)	5.75 (+0.25)	6.00
September 16, 2010	5.00 (+0.50)	6.00 (+0.25)	6.00
November 2, 2010	5.25 (+0.25)	6.25 (+0.25)	6.00

Note: 1. Reverse repo indicates absorption of liquidity and repo indicates injection of liquidity.
2. Figures in parentheses indicate change in policy rates in percentage points.

basis points between March and November 2010. The increase in cash reserve ratio (CRR) in February and April 2010 contributed to the gradual tightening of liquidity and the effective switch of the Liquidity Adjustment Facility (LAF) from absorption through reverse repo to injection through repo (Chart IV.1). From end-May 2010, liquidity tightened on account of the monetary policy actions, which was exacerbated by autonomous factors such as large increase in government surplus with the Reserve Bank as well as the unusually high demand for currency on account of high inflation, increased asset prices and payments under government schemes such as MGNREGS. As deficit liquidity conditions persisted for most part of the year and the severity of the pressure at times became excessive, the Reserve Bank operationalised several liquidity-easing measures at regular intervals in order to reduce the liquidity deficit (Table IV.2).

Chart IV.1: LAF Volumes

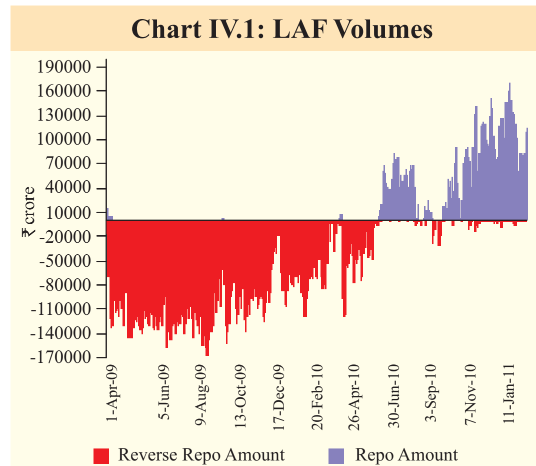


Table IV.2: Liquidity Management Measures taken by the Reserve Bank in 2010-11

Time Period/Event	Measures
1	2
End-May 2010: Larger than anticipated collection for 3G/ BWA spectrum in addition to advance tax outflow resulted in migration of liquidity to central government's cash balance account with the Reserve Bank	For the period May 28, 2010-July 2, 2010, SCBs were: (i) Allowed to avail additional liquidity support under the LAF to the extent of up to 0.5 per cent of their NDTL (for any shortfall in maintenance of SLR arising out of availment of this facility, banks were allowed to seek waiver of penal interest). (ii) Given access to second LAF (SLAF) on a daily basis. With the persistence of deficit liquidity conditions, measure (i) was extended up to July 16, 2010 and measure (ii) up to July 30, 2010.
End-October 2010: Frictional liquidity pressure due to autonomous factors compounded by banks' high CRR requirement (since the fortnight ended October 22, 2010 had seen a large increase in NDTL)	(i) The Reserve Bank conducted special SLAF on October 29 and November 1, 2010, a special two-day repo auction under the LAF on October 30, 2010, and allowed waiver of penal interest on shortfall in maintenance of SLR (on October 30-31, 2010) to the extent of 1.0 per cent of NDTL for availing additional liquidity support under the LAF. (ii) The Reserve Bank extended these liquidity easing measures further and conducted SLAF on all days during November 1-4, 2010 and extended the period of waiver of penal interest on shortfall in maintenance of SLR (to the extent of 1.0 per cent of NDTL) for availing additional liquidity support under the LAF till November 7, 2010. (iii) The Reserve Bank re-started purchase of government securities under its open market operations (OMO) from November 4, 2010. (iv) On November 9, 2010, the Reserve Bank reintroduced daily SLAF and extended the period of waiver of penal interest on shortfall in maintenance of SLR to the extent of 1.0 per cent of NDTL for availing additional liquidity support under the LAF till December 16, 2010. (v) On November 29, 2010, the Reserve Bank extended the daily SLAF and allowed additional liquidity support to the SCBs under the LAF to the extent of up to 2.0 per cent of their NDTL till January 28, 2011.
Mid-December 2010: Continued build up in government balances on account of third quarterly advance tax collections	In the mid-Quarter Review of December 2010, the Reserve Bank: (i) Reduced the SLR of SCBs from 25 per cent of NDTL to 24 per cent with effect from December 18, 2010. Given the permanent reduction in the SLR, additional liquidity support of 1.0 per cent of NDTL under the LAF would be available from December 18, 2010 till January 28, 2011. (ii) Announced conduct of OMO auctions for purchase of government securities for an aggregate amount of ₹48,000 crore in the next one month (staggered as purchases of ₹12,000 crore per week).

Note: The central government, in consultation with the Reserve Bank, undertook a number of measures for cash management which also helped in management of liquidity. These included repurchase of dated securities in tranches, reduction in the amount of borrowing in the indicative calendar for the second half of 2010-11 by ₹10,000 crore and rescheduling of auction amount of g-secs from that mentioned in the indicative calendar on a few occassions.

Table IV.3: Reserve Bank's Liquidity Management Operations

(₹ crore)

Item	2009-10				2010-11		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8
A. Drivers of Liquidity (1+2+3+4)	**-45,110**	**-44,514**	**-66,785**	**55,055**	**-1,04,914**	**27,034**	**-1,09,215**
1. RBI's net Purchase from Authorised Dealers	-15,874	2,523	436	910	816	751	5,991
2. Currency with the Public	-18,690	-9,020	-43,224	-31,650	-58,210	54	-42,730
3.a. Centre's surplus balances with RBI	3,382	-67,938	-22,663	85,257	-58,249	10,953	-78,960
3.b. WMA and OD	0	0	0	0	0	0	0
4. Others (residual)	-13,928	29,921	-1,334	538	10,729	15,275	6,484
B. Management of Liquidity (5+6+7+8)	**-21,674**	**62,376**	**89,870**	**1,618**	**67,255**	**-41,456**	**1,34,075**
5. Liquidity impact of LAF	-1,30,020	25,390	86,330	18,795	75,785	-44,545	83,165
6. Liquidity impact of OMO* (net)	43,159	32,869	3,540	2,787	1,550	2,772	50,910
7. Liquidity impact of MSS	65,187	4,117	0	16,036	2,420	317	0
8. First round impact of CRR change	0	0	0	-36,000	-12,500	0	0
C. Bank Reserves # (A+B)	**-66,784**	**17,863**	**23,085**	**56,673**	**-37,659**	**-14,422**	**24,860**

(+) : Injection of liquidity into the banking system.
(-) : Absorption of liquidity from the banking system.
* : Includes oil bonds but excludes purchases of government securities on behalf of State Governments.
\# : Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.
Note: Data pertain to March 31 for Q4 and last Friday for all other quarters. Data are provisional.

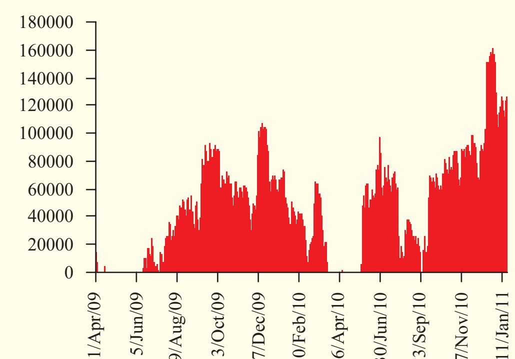
IV.3 The tight liquidity conditions during the third quarter of the year were mainly the result of autonomous factors, *i.e.*, increase in the government's surplus balance with the Reserve Bank and currency with the public. The Reserve Bank managed the liquidity conditions primarily through operations under the LAF and OMO, by means of which large amount of primary liquidity was injected into the system (Table IV.3).

Frictional tightness in liquidity reflected unusually large government surplus balances with the Reserve Bank

IV.4 The tight liquidity conditions since end-October 2010 were primarily on account of unusually large unspent cash balances of the government. During the third quarter of 2010-11, the government surplus with the Reserve Bank hovered in the range of 1.0 to 3.0 per cent of net demand and time liabilities (NDTL) of banks (Chart IV.2). The effective impact on liquidity, therefore, was equivalent to an increase in CRR by 100-300 basis points.

IV.5 It may be noted that in 2009-10, the surplus balance of the government helped in modulating the liquidity overhang in the system. With the change in the liquidity conditions from the previous year, however, the same factor widened the deficit in liquidity to the extent of becoming a source of stress for the financial system. Since government's surplus balances only reflect the temporary mismatch in their cash flows on receipts and expenditure side, this factor is generally seen as a frictional determinant of autonomous liquidity. The unusually tight liquidity in the system in recent months has been a result of this frictional factor persisting longer than usual.

Chart IV.2: GoI Balance with the Reserve Bank (₹ crore)

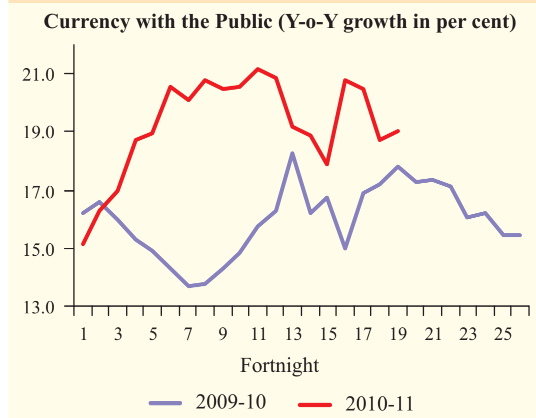


Structural imbalance between deposit and credit growth and above trend growth in currency added to the liquidity pressure

IV.6 The divergence between the growth rates of credit and aggregate deposits of SCBs widened during the third quarter of 2010-11 (the gap peaked at 9 percentage points in mid-December), emerging thereby as a structural source of pressure on liquidity (Chart IV.3). During the quarter, up to mid-December, banks mobilised ₹88,514 crore of deposits and lent out ₹2,14,638 crore of credit. This mismatch partly reflected the delayed response of banks in raising deposit rates, even though the monetary policy stance had provided the signals for timely response by the banks. With active deposit mobilisation in the last reporting fortnight of December 2010, the mismatch narrowed considerably.

IV.7 The subdued deposit growth partly reflected the higher growth in currency demand in 2010-11 (Chart IV.4). Increase in currency with the public is another autonomous factor which drains liquidity from the system. The growth rate of currency with the public during the year so far has been, on average, 3.4 percentage points higher than during the corresponding period of last year. Moreover, the third quarter of the financial year typically registers an increase in currency demand due to the festive season. The observed pattern in currency demand and deposit, reflected partly the normal response to high inflation and persistent low or even negative real return on deposits.

Chart IV.4: Currency Demand



With room for collateralised borrowing by banks from the Reserve Bank getting smaller, lowering of SLR requirement helped ease the pressure

IV.8 On account of the tight liquidity conditions and the consequent measures taken by the Reserve Bank, *i.e.*, reduction and temporary reprieve in SLR maintenance, the excess SLR investments of SCBs moderated to ₹1,77,694 crore as on December 31, 2010 from ₹2,56,566 crore a year ago. After the reduction in SLR, banks could use the additional space for accessing liquidity through OMOs and the repo window. Excess SLR holdings for the system as a whole are much lower than last year, with large divergence across banks (Chart IV.5).

Chart IV.3: Aggregate Deposits and Bank Credit (Y-o-Y growth rate in per cent)

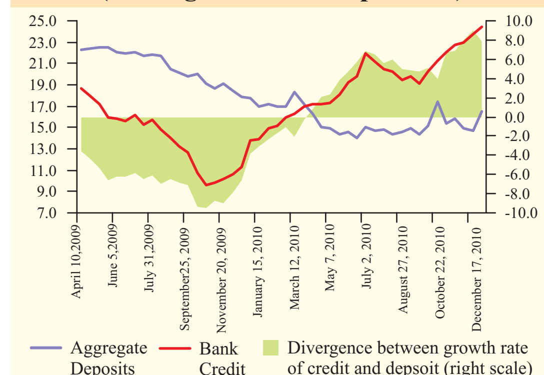
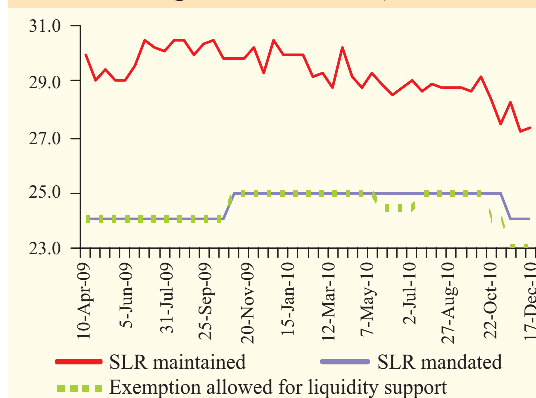


Chart IV.5: SLR Maintenance by Banks (per cent of NDTL)



Liquidity tightness could ease further with increase in government spending

IV.9 Alongside the build up of government surplus with the Reserve Bank that drained liquidity from the system, the injection of liquidity under the LAF scaled up significantly (Table IV.4). The surplus peaked in December 2010 reflecting advance tax collections. The salutary effect of higher government spending since end-December 2010 is mirrored in the lower surplus balances and the corresponding decline in LAF volumes. The gradual easing of liquidity conditions is also reflective of the staggered OMOs carried out by the Reserve Bank since the mid-quarter Review of December 2010. It is expected that the government would spend in order to meet its committed expenditure for the year during the ongoing quarter, which is the last quarter of the financial year. With government cash surplus beginning to flow back into the system, the liquidity position would improve.

Table IV.4: Liquidity Position

(₹ crore)

Outstanding as on Last Friday	LAF	MSS	Centre's Surplus@	Total
1	2	3	4	5=(2+3+4)
2009				
April	1,08,430	70,216	-40,412	1,38,234
May	1,10,685	39,890	-6,114	1,44,461
June	1,31,505	22,890	12,837	1,67,232
July	1,39,690	21,063	26,440	1,87,193
August	1,53,795	18,773	45,127	2,17,695
September	1,06,115	18,773	80,775	2,05,663
October	84,450	18,773	69,391	1,72,614
November	94,070	18,773	58,460	1,71,303
December	19,785	18,773	1,03,438	1,41,996
2010				
January	88,290	7,737	54,111	1,50,138
February	47,430	7,737	33,834	89,001
March*	990	2,737	18,182	21,909
April	35,720	2,737	-28,868	9,589
May	6,215	317	-7,531	-999
June	-74,795	317	76,431	1,953
July	1,775	0	16,688	18,463
August	11,815	0	20,054	31,869
September	-30,250	0	65,477	35,227
October	-1,17,660	0	86,459	-31,201
November	-1,03,090	0	93,425	-9,665
December	-1,13,415	0	1,44,437	31,022
2011				
January 14	-82,570	0	1,14,290	31,720

@ : Excludes minimum cash balances with the Reserve Bank in case of surplus.

* : Data pertain to March 31.

Note: 1. Negative sign in column 2 indicates injection of liquidity through LAF.

2. Negative sign in column 4 indicates WMA /OD availed by the central government.

Money supply growth deceleration continued reflecting the deposit pattern, but reached closer to the indicative trajectory of the Reserve Bank

IV.10 At the end of the third quarter of 2010-11, money growth remained below the Reserve Bank's indicative trajectory as set out in the Second Quarter Review of Monetary Policy (Table IV.5). Broad money (M_3) growth trend is largely influenced by the pattern of growth in aggregate deposits of the banking system, which account for over 85 per cent of the stock of M_3 (Chart IV.6). There has been a sharp moderation in both time (which are nearly 87 per cent of total deposits) and demand deposits, partly reflecting the response to lower deposit rates in an environment of high inflation. There was, however, a sharp turnaround in the last fortnight of the quarter when banks mobilised almost 66 per cent of the total incremental deposits for the entire quarter. This reflected active mobilisation as well as quarter-end/ month-end accruals of interest payments and salaries/pensions credited to accounts[1]. Besides, there were two fortnights during the third quarter of 2010-11, during which deposit growth, and hence, money growth, registered notable increase. This was on account of inflows for subscription to Coal India and Power Grid capital issues in the second fortnights of October and November 2010, respectively.

IV.11 The moderation in the growth rate of money is also on account of the change in the key determinants of the money multiplier. During the current year, currency growth has

[1]Reporting fortnight for data compilation coincided with the last day of the month and the quarter, *i.e.*, December 31, 2010. Hence, interest payments and accruals to salary/pension accounts contributed partly to the higher incremental deposits.

Table IV.5: Monetary Indicators

(Growth in per cent)

Item	Year-on-Year		Financial year to date	
	2010-11	2009-10	2010-11	2009-10
1	2	3	4	5
Broad Money (M_3)	16.5	17.9	10.8	11.0
Narrow Money (M_1)	15.6	19.8	5.7	8.5
Main Components of M_3				
Currency with the Public	19.1	17.2	13.1	9.6
Aggregate Deposits	16.1	18.1	10.4	11.3
of which: Demand Deposits	11.7	23.6	-2.1	7.6
Time Deposits	16.8	17.3	12.6	11.9
Main Sources of M_3				
Net Bank Credit to the Government	17.0	34.3	7.5	19.9
Bank Credit to the Commercial Sector	23.2	13.5	15.3	8.4
Net Foreign Assets of the Banking Sector	2.2	3.9	6.5	-1.2
Reserve Money	22.5	14.8	8.7	3.8
Reserve Money adjusted for CRR changes	17.3	16.9	7.7	3.7
Scheduled Commercial Banks				
Non-food Credit	24.1	14.4	15.7	9.1
Aggregate Deposits	16.5	17.7	10.7	11.3

Note: 1. Data are provisional.
2. Data pertain to December 31, 2010 except reserve money, which is for January 14, 2011.

been much higher than deposit growth, which led to a higher currency to deposit ratio. The reserve to deposit ratio has also gone up on account of the increase in the CRR that was effected in February and April 2010. The increase in both these ratios has had some moderating influence on the money multiplier, thereby lowering M_3 growth (Chart IV.7). Higher incremental deposits in the last fortnight of 2010, however, led to a significant moderation in the currency to deposit ratio.

IV.12 Among the major sources of M_3 growth, the banking system's credit to the commercial sector has steadily gone up since November 2009, reflecting the growth momentum and the associated demand for credit, while the growth in banking system's credit to the government has decelerated.

Base money expansion remains strong reflecting injection of primary liquidity by the Reserve Bank

IV.13 Reserve money continued to grow at an accelerated pace during the third quarter of 2010-11, reflecting the injection of primary liquidity in the face of tight liquidity conditions. The third quarter registered the highest quarterly increment in base money during the current financial year. The injection of primary liquidity during the third quarter in the form of repo operations under the LAF and open market

Chart IV.6: Money and Aggregate Deposit (Y-o-Y growth in per cent)

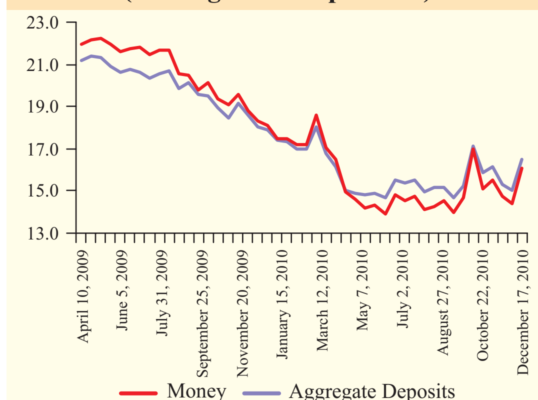


Chart IV.7: Money Multiplier and Behavioural Ratios

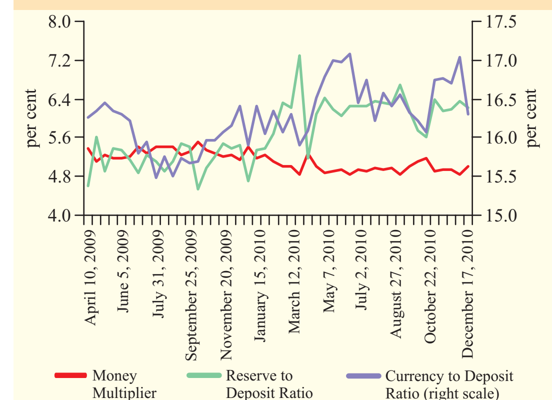
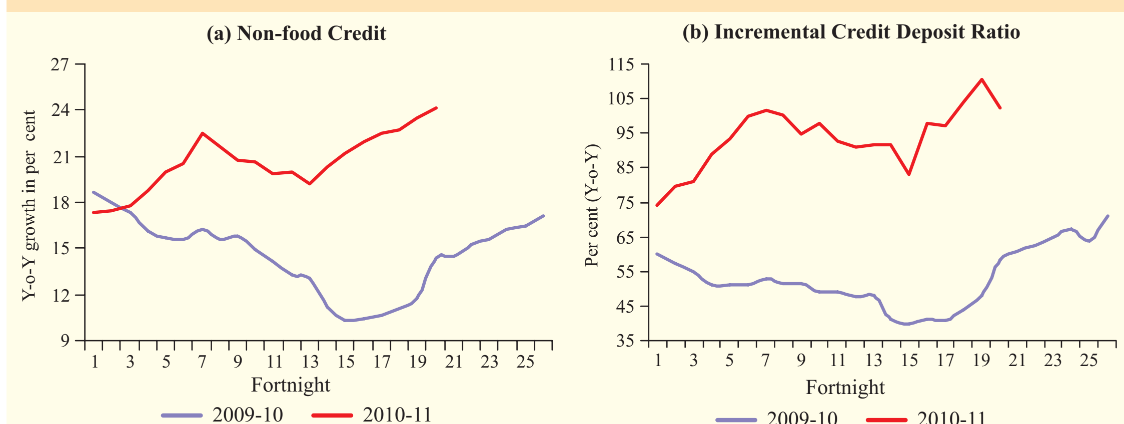


Chart IV. 8: Credit Indicators



purchases was ₹1,32,902 crore, roughly 60 per cent of which was offset by the incremental build-up in government surplus with the Reserve Bank.

Credit growth, though still dominated by infrastructure, is gradually getting broad-based

IV.14 With economic growth consolidating around the pre-crisis trend, non-food credit continued to grow at an accelerated pace during the third quarter of the year. Also, with deposit mobilisation lagging behind the fast pace of increase in credit, the incremental non-food credit to deposit ratio peaked at 110.5 per cent in mid-December 2010, an indication of the role of the structural squeeze on liquidity during the quarter. The ratio, however, dipped by over 8 percentage points by end-December 2010 (Chart IV.8).

IV.15 The increased credit off-take was seen across all bank groups (Table IV.6). Even as private sector banks and foreign banks registered high growth in credit flow as compared to the previous year, public sector banks remained the dominant lenders in the banking system, accounting for nearly three-fourths of the incremental year-on-year credit off-take at the end of the third quarter of 2010-11.

IV.16 Data on sectoral deployment of gross non-food credit show the increasing broad-based pattern (Chart IV.9). Disaggregated data suggest that credit flow to industry has been robust. Infrastructure, basic metal and metal products and engineering industries accounted for two-third of the annual incremental credit off-take as on December 17, 2010.

IV.17 Due to the buoyancy in credit flow from the banking system, banks accounted for nearly three-fifth of total incremental financing to the commercial sector during April-December 2010 (Table IV.7). For the period

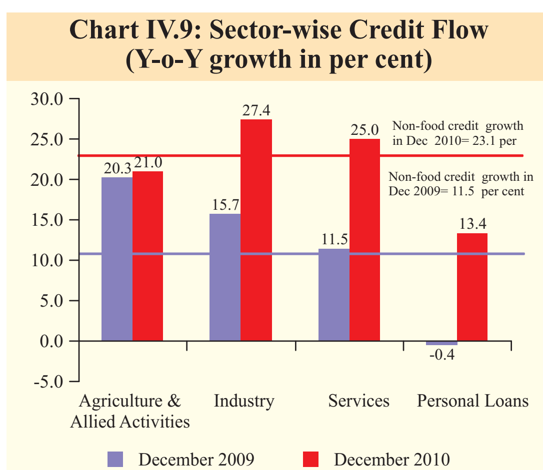
Table IV.6: Credit Flow from Scheduled Commercial Banks

(Amount in ₹ crore)

Item	Outstanding as on Dec 31, 2010	Variation (Y-on-Y)			
		As on Jan 1, 2010		As on Dec 31, 2010	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
1. Public Sector Banks	27,93,705	3,25,608	16.9	5,41,737	24.1
2. Foreign Banks	1,90,766	-14,028	-8.1	31,474	19.8
3. Private Banks	6,89,232	41,424	8.4	1,51,618	28.2
4. All Scheduled Commercial Banks*	37,63,213	3,66,914	13.8	7,38,641	24.4

* : Including Regional Rural Banks.
Note: Data for December 31, 2010 are provisional.

Chart IV.9: Sector-wise Credit Flow (Y-o-Y growth in per cent)



Note: Chart IV.9 and the details in paragraph IV.16 are based on data collected from select SCBs that account for 95 per cent of the total non-food credit extended by all SCBs. These data are being disseminated every month from November 2010.

under consideration, funding from non-bank sources registered a decline compared to the previous year, on account of a decline in both domestic and foreign non-bank sources. The funding from foreign sources decreased on account of lower amount of net FDI inflow into India as well as lower subscription to ADRs/ GDRs.

Stronger monetary policy transmission is expected to enhance the effectiveness of policy

IV.18 The anti-inflationary monetary policy measures taken during the course of the year could become more effective with the stronger transmission in the financial system that has become visible since the third quarter of the financial year. The tight liquidity conditions would improve as the government steps up its expenditure, but the magnitude of the deficit may have to continue at around 1.0 per cent of NDTL for monetary transmission to remain effective.

Table IV.7: Flow of Financial Resources to the Commercial Sector

(₹ crore)

Item		April-March		April-December	
		2008-09	2009-10	2009-10	2010-11
1	2	3	4	5	
A.	**Adjusted Non-food Bank Credit (NFC)**	**4,21,091**	**4,80,258**	**2,51,774**	**5,34,276**
	i) Non-Food Credit	4,11,824	4,66,960	2,48,874	5,00,966
	of which petroleum and fertiliser credit	31,159	8,491	-181	-23,136 *
	ii) Non-SLR Investment by SCBs	9,267	13,298	2,900	33,310
B.	**Flow from Non-banks (B1+B2)**	**4,51,399**	**5,88,559**	**3,84,661**	**3,66,238**
	B1. Domestic Sources	**2,58,132**	**3,64,989**	**2,37,733**	**2,27,255**
	1. Public issues by non-financial entities	14,205	31,956	19,791	23,224
	2. Gross private placements by non-financial entities	77,856	1,41,964	70,991	43,280 ^
	3. Net issuance of CPs subscribed to by non-banks	4,936	25,835	69,603	34,390 #
	4. Net credit by housing finance companies	25,876	28,485	9,852	22,911 *
	5. Total gross accommodation by the four RBI regulated AIFIs - NABARD, NHB, SIDBI and EXIM Bank	31,408	33,871	-1,443	32,361
	6. Systemically important non-deposit taking NBFCs (net of bank credit)	42,277	60,663	40,611	51,534 *
	7. LIC's gross investment in corporate debt, infrastructure and social sector	61,574	42,215	28,328	19,556
	B2. Foreign Sources	**1,93,267**	**2,23,570**	**1,46,928**	**1,38,983**
	1. External commercial borrowings/FCCBs	30,948	15,674	13,552	27,947
	2. ADR/GDR issues excluding banks and financial institutions	4,788	15,124	15,164	8,490
	3. Short-term credit from abroad	-13,288	34,878	-283	31,016 ^
	4. FDI to India	1,70,819	1,57,894	1,18,495	71,530 *
C.	**Total Flow of Resources (A+B)**	**8,72,017**	**10,68,817**	**6,36,435**	**9,00,514**
Memo Item:					
Net resource mobilisation by Mutual Funds through Debt (non-Gilt) Schemes		-32,168	96,578	1,50,085	-29,961

* : April-November ^ : April-September # : April-Dec 15, 2010.

V. FINANCIAL MARKETS

The global financial market conditions largely reflected concerns relating to sovereign debt in the Euro-zone, ample global liquidity resulting from quantitative easing (QE2) in the US and uncertain growth outlook in other advanced economies. Indian markets functioned in an orderly manner although there was a rise in equity prices in the third quarter of 2010-11, partly driven by higher portfolio flows, in line with the trend in other EMEs. In January 2011, equity prices moderated, partly reflecting market expectations of tighter monetary policy in response to higher inflation. The forex market also remained orderly and witnessed two way movements. Severe tightness in liquidity that developed in the last few months of 2010 impacted rates in different segments of the money market. The interest rates/yields on overnight, CPs, CDs, CBLO, Treasury Bills, government dated securities and bank deposits increased. Housing prices in major cities rose in general in the second quarter of 2010-11 and to contain excessive leveraging in the housing sector, the Reserve Bank tightened prudential measures for housing credit.

Global asset price trends and capital inflows influenced the domestic markets

V.1 Renewed concerns regarding sovereign debt crisis in the Euro area and the multi-paced global recovery dominated global financial markets, which underpinned frequent re-pricing of risks. The emerging market economies (EMEs) attracted greater portfolio flows in search of better returns, given the easy availability of liquidity in developed countries especially after the announcement of QE2. These flows, in turn, exerted upward pressures on currencies and asset prices in EMEs, leading some of these economies to resort to macroprudential measures and soft capital controls.

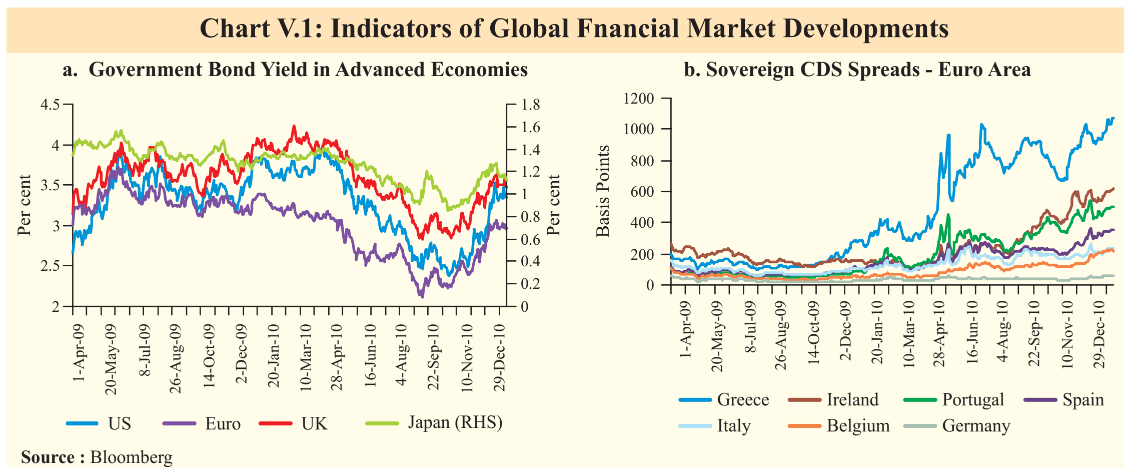
V.2 The Indian financial markets remained orderly, notwithstanding the impact of global developments and tight liquidity conditions in domestic markets. Call rate firmed up in step with policy rates and tight liquidity conditions. It mostly remained above the upper bound of the LAF corridor during the third quarter of 2010-11. Both commercial paper (CP) and certificate of deposit (CD) markets remained active as alternative sources of finance. The yield curve for Government Securities (G-Sec) shifted, reflecting expectation of policy rate changes in an inflationary environment. The Indian Rupee appreciated moderately against the US dollar and stock prices rose on the back of strong foreign portfolio inflows. Prices in the housing market in general continued the rising trend during the second quarter of 2010-11.

Frequent re-pricing of risks in the international financial markets reflected persisting uncertainties

V.3 Sovereign risks in the Euro-area resurfaced during the fourth quarter of 2010 which resulted in higher G-Sec yields and widening of CDS spreads (Charts V.1 a and b). Increased capital inflows into the EMEs exerted upward pressures on their currencies and equity prices (Table V.1).

V.4 Indian financial markets, particularly the equity and foreign exchange markets were impacted by the global developments. Widening interest rate differential due to divergent monetary policies followed by advanced economies and India led corporates to take greater recourse to external commercial borrowings (ECBs). Easy global liquidity and the strong growth prospects of the Indian economy encouraged inflows from foreign

Chart V.1: Indicators of Global Fnancial Market Developments



Source : Bloomberg

institutional investors (FIIs) seeking higher returns. The rupee appreciated against major currencies during the beginning of the third quarter of 2010-11, mainly due to strong FII inflows, but corrected subsequently, in line with the movement of the US dollar *vis-a-vis* other major currencies and moderation of FII inflows (Table V.2).

Policy measures were taken to manage liquidity conditions as money market rates hardened

V.5 During the third quarter of 2010-11, there was a tightening of liquidity on account of persistence of large government cash balances, above-trend currency expansion and mismatch between growth in bank credit and deposits. The call rate mostly remained above the upper bound of the LAF corridor during the third quarter, reflecting the tight liquidity conditions (Chart V.2a). The rates in the collateralised segments (which accounted for more than 80 per cent of the total volume) generally moved in tandem, with the call rate *albeit* below it. In order to stabilise overnight inter-bank rates closer to the operative policy rate, the Reserve Bank implemented liquidity management measures (see Table IV.2 of Chapter IV for details). The activity in the collateralised borrowing and lending obligation (CBLO) and market repo segments showed marginal moderation *vis-a-vis* the uncollateralised market, reflecting

Table V.1: Currency and Stock Price Movement in EMEs

(Per cent)

Appreciation (+)/Depreciation (-) of the US Dollar				Stock Price Variations			
Items	End-March 2009@	End-March 2010@	End-Dec. 2010*	Items	End-March 2009@	End-March 2010@	End-Dec. 2010*
1	2	3	4	5	6	7	8
Japanese Yen	0.7	5.9	15.2	Indonesia (Jakarta Composite)	-41.4	93.7	33.3
Chinese Renminbi	2.6	0.1	3.3				
Russian Ruble	-30.8	15.4	-3.7	Brazil (Bovespa)	-32.9	71.9	-1.5
Turkish Lira	-20.5	9.7	-1.7	Thailand (SET Composite)	-47.2	82.6	31.1
Indian Rupee	-20.9	12.9	0.5	India (BSE Sensex)	-37.9	80.5	17.0
Indonesian Rupiah	-21.1	28.6	1.2	South Korea (KOSPI)	-29.2	40.3	21.2
Malaysian Ringgit	-12.4	11.8	6.5	China (Shanghai Composite)	-31.7	31.0	-9.7
South Korea Won	-28.4	22.3	0.5				
Thai Baht	-11.4	9.8	7.6	Taiwan (Taiwan Index)	-39.2	52.0	13.3
Argentine Peso	-14.8	-4.1	-2.5	Russia (RTS)	-66.4	128.0	12.6
Brazilian Real	-24.6	30.4	7.2	Malaysia (KLSI)	-30.1	51.3	15.0
Mexican Peso	-24.9	14.6	0.2	Singapore (Straits Times)	-43.5	69.9	10.5

@ : Year-on-year variation. * : Variation over End-March.
Source: Bloomberg, IFS, IMF.

Table V.2: Domestic Financial Markets at a Glance

Year/ Month	Money Market			Bond Market				Forex Market			Stock Markets		
				G-Sec		Corporate Bonds							
	Call Money daily turnover (₹crore)	Call rates* (Per cent)	Avg daily LAF (₹crore)	Daily Turn-over^ (₹Crore)	10-year yield (Per cent)	Daily Turn-over (₹ Crore)	Yield - AAA 5-Yr Bonds	Daily inter bank turnover (US$ mn)	Exchange rate @ (₹/US$)	RBI's net purchase (+)/sale(-) (US$ mn)	Daily NSE turnover (₹crore)	CNX Nifty **	BSE Sensex **
1	2	3	4	5	6	7	8	9	10	11	12	13	14
2008-09	**22,436**	**7.06**	**2,885**	**10,879**	**7.54**	**610**	**10.07**	**34,812**	**45.92**	**-34,922†**	**11,325**	**3713**	**12303**
2009-10	**15,924**	**3.24**	**1,00,015**	**13,936**	**7.23**	**1,644**	**8.23**	**30,107**	**47.42**	**-2,505†**	**16,959**	**4658**	**15585**
Oct-09	15,776	3.17	1,01,675	12,567	7.33	1,474	8.50	28,402	46.72	75	18,148	4994	16826
Nov-09	13,516	3.19	1,01,719	17,281	7.33	1,571	8.14	27,599	46.57	-36	16,224	4954	16684
Dec-09	13,302	3.24	68,522	14,110	7.57	1,457	8.23	27,439	46.63	-25	13,948	5100	17090
Jan-10	12,822	3.23	81,027	12,614	7.62	2,769	8.32	32,833	45.96	0	17,813	5156	17260
Feb-10	13,618	3.17	78,661	12,535	7.79	1,988	8.53	34,040	46.33	0	12,257	4840	16184
Mar-10	17,624	3.51	37,640	8,544	7.94	3,196	8.61	32,755	45.50	155	13,631	5178	17303
Apr-10	16,374	3.49	57,150	14,242	8.01	3,342	8.37	36,821	44.5	0	13,828	5295	19679
May-10	16,786	3.83	32,798	24,225	7.56	3,305	8.15	40,243	45.81	0	12,937	5053	16845
Jun-10	14,258	5.16	-47,347	21,300	7.59	2,473	8.21	36,953	46.57	110	13,005	5188	17300
Jul-10	18,954	5.54	-46,653	13,691	7.69	2,899	8.27	34,252	46.84	0	12,661	5360	17848
Aug-10	15,916	5.17	-1,048	16,919	7.93	2,291	8.52	36,528	46.57	0	14,182	5457	18177
Sep-10	17,212	5.50	-24,155	16,215	7.96	2,508	8.52	37,574	46.06	260	15,708	5811	19353
Oct-10	17,840	6.39	-61,658	14,029	7.68	2,299	8.58	49,880P	44.41	450	17,165	6069	20250
Nov-10	17,730	6.81	-99,311	10,193	8.03	1,843	8.64	44,104P	45.02	870	17,333	6055	20126
Dec-10	18,872	6.67	-1,20,495	9,849	8.03	1,723	8.89	34,894P	45.16	-	13,440	5971	19228

* : Average of daily weighted call money rates. ^: Average of daily outright turnover in Central Government dated securities
@ : Average of closing rates. **: Average of daily closing indices.
† : Cumulative for the financial year. NSE: National Stock Exchange of India Limited. P: Provisional - : Not available.
Note : In col 4 (-)ve indicates injection of liquidity while (+)ve indicates absorption of liquidity.

demand for funds in excess of available securities for collateral backing (Chart V.2b). Secondary market yields on CDs and CPs witnessed higher increases by the end of the third quarter as compared to the overnight rates as well as the Treasury Bills of comparable maturity (Table V.3, Chart V.2c).

V.6 The average fortnightly issuance of CDs during the third quarter was higher than that in the previous quarter; issuances of CPs also increased as companies accessed alternative avenues for funds, given the tight liquidity conditions. Leasing and finance, and manufacturing companies continued to be the

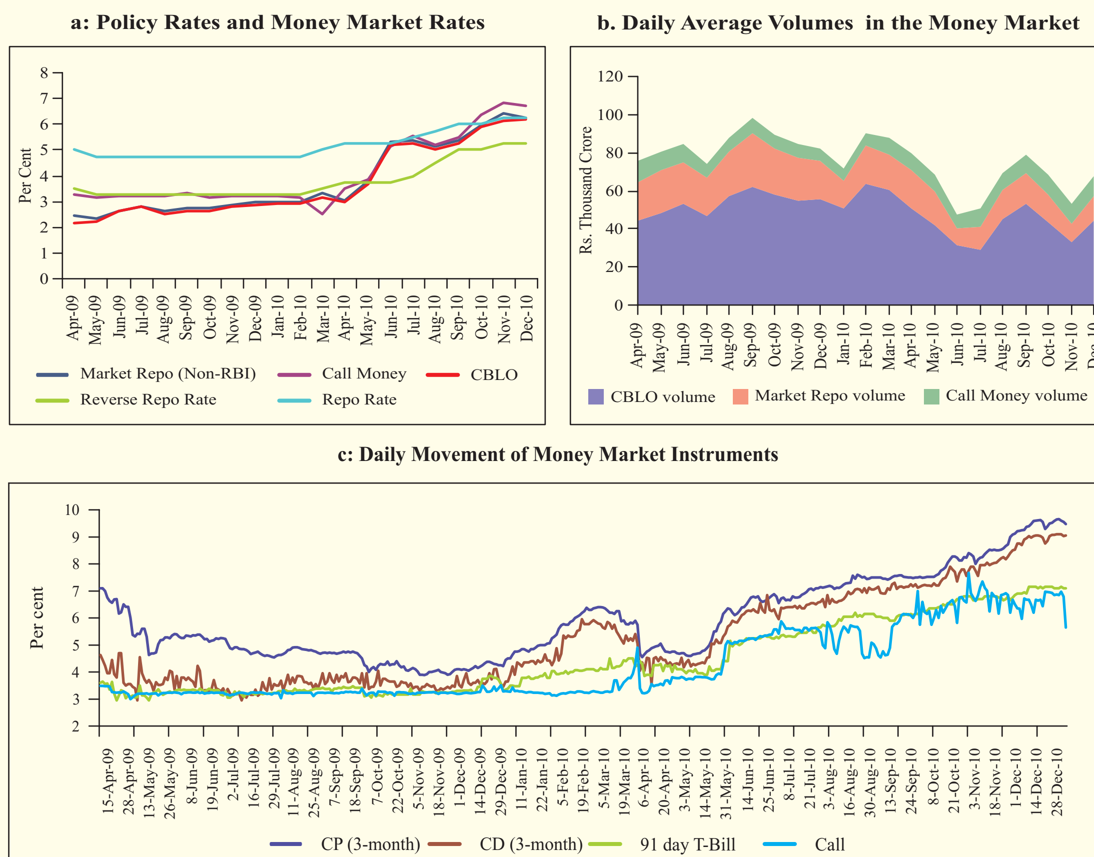
Table V.3: Activity in Money Market Segments

(₹ Crore)

Year/Month	Average Daily Volume (One leg)			Commercial Paper		Certificates of Deposit	
	Call Money	Market Repo	CBLO	Outstanding	WADR (%)	Outstanding	WAEIR (%)
1	2	3	4	5	6	7	8
Sep-09	8,059	27,978	62,388	79,228	5.04	2,16,691	5.30
Oct-09	7,888	23,444	58,313	98,835	5.06	2,27,227	4.70
Nov-09	6,758	22,529	54,875	1,03,915	5.17	2,45,101	4.86
Dec-09	6,651	20,500	55,338	90,305	5.40	2,48,440	4.92
Jan-10	6,411	14,565	50,571	91,564	4.80	2,82,284	5.65
Feb-10	6,809	19,821	63,645	97,000	4.99	3,09,390	6.15
Mar-10	8,812	19,150	60,006	75,506	6.29	3,41,054	6.07
Apr-10	8,187	20,319	50,891	98,769	5.37	3,36,807	5.56
May-10	8,393	17,610	42,274	1,09,039	6.85	3,40,343	5.17
Jun-10	7,129	9,481	31,113	99,792	6.82	3,21,589	6.37
Jul-10	9,477	12,011	29,102	1,12,704	6.93	3,24,810	6.69
Aug-10	7,958	15,553	45,181	1,26,549	7.32	3,41,616	7.17
Sep-10	8,606	15,927	53,223	1,12,003	7.82	3,37,322	7.34
Oct-10	8,920	14,401	43,831	1,49,620	12.15	3,43,353	7.67
Nov-10	8,865	9,967	32,961	1,17,793	12.22	3,32,982	8.16
Dec-10	9,436	12,989	43,784	1,02,156@	12.52	3,28,566 #	9.01

@: As on December 15, 2010 #: As on December 17, 2010
CBLO: Collateralised Borrowing and Lending Obligation WADR: Weighted Average Discount Rate
WAEIR : Weighted Average Effective Interest Rate.

Chart V.2: Movement in Money Market Rates and Turnover



major issuers of CPs (Table V.4). The Weighted Average Effective Interest Rate (WAEIR) on CDs and Weighted Average Discount Rate (WADR) of CPs in the primary markets increased during the third quarter reflecting demand for funds.

V.7 The yield on Treasury Bills in the primary market firmed up during the third quarter of 2010-11 (Table V.5). The calendar for issuance of Treasury Bills for the fourth quarter of 2010-11, released on December 31, 2010, projected mobilisation of ₹17,000 crore, over and above the rollover during the quarter.

Table V.4: Major Issuers of Commercial Paper

(₹ Crore)

End of Period	Leasing and Finance		Manufacturing		Financial Institutions		Total
	Amount	Share (%)	Amount	Share(%)	Amount	Share(%)	Outstanding
1	2	3	4	5	6	7	8
Mar-09	27,183	62	12,738	29	4,250	10	44,171
Jun-09	34,437	50	23,454	34	10,830	16	68,721
Sep-09	31,648	40	31,509	40	16,071	20	79,228
Dec-09	36,027	40	42,443	47	11,835	13	90,305
Mar-10	39,477	52	22,344	30	13,685	18	75,506
Jun-10	42,572	43	43,330	43	13,890	14	99,792
Aug-10	57,161	45	55,933	44	13,455	11	1,26,549
Sep-10	58,098	52	40,485	36	13,420	12	1,12,003
Oct-10	80,305	54	54,894	37	14,421	9	1,49,620
Nov-10	58,871	50	45,457	39	13,465	11	1,17,793
Dec-10	53,329	52	35,767	35	13,060	13	1,02,156 @

@ As on Dec 15, 2010

Table V.5: Treasury Bills in the Primary Market

Year/ Month	Notified Amount (₹ crore)	Average Implicit Yield at Minimum Cut-off Price (Per cent)		
		91-day	182-day	364-day
1	2	3	4	5
2008-09	2,99,000	7.10	7.22	7.15
2009-10	3,80,000	3.57	3.99	4.37
2010-11				
(up to Jan. 12, 2011)	2,27,000	5.90	6.18	6.30
Apr-10	36,000	4.14	4.64	5.07
May-10	36,000	4.39	4.76	4.92
Jun-10	12,000	5.29	5.31	5.49
Jul-10	16,000	5.56	5.86	5.99
Aug-10	33,000	6.15	6.41	6.48
Sep-10	13,000	6.14	6.46	6.59
Oct-10	27,500	6.65	6.94	6.97
Nov-10	24,000	6.82	7.20	7.14
Dec-10	19,000	7.14	7.32	7.37

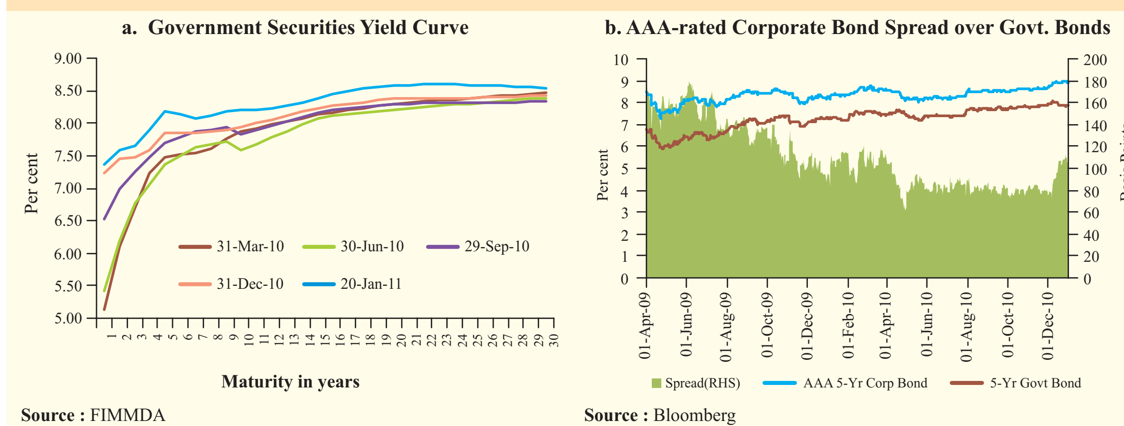
G-Sec yield curve shift reflects expectation of policy rate changes in an inflationary environment

V.8 The prevalence of tight liquidity conditions and expectations of further hike in the Reserve Bank's policy rates were reflected in an upward movement in primary as well as secondary yields for short and medium-term G-Secs during the third quarter. Though long-term yields remained range-bound, the short-term and medium-term yields eased temporarily in November, reflecting improvement in liquidity conditions due to reduction in Government cash balances and OMO purchases of G-Sec by the Reserve Bank. In January 2011, the short-term as well as long-term yields have again hardened on inflation concerns (Chart V.3a). The average daily turnover of G-Sec in the secondary market declined during the third quarter of 2010-11.

V.9 The spreads on five-year corporate bonds over the corresponding government bond yield hovered in a narrow range of 73-85 basis points during October-November 2010, but increased during the second half of December 2010, partly reflecting the deficit liquidity conditions (Chart V.3b).

V.10 Taking into account the need for fiscal consolidation and the strong buoyancy in tax and non-tax revenue (particularly receipts under 3G spectrum auctions), the indicative calendar for the issuance of dated securities during the second half of 2010-11 was scaled down by ₹ 10,000 crore. Nearly 89 per cent of the GOI's gross market borrowing programme for 2010-11 was completed during the year (up to January 19, 2011). Both the average maturity of debt issuances and weighted average yield increased during 2010-11 (up to January 19, 2011), as compared with the corresponding period of the previous year (Table V.6). Despite hardening of yields, investors' sentiment remained positive, as evident from the bid-cover ratio of the auctions that stood in the range of 1.4-3.9 during 2010-11 so far and 1.7-3.1 during the third quarter. As the yield curve flattened at the longer end, more long dated securities were issued during the second half so far, taking advantage of the yield curve movements.

Chart V.3: Turnover and Yield in the Bond Market



Source : FIMMDA

Source : Bloomberg

Table V.6: Issuances of Central and State Government Dated Securities

(₹ Crore)

Item	2009-10	2009-10*	2010-11*
1	2	3	4
Central Government			
Gross amount raised (₹ crore)	4,18,000	4,03,000	4,06,000
Devolvement on Primary Dealers (₹crore)	7,219	7,219	5,773
Bid-cover ratio (Range)	1.4-4.3	1.4-4.3	1.4-3.9
Weighted average maturity (years)	11.20	11.15	11.56
Weighted average yield (per cent)	7.23	7.39	7.94
State Governments			
Gross amount raised (₹crore)	1,31,122	1,00,085	82,464
Cut-off yield (Per cent)	7.04-8.68	7.04-8.49	8.1-8.6
Weighted average yield (per cent)	8.11	8.03	8.37

* : Up to January 19, 2011.

V.11 As regards State Government market borrowings, about 50 per cent of the gross allocations for the States for 2010-11 were raised by 22 States up to January 19, 2011 as compared with nearly 90 per cent of the gross borrowings raised during the comparable period of 2009-10. Taking into account the comfortable cash balances of the State Governments coupled with buoyant National Savings Scheme Fund (NSSF) flows there may be a moderation in their borrowings for 2010-11. Weighted average yields on market borrowings went up by 34 basis points so far during 2010-11.

The credit market exhibits strengthening of monetary policy transmission

V.12 The scheduled commercial banks (SCBs) raised the deposit rates to step up their deposit mobilisation to support the high credit growth (Table V.7). Several banks revised their base rates upwards in the range of 25-100 basis points during July-January 17, 2011. Forty SCBs also increased their BPLR in the range of 50-150 bps during July-January 17, 2011.

The forex market remains orderly, despite larger capital inflows

V.13 The Indian rupee exhibited a two-way movement against major international currencies with minimal intervention or capital account management during the third quarter of 2010-11(Chart V.4a). With the sharp appreciation of the rupee during October 2010, forward premia firmed up across maturities, reflecting the increased demand for forward cover. Forward premia eased subsequently, but remained higher than in the first two quarters of 2010-11. The turnover in both inter-bank and

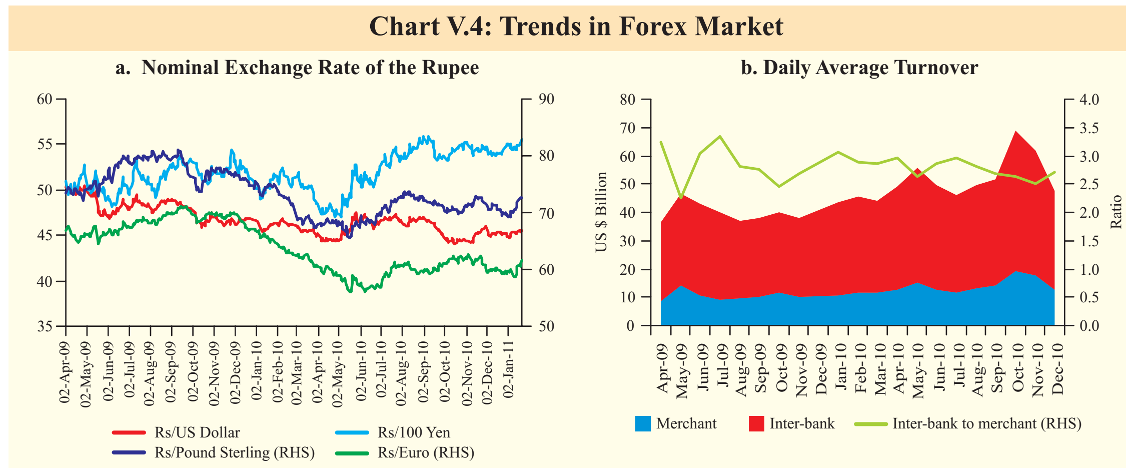
Table V.7: Deposit and Lending Rates of Banks

(Per cent)

	Dec-09	Mar-10	Jun-10	Sep-10	Jan-11@
1	2	3	4	5	6
1. Domestic Deposit Rate (1-3 years tenor)					
Public Sector Banks	6.00-7.25	6.00-7.25	6.00-7.25	6.75-7.75	7.00-9.25
Private Sector Banks	5.25-7.50	5.25-7.75	6.25-7.50	6.50-8.25	7.75-9.00
Foreign Banks	2.25-7.75	2.25-8.00	3.00-8.00	3.00-8.00	3.50-8.75
2. BPLR/Base Rate#					
1. Public Sector Banks	11.00-13.50	11.00-13.50	11.00-13.50	7.50-8.25	8.00-9.00
2. Private Sector Banks	12.50-16.75	12.50-16.75	12.50-16.75	7.00-8.75	7.75-9.50
3. Foreign Banks	10.50-16.00	10.50-16.00	10.50-16.00	5.50-9.00	6.25-9.00
3. Actual Lending Rate*					
1. Public Sector Banks	3.25-18.00	3.25-18.00	3.25-18.00	3.50-25.00	-
2. Private Sector Banks	3.50-25.84	3.00-28.00	2.80-26.00	4.00-27.00	-
3. Foreign Banks	3.50-22.00	3.60-23.00	3.60-25.00	2.25-35.98	-

* : Interest rate on non-export demand and term loans above ₹ 2 lakh excluding lending rates at the extreme five per cent on both sides.
# : With effect from July 1, 2010, the BPLR system was replaced with the Base Rate system.
@ : As on January 17, 2011.

Chart V.4: Trends in Forex Market



merchant segments of the forex market increased in October 2010 but declined thereafter (Chart V.4b).

V.14 The offshore market for Indian Rupee grew in size in the past five years reflecting the increasing globalisation of the economy, and the need for non-residents to hedge the rupee risk in their portfolio. The preliminary triennial central bank survey results published by the Bank for International Settlements (BIS) in April 2010 shows that more than half of the average daily turnover in forex derivatives on Indian Rupees took place offshore. Trading volumes in currency futures, which had spiked in September 2010, with the commencement of operations by the United Stock Exchange of India (USEI), declined thereafter up to December 2010. The volumes recovered in January 2011, so far.

Volatile equity markets reflect largely the impact of volatile portfolio flows

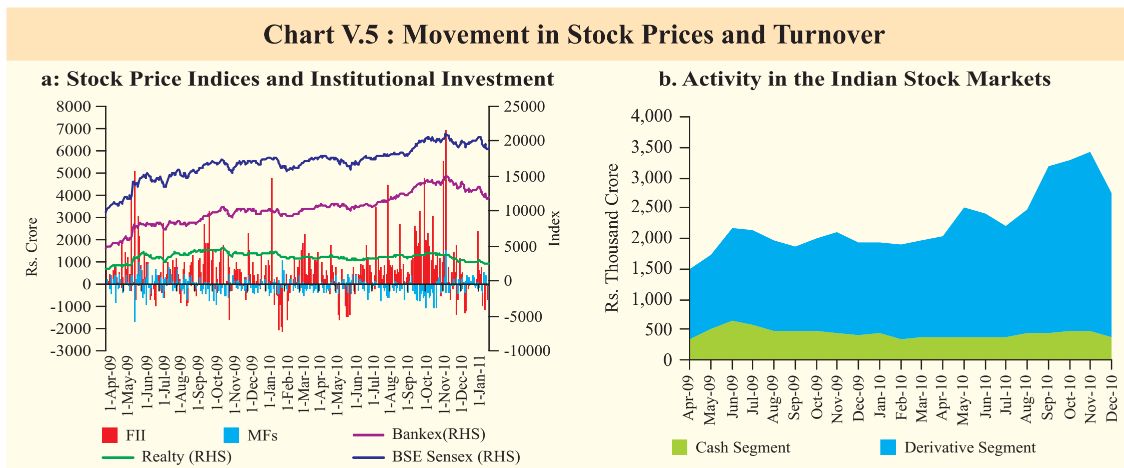
V.15 The Indian equity markets remained volatile, in line with the global trend during the third quarter of 2010-11. Strong domestic fundamentals helped in attracting FII flows in equities, even though mutual funds turned net sellers. However, as concerns relating to Ireland's debt rating resurfaced in November 2010, the volume of FII support to the equity markets declined considerably since the last week of the month. The market regained some strength by the end of the third quarter, in view of strong growth prospects of the Indian economy and expectations of encouraging corporate results (Table V.8). As compared to the rise in the benchmark BSE Sensex by 2.2 per cent during the third quarter, the banking and reality indices declined by 4.6 per cent and

Table V.8: Key Stock Market Indicators

Indicator	BSE			NSE		
	2009-10	2009-10 (Apr- Dec)	2010-11 (Apr- Dec)	2009-10	2009-10 (Apr-Dec)	2010-11 (Apr-Dec)
1	2	3	4	5	6	7
1. BSE Sensex/S&PCNX Nifty						
(i) End-period	17528	17465	20509	5249	5201	6135
(ii) Average	15585	15151	18610	4658	4527	5587
2. Coefficient of Variation	11.88	12.6	6.96	11.33	11.9	7.04
3. Price-Earning Ratio (end-period)*	21.32	22.36	23.56	22.33	23.17	24.48
4. Price-Book Value Ratio	3.90	4.20	3.84	3.70	3.65	3.87
5. Market Capitalisation to GDP Ratio (per cent)@	98.9	97.6	101.9	96.4	91.5	103.0

* : Based on 30 scrips included in the BSE Sensex and 50 scrips included in the S&P CNX Nifty. @ : As at end-period.
Source: Bombay Stock Exchange Ltd. (BSE) and National Stock Exchange of India Ltd. (NSE).

Chart V.5 : Movement in Stock Prices and Turnover



23.4 per cent, respectively, in view of the concerns relating to the banks' financing of the reality sector (Chart V.5a). In the recent period, particularly from the beginning January 2011, equity markets have witnessed some correction in anticipation of policy response to high inflation. FIIs turned net sellers in 2011 (up to January 19).

V.16 The activity in the primary segment of the domestic capital market continued to display signs of buoyancy during October-November 2010. Resources raised through public issues increased considerably during April-December 2010 as compared to the corresponding period last year (Table V.9). There was a net outflow of resources mobilised by mutual funds during April-December 2010 as compared to an inflow during the corresponding period of the previous year due to tight liquidity conditions exerting pressure on redemptions. Mobilisation of resources through private placement increased by 2.7 per cent during April-September 2010 largely on account of debt issuances by the financial companies.

V.17 The FIIs were net buyers and mutual funds turned net sellers during April-December 2010 and this trend reversed in January 2011 (up to January 11) (Chart V.5a). Net FII investment in Indian equities increased strongly during the first two months of the third quarter, while investment in debt remained subdued. FII investments, however, witnessed some slowdown in December 2010, mainly on account of year-end redemption pressures which resulted in a moderation of turnover in both cash and derivative segments (Chart V.5b).

Table V.9: Resource Mobilisation from Capital Market

(₹ crore)

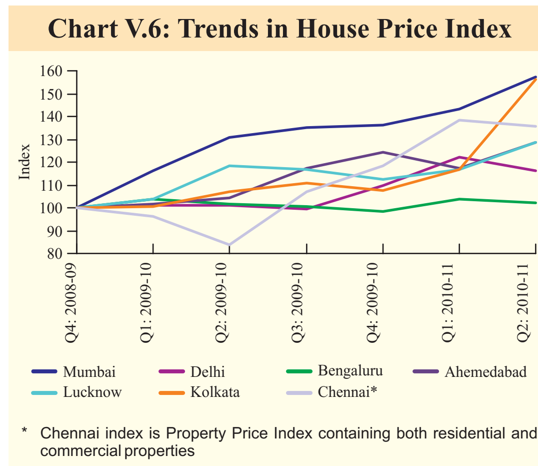
Category	2009-10 (Apr-Mar)	2009-10 (Apr-Dec)	2010-11 (Apr- Dec)
1	2	3	4
A. Prospectus and Rights Issues*	32,607	20,104	27,697
1. Private Sector (a+b)	25,479	13,301	18,799
a) Financial	326	313	3,420
b) Non-financial	25,153	12,988	15,379
2. Public Sector	7,128	6,803	9,079
B. Euro Issues	15,967	15,164	8,491
C. Mutual Fund Mobilisation(net)@	83,080	1,41,639	-32,164
1. Private Sector	54,928	1,08,170	-8,949
2. Public Sector #	28,152	33,469	-23,214

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

Rise in property prices continues

V.18 Property prices continued to rise in most cities during the second quarter of 2010-11, as reflected in the quarterly House Price Index (HPI) based on data collected from the Department of Registration and Stamps (DRS). However, property prices in Delhi and Chennai recorded some moderation (Chart V.6). In November 2010, with a view to preventing excessive leveraging, the Reserve Bank had tightened the prudential norms for housing credit.

Chart V.6: Trends in House Price Index



* Chennai index is Property Price Index containing both residential and commercial properties

While orderly financial markets would support the growth momentum, liquidity conditions would reflect the anti-inflationary stance

V.19 During the third quarter of 2010-11, the interest rates in most segments of financial markets shot up, mainly reflecting the deficit liquidity conditions. Going forward, the recent substantial easing of liquidity conditions on account of policy actions initiated by the Reserve Bank and reduction in the unusually high Government balances may reduce the pressure on the rates. The expected continuation of the robust growth momentum suggests that demand for financing economic activities would increase, which have to be met by banks and markets in a more competitive environment. Banks would have to respond to the structural mismatch between deposit and credit growth through appropriate rate adjustments. The risk of volatile portfolio flows impacting asset prices and exchange rate could be expected to persist, while maintaining orderly conditions in various segments of the financial markets would continue to be a policy priority.

VI. PRICE SITUATION

Reflecting favourable base effects and modest softening of manufactured products price pressures aided by past monetary tightening, headline inflation exhibited moderation during August-November 2010 relative to double digit levels experienced during March-July 2010. However, renewed inflationary pressures became evident in December 2010 as headline WPI inflation increased to 8.4 percent from 7.5 per cent in November 2010. New drivers are seen from fuel and non-fuel international commodity prices and demand-supply imbalances in some food items. Food inflation in particular has remained stubbornly in double digits for over two years now, which has welfare costs. The sources of price pressure in this segment, however, could be largely non-responsive to monetary policy actions. While inflation is likely to soften in coming months it is likely to stay elevated above the earlier anticipated path. The upside risks to inflation, particularly from the impact of supply rigidities and hardening commodity prices have increased, which could dampen the expected impact of monetary policy to some extent. Policy response ahead has to recognise these risks.

Inflation rebound in December 2010 was largely driven by unanticipated factors

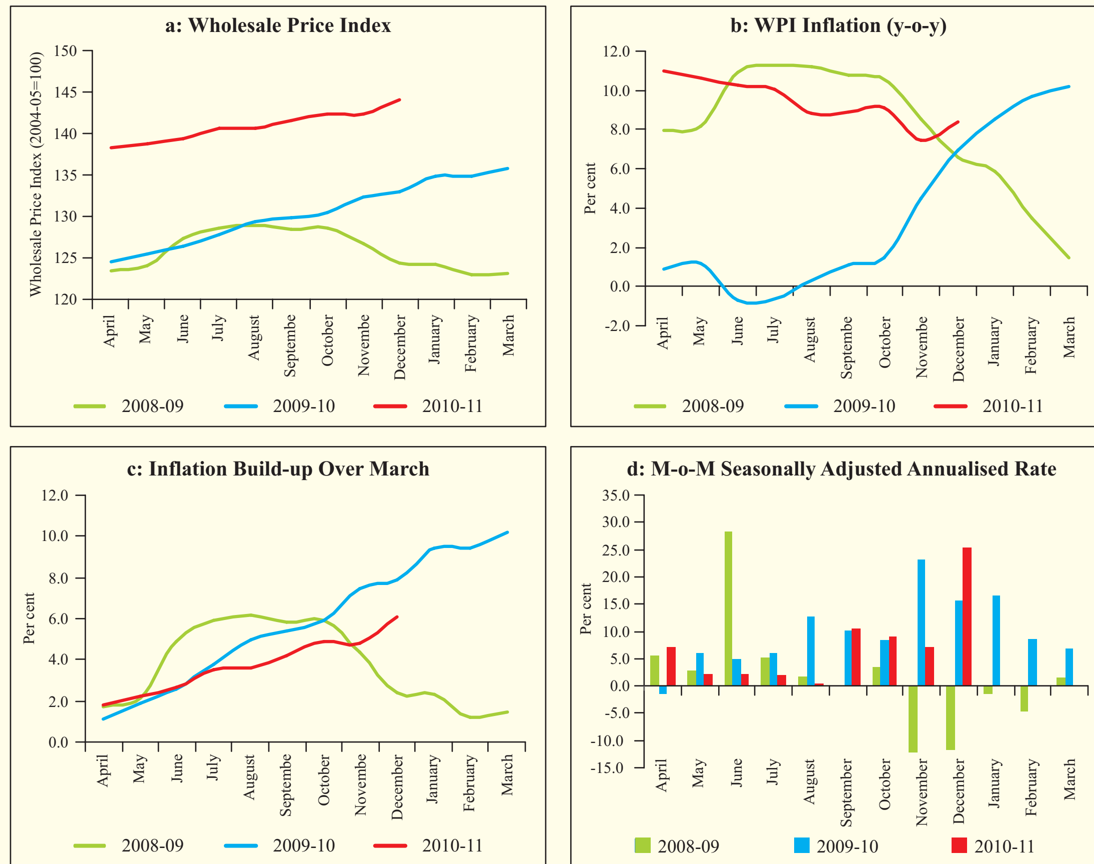
VI.1 Inflation resurgence during December 2010 was mainly led by a sudden spurt in prices of primary food articles, especially vegetables, and fuels. These together accounted for nearly 60 per cent of the WPI increase during the month. Currently inflation remains above the Reserve Bank's comfort level and the long-term average that was experienced during the pre-crisis high growth phase. Price expectations also remain elevated and price-level changes have not yet dampened (Chart VI.1a). Base effects have helped lower inflation on a year-on-year basis, but price pressures persist (Chart VI.1b). Food inflation moderated for a significant part of the year but still remains elevated and has witnessed renewed pressures in recent weeks. Though non-food manufactured products inflation remained range-bound during 2010-11 so far, the price index has shown some uptick in recent months and the risks to more generalised inflation appear to have re-emerged.

VI.2 Apart from food inflation, inflationary pressures have increased both from higher global commodity prices and domestic demand. Increasing trends in international commodity prices, especially crude oil and metals, entail the risk that rising international commodity prices will spill over into domestic inflation. Furthermore, significant price pressures in domestic non-food primary articles such as raw cotton, raw rubber and minerals may lead to increase in input costs for the manufacturing sector. The persistent price pressures are also evident from the high month-over-month seasonally adjusted annualised inflation in recent months (Chart VI.1d).

Changing dynamics underlying the inflation rebound

VI.3 Since the second quarter review of monetary policy in October 2010, there have been significant changes in the factors conditioning the inflation path. First, the primary food articles inflation declined to single digit after almost two years in November 2010 along the expected lines, but rose again on the back of significant rise in prices of vegetables like onion, tomato, okra, cabbage and brinjal owing to loss of output caused by unseasonal rains and supply chain rigidities. Some price pressures emerged in condiments and spices as well. Second, the global crude oil prices were averaging at about US$ 75 per barrel in the second quarter of 2010-11 with most forecasts and even futures prices indicating only gradual

Chart VI.1: Trends in Wholesale Price Inflation



recovery going forward. Contrary to the expectations, crude oil prices have firmed up significantly and crossed US$90 per barrel now. This exerted upward pressure on prices of freely priced products under the fuel group and increased risks ahead for further pass-through. Third, the global commodity prices, especially food, primary commodities and metals have increased substantially and the pass-through of global increases to domestic prices have so far been limited, suggesting risks from imported inflation going forward. Finally, the sharp increase in prices of non-food primary articles and minerals, like raw cotton and iron ore could put pressure on input costs for the manufactured products. Therefore, a host of factors, both anticipated and unanticipated, contributed to the upside surprise on expected inflation trajectory.

VI.4 As a result of newer factors and increased risks, the inflation trajectory is likely to show some persistence and moderate only gradually. In the Second Quarter Review of Monetary Policy, the inflation projection for March 2011 was placed at 5.5 per cent. In the mid-Quarter review of December 16, 2010, it was indicated that the risks to this projection are on the upside. Some of these upside risks have since materialised. First, the seasonal decline in food prices has still not occurred as a result of persistent inflation in primary food items. Second, global commodity prices are again on the upswing. This occurred due to: (a) better-than-anticipated growth outlook for certain key advanced economies, especially the US, (b) supply-disruptions in a number of primary commodities and (c) spillover effects of further quantitative easing (QE-2) in the US. The FAO food price index in December 2010 surpassed the peak it reached during the global food price shock of 2008, indicating significant price

pressures. Crude oil prices have firmed up further, putting pressure on the prices of the freely priced petroleum products, even while pass-through remains incomplete for the administered items. Third, input cost pressures from high primary commodity prices are exerting further pressure on manufactured products prices, combined with robust growth and strong demand.

Global inflation outlook suggests growing divergence and the associated asymmetry in the stance of monetary policy

VI.5 The global inflation environment continues to remain moderate but a rising divergence in inflation trends between advanced and emerging economies is perceptible (Table VI.1). Some of the advanced economies like the US and Japan face the macroeconomic challenge of generating some inflation to stimulate economic activity. Others like the euro area and UK are witnessing acceptable level of core inflation but with rising headline inflation and high rates of unemployment. Among emerging economies, China recorded a two year high in CPI inflation in November 2010. With the exception of Malaysia, all major South East Asian economies are facing inflationary pressures, just as is the case with most Latin American and East European economies.

VI.6 Subdued growth in advanced economies along with slack labour market conditions and well anchored inflation expectations provide room to sustain policy accommodation. However, advanced economies face enhanced risks of higher long-term inflation expectations, in the context of further fiscal stimulus being

Table VI.1: Global Inflation Indicators

(Per cent)

Country/ Region	Key Policy Rate	Policy Rate	(as on Jan. 21, 2011)	Changes in Policy Rates (basis points)		CPI Inflation (y-o-y)	
				Apr-09 to Aug-09	Since Sep-09	Dec-09	Dec-10
1	2	3		4	5	6	7
Developed Economies							
Australia	Cash Rate	4.75	(Nov. 3, 2010)	(-)25	175	1.3 ^	2.8 ^
Canada	Overnight Rate	1.00	(Sep. 8, 2010)	(-) 25	75	1.0 *	2.0 *
Euro area	Interest Rate on Main Refinancing Operations	1.00	(May 13,2009)	(-) 50	0	0.9	2.2
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10	(Oct. 5, 2010)	0	0	-1.9 *	0.1 *
UK	Official Bank Rate	0.50	(Mar. 5,2009)	0	0	2.9	3.7
US	Federal Funds Rate	0.0 to 0.25	(Dec.16,2008)	0	0	2.7	1.5
Developing Economies							
Brazil	Selic Rate	11.25	(Jan. 20, 2011)	(-) 250	250	4.3	5.9
India	Reverse Repo Rate	5.25	(Nov. 2, 2010)	(-)25	200	13.5 *	8.3 *
	Repo Rate	6.25	(Nov. 2, 2010)	(-) 25	150(100)		
China	Benchmark 1-year Deposit Rate	2.75	(Dec.26, 2010)	0	50	1.9	4.6
	Benchmark 1-year Lending Rate	5.81	(Dec.26, 2010)	0	50 (350)		
Indonesia	BI Rate	6.50	(Aug. 5, 2009)	(-) 125	0	2.8	7.0
Israel	Key Rate	2.00	(Oct. 1, 2010)	(-)25	150	3.9	2.7
Korea	Base Rate	2.75	(Jan 13, 2011)	0	75	2.8	3.5
Philippines	Reverse Repo Rate	4.00	(Jul. 9, 2009)	(-)75	0	4.4	3.0
	Repo Rate	6.00	(Jul. 9, 2009)	(-)75	0		
Russia	Refinancing Rate	7.75	(Jun. 1, 2010)	(-)225	(-)300	8.8	8.8
South Africa	Repo Rate	5.50	(Nov. 19, 2010)	(-)250	(-) 150	6.3	3.5
Thailand	1-day Repurchase Rate	2.25	(Jan.12, 2011)	(-) 25	100	3.5	3.0

^ : Q2 of 2010-11 * : November

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

Source: Websites of respective central banks/statistical agencies.

used in conjunction with enhanced monetary stimulus. Policy rates in advanced economies continue to remain near zero/very low as the concerns relating to sustainability of recovery still persist (Table VI.1). For EMEs, however, further quantitative easing by advanced economies and its potential impact on commodity prices could raise the upside risks to their domestic inflation. Several EMEs have started normalisation of their monetary policy stance, and the anti-inflationary monetary policy could become a more common response, going forward.

Risks of imported inflation from rising global commodity prices have amplified

VI.7 Upside risks to domestic inflation emanate from further hardening of global commodity prices, which have already started to rise since mid-2010. Global non-fuel commodity prices, especially food and metals, have been firming up since July 2010. Supply disruptions in many commodities and indications of further quantitative easing by some advanced economies initiated these trends (Chart VI.2). Since October 2010, international commodity price pressures have been exacerbated by hardening of global crude oil prices. On the back of easy global liquidity and severe winters in Europe and US, global crude oil prices crossed US$90 per barrel, in spite of ample spare capacities with some OPEC members. Simultaneous increase in prices of a number of commodities poses the risk of higher imported inflation.

VI.8 The magnitude of the spillover impact of rising prices of commodities in the world markets to India's inflation path would depend upon four factors: (a) the extent of increase in world prices of imported items, (b) movements in the exchange rate of rupee, (c) share of imported items in India's consumption basket, and (d) the degree of pass-through that may be suppressed by policy intervention in the domestic market. The pass-through from global prices to domestic prices has been particularly low in case of wheat, maize, sugar and edible oils (Table VI.2). These could be attributed to local supply conditions and administrative price measures in place. With significant increase in world prices of cotton, iron ore, gold and silver, domestic wholesale prices also rose significantly, though the pass-through was incomplete in many cases. Overall, domestic prices are now significantly impacted by the global commodity price movements, and hence, rising international prices is an important source of upward risk to domestic inflation.

Persistence of high food inflation reflects both structural imbalances and supply chain rigidities

VI.9 Persistence of food inflation has become a primary impediment to faster moderation of inflation. The expected degree of correction in

Chart VI.2: International Commodity Prices

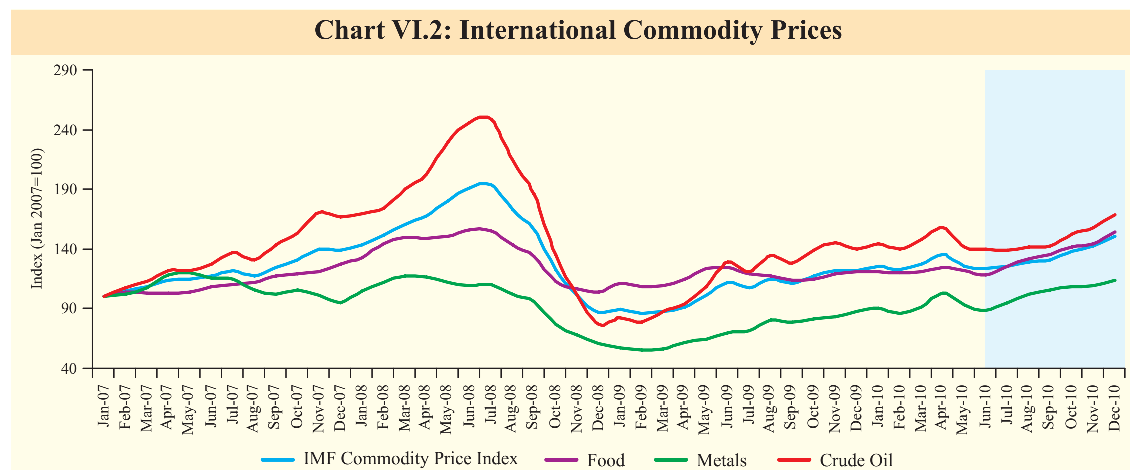


Table VI. 2: Movement in International and Domestic Commodity Prices

(Per cent change in December over March 2010)

Item	International Prices	Domestic Prices (WPI)
1	2	3
Rice	5.9	1.9
Wheat	60.4	-0.7
Maize	57.4	12.0
Soyabean oil	44.5	7.4
Sugar	50.0	-8.9
Cotton	95.8	31.6
Coal	21.9	0.0
Crude Petroleum	13.5	1.0 (9.5*)
Iron ore	80.3	23.9
Fertilizers	29.9	5.9
Aluminium	6.6	2.4
Copper	22.6	-0.7
Gold	24.9	31.7
Silver	71.2	39.7

Source: World Bank and Ministry of Commerce and Industry, GOI.
* Mineral Oils.

food prices after a normal monsoon did not materialise. Primary food articles with a weight of 14.3 per cent in WPI, contributed 38.6 per cent to the increase in overall WPI during Q3 of 2010-11 (Table VI.3). The decomposition of food inflation indicates that during the recent period the key drivers of food inflation are non-cereals (Chart VI.3). These were, apart from vegetables, the protein rich items. The supply response to growing demand in some of these items has been weak, leading to growing imbalances. Medium-term supply augmenting measures would be critical to contain the persistent pressure of inflation from this source. Import option to deal with this challenge on a permanent basis remains limited, given the size of demand and high global food prices.

VI.10 Extended spells of South-West monsoon and unseasonal rains in certain parts of the

Chart VI.3: Primary Food Articles Inflation

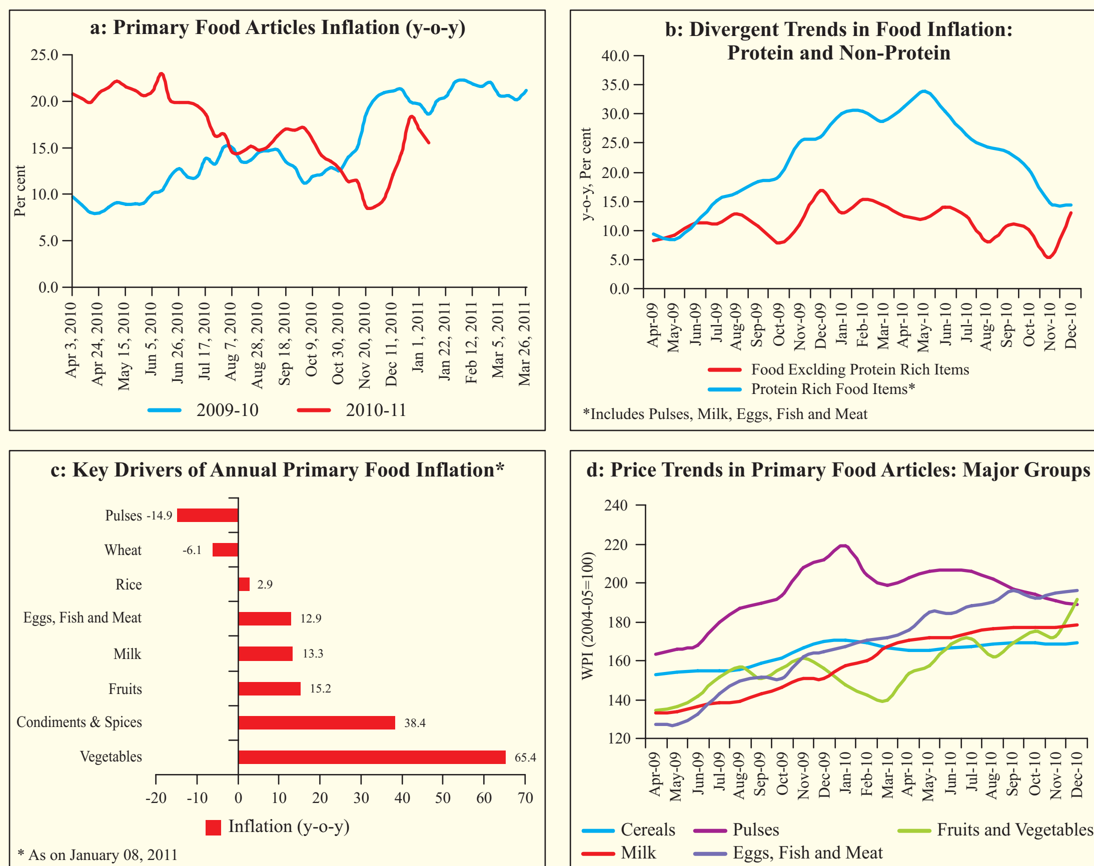


Table VI.3: Wholesale Price Inflation in India (2004-05=100)

Per cent

Commodity	Weight	2009-10 (March-10)		Year on Year Variation December-10		Financial Year Variation (Mar-10 to Dec-10)		Quarterly Variation (Sep-10 to Dec-10)	
		Inflation (y-o-y)	C *	Change in WPI	C*	Change in WPI	C*	Change in WPI	C*
1	2	3	4	5	6	7	8	9	10
All Commodities	**100.0**	**10.2**	**100.0**	**8.4**	**100.0**	**6.1**	**100.0**	**1.8**	**100.0**
1. Primary Articles	**20.1**	**22.2**	**48.1**	**16.5**	**48.0**	**13.9**	**55.7**	**4.5**	**62.7**
Food Articles	14.3	20.6	31.9	13.5	28.5	14.2	40.2	3.9	38.6
i. Rice	1.8	8.1	1.7	1.2	0.3	1.9	0.7	-0.1	-0.1
ii. Wheat	1.1	14.7	2.0	-5.1	-0.9	-0.7	-0.2	0.0	0.0
iii. Pulses	0.7	25.0	2.3	-10.9	-1.5	-5.0	-0.9	-3.8	-2.1
iv. Vegetables	1.7	13.6	2.2	24.9	7.0	70.4	19.4	18.7	23.6
v. Fruits	2.1	18.2	3.7	20.4	5.2	12.5	4.6	7.3	9.0
vi. Milk	3.2	24.9	8.6	18.2	8.0	6.8	4.4	0.8	1.7
vii. Eggs, Fish and Meat	2.4	35.5	8.6	19.2	6.8	13.8	6.9	-0.1	-0.2
Non-Food Articles	4.3	20.4	8.6	22.3	11.9	14.2	10.9	6.8	18.0
i. Raw Cotton	0.7	20.0	1.4	31.8	3.0	31.6	4.0	8.8	4.3
ii. Oilseeds	1.8	6.7	1.2	2.5	0.6	3.5	1.0	0.9	0.8
iii. Sugarcane	0.6	53.3	2.7	49.8	2.9	0.0	0.0	0.0	0.0
Minerals	1.5	37.9	7.7	27.7	7.5	10.3	4.4	4.2	6.0
2. Fuel Group	**14.9**	**13.8**	**20.1**	**11.2**	**20.1**	**7.1**	**18.0**	**1.7**	**14.3**
i. Coal	2.1	7.9	2.0	0.2	0.1	0.0	0.0	0.0	0.0
ii. Mineral Oils	9.4	18.6	17.1	15.8	18.3	9.5	15.7	2.5	14.0
iii. Electricity	3.5	3.4	1.0	5.0	1.7	5.0	2.2	0.0	0.0
3. Manufactured Products	**65.0**	**5.2**	**32.0**	**4.5**	**31.9**	**2.6**	**25.8**	**0.8**	**25.0**
i. Food Products	10.0	15.1	14.7	0.4	0.4	0.7	1.2	1.6	8.8
of which: Sugar	1.7	44.3	7.8	-9.9	-2.9	-8.9	-3.4	4.7	5.0
Edible Oils	3.0	0.4	0.1	5.3	1.7	7.0	2.9	1.9	2.7
ii. Cotton Textiles	2.6	12.7	2.7	14.1	3.7	9.4	3.4	3.6	4.4
iii. Man Made Fibres	1.7	10.5	1.4	11.9	1.8	5.3	1.1	3.2	2.3
iv. Chemicals and Chemical Products	12.0	3.7	4.1	4.4	5.6	2.6	4.5	0.6	3.2
of which : Fertilisers	2.7	1.9	0.4	6.7	1.7	5.9	2.1	-0.2	-0.2
v. Non-Metallic Mineral Products	2.6	3.2	0.9	3.6	1.1	1.0	0.4	0.7	1.0
of which: Cement & Lime	1.4	2.3	0.4	2.5	0.5	-0.7	-0.2	0.0	0.0
vi. Basic Metals, Alloys and Metal Products	10.7	1.4	1.5	7.9	9.5	4.3	7.3	0.6	3.3
of which: Iron and Semis	1.6	-0.2	0.0	9.3	1.5	1.7	0.4	1.5	1.1
vii. Machinery and Machine Tools	8.9	1.5	1.3	2.8	2.6	1.3	1.7	0.0	0.0
of which: Electrical Machinery	2.3	-1.1	-0.3	2.5	0.6	0.7	0.3	-0.1	-0.1
viii. Transport Equipment and Parts	5.2	1.2	0.6	2.6	1.4	1.4	1.0	0.3	0.8
Memo:									
Food Items (Composite)#	**24.3**	**18.5**	**46.6**	**8.6**	**29.0**	**9.2**	**41.4**	**3.1**	**47.4**
Food Items (Protein Based)$	**6.4**	**28.7**	**19.5**	**14.3**	**13.3**	**7.9**	**10.5**	**-0.1**	**-0.5**
Manufactured Non-food Products	**55.0**	**3.3**	**17.2**	**5.3**	**31.5**	**3.0**	**24.6**	**0.6**	**16.2**
WPI Excluding Food	**75.7**	**7.4**	**53.4**	**8.4**	**71.0**	**4.9**	**58.6**	**1.3**	**52.6**
WPI Excluding Fuel	**85.1**	**9.6**	**79.9**	**7.9**	**79.9**	**5.9**	**82.0**	**1.9**	**85.7**
Essential Commodities	**14.4**	**18.6**	**28.3**	**4.5**	**9.2**	**5.5**	**15.0**	**2.1**	**18.8**

* : Weighted contribution to increase in WPI. # : Primary Food Articles + Manufactured Food Products.
$: Includes milk, 'eggs, fish and meat' and pulses.

country have led to loss of vegetables output. Given its perishable nature and also the lack of adequate warehousing and storage facilities, the prices of vegetables increased significantly in December 2010 (Table VI.4). This is in contrast to the trend witnessed in previous years as the prices of vegetables usually show some seasonal decline during December following the arrival of winter crop in the market.

Table VI.4: Increase in Vegetables Wholesale Price Index

Per cent

Commodity	2009-10				2010-11			
	November		December		November		December	
	Variation	C*	Variation	C*	Variation	C*	Variation	C*
1	2	3	4	5	6	7	8	9
All Vegetables	1.7	100.0	-14.3	100.0	2.1	100.0	41.0	100
Potato	-12.1	-137.9	-27.3	-31.7	-0.5	-2.1	12.6	2.9
Onion	8.5	64.1	0.7	0.7	11.0	85.5	46.4	19.9
Tomato	46.7	359.6	-42.8	-56.1	-14.9	-93.7	116.8	31.1
Cauliflower	-12.1	-81.3	-4.6	-3.2	-18.6	-137.9	33.4	10.0
Brinjal	-14.1	-132.7	-13.8	-13.0	22.5	127.6	65.1	22.5
Okra (Lady Finger)	7.2	23.1	17.8	7.1	9.0	26.2	35.4	5.6
Cabbage	-14.8	-92.2	-5.9	-3.6	42.1	236.9	19.1	7.6

* Weighted contribution to overall increase in vegetable price index (in per cent).

Contribution of non-food manufactured products inflation to headline inflation remains steady

VI.11 On a year-on-year basis, the moderation in inflation witnessed up to November 2010 was largely on account of the decline in the contribution of food inflation to overall inflation (Chart VI.4). The contribution of manufactured non-food products increased marginally in November 2010 and remained unchanged in December 2010. Fuel group and non-food primary articles also continue to contribute significantly to overall inflation pointing towards persisting and generalised inflationary pressures.

VI.12 Among the major sub-groups of WPI, inflation remains higher in primary articles and 'fuel and power' group relative to manufactured products (Chart VI.5.a). Manufactured products inflation moderated largely on account of decline in sugar prices. Currently, all segments of primary articles - food, non-food and minerals are showing double-digit inflation. Non-food primary articles inflation has been exacerbated by revision in sugarcane index by about 50 per cent in March 2010 and increase in iron ore and raw cotton prices. Iron ore prices have doubled since December 2009, while raw cotton prices increased by more than 42 per cent since September 2010. Inflation in essential commodities declined significantly, more on account of the high base recorded a year ago.

Non-food manufactured products inflation remains range-bound, but some indication of price pressures visible

VI.13 Manufactured non-food products, which account for 55 percent weight in the WPI basket and seen as a broad indicator of generalised

Chart VI.4: Contribution to Overall Inflation - Major Groups

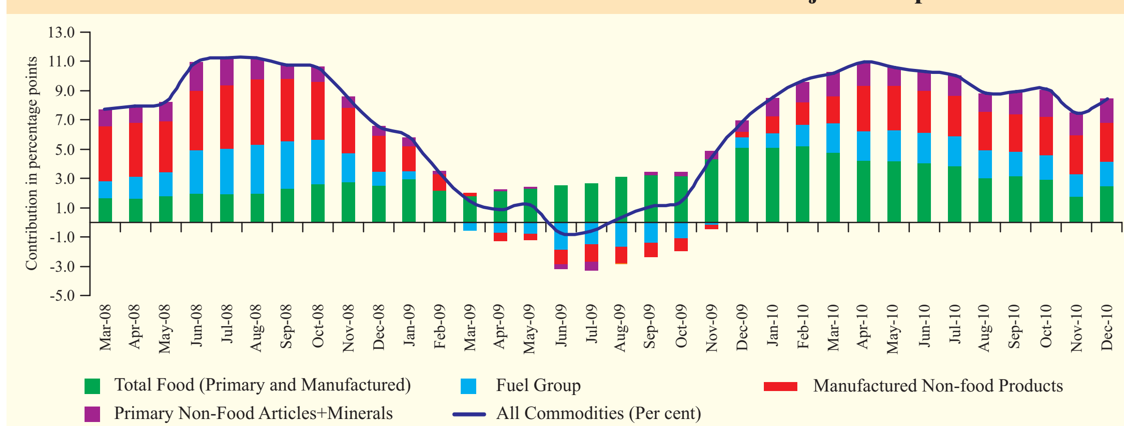
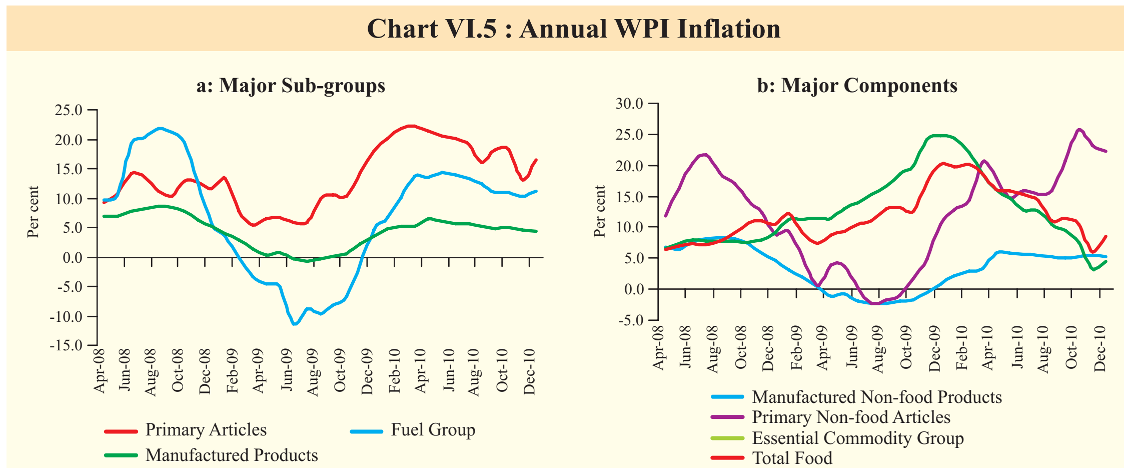


Chart VI.5 : Annual WPI Inflation



inflationary pressures exhibited near stable inflation path during 2010-11 (Chart VI.6). The flattening of inflation in non-food manufactured items in past few months could be partly in response to the monetary tightening of the past, but upside risks to this segment persist. This is corroborated by both upward trend in the price index and high month-over-month seasonally adjusted annualised inflation. This could largely be on account of the significant input cost pressures emanating from high primary commodity prices translating to higher output prices in the wake of buoyant demand.

Divergence between CPI and WPI inflation narrows, but elevated levels point to persistence of welfare costs

VI.14 Inflation, as measured by various consumer price indices, generally moderated during 2010-11, with some reversal witnessed in December 2010 (for CPI-Agricultural and Rural Labourers). Various measures of inflation remained in the range of 8.0-8.4 per cent in November/December 2010. While the extent of divergence between WPI and CPI inflation narrowed significantly, both remained elevated leading to significant welfare costs (Chart VI.7).

Upside risks to inflation have increased, suggesting the need for sustained anti-inflationary policy focus

VI.15 The underlying inflation trends suggest that the return of inflation to a more acceptable level could at best be gradual. Some of the domestic supply-side pressures could be transient in nature, and administrative steps to curb the price spiral and seasonal correction could soften prices, going ahead. However, the expected moderation can get offset by rising risk of transmission from increasing global commodity prices. Hardening international commodity prices, particularly petroleum, minerals and metal prices have already begun to seep through to domestic prices. As a result, some price pressures could persist, even as inflation softens. Suppressed inflation in the near-term due to administrative price interventions to insulate domestic prices from global price surges, particularly in respect of some of the petroleum products, could also become more open at a later stage.

Chart VI.6: Trends in Manufactured Non-food Products Inflation

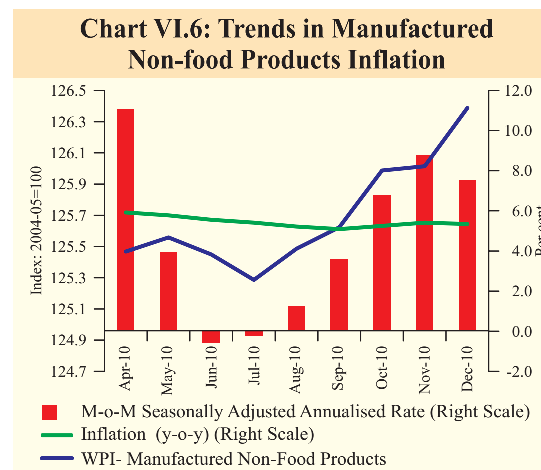
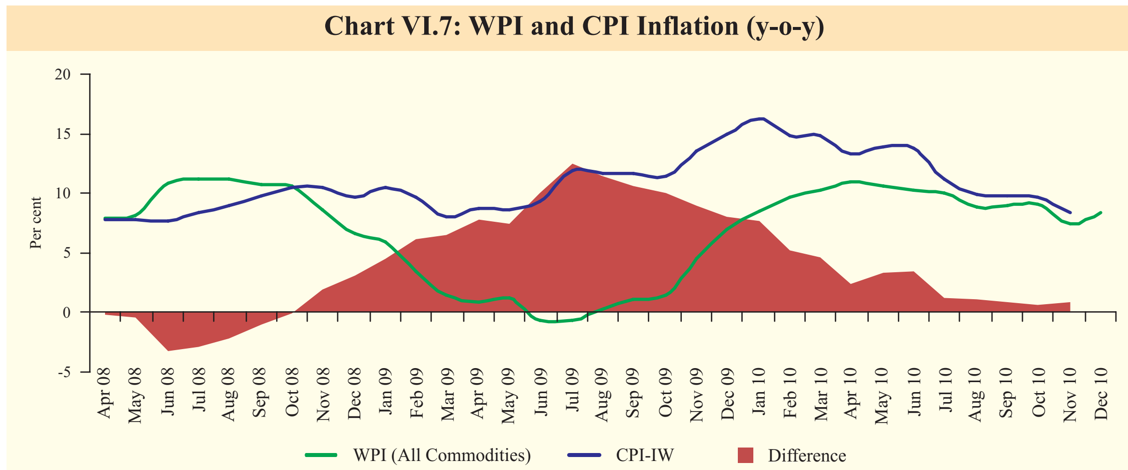


Chart VI.7: WPI and CPI Inflation (y-o-y)



VI.16 Even if inflation softens in the near-term, sustaining a low inflation regime would require addressing structural issues at a micro level. In the near-term, closer monitoring of production, consumption and price patterns in specific commodities with a focus on supply-chain management to contain market pressures would be helpful. There is also a need to focus on supply augmentation in the short-run, *inter alia,* through timely imports, wherever feasible.

VI.17 While inflation upsurge has largely come from supply-side elements, monetary policy would need to factor in near-term risks to inflation from high input cost pressures transmitting to output prices. The risks to generalised inflation cannot be overlooked as inflation expectations are currently ruling high. Anchoring inflationary expectations would be necessary to mute the second-round impact of supply-side shocks.

VII. MACROECONOMIC OUTLOOK

Indian economy has moved to a higher growth trajectory with the outlook remaining optimistic. Various forward looking surveys also indicate receding downside risks to growth in the near term. This is broadly corroborated by the Reserve Bank's Industrial Outlook Survey and the Professional Forecasters' Survey. Persistence of inflation at a high level and widening current account deficit are the two major policy concerns at the present juncture. While sensitivity of inflation to past monetary policy measures has remained subdued due to the very nature of the inflation process, larger capital inflows have met the financing need of the current account. Going forward, waning risks to the robust growth outlook and visible upside risks to the inflation outlook would shape the stance of monetary policy in the near term.

Growth optimism continues but high inflation could dent the process

VII.1 The robust growth momentum seen so far and the lead indications that this performance would be sustained in the near future are reflected in the forward looking surveys conducted by various agencies, which generally show significant y-o-y gains. The Reserve Bank's Industrial Outlook Survey also mirrors the optimism, especially regarding improvement in demand and overall financial conditions. The Professional Forecasters' Survey shows an improvement in (median) GDP growth rate to 8.7 per cent from 8.5 per cent reported in the previous survey. The growth projections of various domestic and international agencies also reflect the buoyant optimism.

Business expectations surveys exhibit optimism

VII.2 Various business expectations surveys show an optimistic picture about the near-term outlook (Table VII.1). Factors which provided a boost to the overall business expectations include possibility of improvement in exports (the CII Survey) and buoyant future demand conditions, alongwith rise in volume of sales and new orders (Dun and Bradstreet Survey). Factors that affected the business sentiment adversely include: (i) deterioration in investment climate and financial position of the firm relative to the previous round (the NCAER Survey), and (ii) concerns regarding the mounting inflationary pressures (the Dun and Bradstreet Survey and NCAER Survey).

VII.3 The seasonally adjusted HSBC Markit Manufacturing Purchasing Managers' Index (PMI) witnessed a slowdown in December 2010 even though the survey indicated strong momentum in manufacturing sector and rapid growth in order books. The survey, however, suggests that tight capacity constraints are getting reflected in higher outstanding business orders,

Table VII.1: Business Expectations Surveys

Period Index	NCAER- Jan. 2011 Business Confidence Index	FICCI Q2:2010-11 Overall Business Confidence Index	Dun & Bradstreet Q1: 2011 Business Optimism Index	CII Oct.-Dec. 2010-11 Business Confidence Index
1	2	3	4	5
Current level of the Index	158.5	76.2	171.2	66.2
Index as per previous survey	162.1	71.9	163.5	67.6
Index levels one year back	153.8	72.4	137.3	66.1
percentage change (q-on-q)	-2.2	6.0	4.7	-2.1*
percentage change (y-on-y)	3.1	5.2	24.7	0.2**

* : Change over the previous survey.
**: Change over October-March 2009-10 survey.

lengthening of delivery times and increase in both input and output prices.

VII.4 The pace of growth in the HSBC Markit Services PMI showed a moderation in December 2010, even though the outlook about future business prospects remained generally optimistic. On the downside, the input costs as well as the output prices of the services sector rose substantially, suggesting that Indian companies passed on higher costs to customers.

The Industrial Outlook Survey of the Reserve Bank shows improvement in demand and overall financial conditions

VII.5 The 52nd round of the Industrial Outlook Survey of the Reserve Bank conducted during October-December 2010, based on a sample of 1,561 companies, showed an improvement for the assessment quarter (October–December 2010) and a marginal moderation for the expectation quarter (January-March 2011) (Chart VII.1a and b). The modest moderation at a high level of the index suggests expectations of sustained buoyancy in economic activities. The indices for both assessment and expectation quarter remained in the growth terrain (*i.e.* above 100, which is the threshold that separates contraction from expansion).

VII.6 The survey shows that the Indian manufacturing sector has an optimistic view about improvement in demand conditions *viz.* production, order books, capacity utilisation and exports for the assessment quarter. However, a slight moderation is indicated for the expectation quarter. Overall financial situation, working capital finance requirement as well as availability of finance showed improvement for both assessment and expectation quarters, *albeit* at higher costs. The survey results suggest that manufacturers expect selling prices and profit margins to increase despite expectations of rising input costs, which reflect their pricing power. On the employment outlook, Indian manufacturers were perceived to be net hirers (Table VII.2).

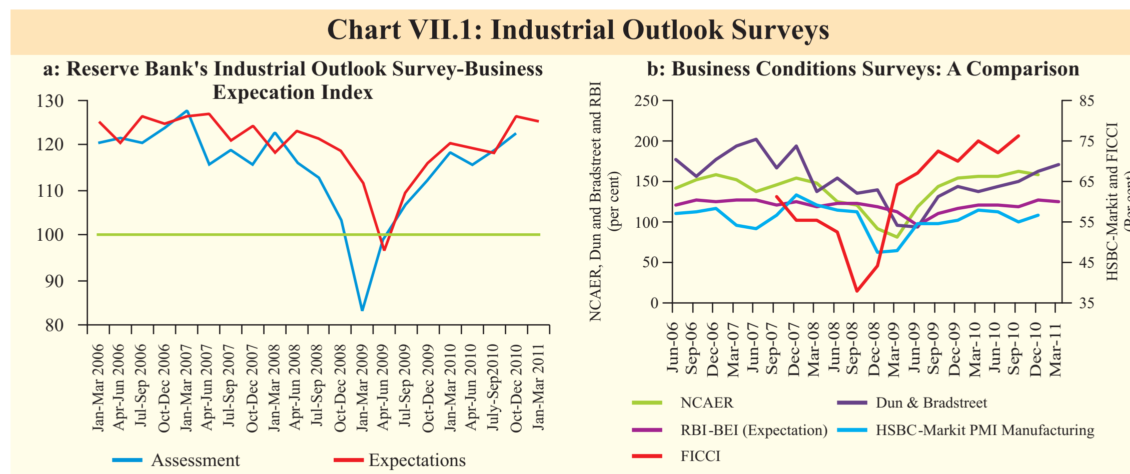
Survey of Professional Forecasters[1]

VII.7 The results of the 14th round of 'Survey of Professional Forecasters' conducted by the Reserve Bank in December 2010 shows overall (median) GDP growth rate for 2010-11 at 8.7 per cent, as against 8.5 per cent reported in the previous survey (Table VII.3).

Projections of different agencies peg growth in the range of 8.4 to 9.1 per cent

VII.8 All available projections for GDP growth in 2010-11 generally suggest

Chart VII.1: Industrial Outlook Surveys



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

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

Parameter	Optimistic Response	Net Response						
		Apr-Jun 2010		July-Sep 2010		Oct-Dec 2010		Jan-Mar 2011
		E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9
1 Overall business situation	Better	41.2	40.7	41.5	38.7	47.5	45.9	50.1
2 Overall financial situation	Better	36.3	32.2	34.1	30.6	39.6	37.1	41.1
3 Availability of finance	Improve	26.8	26.4	28.5	26.6	31.3	30.3	32.3
4 Cost of external finance	Decrease	-20.6	-21.9	-23.3	-28.3	-28.3	-33.9	-31.3
5 Production	Increase	35.9	35.4	40.2	40.0	49.1	43.9	48.6
6 Order books	Increase	33.4	31.3	36.3	36.1	44.8	37.9	44.0
7 Cost of raw material	Decrease	-48.6	-62.7	-49.3	-58.3	-49.3	-63.9	-53.6
8 Capacity utilisation	Increase	19.7	21.1	26.5	23.3	32.3	27.9	33.1
9 Employment in the company	Increase	13.6	14.7	16.8	18.7	21.0	19.4	20.6
10 Selling prices	Increase	13.3	17.3	15.2	13.8	17.0	20.2	18.6
11 Profit margin	Increase	3.2	-4.8	3.1	-2.5	9.2	-0.4	8.3

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.

an optimistic picture (Table VII.4). Recently, the IMF and World Bank revised their growth projections for India upwards.

Table VII.3: Professional Forecasters' Survey

	Actual	Annual Forecasts				Quarterly Forecast									
	2009-10	2010-11		2011-12		2010-11				2011-12					
						Q3		Q4		Q1		Q2		Q3	
		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)	7.4R	8.5	8.7	8.5	8.5	8.7	8.9	8.3	8.5	8.1	8.4	8.5	8.5	-	8.3
a. Agriculture & Allied Activities	0.2R	4.6	5.0	3.2	3.3	6.5	6.8	5.1	5.0	3.2	3.5	3.0	3.1	-	3.4
b. Industry	10.4R	9.0	9.0	9.1	8.7	8.7	8.5	7.9	7.3	8.1	7.6	8.0	8.1	-	8.8
c. Services	8.3R	9.2	9.6	9.5	9.5	9.4	9.8	9.2	9.6	9.5	9.5	9.6	9.5	-	9.6
2. Gross Domestic Saving (per cent of GDP at current market price)	-	34.0	34.0	35.3	35.5	-	-	-	-	-	-	-	-	-	-
3. Gross Domestic Capital Formation (per cent of GDP at current market price)	-	36.0	36.0	37.0	37.0	35.5	35.1	37.5	36.3	36.0	35.7	36.5	35.9	-	36.8
4. Corporate profit after tax (growth rate in per cent)*	28.8	20.0	20.0	23.0	21.2	15.0	12.8	20.0	15.8	20.0	17.5	20.0	14.1	-	16.0
5. Inflation WPI (Avg.)	3.6	8.1	8.5	5.6	6.6	7.4	7.8	6.0	6.6	5.4	6.4	5.9	6.9	-	7.0
6. Exchange Rate (INR/US$ end period)	45.1	44.5	44.5	43.5	43.5	45.0	44.9	44.4	44.5	44.3	44.1	43.5	43.9	-	43.9
7. T-Bill 91 days Yield (per cent-end period)	4.4	6.0	6.8	5.8	6.9	-	-	-	-	-	-	-	-	-	-
8. 10-year Govt. Securities Yield (per cent-end period)	7.8	7.9	8.0	7.9	8.0	-	-	-	-	-	-	-	-	-	-
9. Exports (growth rate in per cent)!	-3.6	15.9	18.0	15.0	17.8	-	-	-	-	-	-	-	-	-	-
10. Imports (growth rate in per cent)!	-5.6	19.7	20.0	15.7	18.0	-	-	-	-	-	-	-	-	-	-
11. Trade Balance (US$ billion)	-108.2	-	-	-	-	-38.5	-31.5	-37.9	-35.7	-37.3	-38.1	-36.9	-40.7	-	-41.2

E: Previous Round Projection. L: Latest Round Projection. R: Revised Estimate

P: Preliminary Value - : Not Available. *: BSE listed companies. !: US$ on BoP basis.

Note: The latest round refers to fourteenth round for the quarter ended December 2010, while previous round refers to the thirteenth round for the quarter ended September 2010.

Source: Survey of Professional Forecasters, Third Quarter 2010-11.

While downside risks to growth have receded, upside risks to inflation have increased

VII.9 The outlook for growth remains buoyant. The inflation persistence led by stubbornly high food inflation in double digits for close to two years, however, remains a major concern. Going forward, the factors that may lend further support to the growth momentum include: (a) improved *kharif* production (that will be reflected in Q3 GDP data) and favourable prospects of *rabi* production on account of satisfactory north-east monsoon and higher reservoir levels, (b) robust growth in lead indicators of services sector, (c) sharp rise in tax revenues indicating strong economic activity, (d) stronger growth in corporate sales and earnings, (e) improvement in employment indicators, (f) pick-up in private consumption demand, (g) continuing strong credit growth, especially to the infrastructure sector, (h) buoyancy in various business expectation surveys, (i) possibility of fiscal consolidation, which would reduce crowding out risks and (j) easing of liquidity conditions, as the government spends more from its surplus balances, which in turn may ease the concerns of liquidity stress impacting flow of credit.

VII.10 However, certain downside risks to growth remain, which include: (a) sovereign debt risks spreading from the Euro zone periphery, which may adversely affect external demand, (b) strong capital inflows beyond the absorptive capacity putting pressure on the exchange rate, which could also weaken price competitiveness of Indian exports, (c) volatile industrial growth, which adds to uncertainty to the industrial growth outlook, (d) growth in core infrastructure lagging behind GDP growth as well as industrial growth and, (e) inflationary pressures.

VII.11 The persistence of inflation at an elevated level and the significant pick-up in December 2010 suggest the amplification of upside risks to inflation. Going forward, factors which may exert further upward pressure on inflation are: (a) higher international commodity prices, especially oil, (b) increase in global food prices and the regional outlook suggesting continuation of the trend, which could further limit the import option as countries may ban/ restrict exports to ease potential pressures on their domestic inflation, (c) return of pricing power to corporates, (d) improving bargaining power of both organised and unorganised labour, with MGNREGS contributing to the wage pressures in the farming and unorganised manufacturing sectors, (e) capacity constraints in several sectors, particularly farm products, where supply response to high prices may continue to be slow, (f) continuous upward revision in minimum support prices reflecting rising input costs, (g) risk of suppressed inflation becoming open, resulting from revision of diesel and other administered petroleum product prices,

Table VII.4: Agencies' Projections for 2010-11

Agency	Latest Projection		Earlier Projection	
	Real GDP Growth (Per cent)	Month	Real GDP Growth (Per cent)	Month
1	2	3	4	5
World Bank	8.7	Jan-11	8.5	Jun-10
IMF	8.8	Jan-11	8.0	Feb-10
Ministry of Finance	8.8(+/-0.35)	Dec-10	8.5(+/-0.25)	Feb-10
OECD@	9.1	Nov-10	8.3	May-10
NCAER	8.4	Oct-10	8.1	July-10
ADB	8.5	Sep-10	8.2	July-10
Economic Advisory Council to the PM	8.5	July-10	8.2	Feb-10

@: At market prices, while others are at factor cost.

when the implicit subsidy burden increases significantly and (h) prevalence of high inflationary expectations.

VII.12 Notwithstanding these risks, factors that may help in restraining the inflationary pressures include: (a) government measures to improve bottlenecks in the supply chain from farm gate to retail, (b) expected moderation in food inflation with a good *rabi* crop, (c) subdued risk to inflation in advanced economies due to large excess capacity and high unemployment, even though in the Euro-area and the UK headline inflation has edged up in the recent period and (d) the impact of monetary policy actions taken by the Reserve Bank, particularly after the strengthening of transmission in recent months.

VII.13 To sum up, while growth prospects remain robust, persistence of high inflationary expectations poses a complex challenge for the conduct of monetary policy. The challenge is exacerbated by the fact that inflationary pressures are emanating from sources that are not very sensitive to monetary policy measures. Growing demand-supply imbalances in several non-cereal food items have led to sharp relative price changes, which in turn have pushed up the headline inflation. While non-food manufactured inflation has been stable in a range of 5.1-5.9 per cent, the month-over-month increase in price index in recent months reflects emerging demand side pressures as well as rising input costs. In an environment of high food and fuel inflation, the risk of spillover to the core inflation through higher input costs and inflationary expectations, remains. As long as the structural factors underpinning the relative price pressures persist, the impact of anti-inflationary monetary policy could remain dampened. The 300 basis points effective increase in the policy rate from March 2010 so far, was carefully calibrated by the Reserve Bank reflecting the need for sensitivity of monetary policy to both growth and inflation objectives. Since persistent high inflation could endanger the growth objective and also amplify risks to inclusive growth, containing inflation will have to remain as the predominant objective of monetary policy in the near-term.