RESERVE BANK OF INDIA

Macroeconomic and Monetary Developments Third Quarter Review 2013-14

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

Overview

1. *During the course of 2013-14, monetary policy had to face an extraordinary spell of financial turbulence arising from the US Fed contemplating tapering its large scale asset purchase programme. The news heralded the turning of the global interest rate cycle with volatile movements for cross-border capital flows and asset prices. Like most emerging market and developing economies (EMDEs), India faced capital outflows and intense exchange rate pressures. Monetary policy had to depart from its charted course of calibrated monetary easing that had started in April 2012 using the monetary policy space that was gradually becoming available. Past monetary tightening was dampening the pricing power of the corporates and the return to fiscal consolidation in H2 of 2012-13 was reducing the twin deficit risks. Though macroeconomic weaknesses were evident in the form of persistence in inflation, falling growth, weaker corporate balance sheet, deteriorating asset quality of the banks, fiscal imbalances and external sector vulnerabilities, the economy seemed to be mending. However, the prospect of tapering interrupted this.*

2. *The event resulted in a rapid deterioration of financial conditions across emerging markets, including India. The rupee exchange rate depreciated by 17 per cent against the US dollar, amid a foreign exchange reserve depletion of nearly US$17 billion, between the first indication of tapering and September 3, 2013. There were net FII disinvestments of over US$13.4 billion (US$10.5 billion in debt and US$2.8 billion in equity) over this period. Large capital outflows and sliding currency brought to fore the underlying macro-economic weaknesses. Stabilisation of the economy by restoring exchange rate stability became the overriding task.*

3. *Short-term interest rates were raised by hiking the Marginal Standing Facility (MSF) rate by 200 bps and siphoning off excess liquidity with a view to defending the rupee exchange rate. Several other measures were introduced, either to restrain the current account deficit (CAD) or to improve its financing. These policies, along with a forward-looking blueprint for further financial market reforms laid down by the Reserve Bank on September 4, helped turn the tide and stabilise financial market conditions. Since that point, rupee has appreciated 6.7 per cent (till January, 27, 2014) against the US dollar and the reserve loss has been more than fully recouped. Capital flows resumed, with net investment of US$9.1 billion in equities during September 4, 2013 to January 24, 2014. Though there were large disinvestments in the debt segment aggregating US$ 14.5 billion from May 22 to end-November 2013, debt flows have turned positive thereafter with net investments of US$ 3.8 billion. More importantly, the looming external sector risks*

were mitigated with CAD shrinking from 4.9 per cent in Q1 of 2013-14 to 1.2 per cent of GDP in Q2. With the resultant improved stability in the foreign exchange market, the Reserve Bank quickly moved to normalise exceptional liquidity and monetary measures and recalibrate monetary policy, taking into account, the prevailing inflation and growth conditions. The MSF rate was lowered by 150 bps in three steps, while the repo rate was raised by 50 bps in two steps. Besides liquidity conditions were eased to realign operational policy rate to the repo rate that is now 25 bps higher than at the start of the year. The Reserve Bank has maintained a tight monetary policy stance but has desisted from stiff tightening keeping in mind the weak state of economy. It has been evolving its policy action with rapidly changing financial and macroeconomic conditions.

4. *This Report explains the recent policy actions and provides a macroeconomic backdrop to global and domestic economic conditions that have gone into formulating the monetary policy response to the third quarter review. The highlights of the report are the following:*

Global Economic Conditions

Global growth prospects improve, though downside risk still exist

5. *Global growth, after decelerating for the last three years is poised to improve in 2014, but risks to outlook remain with uncertainties arising from moves to unwind unconventional monetary policies and possibility of a renewed deflation in the euro area. Economic expansion in the US is gaining firmer footing and will aid recovery in global activity and trade. Recovery in large EMDEs could stay moderate as supply-side constraints, tight monetary policies and tightening of financial conditions with tapering by the US could act as a drag on growth acceleration.*

6. *Inflation has continued to be low in advanced economies (AEs) aided by high unemployment and large spare capacities. After a year of deflation, inflation picked up in Japan. Among the emerging economies, monetary policy was tightened further by Indonesia, India, and Brazil, as they confronted high inflation and pressures on their exchange rates. Going forward, inflation risks for EMDEs are likely to stay in the near-term conditioned by structural factors and demand pressures emanating from narrowing output gap. However, global commodity price cycle is likely to stay benign on the back of improved supplies of oil, metals and food.*

7. *The US Fed's announcement on December 18 of tapering of its large scale asset purchase programme had a limited impact on global financial markets in sharp contrast to the May indication. India, having rebuilt its buffers during Q3, withstood the announcement better than many of its peers. Going forward, the spacing of the Fed's tapering moves over the course of 2014 could influence market movements even though some of it seems to have been priced in.*

Indian Economy: Developments and Outlook

Output

Growth may improve a tad in H2 of 2013-14 due to rebound in agriculture and improved exports

8. *Growth in H2 of 2013-14 may turn out to be marginally higher than H1, mainly due to a rebound in agriculture output and improved export performance. However, industrial growth continues to stagnate and leading indicators of the services sector exhibit a mixed picture.*

Clear signs of a pickup are yet to emerge, though a modest recovery is likely to shape up in 2014-15. Durable recovery remains contingent on addressing persistent inflation, and the bottlenecks facing the mining and infrastructure sectors.

Aggregate Demand

Aggregate demand slowly picking up, but would require support through public investment to crowd-in private investment

9. *Aggregate demand in the economy exhibited some improvements during Q2 of 2013-14 mainly on account of surge in net exports. However, private consumption expenditure, the mainstay of aggregate demand stayed low in the face of high inflation that has caused discretionary demand to fall. The investment cycle is yet to turnaround. However, corporate sales have improved during Q2, indicating that demand may have started improving. Overall, aggregate demand is expected to receive support from rural demand and exports, though downside risks emanate from public spending cuts. The pick-up in demand in the coming year depends critically on the successful resolution of bottlenecks facing infrastructure and energy-intensive industrial projects. It is also important to create fiscal space in 2014-15 to support public investment by restraining revenue spending, so as to crowd in private investment. As such the quality of government spending has to improve to support growth.*

External sector

Lower trade deficit in Q2 and Q3 of 2013-14 brings CAD to sustainable levels

10. *In response to the adjustment of the rupee exchange rate, disincentivising on gold imports, as also improvement in global trade, India's trade deficit during April-December 2013 has been 25 per cent lower than last year. Consequent to lower trade deficit, CAD declined from 4.9 per cent of GDP in Q1 to 1.2 per cent of GDP in Q2 of 2013-14 and the full year CAD is likely to be below 2.5 per cent of GDP. This, along with recouping the reserve loss due to the Reserve Bank's swap windows helped mitigate external sector risks. However, as capital flows to EMDEs could moderate over 2014-15, there is no scope for complacency and the breather provided by a reduction in the immediate risks, needs to be used to develop the resilience of the external sector over the medium-term.*

Monetary and Liquidity Conditions

Monetary policy evolving with changing macro-financial conditions

11. *Large capital outflows and consequent exchange rate pressures since May changed the course of monetary policy. Short-term interest rates were raised and liquidity conditions were tightened considerably through exceptional measures till such time as the exchange rate stabilised. Since then the exceptional measures have been normalised, though resurgence in inflation prompted policy rate increases. Also, additional liquidity was provided through term repos and forex swaps. The latter added to net foreign assets (NFAs) and turned out to be a significant driver of reserve money growth in Q3 of 2013-14.*

Financial Markets

Normalcy restored in financial markets but political outcomes and commitment to reforms hold the key

12. *Normalcy was restored in both global and domestic financial markets after the May tapering indications abruptly tightened financial*

conditions. Due to rebuilding of buffers, the Indian financial markets successfully withstood the effect of the Fed's tapering decision in December 2013. In fact, equity markets gained by over 9 per cent during Q3 as markets priced in macroeconomic improvement arising mainly from lower external sector risks and better-than-expected corporate results. However, primary capital markets remained subdued. While global investors had turned overweight on Indian equities in the 2014 asset allocations, the performance of markets in the near term will be conditioned by political risks and commitment to reforms.

Price Situation

Inflation declines significantly on vegetable price correction but CPI ex-food and fuel inflation exhibits persistence

13. *Inflation declined significantly in December 2013, both in terms of the CPI and WPI, driven by falling food prices which had firmed up considerably during April-November. Despite the moderation, CPI inflation continued to remain high near 10 per cent with inflation excluding food and fuel components also remaining persistent at 8.0 per cent. Earlier, the path of disinflation was disrupted by a series of food price shocks during June-November and a weaker rupee. Food price pressures reflect rising input costs, including higher agriculture wages, output shortfalls and uncompetitive supply chains. Non-food manufactured products WPI inflation has remained subdued so far in the presence of a negative output gap, though it has increased recently due to cost-push pressures. These pressures, along with second-round impacts, have also caused consumer price inflation, ex-food and fuel to remain persistently high.*

Macroeconomic Outlook

Gradual recovery likely in 2014-15; risks to inflation stay despite some moderation

14. *Various surveys, including the Reserve Bank's Industrial Outlook Survey, show that business confidence has started to rebuild. On current reckoning, growth in 2013-14 is likely to fall somewhat short of the Reserve Bank's earlier projection of 5.0 per cent. However, a moderate paced recovery is likely to shape in the next year with support from rural demand, a pick-up in exports and some turnaround in investment demand. The growth in 2014-15 is likely to be in the range of 5 to 6 per cent, with likelihood of it being in higher reaches of this forecast range as project clearances translate into investment, global growth outlook improves, and inflation softens. Despite moderation in December and some further softening expected in near term, inflation risks have to be watched carefully as we enter into the next year. This is due to upward revision in domestic energy prices, expected growth acceleration, structural bottlenecks affecting food inflation and adverse base effects. Headline CPI inflation is expected to remain above 9 per cent in Q4 of 2013-14 and range between 7.5 to 8.5 per cent in Q4 of 2014-15, with the balance of risks tilted on the upside.*

I. OUTPUT

After subdued activity in H1 of 2013-14, growth may improve a tad in H2 on the back of a rebound in agriculture output and improved export performance. However, industrial growth continues to languish and most segments of the services sector continue to underperform. Clear signs of a pickup are yet to emerge, though with some improvements in the business climate, modest recovery is likely to shape up in 2014-15. On the global front, advanced countries have recorded better-than-expected growth led by the recovery in the US. However, the acceleration in growth could lose some steam with the gradual withdrawal of accommodative policies. Nevertheless, with improved prospects for global growth in 2014, external demand could lend some support to domestic growth. Durable domestic recovery, however, remains contingent on addressing persistent inflation and bottlenecks facing the mining and infrastructure sectors.

Global growth prospects improve, though downside risks still exist

I.1 After three years of deceleration, global growth is poised to improve in 2014, but risks to outlook remain with uncertainties about how growth will withstand the withdrawal of extraordinary monetary accommodation on the back of unconventional monetary policies and risks of renewed deflation in the euro area. Though growth in advanced economies (AEs) may improve, negative output gaps may persist. Recovery in the large emerging market and developing economies (EMDEs) is expected to be slow, in part, due to tighter financial conditions. The International Monetary Fund (IMF) in its January 2014 World Economic Outlook update, projected the global growth to be higher in 2014, at 3.7 per cent as compared with 3.0 per cent in 2013. The latest projection is 0.1 percentage point higher as compared with October 2013 forecast and reflects mainly an improved growth outlook for AEs.

I.2 The US GDP increased at an annual rate (seasonally adjusted annualised quarter-on-quarter growth rate, q-o-q saar) of 4.1 per cent in Q3 of 2013 as against 2.5 per cent in Q2. This was primarily due to a deceleration in imports and acceleration in both private inventory investments and state and local government spending that were partly offset by deceleration in exports. The United Kingdom continued on a recovery path for the third consecutive quarter in Q3 of 2013 with a growth of 3.1 per cent (q-o-q saar). However, the expectation of faster growth has diminished for Japan with q-o-q deceleration for two successive quarters. Also the prospects of its recovery in 2014 have been diminished by consumption tax increases that are scheduled for April. The euro area also slowed down in Q3 of 2013, though maintaining positive growth.

I.3 Among the EMDEs, China's GDP growth in Q4 of 2013 slowed down to 7.4 per cent (q-o-q saar) as compared with 9.1 per cent in Q3. China's local government debt and financial sector problems pose a downside risk. Growth imbalances continue in China with sustained reliance on investment-led growth and rising local government debt levels. Brazil's GDP witnessed a contraction of 1.9 per cent (q-o-q saar) in Q3 of 2013 in contrast to a growth of 7.2 per cent in Q2.

I.4 Gradual improvement in labour market conditions continue in the US with the unemployment rate dropping from 7.9 per cent in January 2013 to 6.7 per cent in December. The United Kingdom also witnessed a distinct decline in the unemployment rate to 7.1 per cent during September-November 2013. However, the euro area continued to witness high

Table I.1: Slow growth persists with slack in industrial output and under-performance of services sector

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

(Per cent)

Industry	2011-12*	2012-13#		2012-13				2013-14		2012-13	2013-14
		Growth	Share	Q1	Q2	Q3	Q4	Q1	Q2	H1	H1
1	2	3	4	5	6	7	8	9	10	11	12
1. Agriculture, forestry & fishing	**3.6**	**1.9**	**13.7**	**2.9**	**1.7**	**1.8**	**1.4**	**2.7**	**4.6**	**2.3**	**3.6**
2. Industry	**2.7**	**1.2**	**18.9**	**-0.2**	**0.5**	**2.3**	**2.0**	**-0.9**	**1.6**	**0.2**	**0.3**
2.1 Mining & quarrying	-0.6	-0.6	2.0	0.4	1.7	-0.7	-3.1	-2.8	-0.4	1.0	-1.6
2.2 Manufacturing	2.7	1.0	15.1	-1.0	0.1	2.5	2.6	-1.2	1.0	-0.5	-0.1
2.3 Electricity, gas & water supply	6.5	4.2	1.9	6.2	3.2	4.5	2.8	3.7	7.7	4.7	5.7
3. Services	**7.9**	**6.8**	**67.4**	**7.6**	**7.1**	**6.2**	**6.3**	**6.2**	**5.8**	**7.3**	**6.0**
3.1 Trade, hotels, transport & communication	7.0	6.4	27.8	6.1	6.8	6.4	6.2	3.9	4.0	6.4	4.0
3.2 Financing, insurance, real estate and business services	11.7	8.6	18.7	9.3	8.3	7.8	9.1	8.9	10.0	8.8	9.5
3.3 Community, social & personal services	6.0	6.6	13.0	8.9	8.4	5.6	4.0	9.4	4.2	8.6	6.6
3.4 Construction	5.6	4.3	7.8	7.0	3.1	2.9	4.4	2.8	4.3	5.1	3.5
4. GDP at factor cost	**6.2**	**5.0**	**100.0**	**5.4**	**5.2**	**4.7**	**4.8**	**4.4**	**4.8**	**5.3**	**4.6**

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

unemployment rate at 12.1 per cent in November 2013. The unemployment rate in Japan remained unchanged at 4 per cent in November 2013.

Growth deceleration in India arrested in Q2 of 2013-14

I.5 Growth in India's GDP picked up moderately in Q2 of 2013-14 reversing the direction of the previous quarter's movement (Table I.1). The pickup was confirmed by the trend in the GDP growth saar (Chart I.1). However, despite this pickup, the growth rate in H1 of 2013-14 was lower than in H1 of last year. Inflationary pressures and structural bottlenecks are some of the factors weighing down the growth process.

Prospects for rabi crops improve due to post-monsoon rainfall

I.6 After a normal south-west monsoon, the post-monsoon rainfall added to the soil moisture and major reservoirs continued to have water storage above the previous year's level. The absence of extreme climatic events has further helped the progress of *rabi* sowing. Preliminary data suggest that sowing under all *rabi* crops till January 24, 2014 was 5.3 per cent higher than in the previous year (Table I.2). The confluence of these favourable factors is expected to boost agricultural growth prospects significantly during 2013-14. The production of

Chart I.1: Momentum indicator confirms pickup in growth

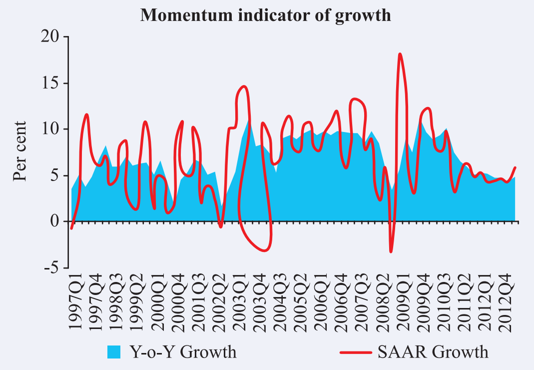


Table I.2: Prospects for *rabi* crop are satisfactory

Progress of rabi sowing 2013-14

(Area in million hectares)

Crops	Sowing as on January 24, 2014			Percentage Change
	Normal as on Date	2014	2013	
1	2	3	4	5
Foodgrains	**50.8**	**54.7**	**51.8**	**5.6**
Wheat	28.9	31.5	29.6	6.4
Rice	1.3	1.5	1.1	36.4
Coarse Cereals	6.3	6.0	6.2	-3.2
Pulses	14.4	15.7	14.9	5.4
Oilseeds	8.8	8.8	8.6	2.3
All Crops	**59.7**	**63.5**	**60.3**	**5.3**

Source: Ministry of Agriculture, Government of India.

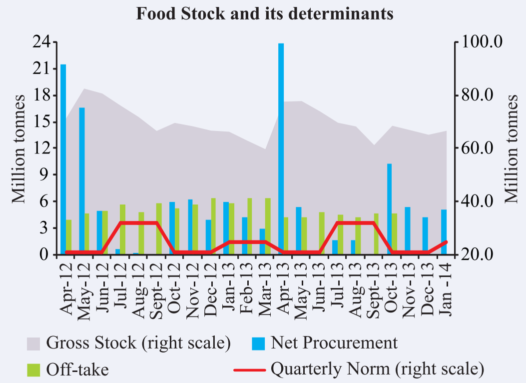
most *kharif* crops as per the first advance estimates has been estimated to be higher than the previous year.

I.7 However, the prices of food articles in recent months, particularly of vegetables and fruits, witnessed spikes due to the high cost of delivery, inefficient supply chain and demand persistently outstripping supply. In this context, there is a need to relook at the Agriculture Produce Market Committee (APMC) Act and its functioning. The current stock of foodgrains at 66.7 million tonnes (till mid-January 2014) is sufficient to meet various obligations However, a reassessment of the food management strategy may be required keeping in view the expected higher off-take with the phased implementation of the National Food Security Act at the all-India level, as also the need for greater open market sales to tackle rising food prices (Chart I.2).

Prospects of industrial sector remain uncertain

I.8 Subdued investment and consumption demand resulted in contraction in industrial output during April-November 2013, which is reflected in a decline in the production of capital goods and consumer durables (Table I.3). This

Chart I.2: Stock of foodgrains remains above stipulated norms



Note: 1. 1.Data for off-take is up to Oct 2013 and stock as at mid-Jan 2014.
2. Off -take data are monthly figures.
3. Data for procurement is up to Jan 15, 2014.

apart, contraction of the mining sector due to regulatory and environmental issues has also contributed to the overall decline in the industrial output.

Table I.3: Industrial slowdown continues mostly due to consumer durable and capital goods

Sectoral and use-based classification of industries of IIP

(Per cent)

Industry Group	Weight in the IIP	Growth Rate		
		April-March 2012-13	April-November 2012-13	April-November 2013-14P
1	2	3	4	5
Sectoral				
Mining	14.2	-2.3	-1.6	-2.2
Manufacturing	75.5	1.3	0.9	-0.6
Electricity	10.3	4.0	4.4	5.4
Use-Based				
Basic Goods	45.7	2.5	2.8	0.7
Capital Goods	8.8	-6.0	-11.3	-0.1
Intermediate Goods	15.7	1.6	1.8	2.7
Consumer Goods (a+b)	29.8	2.4	3.6	-2.6
a) Consumer Durables	8.5	2.0	5.2	-12.6
b) Consumer Non-durables	21.3	2.8	2.3	6.3
General	**100**	**1.1**	**0.9**	**-0.2**

P: Provisional
Source: Central Statistics Office.

I.9 Output in the manufacturing sector declined by 0.6 per cent during April-November 2013 as compared with a growth of 0.9 per cent last year highlighting moderation in aggregate demand. Notably, 11 out of the 22 industries within the sector recorded a decline in output. Major industries which registered a decline in output include basic metals, machinery & equipment, radio, TV & communication equipment, motor vehicles and fabricated metal products. Excluding volatile items the truncated IIP (96 per cent of IIP) growth in April-November 2013 was (-)0.9 per cent.

I.10 Among the use-based industries, the growth of intermediate goods and consumer non-durables improved in comparison with last year (Chart I.3). However, falling discretionary consumption demand in face of high inflation and weak consumer confidence impacted consumer durables that contracted 21.5 per cent in November.

Core industries remain a drag on industrial growth

I.11 Recovery in industrial sector is constrained by the continued sluggishness in the growth of core industries. The index of eight core industries registered a lower growth of 2.5 per cent during April-November 2013 as compared with 6.7 per cent in the corresponding period of the previous year. While natural gas and crude oil output contracted during the period, there was also deceleration in the production of coal, petroleum refinery products and cement.

I.12 Natural gas production has been contracting on a y-o-y basis primarily due to the fall in production in the KG-D6 basin. Crude oil production has been stagnating with delays in commissioning of new discoveries, especially the oilfields in Rajasthan. The deceleration in petroleum and refinery products comes on a high base of capacity additions in the private sector in the preceding year. Coal production continues to witness disappointing growth due to a failure to ramp up production.

Capacity utilisation increased

I.13 Capacity utilisation (CU), as measured by the 23rd round of the Order Books, Inventories and Capacity Utilisation Survey (OBICUS) of the Reserve Bank, picked up in Q2 of 2013-14 but remained lower than the level achieved in Q2 of 2011-12 (http://www.rbi.org.in/OBICUS23). This is also reflected in the detrended Index of Industrial Production (IIP) (Chart I.4). New orders' growth increased in Q2 of 2013-14 both on q-o-q as well as y-o-y basis. Finished goods inventory to sales and raw material inventory to sales ratios declined in Q2

Chart I.3: Performance of consumer durables remains weak

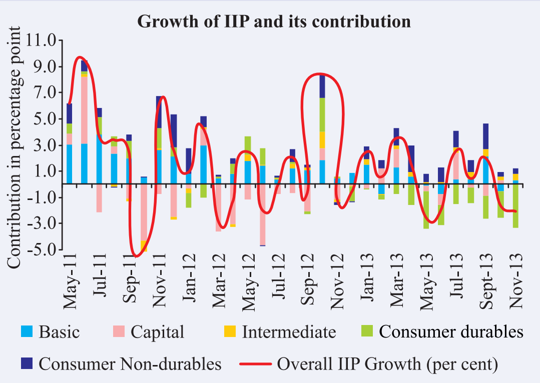
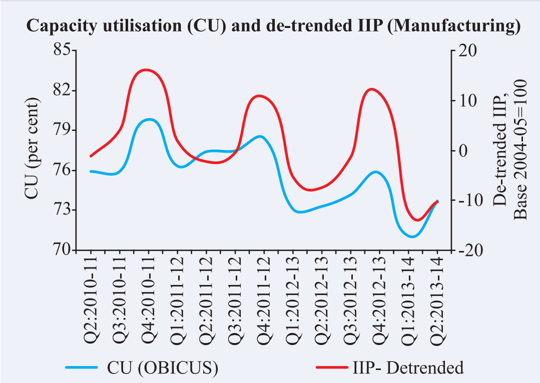


Chart I.4: Capacity utilisation picked up in Q2 of 2013-14



of 2013-14 over the previous quarter and were also lower than that in Q2 of the previous year.

Lead indicators suggest mixed picture for services sector growth in Q3

I.14 The services sector recorded the lowest growth in 12 years at 5.8 per cent during Q2 of 2013-14. This was largely due to the moderation in the growth of 'Trade, hotels, restaurant, transport & communication' and 'Community, social & personal services' sectors. Various lead indicators of the services sector portrayed a mixed picture during Q3 of 2013-14 (Table I.4). The Reserve Bank's services sector composite indicator, which is based on growth in indicators of construction, trade & transport and finance witnessed an upward trend in Q2 of 2013-14, but showed a downturn in October-November 2013 (Chart I.5). However, partially available data for December suggest some pick up.

Growth stays muted for now, recovery will require further efforts

I.15 During the current fiscal so far, the Indian economy has experienced an adverse mix of slowing growth and high inflation. However, an expected rebound in agriculture on the back of better *kharif* and *rabi* crops and a pickup in exports driven by improved global growth prospects and depreciated exchange rate is likely to keep growth in H2 of 2013-14 a tad higher than it was in H1. The government, in recent months, has been taking several policy initiatives to speed up infrastructure investment but these measures will take some time to fructify. Nonetheless, these may provide a toehold for recovery as we enter into 2014-15.

Chart I.5: Services sector composite indicator showed a downturn during October-November 2013

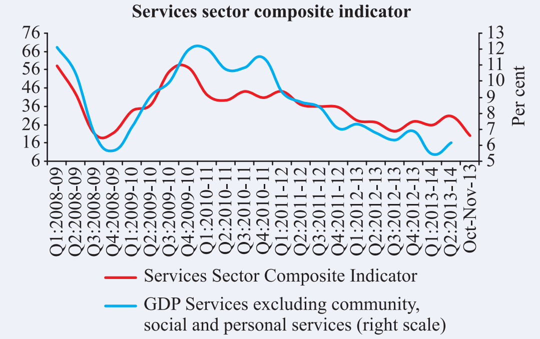


Table I.4: Services sector witnessed a mixed picture in Q3

Lead indicators of services sector activity

(Growth in per cent)

Services Sector Indicators	2011-12	2012-13	H1		Q3	
			2012-13	2013-14	2012-13	2013-14
1	2	3	4	5	6	7
Tourist arrivals	9.7	2.0	1.7	4.3	2.1	4.9
Cement	6.7	7.7	9.1	4.5	3.3#	2.6#
Steel	10.3	2.5	2.6	4.5	1.6#	3.7#
Automobile Sales	11.1	2.6	3.5	1.2	6.3	4.1
Railway revenue earning freight traffic	5.2	4.1	4.8	6.2	5.9	1.9
Cargo handled at major ports	-1.6	-2.5	-3.3	2.3	-2.6	1.1
Civil aviation						
Domestic cargo traffic	-4.8	-3.4	-0.8	0.6	-3.8*	21.9*
International cargo traffic	-1.9	-4.2	-4.9	-0.9	-2.5*	7.1*
International Passenger traffic	7.6	5.5	2.7	12.0	-2.4*	12.1*
Domestic Passenger traffic	15.1	-4.3	-3.7	6.6	-15.6*	11.3*

* Data refer to Oct.; # Data refers to Oct.-Nov.
Source: Ministry of Statistics and Programme Implementation, Ministry of Tourism, IPA, SIAM and CMIE

II. AGGREGATE DEMAND*

Aggregate demand in the economy exhibited some improvement during Q2 of 2013-14 mainly on account of a surge in net exports. However, total consumption expenditure decelerated over the previous quarter on account of a decline in government consumption expenditure. Private consumption expenditure, the mainstay of aggregate demand stayed low in the face of high inflation with subdued discretionary demand. Investment demand improved somewhat during the quarter but the investment cycle is yet to witness a turnaround. On the whole, corporate sales improved during Q2, although some major industries continued to experience contraction in sales. Overall aggregate demand is expected to receive support in H2 of 2013-14 due to the favourable impact from rural demand and exports, though downside risks will emanate from public spending cuts. A pickup in demand in the coming year depends critically on the successful resolution of bottlenecks facing infrastructure projects. It is also important to create a fiscal space in 2014-15 to support public investment by restraining revenue spending, so as to crowd-in private investment.

Exports propelled aggregate demand in Q2 of 2013-14

II.1 During Q2 of 2013-14, GDP at market prices increased markedly to 5.6 per cent as against 2.4 per cent in Q1. This essentially reflected increased taxes and decline in subsidies due to deferment of outgo during the quarter. As a result of this, the overall growth rate picked up in H1 of 2013-14 as compared with H1 of last year (Table II.1).

Table II.1: Aggregate demand improved, although total final consumption expenditure decelerated during Q2

Expenditure-side GDP (2004-05 prices)

(Per cent)

Item	2011-12@	2012-13#	2012-13 Q1	2012-13 Q2	2012-13 Q3	2012-13 Q4	2013-14 Q1	2013-14 Q2	2012-13 H1	2013-14 H1
1	2	3	4	5	6	7	8	9	10	11
Growth Rates (y-o-y)										
GDP at Market Prices	6.3	3.2	3.4	2.5	4.1	3.0	2.4	5.6	2.9	4.0
Total Final Expenditure	8.1	3.9	4.7	4.0	3.8	3.3	3.0	1.7	4.4	2.3
(i) Private	8.0	4.0	4.3	3.5	4.2	3.8	1.6	2.2	3.9	1.9
(ii) Government	8.6	3.9	7.2	6.9	2.2	0.6	10.5	-1.1	7.0	4.7
Gross Fixed Capital Formation	4.4	1.7	-2.2	1.1	4.5	3.4	-1.2	2.6	-0.6	0.7
Change in Stocks	-30.6	73.4	69.8	71.7	75.8	76.0	-0.4	2.3	70.7	0.9
Valuables	6.6	-12.0	-20.9	4.3	-6.9	-20.2	92.5	23.9	-10.0	58.0
Net Exports	-42.5	-17.3	-6.7	-21.4	-23.7	-16.4	-6.0	36.1	-14.1	16.4
Discrepancies	-100.3	152.0	-12.9	28.6	-128.5	-6.3	29.1	40.6	4.6	35.1
Relative Shares										
Total Final Expenditure	70.5	71.0	72.1	72.8	73.5	65.9	72.5	70.1	72.5	71.3
(i) Private	59.2	59.6	61.1	61.8	61.4	54.7	60.6	59.8	61.5	60.2
(ii) Government	11.3	11.3	11.0	11.0	12.1	11.2	11.9	10.3	11.0	11.1
Gross Fixed Capital Formation	33.7	33.2	33.8	34.6	32.0	32.6	32.6	33.6	34.2	33.1
Change in Stocks	2.3	3.8	3.9	4.0	3.7	3.8	3.8	3.8	4.0	3.8
Valuables	2.4	2.0	2.1	2.2	2.0	1.8	4.0	2.5	2.1	3.3
Net Exports	-8.8	-10.0	-9.6	-11.0	-11.3	-8.4	-9.9	-6.6	-10.3	-8.3
Discrepancies	0.0	0.0	-2.4	-2.6	0.1	4.2	-3.0	-3.4	-2.5	-3.2
Memo:										
GDP at market prices (₹ billion)	56314	58137	13702	13536	15062	15836	14034	14301	27238	28335

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

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

II.2 The pickup in growth in Q2 of 2013-14 essentially emanated from a surge in exports driven by the impact of rupee depreciation and improved growth in advanced economies. The contribution of exports to growth was placed at 4.1 percentage points in Q2, which was substantially higher than other components on the expenditure side (Table II.2). Gross fixed capital formation and private final consumption expenditure (PFCE) increased marginally while government final consumption expenditure (GFCE) declined during the period. Further, the growth rate of spending on valuables decelerated distinctly in Q2 as compared with Q1 reflecting moderation in gold imports.

Efforts to address infrastructure bottlenecks gain momentum, though revival of activity on the ground has been modest so far

II.3 The Cabinet Committee on Investment (CCI) (January 2013) and later the Project Monitoring Group (PMG) (June 2013) were constituted by the government to expedite key mega projects. So far the CCI has helped in the resolution of logjams for around 300 projects, worth above ₹5 trillion. The PMG alone has accepted 411 projects worth ₹19 trillion for consideration; of these issues relating to projects worth ₹4.9 trillion (138 projects) have been resolved. A majority of these resolved projects are in power (86), coal (21), petroleum (7), roads and railways (6 each) and shipping (5). The new legislation for Land Acquisition, Rehabilitation and Resettlement has been enacted with an objective to fast track stalled infrastructure projects. In addition, a series of measures, including delinking of environmental clearance from forest clearances, encouraging infrastructure debt funds and enhancing credit to infrastructure companies, initiated by the government during January-September 2013 are likely to boost infrastructure investments in general in the coming months. However, the time and cost overrun for central sector infrastructure projects (of ₹1.5 billion and above) continues to be high.

II.4 The performance of power generation during April-November 2013 was somewhat better than last year; mainly supported by increased hydel power generation on account of good rainfall and consequent high reservoir levels. Notwithstanding some improvement in coal supply position, the Plant Load Factor (PLF) in the thermal power sector at 65.4 per cent in November 2013 remains lower than 71.0 per cent last year due to moderation in demand in line with slowdown in economic activity (Chart II.1).

Table II.2: Exports played a major role in increasing overall growth

Contribution-weighted growth rates on the expenditure side GDP (2004-05 prices)*

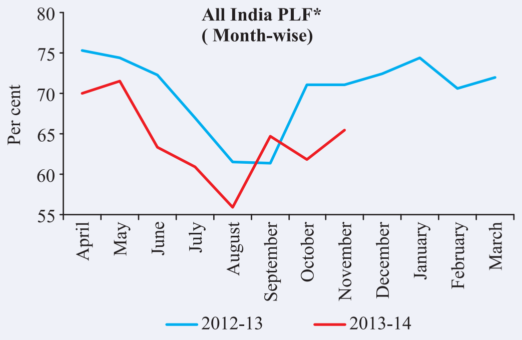
(Per cent)

Item	2012-13				2013-14		2012-13	2013-14
	Q1	Q2	Q3	Q4	Q1	Q2	H1	H1
1	2	3	4	5	6	7	8	9
1. Private Final Consumption Expenditure	2.6	2.2	2.6	2.1	1.0	1.3	2.4	1.2
2. Government Final Consumption Expenditure	0.8	0.7	0.3	0.1	1.2	-0.1	0.7	0.5
3. Gross Fixed Capital Formation	-0.8	0.4	1.4	1.1	-0.4	0.9	-0.2	0.2
4. Change in Stocks	1.7	1.7	1.7	1.7	0.0	0.1	1.7	0.0
5. Valuables	-0.6	0.1	-0.2	-0.5	2.0	0.5	-0.2	1.2
6. Net Exports (i-ii)	-0.6	-2.0	-2.3	-1.2	-0.6	4.0	-1.3	1.7
(i) Exports	3.0	1.2	-0.9	-0.2	-0.3	4.1	2.1	1.9
(ii) Less Imports	3.6	3.2	1.4	1.1	0.3	0.1	3.4	0.2
7. Sum 1 to 6	**3.0**	**3.1**	**3.5**	**3.2**	**3.1**	**6.7**	**3.1**	**4.9**
8. Discrepancies	0.4	-0.6	0.6	-0.3	-0.7	-1.1	-0.1	-0.9
9. GDP at Market Prices (7+8)	**3.4**	**2.5**	**4.1**	**3.0**	**2.4**	**5.6**	**2.9**	**4.0**

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

Source: Central Statistics Office.

Chart II.1: Low capacity utilisation in the thermal power sector is worrisome



* For coal and lignite based plants

II.5 The government has been taking initiatives to revive the telecom sector. These include introduction of the National Telecom Policy 2012, simplifying the licensing regime, improving availability of spectrum and its allocation and raising the limit on foreign direct investment (FDI) in this sector from 74 per cent to 100 per cent. The Union Cabinet recently approved the finalisation of the reserve price for auction of spectrum in 1,800 MHz band for all service areas and for 900 MHz band in metro areas, which is likely to provide some impetus to telecom services.

II.6 In the roads sector, in the absence of an encouraging response from private developers, the government has shifted its focus of awarding road projects through 'Engineering, Procurement and Construction' (EPC). However, given the tight fiscal situation of the government, the sustainability of this approach requires a significant repurposing of government spending. Against this backdrop, the government has been organising investors' conclaves/road shows in major centres abroad to promote infrastructure financing.

Corporate investment intentions showed nominal improvement

II.7 Corporate investment intentions in Q2 of 2013-14 showed some improvement over Q1. However, it still remained much lower than the level achieved in Q2 of 2012-13. Improvement in projects investment in Q2 of 2013-14 was observed for metal & metal products (Table II.3).

Aggregate sales growth (y-o-y) improved but profit margins low

II.8 Sales growth (y-o-y) of non-government non-financial listed companies improved in Q2 of 2013-14 after successive deceleration since Q3 of 2011-12. The upturn in sales growth was noticeable for the manufacturing and the IT sectors, while the slowdown continued in the non-IT services sector. Industries like fertilisers, coke & refined petroleum products, textiles and pharmaceuticals witnessed decent improvement in sales growth. However, the contraction continued in some major industries, such as motor vehicles, machinery, cement and iron & steel. The improvement in sales growth was, however, not reflected in profit growth. Pricing power in terms of EBITDA and net profit margins declined in Q2 of 2012-13 as compared

Table II.3: Institutionally assisted project investments showed marginal improvement

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

(₹ billion)

Financial Year		No. of Projects	Envisaged Cost (Total)	*of which* Power industries	*of which* Metal & metal products industries
1		2	3	4	5
2011-12	Q1	147	749	284	231
	Q2	184	452	218	23
	Q3	137	462	242	14
	Q4	168	253	69	46
2012-13	Q1	110	413	240	36
	Q2	132	666	207	145
	Q3	89	256	157	15
	Q4	94	629	187	352
2013-14	Q1	96	254	76	17
	Q2	116	321	70	131

*: Data are provisional and may undergo changes due to modification/cancellation of projects if reported subsequently.

Note: based on data reported by 39 banks/FIs usually active in project finance.

Table II.4: Corporate sales have improved during the quarter

Performance of non-government, non-financial companies

(Per cent)

	2012-13			2013-14	
	Q2	Q3	Q4	Q1	Q2
1	2	3	4	5	6
No. of Companies			**2353**		
			Growth rates (y-o-y)		
Sales	11.9	10.0	4.7	3.3	7.6
Value of Production	12.4	8.6	4.8	2.7	6.9
Expenditure, *of which*	12.7	8.6	5.5	2.8	8.2
Raw Materials	14.4	9.3	3.1	-1.5	6.2
Staff Cost	15.5	13.6	13.8	12.0	14.1
Power & Fuel	21.3	11.1	3.5	-0.2	0.6
Operating Profits (EBITDA)	10.5	8.7	0.2	2.3	-1.0
Other Income*	44.8	-0.8	4.0	26.3	0.1
Depreciation	10.0	10.3	8.3	8.5	11.7
Gross Profits (EBIT)	17.0	6.4	-1.1	5.1	-4.2
Interest	11.2	17.3	11.1	10.5	20.8
Tax Provision	9.2	6.2	-2.5	2.9	4.4
Net Profits	19.0	23.4	-13.5	-8.1	-19.9
			Ratios in per cent		
Interest Burden	26.9	32.3	29.8	33.5	34.0
EBITDA to Sales	13.4	12.9	12.8	12.9	12.4
EBIT to Sales	12.8	11.4	11.9	12.0	11.4
Net Profit to Sales	7.1	5.8	5.9	5.4	5.3

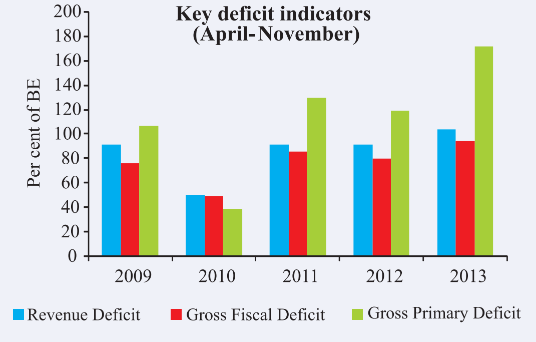
*: Other income excludes extraordinary income/expenditure if reported explicitly.

with the previous quarter (Table II.4). Early results for Q3 of 2013-14, from 194 companies show y-o-y sales growth at 12.4 per cent and EBITDA growth at 14.8 per cent.

Central government's key deficit indicators continue to rule high

II.9 The key deficit indicators of the central government during April-November 2013 as percentages to their budget estimates (BE) were the highest for the comparable period in the last five years (Chart II.3). During April-November 2013, the revenue deficit of the central government had already breached the BE and reached 103.5 per cent of BE for the full year, mainly on account of a sharp increase in revenue expenditure. The widening of revenue deficit, coupled with higher capital expenditure resulted in a gross fiscal deficit of 93.9 per cent of BE during April-November 2013.

Chart II.3: Key deficit parameters of the government were the highest in the last five years



Growth slowdown affecting tax collections

II.10 The central government's gross tax revenue as per cent of BE was lower than a year ago, with a deceleration in revenue growth for income tax and service tax, and a decline in union excise duties during April-November 2013. Although corporation tax during the period registered a higher growth than last year, it was lower than budget estimates (Chart II.4).

Challenging task ahead for government to meet deficit targets in the face of higher expenditures

II.11 Total expenditure as a per cent of budget estimates in April-November 2013 was higher than a year ago, with both the revenue and capital expenditure contributing to the increase (Table II.5). Plan expenditure was significantly higher, both in terms of BE as well as growth rates, with a notable increase in expenditure on

Chart II.4: Non-tax revenue was significantly higher as proportion to budget estimates

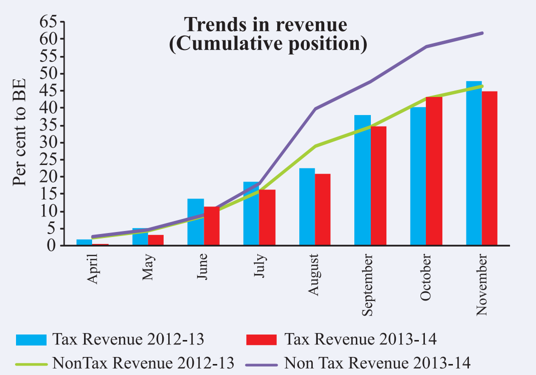


Table II.5: Expenditure growth has been higher than revenue growth

Central government finances during April-November 2013

(In ₹ billion)

Item	Amount		Percentage to Budget Estimates		Growth Rate (per cent)	
	2012-13	2013-14	2012-13	2013-14	2012-13	2013-14
1	2	3	4	5	6	7
1. Revenue Receipts (i+ii)	**4458.2**	**5026.9**	**47.6**	**47.6**	**13.5**	**12.8**
i) Tax Revenue (Net)	3696.0	3961.7	47.9	44.8	15.3	7.2
ii) Non-Tax Revenue	762.2	1065.3	46.3	61.8	5.4	39.8
2. Non-Debt Capital Receipts	89.0	89.5	21.4	13.5	-38.7	0.5
3. Non -Plan Expenditure	6242.6	7302.0	64.4	65.8	15.7	17.0
of which						
i) Interest Payments	1828.6	2144.3	57.2	57.8	10.2	17.3
ii) Food Subsidies	620.0	749.1	82.7	83.2	40.7	20.8
iii) Fertiliser Subsidies	552.9	530.8	90.7	80.5	22.8	-4.0
iv) Petroleum Subsidies	403.2	548.7	92.5	84.4	73.0	36.1
4. Plan Expenditure	2433.9	2909.9	46.7	52.4	10.0	19.6
5. Revenue Expenditure	7653.2	8957.1	59.5	62.4	13.7	17.0
6. Capital Expenditure	1023.3	1254.9	50.0	54.8	17.0	22.6
7. Total Expenditure	**8676.5**	**10212.0**	**58.2**	**61.3**	**14.1**	**17.7**
8. Revenue Deficit	**3195.0**	**3930.2**	**91.2**	**103.5**	**13.9**	**23.0**
9. Gross Fiscal Deficit	**4129.3**	**5095.6**	**80.4**	**93.9**	**16.9**	**23.4**
10. Gross Primary Deficit	**2300.7**	**2951.2**	**118.7**	**171.8**	**22.7**	**28.3**

Source: Controller General of Accounts, Ministry of Finance, Government of India.

transport, and rural and urban development. Grants to states/UTs under central and centrally sponsored schemes were also higher in terms of BE than a year ago.

Need to strive for a deft balance between fiscal consolidation and economic growth by focusing on quality of government spending

II.12 Notwithstanding the widening of GFD in the first eight months of the current fiscal, the government has reiterated its commitment to meeting the budgetary target of 4.8 per cent of GDP in 2013-14. This may require further cutbacks in expenditure if the revenue and non-debt capital receipts do not meet budgetary targets. The additional provisions made for meeting subsidy payments this year may not be adequate to cover the gap between costs and administered prices of OMCs and fertiliser companies during 2013-14. In this milieu, it is important to focus on fiscal consolidation, keeping its quality uppermost in consideration. As per the amended FRBM rules, GFD/GDP ratio of the centre needs to be brought down by at least 0.5 percentage points each year to reach 3.0 per cent in 2016-17. The task remains challenging and, *inter alia,* will require poorly targeted subsidies such as cooking gas and diesel (centre) and electricity (states) to be rationalised. The progress in this direction so far has been partial. While diesel prices have been increased steadily, subsidy on gas cylinders remains large. Adhering to fiscal discipline hinges upon the ability to withstand pressures to increase subsidies, including those on fuel and public utilities. The power sector still needs to make progress on full recovery of costs while needing more investment.

Aggregate demand expected to recover in the near term

II.13 Aggregate demand increased during Q2 of 2013-14. In order to sustain it through H2 of 2013-14, support will be required from investment demand, as government final consumption expenditure may remain subdued in the face of policy-induced expenditure compression to meet fiscal deficit targets. The revival of large stalled projects cleared by the CCI is expected to provide necessary impetus to investments towards the close of the year. There has been significant deceleration in valuables with curbs on gold imports and this is expected to positively impact household financial savings and help restrain CAD.

III. THE EXTERNAL SECTOR

In response to the adjustment of the rupee exchange rate, slowdown in imports, particularly gold, as also improvements in global trade, India's trade deficit contracted y-o-y for the sixth consecutive month in December 2013. Consequent upon the shrinking of the trade deficit, the CAD declined from 4.9 per cent of GDP in Q1 to 1.2 per cent of GDP in Q2 of 2013-14. The full year CAD is likely to be contained within the sustainable level of about 2.5 per cent of GDP. This, along with renewed capital inflows, bolstered through the Reserve Bank's swap windows helped reduce external vulnerabilities and boost confidence. The forex reserve loss earlier in the year has been more than recouped and near-term external vulnerabilities have been mitigated. However, as the capital flows to EMDEs could moderate over 2014-15, there is no scope for complacency and the breather provided by a reduction in the immediate risks needs to be used for developing the resilience of the external sector over the medium term.

Gradual recovery in world trade

III.1 Global growth remained below the trend in 2013, though activity strengthened during H2 of 2013 (see also Chapter I). In line with the expanding activity, world trade is gradually recovering *albeit* at a pace lower than that observed before the global financial crisis. Amongst EMDEs, upward momentum in exports has been particularly observed in the case of Brazil, South Africa and Russia (Chart III.1).

Trade deficit continued to narrow in Q3

III.2 India's exports benefited from a moderate recovery in major advanced economies. With a pickup in merchandise exports since July 2013 and a moderation in imports since June 2013, the trade deficit at US$ 110 billion during April-December 2013 was 25 per cent lower than that in the corresponding period of 2012-13 (Table III.1 and Chart III.2a). Export growth is gradually becoming more broad-based both in terms of destination countries as well as commodities. In recent months, exports to the US, Germany, Saudi Arabia, China, Hong Kong SAR and Malaysia have grown significantly. Commodity-wise, exports of engineering goods, readymade garments, cotton yarn, basic chemicals, plastic & linoleum, leather & leather products, man-made fiber and marine products have grown significantly in recent months. Moreover, the Reserve Bank's and the Government's policies

Chart III.1: World export growth mainly driven by advanced economies in Q3

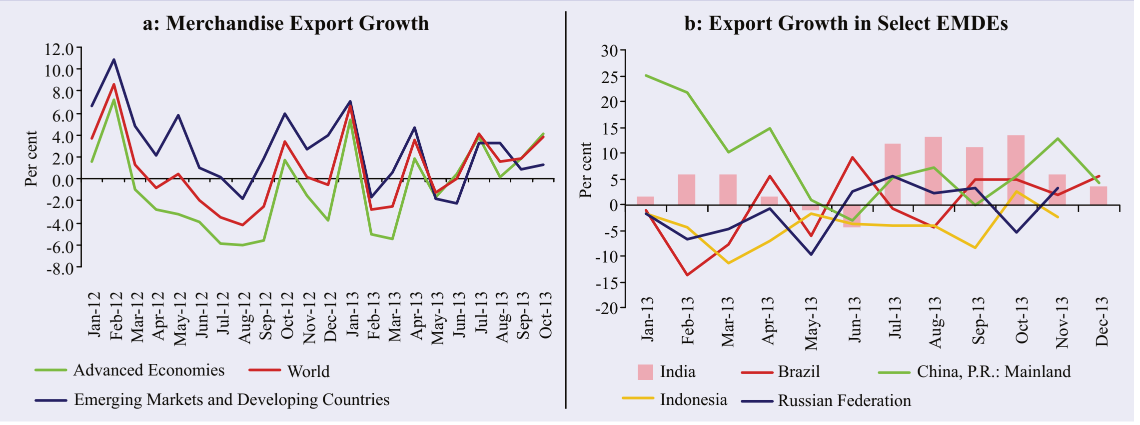


Table III.1: Trade deficit narrowed significantly in H1 of 2013-14 reflecting turnaround in Q2 of 2013-14

India's merchandise trade

(US$ billion)

Item	April-March				April-December			
	2011-12		2012-13		2012-13		2013-14	
	Value	Growth	Value	Growth	Value	Growth	Value	Growth
1	2	3	4	5	6	7	8	9
Exports	306.0	21.8	300.4	-1.8	217.4	-4.0	230.3	5.9
Of which: Oil	56.0	35.1	60.9	8.6	44.8	5.7	45.4	1.5
Non-oil	249.9	19.2	239.5	-4.2	172.7	-6.3	184.9	7.1
Gold	6.7	10.8	6.5	-3.2	4.7	-6.0	4.4	-5.4
Non-Oil Non-Gold	243.2	19.5	233.0	-4.2	168.0	-6.3	180.5	7.4
Imports	489.3	32.3	490.7	0.3	364.2	0.1	340.4	-6.6
Of which: Oil	155.0	46.2	164.0	5.9	121.8	9.8	125.0	2.6
Non-oil	334.4	26.7	326.7	-2.3	242.4	-4.1	215.4	-11.1
Gold	56.3	39.1	53.7	-4.7	38.0	-9.0	23.7	-37.6
Non-Oil Non-Gold	278.0	24.5	273.0	-1.8	204.4	-3.2	191.7	-6.2
Trade Balance	-183.4		-190.3		-146.8		-110.0	
Of which: Oil	-98.9		-103.2		-77.1		-79.5	
Non-oil	-84.4		-87.2		-69.7		-30.5	
Non-Oil Non-Gold	-34.8		-40.0		-36.4		-11.2	

Note: Negative value indicates deficit.
Source: DGCI&S.

relating to gold imports, including increases in customs duty, helped in moderating gold imports since July 2013. This accounted for nearly 72 per cent of the total decline in imports during July-December 2013 (Chart III.2b).

Lower trade deficit in Q2 and Q3 of 2013-14 brings CAD to sustainable levels

III.3 Following a lower trade deficit in Q2, India's current account deficit narrowed sharply to US$ 5.2 billion (1.2 per cent of GDP) in Q2 of 2013-14 from US$ 21 billion (5.0 per cent

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

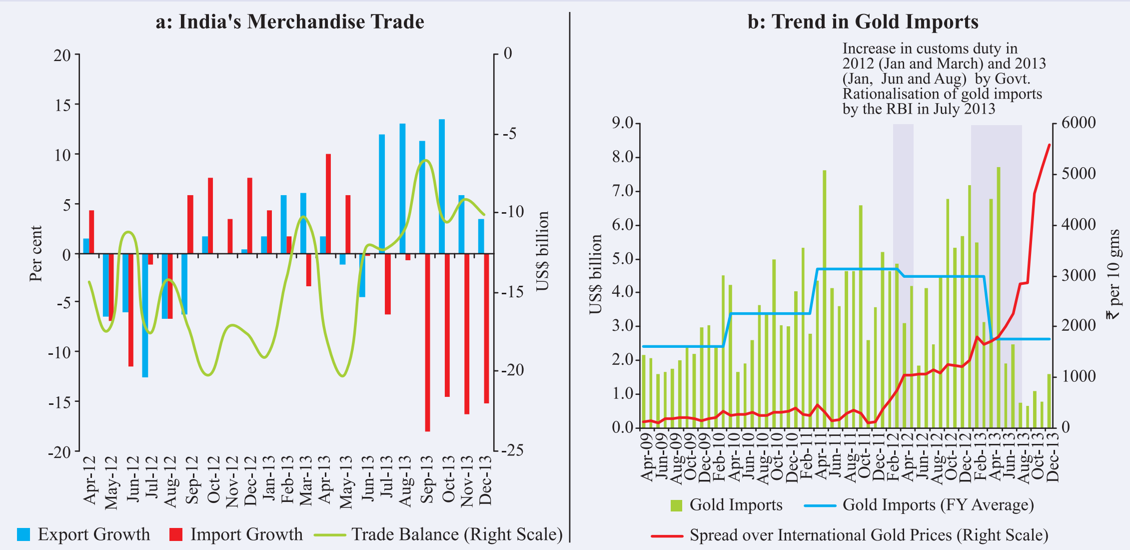


Table III.2: Significant improvement in trade balance leads to a lower CAD to GDP ratio

Major items in India's balance of payments

(US $ billion)

	2012-13 (PR)	2012-13				2013-14	
		Q1(PR)	Q2 (PR)	Q3 (PR)	Q4 (PR)	Q1 (P)	Q2 (P)
1	2	3	4	5	6	7	8
1. Goods Exports	306.6	75.0	72.6	74.2	84.8	73.9	81.2
2. Goods Imports	502.2	118.9	120.4	132.6	130.4	124.4	114.5
3. Trade Balance (1-2)	-195.7	-43.8	-47.8	-58.4	-45.6	-50.5	-33.3
4. Services Exports	145.7	35.8	35.0	37.1	37.8	36.5	36.7
5. Services Imports	80.8	20.8	18.7	20.4	20.9	19.7	18.3
6. Net Services (4-5)	64.9	15.0	16.3	16.6	17.0	16.9	18.4
7. Goods & Services Balances (3+6)	-130.7	-28.9	-31.5	-41.7	-28.7	-33.6	-14.9
8. Primary Income (Net)	-21.5	-4.9	-5.6	-5.8	-5.2	-4.8	-6.3
9. Secondary Income (Net)	64.4	16.9	16.1	15.7	15.8	16.7	16.1
10. Net Income (8+9)	42.9	11.9	10.5	9.9	10.6	11.8	9.8
11. Current Account Balance (7+10)	-87.8	-16.9	-21.0	-31.9	-18.1	-21.8	-5.2
12. Capital Account Balance	-0.3	-0.2	-0.2	0.0	0.2	0.8	-0.1
13. Financial Account Balance	85.4	16.1	21.0	30.8	17.6	20.1	5.0
of which: Change in Reserves	-3.8	-0.5	0.2	-0.8	-2.7	0.3	10.4
14. Errors & Omissions (11+12+13)	2.7	1.1	0.2	1.1	0.3	0.9	0.2
Memo: As a ratio to GDP							
15. Trade Balance	-10.6	-10.2	-11.4	-12.0	-9.0	-11.3	-7.9
16. Net Services	3.5	3.5	3.9	3.4	3.3	3.8	4.4
17. Net Income	2.3	2.8	2.5	2.0	2.1	2.6	2.3
18. Current Account Balance	-4.8	-4.0	-5.0	-6.5	-3.6	-4.9	-1.2
19. Capital and Financial Account, Net (Excl. changes in reserves)	4.8	3.8	4.9	6.5	4.0	4.6	-1.3

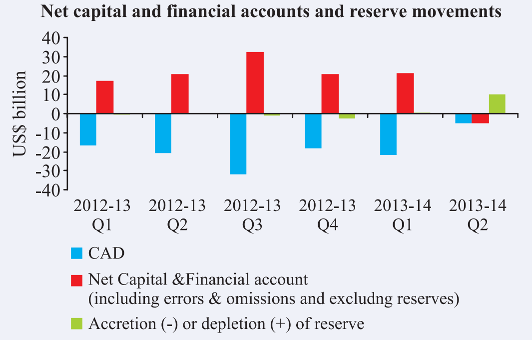
Note: Total of sub-components may not tally with aggregate due to rounding off.
P: Preliminary. PR: Partially Revised.

of GDP) in Q2 of 2012-13, also much lower than the 4.9 per cent of GDP in Q1 of 2013-14 (Table III.2). Besides the fall in trade deficit, net invisibles improved during Q2 of 2013-14, essentially reflecting a rise in net services exports, mainly on account of 'computer services'. DGCI&S trade data for Q3 suggests that the CAD correction in Q2 has been sustained in Q3. So, unless unforeseen factors again make a dent in the CAD in the last quarter, the full-year CAD will fall below 2.5 per cent of GDP. However, given continuing uncertainty of global capital flows, this should not breed complacency.

CAD in Q2 financed by drawdown of foreign exchange reserves

III.4 Although the CAD in Q2 was significantly lower than Q1, there was net outflow of capital thereby leading to a drawdown of India's foreign exchange reserves (on BoP basis) by US$ 10.4 billion in Q2 (Chart III.3). Although flows under net FDI and NRI deposits rose in Q2 as compared to the preceding quarter, these were offset by outflows under FIIs, repayments of short-term trade credit and an overseas build up of assets by commercial banks particularly in September 2013 (Table III.3). Subsequent to the Fed's indication on QE tapering on May 22, 2013, there were large FII outflows, particularly in the debt segment as bond prices fell, the cost of hedging a volatile rupee rose and yield differentials narrowed for FII debt investors. However, the trend in FII flows reversed since mid-November 2013 and there was a net capital inflow of nearly US$ 7.7 billion up to January 24, 2014, comprising of US$ 3.7 billion of equity and US$ 3.9 billion of debt.

Chart III.3: Financing of CAD through drawdown of foreign exchange reserves in Q2 of 2013-14



III.5 In September 2013, the Reserve Bank had offered a window for the banks to swap the fresh FCNR(B) dollar funds with the Reserve Bank, and increased their overseas borrowing limit from 50 to 100 per cent of the unimpaired Tier-I capital of banks (with the option of swap with the Reserve Bank). Accordingly, a significant rise was discernible in NRI deposits in the recent period (Table III.4). Inflows of US$ 34.3 billion under the swap windows have helped to rebuild foreign exchange reserves thus covering possible external financing requirements and concomitantly providing stability to the foreign exchange market. These swap schemes were closed on November 30, 2013. Since end-August 2013, India's foreign exchange reserves had surged by US$ 16.6 billion to US$ 292.1 billion as on January 17, 2014.

Exchange rate stabilised in a narrow range since mid-September 2013

III.6 With the Fed's first indication on QE tapering on May 22, 2013, sudden and large capital outflows occurred from most EMDEs, including from India. These outflows caused EMDE-currencies to come under intense

Table III.3: In Q2, forex reserve declined mainly due to outflow of FII investment in debt

Disaggregated items of the financial account

(US$ billion)

	2012-13 (PR)	2012-13				2013-14	
		Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (PR)	Q1 (P)	Q2 (P)
1	2	3	4	5	6	7	8
1. Direct Investment (net)	**19.8**	**3.8**	**8.2**	**2.1**	**5.7**	**6.5**	**6.9**
1.a Direct Investment to India	26.9	5.9	9.5	4.3	7.2	6.5	7.5
1.b Direct Investment by India	-7.1	-2.1	-1.4	-2.2	-1.4	0.0	-0.6
2. Portfolio Investment	**26.7**	**-2.0**	**7.6**	**9.8**	**11.3**	**-0.2**	**-6.6**
2.a Portfolio Investment in India	27.6	-1.7	7.9	9.8	11.5	-0.5	-6.6
2.b Portfolio Investment by India	-0.9	-0.3	-0.3	-0.1	-0.2	0.2	0.0
3. Financial Derivatives & Employee Stock Options	**-2.3**	**-0.6**	**-0.5**	**-0.4**	**-0.9**	**-0.5**	**-1.6**
4. Other Investment	**45.2**	**15.4**	**5.6**	**20.0**	**4.2**	**14.0**	**-4.0**
4.a Other equity (ADRs/GDRs)	0.2	0.1	0.1	0.0	0.0	0.0	0.0
4.b Currency and deposits	15.3	6.4	3.5	2.6	2.8	5.6	8.4
Deposit-taking corporations, except the central bank: (NRI Deposits)	14.8	6.6	2.8	2.7	2.8	5.5	8.3
4.c Loans*	10.7	3.5	3.0	5.7	-1.6	5.9	-5.3
4.c.i Loans to India	11.1	3.5	3.3	5.9	-1.6	5.4	-5.5
Deposit-taking corporations, except the central bank	1.3	3.0	2.0	2.6	-6.3	4.7	-6.7
General government (External Assistance)	1.3	0.1	0.1	0.4	0.6	0.3	-0.1
Other sectors (ECBs)	8.6	0.4	1.2	2.9	4.1	0.4	1.3
4.c.ii Loans by India	-0.4	0.1	-0.3	-0.2	0.0	0.4	0.2
General government (External Assistance)	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other sectors (ECBs)	-0.1	0.1	-0.3	-0.1	0.1	0.5	0.2
4.d Trade credit and advances	21.7	5.4	4.1	7.7	4.5	2.5	-1.9
4.e Other accounts receivable/payable - other	-2.7	-0.1	-5.1	4.0	-1.5	0.2	-5.3
5. Reserve assets	**-3.8**	**-0.5**	**0.2**	**-0.8**	**-2.7**	**0.3**	**10.4**
Financial Account (1+2+3+4+5)	**85.4**	**16.1**	**21.0**	**30.8**	**17.6**	**20.1**	**5.0**

P: Preliminary. PR: Partially Revised.
*: Includes external assistance, ECBs, non-NRI banking capital and short term trade credit.
Note: Total of sub-components may not tally with aggregate due to rounding off.

Table III.4: FII flows reversed since mid-November 2013

Trend in capital flows

(US$ billion)

Monthly Average	2012-13				2013-14		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8
FDI in India	2.0	3.2	1.4	2.4	2.2	2.5	1.6
FDI by India	0.7	0.5	0.7	0.5	0.0	0.2	-0.2
FIIs	-0.6	2.6	3.3	3.8	-0.2	-2.2	0.8
ADRs/GDRs	0.03	0.03	0.0	0.0	0.0	0.0	0.0
ECB	0.1	0.4	1.0	1.4	0.1	0.4	1.8#
NRI	2.2	0.9	0.9	0.9	1.8	2.7	9.7

#: Estimate (Oct-Dec, 2013).
Note: Data for Q3 pertain to October-November 2013 only except for FII and ECB.

pressure. However, several measures relating to the policy rate, liquidity and forex swap facilities by the Reserve Bank have helped in containing forex volatility (Chart III.4). These policy measures and the postponement of QE tapering by the US Fed helped the rupee to recover since early-September 2013.

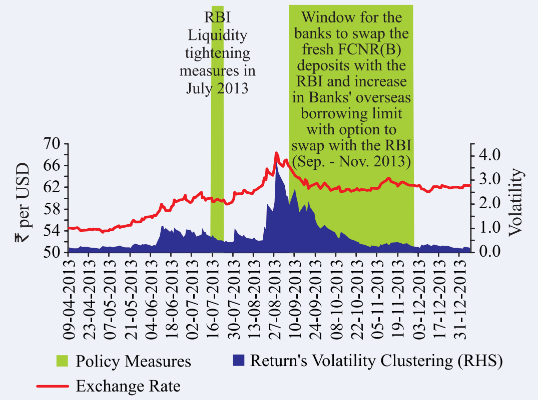
III.7 On December 18, 2013, the US Fed announced a modest tapering of QE from January 2014. In sharp contrast to the experience in May 2013, the Indian rupee exhibited strong resilience in relation to other currencies in terms of exchange rate movements and its volatility in the post announcement period. This was mainly because of the rebuilding of buffers and shrinking of the CAD supported by appropriate policies, including exchange rate adjustment (Chart III.5).

III.8 In terms of the real exchange rate, as on January 24, 2014, the 6-currency and 36-currency REER showed a depreciation of 10.4 and 7.8 per cent respectively over March 2013 (Table III.5).

Some external sector vulnerability indicators show improvement in Q2 of 2013-14

III.9 India's external debt stock has not increased during H1 of 2013-14. However, external debt as a ratio to GDP was marginally

Chart III.4: Reserve Bank policy measures have been largely successful in containing forex volatility, even in the face of the Fed's tapering announcement

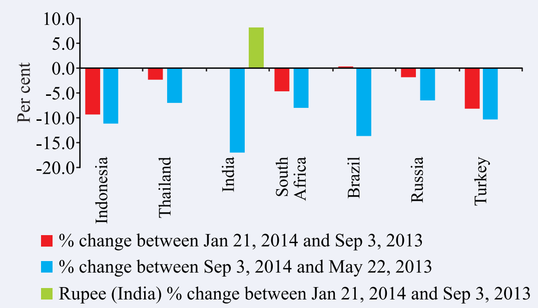


Note: Returns volatility plot captures GARCH (1,1) variance of exchange rate returns.

higher at end-September 2013, mainly reflecting rupee depreciation. Composition-wise, while the level of long-term debt rose in Q2 of 2013-14, short term external debt (original as well as residual maturity) as a ratio of total external debt decline marginally. This decline reflected a fall in the short-term trade credit and FII outflows from the debt segment during the period (Table III.6).

III.10 Broadly reflecting a fall in India's foreign exchange reserves during Q2 of 2013-14, most reserve based external sector vulnerability indicators worsened during the period. In spite of a fall in India's reserves by US$ 5.2 billion in Q2, the import cover fell only

Chart III.5: Most EMDEs' exchange rate movements indicate resilience to the Fed's asset purchase taper announcement



Note: (+) indicates appreciation of the respective currency.

Table III.5: Real exchange rate movements indicate rupee depreciation

Nominal and real effective exchange rates: trade-based (base: 2004-05=100)*

Index	Jan 24, 2014 (P)	Y-o-Y Variation 2012-13 over 2011-12	FY Variation (Jan 24, 2014) over Mar 2013)
1	2	3	4
36- REER	87.7	-6.7	-7.8
36-NEER	69.9	-10.4	-11.2
6-REER	95.8	-5.9	-10.4
6-NEER	65.0	-10.5	-15.4
₹ /US$	62.2	-11.9	-12.5

P: Provisional; *: For countries other than India, CPI is used, while for India WPI is used.
Rise in indices indicates appreciation of the rupee and *vice versa*.
Note: NEER: Nominal Effective Exchange Rate. REER: Real Effective Exchange Rate.

marginally as imports contracted during this period (Table III.7). In line with capital outflows, net external liabilities, as reflected by the net international investment position (net IIP) - GDP ratio, declined at end-September 2013.

Table III.6: India's external debt remains unchanged in H1 of 2013-14

(US$ billion)

Item	End-Mar 2013 (PR)	End-Jun 2013 (PR)	End-Sep 2013 (QE)	Per cent Variation (4) over (3)
1	2	3	4	5
1. Multilateral	51.6	51.7	52.5	1.6
2. Bilateral	25.1	24.8	24.7	-0.3
3. IMF	6.0	6.0	6.1	2.0
4. Trade Credit (above 1 year)	17.8	17.4	16.6	-4.5
5. Commercial Borrowings	131.0	131.6	129.1	-1.9
6. NRI Deposits	70.8	71.1	75.1	5.5
7. Rupee Debt	1.3	1.2	1.4	10.5
8. Long-term (1 to 7)	303.6	303.9	305.5	0.5
9. Short-term	96.7	96.8	94.8	-2.1
Total (8+9)	**400.3**	**400.6**	**400.3**	**-0.1**

PR: Partially Revised. QE: Quick Estimates.

Moderation in CAD should not build complacency given volatility in capital flows

III.11 An improved trade performance and a sharp decline in CAD in recent months have instilled confidence in India's external sector. A sustained improvement in India's trade performance over the long run will, however, hinge on the pace of global recovery and improvement in the competitiveness of Indian exports.

III.12 It is important that the lower CAD in recent quarters does not breed complacency, particularly after the US Fed's asset purchase tapering announcement, which could impact capital flows. Looking ahead improving global trade and a reduced CAD are likely to keep external sector risks manageable in face of external shocks.

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

(Ratios in per cent)

Indicator	End-Mar 2013	End-Jun 2013	End-Sep 2013
1	2	3	4
1. Ratio of Total Debt to GDP	21.7	23.4	23.8
2. Ratio of Short-term to Total Debt (Original Maturity)	24.2	24.2	23.7
3. Ratio of Short-term to Total Debt (Residual Maturity)#	43.1	42.5	42.3
4. Ratio of Concessional Debt to Total Debt	11.4	11.3	11.5
5. Ratio of Reserves to Total Debt	73.0	71.1	69.3
6. Ratio of Short-term Debt to Reserves (Original Maturity)	33.1	34.0	34.2
7. Ratio of Short-term Debt to Reserves (Residual Maturity)	59.0	60.2	61.0
8. Reserves Cover of Imports (in months)	7.0	6.7	6.6
9. Reserves Cover of Imports and Debt Service Payments (in months)	6.6	6.3	6.2
10. Debt-Service Ratio (Debt Service Payments to Current Receipts)	5.9	6.3	5.4
11. External Debt (US$ billion)	400.3	400.6	400.3
12. Net International Investment Position (IIP) (US$ billion)	-317.6	-309.0	-296.2
13. Net IIP/GDP Ratio	-17.2	-16.6	-15.9

#: RBI Estimate.

IV. MONETARY AND LIQUIDITY CONDITIONS

The course of gradual monetary easing that had started alongside some dampening of inflationary pressures was disrupted by the over-riding need to stabilise the exchange rate in the face of large capital outflows since May 2013. Liquidity conditions were tightened considerably till such time as the exchange rate stabilised. Since then the interest rate corridor's width has been normalised through a 150 bps reduction in the MSF rate and an increase of 50 bps in the policy rate, the latter reflecting the need to tackle the resurgence in inflation. Additional liquidity was also provided in terms of variable rate term repos and forex swaps. The latter turned out to be a significant driver of reserve money growth in Q3 of 2013-14 as NFA were built up. The momentum in mobilising FCNR(B) deposits on the back of the swap facility also pushed up growth in aggregate deposits and, hence, money supply.

Normalisation of exceptional monetary measures revert policy corridor back to (+/-) 100 bps

IV.1 In the wake of the uncertainty emanating from the US tapering indication, the Reserve Bank resorted to exceptional monetary measures to address exchange market pressures. *Inter alia*, it raised the marginal standing facility (MSF) rate by 200 basis points (bps) in mid-July 2013 and capped the borrowing under LAF to 0.5 per cent of each bank's net demand and time liabilities (NDTL).

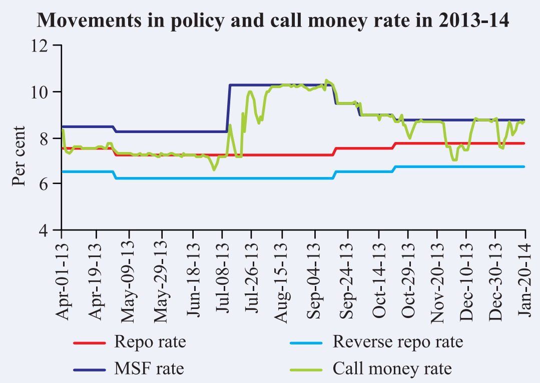
IV.2 Following the ebbing of volatility in the foreign exchange market, the Reserve Bank initiated normalisation of the exceptional measures in a calibrated manner since its mid-quarter review (MQR) of September 20, 2013. The interest rate corridor was realigned to normal monetary policy operations with the MSF rate being reduced in three steps to 8.75 per cent between September 20, 2013 and October 29, 2013 even as the repo rate was increased in two steps of 25 bps each to 7.75 per cent with a view to containing inflation and inflation expectations (Chart IV.1).

Tight liquidity situation eased gradually in Q3 in line with unwinding of exceptional measures

IV.3 The policy induced tight liquidity conditions during Q2 of 2013-14 eased considerably in October 2013 with the gradual normalisation of exceptional monetary measures. Although the festival-induced increase in currency in circulation kept the liquidity situation generally tight in November 2013, the buoyant capital inflows under the Reserve Bank's swap facilities for bank's overseas borrowings and non-resident deposit funds (which were operational till November 30, 2013), eased domestic liquidity significantly. The narrowing of wedge between the credit and deposit growth also contributed to improving the liquidity condition.

IV.4 The easing of liquidity conditions got reflected in the under-utilisation of limits by the banks under the overnight LAF repo and export credit refinance, a steady decline in access to the MSF and the parking of excess liquidity with

Chart IV.1: Gradual normalisation of the policy rate corridor



the Reserve Bank through reverse repos. Though the liquidity situation tightened temporarily from the third week of December 2013, reflecting advance tax outflows from the banking system and some restraint on government spending, it reverted to normal level in the first week of January 2014. However, the liquidity situation tightened again thereafter, primarily on account of build-up of government's cash balances and a rise in currency in circulation.

Reserve Bank steps up measures to ease frictional liquidity stress in the system

IV.5 In order to manage the evolving liquidity situation, the Reserve Bank conducted two OMO purchase auctions during Q3 of 2013-14, injecting liquidity to the tune of ₹161 billion. Liquidity support was also provided through the variable rate 7-day and 14-day term repo facility up to a limit of 0.5 per cent of the banking system's NDTL. Anticipating liquidity stress in mid-December, induced by the advance tax outflows, an additional liquidity support of ₹100 billion was provided through a 14-day term repo on December 13, 2013. As the strain on market liquidity is expected to continue in view of the fiscal targets set for the year, the Reserve Bank also conducted an OMO purchase auction injecting liquidity of ₹95 billion and two 28-day term repos to ease the liquidity pressure in January 2014.

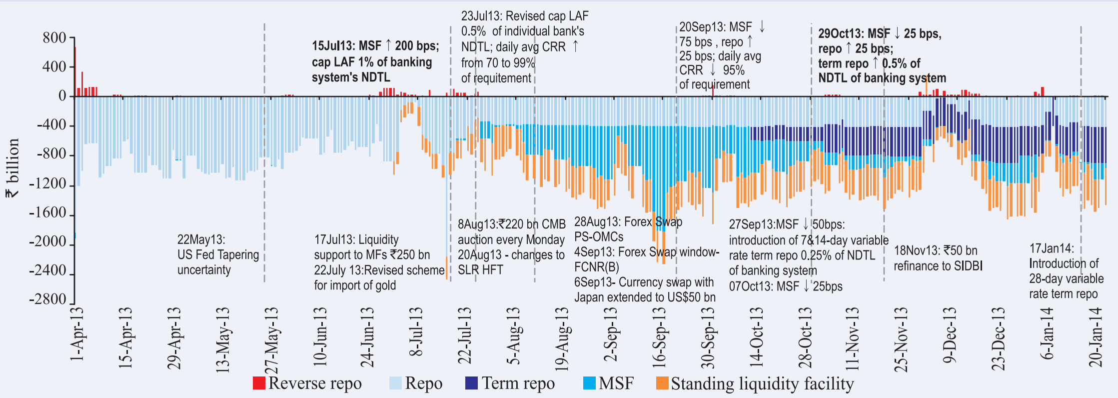
IV.6 To address the liquidity stress faced by the medium, micro and small enterprises sector, the Reserve Bank opened a refinance facility of ₹50 billion to the Small Industries Development Bank of India (SIDBI) (Chart IV.2).

NFA pushes up reserve money growth in Q3

IV.7 The range of liquidity enabling measures undertaken by the Reserve Bank after the exchange market volatility subsided, have led to a significant build-up in two major sources of reserve money - net foreign assets (NFA) adjusted for valuation changes, and net credit to the centre. The latter expanded on account of LAF, MSF, term repo and OMO purchases. However, it moderated towards the end of Q3 on account of a build-up in the government's surplus cash balances with the Reserve Bank on account of advance tax receipts.

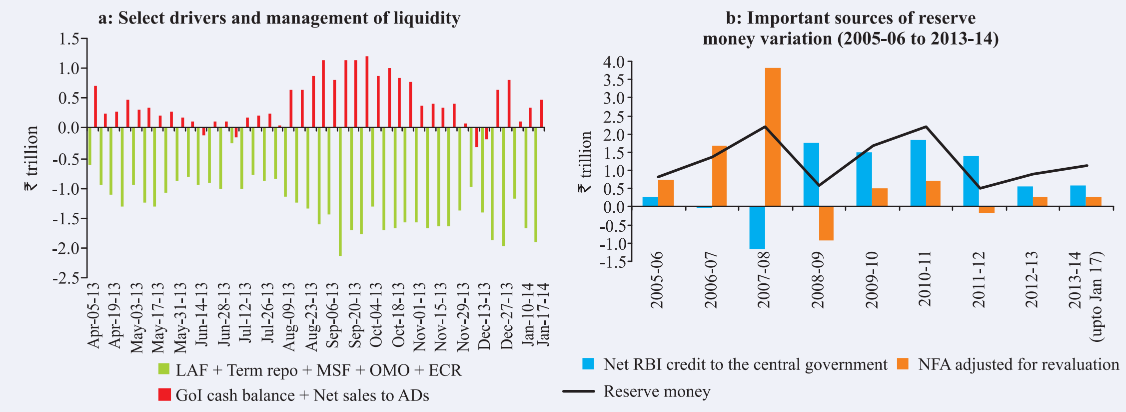
IV.8 Notwithstanding the offsetting effect of an increase in government deposits on the expansion in credit to the centre, reserve money increased by ₹542 billion in Q3 of 2013-14 following a build-up in net foreign assets (adjusted for valuation changes). While reserve money growth has mostly been led by domestic assets in recent years, 2013-14 so far has seen a more balanced NDA-NFA mix. NFA has been beefed up following the US$ 34 billion inflow

Chart IV.2: RBI unwinds exceptional monetary measures



Note: Standing liquidity facility include export credit refinance, refinance to SIDBI, standing facility availed by primary dealers.

Chart IV.3: Reserve money growth led by a more balanced NDA-NFA mix



under FCNR(B) funds and banks' overseas borrowing related swap facilities (Chart IV.3).

IV.9 The expansion in reserve money was matched by a seasonal pickup in the currency in circulation and an increase in bankers' deposits on the components side. The y-o-y variation in reserve money averaged around 10.3 per cent in Q3. However, reflecting the pickup in the bankers' deposit variation (y-o-y) on account of CRR cuts that became effective in September and November of the previous year, the reserve money growth (y-o-y) averaged around 11.3 per cent in the first half of November 2013 and has since been range bound (Table IV.1).

Money supply picks up on the back of faster pace of deposit mobilisation

IV.10 A stronger pickup in the seasonal festive demand in Q3 helped currency with the public increase to 11.2 per cent (y-o-y) at the end of Q3 from 9.6 per cent at the end of Q2 of 2013-14. It has since moderated to 10.6 per cent in mid-January 2014. In addition, backed by a large flow of FCNR(B) deposits and advance tax mobilisation, aggregate deposit growth

Table IV.1: Monetary aggregates in line with indicative trajectory

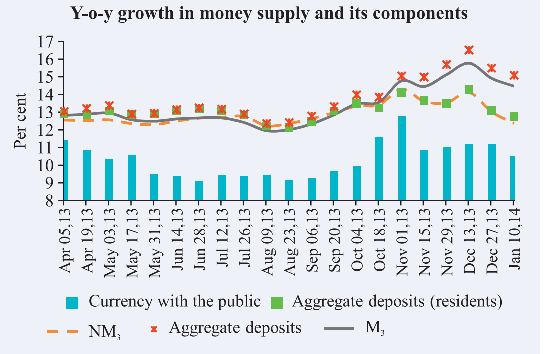
Item	Outstanding amount (₹ billion) 10-Jan-14	FY variations (per cent)		Y-o-Y variations (per cent)	
		2012-13	2013-14	11-Jan-13	10-Jan-14
1	2	3	4	5	6
Reserve money (M_0)*	**16,277**	**3.7**	**7.4**	**2.0**	**10.0**
Reserve money (adjusted)*		**5.9**	**6.9**	**10.0**	**10.6**
Broad money (M_3)	**92,848**	**10.1**	**10.8**	**12.9**	**14.5**
Main components of M_3					
Currency with the public	12,264	8.5	7.1	11.0	10.5
Aggregate deposits	80,561	10.4	11.4	13.2	15.1
of which: Demand deposits	7,586	-3.5	1.6	1.5	10.6
Time deposits	72,975	12.2	12.5	14.6	15.6
Main sources of M_3					
Net bank credit to govt.	29,914	11.9	10.5	16.8	12.7
Bank credit to commercial sector	62,111	9.6	9.6	16.3	14.3
Net foreign assets of the banking sector	18,735	5.3	14.5	6.5	15.3
NM_3 (money supply net of FCNR(B) effect)	**90,955**	**9.8**	**8.8**	**13.3**	**12.4**

*: Data for reserve money pertain to January 17, 2014
Note: Data are provisional.

picked up to a financial year high of 17.1 per cent in mid-December which moderated to 15.6 per cent by mid-January 2014. The growth in aggregate deposits net of FCNR(B) deposits, however, has averaged around 14 per cent, in line with the Reserve Bank's indicative trajectory, since October 2013.

IV.11 In line with this, money supply growth increased to 14.5 per cent in mid-January 2014 from 12.9 per cent at the end of Q2 of 2013-14. On the sources side, the credit off-take, although moderating, supported money growth. The growth in money supply excluding the FCNR(B) effect, however, was lower at 12.4 per cent (mid-January 2014) (Chart IV.4).

Chart IV.4: Money supply adjusted for FCNR(B) effect is in line with indicative trajectory



Sectoral deployment of credit shows slack agricultural and industrial off-take

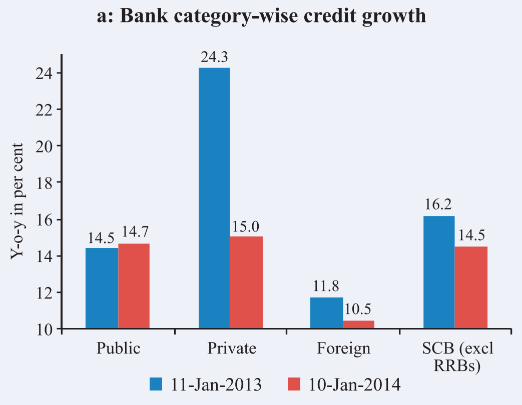
IV.12 There has been some moderation in credit disbursement (y-o-y) since November 2013. Private sector banks showed sharp deceleration in January 2014 (Chart IV.5a).

IV.13 Based on gross non-food credit data of select SCBs, a slowdown in credit off-take across agriculture and allied activities and industry was observed during December 2013. On the other hand, the services sector continued to exhibit a strong build-up. The overall growth in credit to industry decelerated to 14.1 per cent (from 15.2 per cent last year) led by sectors, including petroleum, mining, gems and jewellery (Chart IV.5b).

Despite moderation, pace of credit growth is in line with the indicative trajectory

IV.14 Non-food credit growth (y-o-y) decelerated from a financial year peak of 18.1 per cent on September 6, 2013 to 15 per cent on January 10, 2014. In view of the higher cost of non-bank funds, corporates had earlier resorted to cheaper bank credit, thereby causing an uptick in the credit growth in Q2 of 2013-14. However, with the normalisation of the policy rate corridor, *i.e.,* lowering of the MSF rate to the current 100 bps above the repo rate, credit growth moderated in line with the Reserve Bank's indicative trajectory of 15 per cent.

Chart IV.5: Credit off-take moderates since November 2013



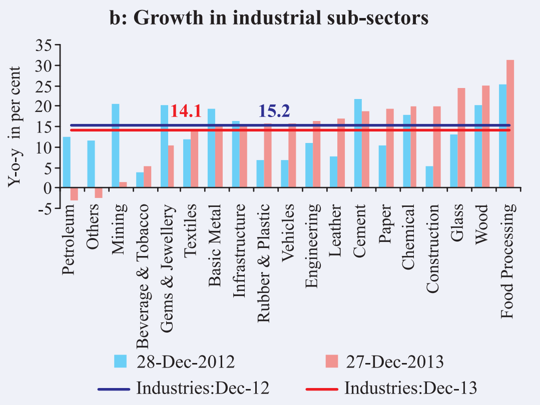


Chart IV.6: Moderation in slippage ratio in H1 of 2013-14

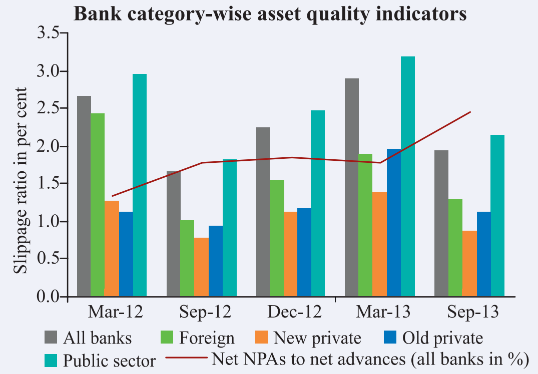
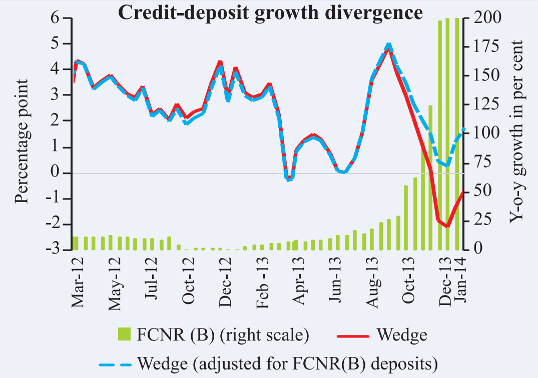


Chart IV.7: Spurt in FCNR(B) deposit mobilisation contracts credit-deposit wedge



Asset quality indicators that have been deteriorating since 2011-12 are moderating credit off-take in the face of slowdown in economic activity. However, the fall in slippage ratio in Q2 of 2013-14 may offer some respite (Chart IV.6).

IV.15 Following the build-up of FCNR(B) deposits, the y-o-y growth in deposit mobilisation outstripped that of credit off-take for SCBs since end-November 2013. However, adjusted for the FCNR(B) effect, the deposit growth lags credit growth, resulting in a small wedge (Chart IV.7).

Lending rates decline tracking normalisation of the policy rate corridor

IV.16 The weighted average lending rate (WALR) of banks declined during Q3 of 2013-14 with the decline being more pronounced for fresh loans (Table IV.2). In the face of the gradual easing of the tight liquidity situation and the lowering of funding costs as normalcy returned to money markets, average domestic deposit rates across bank categories declined from the highs seen at the end of Q2. Notwithstanding the q-o-q decline, the average domestic deposit rates are about 45 bps higher

Table IV.2: Deposit and lending rates of scheduled commercial banks (SCBs)

(Per cent)

Items	Dec-12	Mar-13	Jun-13	Sep-13	Dec -13 #
1	2	3	4	5	6
1. Domestic deposit rate (all tenors - average)	**7.16**	**7.27**	**7.33**	**7.81**	**7.72**
i) Public sector banks	7.36	7.63	7.50	7.77	7.76
ii) Private sector banks	6.65	7.35	7.37	7.72	7.62
iii) Foreign banks	7.06	6.87	7.13	7.93	7.76
Median domestic deposit rates (all tenors)	***7.35***	***7.42***	***7.48***	***7.78***	***7.75***
2. Base rate					
i) Public sector banks	9.75-10.50	9.70-10.25	9.70-10.25	9.80-10.25	9.95-10.25
ii) Private sector banks	9.70-11.25	9.60-11.25	9.60-11.25	9.80-11.50	10.00-11.50
iii) Foreign banks	7.20-11.75	7.20-14.50	7.20-14.00	7.50-14.00	7.50-14.25
Median base rate of SCBs	***10.25***	***10.20***	***10.20***	***10.25***	***10.25***
3. Weighted average lending rate (WALR)*					
i) Public sector banks	12.23	12.18	12.10	12.10	12.09
ii) Private sector banks	12.14	12.13	12.10	12.47	12.23
iii) Foreign banks	11.51	12.37	12.24	12.86	12.60
WALR of SCBs (outstanding)	***12.18***	***12.18***	***12.11***	***12.21***	***12.15***
4. WALR of SCBs (fresh loans)	**-**	**11.57**	**11.65**	**12.24**	**11.95**

#: Data on WALR relate to November 2013. *: Based on outstanding loans.
Note: Data on WALR are provisional.

Table IV.3: Resource flow to the commercial sector dominated by bank sources

(₹ billion)

	Apr-Mar			Apr-1 to Jan-10	
	2010-11	2011-12	2012-13	2012-13	2013-14
1	2	3	4	5	6
A. Adjusted non-food bank credit (NFC)	**7,110**	**6,773**	**6,849**	**4,377**	**5,360**
1. Non-food credit	6,815	6,527	6,335	4,044	5,122
of which: petroleum and fertiliser credit	*-243*	*116*	*141*	*-35*	*-97* $
2. Non-SLR investment by SCBs	295	246	514	333	238
B. Flow from non-banks (B1+B2)	**5,515**	**5,383**	**7,335**	**4,721**	**3,555**
B1. Domestic sources	**3,011**	**3,079**	**4,212**	**2,936**	**2,074**
1. Public issues by non-financial entities	285	145	119	102	103 *
2. Gross private placements by non-financial entities	674	558	1,038	487	466 ^
3. Net issuance of CPs subscribed to by non-banks	68	36	52	774	469 *
4. Net credit by housing finance companies	428	539	859	387	406 $
5. Total accommodation by 4 RBI-regulated AIFIs – NABARD, NHB, SIDBI & EXIM Bank	400	469	515	180	92 *
6. Systemically important non-deposit taking NBFCs (net of bank credit)	795	912	1,188	665	341 ^
7. LIC's net investment in corporate debt, infrastructure and social sector	361	419	441	341	197 *
B2. Foreign sources	**2,504**	**2,304**	**3,123**	**1,785**	**1,481**
1. External commercial borrowings/FCCBs	539	421	466	243	430 *
2. ADR/GDR issues, excluding banks and financial institutions	92	27	10	10	1 $
3. Short-term credit from abroad	549	306	1,177	519	21 ^
4. Foreign direct investment to India	1,324	1,550	1,470	1,013	1,029 $
C. Total flow of resources (A+B)	**12,626**	**12,156**	**14,184**	**9,098**	**8,915**
Memo: *Net resource mobilisation by mutual funds through debt (non-gilt) schemes*	-367	-185	830	699	138 *

^: Up to September 2013. $: Up to November 2013. *: Up to December 2013.

than at the start of the financial year. In recent years, low deposit rates in the face of high inflation had been impacting the mobilisation of financial savings.

Flow of resources to commercial sector weighed down by non-bank sources

IV.17 During 2013-14 (up to January 10, 2014) the estimated flow of financial resources from banks to the commercial sector improved. Recourse to non-bank sources decelerated on account of CPs, non-deposit taking NBFCs, net investment by LIC and short-term credit from abroad (Table IV.3).

Monetary policy evolving with changing macro-financial conditions

IV.18 During the course of 2013-14, the Reserve Bank eased as well as tightened liquidity and monetary conditions in line with the rapidly changing macroeconomic and financial conditions. The width of the policy rate corridor has reverted to 100 bps on either side of the central policy rate, while the policy rate is 25 bps higher than at the start of the year. In the MQR (December 18, 2013), the Reserve Bank maintained the policy rate, awaiting further information on growth and inflation.

V. FINANCIAL MARKETS

The Fed tapering announcement on December 18, 2013 did not exert significant pressures on equity and bond markets across the globe. Unlike the May 22 situation when the tapering announcement unnerved markets, this time around, Indian markets withstood the announcement better than other emerging market peers, having utilised the interim period to re-build buffers. Encouraging news on the trade front along with return of capital flows appears to have abated the pressures on the Indian rupee. However, going forward, markets will be conditioned by political outcomes and the commitment to reforms.

Global financial markets improve; withstand the tapering decision

V.1 10-year US bond yields, which stood at 2.85 per cent on the eve of the FOMC meet on December 17, 2013 rose to above 3 per cent on December 31, 2013 following the Fed announcement on December 18 that it will lower the monthly pace of asset purchases by US $ 10 billion to US $ 75 billion starting in January 2014. The reduction is split equally between Treasuries (from US$ 45 billion to US$ 40 billion) and mortgage-backed securities (from US$ 40 billion to US$ 35 billion).

V.2 Reactions to the actual tapering decision were far more muted than those at the mere indication of a tapering possibility in May 2013. At that point, there were several disruptions that the event caused. First, the US generic 10-year bond yield rose by 46 bps in May and crossed 2 per cent, prompting a bond sell-off across the globe as financial markets priced in the global interest rate cycle turning earlier-than-anticipated. Second, capital outflows began from emerging economies bond markets, prompting their exchange rates to weaken, which in turn motivated equity sell-offs. This further exacerbated exchange rate pressures through a self-perpetuating cycle that rapidly deteriorated financial conditions across emerging markets. Thirdly, there were macroeconomic costs in terms of resurgence of inflation in EMDEs fuelled by pass-through from exchange rate depreciation. Fourth, capital flow reversals and tightening financial conditions along with domestic risks had adverse effects on economic growth in these countries. India was amongst the countries that faced these headwinds, even though subsequent policy actions helped mitigate the effects.

V.3 The postponement of tapering by a few months enabled global financial markets to return to more orderly conditions. Equity indices such as S&P 500 and the Dow Jones reached all-time highs following the positive news on employment, economic growth, confirmation by the US Senate of Janet Yellen as the Fed chair, and a two-year budget agreement that eased automatic spending cuts and reduced the risk of a government shutdown (Chart V.1). On the other side of the Atlantic, the ECB kept its policy rate unchanged in its meeting on January 9, 2014. Coupled with the progress towards a European Banking Union, these developments provided support to equity and bond markets.

Chart V.1: Equity markets in a recovery mode

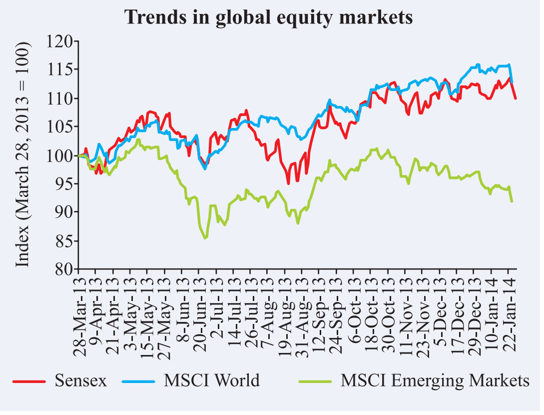
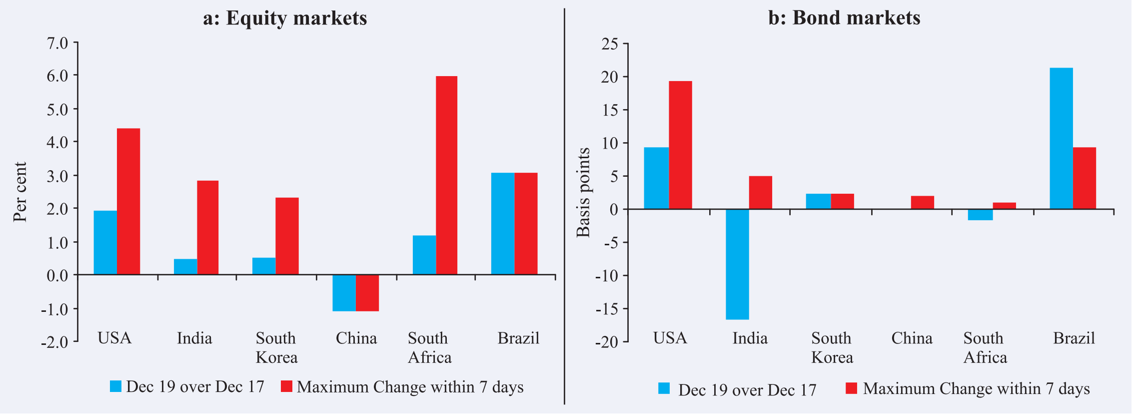


Chart V.2: Equity and bond markets remained unaffected by tapering announcement

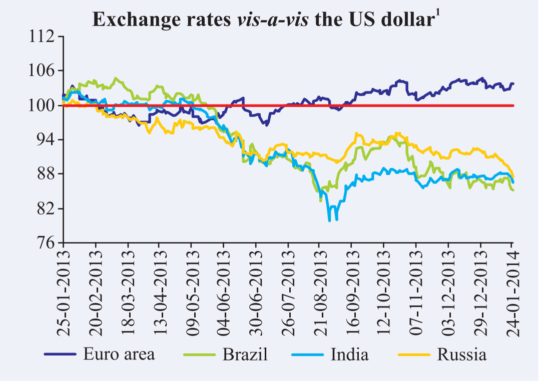


V.4 The Fed tapering moves over the course of 2014 will be closely watched by central banks in EMDEs. The Fed's decision to delay tapering in September had stabilised EMDE capital markets and eased capital outflows considerably, providing breathing space to several countries to address domestic risks. Certain countries with large CADs that came under pressure in the summer continued to tighten their monetary policies post-September in efforts to calm investors, whereas India scaled back exceptional tightening measures amidst the revival of capital flows and a decline in CAD. As compared to tremors across financial markets after the May 22 announcement, this time around, the Fed statement had limited impact on EMDE equity and bond markets (Chart V.2). In addition to the continuing tapering concerns, EMDEs have come under considerable pressure in the latter part of January 2014 amid slowing growth in China, political risks in Thailand and Ukraine and a sudden currency depreciation in Argentina.

Rupee remains range-bound in Q3 of 2013-14

V.5 As already stated, when the Fed first announced its taper intention in May 2013, the rupee depreciated sharply, hitting a historic low in end-August. However, unlike that time, the impact of the actual tapering decision on December 18 on the rupee was not significant. In fact, Q3 of 2013-14 was marked by low exchange rate volatility with a small appreciation of 0.3 per cent (based on average exchange rate of Q3 over Q2). In contrast, in Q1 and Q2 the exchange rate was volatile and the rupee depreciated by 3.2 per cent and 10.1 per cent, respectively (Chart V.3). Exchange rate stability was to a considerable extent driven by introduction of a forex swap window for the public sector oil marketing companies, postponement of tapering by the Fed and a lower CAD during Q2 of 2013-14. Besides, confidence was instilled by forex buffers built by FCNR(B)/ banks' overseas foreign currency borrowings (see also Chapter III).

Chart V.3: Positive domestic developments keeps the Rupee range-bound



[1] US dollars per unit of local currency. An increase indicates appreciation of the local currency

Money market rates soften upon normalisation of exceptional monetary policy measures

V.6 Rates in the money market were range-bound during the early part of July 2013. However, as the rupee depreciated sharply, the Reserve Bank responded with a series of policy measures during July-August to tighten liquidity and contain exchange rate volatility (see also Chapter IV). The net effect of these measures led to a significant rise in money market rates across the spectrum. As markets gradually returned to normalcy, the Reserve Bank effected a calibrated unwinding of its exceptional measures. As a result, money market rates gradually softened during Q3 of 2013-14 across the spectrum. Having utilised the interim period to build buffers, when the actual path of tapering was announced in December 2013, the markets were not unduly concerned. From a high of 9.97 per cent in September 2013, weighted average call rates declined to 8.16 per cent in December 2013 (Chart V.4). A similar magnitude of decline was witnessed in the CBLO rate as well. Money market rates have witnessed some hardening since the second half of December, on the back of tighter liquidity conditions emanating from advance tax outflows. After initial softening, money market rates remained elevated during January 2014 so far, reflecting tight liquidity conditions arising out of elevated government balances with the Reserve Bank and rise in currency in circulation.

Increase in CD issuance

V.7 The tightening in money market rates impacted CD issuances, with the weighted average effective interest rate (WAEIR) peaking to 11.2 per cent in the early part of September 2013. As markets returned to normalcy and liquidity conditions improved, rates declined whereas volumes increased (Chart V.5).

Gradual improvement in CP issuance

V.8 As in the case with CDs, in response to the exceptional measures by the Reserve Bank, issuance of CPs by firms hit a two-year low, in July 2013. The weighted average discount rate (WADR) also touched a high of 11.9 per cent at end-August 2013. As the calibrated unwinding took hold, the volume of issuances picked up and rates declined (Chart V.6). Accordingly, the outstanding amount of CPs also increased.

G-sec yields remained firm in Q3 of 2013-14

V.9 The effect of the announcement on May 22, 2013 and the subsequent measures by the Reserve Bank firmed up government yields to a significant extent. As markets stabilised, the Reserve Bank announced a cautious unwinding of its earlier measures. More specifically, taking

Chart V.4: Money market rates decline

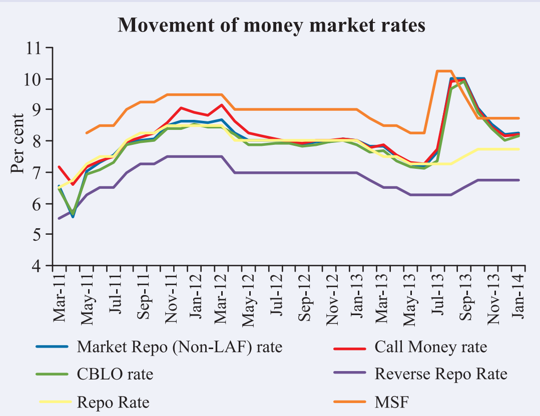


Chart V.5: CD issuances increase and WAEIR decreases

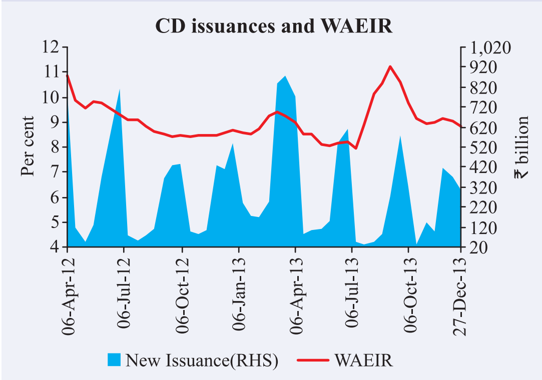


Chart V.6: Improved liquidity conditions lowers WADR of CPs

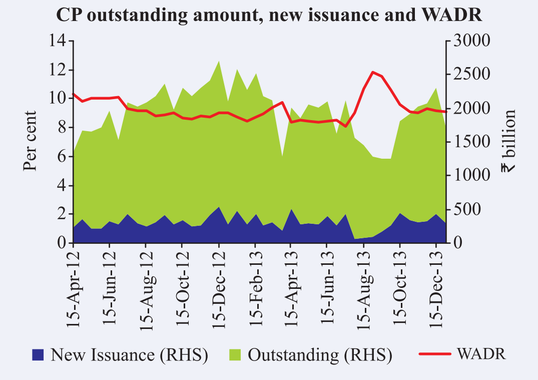
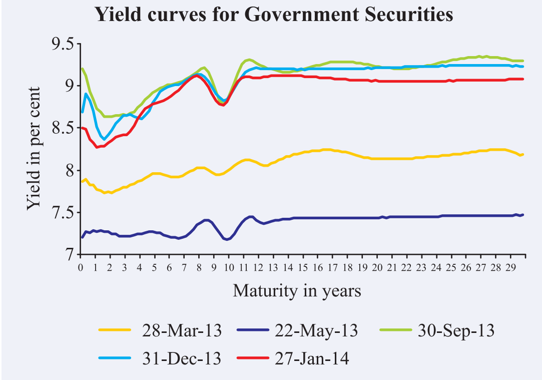


Chart V.7: Yield curve hardens, driven by domestic and global factors



cues from the OMO purchase auction and a 50 bps reduction in the MSF rate on October 7, 2013, G-sec yields softened. However, the yields hardened during November 2013 led by a hike in the repo rate by 25 bps on October 29, 2013, better than expected US non-farm payroll numbers and higher domestic inflation numbers for October 2013. The G-sec yields softened to some extent towards the end of the month on OMO auction announcement and introduction of new benchmark security.

V.10 Yields hardened again in December 2013 on higher domestic inflation numbers for November 2013 and the US Fed tapering announcement, despite getting some support after the policy rate was left unchanged in the mid-quarter review on December 18, 2013. Thus, during Q3 of 2013-14, G-sec yields remained firm. However, in the start of Q4 of 2013-14, the yields have softened on better inflation numbers for December 2013 and on announcement of OMO purchase auction and 28-day term repo auction (Chart V.7).

V.11 The average daily trading volume of central government securities has remained low during Q3 of 2013-14 (Chart V.8).

V.12 During the year thus far, the government has completed 93 per cent of its overall borrowings (96 per cent on a net basis) for the year (Table V.1). The government availed WMAs on ten occasions and availed overdraft on three occasions during this period.

Inflation indexed bonds launched

V.13 The Reserve Bank of India, in consultation with the Government of India (GoI) launched Inflation Indexed Bonds (IIBs) for institutional investors, with inflation protection to both principal and coupon, on June 4, 2013. IIBs have been issued seven times during 2013-14 so far, with an outstanding amount of ₹65 billion.

V.14 Subsequently, a special series of IIBs for retail investors (such as individuals, trusts and universities), namely Inflation Indexed National Saving Securities-Cumulative (IINSS-C), was launched on December 23, 2013. The inflation compensation in this product

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

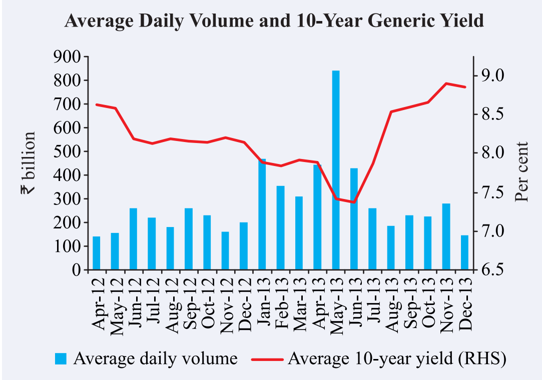


Table V.1: Weighted average yield remains broadly unchanged for central government

Item	2011-12	2012-13	2013-14*
1	2	3	4
Central Government			
Gross amount raised (₹ billion)	5,100	5580	5,395
Devolvement on Primary Dealers (₹ billion)	121.13	18.28	174.50
Bid-cover ratio (Range)	1.39-5.12	1.47-4.59	1.33-6.42
Weighted average maturity (years)	12.66	13.50	14.26
Weighted average yield (per cent)	8.52	8.36	8.38
State Governments			
Gross amount raised (₹ billion)	**1,586.32**	**1772.79**	**1524.14**
Cut-off yield range (Per cent)	8.36-9.49	8.42-9.31	7.57-9.94
Weighted average yield (Per cent)	8.79	8.84	9.06

*: Up to January 17, 2014.

has been linked to the combined consumer price index [CPI base: 2010=100] and the interest rate comprises of two parts: a fixed rate of 1.5 per cent per annum plus an inflation rate based on CPI, with a lag of three months. The initial response to the new product has been somewhat limited with a subscription of ₹603 million till January 25, 2014. As retail investors need more time to understand the product, the last date for application to the scheme has been extended to March 31, 2014.

Equity market stages a recovery

V.15 After initial gains during the early part of the year, the Fed taper announcement had disrupted global stock markets. During May 22 - August 30, the Sensex and Nifty declined as FIIs withdrew US$ 13 billion from domestic debt and equity markets. As normalcy returned, the stock market also recovered. The BSE Sensex and Nifty both increased by over 9 per cent during the third quarter as compared to a decline in both these indices during the previous quarter (Chart V.9). Buoyed by the demonstrated resilience after the December 18 Fed announcement, key stock market indices rallied on account of buying by FIIs. However, in line with global sell-offs, Indian equity market witnessed selling pressure in January 2014 thus far.

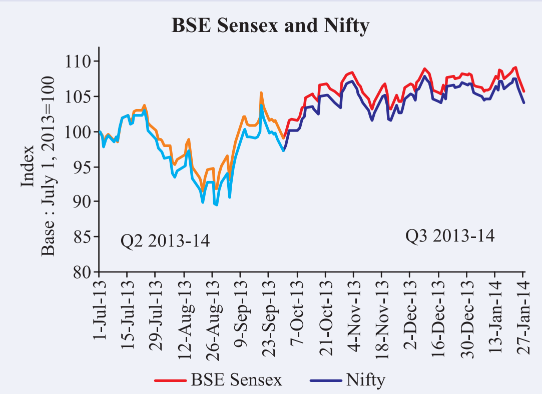
FII investments in equity witness a revival

V.16 As confidence returned to the markets, FII investments also witnessed a revival (Chart V.10). Earlier, FIIs were net sellers in the debt segment. In December 2013, FIIs turned net investors in the debt segment as well. Mutual funds, however, continued to remain net sellers in the equity segment, but net buyers in the debt segment.

Primary equity market continues to remain lacklustre

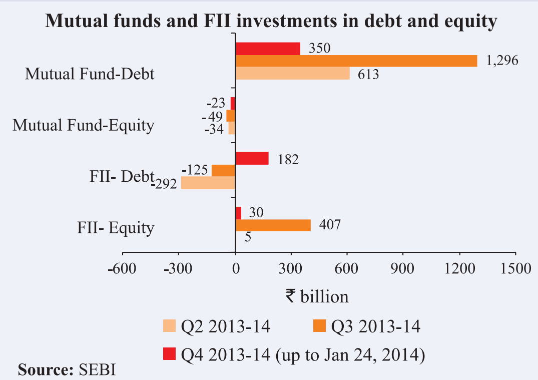
V.17 Low earnings growth in the corporate sector and slowdown in investment demand weighed adversely on the primary equity market. The total amount raised through public

Chart V.9: Sensex and Nifty show recovery



Source: BSE and NSE

Chart V.10: FII investments in equity increase during Q3 of 2013-14



Source: SEBI

Table V.2: Primary capital market mobilisation remains subdued

(₹ billion)

Category	2012-13 (Apr-Mar)	2012-13 (Apr-Dec)	2013-14 (Apr-Dec)
1	2	3	4
a. Public Issue (i) + (ii)	219.2	123.1	322.0
i) Public Issue (Equity)	49.4	44.9	81.2
of which: IPOs	49.4	44.9	11.7
FPOs	0.0	0.0	69.6
ii) Public Issue (Debt)	169.8	78.2	240.8
b. Rights Issue	89.4	70.1	21.7
Total Equity Issues (i+b)	**138.8 (48)**	**115.0 (30)**	**102.9 (35)**
c. ADR/GDR	10.4	10.4$	1.2$
d. Mutual Fund Mobilisation (net)	765.4	1202.7	761.0
i) Private Sector	637.9	1009.1	602.0
ii) Public Sector	127.5	193.6	159.0
e. Private placement in corporate debt market	3614.6	2636.4	2018.4
f. QIP	160.0	67.3$	52.0$

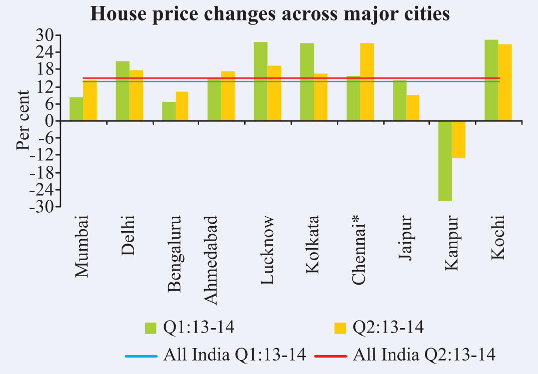
$: Up to November.
Notes: 1. Number of issues within brackets.
2. Figures in column may not add up to the total due to rounding off.
Source: SEBI.

and rights issues was about 90 per cent of the amount raised during the corresponding period of the previous year (Table V.2). Twenty four of the 25 IPOs during 2013-14 so far were by SMEs who mobilised ₹2.5 billion. Resource mobilisation by mutual funds also remained low.

Price pressures persist in housing

V.18 House price pressures, that abated in Q1 of 2013-14 have shown some signs of increase in Q2. The y-o-y increase in the Reserve Bank House Price Index (Base year = 2010-11) at the all-India level was 15.0 per cent in Q2 of 2013-14 as compared to 13.8 per cent in the preceding quarter (Chart V.11).

Chart V.11: House price increases persist



Indian financial markets better placed as global investor sentiments improve, but uncertainties remain

V.19 The government and the Reserve Bank acted proactively in the recent period to ensure better macroeconomic management and reduce financial volatilities. This has helped in improving global investor sentiments and several investment houses turned overweight on India in November-December 2013, even while being underweight on emerging markets for their portfolio allocation calls for 2014. Nonetheless, with domestic demand remaining sluggish and investment activity hesitant, the economy does not appear to be out of the woods, yet. While recessionary headwinds are feeding into corporates' and banks' balance sheets, there are some signs that slippages are starting to come off. By now, markets appear to have priced-in much of the upside and the tipping point could come around the forthcoming general elections. If political risks are well-managed and a renewed political commitment to reforms is seen to be in place, both financial markets and the real sector could gain. In the interim, a closer and continuous monitoring of potential risks and pre-emptive policy action appears to be the need of the hour.

* Based on both residential and commercial properties.

VI. PRICE SITUATION

Inflation declined significantly in December 2013, both in terms of the CPI and WPI, driven by falling food prices which had firmed up considerably during April-November. Despite the moderation, CPI inflation continued to remain high near 10 per cent with inflation excluding food and fuel components also persistent at 8.0 per cent. Going forward, inflation is expected to moderate gradually but stay above the Reserve Bank's comfort level. Upside risks to inflation in 2014-15 arise from likely upward revisions in domestic energy prices and growth acceleration. However, global commodity prices, especially for metals, are expected to remain soft and partially counter-balance these pressures.

Inflation continued to be benign in AEs while there were pressures in EMDEs, including in India

VI.1 Inflation remained low in advanced economies (AEs) aided by high unemployment and large spare capacity (Table VI.1). Annual CPI inflation in the OECD countries remained low at 1.5 per cent in November 2013. Negative output gaps and muted commodity price movements imparted a softening bias to inflation even as it remained range-bound, except in Japan. After a year of deflation, inflation in Japan picked up since June to reach a five-year high of 1.5 per cent in November

Table VI.1: AEs continue an accommodative stance while EMDEs hike policy rates

Global inflation and policy rates

Country/ Region	Key Policy Rate	Policy Rate (as on January 27, 2014)	Changes in Policy Rates (basis points)		CPI Inflation (Y-o-Y, per cent)	
			Sep 2009 to Dec 2011	Jan 2012 to Nov 2013	Dec 2012	Dec 2013
1	2	3	4	5	6	7
Advanced Economies						
Australia	Cash Rate	2.50 (Aug 7, 2013)	125	(-) 175	2.2#	2.7#
Canada	Overnight Rate	1.00 (Sep 8, 2010)	75	0	0.8	1.2
Euro area	Interest Rate on Main Refinancing Operations	0.25 (Nov 13, 2013)	0	(-) 75	2.2	0.8
Israel	Key Rate	1.00 (Oct 1, 2013)	225	(-) 175	1.6	1.8
Japan	Uncollateralised Overnight Call Rate	0.0 to 0.10@ (Oct 5, 2010)	(-) 10	0	-0.2*	1.5*
Korea	Base Rate	2.50 (May 9, 2013)	125	(-) 75	1.4	1.1
UK	Official Bank Rate	0.50 (Mar 5, 2009)	0	0	2.7	2.0
US	Federal Funds Rate	0.0 to 0.25 (Dec 16, 2008)	0	0	1.7	1.5
Emerging and Developing Economies						
Brazil	Selic Rate	10.50 (Jan 15, 2014)	225	(-) 50	5.8	5.9
China	Benchmark 1-year Deposit Rate	3.00 (Jul 6, 2012)	125	(-) 50	2.5	2.5
	Benchmark 1-year Lending Rate	6.00 (Jul 6, 2012)	125 (600)	(-) 56 (-150)		
India	Repo Rate	7.75 (Oct 29, 2013)	375 (100)	(-) 75 (-200)	10.6	9.9
Indonesia	BI Rate	7.5 (Nov.12, 2013)	(-) 50	175	4.3	8.4
Philippines	Reverse Repurchase Rate	3.50 (Oct 25, 2012)	50	(-) 100	3.0	4.1
	Repurchase Rate	5.50 (Oct 25, 2012)	50	(-) 100		
Russia	Refinancing Rate	8.25 (Sep 14, 2012)	(-) 275	25	6.5	6.5
South Africa	Repo Rate	5.00 (Jul 20, 2012)	(-) 150	(-) 50	5.7	5.4
Thailand	1-day Repurchase Rate	2.25 (Nov 27, 2013)	200	(-) 100	3.6	1.7

@: Change is worked out from the minimum point of target range. #: Q4 (Oct-Dec). *: Nov.

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

Source: Websites of respective central banks/statistical agencies.

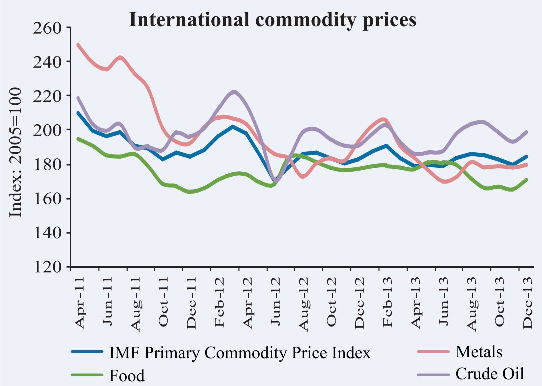
2013, aided by concerted policy efforts to stimulate demand that included the Bank of Japan setting a target of 2.0 per cent inflation in two years in January 2013. In contrast, inflation in some Emerging Market and Developing Economies (EMDEs) was high, driven largely by weaker exchange rates and supply disruptions.

VI.2 Most of the central banks in the AEs continued with unconventional monetary measures to support a fragile economic recovery amid low inflation and well anchored inflation expectations. The European Central Bank, faced with the likelihood of a prolonged period of weak economic activity and low inflation, cut its main refinancing rate by 25 basis points to 0.25 per cent in November 2013. Among the emerging economies, monetary policy was tightened further in Indonesia, India and Brazil as they confronted high inflation. Going forward, inflation risks for EMDEs are likely to remain firm in the near-term conditioned by structural factors and demand pressures in select countries emanating from narrowing output gaps.

Global commodity prices remain range-bound even as US taper begins

VI.3 Global commodity prices in terms of the IMF Primary Commodity Price Index remained largely range-bound during Q4 of 2013 with marginal increase in December as food and energy prices edged up (Chart V1.1). Global food prices declined up to November 2013, led by a downtrend in cereal prices, particularly the prices of wheat following rising supplies from Canada and Australia. Metals prices declined marginally in tandem with weak demand from the EMDEs. Average crude oil prices remained range-bound during November at around US$ 102 per barrel. Brent oil prices, however, rebounded to US$ 112 a barrel in December 2013 on the back of supply disruptions from Libya and South Sudan, while increased oil inventories in the US kept WTI prices range-bound. Oil prices have moderated somewhat again in recent days. The immediate impact of the unwinding of the US stimulus taper on commodity prices remains limited as weak demand and improved supply prospects have kept commodity prices largely stable. Favourable outlook on supply and modest demand could keep commodity prices range-bound in 2014 as well.

Chart VI.1: Range-bound global commodity prices

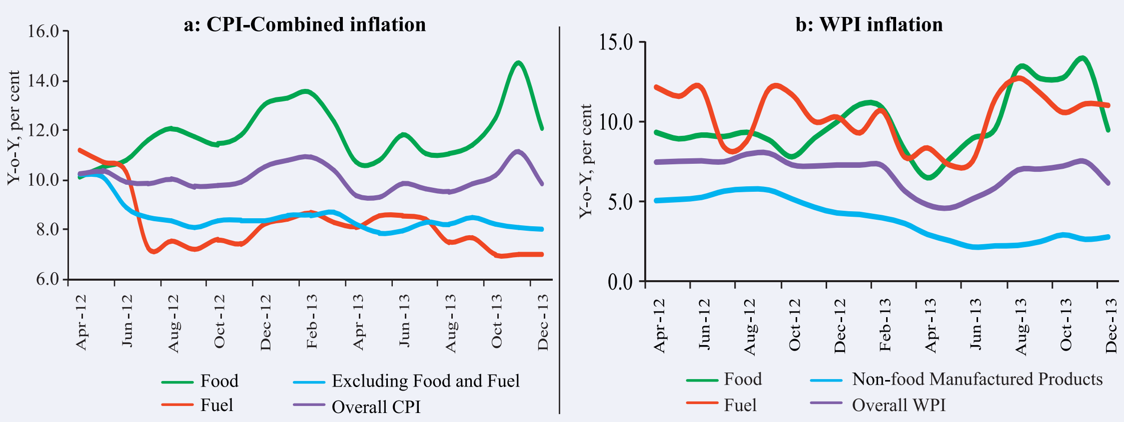


Inflation in India declined in December 2013 driven by food price moderation

VI.4 Inflation in terms of the all India Consumer Price Index (CPI)-Combined (Rural + Urban) declined to 9.87 per cent in December 2013 from a high of 11.16 per cent in November 2013 induced by a fall in vegetable prices (Chart VI.2a). Despite the moderation, inflation remained persistent with the average CPI inflation at 9.9 per cent during first nine months of 2013-14. Excluding food and fuel components, CPI inflation stood at 8.0 per cent in December 2013 with significant contributions from housing, transport & communications and miscellaneous group, which includes services.

VI.5 Wholesale Price Index (WPI) inflation (y-o-y) in India also moderated to 6.2 per cent in December 2013 from 7.5 per cent in November primarily on account of a decline in vegetable prices. WPI inflation had steadily increased during July-November 2013 from a low of 4.6 per cent in May 2013. A number of

Chart VI.2: Declining food prices lead to moderation in both CPI and WPI inflation



supply-side factors contributed to the pickup in inflation. Vegetable prices more than doubled during April-November leading to y-o-y inflation at 15-year high of 95.2 per cent in November 2013. Fuel price inflation also edged up to the double digit level (11.0 per cent in December 2013) driven by prices of freely priced fuel products and administered price changes in diesel and electricity (Chart VI.2b). Non-food manufactured products (NFMP) inflation exhibited moderate increase as weak demand conditions contained generalised inflationary pressures to some extent, even with exchange rate depreciation and escalation in input costs.

VI.6 The build-up in inflation during 2013-14 so far, has been driven by continued increase in food and fuel group inflation, which accounted for about 70 per cent of the increase in the CPI during April-December 2013 (Chart VI.3). The contribution of these two groups to the increase in the WPI was even higher at nearly 78 per cent.

Food prices fall significantly in December after unprecedented rise during April-November 2013

VI.7 Supply-side shocks to inflation from food have become frequent and price rise cycles are getting elongated (Chart VI.4 and VI.5). Vegetable prices exerted persistent pressures on food inflation propelled by increasing potato prices during April-July, ginger prices during April-June, onion prices during June-September

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

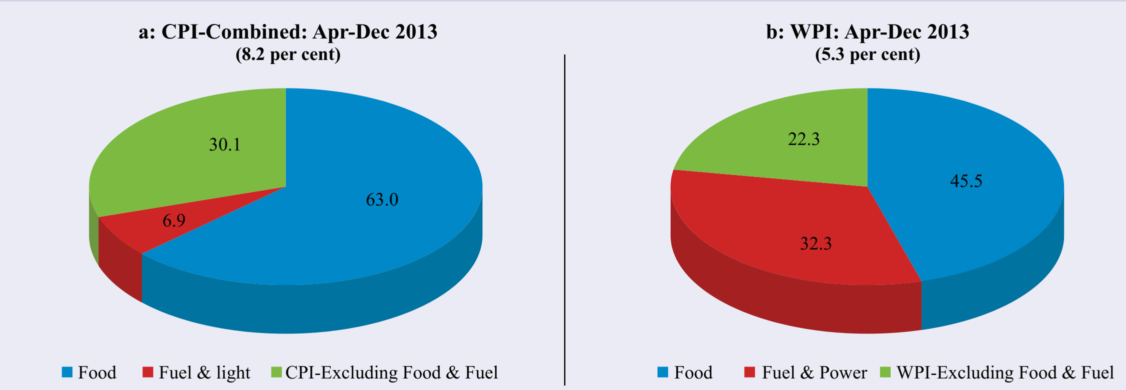
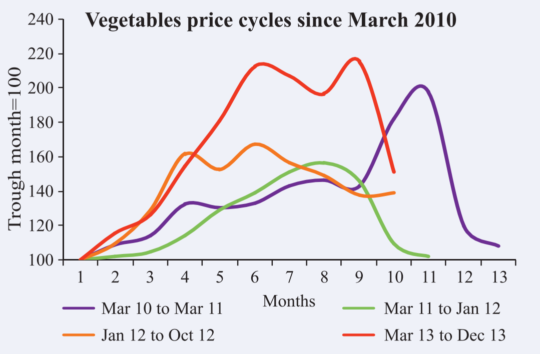


Chart VI.4: Recent spike in vegetables prices was more pronounced but decline has also been sharper



and tomato prices during November. Apart from seasonal pressures, rise in vegetable prices in the recent period also pointed to uncompetitive intermediation structures with multi-tiering of traders and cartelisation in APMCs, besides reflecting a rise in input costs, including rural wages. Among other food articles, rice price inflation escalated to over 20 per cent in Q2 of 2013-14 on the back of output shortfalls, rising input costs, higher procurement and an upsurge in exports. Rice prices declined in December 2013 with the new crop arrivals.

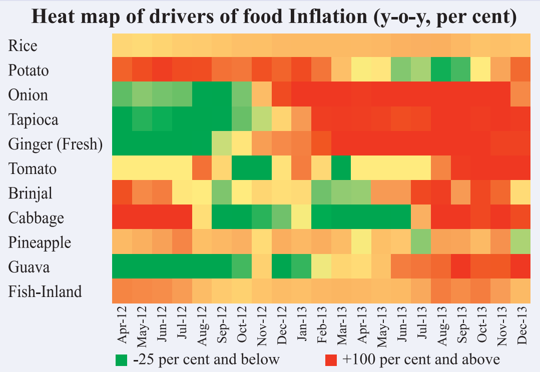
Prices of vegetables moderated with seasonal crop arrivals

VI.8 The spike in vegetable prices was adjudged to be temporary by the Reserve Bank while formulating its Mid-Quarter Review of Monetary Policy in December 2013. In line with this assessment, vegetable prices fell sharply in December 2013 with brinjal, onion, cabbage, tomato and peas recording monthly fall in prices in the range of 31-43 per cent at the wholesale level. Data from the Reserve Bank's regional price monitoring indicate that there were further corrections in vegetable prices in the first fortnight of January 2014. Tomato prices declined by over 15 per cent both in the wholesale and retail markets over the previous fortnight. Potato and onion prices also experienced a fall of over 7 per cent in both markets. Data on prices of essential commodities released by the Price Monitoring Cell (PMC) of the Ministry of Consumer Affairs, Food and Public Distribution also corroborate this trend.

Fuel inflation remains high driven by administered price changes

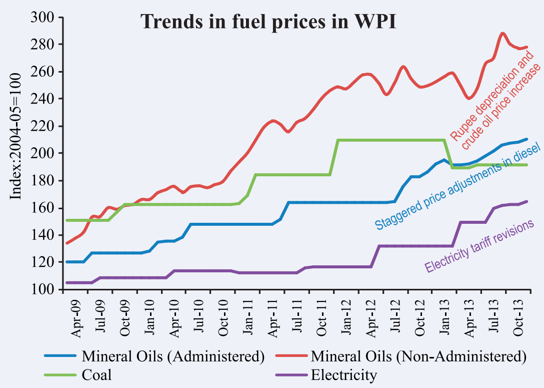
VI.9 High domestic fuel inflation amidst range-bound global crude oil prices reflected the impact of exchange rate pass-through and the role of administered price changes. Revisions in the administered prices hiked up fuel inflation even as prices of freely priced products showed some decline in recent months, thereby making fuel inflation more persistent (Chart VI.6). Retail prices of diesel were increased in a staggered manner during September-December 2013. Furthermore, rise in electricity prices in August and December 2013 also exerted pressure on the fuel group inflation.

Chart VI.5: Multiple pressure points on food prices



Note: Shades between green and red indicate increasing order of inflation.

Chart VI.6: Fuel group inflation led by administered price revisions



VI.10 Although the revisions in administered fuel prices led to some decline in suppressed inflation, the gap persists for certain subsidised items. The under-recoveries of oil marketing companies (OMCs) continued to remain high at ₹ 600 billion during H1 of 2013-14, of which around half was on account of diesel.

CPI ex-food and fuel inflation stays persistent

VI.11 CPI excluding food and fuel inflation averaged high at 8.1 per cent during 2013-14 so far. Housing and transport & communication emerged as major contributors to non-food non-fuel CPI inflation (Chart VI.7). Also, persistent contribution to CPI inflation from services such as education and medical care was reflective of the second round impact of increase in input costs and wages on aggregate inflation. The CPI excluding the food and fuel components includes transport and communication, wherein rising fuel prices exhibited input cost pressures.

Wage pressures continue to remain significant

VI.12 Wage inflation pressures remained significant despite some reduction in the rate at which wages increased. Staff costs for a sample of corporate firms increased at about 14 per cent (y-o-y) in Q2 of 2013-14 despite a weaker employment scenario. In nominal terms, rural wage growth showed a declining trend for over two years, but the rate of increase at 15.5 per cent in October 2013 was strong and continued to exert pressure on overall inflation (Chart VI.8). Real rural wage growth showed a sharper decline in the recent period as increasing CPI-rural labour (RL) based inflation eroded a part of the gains from rising nominal wages.

VI.13 State-wide dispersion in rural wage inflation was considerable (Chart VI.9). Such wide disparities in wage inflation linkages also point to the role of state-specific factors.

Chart VI.8: Rural wage inflation remains high despite deceleration in nominal and real terms

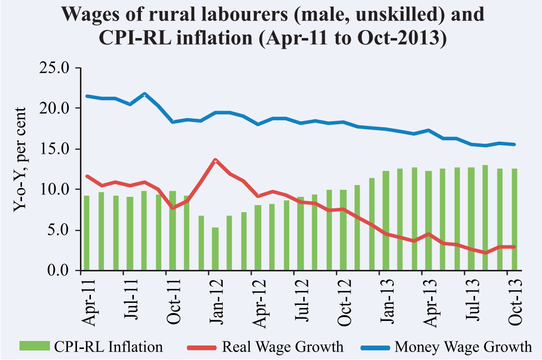
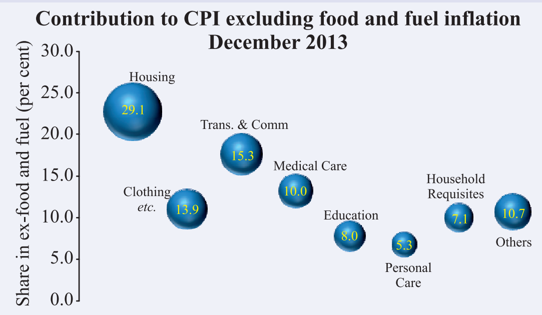
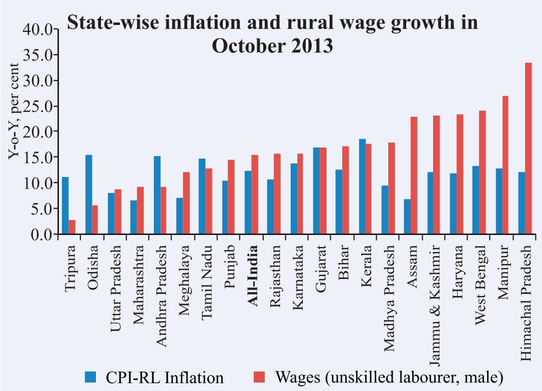


Chart VI.7: Pressure on CPI excluding food and fuel inflation from housing, transport & communication and services



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

Chart VI.9: Inter-state dispersion in rural nominal wage growth



VII. MACROECONOMIC OUTLOOK

Various surveys indicate that business confidence has started to rebuild, though it still stays weak. Growth in 2013-14 is likely to be somewhat weaker than the earlier projection as signs of pick up are yet to emerge. Improved confidence and actions to support infrastructure projects could translate into a slow-paced recovery in 2014-15 provided these actions are sustained. Inflation has exhibited marked moderation in December and may soften further in Q4 but upside risks remain for 2014-15. The persistence in high inflation continues to pose a challenge to growth over the medium-term, even as its fallout in terms of a wide CAD, on the back of lower savings, has been contained through policy responses over Q3 of 2013-14.

Surveys show business confidence has improved

VII.1 Business confidence has turned around as indicated by a sharp q-o-q growth in various business indices (Table VII.1). These surveys indicate that better investment prospects, improving sales, new orders and improved export performance have contributed to rising optimism. However, weak demand, political uncertainty and high inflation appear to be among the factors restraining growing optimism. The seasonally adjusted HSBC Markit Purchasing Managers' Index (PMI) for services continued to be in contraction mode in December 2013, while that for manufacturing showed marginal expansion in activity.

Table VII.1: Expectations surveys show improvement

Business expectations surveys

Period Index	NCAER-Business Confidence Index Jan 2014	FICCI Overall Business Confidence Index Q2:2013-14	Dun & Bradstreet Business Optimism Index Q1:2014	CII Business Confidence Index Q3:2013-14
1	2	3	4	5
Current level of the Index	122.3	59.3	157.2	54.9
Index as per previous survey	100.4	49.0	134.9	45.7
Index level one year back	119.7	62.4	146.8	49.9
% change (q-on-q) sequential	21.8	21.0	16.6	20.1
% change (y-on-y)	2.2	-5.0	7.1	10.0

Industrial Outlook Survey reflects marginal recovery in business outlook

VII.2 The Reserve Bank's 64th round of the Industrial Outlook Survey (http://www.rbi.org.in/IOS64) conducted during November-December 2013, showed that in terms of assessment, the Business Expectation Index (BEI) improved marginally for Q3 of 2013-14, but still remained below the threshold level of 100 separating contraction from expansion. Based on expectations, the index showed an improvement in Q4 of 2013-14 over the previous quarter (Chart VII.1).

VII.3 An analysis of the net responses for various components of demand conditions shows marginal improvement in sentiments regarding production, order books, capacity utilisation, exports and imports for Q3 of 2013-14. The demand outlook for Q4 of 2013-14 shows improved optimism as well.

Chart VII.1 Business outlook shows improvement

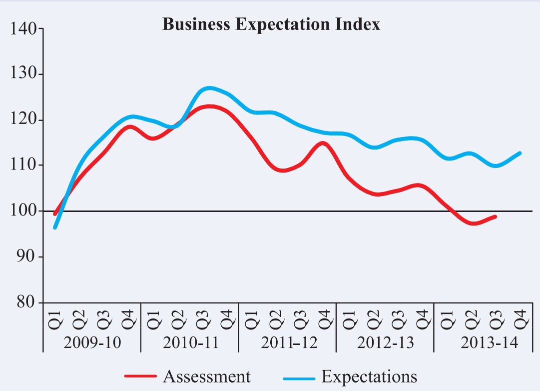


Table VII.2 Business confidence rises

Reserve Bank's Industrial Outlook Survey

Parameter	Optimistic Response	Net Response#										
		October-December		January-March		April-June		July-September		October-December		January-March
		2012		2013		2013		2013		2013		2014
		E	A	E	A	E	A	E	A	E	A	E
1	2	3	4	5	6	7	8	9	10	11	12	13
1. Overall Business Situation	Better	32.2	17.2	37.5	18.4	29.6	12.8	30.0	7.4	25.7	9.6	31.5
2. Overall Financial Situation	Better	25.8	12.7	27.0	11.8	21.9	9.5	24.1	1.8	17.3	6.4	23.5
3. Production	Increase	35.7	18.6	37.1	18.6	24.4	9.8	28.5	10.8	28.9	11.5	32.1
4. Order Books	Increase	30.3	12.9	29.8	14.0	22.3	9.7	25.3	5.5	21.0	7.0	27.6
5. Capacity Utilisation	Increase	20.0	5.7	21.7	7.8	11.7	2.3	15.9	0.0	14.2	1.3	16.3
6. Exports	Increase	18.0	9.3	18.4	10.8	16.7	8.6	18.6	7.8	16.5	10.9	19.5
7. Imports	Increase	14.0	8.8	13.5	8.3	11.9	8.0	11.2	3.6	7.7	7.0	13.4
8. Employment in the Company	Increase	13.3	6.7	10.3	5.5	8.0	3.2	7.7	-0.2	4.5	0.4	7.0
9. Availability of Finance (from internal accruals)*	Improve				12.1	18.7	10.8	17.2	3.1	14.0	7.6	18.4
10. Availability of Finance (from banks and other sources)*	Improve				13.4	15.3	12.1	15.2	3.9	12.0	8.7	14.2
11. Availability of Finance (from overseas)*	Improve				3.4	6.3	5.0	7.0	-0.1	2.9	3.9	8.1
12. Cost of External Finance	Decrease	-20.6	-24.4	-18.1	-17.6	-14.3	-14.5	-12.4	-32.7	-28.3	-32.0	-26.7
13. Cost of Raw Material	Decrease	-48.6	-50.7	-45.0	-53.5	-45.6	-49.9	-43.4	-62.2	-51.5	-55.3	-46.3
14. Selling Price	Increase	17.3	10.2	15.8	9.1	14.9	7.3	12.1	11.3	13.9	7.8	15.1
15. Profit Margin	Increase	-1.3	-16.7	-2.0	-15.3	-4.9	-18.4	-3.7	-24.1	-9.3	-22.4	-4.0

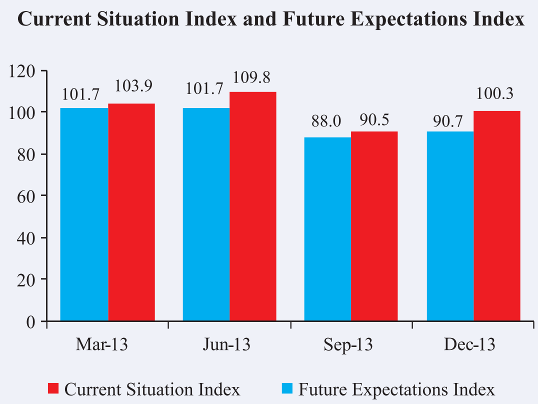
#: Net response is the percentage difference between the optimistic (positive) and pessimistic (negative) responses; responses indicating status quo (no change) are not reckoned. Higher 'net response' indicates higher level of optimism and vice versa.
E: Expectations. A: Assessment.
*: These questions are newly added by splitting the question on Availability of Finance (both internal and external sources) in the 61st Round (Jan-March 2013).

Perceptions on overall financial situation were also better for Q4 of 2013-14 (Table VII.2).

Consumer confidence shows signs of improvement

VII.4 The Reserve Bank's 15th round of the Consumer Confidence Survey (http://www.rbi.org.in/CCS15) conducted in December 2013 shows improvement in consumer confidence as indicated by the Current Situation Index (CSI) and Future Expectations Index (FEI) (Chart VII.2).

Chart VII.2: Consumer confidence goes up



Downward revision in India's growth projections by external agencies

VII.5 Various external agencies have reduced India's growth projections further. However, the World Bank and the IMF revised it moderately upwards (Table VII.3). The IMF projects India's 2014-15 growth at 5.4 per cent, while the World Bank places its forecast at 6.2 per cent.

Table VII.3: Growth projections revised downwards

Agencies' projections for 2013-14

Agency	Latest Projection		Earlier Projection	
	GDP Growth (Per cent)	Month/Year	GDP Growth (Per cent)	Month/Year
1	2	3	4	5
Finance Ministry	5.0-5.5	Sept. 2013	6.1-6.7	Feb. 2013
PMEAC	5.3	Sept. 2013	6.4	Apr. 2013
IMF*	4.6	Jan. 2014	4.3	Oct. 2013
World Bank	4.8	Jan. 2014	4.7	Oct. 2013
OECD**	3.4	Nov. 2013	5.3	May. 2013
ADB	4.7	Dec. 2013	4.7	Oct. 2013
NCAER	4.8-5.3	Nov. 2013	5.9	Aug. 2013

*: IMF's projection in factor cost corresponding to 4.4 per cent in market prices. **: GDP at market prices.

Survey shows professional forecasters expect modest recovery in 2014-15[1]

VII.6 The Reserve Bank's 26th round of the Survey of Professional Forecasters outside the Reserve Bank (http://www.rbi.org.in/SPF26) indicated growth bottoming out in 2013-14, and a modest recovery in 2014-15 with growth pegged at 5.6 per cent. CPI inflation is expected to exhibit persistence and decline slowly averaging 8.9 in Q2 of 2014-15 and

Table VII.4: Forecasters outside the Reserve Bank expect modest growth recovery and inflation persistence in 2014-15

Median forecasts of select macroeconomic indicators by professional forecasters 2013-14 and 2014-15

	Actual 2012-13	Annual forecasts				Quarterly Forecast									
		2013-14		2014-15		2013-14				2014-15					
						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 (%)	5.0	4.8	4.8	5.8	5.6	5.0	5.0	5.0	5.2	5.6	5.3	5.8	5.6	-	5.6
a. Agriculture and Allied Activities	1.9	3.7	4.1	3.0	2.9	4.1	5.0	4.4	4.8	3.0	3.4	3.0	3.0	-	3.0
b. Industry	1.2	1.3	1.5	3.8	3.6	1.4	1.5	2.1	2.0	3.4	3.0	3.3	3.2	-	3.7
c. Services	6.8	6.2	6.2	7.0	7.0	6.5	6.2	6.5	6.3	6.9	6.5	7.0	6.8	-	7.2
2. Gross Domestic Saving (% of GDP at current market price)	-	30.0	30.5	31.0	31.0	-	-	-	-	-	-	-	-	-	-
3. Average WPI-Inflation	7.4	6.0	6.4	5.5	6.0	6.5	-	6.5	6.6	6.5	6.8	5.8	6.0	-	5.5
4. Average CPI-Combined Inflation*	10.2	-	9.9	-	8.5	-		-	9.7	-	9.5	-	8.9	-	8.0
5. Exchange Rate (₹/ US$ end period)	54.4	-	-	-	-	62.0	-	60.8	61.9	60.9	61.5	61.0	61.5	-	61.0
6. YTM of Central Govt. Securities with term to maturity of 10-years (%-end period)	8.0	8.3	8.5	7.9	8.1	-	-	-	-	-	-	-	-	-	-
7. Merchandise Export (growth rate in %)!	-1.0	3.8	6.3	8.9	8.9	-	-	-	-	-	-	-	-	-	-
8. Merchandise Import (growth rate in %)!	0.5	-1.9	-3.7	6.4	7.6	-	-	-	-	-	-	-	-	-	-
9. Trade Balance (US$ billion)	-195.7	-	-	-	-	-45.6	-36.3	-42.5	-36.9	-46.0	-41.7	-47.6	-38.3	-	-41.6
10. Current Account Deficit (% of GDP)	4.8	3.5	2.7	3.3	2.8	-	-	-	-	-	-	-	-	-	-
11. Central Government Fiscal Deficit (% of GDP)	4.9	5.0	5.0	4.7	4.7	-	-	-	-	-	-	-	-	-	-

E: Previous Round Projection. L: Latest Round Projection. -: Not Available. !: US$ on BoP basis.
*: The forecast for CPI-Combined has been incorporated from 26th round only *i.e.* the current round.
Note: The latest round refers to 26th round for the quarter ended December 2013, while previous round refers to 25th round for the quarter ended September 2013.
Source: Survey of Professional Forecasters, Third Quarter 2013-14.

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

average 8.5 per cent for the full year. Growth expectations for 2013-14 have remained unchanged, while expected WPI inflation is higher. There has been a significant downward revision in the forecast for CAD for 2013-14 to 2.7 per cent from 3.5 per cent forecasted earlier (Table VII.4).

Households' near term inflation expectations go down marginally

VII.7 The latest round (October-December 2013) of Inflation Expectations Survey of Households (IESH Round 34) (http://www.rbi.org.in/IESH34) indicates that the perception of three-month ahead median inflation expectations of households moved down whereas that for the one-year ahead period, remained at the same level as compared to the previous quarter (Chart VII.3).

Growth Outlook: Economy poised for gradual recovery in 2014-15

VII.8 Prospects of a pick-up in real GDP growth in the second half of 2013-14, have been dampened by negative growth in industrial production over two consecutive months, sluggishness in services sector activity and the weakening in private consumption and investment demand. Notwithstanding the improved export performance and buoyant outlook for agricultural production, GDP growth for 2013-14 could be somewhat lower than the central estimate of 5 per cent projected at the time of the Second Quarter Review.

VII.9 For 2014-15, the Reserve Bank's assessment is that a gradual recovery could set in, though further actions will be needed to secure it. The GDP growth is likely to be in the range of 5 to 6 per cent, with risks balanced around the central estimate of 5.5 per cent (Chart VII.4). As projects cleared by the CCI so far translate into investment, global growth outlook improves, and inflation softens, real

Chart VII.3: Inflation expectations remain high though near term expectations fall slightly

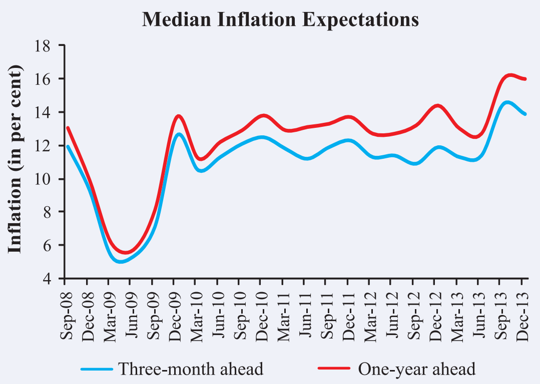


Chart VII.4: Quarterly Projection of GDP growth (y-o-y) for 2013-14 and 2014-15

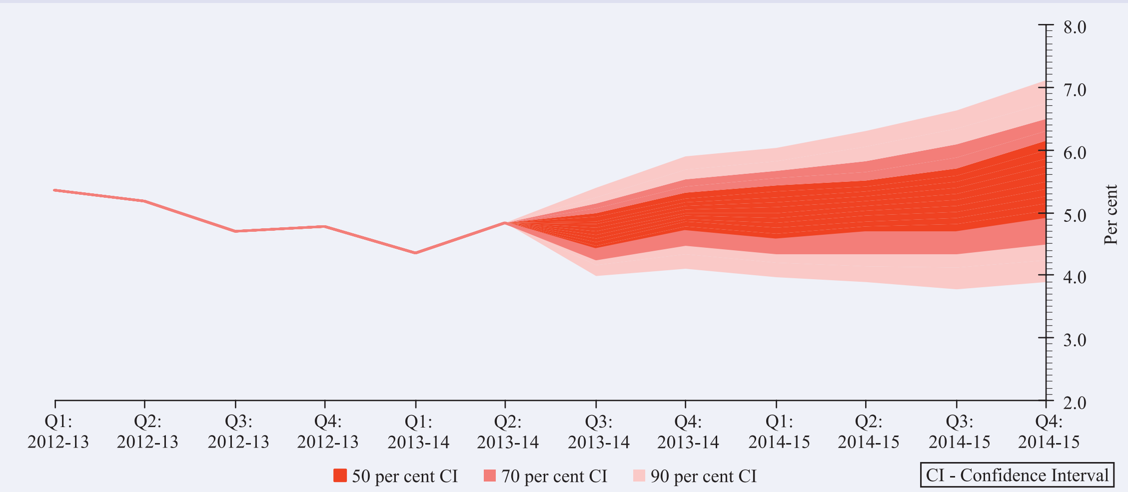
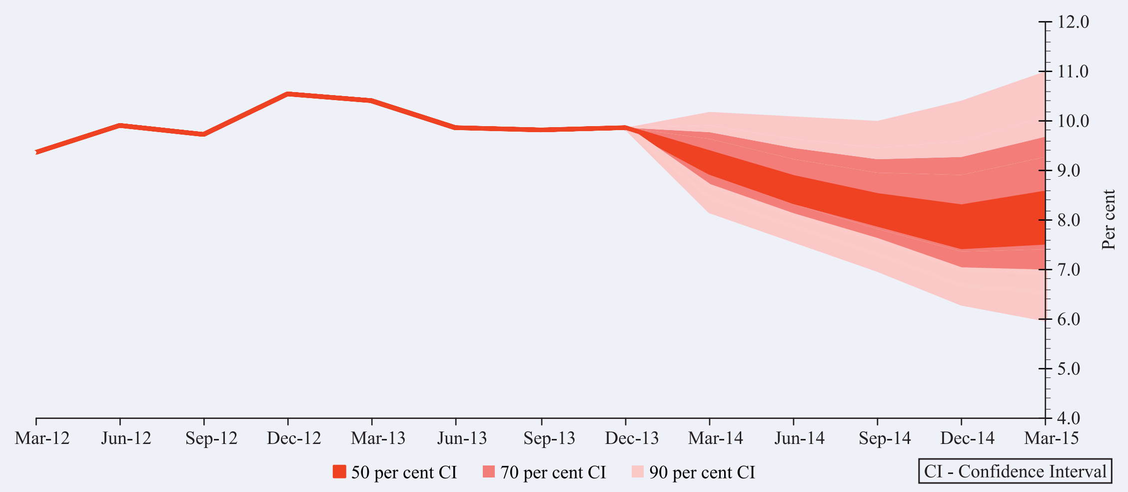


Chart VII.5: Projection of CPI-Combined Inflation (y-o-y) for 2013-14 and 2014-15



GDP growth in 2014-15 could turn up into the higher reaches of this forecast range.

Inflation Outlook: Inflation anticipated to moderate further but remain above comfort zone

VII.10 Retail inflation measured by the CPI is expected to moderate from current levels, driven down by further seasonal softening in vegetables and fruits prices in Q4 of 2013-14. However, CPI excluding food and fuel inflation is expected to remain elevated, imparting persistence to the headline. Accordingly, headline CPI inflation could still remain above 9 per cent in the rest of 2013-14.

VII.11 In 2014-15, a slow paced inflation moderation amidst sticky prices could continue. Based on the assumptions of the normal rainfall, some cost pressures from administered fuel price increases, elevated rural wages, supply chain bottlenecks and still heightened inflation expectations, CPI inflation is expected to range between 7.5 and 8.5 per cent in Q4 of 2014-15, *albeit,* with the balance of risk tilted to the upside (Chart VII.5).