Economic Outlook for 2008/09

Economic Advisory Council to the Prime Minister
Vigyan Bhavan, Hall E, Maulana Azad Road
New Delhi 110011

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ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER

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Economic Advisory Council to the Prime Minister
Hall-E
Vigyan Bhavan
Maulana Azad Road
New Delhi

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ECONOMIC OUTLOOK FOR 2008/09

Executive Summary

ECONOMIC OUTLOOK FOR 2008/09
EXECUTIVE SUMMARY

Growth Performance and Outlook

1. The Indian economy grew by 9.0 per cent in 2007/08, an average of 8.8 per cent over the past five years (2003/04 through 2007/08) which was a clear break from the previous spurts in growth. However a number of factors inimical to growth have intensified in 2008 such as a sharp elevation in global inflation rates specially crude oil, tightening in credit and equity markets and global slowdown in growth. India may not emerge unscathed and the increase in the Oil Import bill is bound to widen the Current Account Deficit (CAD) in the Balance of Payments (BoP). The pressure on the fiscal system will intensify on account of key subsidy elements. Overall, economic growth will slow down.

2. The Council projects that the Indian economy will grow by 7.7 per cent during 2008/09. Considering the magnitude of the adverse economic developments in 2008, the projected drop from 9.0 per cent last year to 7.7 per cent this year is in fact modest. We expect that farm sector incomes will expand by 2.0 per cent, industrial GDP growth by 7.5 per cent and services sector growth by 9.6 per cent. Overall, non-farm sector GDP is projected to increase by 8.9 per cent in 2008/09, compared to 10.0 per cent last year and 11.0 per cent in 2006/07 (Table-1).

3. The downside risk to our growth expectations in 2008/09 is primarily from a further deterioration in global conditions with its attendant impact on India – be it in the sphere of oil prices or capital markets. Domestically, aside from the plethora of challenges already on the table, there is also some danger on the food price inflation front.

International Economic Conditions

4. The global economy has been subjected to the twin onslaught of a financial crisis that has gripped capital markets, and a sharp increase in the prices of primary

Table 1: Growth – Past Performance and Projections for 2008/09						
Annual Rates	**2003/04**	**2004/05**	**2005/06**	**2006/07 QE**	**2007/08 Rev**	**2008/09 Projected**
Percentage change over previous year						
1. Agriculture & allied activities	10.0	-0.2	5.9	3.8	4.5	2.0
2. Mining & Quarrying	3.1	8.2	4.9	5.7	4.7	7.5
3. Manufacturing	6.6	8.7	9.0	12.0	8.8	7.2
4. Elect., Gas & Water Supply	4.8	7.9	4.7	6.0	6.3	6.5
5. Construction	12.0	16.1	16.5	12.0	9.8	8.5
6. Trade, Hotels, Transport, Storage & Communication	12.1	10.9	11.5	11.8	12.0	9.8
7. Finance, insurance, real estate & business services	5.6	8.7	11.4	13.9	11.8	10.0
8. Community & personal services	5.4	6.8	7.2	6.9	7.3	8.4
9. Gross Domestic Product (factor cost & constant prices)	**8.5**	**7.5**	**9.4**	**9.6**	**9.0**	**7.7**
Industry (2 + 3 + 4 + 5)	7.4	10.3	10.1	11.0	8.5	7.5
Services (6 + 7 + 8)	8.5	9.2	10.3	11.1	10.8	9.6
Non-agriculture (9 – 1)	8.1	9.6	10.3	11.0	10.0	8.9
GDP (factor cost, const. prices) per capita	**6.7**	**5.8**	**7.8**	**8.1**	**7.5**	**6.2**

goods, particularly those of crude petroleum and food. Though the US economy had contracted by 0.2 per cent in the last quarter of 2007, in 2008 the world's major economies have continued to grow more strongly than might have been expected. There is a measure of slowing, but this is as yet modest. On the one hand this points to the resilience of the world's economies in the globalized era; on the other hand this also suggests that across the world resource utilisation pressures continue to tighten, with negative implications for inflationary outcomes.

5. While expected losses from US sub prime exposures have by now been mostly acknowledged, but it is too early to assess whether the worst of the

turmoil and loss of asset values is behind us. There may be further setbacks in the months to come, but broadly financial conditions are not likely to stabilise before early 2009.

6. The main global shocks important for India are from elevated commodity (oil, food, and base metals) prices, a significant slowdown in the global growth momentum, turbulence in International financial markets, and a possible reversal of the USD towards an appreciation path over the next 2-4 quarters. The achievement of a reasonable rate of growth in the Indian economy is built on the presumption of a slow return to normalcy in global financial market conditions.

Structural & Sectoral Factors in Sustaining High Rates of Growth

7. The economy continues to be supply constrained, most acutely in the areas of physical and social infrastructure, which require focussed policy attention. In the area of economic infrastructure the constraints are patent in electricity, irrigation and drinking water, road and rail transportation, urban and rural economic infrastructure, and in extending the benefits of technology to aid our farmers in raising productivity.

8. In 2008/09, we expect the investment rate to be similar to 2007/08, although savings are projected to decline. Public sector savings will be adversely affected by the increase in the subsidy burden. Erosion of corporate margins would also contribute to a relative decline in private corporate savings. Consequently, the overall savings rate will for the first time in recent years be significantly lower than the investment rate – reflecting an expansion in the rate of net absorption of foreign savings (that is, the current account deficit). However, the savings rate is expected to recover next year (2009/10) on the presumption that the subsidy burden would be lower.

9. The contribution of investment to growth has actually been as great as, if not greater than, that of consumption till 2005/06. The contribution of domestic consumption expenditure to overall GDP growth has been fairly steady since 2005/06, while its relative share in growth has risen over the past two years. This trend is projected to continue in 2008/09 also. In 2008/09 we expect to see both investment and consumption expenditure growth to slow down a bit.

Trade and Balance of Payments

10. We expect that for 2008/09 as whole non-oil merchandise exports will increase by 22.5 per cent. Import of equipment and industrial intermediates is expected to continue growing at a brisk pace. Non-oil, non-bullion imports are projected to grow at 22.5 per cent, slightly lower than in the previous year. Bullion imports, after surging in the first quarter of 2007/08, had a negative growth rate in the second half of the year. We project a modest expansion in bullion imports of 10 per cent during 2008/09. We also expect that the value of crude oil and product imports would rise by 80 per cent to $138.2 billion, while the value of product exports would rise similarly to $47.1 billion. The projected value of merchandise exports and imports is $ 208 and $342 billion respectively, leaving a BoP merchandise trade deficit of $134 billion, equivalent to 10.4 per cent of GDP, a sizeable increase from 7.7 and 7.1 per cent in the last two years.

11. In the fiscal year 2008/09, we expect aggregate net software & business service earnings and remittances to expand by 28 per cent and net investment income is projected to increase. Total net invisibles are expected to increase by 27.5 per cent (compared to 31.4 per cent last year) to $92.7 billion. As a result the Current Account Deficit (CAD) is likely to expand to $41.5 billion, equivalent to 3.2 per cent of GDP - a major increase from 1.5 per cent of GDP in 2007/08. We estimate that the CAD/GDP ratio may be above 4.5 per cent in the first and second quarters of 2008/09 and subsequently decline in the last two quarters.

12. Aggregate FDI inflows are estimated at $ 19.7 billion. Portfolio inflows are estimated to be $4.1 billion in 2008/09, which is very large reduction from 2007/08. Net inflows on account of loans are expected to be $34 billion, about 19 per cent lower than in the previous year primarily due lower ECB/FCCB inflows. Net banking capital inflow and inflows under “other capital” are expected to be 50 percent lower than the previous year. Our estimate of total capital inflows in 2008/09 is $70.9 billion, which is 34 per cent less than in the previous year. This will however be more than adequate to finance the enlarged CAD, leaving about $29 billion to accrue in the foreign exchange reserves of the RBI. Policy makers may however have to be prepared to face a situation of greater volatility in capital inflows on account of the uncertain external environment.

Table 2: Projected Balance of Payments for 2008/09

Unit: US$ billion

	2004/05 R	2005/06 PR	2006/07 (P)	2007/08 (P)	2008/09 (f)
Merchandise Trade Balance	–33.7	–51.8	–64.9	–90.1	–134.1
	–4.8%	*–6.4%*	*–7.1%*	*–7.7%*	*–10.4%*
Net Invisibles	31.2	42.7	55.3	72.7	92.7
o/w Software & BPO	14.7	24.6	31.2	37.0	47.5
Private Remittances	20.5	24.1	27.9	40.8	52.0
Investment Income	–4.1	–4.9	–6.0	–5.2	–6.5
Current Account Balance	**–2.5**	**–9.2**	**–9.6**	**–17.40**	**–41.5**
	–0.4%	***–1.1%***	***–1.0%***	***–1.5%***	***–3.2%***
Foreign Investment	13.0	17.2	15.5	44.8	23.8
o/w FDI (net)	3.7	4.7	8.5	15.5	19.7
Inbound FDI	6.0	7.7	22.0	32.3	46.2
Incl. Private Equity	–	–	–	*10.0*	*7.5*
Outbound FDI	2.3	2.9	13.5	16.8	26.5
Portfolio capital	9.3	12.5	7.1	29.3	4.1
Loans	10.9	6.1	24.5	42.0	34.10
Banking capital	3.9	1.4	1.9	11.8	8.0
Other capital	0.7	–0.7	4.0	9.6	5.0
Capital Account Balance	**28.0**	**23.4**	**45.8**	**108.03**	**70.9**
	4.0%	***2.9%***	***5.0%***	***9.2%***	***5.5%***
Errors & Omissions	0.6	0.8	0.6	1.5	0.0
Accretion to Reserves	**26.2**	**15.1**	**36.6**	**92.2**	**29.4**
	3.7%	1.9%	4.0%	7.9%	2.3%

Note: * Business process outsourcing
Figures in parentheses denote proportion to GDP at current and market prices

Prices

13. The rate of inflation as measured by the Wholesale Price Index (WPI) showed a declining trend through the first three quarters of 2007/08. But the

surging international prices of commodities and the underlying resource tightness at home generated enormous inflationary pressure in the last quarter of 2007/08. WPI inflation soared from 3.8 per cent at the end of December 2007 to 7.8 per cent by the end of March 2008, coming mainly from oil, food and commodities. International price conditions turned particularly negative in the first two quarters of the calendar year 2008. Over the past month, some cooling of the temperature is in evidence and we expect this process of stabilisation to continue into the balance part of 2008/09 at more-or-less present price levels.

14. The Council is of the view that co-ordinated policy action, coupled with some reinforcement of the recent cooling evident in world commodity prices and monetary actions by other central bankers can help bring the rate of inflation down by the end of March 2009 to 8 to 9 per cent. However in view of the large backlog of fuel price adjustments achieving a reduction to 7 per cent will take considerable effort and a confluence of favourable factors.

Employment

15. According to the NSSO data the period covered by the 61st Round (1999/2000 to 2004/2005) was one of strong employment growth. The workforce growth rate of 2.9 per cent was almost twice the population growth rate, and there was a threefold increase in the employment elasticity to 0.48. Agriculture accounted for a large share in incremental employment, but in terms of growth rate, it turned in a relatively weak performance at 1.54 per cent. The other two sectors delivered robust employment numbers, with the industrial workforce growing at 5.86 per cent and services at 4.01 percent. In industry, workforce growth rate outstripped the SDP growth rate in 11 states implying declining productivity growth per worker. The service sector performance was good with 12 states achieving workforce growth rates above 3 per cent.

16. The state wise employment numbers also showed strong growth rates. Employment elasticity was very high, with twelve states showing elasticity above 0.38. However, across states there were wide variations in workforce growth rates, ranging from 5.61 per cent to 1.29 per cent. The wide interstate variations in SDP and workforce growth rates make generalizations difficult. However the data does indicate that in the non-agriculture sector a positive growth in output is a necessary condition for a positive growth in employment, while this is not necessarily the case with agriculture.

Monetary Conditions and the Financial Sector

17. Monetary expansion (M3) at 21.0 per cent in 2007/08 was comparable to that of previous years. This reflected the strong pace of economic activity that resulted in strong demand for funds and the base money expansion due to a surge in capital flows that were not fully sterilized. During the current financial year RBI has repeatedly intervened to rein in excess liquidity, increasing the Cash Reserve Ratio (CRR) by a total of 150 basis points to 9.0 per cent, and the repo rate by 100 basis points to 9.0 per cent. Notwithstanding the sustained increase in the broad money aggregate, the growth in bank credit to the commercial sector showed some signs of deceleration.

18. Despite tightening of liquidity, credit growth in the first quarter of 2008/09 was stronger than what it was in the corresponding period of 2006/07. Up to the fortnight ended July 6, 2008, non-food credit increased by Rs 40,344 crore (1.7 per cent) and total accommodation by Rs 33,218 crore (1.4 per cent) over the end of March 2008. This was due to an increase in credit default swap (CDS) rates reducing access to external debt and low equity prices making it difficult to raise money domestically.

19. In our Outlook in July 2007, we had suggested some temporary restrictions on ECB. However in view of the altered circumstances this year with respect to capital flows and accretion to reserves, it may be time to review the temporary restraints placed last year. The Council also suggests that in view of the pressure of domestic aggregate demand interacting with exceptionally high international commodity prices, a tight monetary stance has to be maintained for the balance part of 2008/09 in order to contain and reduce the inflation rate.

Government Finances

20. There has been a perceptible improvement in the fiscal situation in India in recent years at both Central and State levels. The consolidated gross fiscal deficit relative to GDP declined steadily from 9.9 percent in 2001/02 to 7.5 per cent in 2004/05 and is budgeted at 4.6 percent in 2008/09. The aggregate revenue deficit declined from 7 percent of GDP in 2001/02 to 2 percent in 2006/07 and is budgeted at 0.5 percent in 2008-09. The progress in fiscal consolidation shows that both the Central and the State governments are likely to overreach the fiscal deficit target while the persisting revenue deficit would remain a matter

of concern. The improvement in the fiscal situation is mainly attributable to a significant increase in tax revenues. There are however serious fiscal risks arising from growing off-budget liabilities on account of fertiliser, food and oil, along with unbudgeted liabilities arising out of the farm loan waiver and NREGA schemes and the implementation of the Sixth central Pay Commission. These liabilities could amount to 5 per cent of the GDP in 2008/09, over and above the budgeted central fiscal deficit of 2.5 per cent.

ECONOMIC OUTLOOK FOR 2008/09

Full Report

ECONOMIC OUTLOOK FOR 2008/09 REPORT

I. Growth Performance and Outlook

1. The Indian economy grew by 9.0 per cent in 2007/08, slightly less than the 9.6 per cent registered in 2006/07 and average of 8.8 per cent over the past five years (2003/04 through 2007/08). The elevated pace of growth of the Indian economy in recent years is a clear break from previous spurts in growth. Of the past five years, growth was 9.0 per cent and above in three successive years – 2005/06 through 2007/08 – and was 7.5 and 8.5 per cent in the two years prior to that.

2. Growth in the farm sector appears to have made a signal recovery over the past few years. In 2007/08 GDP arising in the farm sector increased by 4.5 per cent with the average of the past four years being 3.5 per cent. This is an important improvement over the trend since the mid-1990s that saw farm sector growth gravitate towards 2.5 per cent per annum. However, focused efforts need to be maintained to improve rural infrastructure and provide technological and system support for further raising productivity.

3. There was a clear slowdown in growth in the manufacturing sector in 2007/08, principally in the second half of the year. For the year as a whole, growth was 8.8 per cent, much lower than the 12.0 per cent achieved in 2006/07, reflecting a significant deceleration over the last few years.

4. A number of factors inimical to growth have intensified in 2008. Firstly, there is a sharp elevation in inflation rates: there has been a runaway increase in the prices of crude, petroleum and steel. This has set off increases in the prices of a wide range of downstream products, including chemicals, fertilisers, synthetic fibres and machinery. The sharp rise in the global prices of food grain and edible oil has lent a particularly harsh edge to the headwinds of world wide inflation that have been blowing for more than six months now. Secondly, both credit and

equity markets have not only tightened but have also become extremely nervous, underscored by the strong feedback loop of deteriorating asset markets. As a result, the cost of both equity and debt has risen, and companies are finding it harder to secure financial closure on their existing projects. Thirdly, growth has slowed down globally in response to the combination of declining consumer and investor confidence, monetary tightening and capital market uncertainty.

5. No country, except the large commodity exporting nations, can perhaps hope to emerge unscathed from such adverse worldwide conditions. Inflation, growth and other macro-economic outcomes are all likely to be severely impacted, the particulars varying with the specific economic condition prevailing in the national economy. We have already seen new highs in domestic inflation. Industrial production data also reflects the sluggishness in industry. The increase in the oil import bill is bound to widen the Current Account Deficit (CAD) in the Balance of Payments (BoP). The pressure on the fiscal system will intensify on account of key subsidy elements. Equity and other asset markets have already taken a big beating. Overall, economic growth will slow down.

6. It is against this backdrop that we have assessed that the Indian economy will grow by 7.7 per cent during 2008/09. Considering the magnitude of the adverse economic developments in 2008, the projected drop from 9.0 per cent last year to 7.7 per cent this year is in fact modest. Our assessment is based on our understanding of the structural strengths of the Indian economy that are discussed subsequently. It should be pointed out that tightening international and domestic supply conditions had also impacted growth in 2007/08, especially in the second half of the year. Projections by industry of origin, along with growth numbers for previous years and some broad magnitudes, are presented in Table-1.

7. Most recent national and international estimates (since June 2008) have projected the Indian economy to grow within a range of 7 to 8 per cent. The Reserve Bank of India in its Policy Statement of July 28, 2008 has estimated economic growth in 2008/09 at around 8.0 per cent.

8. The South West (SW) monsoon set in early in 2008. After receiving above average rains in the pre-monsoon period (May) and in the first month (June), peninsular, central and western India saw the SW monsoon weaken significantly in July 2008. Though rains have returned in the last week of the month, some

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3. Manufacturing	6.6	8.7	9.0	12.0	8.8	7.2
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5. Construction	12.0	16.1	16.5	12.0	9.8	8.5
6. Trade, Hotels, Transport, Storage & Communication	12.1	10.9	11.5	11.8	12.0	9.8
7. Finance, insurance, real estate & business services	5.6	8.7	11.4	13.9	11.8	10.0
8. Community & personal services	5.4	6.8	7.2	6.9	7.3	8.4
9. Gross Domestic Product (factor cost & constant prices)	**8.5**	**7.5**	**9.4**	**9.6**	**9.0**	**7.7**
Industry (2 + 3 + 4 + 5)	7.4	10.3	10.1	11.0	8.5	7.5
Services (6 + 7 + 8)	8.5	9.2	10.3	11.1	10.8	9.6
Non-agriculture (9 – 1)	8.1	9.6	10.3	11.0	10.0	8.9
GDP (factor cost, const. prices) per capita	**6.7**	**5.8**	**7.8**	**8.1**	**7.5**	**6.2**
Some Magnitudes						
GDP factor cost – 1999/00 prices (Rs trillion)	22.2	23.9	26.1	28.6	31.2	33.5
GDP market & current prices (Rs trillion)	27.5	31.5	35.8	41.5	47.1	54.3
GDP market & current prices in US$ Billion	599	701	809	918	1,174	1,293
Population (million)	1,073	1,090	1,106	1,122	1,138	1,154
GDP current & market prices per capita (Rs)	25,672	28,894	32,372	36,950	41,416	47,056
GDP current & market prices per capita (US$)	559	643	731	818	1,032	1,120

negative impact on farm output in the affected regions is perhaps inevitable. We have assumed that for the balance period of the SW monsoon there will be no further setbacks, and that the winter growing conditions will also be more-or-less normal.

9. Growth in farm sector output was very strong in 2007/08, with food grain production touching a new record of 230.7 million tonnes. Keeping in view the level of output last year, and the progress of the SW Monsoon so far this year, we expect that farm sector output will expand by 2.0 per cent, distinctly slower than what was achieved last year. We expect that manufacturing output growth will slow to 7.2 per cent, pulling industrial GDP growth down to 7.5 per cent, a full one percentage point below that of last year, and 3.5 percentage points less than that recorded in 2006/07. Services sector growth is also expected to slow slightly to 9.6 per cent (down from 10.8 per cent last year). Overall, non-farm sector GDP is projected to increase by 8.9 per cent in 2008/09, compared to 10.0 per cent last year and 11.0 per cent in 2006/07.

10. The downside risk to our growth expectations in 2008/09 is primarily from a further deterioration in global conditions with its attendant impact on India – be it in the sphere of oil prices or capital markets. Further, on the domestic front, aside from the plethora of challenges already on the table, there is also some danger on the food price inflation front and the possible adverse impact on growth due to a tight monetary policy. So far a combination of effective policy interventions, good weather conditions and strong supply response from the grower has kept food price inflation under reasonable control. If farm production is hit because of adverse weather conditions, food prices may come under pressure.

II. INTERNATIONAL ECONOMIC CONDITIONS

11. The global economy has been subjected to the twin onslaught of a financial crisis that has gripped capital markets, and a sharp increase in the prices of primary goods, particularly those of crude petroleum and food. Simultaneous turmoil in financial, energy, and food sectors is unprecedented in recent world economic history. This has adversely affected consumer confidence and prospects for world economic growth, dented a range of asset prices, heightened inflationary expectations and is severely testing theories of 'decoupling' through global contagion.

12. While the sub-prime crisis erupted a year ago, the full grip of the erosion in confidence in financial markets dates back to the beginning of 2008. While crude oil and food grain prices, as well as those of several other natural resources, were elevated through most of 2007, the current calendar year has seen rises of unprecedented magnitude.

13. The pace of economic expansion has reduced sharply in the USA, although it has not entered recession in the technical sense of two successive quarters of negative growth as was widely expected. In fact GDP growth in the quarter ended June 2008 was 1.9 per cent, following on 0.9 per cent growth in the quarter ended March 2008 (both on annualized basis). However, the latest revisions show that the US economy had contracted by 0.2 per cent in the last quarter of 2007. In the first quarter of 2008, the Euro-zone reported growth of 2.1 per cent[1], which is a little above trend. The situation was similar in other developed economies in Europe. In Japan, growth was 1.3 per cent,[2] fairly strong compared to the recent past.

14. Economic growth was strong in resource-rich Australia (2.5 per cent). Though first quarter growth in Canada was lower than anticipated, it is expected to pick up during the rest of 2008 and next year. China reported a growth rate of 10.4 per cent in the first half of 2008. The Russian economy expanded by 8.5 per cent in Q1 of 2008, while Brazil registered a growth of 5.8 per cent. Notwithstanding the enormous increase in inflationary pressure and some monetary tightening outside of the USA, the world's major world economies have continued to grow more strongly than might have been expected. There is a measure of slowing, but this is as yet modest. On the one hand this points to the resilience of the world's economies in the globalized era; on the other hand this also suggests that across the world resource

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[1] Year on year; the annualized quarter-on-quarter growth in Q1 of 2008 was higher at 2.8 per cent.

[2] Quarter-on-quarter annualized growth in Q1 of 2008 was much higher at 4.0 per cent.

utilisation pressures continue to tighten with negative implications for inflationary outcomes.

15. Financial market risk perception had declined sharply between 2004 and 2007 to levels where the need for correction had become apparent by the end of 2006. The markets however continued to further push risk costs down through the middle of 2007. After the sub-prime crisis broke out in August 2007, the pendulum swung the other way. Asset prices, particularly those of equity, lost ground, while credit premium for all classes of credit exposures shot up. Signals from central bankers have been mixed, leaving the market uncertain whether there was a recession in store (and concomitantly cheap money) or whether the containment of inflation (and higher interest rates) would be on top of the agenda. While the U.S. Fed has largely focussed on growth, the signalling from central bankers in Europe, the Far East and Australia (including India) however was along conventional lines. The net result was that the flux in foreign exchange markets intensified beyond what might have been expected from a valuation crisis in financial asset markets alone.

16. While expected losses from US subprime exposures have by now been mostly acknowledged, and banks have been able to raise capital in response, delinquencies and foreclosures in the US housing markets continue to rise sharply, house prices continue to plummet, loan deterioration has moved beyond subprime and housing portfolios, bank balance sheets and equity prices continue to be under pressure, and credit markets are still to normalize. It is therefore too early to assess whether the worst of the turmoil and loss of asset values is behind us. It is also difficult to anticipate the pace of recovery in financial market conditions. We expect it to be a slow process peppered with occasional setbacks. There may be further setbacks in the months to come, but broadly financial conditions are unlikely to stabilise before early 2009.

17. The main global shocks important for India are from elevated commodity (oil, food, and base metals) prices, a significant slowdown in the global growth momentum, turbulence in international financial markets, and a possible reversal of the USD towards an appreciation path over the next 2-4 quarters. The achievement of a reasonable rate of growth in the Indian economy is built on the presumption of a slow return to normalcy in global financial market conditions, modest world wide economic expansion, and persistence of inflationary pressures in the near future. A more detailed discussion on the likely impact of the external economic environment on India is at ***Annexure 1***.

III. STRUCTURAL & SECTORAL FACTORS IN SUSTAINING HIGH RATES OF GROWTH

Structural Factors

18. There is uneasiness in many quarters about whether the experience of the past five years of 8.8 per cent growth is sustainable. In the Economic Outlook for 2007-08 we had addressed the misconception that the present phase of growth was consumption-led. Investment, particularly private corporate investment, was clearly the prime driver, matched by the improvement in the savings rate, brought about in large measure by the progress in fiscal consolidation that has reduced government dissavings. The ability of the banking industry and other parts of the financial sector to support this process, as also the maturity of the corporate sector in global business conditions, provided the necessary architecture to allow the growth process to bear fruit. None of this has changed, except for the additional subsidy burden on the fiscal balance.

19. The economy continues to be supply constrained, most acutely in the areas of physical and social infrastructure, where the goods involved are to a greater or lesser extent public goods, and where Government is involved to a significant extent. These shortages require focused policy attention. Inadequacies in capacity creation in these infrastructural areas will determine the pace at which we will be able to benefit our citizens by sustaining a process of rapid economic growth in the medium and longer term. In the area of economic infrastructure the constraints are patent in electricity, irrigation and drinking water, road and rail transportation, urban and rural economic infrastructure, and in extending the benefits of technology to aid our farmers in raising productivity.

20. The provisional estimates of investment and savings for 2007/08 are fairly close to the projections that we had made in the Economic Outlook for 2008/09. In 2008/09, we expect the investment rate to be similar to 2007/08, although savings are projected to decline. Public sector savings will be adversely affected by the increase in the subsidy burden. Erosion of corporate margins would also contribute to a relative decline in private corporate savings. Consequently, the overall savings rate will for the first time in recent years be significantly lower than the investment rate – reflecting an expansion in the rate of net absorption of foreign savings (that is, the current account deficit). However, the savings rate

Table 2: Movement in some key macroeconomic parameters

Unit: per cent

	Investment Rate	Domestic Savings Rate	Growth rate at constant prices				
			Gross Domestic Capital Formation (GDCF)		GDCF in Fixed Capital only		Final Consumption Expenditure
			Total	Pvt. Corp.	Total	Pvt. Corp.	
2000/01	24.3	23.7	–4.0	–28.3	–0.0	–11.0	1.6
2001/02	22.8	23.5	3.5	8.6	7.4	3.6	6.1
2002/03	25.2	26.4	10.6	12.9	6.7	–1.6	1.8
2003/04	28.2	29.8	13.9	24.3	13.7	24.0	6.2
2004/05	32.2	31.8	23.5	71.1	18.9	65.3	5.4
2005/06	35.5	34.3	18.2	36.2	17.4	35.7	7.9
2006/07	35.9	34.8	14.4	20.4	15.1	20.5	7.0
2007/08	37.4	36.2	13.3	17.5 e	13.8	17.5 e	8.1
2008/09	37.5	34.5	10.0	12.5	10.0	12.5	6.5

Note: e : Estimated
Figures for 2008/09 are projections

is expected to recover next year (2009/10) on the presumption that the subsidy burden would be lower.

21. The sharp increase in the domestic savings rate by 6.4 percentage points of GDP between 2003/04 and 2007/08 permitted incremental investment equivalent to 9 percentage points of GDP to be largely domestically financed. In consequence, although the current account balance shifted from positive (2001/02 to 2003/04) to negative thereafter, the magnitude of the CAD was contained at around 1 per cent of GDP. The sharp increase in the price of crude petroleum, however, is likely to alter this fundamentally in 2008/09. While investment (in terms of GDP) is likely to be at roughly the level of 2007/08, the domestic savings rate is however likely to be significantly lower, corresponding to a larger current account deficit. The bulk of the lowering of the savings rate will be reflected in government finances, and in part through erosion in the profit

Table 3: Contribution to GDP growth by expenditure category								
	2001/ 02	**2002/ 03**	**2003/ 04**	**2004 /05**	**2005 /06**	**2006 /07**	**2007 /08**	**2008 /09**
GDP (market prices) growth rate	5.22	3.77	8.37	8.28	9.24	9.69	9.03	7.70
Total Investment or total GDCF	–0.70	3.78	4.98	5.41	5.94	3.63	4.51	**3.62**
o/w GDCF in Fixed Capital	1.66	1.52	3.22	4.66	4.73	4.41	4.21	
Domestic Final Consumption Exp.	4.57	1.34	4.60	3.93	5.62	4.88	5.54	**5.09**
o/w Private Final Consumption Exp	3.82	1.39	4.31	3.33	5.25	4.25	4.86	
Net Exports of Goods & Services and Discrepancies	1.34	–1.36	–1.21	–1.06	–2.32	1.18	–1.03	**–1.01**

Note: Figures for 2007/08 are provisional based on the May 2008 release of CSO.
Those for 2007/08 are our projections.

margins of companies. This situation could change in 2009/10 if the domestic savings rate goes up through improved government finances and reductions in the merchandise trade and current account deficits

22. The contribution of investment to growth has actually been as great as, if not greater than, that of consumption till 2005/06 as a perusal of Table 3 will show. The contribution of domestic consumption expenditure to overall GDP growth has been fairly steady since 2005/06, while its relative share in growth has risen over the past two years. This trend is projected to continue in 2008/09 also. In 2008/09 we expect to see both investment and consumption expenditure growth to slow down a bit.

23. In some sectors, however, adequate investment has been forthcoming from the private sector to create the additional production capacities needed. A good example of this is the cement industry. During the period 2001/02 to 2004/05 domestic demand lagged capacity addition, leading to significant excess capacity creation and consequent loss of pricing power. In 2005/06 and 2006/07 domestic demand increased considerably, wiping out the excess capacity. This led to a return of pricing power manifested through rising cement prices. This has in turn triggered a fresh round of capacity creation. We had estimated last year that operating capacity would increase by over 20 million metric tonnes in 2007/08, and also during the two subsequent years, that would alter the pricing

power dynamics in the business. In fact the capacity addition during 2007/08 was as much as 22.2 million tonnes, although the bulk of the addition was towards the end of the year. In the first quarter of 2008/09 as much as 11.6 million tonnes of further capacity was added. Cement output increased by over 14 per cent in the first quarter of 2008/09, in contrast to the less than robust growth in manufacturing.

24. The normal process of price adjustment and investment/supply response has been pushed to the background this year by the onslaught of surging international prices of crude oil and other commodities, particularly fertilisers and steel. Petroleum is a basic input in the industrial process as a universal transport fuel and chemical feedstock. This has combined with inadequate investments in capacity creation in a host of industries from fertiliser to steel, resulting in a powerful surge in their prices. Further, the prevalent grid power outages meant that industry drew a significant proportion of its power requirement from captive power generation that is mostly based on petroleum fuels.

25. Infrastructure, particularly electricity, however, remains an enormous challenge. Power sector reforms are still to be completed and ATC (aggregate technical and commercial) losses, though reduced from previous levels, still remain high. Despite new capacity coming on line, the increase in power generation is frustratingly low. While some private corporate investment has been forthcoming in this sector, government companies still account for the largest share of on-going investments. It is important that more private investment flows into the power business. Completing the reform process will greatly accelerate this process. There is special urgency to step up the pace of capacity creation – in both generation and distribution – and to complete the process of commercial reform in the power sector, including incentivising efficiency of generation, distribution and consumption. The opportunity cost of forgone power generation is expressed in the form of foregone incremental industrial output and an increase in their average cost of supply.

Farm Sector

26. In general, agricultural growth fell from 3.2 per cent during the 1980s and 1990s to a trend average of 1 per cent during 2002/03 to 2004/05 on account of declining productivity, both crop-wise and region-wise. The increase in farm sector output over the past few years is a notable improvement over the closing years of the nineties and early part of this decade.

27. Since there is so much volatility in the year-to-year rates of GDP growth arising in agriculture & allied activities, the practice has been to use 3-year moving averages for the purpose of analysis. The average rate of growth for farm sector GDP between 1959/60 and 2007/08 was 2.6 per cent. For the period up to 1990/91 the average was slightly lower at 2.4 per cent. In the 17-year period after 1991, the average growth rate was slightly higher at 2.9 per cent. The volatility in growth rates has also diminished sharply: the coefficient of variation fell from nearly 100 per cent in the period 1960–91, to 52 per cent in the period from 1991 to 2008.

28. The slightly better growth outcomes in the post 1991 period was despite weak farm sector growth in the years 1999/2000 to 2002/03 on account of low rainfall. In 1999, the SW monsoon was normal by the standard definition, but most of the drier parts of the country received insufficient rain. The SW Monsoon was deficient in 2000, 2001 and 2002. As a result, farm sector growth during this period fell to (–) 0.2 per cent.

29. In 2003/04, farm sector growth rebounded from the contraction of the previous year owing to the very bad drought. Growth in the sector continued to be strong in the four subsequent years (2004/05 to 2007/08), averaging 3.5 per cent on account of the base effect, succession of good monsoons, and concerted policy interventions such as the National Food Security Mission, the Rashtriya Krishi Vikas Yojana and distribution of certified high quality seeds. The Eleventh Plan (2007–12) has targeted 4 per cent annual growth for the farm sector as being necessary to meet the socio-economic objectives of reducing poverty and creating adequate income incentives for sustaining future growth in the sector.

30. Despite the recent upward trend in food grains production, India's food security remains an area of concern. As against the record production of 230.7 million tonnes in the year 2007/08, the demand for foodgrains is projected to increase to 250 million tonnes by the terminal year of the Eleventh Five Year Plan (2011) according to the Report of the Steering Group on Agriculture and Allied Sector for the Eleventh Five Year Plan. There is consequently a challenging task ahead in bridging the demand - supply gap by accelerating the pace of domestic production of food grains.

31. The major challenges confronting the agriculture sector, particularly in food grains production, is the slowdown in fertilizer, irrigation, and energy use at the farm level and technological stagnation. Crop intensity and area under

cultivation have also shown a decline. The earlier trend of crop diversification has shifted from high value crops to low value, less risky and less input demanding crops. The terms of trade for agriculture had deteriorated in recent years, and are only now beginning to move in the other direction. Besides, there has been a decline in both public and private investment, absence of new technologies, deterioration in soil health, and overall climate change. Improvement in rural infrastructure, proper price, marketing, storage, and extension support services and facilities, better irrigation based on improved methods of water utilisation, extension of improved technologies, balanced use of fertilisers and crop diversification provide the necessary framework for sustaining a growth rate in the farm sector of close to 4 per cent. It is also imperative to consolidate unviable and fragmented holdings, substantially raise agricultural productivity and improve opportunities of non-agricultural employment to relieve the pressure on agriculture for residual labour absorption.

Electricity Sector

32. The Economic Outlook for 2007-08 had suggested that the bar on electricity generation capacity needed to be raised and had suggested a figure in the region of 100,000 MW for the present plan period, going up to a cumulative total of 300,000 MW of incremental capacity creation by the end of the next decade (2020). In the Eleventh Plan period, a figure of 78,700 MW of capacity creation is presently envisaged for which projects and equipment supply have been largely tied up.

33. It needs to be mentioned that in 2007/08 the total increase in power generating capacity was 9,732 MW, 8 per cent more than the 9,042 MW commissioned in 2006/07. This compares well with the average of 4,810 MW in the previous four-year period. However, power generation has not kept pace with commissioned capacity. In the first quarter (April to June) of 2008/09, power generation increased by a mere 2.3 per cent compared to the programmed 12 per cent plus growth. This anomalous situation needs to be rectified.

34. In order to sustain higher rates of growth, the order of increase in generating and distribution capacity will have to be higher still. It is also imperative that normal economic conditions are restored in the sector by reforming the distribution end and making distribution companies financially solvent.

IV. SECTORAL DEVELOPMENTS

Agriculture

35. The fourth advance estimates for 2007/08, released by the Ministry of Agriculture and Cooperation, show that food grain output increased by 6.2 per cent to 230.67 million tonnes from 217.28 million tonnes (final estimate) in 2006/07. The output in both these years marked new record levels of production.

36. Output of rice was higher by 3.3 per cent at 96.43 million tonnes, while that of wheat increased by 3.4 per cent to 78.4 million tonnes. The biggest gain was in coarse cereals where production increased by 20.1 per cent to reach 40.73 million tonnes. Production of pulses was higher at 15.11 million tonnes, an increase of 6.4 per cent, while oilseeds output rose by 18.7 per cent to a record level of 28.82 million tonnes. Output of raw cotton was higher by 14.0 per cent, with only sugarcane seeing a small (4 per cent) decline in production.

37. Higher levels of output, combined with restrictions placed on the export of these products, have helped keep domestic food prices from reflecting the sharp increase in international prices. In the case of edible oil, however, where India is a large importer, the situation is different. Despite the record output of oilseeds and reduction in import duty, the prices of edible oil, and hence of oilseeds, have increased significantly in the past months. Likewise in the case of cotton, large exports have helped equalise domestic and world prices, resulting in a sharp rise in domestic raw cotton prices.

38. The South West (SW) monsoon set in early this year. Rainfall was above normal in June, as also in the pre-monsoon month of May, in most parts of the country. However, in the month of July, rains were deficient in peninsular, central and western India. Weak rainfall in July generally has adverse implications for the prospect of the kharif (summer) crop. Above-normal rains in May and June have nevertheless raised sub-surface moisture availability which, combined with the resumption of rain since the fourth week of July 2008 in the affected areas, has the potential of significantly limiting crop damage.

39. In view of the above scenario, we expect that kharif foodgrain and oilseed output may be at about the same level as last year, while there may be some

expansion in the (largely irrigated) rabi harvest. Market gardening (horticulture) and animal husbandry (dairy and poultry) have been growing rapidly for some years now, and we expect this trend to continue this year also. On this basis, we project that GDP originating in agriculture & allied activities is likely to grow by 2.0 per cent in 2008/09, less than what it has done in the previous three years. The lower growth projection is in part due to the base effect of very high growth in 2007/08, and the weak SW monsoon over peninsular, central and western India in July 2008.

Industry

40. Overall, growth of GDP arising in the industrial sector is expected to be 7.5 per cent, about one percentage point below what was recorded in the previous year. The primary reason for this is slower domestic consumer demand growth and weaker expansion of export demand. Over the medium term, the main constraint on industrial growth emanates from infrastructure, particularly electrical energy.

Mining

41. GDP originating in the mining sector rose by 4.7 per cent in 2007/08, lower than what was recorded in each of the previous three years. This was largely due to a small contraction in crude oil production, and weak growth in coal output. In 2008/09, however, it is expected that both crude oil and coal production will increase by 8 per cent or more. The output of natural gas is also expected to increase significantly during 2008/09 on account of production from the KG basin. Hence, the GDP originating in the mining sector is expected to increase by 7.5 per cent in 2008/09. It could well be higher.

Manufacturing

42. The manufacturing sub-index of the Index of Industrial Production (IIP) reported an output growth of 5.3 per cent for the first two months of 2008/09. In some sense, this carried forward a trend manifest in the data for the last quarter of 2007/08. In some months the aggregate number was revised upwards subsequently. Thus the manufacturing IIP growth in January 2008 improved from 5.9 per cent in the provisional release to 6.7 per cent in the revised figure. However, the provisional growth figure of 2.9 per cent for March 2008, despite the subsequent upward revision to 3.9 per cent, is cause for serious concern. This was

followed by a provisional estimate of 3.9 per cent for May 2008 and a downward revision of the April growth estimate.

43. The detailed IIP data, not surprisingly, has elements that should cause further concern. For instance, the growth of capital goods, which had plummeted to 2.6 per cent in January 2008, but showed some recovery in subsequent months, fell again to 2.5 per cent in May 2008. Growth in the output of both basic and intermediate goods fell to 3 per cent and 1 per cent respectively in May, after reporting low numbers in both March and April. In contrast, durable consumer good output, after reporting less than 1 per cent growth in March, bounced back in April and May, while non-durable consumer goods output has remained strong, except in March 2008.

44. Although anecdotal evidence does suggest some slowing in output expansion in manufacturing industry, this is of a much smaller order than what is reflected in the IIP data. The fundamental problem with anecdotal evidence is its partial nature. It can therefore run counter to what a more broad-based indicator such as IIP would throw up. There are some problems associated with the antiquated base-year. There are also classification problems since the IIP 4-digit levels correspond to the NIC-87 list and most of these categories are now 5-digit level entries in the NIC-98/NIC-2004 classification. In some cases it is possible to examine the 4-digit level IIP data and clearly see a problem arising from the classification and weights. However it is less than obvious in other cases. Clearly, the IIP base year and classification categories are in need of urgent revamp.

45. The Council is of the view that some slowing has occurred in output growth in consumer goods and this can be reconciled to what might be reasonably expected from the compression of leveraged consumer demand. It sees sustained, if somewhat slowing, export demand and a continuing momentum in underlying domestic demand. It expects output growth in basic and intermediate goods at a pace possibly higher than being reported by the IIP. For example, cement production data shows growth of over 14 per cent in the April–June quarter of 2008/09, while the IIP data for the corresponding 2-digit category (non-metallic minerals) reports growth of 1.4 per cent during April & May 2008. In the case of capital goods, the most important 2-digit IIP category (machinery & equipment) reportedly grew by 7.4 and 7.2 per cent in March and April. The provisional estimate for May 2008 was 4.4 per cent. Accordingly, we expect that output growth in capital goods will recover to a level, which though lower than the sizzling 20 per cent plus rates of the previous two years, close to 10 per cent.

46. On the basis of this understanding, the Council has projected a growth of 7.2 per cent for the manufacturing sector, which is significantly lower than what was achieved in the past four years.

Electricity, gas & water supply

47. The electricity industry makes up the bulk of the weight of this sector. Power generation by public utilities grew by 9.0 per cent in 2007/08, higher than the 7.3 per cent in 2006/07, and a marked improvement on previous years. The programme generation of electricity in 2008/09 envisages a growth of 12.2 per cent over that of last year. However, actual output in the first quarter of 2008/09 was only 2.3 per cent more than in the corresponding period of last year.

48. The shortfall in power generation is from thermal and nuclear, while hydro has been in line with targets. In the first quarter of 2008/09, thermal power generation was expected to be higher by 13.1 per cent, but the achievement was only 2.9 per cent. Nuclear power generation was expected to be lower by 14.5 per cent (possibly due to difficulties in eking out the available fuel) but generation actually fell by 23.7 per cent.

49. We expect that the generation situation will improve in the balance part of the current fiscal year and overall GDP arising in the sector is likely to grow by 6.5 per cent, about the same level as in the previous year.

Construction

50. Residential and commercial construction activity has been adversely affected by the higher cost of borrowing and the difficulties faced by companies in raising funds from the international market. There is no reason to believe that construction activities in infrastructure and plant construction suffered similarly, though there is anecdotal evidence that suggests that the sharp increase in steel prices has become a factor slowing down the pace of several construction projects. Although output of cement in the first quarter was 14 per cent higher than in the corresponding period of last year, we expect a slower pace of expansion in the construction sector as a whole. GDP growth arising in the construction sector is estimated to increase by 8.5 per cent. This is lower than in any of the previous five years.

Services

51. The services sector has been an important driver of growth over the past decade. In recent years, industry has contributed its bit, thus lifting the pace of overall economic growth. In 2007/08, the service sector aggregated growth of 10.8 per cent, marginally lower than the 11.1 per cent achieved in the previous year.

52. The pace of expansion has been hectic in recent years in the transport sector, and some easing is expected in the current year. This is particularly true for civil aviation, but perhaps less so for railways, road transport and ocean cargo. The available data shows strong growth in railway and ocean cargo movement and decline in civil aviation in recent months. There are also reports of fall in hotel occupancies and in other indicators of the intensity of pace in trade and business activities. The rate of expansion in the category transport, hotels, restaurants & communications was 12.0 per cent in 2007/08, and close to that level in the two previous years. We expect growth in this sector to decline to 9.5 per cent in 2008/09.

53. Finance, insurance, real estate and business services grew by 11.8 per cent in 2007/08, and by 13.9 per cent in the previous year. We expect this to come down to 10 per cent in 2008/09. Government is likely to implement the broad recommendations of the Sixth Pay Commission, and several State governments are likely to follow with pay increases along similar lines. This will increase the pace of expansion of the public administration component of the sector entitled community, social and personal services to above the trend. In consequence, we project this category to grow by 8.4 per cent compared to 7.3 per cent last year.

54. The favourable exchange rate situation is helpful to exporters of software and other IT-enabled business services. However, declining growth in export markets, in particular the travails of the financial sector, could exercise a dampening influence. Though first quarter results for leading service exporters show margin pressure, in most cases top-line (that is gross revenue) growth still remains robust. Margin pressures may discourage new businesses and slow expansion into new markets and products, but the pace of overall expansion of activity levels is likely to remain strong during 2008/09.

55. Overall, we estimate that GDP arising in the services sector will grow by 9.6 per cent in 2008/09, lower than in any of the previous three years.

V. TRADE AND BALANCE OF PAYMENTS

BoP – 2007/08 Outcome

56. The DGCI&S data of the Ministry of Commerce and Industry shows merchandise exports in 2007/08 at $ 155.5 billion, an increase of 23.1 per cent over the previous year. Imports increased to $ 235.9 billion, registering a growth of 27.0 per cent over the previous year. Imports of crude oil and refined petroleum products in 2007/08 aggregated $77 billion, an increase of 66 per cent over the previous year.

57. Provisional figures place the current account deficit (CAD) in 2007/08 at $17.4 billion, or 1.5 per cent of GDP, a significant increase from the region of 1.0 per cent during the previous two years. The primary reason for the increase in the CAD appears to be the sharp increase in the oil import bill.

58. On the capital account side the surplus was $108 billon, or 9.2 per cent of GDP, a massive increase from 5.0 per cent last year, and 2.9 per cent in the year prior to that. The increase was due to large increases in FDI, portfolio and loan inflows. Net FDI inflows nearly doubled to $15.5 billion. Loans (mostly commercial) also almost doubled to $42 billion. Banking capital flows (not NRI deposits) were surprisingly huge at nearly $12 billion. Portfolio flows, including private equity, grew over four times to almost $ 30 billion.

59. The net effect of an expansion in the already big gap between capital inflows and the CAD was a large accumulation of reserves by the Reserve Bank of India (RBI) amounting to nearly $92 billion, almost three times higher than in the previous year.

60. The value of merchandise exports and imports increased by 23 and 27 per cent respectively in 2007/08. A large component (17 per cent) of merchandise exports in 2007/08 comprised refined petroleum products, while an even larger component (33 per cent) of merchandise imports comprised crude petroleum and refined products. In the first eleven months (April to February 2007/08), total merchandise exports increased by 25.7 per cent in dollar terms. Non-petroleum product exports increased by 23 per cent, while petro-products increased by 41 per cent. While total imports during this period increased by 32 per cent, petroleum

Table 4: Projected Balance of Payments for 2008/09

Unit: US$ billion

	2004/05 R	2005/06 PR	2006/07 (P)	2007/08 (P)	2008/09 (f)
Merchandise Exports	85.2	105.2	127.1	158.5	208.3
Merchandise Imports	118.9	157.0	192.0	248.5	342.4
Merchandise Trade Balance	–33.7	–51.8	–64.9	–90.1	–134.1
	–4.8%	*–6.4%*	*–7.1%*	*–7.7%*	*–10.4%*
Net Invisibles	31.2	42.7	55.3	72.7	92.7
o/w Software & BPO	14.7	24.6	31.2	37.0	47.5
Private Remittances	20.5	24.1	27.9	40.8	52.0
Investment Income	–4.1	–4.9	–6.0	–5.2	–6.5
Current Account Balance	**–2.5**	**–9.2**	**–9.6**	**–17.40**	**–41.5**
	–0.4%	***–1.1%***	***–1.0%***	***–1.5%***	***–3.2%***
Foreign Investment	13.0	17.2	15.5	44.8	23.8
o/w FDI (net)	3.7	4.7	8.5	15.5	19.7
Inbound FDI	6.0	7.7	22.0	32.3	46.2
Incl. Private Equity	–	–	–	*10.0*	*7.5*
Outbound FDI	2.3	2.9	13.5	16.8	26.5
Portfolio capital	9.3	12.5	7.1	29.3	4.1
Loans	10.9	6.1	24.5	42.0	34.10
Banking capital	3.9	1.4	1.9	11.8	8.0
Other capital	0.7	–0.7	4.0	9.6	5.0
Capital Account Balance	**28.0**	**23.4**	**45.8**	**108.03**	**70.9**
	4.0%	***2.9%***	***5.0%***	***9.2%***	***5.5%***
Errors & Omissions	0.6	0.8	0.6	1.5	0.0
Accretion to Reserves	**26.2**	**15.1**	**36.6**	**92.2**	**29.4**
	3.7%	***1.9%***	***4.0%***	***7.9%***	***2.3%***

Note: * Business process outsourcing

Figures in parentheses denote proportion to GDP at current and market prices

product imports rose by 35 per cent. The import of gold and silver increased by 25 per cent to touch $16.4 billion. The value of non-oil, non-gold imports in the first eleven months of 2007/08 was higher by 31.9 per cent over the corresponding period in the previous year.

61. The DGCI&S trade data for the April–June quarter of 2008/09 shows the dollar value of merchandise exports rising by 22.3 per cent, and imports by 29.7 per cent. The value of oil imports was reported 50.2 per cent higher and non-oil imports 20.9 per cent. We expect that for 2008/09 as a whole non-oil merchandise exports will increase by 22.5 per cent. Import of equipment and industrial intermediates is expected to continue growing at a brisk pace. Non-oil, non-bullion imports are projected to grow at 22.5 per cent, slightly lower than in the previous year. Bullion imports, after surging in the first quarter of 2007/08, had a negative growth rate in the second half of the year. We project a modest expansion in bullion imports of 10 per cent during 2008/09.

62. In estimating the value of petroleum imports and exports, we have assumed an average price of crude oil at $130 per barrel in 2008/09, and a 5 per cent volume growth in domestic consumption. We have ignored the impact of the commissioning of the second refinery of Reliance Industries expected this year, since the additional crude import on that count will be matched by equivalent exports of refined products and would be therefore largely trade neutral. On this basis, the value of crude oil and product imports would rise by 80 per cent to $138.2 billion, while the value of product exports would rise similarly to $47.1 billion.

63. We project total merchandise exports of $205 billion and imports of $332 billion in 2008/09, resulting in a trade deficit of $127 billion corresponding to DGCI&S trade data. When this is adjusted for imports and exports included in the Balance of Payments, but not in the DGCI&S trade data, the projected value of merchandise exports and imports would amount to $ 208 and $342 billion respectively. This would leave a BoP merchandise trade deficit of $134 billion, equivalent to 10.4 per cent of GDP, a sizeable increase from 7.7 and 7.1 per cent in the last two years.

Invisibles

64. Net invisibles, including non–factor service exports, worker remittances, income from tourism & travel and investment income flows aggregated $72.7

billion in 2007/08, an increase of 31 per cent over the previous year. Net invisibles also grew by about 30 per cent in 2006/07. The principal components of net invisibles are software and business service exports and remittances from Indians working overseas. It should be noted that a large part of the remittances derive directly from the activities of Indian software and BPO companies in overseas locations. The outgo on account of net investment income was slightly lower in 2007/08 compared to the previous year.

65. In the fiscal year 2008/09, we expect aggregate net software & business service earnings and remittances to expand by 28 per cent, slightly less than the 31.5 per cent growth last year. Net investment income is projected to increase, reflecting the greater stock of overseas corporate debt. Total net invisibles are thus expected to increase by 27.5 per cent (compared to 31.4 per cent last year) to $92.7 billion.

66. As a result the Current Account Deficit (CAD) is likely to expand to $41.5 billion, equivalent to 3.2 per cent of GDP. This is a major increase from 1.5 per cent of GDP in 2007/08, and about 1 per cent in the previous two years. The expansion in the CAD is directly attributable to the doubling of crude oil prices. Had the price of crude oil remained at an average of $80 per barrel, ceteris paribus, the CAD in 2008/09 would have been less than 1.0 per cent of GDP. Conversely, if the average price of crude oil in 2008/09 were to rise to $150 per barrel, again other things remaining constant, the CAD would rise to 4.3 per cent of the GDP.

67. The CAD is likely to be very high as a ratio of GDP in the first and second quarters of 2008/09, and decline to the average indicated for the full year through the third and fourth quarters. We estimate that the CAD/GDP ratio may be above 4.5 per cent in the first and second quarters of 2008/09.

Capital Flows

68. Private Equity (PE) inflows are estimated at about $10 billion in 2007/08. We expect a lower inflow of $7.5 billion in 2008/09. It is understood that the RBI classifies PE under Foreign Direct Investment ("acquisition of shares in Indian companies") although a case may be made for reporting PE under portfolio flows since in many, if not most, cases the private equity partner does not own controlling interest in the Indian entity. We have included PE inflows under in-bound FDI.

69. In-bound foreign direct investment (FDI) saw a large increase of 47 per cent in 2007/08, rising to $32.3 billion. Out-bound FDI however also rose to $16.8 billion. The net FDI inflow in 2007/08 was therefore $15.5 billion, almost double that of the previous year. RBI data shows that in-bound FDI has continued to increase in the current year. In-bound FDI more-than-doubled to $ 7.7 billion in April–May 2008/09 compared to the corresponding period last year. It is possible that this doubling is due to a bunching of transactions and is unlikely to be sustained through the year. For the year as a whole we have taken a 43 per cent increase in in-bound FDI to $46.2 billion (including PE) which, combined with a greater increase in out-bound FDI, gives us net FDI inflows of $19.7 billion for the year, which is 27 per cent higher than the previous year.

70. In 2006/07, net portfolio capital inflows amounted to $7.1 billion. In 2007/08, this flow increased four times to $29.4 billion. These comprised $20.3 billion of net Foreign Financial Institution (FII) inflows, $8.8 billion of GDR/ADR issuance and $0.3 billion of other flows. In the April–June quarter of 2008/09, the data released by SEBI shows that there were net FII outflows of $4.2 billion. In July, the net inflow was positive at $0.4 billion. We estimate that flows will remain weak, with periods of net inflows being offset by outflows in the second quarter of 2008/09. There may be some resumption of inflows in the second half of the fiscal, but after making up for the net inflow position till date, it is likely that the net FII accrual at the end of the year would be of the nominal order of $1.3 billion.

71. American/Global Depository Receipts (ADR/GDR) issuance amounted to $8.8 billion in 2007/08. In April–May 2008 ADR/GDR issuance was almost $1.0 billion, which may not be representative of how things are likely to work out for the rest of the year. We assess total ADR/GDR issuance in 2008/09 at $2.5 billion.

72. Aggregate portfolio inflows are thus estimated to be $4.1 billion in 2008/09, which is very large reduction from 2007/08.

73. Loans increased sharply to $42 billion in 2007/08, mainly due to a big increase in External Commercial Borrowings (ECB) and short-term loans. In the April–June quarter of the current year the data shows that ECB/FCCB inflows amounted to $4.1 billion, a decline of 42 per cent over the corresponding period last year. Short-term loans increased sharply by 167 per cent in 2007/08, possibly reflecting the increased financing needs of imports, especially that of crude oil.

However, taking into account the availability of domestic finance, it is likely that short-term loans will stabilise a little below the level reached in March 2008. External assistance was marginally higher in 2007/08 at $2.1 billion – a level that we expect to be maintained in 2008/09 as well. We project inflows on account of ECB/FCCB to be $16 billion – about 28 per cent lower than in the previous year. In the aggregate, net inflows on account of loans are expected to be $34 billion, about 19 per cent lower than in the previous year.

74. Net banking capital inflow were very large in 2007/08 at $11.8 billion. This increase was not on account of NRI deposits, but on account of regular banking activity. We have projected inflows under this head in 2008/09 at $8.0 billion, which implies a 50 per cent reduction from last year's level. Under the head "other capital", we expect flows aggregating $5 billion, which also is about 50 per cent lower than the previous year.

75. As may be seen from Table 4, our estimate of total capital inflows in 2008/09 is $70.9 billion, which is 34 per cent less than in the previous year. This will however be more than adequate to finance the enlarged CAD, leaving about $29 billion to accrue in the foreign exchange reserves of the RBI. We expect the bulk of this accrual to take place in the third and fourth quarters of 2008/09.

Accretion to Reserves

76. The projected expansion of the CAD is much smaller than the projected capital inflows, resulting in a likely net accretion to reserves of about $30 billion, about one-third the level of last year. Policy makers may however have to be prepared to face a situation of greater volatility in capital inflows on account of the uncertain external environment.

VI. PRICES

Wholesale Price Indices

77. The rate of inflation as measured by the Wholesale Price Index (WPI) showed a declining trend through the first three quarters of 2007/08 as inflationary tendencies tended to stabilise. However, surging international prices of commodities – from oil to steel to chemicals to food – erupted into the domestic economy towards the end of 2007, and disrupted the process of stabilisation. This imported element, assisted by the underlying resource tightness at home, a consequence of accelerated economic growth, generated enormous inflationary pressures. Since the international prices of critical tradable commodities were higher than domestic prices, the import option for alleviating domestic price pressure was not available.

78. WPI inflation soared from 3.8 per cent at the end of December 2007 to 7.8 per cent by the end of March 2008. The increase of 3.0 percentage points came mainly from steel and iron ore (42 per cent), primary food (19 per cent), petroleum products (12 per cent) and edible oil & oilseeds (12 per cent). Most of this increase occurred in the month of March 2008.

79. International price conditions turned particularly negative in the first two quarters of the calendar year 2008. The price of crude oil jumped from $90 to $140 per barrel, steel soared to over $1,200 per tonne, gold to nearly $1,000 per ounce and rice to $1,000 per tonne. Most actively traded commodities tended to follow suit. Over the past month, some cooling of the temperature is in evidence and we expect this process of stabilisation to continue into the balance part of 2008/09 at more-or-less present price levels.

80. We have been slow to adjust the retail market price of refined petroleum products. As a consequence, there is a large backlog of adjustments that need to be made. On June 4, 2008, prices of motor spirit, diesel and domestic LPG cooking gas were raised to partly neutralise the cost impact of more expensive crude oil. The prices of other industrial fuels and feedstock were also raised. As a result, the WPI inflation rate rose to 11.1 per cent, and climbed towards 12 per cent over the next one and a half months. However, some more adjustment in oil prices is

not only inevitable, but also necessary. Fuel subsidies are merited only for poor families and not for the economy at large.

81. The sharp increase in steel prices has expectedly driven machinery prices up, just as increase in the price of petroleum pushed up the price of petrochemicals and products such as manmade fibres that are derived from petrochemicals. Some advance in the inflationary impulse through inter-linkages between products and industries is also inevitable. However, if inflation is to be contained, this process needs to be actively combated by a combination of monetary, fiscal and demand management measures. While monetary and fiscal measures have been in evidence over the past few months, price caps have tended to amplify domestic demand-supply imbalances. Emergency measures such as ban on exports and futures trading can be neither permanent nor effective.

82. The good monsoon of the past year, generally favourable weather conditions, and the strong supply response to public policy, have yielded a strong harvest, good procurement and adequate official stocks of food grain. WPI inflation in primary foods has thus been moderate, notwithstanding the elevated food inflation across the world. The inflation rate for primary food dropped from 6.5 per cent at the end of March 2008 to 5.4 per cent in mid-July 2008. Only in edible oil (17 per cent) and oilseeds (19 per cent) inflation is unduly high. This, as discussed earlier, is due to the sizeable amount of palm oil that is imported, and linkage of the latter to petroleum prices.

Consumer Price Indices

83. Consumer price inflation rates have also risen in tandem with WPI inflation. The rate of inflation as measured by the CPI–Urban Non–Manual Employee (UNME) index rose from around 5 per cent during October 2007 to February 2008 to approach the 7 per cent level in April and May 2008. In May 2008, the CPI-UNME inflation rate was 6.8 per cent, with food & beverages showing the highest increase of 9.5 per cent. Following the revision in fuel prices in June, and the increase in cotton and manmade textile prices, the CPI-UNME inflation rate is likely to be higher in the months of June and July 2008.

84. The CPI–Industrial Worker (IW) inflation rate was around 5.5 per cent between October 2007 and February 2008. Thereafter it has risen sharply with the figure for March, April and May being all around 7.8 per cent. CPI inflation rates

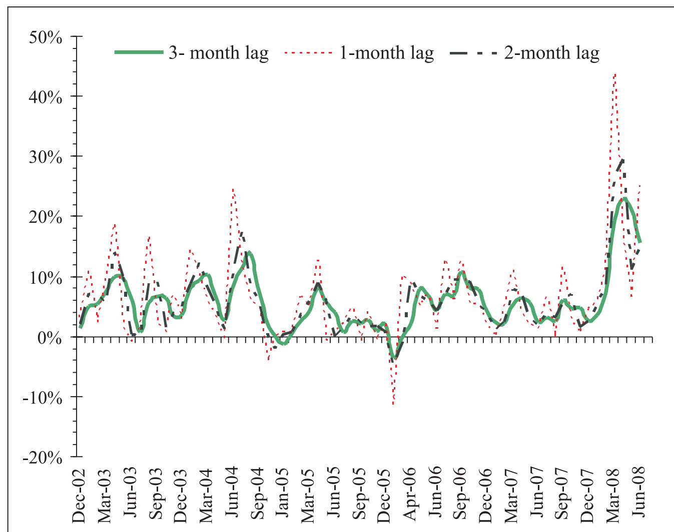
for rural and agricultural workers for these months were even higher at around 9 per cent.

Annualised Short-Period Inflation

85. The computation of annual inflation on point-to-point basis overcomes the problem of seasonal fluctuations in activity levels and therefore prices. However, the location of inflation is not always clear on a static level. Let us take an inflation number for a given month and suppose it to be 10 per cent. What we do not know is whether the bulk of the increase was in recent periods (last few months) or in the more distant past (say ten or eleven months previously). This is clearly relevant for the purposes of inflation management policy. However, in practice we do know the inflation in the current month or week, and also for previous months or weeks. The change in the direction of inflation can be inferred from the trend in these series of year-on-year numbers. Thus, location of the period when the direction of inflation changed (or did not change) is not a problem even with year-on-year computations.

Chart 1

Annualised Quarter-on-Quarter WPI Manufactured Inflation Rates



[3]Seasonally adjusted series can change every time there is a new period for which data is available, since the adjustment indices require to be recomputed. This can be quite disorienting since it can change the computed change (inflation or growth) for a short period considerably and significantly alter the interpretation.

86. However, since the issue of shorter-period annualised rates of inflation has been raised in the media and elsewhere, we provide some estimates here. The practice is to remove seasonal effects on the data series using a filter. Seasonal effects are most pronounced in the case of primary food products. Energy prices are also commonly excluded due to the sharp fluctuations that are often associated with this item. Manufactured goods should not show much seasonal effects so we can use them to see what the order of short-period changes may be. This also eliminates the need for revision of the data series.[3]

87. The month-wise WPI manufacturing indices have been used to compute 3-month lagged annualised rates of inflation (that is, quarterly rates annualised) for the recent period. Shorter-period (1 and 2 month) lagged values were also computed. The latter suffer from large volatility, but are plotted alongside the quarter-on-quarter annualised inflation rate for manufactured WPI in Chart-1.

88. The present spike in inflation is clearly located in March 2008 which is not new information. In the months that followed, the quarter-on-quarter annualised inflation rate has dropped off, but as is evident from the values in June 2008 it is still at a level that is much higher (around 16 per cent) than anytime in the recent past. To argue therefore that inflationary pressures have eased since quarter-on-quarter annualised inflation rates have dropped from 23 per cent in April to 16 per cent in June would be both incorrect in fact and inappropriate in terms of the use of the measure.

Assessment

89. Inflation in the current year is a phenomenon where the pressure of international prices has worked on a substrate of domestic supply tightness to create powerful inflationary impulses. The containment of inflation is vital for ensuring macroeconomic stability and maintaining conditions that are conducive to high medium to long term growth. Containing and stabilising high rates of inflation is also crucial for counter-balancing the adverse economic redistribution inherent in the inflationary process.

90. Maintaining a tight monetary stance and active fiscal and other methods are necessary to bring down inflation rates.

91. The RBI in its Statement on July 29, 2008 has stated "bringing down inflation assumes the highest priority in the stance of monetary policy". The Statement also said that "a noticeable decline in inflation can be expected towards the end of the last quarter of 2008/09". It concludes that a "realistic policy endeavour would be to bring down inflation from the current level of 11.0–12.0 per cent to a level closer to 7.0 per cent by March 31, 2009". The road to this outcome is a challenging one.

92. The Council is of the view that co-ordinated policy action, coupled with some reinforcement of the recent cooling evident in world commodity prices and monetary actions by other central bankers can help bring the rate of inflation down by the end of March 2009 to 8-9 per cent. In the Indian context we have, in addition, a large backlog of fuel price adjustments that need to be urgently completed for (a) preserving fiscal order, (b) transmitting the right signals to dampen the market demand for automotive fuels, which in turn has a large impact on our external payments. Hence, achieving a reduction to 7 per cent will take considerable effort and a confluence of favourable factors.

VII. EMPLOYMENT

93. The first half of the current decade saw India perform reasonably well on the growth front. Even more impressive was the fact that this growth has translated into jobs. The 61st Round of the NSSO quinquennial survey, covering the period 1999/2000 to 2004/2005, revealed that 60 million jobs were created in these five years. India was among the top performers in growth rate of workforce and created the largest number of jobs in absolute terms.

Table 5 : Employment and Unemployment UPSS vs CDS

	1993/94	1999/2000	2004/05	1993/94 to 1999/00	1999/00 to 2004/05
	In million			CAGR %	
Labour Force (UPSS)	381.94	406.05	469.06	1.03	2.93
Labour force (CDS)	334.19	364.88	419.65	1.47	2.84
Workforce (UPSS)	374.45	397	457.82	0.98	2.89
Work force (CDS)	313.93	338.19	384.91	1.25	2.62
No. of Unemployed (UPSS)	7.49	9.05	11.24		
No. of Unemployed (CDS)	20.26	26.68	34.74		

Source: 1. Planning Commission (2008) - Vol I Inclusive Growth - Eleventh Five Year Plan (2007-12)
2. Planning Commission (2001) - Report of Task Force on Employment Opportunities
3. C.Rangarajan, Padma Iyer Kaul, Seema (2007): *Revisiting Employment and Growth*, Money & Finance, August

94. In the **Economic Outlook for 2008**, the UPSS (Usual Principle and Subsidiary Status) measure was used to draw the following conclusions:

o The annual growth rate of the workforce increased from 0.98 per cent in the period 1993/94 to 1999-00 to 2.89 per cent in 1999/00 to 2004/05 (Table 5). This resulted in an incremental employment of 60 million.

o The elasticity of employment, which measures the ratio of workforce growth rates to GDP growth rates, increased from 0.15 in the period 1993/94 to 1999/00, to 0.48 in the period from 1999/00 to 2004/05. There was thus a substantial jump in the elasticity of employment.

- o Agriculture, with lower than average worker productivity, accounted for a large per centage of this increased employment.
- o A significant increase in employment had also taken place in the informal sector where generally the level of wages is low and the working conditions poor. This has implications for the quality of employment.

95. In the Eleventh Plan document the Planning Commission has used the CDS[4] (Current Daily Status) measure to analyse the employment situation. Calculations based on this measure show that labour force, workforce, and unemployment estimates are different from those based on the UPSS data. However, the broad growth trends do not show much difference. Some of the conclusions based on the CDS data are:

- o The annual growth rate of the workforce increased from 1.25 per cent in the period 1993/94 to 1999-00 to 2.62 per cent in the period 1999/00 to 2004/05 (Table 5). This has resulted in an incremental employment of 44 million.
- o The elasticity of employment was 0.44 between the 55th and the 61st round.
- o The agriculture and informal sectors accounted for the major part of this increase in employment.

96. The rich state-wise data thrown up by the 61st Round of the NSS survey provides an opportunity to analyse interstate[5] variations in employment performance. The period covered by the 61st Round was one of strong employment growth. The workforce growth rate of 2.9 per cent was almost twice the population growth rate, and there was a threefold increase in the employment elasticity to 0.48. The state wise employment numbers also showed strong growth rates (Table 6). Employment elasticity was very high, with twelve states showing elasticity above 0.38. However, across states there were wide variations in workforce growth rates, ranging from 5.61 per cent to 1.29 per cent. Most states performed well in terms of SDP growth. Six states (Andhra Pradesh, Gujarat, Haryana, Karnataka, Kerala and West Bengal) had

[4]The UPS and CWS (Current Weekly Status) are "person rates" while the CDS is a "person day" measure. Many economists have criticized the use of CDS to calculate the number of persons in the workforce and labour force.
[5]14 major states have been chosen for analysis of the employment data. These states, however, cover more than 90 per cent of the population.

Table 6 : Growth Rates (CAGR) of GSDP* and Employment						
States	SDP		Employment		Elasticity	
	in per cent		In per cent			
	55th round	61st round	55th round	61st round	55th round	61st round
All India	6.63	6.01	1.02	2.9	0.15	0.48
Andhra Pradesh	5.46	6.52	0.22	1.97	0.04	0.3
Bihar	4.39	4.75	1.92	2.23	0.44	0.47
Gujarat	7.84	6.71	2.28	2.62	0.29	0.39
Haryana	5.91	6.85	1.19	5.61	0.2	0.82
Karnataka	7.63	6.07	1.07	3.1	0.14	0.51
Kerala	5.64	6.84	1.09	1.29	0.19	0.19
Madhya Pradesh	5.38	2.92	1.11	2.71	0.21	0.93
Maharashtra	6.25	5.02	1.04	3.45	0.17	0.69
Orissa	4.29	5.86	0.76	2.56	0.18	0.44
Punjab	4.77	3.94	2.56	2.79	0.54	0.71
Rajasthan	8.21	4.79	0.78	3.06	0.1	0.64
Tamil Nadu	6.63	4.07	0.03	1.77	0	0.44
Uttar Pradesh	4.58	4.23	1.08	3.88	0.24	0.92
West Bengal	7.11	7.01	0.76	3.02	0.11	0.43

Note: * Data regarding GSDP pertains to base year 1993-94
Source: 50th, 55th and 61st round of National Sample Surveys on Employment and Unemployment Situation in India.

a growth rate higher than the all–India average of 6.01 per cent. Among other states, except for Madhya Pradesh and Punjab, all had growth rates between 4 and 6 per cent. However a comparison of the SDP growth rate and the workforce growth rate did not reveal any consistent pattern.

97. There were also sectoral variations at the all India level in workforce growth. Though agriculture accounted for a large share in incremental employment, in terms of growth rate, it turned in a relatively weak performance at 1.54 per cent. The other two sectors delivered robust employment numbers, with the industrial workforce growing at 5.86 per cent and services at 4.01 per cent. In industry, workforce growth rate outstripped the SDP growth rate in 11 states (Karnataka,

Kerala and West Bengal were the exceptions). This implies declining productivity growth per worker. The service sector performance was good with 12 states achieving workforce growth rates above 3 per cent. The 61st round was also witness to higher urban workforce growth rates in most states except for Haryana and Kerala. The difference in the rural-urban workforce growth rates was fairly significant in 5 states (Tamil Nadu, Andhra Pradesh, Gujarat, Maharashtra and Madhya Pradesh). The activity status of the workforce underwent major changes in the 61st round, with 12 out of the 14 states showing an increase in the growth rates of self employed, and 11 of the 14 States showing a decline in the growth rate of casual labour. Further, in a welcome development the RWS (Regular Wage and Salaried) segment of the workforce, which approximates to the organized sector workforce, showed positive growth rates for all states.

98. To sum up, in the period 1999/2000 to 2004/2005 all the states other than Kerala, Tamil Nadu and AP exhibited good performance as far as employment growth was concerned. In all the states SDP and workforce growth rates in the non-agriculture sector moved in the same direction.

99. The wide interstate variations in SDP and workforce growth rates make generalizations difficult. However the data do indicate that in the non-agriculture sector a positive growth in output is a necessary condition for a positive growth in employment, while this is not necessarily the case with agriculture.

VIII. MONETARY CONDITIONS AND THE FINANCIAL SECTOR

Monetary Aggregates and Credit Growth

100. Monetary expansion (M3) at 21.0 per cent in 2007/08 was comparable to that of previous years – 21.3 per cent in 2006/07 and 21.2 per cent in 2005/06. This reflected the strong pace of economic activity that resulted in strong demand for funds and the base money expansion due to a surge in capital flows that were not fully sterilized.

101. During the current financial year, RBI has repeatedly intervened to rein in excess liquidity, increasing the Cash Reserve Ratio (CRR) by a total of 150 basis points to 9.0 per cent, and the repo rate by 100 basis points to 9.0 per cent.

102. Notwithstanding the sustained increase in the broad money aggregate, the growth in bank credit to the commercial sector[6] showed some signs of deceleration. In 2005/06 this had grown by 32.2 per cent, coming down in the next year to 25.4 per cent. In 2007/08 the increase in this item was further reduced to 21.0 per cent. Part of the reason why the broad money aggregate increased by as much as it had in 2006/07 despite a slowing the pace of flow of bank credit to the commercial sector was the sharp increase in net foreign exchange assets of the banking sector by 42 per cent in 2007/08 as compared to 26 per cent in the previous year.

103. The sharpest increase in bank lending was to industry and infrastructure. Bank lending to the Small Scale Industry (SSI) increased by 52 per cent, while the lending to infrastructure was higher by 42 per cent. Fresh bank exposure to personal loans (including housing) decelerated by 17 per cent, while fresh lending to the service sector expanded by 31 per cent. Lending to the real estate sector saw a decline.[7]

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[6]In the context of monetary aggregates, "commercial sector" includes everything other than government. Thus farm and personal loans all come under this classification.

[7]Between May 2007–May 2008: Macro-Economic & Monetary Developments, RBI, July 2008, Table 2.4.

104. Credit growth in the first quarter of 2008/09 was stronger than what it was in the corresponding period of 2006/07. Up to the fortnight ended July 6, 2008, non-food credit increased by Rs 40,344 crore (1.7 per cent) and total accommodation by Rs 33,218 crore (1.4 per cent) over the end of March 2008. This was significantly higher than what was registered in the corresponding period of 2006/07 (– 0.7 and– 0.9 per cent respectively).

105. The sharper pace of credit growth in the current fiscal year has taken place despite the tightening of liquidity through increase in cash reserve requirements and in the repo rate. Banks have been consistently borrowing at the repo window to the extent of Rs 30,000 to 40,000 crore on a daily basis. Call money rates have hovered within a narrow band on either sides of the repo rate on a day-to-day basis, indicating that the money market was consistently tight. The change in sectoral composition of credit flows mentioned earlier testifies to the fact that it was the industrial and infrastructure sectors that have accounted for a large part of the additional borrowing.

106. Companies have on-going capital projects that need to be funded. Although a sizeable part of ECB flows occurred in the first quarter of 2008/09 ($4.1 billion), this was nevertheless 40 per cent lower than the flows in the corresponding period of last year. Access to overseas loan markets has been adversely affected by the reduced appetite for emerging market debt, reflected in the sharp increase in credit default swap (CDS) rates. With equity prices down significantly, Indian companies are finding it harder to raise equity on terms that they are comfortable with. Anecdotal evidence suggests that this tightening is being reflected in enhanced borrowing by Indian corporates from the domestic banking industry.

107. RBI data also shows that instruments issued by mutual funds were lower by Rs 30,000 crore in the first quarter of 2008/09, compared to the corresponding period of last year. A large part of this funding was going to Indian corporates through both debt and equity issuance. To that extent this reduction in volume was also perhaps compensated by credit from the banking industry.

108. In our Outlook in July 2007, we had suggested some temporary restrictions on ECB, bearing in mind the extent of capital flows, the accretion to reserves and

Table 7 : Movement in Important Stock Indices over the Past Year

	One Year Max		One Year Low			As on 31 Jul 08	
	Index	Date	Index	Date	Change from peak	Index	Change from peak
China Shanghai	6,092	16-Oct-07	2,652	1-Jul-08	–56%	2,776	–54%
Philippines Manila	3,838	9-Oct-07	2,342	4-Jul-08	–39%	2,513	–35%
Italy Mib Tel	32,018	12-Oct-07	20,836	15-Jul-08	–35%	21,755	–32%
India BSE 30	20,873	8-Jan-08	12,576	16-Jul-08	–40%	14,356	–31%
Taiwan TSEC	9,810	29-Oct-07	6,711	16-Jul-08	–32%	7,024	–28%
Hong Kong HIS	31,638	30-Oct-07	20,387	17-Aug-07	–36%	22,741	–28%
Australia All Ord.	6,854	1-Nov-07	4,910	15-Jul-08	–28%	5,053	–26%
Spain Madrid	1,725	8-Nov-07	1,200	15-Jul-08	–30%	1,277	–26%
Bangkok SET	915	29-Oct-07	665	18-Jul-08	–27%	685	–25%
Paris CAC 40	5,863	11-Oct-07	4,061	15-Jul-08	–31%	4,392	–25%
Singapore STI	3,876	11-Oct-07	2,793	17-Mar-08	–28%	2,930	–24%
Japan Niikkei 225	17,459	11-Oct-07	11,788	11-Mar-08	–32%	13,377	–23%
Malaysia KLSE	1,516	11-Jan-08	1,103	21-Jul-08	–27%	1,163	–23%
S Korea Seoul	2,065	31-Oct-07	1,507	16-Jul-08	–27%	1,595	–23%
Swiss SMI	9,218	11-Oct-07	6,562	15-Jul-08	–29%	7,141	–23%
Russia RTS	13,337	19-May-08	9,962	29-Jul-08	–25%	10,369	–22%
Frankfurt DAX	8,076	12-Dec-07	6,082	15-Jul-08	–25%	6,437	–20%
US Dow Industrial	14,165	9-Oct-07	10,963	16-Jul-08	–23%	11,378	–20%
UK FTSE 100	6,725	12-Oct-07	5,151	16-Jul-08	–23%	5,412	–20%
Brazil Bovespa	73,517	20-May-07	48,016	16-Aug-07	–35%	59,505	–19%
US S&P 500	1,565	9-Oct-07	1,215	15-Jul-07	–22%	1,268	–19%
Indonesia Jakarta	2,830	9-Jan-08	1,909	16-Aug-08	–33%	2,305	–19%
Argentina Merval	2,351	31-Oct-07	1,834	16-Aug-08	–22%	1,920	–18%
South Africa JSE	33,233	22-May-08	24,005	23-Jan-08	–28%	27,720	–17%
Mexico IPC	32,836	18-Oct-07	25,285	21-Jan-08	–23%	27,501	–16%
Canada Toronto	15,073	18-Jun-08	12,132	21-Jan-08	–20%	13,593	–10%

the problems that created for monetary expansion and domestic inflation. In the altered circumstances this year, it may be time to review the temporary restraints placed last year.

109. Keeping in mind the pressure of domestic aggregate demand interacting with exceptionally high international commodity prices, the tight monetary stance has to be maintained for the balance part of 2008/09 in order to contain and reduce the inflation rate.

Equity Markets

110. Equity markets have slid across the world over the past six months as would be evident from a glance at Table 7. Both emerging and developed markets are down, with China and India having dropped the most, developed countries by relatively less, and commodity exporting countries like South Africa, Brazil, Russia and Saudi Arabia the least.

111. It is however interesting to note that it is hard to draw a distinction between developed and emerging markets in respect of the extent of erosion in stock indices, While it is true that the erosion has been the largest in China, India and the Philippines, the erosion in India is less than that in Italy and comparable to that in Hong Kong and Taiwan which are industrialised economies and not far behind Australia and Spain. It is also not possible to make such a distinction in respect of the timing of either their peaks or troughs.

112. There were four phases when markets bottomed: The first was after the sub-prime crisis broke in August 2007; the second in January 2008 coinciding broadly with the sell-off in equity derivatives following troubles emerging in a European bank; the third was in mid-March in the wake of the rising tide of bad economic and financial news; and the fourth, and most recent one, in mid-July 2008 subsequent to a US bank failure and heightened apprehensions in the US financial sector about the future of the government sponsored Fannie Mae and Freddie Mac, both government sponsored enterprises that back most of the mortgage debt in the US market.

113. Having lost one fifth to one third of their value, equity assets would appear to have greater upside rather than downside prospects. If there are no major

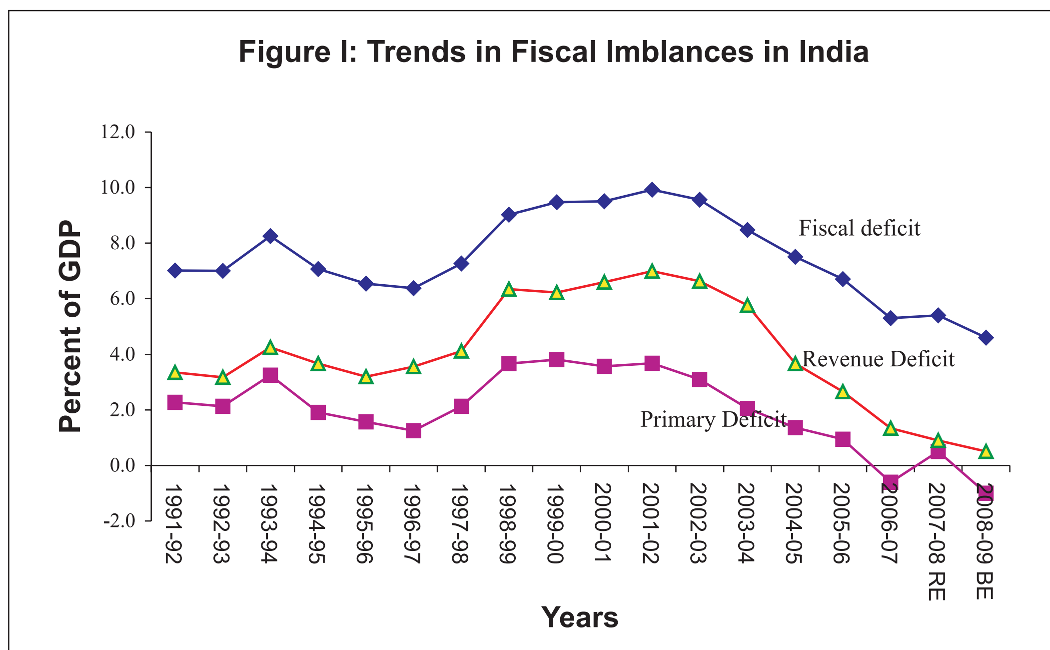
further shocks, a slow albeit hesitant recovery may be envisaged. Offsetting the disturbance arising out of weaknesses in the developed country financial sector, is the fact that the world's economies continue to appear to have the capacity to grow. This may contribute to an improvement in the behaviour of equity markets by early 2009.

IX. GOVERNMENT FINANCES

Fiscal Consolidation

114. There has been a perceptible improvement in the fiscal situation in India in recent years at both Central and State levels. The consolidated gross fiscal deficit relative to GDP declined steadily from 9.9 per cent in 2001/02 to 7.5 per cent in 2004/05 and is budgeted at 4.6 per cent in 2008/09. Both central and state governments have contributed to this fiscal turnaround by reducing fiscal and revenue deficits significantly. The aggregate revenue deficit declined from 7 per cent of GDP in 2001/02 to 2 per cent in 2006/07 and is budgeted at 0.5 per cent in 2008-09 (Chart 2) The fiscal restructuring plan recommended by the 12th Finance Commission requires that by 2008/09, aggregate fiscal deficit should be brought down to 6 per cent of GDP and the revenue deficit should be phased out altogether. The progress in fiscal consolidation shows that both the Central and the State governments are likely to overreach the fiscal deficit target on the one

Chart 2



hand, while the persisting revenue deficit would remain a matter of concern on the other.

115. While the improvement in the fiscal situation is unmistakable – and it is possible to infer that legislated fiscal discipline has substantially contributed to this – as pointed out in the **Economic Outlook for 2007/08** it is important to note that there are significant fiscal risks arising from growing off budget liabilities and unfunded commitments. The keenness to adhere to the targets set in the Fiscal Responsibility and Budget Management Act (FRBMA) has perhaps resulted in the accumulation of off budget liabilities, particularly in oil, fertilizers and food.

116. The revised estimate of fertilizer subsidy for 2007/08 is Rs.30,501 crore. An additional Rs. 7,500 crore is provided by way of bonds to fertilizer companies. The budgeted subsidy in 2008/09 is Rs.30,985 crore. Feedstock prices have however increased sharply, and the subsidy is therefore likely to be substantially higher. Current estimates indicate that the total fertilizer subsidy is likely to be more than Rs.95,000 crore at the prevailing cost of producing fertilizers. Of this, only Rs.30,985 is budgeted, which implies that underestimation on this account alone is 1.2 per cent of GDP. In addition, food subsidy is underprovided in the budget that, together with fertilizer subsidy, could easily be more than 2 per cent of GDP. Losses of the Oil Marketing Companies is of even greater concern. The price of crude oil per barrel increased from USD 106.14 in April 2008 to USD 114.58 in the first half of May, 2008, and is currently over $120/bbl. The Oil Bond burden of the central government in 2008/09 could be a little over 2 per cent of the GDP.

117. The off-budget liabilities on account of fertiliser, food and oil, along with unbudgeted liabilities arising out of the farm loan waiver and NREGA schemes and the implementation of the Sixth central Pay Commission, could amount to 5 per cent of the GDP in 2008/09, over and above the budgeted central fiscal deficit of 2.5 per cent. Similarly, the substantial cash losses of electricity utilities are not accounted for in budgets at the state level. The problem with off budget liabilities is that not only do they impose an additional burden that has to be extinguished when the liabilities mature, but they also have a significant servicing cost.

118. An analysis of the sources of fiscal consolidation at the Central level indicates that the improvement in the fiscal situation is mainly attributable to a significant increase in tax revenues. Since 2003/04 when the FRBMA was enacted, the reduction in revenue deficit relative to GDP amounted to almost 2.5 per centage points. During this period, the ratio of gross Central tax revenue to GDP increased by 3.74 per centage points. After accounting for a one per cent increase in tax devolution to the States, the net central tax revenue increased by 2.8 per cent. On the expenditure side, interest payments as a ratio of the GDP declined from 4.5 per cent in 2003/04 to 3.6 per cent in 2008/09, resulting in a reduction of the revenue expenditure by 0.7 per cent. This indicates that non-interest expenditures have marginally increased.

119. State finances have also shown an appreciable improvement in recent years. There was a 3 per cent improvement as a per centage of the GDP in the revenue deficit from 2.3 per cent in 2003/04 to a marginal surplus of 0.5 per cent in 2008/09. This improvement resulted in a reduction of the fiscal deficit relative to the GSDP from 4.4 to 2.1 per cent. This indicates that capital expenditures increased by about one per centage point. The States have thus been successful in achieving the targets set by the 12th Finance commission.

120. An analysis of the various sources of improvement in State finances reveal some interesting features. The overwhelming proportion of the improvement in State finances since 2003/04 is due to higher central transfers to the States. Higher revenue collections from sales tax and lower interest payments also contributed to some extent. The buoyancy in revenue collections from Central taxes is likely to continue over the medium term. However, the successful introduction of VAT and its eventual transformation into a goods and services tax (GST) crucially depends on strengthening the tax administration, particularly the information system. A major fiscal risk for the States, derives from the impact of the pay revision. Since the Central government is yet to take a decision regarding the pay revision, this may not have a significant impact on the finances of the States governments this year. Moreover, the reasonably healthy state of finances makes the implementation of pay revision much less painful this time as compared to a decade ago. A detailed discussion on government finances is at Annexure 2.

Annexure I : Global Economic Environment Impacting India

I.1. The outlook for the Indian economy is very challenging in FY08/09 given that the negative shocks from the global economy are likely to remain along with domestic challenges on the monetary and fiscal policy fronts. The downside risks to GDP growth and upside risks to inflation are significant in FY08/09. Financial markets in India could face the type of headwinds not seen since the mid to late 1990s in the stock, bond, and currency markets.

I.2. The emergence of simultaneous turmoil in financial, energy, and food sectors can be considered unprecedented in recent world economic history. This has adversely affected the prospects of world economic growth and increased the likelihood of contagion and instability around the globe – with slowing growth, higher inflation, and unrest at the people's level. According to the IMF's World Economic Outlook (July) projections, world economic growth during 2008 is expected to be around 4.1 percent compared with 5 percent in 2007. Since India is now an integral part of the global economy, it cannot remain insulated from the current international environment.

I.3. The main global shocks important for India are elevated commodity (oil, fertilizer, food, and base metals) prices, a significant slowdown in the growth momentum, turbulence in financial markets, and the reversal of the USD towards an appreciation path over the next 2-4 quarters. The outlook for oil prices is aggressive with non-OPEC supply expected to moderate and OPEC supply expected to increase only modestly in 2008. On the demand side, strong growth in Emerging Markets and a recovery in US growth may keep oil prices at elevated levels for the next 2-4 quarters. In addition, demand for financial products related to oil is on the rise, hence the speculative element driving oil prices is likely to remain in the foreseeable future.

I.4. About 70% of India's oil requirement is imported. The future world oil scenario looks a little alarming. The current price of $125 a barrel is about 100% higher than a decade ago. The growing mismatch between supply and demand of oil may lead to a further price spiral in the coming years. The chief factor responsible for this is the increasing oil demand in emerging market economies, particularly

India and China which are on a higher growth path. The requirement of Middle-East countries is also increasing at a faster rate. On the other hand, the US – the world's biggest oil consumer -- share of global oil demand is expected to drop from the current level of 60% to 50%. This is due to improved car efficiency, slower demand on account of slower economic growth, higher use of bio-fuels, and an anticipated 1 million b/d increase in U.S oil production from the Gulf of Mexico by 2012.

I.5. The future oil supply situation is expected to be precarious. The spare capacity of Saudi Arabia, the world's largest supplier, is at its lowest level in a generation. It now stands at 2-3 million b/d, too small to cover a big interruption in supplies from elsewhere. This has already added a sizeable premium to international oil prices. Available information reveals that oil production in Russia, the world's second largest oil producer, recently declined by around half a percentage point, the first drop in a decade. Russia's output was growing at an average rate of 12% just five years ago.

I.6. It is quite telling that not a single oil field discovered in the past 30 years has been able to produce more than 1 million b/d, and the number and size of fields discovered have been shrinking dramatically. Generally, output declines as an oilfield ages, sometimes dramatically. This trend applies to most oil fields around the world. The four biggest oil fields in the world are Ghawar (Saudi Arabia), Cantarell (Mexico), Burgan (Kuwait), and Daqing (China). All these oil field are now pumping less oil than in the past, – leading to a reduced level of world oil availability. Some experts have predicted that world oil production would never cross 100 million b/d. In fact, the International Energy Agency has estimated that this would be the level of world demand in the next 5-6 years.

I.7. All this suggests that oil supply could be a limiting factor impinging on India's economic growth. In order to realize its stated goal of double digit growth, India must target new sources of energy (i.e. nuclear, renewable, and other sources), improve efficiency in energy use, and cut consumer subsidies. Indian consumers will have to accept the harsh truth that oil cannot remain a cheap commodity when the global demand-supply balance is so precarious.

I.8. The outlook for food prices is also aggressive, with a crisis situation prevailing in almost all industrialized and developing countries. The 'Green Revolution' of the 1970s and 1980s perhaps lulled policy makers into complacency in the 1990s. As a result, the level of agricultural investment gradually declined,

including foreign aid to the developing world. For example, the World Bank cut its agricultural lending to $2.0 billion in 2004-05 from $7.0 billion in 1980s.

I.9. From 1970 to 1990, the peak 'Green Revolution' years, food supply grew faster than world population. But after 1990 foodgrain growth fell below population growth. By around 2004, the world economy was growing much faster (around 5% a year) than ever before. Even as food supply lagged population growth, millions of people around the world were earning more money to buy more food per capita and improve their diets, consuming more meat which was very cereal intensive. This particularly applied to developing Asia, including the populous countries of China and India. As a result, the world began to use more grains than what it was producing, cutting into foodgrain stocks. As oil prices also rose, more and more food grain was also diverted for biofuel production. Prices consequently started to rise. Early this year (2008) as stocks of foodgrains fell to perilous levels, international grain prices doubled or even tripled, threatening as many as 100 million people with malnutrition.

I.10. Global food grains stock is not expected to be very comfortable overall. This is likely to have a negative impact on price trends. According to the London-based International Grain Council (IGC), global food grain stocks are expected to go further down, as consumption will remain unmatched by even the highest ever global output. A shift in land acreage towards the bio-fuels sector (i.e. U.S.A., Brazil, and some other countries), massive conversion of food grains into meat production in several developed countries and in recent yeas in China, declining average yield levels in several emerging market countries due to lack of technological innovation and deteriorating soil health and overall impact of climate change have combined to result in declining wheat output in U.S.A., Australia, and some other major wheat growing countries, which had an adverse fall out on overall food grain supplies. All these factors have led to a rising food grain price trend and higher levels of inflation. India is no exception to this trend, even though food prices have risen far less than globally.

I.11. In addition, base metal prices, a major contributor to WPI inflation since Q4 FY07/08, are expected to remain robust in FY08/09. Supply disruptions wherein production losses across several continents emanating to some extent from power shortages, combined with robust demand in China, Emerging Markets, and the US are expected to keep base metal prices high for some time. The global boom in

infrastructure and capital goods spending is unlikely to slow to such an extent in FY08/09 that could bring down base metal prices significantly. At best, what we can hope for is stable base metal prices in FY08/09.

I.12. Another global phenomena impacting Indian economy is the state of international financial markets, in particular the fall out from the collapse of the US housing mortgage sector. What is different about the current market cycle is that even though financial market conditions may improve in the US on back of the improved outlook for growth, Asian financial markets, including those in India, may weaken significantly. Consensus estimates for growth, earnings, and currency values across the region are possibly too high. As a result, there is a downside risk of a large sell off in the stock, bond, and money markets in Asia over the next 2-4 quarters. This could have a knock on effect on India's financial markets as well.

I.13. With the aforementioned aggressive commodity price and weak financial sector outlook in mind, the pressure on India's fiscal deficit, inflation, and balance of payments could be quite large in FY08/09.

I.14. On the feedback loop from Asia's growth to India, the outlook is highly uncertain. Although economic activity indicators have remained resilient across non-Japan Asia inspite of a slowdown in the US, Europe, and Japan so far, the risk is that an abrupt slowing could occur sometime in late 2008 to early 2009. In most countries in the region, property and stock market activities could be softer going forward on back of a significant tightening of monetary policy to fight inflation. Labour market indicators also show that compensation growth and hiring are slowing across Asia and this is likely to impact domestic demand in these economies. As a result, import demand in Asia for India's products may slow considerably. Intra-Asian growth has spurted in recent years as part of the globalization process. Indeed, this trade has been expanding more rapidly than Asia's trade with the developed world. The outlook for Asia would no doubt also have a major impact on India's economic outlook.

Annexure II : Fiscal Consolidation and Outlook in India

Introduction

II.1. There has been a perceptible improvement in the fiscal situation in India in recent years. The turnaround in the fiscal situation is evident at both the Central and State levels. The consolidated gross fiscal deficit relative to GDP declined steadily from 9.9 per cent in 2001-02 to 7.5 per cent in 2004-05, and is budgeted at 4.6 per cent in 2008-09 (Table 1). Both central and state governments have contributed to this fiscal turnaround by significantly reducing fiscal and revenue deficits (Chart 1). The aggregate revenue deficit declined from 7 per cent of the GDP in 2001-02 to 2 per cent in 2006-07, and is budgeted at 0.5 per cent in 2008-09. The fiscal restructuring plan recommended by the 12th Finance Commission requires that by 2008-09 the aggregate fiscal deficit should be brought down to 6 per cent of GDP and the revenue deficit should be phased out altogether. The progress in fiscal consolidation shows that both the Central and the State governments are likely to overreach the fiscal deficit target even though the persistent revenue deficit will continue to be a matter of concern.

Table 1 : Consolidated Fiscal Indicators

(Percent of GDP)

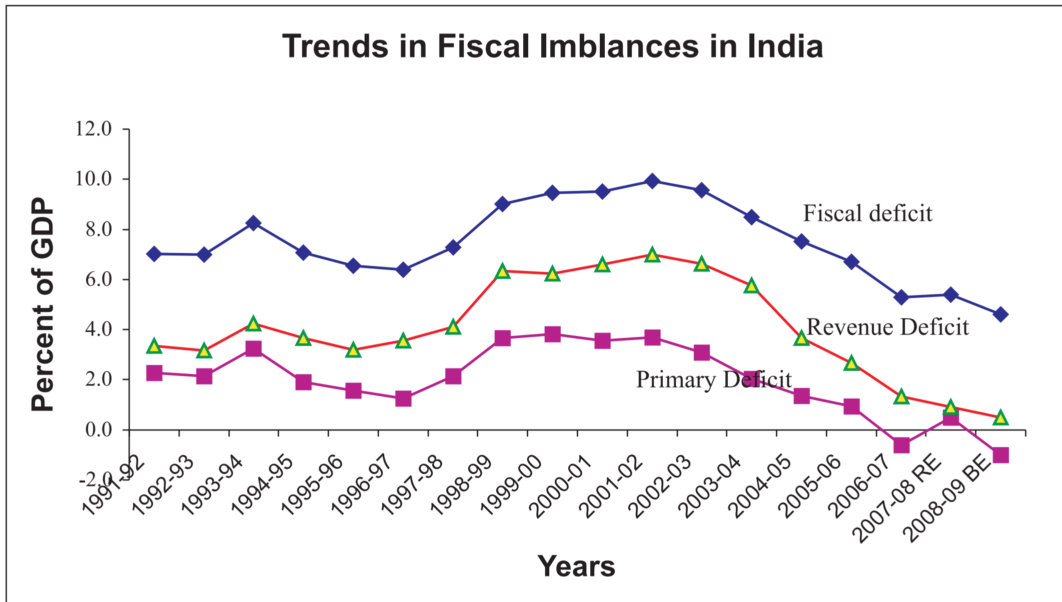
	Revenue Deficit	Primary Deficit	Fiscal deficit
1996-97	3.60	1.30	6.40
2001-02	6.99	3.68	9.93
2002-03	6.63	3.09	9.56
2003-04	5.76	2.05	8.48
2004-05	3.67	1.36	7.51
2005-06	2.66	0.94	6.71
2006-07	1.34	-0.59	5.34
2007-08 (RE)	0.85	0.50	5.36
2008-09 (BE)	0.54	-0.98	4.61

Source: Budget Documents, Government of India, and Finance Accounts, State Governments

II.2. These fiscal improvements have come about in the wake of enactment of fiscal responsibility legislations by the Centre and 26 State governments. The Fiscal Responsibility and Budget Management Act (FRBMA) was enacted by the Central government in 2003 that set the path of revenue and fiscal deficit reduction. All the state governments, barring West Bengal and Sikkim, have enacted Fiscal Responsibility Acts to phase out their revenue deficits and bring down their fiscal deficits to 3 per cent of GSDP by 2008-09.

II.3. While the improvement in the fiscal situation is unmistakable, and it is possible to infer that legislated fiscal discipline has substantially contributed to this, it is important to note that there are significant fiscal risks arising from off budget liabilities and unfunded commitments. These include additional liabilities on food and fertilizer subsidies and under-recoveries in the oil sector. In addition the Union Budget for 2008-09 does not make provision for meeting expenditures on pay revision and farm loan waiver, and has under provided for liabilities likely to arise on account of NREGA. When all these are included, the fiscal situation no longer looks healthy. Besides the commitment to liquidate these liabilities in the future, these create substantial annual financial burden in the form of interest payments. At the state level the uncovered deficits of the state power utilities compound the deficits.

Chart 1



Improvement in Central Finances

II.4. Improvement in the fiscal situation at Central level gathered momentum particularly since 2003-04. The fiscal deficit as a ratio of GDP declined from 6. 2 per cent in 2001-02 to 4.5 per cent in 2003-04 and is budgeted to decline to 2.5 per cent in 2008-09 (Table 2). Similarly, the Centre's revenue deficit relative to GDP declined from 4.4 per cent in 2001-02 to 3.6 per cent in 2003-04 and is budgeted to decline to one per cent in 2008-09. The improvement is seen not only in the magnitude but also in the quality of deficits. The ratio of revenue deficit to fiscal deficit, which shows the extent to which borrowed funds are used to finance current spending, declined from 71 per cent in 2001-02 to 47 per cent in 2007-08 and is estimated to be lower still at 41 per cent in 2008-09.

Table 2 : Fiscal Imbalance of Central Government

(Per cent to GDP)

Year	Fiscal Deficit	Revenue Deficit	Primary Deficit	Revenue Deficit as per cent of Fiscal Deficit
2001-02	6.2	4.4	1.5	71.1
2002-03	5.9	4.4	1.1	74.4
2003-04	4.5	3.6	0.0	79.7
2004-05	4.0	2.5	-0.1	62.6
2005-06	4.1	2.6	0.4	63.0
2006-07	3.4	1.9	-0.2	56.3
2007-08 (RE)	3.2	1.5	-0.2	44.2
2008-09 (BE)	2.5	1.0	-1.1	41.4

Source: Budget Documents, Government of India

Note: The GDP at current market prices are based on CSO's new 1999-2000 series

II.5. While the central fiscal deficit according to the budget estimate of 2008-09 is below the FRBMA target of 3 per cent, there is a slippage in reaching the revenue deficit target. The revenue deficit of Central government continues to be over one per cent of GDP and it is unlikely that this could be phased out soon.

II.6. An analysis of the sources of fiscal consolidation at the Centre summarised in Table 3 shows that the improvement in the fiscal situation is mainly attributable

Table 3: Improvement in Central Finances						
	Percent of GDP				Percentage Points	
	2001-02	2003-04	2007-08	2008-09	Improvement in 2008-09 over 2001-02	Improvement in 2008-09 over 2003-04
Net Revenue Receipts	8.83	9.58	11.19	11.37	2.54	1.79
Tax Revenue (Net)	5.86	6.79	9.2	9.56	3.7	2.77
Non-tax Revenue	2.97	2.79	1.99	1.81	-1.16	-0.98
Gross Revenue Receipts	11.18	12.02	14.46	14.77	3.59	2.75
Gross Tax Revenue	8.21	9.23	12.47	12.97	4.76	3.74
Direct Taxes	3.01	3.81	6.49	6.88	3.87	3.07
Indirect Taxes	5.19	5.44	6	6.1	0.91	0.66
Revenue Expenditure	13.23	13.14	12.54	12.41	-0.82	-0.73
Interest Payments	4.72	4.5	3.66	3.6	-1.12	-0.9
Major Subsidies	1.34	1.58	1.38	1.25	-0.09	-0.33
Defence Expenditure	1.67	1.57	1.99	1.97	0.3	0.4
Capital Expenditure	2.67	3.96	2.57	1.75	-0.92	-2.21
Total Expenditure	15.9	17.11	15.11	14.16	-1.74	-2.95
Fiscal Deficit	6.2	4.5	3.1	2.5	3.7	2.0
Revenue Deficit	4.4	3.6	1.35	1.04	3.36	2.56

Source: Budget Documents, Government of India

Note : The capital expenditure is inclusive of repayment to National Small Savings till For the years 2001-02 and 2002-03, after 2004-05 there was a decline in intermediation to states with the creation of National Small Savings Fund (NSSF).

to a significant increase in tax revenues. Since 2003-04, when the FRBMA was enacted, the reduction in the revenue deficit relative to GDP amounted to almost 2.5 percentage points. During this period, the gross Central tax revenue to GDP increased by 3.74 per centage points, After accounting for the one percentage point increase in tax devolution to States, the net central tax revenue increased by 2.8 percentage points. On the expenditure side, interest payments as a ratio of GDP declined from 4.5 per cent in 2003-04 to 3.6 per cent in 2008-09 to reduce the

revenue expenditure by 0.7 per centage point. This implies non-interest revenue expenditure actually showed a marginal increase.

II.7. Buoyant tax revenues, particularly personal and corporate income taxes and service tax, have thus helped improve the fiscal performance of the Central government. Gross tax revenue of the Central government as a ratio of GDP increased from 9.2 per cent in 2003-04 to 13 per cent in 2008-09. A detailed analysis shows that this increase was mainly due to increased revenue productivity of direct taxes (3 per centage points) and service tax revenues (0.9 point).

II.8. Despite appreciable fiscal consolidation, large and growing off budget liabilities are however a matter of concern. When these are included, the fiscal situation no longer looks stable and sustainable. In 2007-08, the revised estimate of fertilizer subsidy is Rs.30501 crore, and an additional Rs.7,500 crore is provided by way of bonds to fertilizer companies. For 2008-09, the subsidy is budgeted at Rs.30985 crore. Given the increase in feedstock prices and the price of imported fertilizers, total fertilizer subsidy for 2008-09 is likely to be more than Rs.95000 crore. Thus, underestimation on this account alone amounts to 1.2 per cent of GDP. In addition, food subsidy is underprovided in the budget and together with fertilizer subsidy the underestimation could easily be more than 2 per cent of GDP.

II.9. The under-recovery by Oil marketing Companies is of even greater concern. At a crude oil price of USD. 130/barrel, and after taking into account the recent increase in prices of distillates and apportioning some burden to oil extracting companies, the Central government is expected to issue oil bonds equivalent to over 2.2 per cent of GDP. When other unbudgeted (pay commission and farm loan waiver) and under budgeted (NREGA) liabilities are also included, total off budget liabilities of the Centre could exceed 5 per cent of GDP, over and above the budgeted central fiscal deficit of 2.5 per cent.

II.10. The problem with off budget liabilities is that besides the lump sum payment obligation when they mature, they impose a significant interest burden. Bonds issued under the market stabilisation scheme carry a much higher interest rate than the returns earned from the investment of foreign exchange reserves. In 2008-09 the expenditure on this account is estimated at Rs. 13958 crore. Similarly, interest has to be paid on the bonds issued to oil and fertilizer companies and the Food Corporation of India. In 2008-09, the outgo on this account is estimated at Rs.

8000 crore. The sizeable increase in off budget liabilities estimated above would carry an even larger interest payment burden in future.

Recent Trends in State Finances:

II.11. The trends in State finances show an appreciable improvement in recent years. There was a three per centage point improvement to GDP in the revenue deficit from 2.3 per cent in 2003-04 to a marginal surplus of 0.5 per cent in 2008-09. This improvement reduced the fiscal deficit relative to GSDP from 4.4 per cent to 2.1 per cent, which effectively meant that capital expenditures increased by about one per centage point. Thus, the States have been successful in achieving the targets set by the fiscal restructuring plan recommended by the 12th Finance commission.

II.12. An analysis of the various sources of improvement in State finances summarised in Table 4 reveals some interesting features. During the period from 2003-04 to 2008-09, the revenue deficit relative to GDP was compressed by 2.8 per centage points. Of this, 2.3 per centage points was due to increase in revenues, and 0.5 point was from expenditure reduction. Within revenues,

Table 4 : Improvement in State Finances Since 2001-02

Fiscal Trends
(Percent of GDP)

	2001-02	2003-04	2008-09 (BE)	Improvement in 2008-09 over 2001-02	Improvement in 2008-09 over 2003-04
Fiscal deficit	4.21	4.40	2.1	2.11	2.30
Revenue Deficit	2.59	2.30	-0.5	3.09	2.80
Revenue Receipts	10.9	11.20	13.5	2.6	2.30
Own tax Revenue	5.4	5.60	6.3	0.9	0.70
Tax Devolution	2.4	2.40	3.2	0.8	0.80
Grants	1.8	1.80	2.6	0.8	0.80
Revenue Expenditure	13.6	13.40	12.9	-0.7	-0.50
Interest Payment	2.74	2.90	2	-0.74	-0.90
Capital Expenditure	1.62	2.21	2.6	0.98	0.39

Note: BE – Budget Estimates.

almost 1.6 per centage points were due to increase in central transfers, distributed equally between tax devolution and grants. Much of this increase is attributable to the high buoyancy of Central direct taxes. As mentioned earlier, the gross tax revenue of the Central government increased at 26 per cent during this period and the revenue from direct taxes registered an average annual growth rate of over 30 per cent.

II.13. The own tax revenues of State governments increased by about 0.7 per centage point during the period from 2003-04 to 2008-09. Closer examination reveals that much of the increase is attributable to the increased revenue productivity arising from the reform of the sales tax system through the introduction of the value added tax (VAT) in April 2005. Rationalisation of stamp duties and the boom in the real estate market also made their contribution through a significant increase in stamp duties.

II.14. On the expenditure side, the adjustment was only 0.5 per centage point. This is almost entirely attributable to lower interest payments. Besides lowering of interest rates due to the debt swap scheme adopted in 2004-05, lower volume of borrowings from the National Small Savings Fund and to some extent, rescheduling and write off of debt repayments as per the recommendation of the Twelfth Finance Commission have all contributed to this improvement.

II.15. Thus, the overwhelming proportion of the improvement in State finances since 2003-04 is due to higher central transfers to the States. Higher revenue collections from the sales tax and lower interest payments also contributed to some extent. As the buoyancy in revenue collections from Central taxes is likely to continue in the medium term, the buoyancy in revenues is likely to continue. However, the successful introduction of VAT and its eventual transformation into the goods and services tax (GST) crucially depends on strengthening the tax administration, particularly the information system.

II.16. A major fiscal risk for the States in the immediate future arises from possible pay revisions in the wake of the Sixth Central Pay Commission. Since the Central government is still to take a decision regarding the pay revision , and even if the decision is taken before April 2009, it may not have a significant impact on the finances of the States governments in this financial year. Moreover, the reasonably healthy state of finances makes the implementation of pay revision much less

painful this time round compared to a decade ago. The last pay revision entailed an additional expenditure of about 1.5 per cent of GDP at the State level. At present, the states are running a revenue surplus of about 0.5 per cent, unlike in the late 1990s, when the states own revenues were stagnant, central transfers were declining and interest payments were increasing steadily. The states now have buoyant revenues, increasing central transfers and much lower interest payments. They are consequently much better placed to absorb the fiscal impact of a pay revision.