Economic Outlook for 2010/11

Economic Advisory Council to the
Prime Minister

New Delhi

July 2010

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ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER

NEW DELHI

July 2010

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

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Growth Prospects

1. The performance of the Indian economy in 2009/10 greatly exceeded expectations. The farm sector which was expected to contract showed resilience, growing by 0.2 per cent despite the weak South West monsoon. The non farm sector also did well. It is the assessment of the Council that the Indian economy would grow at 8.5 per cent in 2010/11 and 9.0 per cent in 2011/12. In the current fiscal year, agriculture will grow at 4.5 per cent, industry at 9.7 per cent and services at 8.9 per cent.

Global Prospects

2. The global economic and financial situation is recovering slowly. The large fiscal deficits and high debt ratios coupled with slow economic growth have created unsettling conditions for business and have potential for causing great volatility in financial markets. It is hard to visualize strong economic growth in the advanced economies in 2010 and to a large extent in 2011. The implications of this, for India's strategy to return to the 9.0 per cent growth trajectory, are that public policy must promote business confidence and facilitate increased investment.

Structural Factors

3. In 2008/09 the investment rate fell on account of the drawdown of inventories. This trend has reversed and the Council expects the investment rate to be higher at 36 per cent (of GDP) in 2009/10, rising to 37 per cent in 2010/11 and 38.4 per cent in 2011/12. Similarly we expect the domestic savings rate to pick up and reach 33.4 per cent in 2009/10, 34.3 per cent in 2010/11 and 35.5 per cent in 2011/12. These rates should enable the economy to grow in a sustained manner at 9.0 per cent.

4. Private corporate investment and total investment in fixed assets is expected to recover strongly but will not reach the previous high levels. Government Final

Consumption Expenditure to GDP which hit a peak of 12.3 per cent in 2009/10 is expected to fall to 10.3 per cent in 2011/12. On the contrary, Private Final Consumption Expenditure which declined in 2008/09 and 2009/10 is expected to increase in the current and next fiscal year. Since 2001-02 the progressive decline in the Private Final Consumption Expenditure has been accompanied by a matching increase in the investment expenditure component of GDP.

Sectoral Growth Projections

5. In the backdrop of a weak South West (SW) monsoon in 2009, the Council had expected the farm sector GDP to decline by 2 per cent. However, the actual loss in farm sector output was less. The strength in horticulture, animal husbandry and fisheries, as well as higher cotton output, helped farm sector GDP to ultimately register a marginally positive growth of 0.2 per cent.

6. On the basis of a normal SW monsoon forecast by the Meteorological Department, one may reasonably expect a strong rebound in crop output in Kharif and Rabi in 2010/11. The better seed and fertilizer availability and the construction of a large number of water harvesting structures through the MNREGA lend strength to these expectations. Moreover, the expansion in horticulture and animal husbandry and a low base effect should generate a farm sector GDP growth of around 4.5 per cent in the current fiscal.

7. Industrial sector recovery became evident in June 2009 and by August 2009 the General Index of Industrial Production (IIP) registered double digit growth rate driven by similar growth rates in output in the manufacturing and mining sector. The service sector has also shown strong recovery with GDP originating in the important sub-sector of “trade, hotels, restaurant, transport & communication” surging in the second half of 2009/10. The impact of the civil service pay hike and the arrears lifted growth of the “community personal services” sub-sector in the first half, but eased up in the second. Export related service activity (software and Business Process Outsourcing) was sluggish throughout 2009/10 but was more than offset by the recovery in domestic-oriented service activity. Overall, non-farm sector GDP grew by 8.8 per cent in 2009/10.

8. In 2009/10 the mining sector output grew at 10 per cent but a slowdown is expected in 2010/11 with a projected growth of 8.0 per cent in both output and GDP arising in the sector. Manufacturing output growth in 2009/10 was strong

in all the quarters, especially in the case of capital goods and durable consumer goods. The only exception to this was non-durable consumer goods which were impacted by poor export growth and a lower output of sugar. Even though the manufacturing sector has recorded strong growth rate in April and May 2010, we expect this to ease as the base effect wears off. The projected growth rate in the manufacturing sector and the general index (IIP) is expected at 10 per cent in 2010/11.

9. The expected expansion of investment in physical infrastructure, including housing will drive the construction sector. Accordingly, the GDP arising in the construction sub-sector would rise by 10 per cent in 2010/11, which is likely to inch up to 11 per cent in 2011/12. In the “trade, hotel, restaurants, transport & communication” sub sector, growth picked up in the last two quarters of the year. We expect this trend to be reinforced with 10 per cent growth in both 2010/11 as well as 2011/12. There will be no contribution to expansion from civil service pay in the current year but the private sector component of the sub-sector “community and personnel services” will continue to register strong expansion in line with the rest of the economy. Software and BPO activity is expected to expand significantly in 2010/11, both in the domestic and export sectors. Alongwith steady expansion in the financial industry we expect this sub-sector to record growth of 9.5 per cent in 2010/11 which will rise further in 2011/12.

10. Overall, we expect GDP arising in the industrial sector to expand 9.6 per cent in 2010/11, rising to 10.3 per cent in 2011/12. The expansion in the services sector is expected to approach 9 per cent in 2010/11 and inch up to 9.6 per cent in 2011/12. Over all, the non-farm sector is expected to grow by 9.2 per cent in 2010/11 and 9.8 per cent in 2011/12.

Trade & External Sector

11. According to the DGCI&S report the merchandise trade exports touched $176.6 billion in 2009/10 which was 4.7 per cent less than 2008/09. Engineering and electronic goods were the hardest hit declining by more than 20 per cent. Because of currency fluctuations, the rupee value of exports showed practically no decline in 2009/10. The value of merchandise imports in 2009/10 in doller terms was 8.2 per cent lower at $278.7 billion and 4 per cent lower in rupee terms.

Table 1: GDP Growth – Actual & Projected

Unit: per cent

		2005/06	2006/07	2007/08	2008/09 *QE*	2009/10 *Rev*	2010/11 *f*	2011/12 *f*
	Year-on-year Growth Rates							
1	Agriculture & allied activities	5.2	3.7	4.7	1.6	0.2	4.5	4.0
2	Mining & Quarrying	1.3	8.7	3.9	1.6	10.6	8.0	8.0
3	Manufacturing	9.6	14.9	10.3	3.2	10.8	10.0	10.5
4	Electricity, Gas & Water Supply	6.6	10.0	8.5	3.9	6.5	7.5	9.0
5	Construction	12.4	10.6	10.0	5.9	6.5	10.0	11.0
6	Trade, Hotels, Transport, Storage & Communication	12.1	11.7	10.7	7.6	9.3	10.0	10.0
7	Finance, insurance, real estate & business services	12.8	14.5	13.2	10.1	9.7	9.5	10.5
8	Community & personal services	7.6	2.6	6.7	13.9	5.6	6.0	7.5
9	**Gross Domestic Product at factor cost**	**9.5**	**9.7**	**9.2**	**6.7**	**7.4**	**8.5**	**9.0**
10	Industry (2 + 3 + 4 + 5)	9.3	12.7	9.5	3.9	9.3	9.7	10.3
11	Services (6 + 7 + 8)	11.1	10.2	10.5	9.8	8.5	8.9	9.6
12	Non-agriculture (9 - 1)	10.5	11.0	10.2	7.7	8.8	9.2	9.8
14	**GDP (factor cost) per capita**	**7.8**	**8.1**	**7.7**	**5.2**	**6.2**	**7.0**	**7.5**
	Some Magnitudes							
15	GDP at factor cost - 2004/05 prices in Rs lakh crore (or Trillion)	32.5	35.6	38.9	41.5	44.6	48.4	52.8
16	GDP market & current prices in Rs lakh crore (or Trillion)	37.1	42.8	49.5	55.7	62.3	70.3	79.2
17	GDP market & current prices in US$ Billion	837	947	1,231	1,222	1,317	1,529	1,722
18	Population in Million	1,106	1,122	1,138	1,154	1,170	1,186	1,203
19	GDP market prices per capita current prices	33,512	38,182	43,479	48,305	53,258	59,305	65,867
20	GDP market prices per capita in current US$	757	844	1,082	1,059	1,126	1,289	1,432

Note: QE refers to the Quick Estimates for National Income released on 29 Jan 2010. *Rev* refers to the Revised Estimate for National Income released on 31 May 2010.
f stands for forecasts made by the Council.

12. In 2010/11, we expect the value of crude oil imports to be high due to increase in crude prices by almost 15 per cent and an increase in the quantities imported. The oil import bill is expected to rise to $103 billion in 2010/11 and to $120 billion in 2011/12. Amongst the non oil imports we expect a comparatively slower growth in the case of gold, silver imports and a stronger growth in the remaining segments. The overall merchandise imports on balance-of-payments basis are expected to rise to nearly $354 billion (up 18 per cent) in 2010/11 and $414 billion (up 17 per cent) in 2011/12.

13. On the export side, the Council is projecting that in 2010/11 export growth of petroleum products would be slightly higher than that of imports at 24 and 16 per cent in 2010/11 and 2011/12 respectively. The value of exports of gems & jewellery would show growth of 25 per cent. Export of non-oil, non-jewellery products would rise by 20 per cent in 2010/11, and moderate slightly in 2011/12. Our projections for exports on balance-of-payments basis for 2010/11 amounts to $216 billion and for 2011/12 to $254 billion.

14. Overall, the merchandise trade deficit on balance-of-payments (BoP) basis in 2010/11 is estimated at $138 billion which is 18 per cent more than the previous year. The projected trade deficit in 2011/12 is $160 billion, an increase of 16 per cent over the 2010/11. In both years, we are expecting the merchandise trade deficit to be around 9 per cent of GDP.

15. ITES (software exports and business process outsourcing) and private remittances which had shown strong growth rates fell in 2008-09 as a result of the global crisis. In 2009/10, while private remittances showed a growth of 17 per cent, the ITES exports showed a surprising *decline* of 7 per cent. As a result of this, net invisibles showed a *decline* of 12 per cent for the first time in many years.

16. It is our assessment, that the process of revision would see changes in many components of BoP. The current account deficit which is now provisionally placed at 2.9 per cent of GDP is likely to come down on revision to around 2.5 per cent. The projections that are being made for 2010/11 and 2011/12 are on the basis that such revisions would indeed happen. We expect ITES related export earnings to increase by 12 per cent in 2010/11 and 20 per cent in 2011/12. Private remittances are projected to grow at a lower rate of 12 and 16 per cent respectively in these two years. This gives us a current account deficit of $42

billion (2.7 per cent of GDP) in 2010/11 and $51 billion (2.9 per cent of GDP) in 2011/12.

Table 6: Balance of Payments

Unit: US$ billion

	2004/05	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**
Merch. Exports	85.2	105.2	128.9	166.2	189.0	182.2	216.1	254.0
Merch. Imports	118.9	157.1	190.7	257.6	307.7	299.5	353.9	414.3
Merchandise Trade	–33.7	–51.9	–61.8	–91.5	–118.7	–117.3	–137.8	–160.3
Balance	*–4.7%*	*–6.2%*	*–6.5%*	*–7.4%*	*–9.7%*	*–8.9%*	*–9.0%*	*–9.3%*
Net Invisible	31.2	42.0	52.2	75.7	89.9	78.9	96.0	109.7
Earnings	*4.3%*	*5.0%*	*5.5%*	*6.2%*	*7.4%*	*6.0%*	*6.3%*	*6.4%*
o/w ITES	14.7	23.8	27.7	37.2	44.5	41.3	46.2	53.1
Private Remittances	20.5	24.5	29.8	41.7	44.6	52.1	58.3	67.0
Investment Income	–4.1	–4.1	–6.8	–4.4	–4.0	–6.4	–6.5	–6.5
Current Account	**–2.5**	**–9.9**	**–9.6**	**–15.74**	**–28.7**	**–38.4**	**–41.8**	**–50.7**
Balance	*–0.3%*	*–1.2%*	*–1.0%*	*–1.3%*	*–2.4%*	*–2.9%*	*–2.7%*	*–2.9%*
Foreign Investment	13.0	15.5	14.8	45.0	3.5	52.1	55.0	65.0
o/w FDI (net)	3.7	3.0	7.7	15.4	17.5	19.7	30.0	30.0
Inbound FDI	6.0	8.9	22.7	34.2	35.0	31.7	50.0	55.0
Outbound FDI	2.3	5.9	15.0	18.8	17.5	12.0	20.0	25.0
Portfolio capital	9.3	12.5	7.1	29.6	–14.0	32.4	25.0	35.0
Loans	10.9	7.9	24.5	41.9	4.1	11.9	16.8	24.5
Banking capital	3.9	1.4	1.9	11.8	–3.2	2.1	0	0
Other capital	0.7	1.2	4.2	9.5	4.5	–12.7	0	0
Capital Account	**28.0**	**25.5**	**45.2**	**108.0**	**8.7**	**53.6**	**72.8**	**90.5**
Balance	3.9%	*3.0%*	4.8%	8.8%	0.7%	4.1%	4.8%	5.3%
Errors & Omissions	0.6	–0.5	1.0	1.2	1.1	–1.7		
Accretion to Reserves	26.2	15.1	36.6	92.2	–18.9	13.4	30.9	39.8
	3.6%	*1.8%*	*3.9%*	*7.5%*	*–1.5%*	*1.0%*	2.0%	2.3%

Note: Percentage figures proportion to GDP

17. In 2009/10 the net FDI inflow at $20 billion was 11 per cent more in 2009/10 compared to the previous year. Portfolio capital inflows at $32 billion marked a big turnaround from (–) $14 billion in 2008/09, reflecting the growth in domestic and world asset markets. The portfolio inflows were primarily in the form of investments by Foreign Institutional Investors (FIIs) while the overseas equity issuance (GDR & ADR) by Indian corporates was quite subdued. Loan capital inflows stood at $12 billion.

18. In 2010/11 and 2011/12 we see a continued expansion of net FDI to $30 billion in both years, portfolio capital inflows of $25 billion and $35 billion and a steady increase in net loan capital inflows to $17 and $25 billion respectively. Overall, our estimates for capital inflows are $73 billion in 2010/11 and $91 billion in 2011/12. This would be adequate to finance the large current account deficit in the two years and leave a modest $31 and $41 billion (2.0 and 2.4 per cent of GDP) to be absorbed in the foreign exchange reserves.

Prices and Inflationary Pressure

19. Since October 2008, the Indian economy has been experiencing very high inflation in food prices. Initially this high inflation was confined to only food articles – both primary and manufactured. However as economic recovery began to stabilize it has, not unexpectedly, manifested itself in the prices of manufactured goods.

20. The headline inflation rate which was 1 per cent in September 2009 has been rising since then reaching double digits in February 2010. Even in June the provisional headline rate was over 10 per cent. Inflation in manufactured goods also jumped from less than 1 per cent in September 2009 to a high level of 6-8 per cent in April-June 2010.

21. Inflation reflected in Consumer Price Indices has been running in double digits. In July 2009, both CPI-IW (Industrial Workers) and CPI-UNME (Urban Non-Manual Employees) surged from 9 per cent to 12 and 13 per cent respectively. By December 2009, both indices were reporting inflation of around 15 per cent, which increased further to 16 per cent in January 2010. There has been a slight easing thereafter, with both indices reporting inflation of less than 15 per cent in March 2010. The CPI-IW inflation rate for May 2010 was less than 14 per cent.

22. Inflation has remained a major source of concern in the economy for more than a year. The overall WPI inflation rate has remained at double digit levels for the past five months and the consumer price inflation for much longer. Inflationary expectations, particularly food inflation expectations, will be moderated because of the projected normal monsoon. Food prices have already begun to soften. Combined with the base effect, we expect inflation rate to fall to around 6.5 per cent by March 2011. The available food stock must be released in a manner that

they have a dampening effect on prices. The behaviour of inflation will also be a major concern for monetary authorities. Against the background of inflation rates that are more than twice the comfort level, monetary policy has to operate with a bias towards tightening. This is essential to promote conditions for sustainable growth in the medium term.

Monetary Conditions and The Financial Sector

23 In the October 2009 Economic Outlook, the Council had noted that financial conditions had improved sharply across the world and risk perceptions had turned more favourable. However the pace of improvement has slowed down due to the heightened risk perceptions on the sovereign debt, especially after the Greece episode. In January 2010 as the Euro-zone initiative to support Greek sovereign debt began to run into a range of obstacles, a generalised lack of confidence developed with respect to sovereign governments in general and weaker members of the Euro-zone in particular. The Credit Default Swap (CDS) spreads increased not only for public and corporate debt issued by Greece and the other European economies perceived to be relatively weak but also for all emerging and developing economies. However, currency exchange rates did not show much movement till later. Except for the Japanese Yen which strengthened against the US dollar almost all other currencies declined – though the declines were of varying orders. China had linked the Renminbi, to the US dollar at the onset of the crisis. There was no change in the exchange rate till the third week of June 2010, when Chinese authorities announced that they were removing this peg. Since then the currency has gained from a level of 6.83 to the dollar to 6.77.

24. While the monetary easing and the fiscal measures during the crisis effectively limited the damage caused by the contagion, it was always clear that these would have to be rolled back as the economies gradually recovered. The European Union and the US continue to face unsettled recovery conditions, with the possibility of recurrent crisis being particularly pronounced in the Euro-zone. In view of this exit from the accommodative monetary policy and the reduction in fiscal deficit is only likely to materialize in 2011, perhaps in the middle of that year.

25 In those economies where the effects of the crisis have clearly worn off and the recovery is strong, an early exit from both the monetary and the fiscal

stimulus is called for. Australia, India, China, Brazil and Singapore have been tightening their monetary policy by raising policy interest rates and/or rolling back specific liquidity measures that were adopted at the time of the crisis.

26. In India, the excess liquidity conditions created by an easy monetary policy during the crisis, continued to prevail till May 2010, despite the tightening by RBI since October 2009. The situation changed in June when banks at the margin began borrowing at the repo window from the RBI. With the reversal in liquidity conditions, overnight interest rates also reverted to levels that have approached and even exceeded the upper end of the interest rate corridor i.e., the repo rate. To that extent liquidity conditions are taut enough for monetary policy signals to be appropriately transmitted to the financial sector.

27. Credit off-take has picked up since the second half of 2009/10 and displayed a strong growth rate in the first quarter of 2010/11 especially to the commercial sector. In line with this bank holding of government securities (adjusted for repo/reverse repo transactions) has risen much less in the first quarter of 2010/11 as compared to the first quarter of last year. Funds flow from the capital market into the commercial sector has also been quite strong. Corporate bond issuance is estimated at Rs. 60,000 crore in the first quarter of 2010/11 which is much higher than the issuance in the corresponding period of the previous three years. In the case of equity, though the issuance has increased it has not increased to the pre crisis levels.

28. Evidence on funds flow and output indicate a strong economic recovery but with inflation rates that are more than twice the comfort-zone, it is important that monetary policy completes the process of exit and moves towards a bias on tightening. This is essential to preserve price stability and create conducive conditions for sustainable growth in the medium term.

29. BoP projections indicate that the balance of the capital flows, after absorbing the current account deficit, can be readily absorbed by the financing needs of the faster growth process of the Indian economy. They do not pose a serious problem to exchange rate management. It is expected that RBI will continue to manage the exchange rate environment with an objective to reduce excessive volatility. With moderate surplus on capital account after meeting the current account deficit, exchange rate variations will remain within acceptable range.

Government Finances

30. With the Indian economy reviving faster than many had expected, initiating an exit from the expansionary stance is not only feasible but also necessary. According to the Thirteenth Finance Commission (TFC), despite significant corrections undertaken by the Centre and States, the consolidated Debt-GDP ratio in 2009/10 is estimated at 82 per cent which is well above the target set by the Twelfth Finance Commission (75 per cent). TFC has recommended that the consolidated debt as a ratio of GDP should be brought down to 68 per cent by 2014/15. Correspondingly, the ratio of net fiscal deficit to GDP of the Centre should be brought down from 6.8 per cent in 2009/10, to 3 per cent in 2014/15 and that of the States from 2.8 per cent to 2.4 per cent during the period. TFC has also recommended that the Centre should progressively reduce the revenue deficit and have a revenue surplus by 2014/15. The Central government has embarked on the fiscal consolidation programme in the 2010/11 budget which proposes a reduction in the fiscal deficit to 5.5 per cent of GDP and the revenue deficit to 4.0 per cent.

31. Progress in revenue collections in the first quarter of the year shows that high buoyancy has returned to the direct and also indirect tax revenues and that is likely to help realize the target. The unexpected bonanza from the telecom auctions and the decontrol of the petroleum products is likely to provide some additional cushion. The actual fiscal and revenue deficits may be lower than projected in the budget estimates. At the State level too, the budget estimates for 2010/11 do not show serious fiscal imbalance. Thus, the second phase of fiscal adjustment seems to have been set in motion at both Central and State levels. The budgeted consolidated fiscal deficit in 2010/11 stands at 8.4 per cent of GDP, almost 1.8 percentage points less than the revised estimate for 2009/10. Similarly, the revenue deficit as a ratio of GDP is expected to decline from 6.3 per cent in 2009/10 to 4.6 per cent in 2010/11. This order of fiscal adjustment will release substantial additional financial resources for private sector investment and provide greater space for monetary policy calibration. Nevertheless, the budgeted levels of revenue and fiscal deficits are still beyond the comfort zone and challenges to achieve fiscal consolidation in the coming years must have priority.

32. There are two major challenges in pursuing the fiscal restructuring plan detailed by the Thirteenth Finance Commission. First, the relatively easy options available in 2010/11 like the telecom revenues and disinvestment proceeds will not

be available in coming years and serious policy measures to contain unproductive expenditures will have to be initiated. Second, the stringent conditions imposed by the Thirteenth Finance Commission to make the Fiscal Responsibility and Budget Management (FRBM) process transparent and comprehensive will require higher levels of fiscal discipline.

33. It is important to improve the revenue productivity of the tax system and phase out unproductive expenditures. The initiative to partially free prices of petroleum products is a significant measure but the government will also have to rationalise food and fertilizer subsidies. On the revenue side, two important initiatives relate to the passing of the Direct Taxe Code and replacement of domestic indirect taxes at the Central and State levels with the Goods and Services Tax (GST). GST is a major tax reform agenda in the country but a lot of work needs to be done to make it operational.

Policy Actions

33. In the area of economic policy, three issues of primary importance in ensuring a sustainable 9 per cent economic growth rate are - containing inflation; improvement in farm productivity and closing the large physical infrastructure deficit, especially in the power sector.

34. There is a strong linkage between the objective of containing inflation and increasing farm productivity. This is because high rates of inflation in India are most often connected to, and preceded by, high rates of food price inflation. The latter is inevitably linked to shortages of supply caused by the vagaries of the weather and other factors that cause output to fail to respond to rising demand. This has been clearly brought into focus, by developments over the past one-and-a-half years. On the demand side there is strong evidence to show that economic growth in India especially in the rural areas has raised employment and incomes. The higher disposable income amongst the poorer sections of rural India has possibly boosted demand for primary food, creating pressure on prices. High rates of food inflation have been followed by an increase in inflation in non-food manufactured goods primarily due to a rise in money wages. The primary means of responding to higher demand for food would have to be greater production, and better distribution.

35. Raising farm productivity is of crucial importance and any strategy for doing this must take into account the large number of agro climatic zones in the country. The management of water supply for irrigation, soil management techniques and better farm practices are important measures to improve farm productivity. We need to develop an integrated approach to these issues.

36. In the first three years of the Eleventh Plan, there were considerable shortfalls in the completion of infrastructure projects. In the power sector, as against a planned target for creating 78,740 mega watts (MW), it appears we would be lucky to get 62,000 MW by March 2012. This rests on large capacities being commissioned in 2010/11 and 2011/12. The failure to create physical infrastructure in time has not only been persistent, but has also been a binding constraint on the expansion of manufacturing output, and this has been a significant contributor to lower competitiveness. It is important to accelerate the pace of capacity creation in the power sector and reform the distribution set-up in order to attract greater private investment. In the power sector, fuel has increasingly become another limitation. In the medium to long term, we have to broadbase our fuel usage to encompass nuclear power, natural gas and renewable sources and reduce the proportion of coal.

Economic Outlook for 2010/11

Full Report

I. ECONOMIC PERFORMANCE AND GROWTH OUTLOOK

1. The performance of the Indian economy in 2009/10 greatly exceeded expectations. In October 2009, in the shadow of the weak South West (SW) monsoon, which had a record 24 per cent shortfall in rainfall, the Council had projected a 6.5 per cent growth for the Indian economy in its Economic Outlook. This was built on the expectation that the farm sector would see a contraction of 2 per cent and the non-farm sector an expansion of 8.2 per cent. By the time of the Review in February 2010, it had become clear that the Indian farm sector was much more resilient to shortfall in precipitation than previously anticipated. The Council had felt that the *Advance Estimate* released in early February was a fairly accurate assessment, with a likelihood that on account of strong performance in manufacturing the aggregate growth rate may be revised marginally upwards. The *Revised Estimate* released by the Central Statistical Organization (CSO) at the end of May 2010 has indeed revised upward its estimate of growth for 2009/10 from 7.2 to 7.4 per cent. In large measure this was due to an upward revision of growth in the industrial sector from 8.6 to 9.3 per cent and to a lesser extent, a revision in farm GDP growth from a negative 0.2 to a positive 0.2 per cent (see Table-1)

2. The Council's February 2010 Review had also projected likely growth in 2010/11 and 2011/12 at 8.2 and 9.0 per cent respectively. It had assessed that the farm sector would show a strong rebound in 2010/11, of course, subject to a normal SW monsoon, and that this growth would also be in evidence in 2012.

3. In the current Economic Outlook for 2010/11, the Council has broadly stayed with these assessments except that it has projected slightly stronger growth in the industrial sector, in both 2010/11 and 2011/12, and slightly lower growth for the services sector in 2011/12. It is the assessment of the Council that the Indian economy would grow at 8.5 per cent in 2010/11 and 9.0 per cent in 2011/12. This is made on the expectation of a normal SW monsoon in 2011/12. Current indications appear to strongly endorse the Meteorological Department's assessment that the current year (2010/11) will have a normal monsoon.

4. The global economic and financial situation is recovering slowly. However, the

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4	Electricity, Gas & Water Supply	6.6	10.0	8.5	3.9	6.5	7.5	9.0
5	Construction	12.4	10.6	10.0	5.9	6.5	10.0	11.0
6	Trade, Hotels, Transport, Storage & Communication	12.1	11.7	10.7	7.6	9.3	10.0	10.0
7	Finance, insurance, real estate & business services	12.8	14.5	13.2	10.1	9.7	9.5	10.5
8	Community & personal services	7.6	2.6	6.7	13.9	5.6	6.0	7.5
9	**Gross Domestic Product at factor cost**	**9.5**	**9.7**	**9.2**	**6.7**	**7.4**	**8.5**	**9.0**
10	Industry (2 + 3 + 4 + 5)	9.3	12.7	9.5	3.9	9.3	9.7	10.3
11	Services (6 + 7 + 8)	11.1	10.2	10.5	9.8	8.5	8.9	9.6
12	Non-agriculture (9 - 1)	10.5	11.0	10.2	7.7	8.8	9.2	9.8
14	**GDP (factor cost) per capita**	**7.8**	**8.1**	**7.7**	**5.2**	**6.2**	**7.0**	**7.5**
	Some Magnitudes							
15	GDP at factor cost - 2004/05 prices in Rs lakh crore (or Trillion)	32.5	35.6	38.9	41.5	44.6	48.4	52.8
16	GDP market & current prices in Rs lakh crore (or Trillion)	37.1	42.8	49.5	55.7	62.3	70.3	79.2
17	GDP market & current prices in US$ Billion	837	947	1,231	1,222	1,317	1,529	1,722
18	Population in Million	1,106	1,122	1,138	1,154	1,170	1,186	1,203
19	GDP market prices per capita current prices	33,512	38,182	43,479	48,305	53,258	59,305	65,867
20	GDP market prices per capita in current US$	757	844	1,082	1,059	1,126	1,289	1,432

Note: QE refers to the Quick Estimates for National Income released on 29 Jan 2010. *Rev* refers to the Revised Estimate for National Income released on 31 May 2010.
f stands for forecasts made by the Council.

aftermath of the financial crisis of 2008 and 2009 has left the advanced economies of the Western world with serious structural deficiencies in their financial sector which will take some time to repair. The large monetary and fiscal stimulus that these economies used in response to the financial and economic crises, came on top of already enlarged fiscal deficits and high debt ratios. It may be recollected that even before the crisis, the Euro-zone members were having great difficulty in abiding by the conditions of the Stability Pact (Maastricht Treaty) and the US was running a deficit that was far higher than its historical average. In consequence, the order of deficits and its implications on governmental debt are *prima facie* of concern. The developments in Greece, where the government had grossly understated the extent of its fiscal stress, combined with the reality of high deficits and public debt throughout Europe, too bring the issue of debt, and fiscal sustainability and solvency of developed economies into very sharp focus.

5. The financing of these large deficits was greatly facilitated by the extraordinarily easy monetary conditions that were brought into force, again in response to the crisis. The governments of the European Union have responded to this over-extended fiscal situation and the crisis of confidence, generated as a consequence, with initiatives to contain their deficits. This is always hard to do when the economy is not growing, as is the condition in these countries today. The difficulty is compounded by the fact that tax rates are already very high in these economies and reducing expenditures is always very difficult. The US, while recognizing the need for demonstrating a commitment to fiscal sustainability, has so far declined to take any immediate measures to reduce its deficits. This has important implications for monetary policy, since without this support it may be hard to finance the level of deficits that the US has today.

6. These are unsettling conditions for business with an embedded potential for causing great volatility in financial markets. The current year (2010) has seen a lot of such volatility which is negative for business confidence and for investment. This is likely to persist for sometime. In this situation, it is hard to visualize strong economic growth in the advanced economies in 2010 and to a large extent in 2011.

7. This has implications for the strategy to preserve conditions that will enable India to return to the 9 per cent growth trajectory . In the Council's view, this

is eminently feasible, but adequate steps must be taken to offset the impact of negative global conditions. Therefore, it is imperative that public policy promotes an environment of strengthening business confidence, and facilitates increased investment and consolidation of growth in India. These issues are discussed at greater length in subsequent chapters.

8. Since October 2008, the Indian economy has been experiencing very high inflation in food prices. While initially this high inflation was confined to only food articles – both primary and manufactured – once economic recovery began to stabilize it has, not unexpectedly, manifested itself in the prices of manufactured goods. The headline inflation rate rose sharply from less than 1 per cent in September 2009 to over 8 per cent by December 2009 and to over 10 per cent in February and March 2010. The trend has continued into the current financial year with the provisional headline rate for May 2010 at over 10 per cent, and the likelihood that the final estimates may be somewhat higher. Inflation in manufactured goods also jumped from less than 1 per cent in September 2009 to over 5 per cent in December 2009 and 7.4 per cent in March 2010. In April and May of the current fiscal year, manufactured goods inflation continued to run at very high levels of between 6 and 8 per cent. Further, while it is a fact that a large part of the increase in manufactured goods inflation in the last few months of 2009/10 was on account of manufactured food articles, especially sugar, but by March 2010, and even more so in April and May, this was no longer true. The inflation rate in manufactured goods, *excluding* manufactured food articles, rose from (–)2.3 per cent in September 2009 to 5.4 per cent in March 2010 and 6.6 per cent in May 2010. Inflation reflected in Consumer Price Indices has been running in double digit figures. This is a very difficult situation. First such high rates of inflation undermine broad macroeconomic stability and therefore the longer term prospects of high economic growth. Second, and perhaps more importantly, it is extremely iniquitous, insofar as it reduces the real income of wage earners and the weaker sections of society in general. It is imperative to adopt necessary macroeconomic measures to rein in inflation, so that both long-term economic stability and the objective of inclusive growth are properly served. A more detailed discussion on this can be seen in the relevant section.

9. The external payments situation is comfortable. Merchandise exports, as well as software exports, have in fact fared slightly better in 2009/10 than expected. Merchandise imports have also been larger than previously expected, reflecting

the underlying strength of domestic demand recovery. Capital flows have been comparatively modest and the overall balance-of-payments (BoP) surplus has been quite small and lower than what the Council had expected previously. The recently released BoP figures for 2009/10 report a Current Account Deficit (CAD) of 2.9 per cent of GDP, which is significantly larger than the 2.2 per cent of GDP anticipated by the Council in February 2010. It also reports an overall BoP surplus of $13.4 billion which is lower than the Council's assessment in February of $17.6 billion. The higher than expected CAD stems mostly from a lower reported net positive balance for invisible earnings and a larger BoP merchandise trade deficit. It may be noted that the CAD for the first half of 2009/10 has been revised downward in the BoP statement for the full year. The Council feels that like other statistical statements, there will be revision of the provisional BoP statement which will see the CAD for 2009/10 come down to around $33 billion or 2.5 per cent of GDP.

10. In previous reports, the Council has not published projections of balance of payments, but in this report we are doing so for 2010/11, as well as 2011/12. It must be noted that these projections are closer to the ground on the current account side, since a large part of capital flows are hard to project within a defined time frame and thus the variability is significant. The Council's expectation is that relatively weak global conditions will continue to limit export growth. However, strong domestic recovery will see the trend of faster increase in merchandise imports continue. As a result, the current account deficit will be larger in the current year and as well as in the next. Although the projected figures of 2.7 per cent and 2.9 per cent of GDP for this year and the next respectively are higher than the previously considered "safe" level of 2 per cent of GDP, it is not a matter of concern. This is because capital flows are expected to be more than adequate to finance this current account deficit. Moreover today we have very significant foreign exchange reserves. It is also the Council's assessment that any surprises on the current account deficits will be on the lower side, i.e. the likelihood of exports of goods and services doing better than estimated is greater than the likelihood of the trade deficit being larger than projected.

11. We have embarked on fiscal consolidation quite early in our recovery (Budget presented in July 2009) and that, together with the fact that Government wisely did not go overboard on the expenditure side in its stimulus programme, gives us a head start in fiscal consolidation compared to other major economies

in the world. However, significant challenges remain, particularly, on the issue of subsidies and its better targeting and improved efficiency of expenditure programmes. Government is also committed to introduce the GST in 2011 and that would usher in significant efficiency in the tax regime. In the Council's assessment, it is eminently feasible for Government to meet the fiscal consolidation roadmap set out by the Thirteenth Finance Commission and return to an overall fiscal deficit of around 6 per cent of GDP over the next five years. This should result in consolidated (Centre and State) Government debt stabilizing at around 65 per cent of GDP.

II. INTERNATIONAL ECONOMIC CONDITIONS

12. In the February 2010 "Review of the Economy (2009/10)", the Council had made several observations. First, that the worsening of the fiscal positions across the globe, given the already high debt ratio in advanced economies in Europe as well as the United States, is a possible source of continued risk in 2010 as well as in the near term. Although the sharp rally in commodity prices, especially, crude oil, in the second half of 2009 and early 2010 seems to have worn off, the observation made by the Council in February 2010 that a potential spurt from the already high levels of commodity prices continue to pose a major risk particularly to the emerging economies, remains valid. The Council had noted that some of the increase in commodity prices is in reality a reflection of the lack of confidence in the principal reserve currencies and extremely low yields at the short end that encouraged investors to borrow short-term on low rates and invest in commodities. This investment strategy has seemingly been queered by the sharp decline in the Euro (and the corresponding rise of the US dollar), but the fact remains that a more stable currency regime with relatively normal interest rates would discourage speculative pressure on commodity prices. The fundamental fact remains that monetary and fiscal stability is a cornerstone for both financial and price stability.

13. Conditions have not changed much since February 2010, the principal exception being the sharp decline in Euro vis-à-vis the US dollar, as also most emerging market currencies. The rally in commodity prices has also eased, partly on account of fresh uncertainties regarding the global economic outlook and demand and partly due to the strong dollar and the downside foreign exchange risk that it poses to investors with dollar denominated balance sheets. Over the last several months, the principal focus of attention and source of uncertainty has been the issue of the sustainability of overly-stretched government finances in the developed economies, especially in Europe.

14. The crisis in government finances, it may be recollected, began with the admission in October 2009 by the then newly elected government in Greece, that the fiscal deficit was over 12 per cent of GDP, rather than the 3 per cent stated previously. Official agencies of the European Commission (after investigation in

January 2010) also expressed doubts regarding the reliability of data from Greece. Rectification of the false reporting by the previous government eventually saw the deficit rise to over 13 per cent.

15. A sharp sell-off of Greece government bonds saw CDS (Credit Derivative Swap) spreads on these bonds shoot up. Perhaps after a long time there was a re-examination of the external balances of individual members of the Euro-zone. The enormous current account deficits, run up by many members since the formation of the single currency, raised alarm not only in the financial markets but elsewhere as well. It became clear that many countries had taken advantage of the easy access and low rates of credit that became available once they joined the single currency region, to run up massive current account deficits, often in excess of 10 per cent of GDP. In fact, for several years, Greece had a current account deficit of more than 14 per cent of GDP. This happened alongside very high fiscal deficits. Double digit or close to double digit government deficits characterized Greece, Portugal and Spain, as well as Ireland. This was happening when, as a result of policy response to the global economic crisis, the fiscal deficit in France was also climbing towards 8 per cent of GDP.

16. While nobody doubted the ability of the Euro-zone or rather Germany and some of the solvent members, to bailout Greece, clearly it was an impossible task if this bailout had to be extended to all the countries now coming under the lens. Such an eventuality, where one or more members would need a bailout from others, had seemingly not been anticipated and so there were no institutional provisions in the Euro zone to handle the problem when it arose. Furthermore, there was strong public opposition in countries that were expected to come to the rescue (Germany, etc), to extend an open-ended line of accommodation to members such as Greece. The Euro-zone was envisaged as a group of peers and such an eventuality was apparently never foreseen. It also made it hard for the IMF to enter the picture.

17. One solution articulated in many quarters was that Greece could leave the common currency for some time (or permanently) and do the adjustment considered standard for heavily indebted currencies and governments. That is to devalue its newly re-established national currency which would make the holders of Greek debt absorb part of the pain. However, there does not seem to have been any willingness to travel down this path and the Euro-zone slowly veered

around to the view that a temporary accommodation and patch up, with the IMF playing a role, was the best option. However, the announcement that through the European Central Bank (ECB) the Euro-zone would extend a large refinance window of nearly $1 trillion for Greek and other Euro assets, failed to generate great confidence. The demand for Greece to adopt large expenditure cuts ran into violent domestic opposition in that country and resuscitated old intra-European tensions and stereotyping. There clearly was a felt need for doing-by-leading in this club of apparent peers. More so, given that even before the global crisis of 2008, most of the Euro-zone members were fiscally stretched and hard-pressed to meet the terms of Stability Pact. Over the last decade, both the deficits and the debt has been rising in these countries notwithstanding the economic boom that they enjoyed for several years before the onset of the 2008 crisis. In this context, even the less stretched European governments whose creditworthiness was not under a shadow — such as Germany, France, Netherlands and non-Euro member of the EU like the UK — chose to adopt necessary measures that could convincingly set their economies on the path of fiscal consolidation.

18. This has worked up a storm in the developed world, as there was more than one view on the macroeconomic effects of the decision by European economies to exit the fiscal stimulus programmes and move towards fiscal consolidation. The US is not in the same situation as the Euro-zone, even though its own deficit and debt levels are setting new records and some of its most important states, such as California, are under a fiscal cloud. However, even in the US it is increasingly clear that it is no longer possible to carry on with these deficit levels for very much longer and there has to be a medium-term programme for fiscal consolidation. There is thus a divergence of views within the US and the Euro on the timing of the exit of the fiscal stimulus programme, adopted as a response to the global crisis.

19. Differences over this issue have come up in the G-20 meetings of Finance Ministers, as well as in the Summit. However, the issue at stake is a matter of timing. Given that there are significant differences in the context the Euro-zone and the US are placed in the apparent differences in approach have become needlessly amplified.

20. The fiscal and monetary stimulus, adopted worldwide in response to the financial crisis, clearly helped ease the damage. However, it must be recognized

that the ability of fiscal policy to drive economic growth is not unrelated to the pre-existing state of government finances and indebtedness. Today, most governments in the West have systematically run deficits that are either as high, or higher, than permitted by their own guidelines and have seen their debt ratios rise sharply over the last 10–15 years. On the expenditure side they also have inbuilt automatic stabilizers and in many cases large unfunded social obligations. In Europe particularly taxation rates are already very high. Hence additional expenditure is of limited value and poses significant risks, a great departure from the conditions under which Keynes developed the idea of fiscal instruments to deal with economic recessions.

21. The IMF in its *World Economic Outlook* of April 2010 has projected that the advanced economies would grow by 2.3 per cent, compared to a contraction of 3.2 per cent in 2009. This projection is a slight improvement from its January 2010 forecast. In the update to the WEO released on 7 July 2010, the IMF has generally increased its projection of growth in 2010, while slightly scaling down its previous projections for 2011. The strongest rebound is projected for USA which is expected to grow 3.3 per cent in 2010 as compared to a decline of 2.4 per cent in 2009. The Euro-zone is expected to be more sluggish, growing by only 1 per cent in 2010 and up to 1.3 per cent in 2011, compared to a contraction of 4.1 per cent in 2009. Canada, Australia, Korea and other developed East Asian nations are expected to continue to do fairly well in 2010. At market exchange rates, the IMF projects that the world economic output will grow by 3.6 per cent in 2010 and 3.4 per cent in 2011, compared to a contraction of 2.0 per cent in 2009. A summary of some of these projections is placed at Table 2.1 to 2.3.

22. In its July update, the IMF has significantly raised its growth projections for most economies, except the European Union. Projected growth for the US has been raised by 0.2 and 0.3 percentage points for 2010 and 2011 with respect to the April 2010 estimate. Growth estimates for Asia, including Japan, and Brazil, have also been revised upward.

23. The recovery is expected to sustain in 2011. As per the projections, global trade imbalances are also expected to reduce with both current account surpluses and current account deficits falling.

Table 2.1: Economic Growth and Projections made by the IMF

Unit: per cent

	2007	2008	2009	2010	2011
World Output (at market exchange rates)	**3.9**	**1.8**	**–2.0**	**3.6**	**3.4**
Advanced Economies	**2.8**	**0.5**	**–3.2**	**2.6**	**2.4**
Emerging & Developing Economies	**8.3**	**6.1**	**2.4**	**6.8**	**6.4**
U.S.A.	2.1	0.4	–2.4	3.3	2.9
Eurozone	2.8	0.6	–4.1	1.0	1.3
Germany	2.5	1.2	–5.0	1.4	1.6
France	2.3	0.3	–2.2	1.4	1.6
Italy	1.5	–1.3	–5.0	0.9	1.1
Spain	3.6	0.9	–3.6	–0.4	0.6
Netherlands	3.6	2.0	–4.0	1.3	1.3
Japan	2.4	–1.2	–5.2	2.4	1.8
U.K.	2.6	0.5	–4.9	1.2	2.1
Canada	2.5	0.4	–2.6	3.6	2.8
Australia	4.7	2.4	1.3	3.0	3.5
Korea, South	5.1	5.1	0.2	5.7	5.0
Taiwan	6.0	6.0	–1.9	7.7	4.3
Singapore	8.2	8.2	–2.0	9.9	4.9
China	13.0	9.6	8.7	10.5	9.6
India	9.4	7.3	5.7	9.4	8.4
Asean 5	6.2	4.7	1.7	6.4	5.5
Brazil	6.1	5.1	–0.2	7.1	4.2
Russia	8.1	5.6	–6.6	4.3	4.1
South Africa	5.5	3.7	–1.8	2.6	3.6

Note: Asean 5 are Indonesia, Thailand, Philippines, Malaysia and Vietnam
Source: Update to World Economic Outlook, IMF, July 2010 and WEO April 2010 Database

24. It is too early to say whether the IMF's optimistic growth projections for 2010 will be realised. However its 2011 projections are likely to be realised. In other words, while the possibility of a nasty surprise in the advanced economies in 2010 cannot be ruled out, 2011 is likely to present an unambiguously more positive picture.

Table 2.2 : Current Account Balance as percent of GDP Projections for 2010 and 2011 by the IMF*

Unit: per cent

	2007	2008	2009	2010	2011
Advanced Economies	**–0.9**	**–1.3**	**–0.4**	**–0.4**	**–0.5**
U.S.A.	–5.2	–4.9	–2.9	–3.3	–3.4
Eurozone	0.4	–1.5	–0.6	–0.3	–0.2
Germany	7.6	6.7	4.8	5.5	5.6
France	–1.0	–2.3	–1.5	–1.9	–1.8
Italy	–2.4	–3.4	–3.4	–2.8	–2.7
Spain	–10.0	–9.6	–5.1	–5.3	–5.1
Netherlands	8.7	4.8	5.2	5.0	5.3
Japan	4.8	3.2	2.8	2.8	2.4
U.K.	–2.7	–1.5	–1.3	–1.7	–1.6
Canada	1.0	0.5	–2.7	–2.6	–2.5
Australia	–6.1	–4.4	–4.1	–3.5	–3.7
NIC - Asia*	6.1	4.9	8.9	6.6	6.0
of which Korea, South	0.6	–0.6	5.1	1.6	2.2
China	11.0	9.4	5.8	6.2	6.5
India	–1.0	–2.2	–2.1	–2.2	–2.0
Asean 5	5.1	2.7	5.1	3.3	2.2
Brazil	0.1	–1.7	–1.5	–2.9	–2.9
Russia	6.0	6.2	3.9	5.1	4.6
South Africa	–7.2	–7.1	–4.0	–5.0	–6.7
OPEC countries	19.1	19.1	4.3	9.0	10.7
Major Oil Exporters	13.8	14.5	5.8	8.8	9.3

Note: * The current account figures for 2009 in case of other than the developed economies are IMF staff estimates.

1. NIC - Asia comprise of Korea, Taiwan, Singapore and Hong Kong
2. Asean 5 are Indonesia, Thailand, Philippines, Malaysia and Vietnam
3. OPEC members are Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, UAE and Venezuela
4. Major Oil (18) exporters taken above include the OPEC 12 and Bahrein, Brunei, Malaysia, Norway, Oman and Russia

Source: World Economic Outlook, IMF, April 2010 – publication & database

Table 2.3: Current Account Balance in Value Terms Projections for 2010 and 2011 by IMF

Unit: US dollars billion

	2007	2008	2009	2010	2011
U.S.A.	**–727**	**–706**	**–418**	**–487**	**–524**
Euro-zone	47	–106	–44	–5	13
Germany	254	246	161	182	189
France	–26	–65	–39	–51	–50
Italy	–52	–79	–71	–59	–58
Spain	–144	–154	–74	–75	–73
Netherlands	68	42	42	40	43
Japan	211	157	142	150	131
U.K.	–75	–41	–29	–37	–37
Canada	15	8	–36	–40	–40
Australia	–58	–47	–41	–42	–46
NIC - Asia*	112	85	143	121	128
of which Korea, South	6	–6	43	16	24
China	372	426	284	335	391
India	–11	–27	–26	–30	–30
Asean 5	56	34	64	49	35
Brazil	2	–28	–24	–56	–60
Russia	77	102	48	78	80
South Africa	–20	–20	–11	–16	–23
OPEC countries	348	450	88	205	266
Major Oil Exporters	521	691	226	396	464

Note and Sources: Same as in Table 2.2

25. The annualized quarter-on-quarter growth for the US for the quarter ending March 2010 is now assessed at 2.7 per cent which is considerably lower than the 5.6 per cent estimated for the quarter ending December 2009. On year-on-year basis, growth in the quarter ending March 2010 was 2.4 per cent, while that in the quarter ending December 2009 was 0.1 per cent. A large part of the growth in both these quarters was due to increase in private inventories. This is understandable because during a contractionary phase inventories get drawn down and are then rebuilt as the economy recovers. However, it is worth noting that if we were to eliminate the impact of the rebuilding of inventory, the quarter-

on-quarter annualized growth for the quarter ending December 2009 would drop from 5.6 per cent to 1.8 per cent. Likewise, growth for the quarter ending March 2010 will fall from 2.7 per cent to only 0.8 per cent.

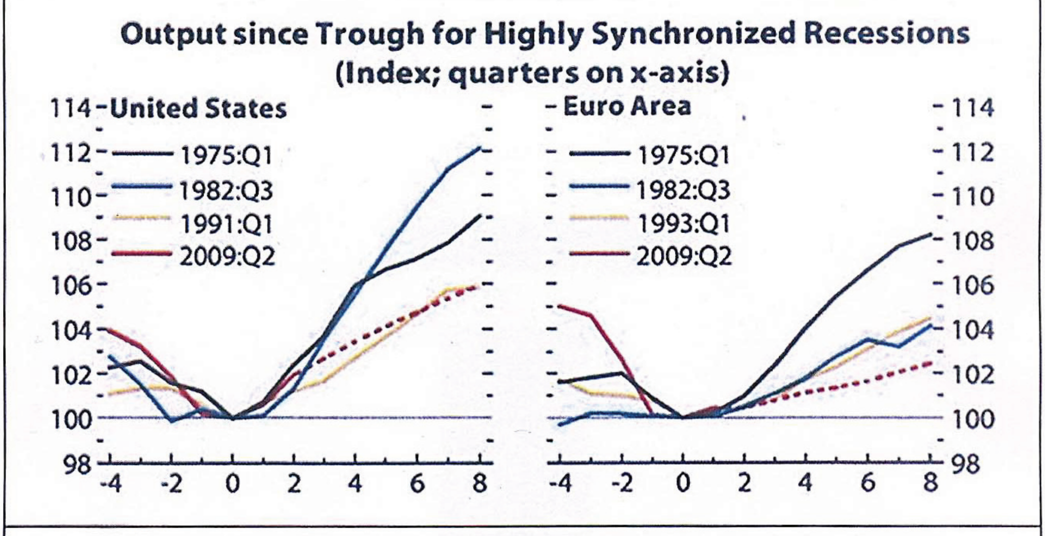
26. Typically, the inventory effect will become smaller in the remaining quarters of 2010. Growth of fixed investment continues to be negative on a year-on-year basis while on an annualized quarter-on-quarter basis fell back to (–) 0.5 per cent in the quarter ending March 2010 after showing a sharp pickup of 5.0 per cent in the last quarter of 2009. A major reason for this was the decline in residential investment. There are reports that foreclosures continue to be very high and the extent of accommodation extended by government-owned mortgage refinance entities has risen. Since the crisis, mortgage assets are being bought only by government-owned re-financiers. It is possible that difficulties with mortgages will continue for some more time. This has negative implications both for fiscal conditions as well as for risk perceptions in financial markets in general. Data available up to the end of June 2010 does not suggest that growth conditions have changed significantly for the better since the first quarter of 2010. In fact, new jobless data, car sales and other indicators point to the recovery getting bogged down. It would take a very strong acceleration in the remaining half of 2010 for growth in the US to approach the IMF's forecast of 3.3 per cent for 2010. It should not be a great surprise if in reality 2010 turns out to be weaker than forecast, although the 2011 forecast of 2.9 per cent growth seems more likely to be achieved.

27. The Euro-zone recorded year-on-year growth of 0.6 per cent in the quarter ended March 2010 which was a big improvement from the contraction of (–) 2.1 per cent in the quarter ended December 2009. The European Union as a whole also recorded similar growth in this period. Germany, which is the largest economy of Europe, had a somewhat stronger showing with 1.5 per cent growth (year-on-year) in the first quarter of 2010, compared to a contraction of 2.2 per cent in the last quarter of 2009. It is quite likely that developments in the first half of 2010 that has seen, amongst other things, a weakening of the Euro, will be favourable for the continued expansion of Germany and other economically and fiscally stronger nations within the Euro-zone, while there may be difficulties in store for the fiscally-more- stressed member economies. The IMF, in April 2010, projected growth for the Euro-zone at 1.0 per cent and for Germany at 1.2 per cent. In its July update, the 2010 projection has been maintained, while

that for 2011 has been scaled down to 1.3 per cent. The projection for Germany has been increased to 1.4 per cent for 2010. There is a strong possibility that the German economy may do better than what the IMF had forecast in April and July. Even the Euro-zone as a whole may do as well, or slightly better than the IMF forecast

28. The World Economic Outlook of April 2010 looked at the trajectory of the rebound in the US and Europe from the trough of the recession in three previous periods compared to the present.(reproduced in Figure-1). It may be observed that the recoveries in 1982 and 1975 were unambiguously strong. In the US, the recovery after the 1991 recession was relatively mild and that was because the contraction during the recession was also mild. However, it is clear that the record of the current recovery, as well as its projected outlook, both in the US and Europe, compare poorly with the previous episodes. This points to deeply embedded structural issues affecting the US and European economies that need to be recognized and at least partially addressed, before we can hope for a sustained

Figure 1: Output Since Trough for Highly Synchronised Recessions



Source: Figure 1.3, World Economic Outlook, April 2010, p.5.

strong economic recovery. In fact, the financial crisis of 2008 in considerable measure developed as a consequence of these structural deficiencies.

29. The IMF, as indicated in Table 2.2 & 2.3, reported continued declines in the current account deficits (CAD) of the US. It should however be pointed out that whereas the US CAD dropped sharply to 2.9 per cent of GDP in 2009 from 4.9 per cent in 2008, the persistent increase in the CAD in the last quarter of 2009 and in first quarter of 2010 suggest that for 2010 as well the CAD is likely to be over 3 per cent which is in line with the IMF forecast.The Euro-zone has reported a current account deficit for the quarter ended March 2010. However, the weakening of the Euro may turn this deficit into a surplus. In any case, the Euro-zone has been running a rising deficit with Eastern Europe and even more so with China, while operating a surplus with the US. The rising currency movements, if anything, may make the latter surplus trend more pronounced.

30. In summary, the economic scenario for 2010, as presented by the *World Economic Outlook* in April 2010 followed up by the July update, is likely to unfold with the possible *proviso* that the US may fall short of the recovery indicated, while Europe may do as well or better. It is also possible that the sharply enhanced growth prospects for Asian economies may turn out to be unduly optimistic. Trade balances may also not quite move in the direction the *World Economic Outlook* has indicated. It is also likely that growth conditions in 2011 may be better and may indeed match the forecast made by the IMF in its July update of the *World Economic Outlook.*

31. The implications of the above analysis clearly point in the direction of some improvement in conditions albeit with volatility in world financial markets. It is likely the recent reversal in lowering of risk perceptions seen in the first quarter of 2010 may continue for the better part of the rest of the year with significant and sustained improvement happening only in 2011.

32. China has made several announcements that it is placing greater emphasis on encouraging domestic demand and relying less on its traditional export-led growth strategy. At the same time, it has taken monetary policy measures to cool its reportedly overheated property sector and its rapidly growing economy in general. There have been recent reports that, as a consequence, manufacturing activity has shown a slight reduction in its otherwise very high rates of growth. This has caused a weakening of the perception of investors in late June and early

July. However, this may well be temporary.

33. It will be unwise to ignore a very important element of the current context. With the Western economies belying recovery expectations, investors and markets have increasingly pinned their hopes on a strong Asian economic recovery and performance. The latter has now become a major factor in setting investment sentiment. Thus, the steps that India, China and East and South East Asian economies take to preserve their growth momentum are relevant not only to the outcome within their economies, but also have a significant impact on what happens outside of their own economies in the global investment and financial world. Thus, the rewards of adopting coherent policies to preserve the growth momentum are not only much larger, but the cost of failure are also amplified.

34. Continued disquiet in global financial conditions may result in further strengthening of the US currency, not only vis-à-vis Euro, but perhaps against other emerging economies also. At the same time high rates of domestic inflation in countries like India will contribute to weakening of nominal exchange rates even as talk of capital control in Asia and other such measures results in undermining the financial strength of the region.

III. STRUCTURAL FACTORS

35. In its February review, the Council had noted that the decline in the investment rate to 34.9 per cent, in 2008/09 compared to the previous year's 37.7 per cent, was almost entirely on account of the drawdown of inventories. The ratio of increase in stocks to GDP fell from about 3.5 per cent in each of the two previous years to 1.3 per cent. Provisional estimates report that the ratio of fixed investment to GDP has fallen from 33 per cent in 2007/08 and 2008/09 to 32.4 per cent in 2009/10 at current prices and to 32.8 per cent at constant prices. At that time we had assessed that on revision, the fixed investment rate in 2009/10 would be 33 per cent, as in the previous two years, or quite close to it. We continue to stand by that view. A notable element has been the robustness of the fixed investment rate through the period of the crisis. It is expected that in a down-turn, inventory build up slows down or even turns negative for a short span of time. Provisional estimates of Gross Domestic Capital Formation (before errors & omissions) for 2009/10 place it at 35.0 per cent of GDP, comparable to the previous year. The Council assesses that the investment rate would have been around 36 per cent in 2009/10, after factoring in errors & omissions. Inventory build up is expected to gain steam during 2010/11 and in the subsequent year maintaining pace with higher levels of activity, while the fixed investment rate would also show a gradual improvement. As a result of these two factors, the overall investment rate is projected to be around 37 per cent in 2010/11, rising to over 38 per cent of GDP in 2011/12 (see Table 3)

36. The pace of asset creation can be measured by the annual growth of capital formation at constant (2004/05) prices. This pace was certainly disrupted in 2008/09 especially that of investment made by the private corporate sector. Fixed investment, which had been increasing at double digit levels since 2003/04, recorded negative growth of (–)5.1 per cent in 2008/09. Total fixed investment also dropped from double digit figures to a mere 4.0 per cent in 2008/09. A recovery did take place in 2009/10 with total fixed investment rising 7.2 per cent. Investment by the private corporate sector is also likely to have risen by a similar amount. In the current year and 2011/12, both private corporate investment as well as total investment in fixed assets is expected to recover strongly to low double digit figures, but is not expected to return to levels that prevailed in 2004/05 -

Table 3: Values of Key Macro-economic Parameters

Unit: per cent

	Investment Rate	Gross Domestic Capital Formation	Gross Domestic Fixed Capital Formation	Domestic Savings Rate	Current Account Balance	Final Consumption Rate		Gross Domestic Capital Formation (GDCF)		GDCF in Fixed Capital only		Final Consumption Expenditure		
						Private	Govt.	Total	Pvt. Corp	Total	Pvt. Corp	Pvt	Govt.	Total
	Ratio to GDP at market prices							Growth rate at Constant Prices						
2000/01 *	24.3	24.2	22.7	23.7	–0.6	64.0	12.6	–4.0	–28.3	–0.01	–11.0	3.6	0.9	3.2
2001/02 *	22.8	24.2	23.6	23.5	0.7	64.5	12.4	3.8	8.6	7.4	3.6	5.7	2.3	5.2
2002/03 *	25.2	25.2	23.8	26.3	1.2	63.3	11.9	10.9	17.1	6.8	3.5	2.8	–0.4	2.3
2003/04 *	27.6	26.8	25.0	29.8	2.3	61.8	11.3	12.9	24.6	13.6	23.2	6.0	2.6	5.5
2004/05	32.7	32.5	28.8	32.2	–0.3	59.5	11.0	22.3*	68.1*	18.9*	62.8*	5.5*	3.6*	5.2*
2005/06	34.3	34.3	30.4	33.1	–1.2	58.2	10.9	16.0	44.1	15.3	41.7	8.6	8.3	8.5
2006/07	35.5	36.0	31.4	34.4	–1.0	57.8	10.4	16.1	20.2	14.3	18.7	8.3	3.8	7.6
2007/08	37.7	37.6	33.0	36.4	–1.3	56.9	10.4	15.2	23.0	15.2	20.6	9.7	9.7	9.7
2008/09 QE	34.9	35.6	33.0	32.5	–2.4	57.7	11.7	–2.4	–16.6	4.0	–5.1	6.8	16.7	8.3
2009/10 est.	**36.0§**	**35.0**	**33.0§**	**33.4§**	–2.6	**57.3**	**12.3**	**7.1**	**9.5§**	**7.2**	**7.0§**	**4.3**	**10.5**	**5.3**
2010/11	37.0	37.0	34.0	34.3	–2.7	56.0	10.8	15.0	23.0	12.5	15.0	6.6	3.0	6.0
2011/12	38.4	38.4	35.0	35.5	–2.9	55.5	10.3	12.7	15.0	12.5	15.0	8.0	4.0	7.4

Note: * For these years the GDP and component figures are as per the old NAS series;
§ Estimates

2007/08. In part, this is because of the already elevated level of investment as a proportion of GDP.

37. Government Final Consumption Expenditure rose 9.7 per cent in 2007/08 and jumped 16.7 per cent in 2008/09. This was primarily due to high subsidy level, especially for petroleum and fertilizer, the farm loan waiver and higher expenditure arising from the fiscal stimulus in the second half of the year. Provisional estimates show that government final consumption expenditures increased further by 10.5 per cent in 2009/10. The ratio of Government Final Consumption Expenditure to GDP hit a peak of 12.3 per cent in 2009/10, the highest since 2001/02. The pace of expansion of government expenditure is expected to fall in 2010/11 and 2011/12 to 3 and 4 per cent respectively. This would result in bringing down the ratio of Government Final Consumption Expenditure to GDP from the high of 12.3 per cent in 2009/10 to 10.3 per cent of 2011/12.

38. Growth in Private Final Consumption Expenditure hit a peak of 9.7 per cent in 2007/08 which declined to 6.8 per cent in 2008/09 and further to 4.3 per cent in 2009/10. Many items such as durable consumer goods have showed a strong rebound in the second half of 2009/10. The increase in the current fiscal year is expected to be 6.6 per cent, rising further to 8.0 per cent in 2011/12. The proportion of Private Final Consumption Expenditure to GDP has progressively dropped from 64.5 per cent in 2001/02 to 57.3 per cent in 2009/10. This decline has been largely matched by the increase in the investment expenditure component of GDP.

39. Details of the savings rates in 2009/10 are not yet available. The domestic savings rate fell from 36.4 per cent of GDP in 2007/08 to 32.5 per cent in 2008-09. The Council expects the domestic savings rate would have recovered to about 33.4 per cent in 2009-10 and expects this process to continue in the current fiscal and in 2011/12, thereby taking the domestic saving rate to 35.5 per cent, sufficient to finance the expected investment rate of more than 38 per cent.

40. As compared to the saving rate in 2007/08, the decline in 2008/09 as well as in the following years is primarily on account of an increase in government dis-savings. The larger operating deficits of government, on account of higher civil service pay, arrears of pay, higher subsidy burden and stimulus related loss of revenue and higher expenditure in 2008/09 and 2009/10, effectively turned

the item from a positive savings value of 0.6 per cent of GDP in 2007/08 to a negative value of (–) 2.5 per cent in 2008/09. Thus, in the short period of one year, government dis-savings increased (or savings declined) by 3.1 percentage points of GDP. Private savings remained largely unchanged in 2008/09, although there was small erosion in the corporate savings rate. It is estimated that in 2009/10 there was a small recovery in both private corporate savings and household savings which, combined with a slightly better public sector position, may have taken the domestic savings rate to 33.4 per cent. Further improvement in government finance is expected to materialise in 2010/11 and 2011/12. Some improvement in private savings is also likely. The combination is expected to take the overall domestic savings rate to over 34 per cent in 2010/11 and close to 36 per cent in 2011/12.

IV. MONSOON & FARM SECTOR

41. In 2009, India had the weakest South West (SW) monsoon since 1972, with a shortfall in precipitation of 24 per cent from the Long Period Average (LPA). As the weak SW monsoon season closed last year, there were serious apprehensions about the extent to which crop output would suffer on account of this shortfall of rainfall. *Kharif* acreage had dropped significantly and it was our assessment in the *Economic Outlook* of October 2009 that rice output would fall by 11 Million Tonnes (MT) while coarse cereal production may not be affected. We had also expected oilseed production to be 6 lakh tonnes lower. Some of the loss in cereal production was expected (in value terms) to be partially offset by higher production of cotton and continued growth in horticulture and animal husbandry. On the basis of these expectations, we had assessed farm sector GDP would decline 2 per cent.

42. However, the actual loss in farm sector output was less than feared earlier. K*harif* rice production did indeed fall by 10 MT while *rabi* rice was higher by about 0.3 MT. However, production of *kharif* coarse cereals was much lower (17 per cent) with *bajra* accounting for the bulk of the decline. Overall foodgrain output in 2009/10 was over 16 MT (nearly 7 per cent), lower than the 234.5 MT recorded in 2008/09. Oilseeds output was lower by nearly 14 lakh tonnes (5 per cent) with groundnut production registering a decline of nearly 18 lakh tonnes. According to the Ministry of Agriculture, cotton output was higher by 5.6 lakh bales (2.5 per cent) while sugarcane production registered a 3.6 per cent decline (see Table 4).

43. In 2009 heavy rainfall in central India, towards the end of September and the first week of October, resulted in massive flooding which damaged standing crops. This was another factor that contributed to overall output losses.

44. The strength in horticulture, animal husbandry and fisheries, as well as higher cotton output, helped farm sector GDP to ultimately register a marginally positive growth of 0.2 per cent, instead of the large decline expected previously.

45. We have now had two successive years of subdued growth in farm output. GDP arising in the farm sector registered a growth of 1.6 per cent in 2008/09 and 0.2 per cent in 2009/10. Growth in the Tenth Plan period (2002–2007)

Table 4: Farm Crop Output

	Output in 2008/2009 (final)			Output in 2009/10 (3rd AE)			Change in 2009/10	
	Kharif	*Rabi*	Total	*Kharif*	*Rabi*	Total		Absolute in MT
	Million Tonnes (MT)							
Rice	84.91	14.27	99.18	74.78	14.53	89.31	–10.0%	–9.87
Wheat		80.68	80.68		80.98	80.98	0.4%	0.30
Coarse Cereals	28.54	11.49	40.04	23.20	9.93	33.13	–17.3%	–6.91
Pulses	4.69	9.88	14.57	4.36	10.41	14.77	1.4%	0.20
Foodgrains	**118.14**	**116.32**	**234.47**	**102.34**	**115.85**	**218.19**	**–6.9%**	**–16.28**
Jowar	3.05	4.19	7.24	2.85	3.99	6.84	–5.5%	–0.40
Bajra	8.89		8.89	6.46		6.46	–27.3%	–2.43
Maize	14.12	5.61	19.73	11.64	4.68	16.32	–17.3%	–3.41
Ragi	2.04		2.04	1.89		1.89	–7.4%	–0.15
Small millets	0.44		0.44	0.36		0.36	–18.2%	–0.08
Barley		1.69	1.69		1.26	1.26	–25.4%	–0.43
Coarse Cereals	28.54	11.49	40.04	23.20	9.93	33.13	**–17.3%**	**–6.91**
Tur (Arhar)	2.27		2.27	2.56		2.56	12.8%	0.29
Gram		7.06	7.06		7.38	7.38	4.5%	0.32
Urad	0.84	0.33	1.17	0.86	0.43	1.29	10.3%	0.12
Moong	0.78	0.26	1.04	0.44	0.29	0.73	–29.8%	–0.31
Others	0.80	2.23	3.03	0.50	2.31	2.81	–7.3%	–0.22
Pulses total	4.69	9.88	14.57	4.36	10.41	14.77	1.4%	0.20
	Lakh Tonnes							Lakh Te
Nine Oilseeds	178.07	99.11	277.18	152.33	101.20	263.20	**–5.0%**	**–13.98**
Groundnut	56.17	15.51	71.68	36.57	17.26	53.83	–24.9%	–17.85
Castorseed	11.71		11.71	10.03		10.03	–14.3%	–1.68
Sesamum	6.40		6.40	6.12		6.12	–4.4%	–0.28
Nigerseed	1.17		1.17	1.02		1.02	–12.8%	–0.15
Rape & Mustard		72.01	72.01		65.90	65.90	–8.5%	–6.11
Linseed		1.69	1.69		1.21	1.21	–28.4%	–0.48
Safflower		1.89	1.89		1.55	1.55	–18.0%	–0.34
Sunflower	3.57	8.01	11.58	2.11	6.99	9.10	–21.4%	–2.48
Soybean	99.05		99.05	105.40		105.40	6.4%	6.35
Cotton	Lakh bales 170 kg		222.8			228.3	2.5%	5.58
Jute & mesta	Lakh bales 180 kg		103.9			111.0	6.9%	7.19
Sugarcane	Lakh tonnes		2,850.3			2,746.6	–3.6%	–103.71

Source: Ministry of Agriculture

was stronger than in the previous decade. In 2007/08, farm sector GDP growth continued its upward trend with 4.7 per cent expansion on the back of 3.7 and 5.2 per cent of growth in the immediately preceding two years of 2006/07 and 2005/06 respectively.

46. Vagaries of weather and other conditions having a bearing on agricultural productivity affect the pace of farm output expansion. These patterns tend to vary across regions and States resulting in much larger volatility at the local level than may be observed at the aggregate all-India level. Often these regional/State cycles overlap more than offset each other, contributing to irregular periods of strong growth at the all-India level interspersed with periods of weak expansion.

Monsoon 2010

47. Normal SW monsoon has been forecast not only in the advance Long Range Forecast (LRF) released by the Meteorological Department before the monsoon set in, but also in the updated LRF released on 25 June 2010. The latter has projected 98–106 per cent precipitation this monsoon season compared to the Long Period Average (LPA) rainfall.

48. On this basis, one may reasonably expect a strong rebound in crop output in 2010/11. This is especially so, since seed and fertilizer availability across the country this year is considerably stronger. Moreover the large number of water harvesting structures built in villages across the country through the MNREGA should help trap rain water and increase water supply to farm fields enabling the provision of life-saving irrigation.

49. Rainfall up to the end of June 2010 was 16 per cent below LPA, with 23 meteorological sub-divisions experiencing normal/excess rainfall and 13 sub-divisions having deficient/scanty rainfall. In comparison, rainfall in June last year was 46 per cent below LPA. However, it is important that a comparison be made with a larger number of years. We would then find that in 2005 and 2006, rainfall at the end of June was 20 and 21 per cent below LPA respectively. However, both 2005/06 and 2006/07 went on to register very strong farm sector growth of 5.2 and 3.7 per cent respectively. In 2007 and 2008 June rainfall was in excess of LPA but 2008/09 recorded a comparatively lower farm output growth of 1.6 per cent.

50. It may be argued that rainfall at the aggregate all-India level is misleading. If we decompose the aggregate rainfall for the month of June 2010 regionally, and make a comparison with rainfall in the same period in 2005 and 2006, this is what we would observe:

- **North East India:** June 2010 had the best precipitation in comparison with 2005 and 2006. Rainfall in 2005 was second and 2006 was third. However, precipitation in all of these years was *below* LPA.

- **Eastern India:** (West Bengal, Orissa, Jharkhand and Bihar). In these States, June 2006 had the best rainfall, but June 2010 was second and 2005 third. Here again rainfall in all years was *below* LPA.

- **North West India:** (Uttar Pradesh, Punjab, Haryana, Rajasthan, J&K, Himachal and Uttarakhand). Here again June 2006 was the best year. However, rainfall in June 2010 was the weakest, while 2005 came in between. Haryana and Punjab had rainfall in excess of LPA in 2005 and 2006, though for other sub-divisions rainfall in 2005 and 2006 was below LPA.

- **Central India** (Madhya Pradesh, Gujarat, including Saurashtra, Maharashtra, Chhattisgarh and Telangana sub-division of Andhra Pradesh). Here June 2005 was the best year while June 2010 was better than 2006. One sub-division (Madhya Maharashtra) received more rainfall than LPA in both 2006 and 2010 while 3 sub-divisions (Madhya Maharashtra, Saurashtra and Gujarat regions) had more rainfall than LPA in June 2005.

- **Southern India** (rest of Andhra Pradesh, Karnataka, Tamil Nadu and Kerala): In these States June 2010 has been unambiguously better than June 2006 that, in turn, was better than June 2005. Five sub-divisions (coastal Andhra, Rayalseema, Tamil Nadu and South Interior Karnataka and North Interior Karnataka) received more rainfall than LPA in June 2010. These same 5 sub-divisions also had more rainfall than LPA in 2006.

51. This shows that in June 2010 rainfall was better than in *both* 2005 and 2006 in north-eastern and southern India. Rainfall in June 2010 was better in at least one of the two years (2005 and 2006) in eastern and central India. Only northwest India has received less rainfall in June 2010 compared to 2005 *and*

2006. Thus up to the end of June 2010, northwest India has fared the worst in rainfall, but here too in J&K, Himachal, Uttarakhand, West Rajasthan and Punjab rainfall has been better than in 2009 and in a few cases (J&K, Himachal) rainfall has not only been better than in June 2005 and 2006, but has also been more than the LPA.

52. The Meteorological Department's forecast that the SW monsoon will advance into North India in the first week of July 2010 has been borne out. However, it remains to be seen whether their updated LRF for the season as a whole turns out to be accurate. The Council has proceeded on the basis that this forecast of rainfall will turn out to be reasonably accurate.

53. On this basis the Council expects that 2010 will show a strong recovery in *kharif* crop output, as well as expansion in the output of sugarcane and cotton. This coupled with improved water availability for the *rabi* season and the ongoing expansion in horticulture and animal husbandry should generate farm sector GDP growth of around 4.5 per cent.

V. INDUSTRY & SERVICES

54. Recovery in the industrial sector became evident in June 2009 and the pace of output expansion gained strength from August 2009 with growth in the General Index of Industrial Production (IIP) going into double digits. Manufacturing output growth rose to hover around 15–16 per cent level in the second half of 2009/10. Mining activity also recorded double digit growth in the second half of 2009/10, in part because of the increased availability of natural gas from the KG Basin.

55. The service sector has also shown strong recovery with GDP originating in the important sub-sector of "trade, hotels, restaurant, transport & communication" surging to record double digit growth in the second half of 2009/10. The impact of the civil service pay hike and the arrears lifted growth of the "community personal services" sub-sector in the first half, but eased up in the second. Export related service activity (software and Business Process Outsourcing) was sluggish throughout 2009/10, with aggregate export billings reportedly rising by only 7 per cent. However, the recovery in domestic-oriented service activity generated overall growth of 8.5 per cent in 2009/10. It is noteworthy that 2009/10 was the first year in some time when the growth of GDP arising in the industrial sector (9.3 per cent) was greater than in the service sector (8.5 per cent). The last time this happened was in 2006/07 and prior to that in 2004/05. Overall, non-farm sector GDP grew by 8.8 per cent in 2009/10.

Mining

56. Crude petroleum output has stagnated for some years, registering negative growth of 1.8 per cent in 2008/09 and marginally positive growth of 0.5 per cent in 2009/10. Total output in 2009/10 was 33.7 Million Tonnes (MT) although planned production for the year was 38.0 MT. The main reason for the shortfall of 4.3 MT was that output from the new oilfields in Rajasthan (Cairns) was delayed, causing a potential output loss of 2.6 MT from the planned target. Oil has begun to flow from these fields in recent months, and it is reasonable to expect total output of over 36 MT in 2010/11, a growth of 7 per cent.

57. In the case of natural gas, 2009/10 saw a substantial (45 per cent) increase in output to 52.2 Billion Cubic Metres (BCM). Output in 2010/11 will not record a similar jump but it would register some expansion. Coal output grew by 6.8

per cent in 2007/08, 7.8 per cent in 2008/09 and by 8.3 per cent in 2009/10 to touch 527 MT. Although coal output growth has been extremely weak in the first two months of 2010/11, overall for the year it would be reasonable to expect coal output in excess of 560 MT, implying a growth of well over 6 per cent.

58. Overall, the mining component of the IIP registered a growth of about 10 per cent in 2009/10. The Council expects that there will be an easing in the growth rate in 2010/11 and we have set this estimate at 8 per cent, both for output as well as the GDP arising in this sector.

Manufacturing

59. Manufacturing output growth as reported by the IIP collapsed from 9.0 per cent in 2007/08 to 2.8 per cent in 2008/09, on account of the global economic crisis. Growth revived sharply from June 2009 onwards and gained momentum in the second half of 2009/10. There were two effects at play here. First, there was a base effect on account of the depressed level of manufacturing in the corresponding (October–March) period of 2008/09 at which time many industrial units saw a massive decline in production.

60. However, aside from the base effect there was also real growth. One way to measure this is to compute the annualised growth for a point in time in 2009/10 with respect to the corresponding point in the pre-crisis year of 2007/08. If this is done for the manufacturing sub-index for the second half of 2009/10, it is found that the annualised rate is 7.6 per cent. The corresponding figure for the first quarter of 2009/10 is 4.6 per cent. This rises to 7.0 per cent in the second quarter and 7.3 and 7.9 per cent in the third and fourth quarter respectively. This clearly shows that the high year-on-year rates of growth for the manufacturing sub-index (9.2 per cent in Q2, 14.6 per cent in Q3 and 16.0 per cent in Q4) are not on account of the base effect *only*, but also reflect strong underlying real growth which has been rising in a systematic fashion from the first quarter of 2009/10 through the succeeding three quarters of the year. This is entirely consistent with our understanding of the way the recovery process has played out in the Indian economy during the 2009/10.

61. Manufacturing output growth in 2009/10 has been strong in every quarter and especially so in the case of capital goods and durable consumer goods. The only exception has been non-durable consumer goods and this is partly due to

the fact that a significant part of these goods are exportable products and export growth did languish for a large part of the year. The second reason is the reported lower output of sugar, especially in the first few months of the crushing season (i.e. up to January 2010). Edible oil output and consumer food products and beverages have also shown weak output growth through 2009/10 and in the first two months of the current fiscal year. A strong output growth in capital goods sector, along with a sharp pickup in the import of machinery, is an integral part of the investment story, the strength and recovery of which, is an important component of our understanding of the ongoing growth process. The production of basic and intermediate goods is also likely to continue at a steady pace. While the strong IIP growth figures reported in April and May 2010 are an extension of the trend that emerged in the last fiscal, there will certainly be an easing in the numbers, as the base effect begins to wear off in the second and third quarters of 2010/11. Overall, we expect manufacturing output to expand by about 10 per cent in 2010/11 and the general index (IIP) to register growth of almost 10 per cent. Capital goods output will register high growth, as will durable consumer goods (see Table 5)

Services

62. Construction activity showed a sharp up-tick in the third and fourth quarters of 2009/10, with 8.1 and 8.7 per cent growth respectively. We expect this trend to be further reinforced in 2010/11 and in the next year. This conclusion flows from the expected expansion of investment in physical infrastructure, including housing. Accordingly, the GDP arising in the construction sub-sector would rise by 10 per cent in 2010/11, which is likely to inch up to 11 per cent in 2011/12.

63. The large sub-sector "trade, hotel, restaurants, transport & communication", should reflect the rapid growth occurring elsewhere. In 2009/10, growth picked up to 10.2 and 12.4 per cent respectively in the last two quarters of the year. We expect this trend to be reinforced with 10 per cent growth in both 2010/11 as well as 2011/12. There will not be any contribution to expansion from civil service pay in the current year but the private sector component of the sub-sector "community and personnel services" will continue to register strong expansion in line with the rest of the economy.

64. Software and BPO activity is expected to expand significantly in 2010/11, both in the domestic as well as in the export sectors. Along with steady expansion

Table 5: Trends in Industrial Output

Unit: per cent

	Sectoral Classification				Use Based Classification					
	General	Manu-facture	Electri-city	Mining	Basic goods	Capital goods	Inter-mediate goods	Consumer Goods		
								Total	Durables	Non-durables
2007/08										
Q1	10.3	11.1	8.3	2.7	9.4	19.1	9.3	9.0	–0.7	12.4
Q2	8.7	8.9	7.1	7.4	9.3	21.3	10.5	2.2	–5.5	5.1
Q3	8.3	8.9	4.6	5.5	5.0	20.8	8.9	6.2	2.1	7.6
Q4	6.7	7.3	5.5	5.2	4.7	12.2	7.1	6.8	0.1	8.9
2008/09										
Q1	5.3	5.8	2.0	4.0	3.1	7.9	2.6	8.6	3.5	10.1
Q2	4.7	4.9	3.2	3.8	4.7	13.2	–1.7	6.6	10.8	5.1
Q3	0.8	0.5	2.9	2.0	2.4	3.8	–5.8	3.3	–1.8	4.9
Q4	0.8	0.3	3.0	0.9	0.4	5.0	–3.2	1.2	5.6	–0.1
2009/10										
Q1	3.8	3.4	6.0	6.8	6.3	2.0	7.4	–0.5	15.6	–5.3
Q2	9.0	9.2	7.4	9.0	5.9	8.6	11.7	10.1	23.7	5.1
Q3	13.4	14.6	3.8	10.3	6.1	21.6	19.3	12.5	33.7	6.0
Q4	15.1	16.0	6.7	12.7	10.1	41.1	17.1	7.5	31.5	0.2
2007/08	8.5	9.0	6.4	5.2	7.0	18.0	8.9	6.1	–1.0	8.5
2008/09	2.8	2.8	2.8	2.6	2.6	7.3	–2.1	4.7	4.5	4.8
2009/10	10.1	10.5	5.8	9.7	7.3	20.0	13.5	7.3	25.1	1.6
2010/11	9.8	10.1	7.5	8.0	5.7	28.0	6.3	8.5	16.5	5.3

in the financial industry we expect the sub-sector to record growth of 9.5 per cent in 2010/11 which will rise further in 2011/12.

65. Overall, we expect GDP arising in the industrial sector to expand 9.7 per cent in 2010/11, rising to 10.3 per cent in 2011/12. The expansion in the services sector is expected to approach 9 per cent and inch up to 9.6 per cent in 2011/12. Over all, the non-farm sector is expected to grow by 9.2 per cent in 2010/11 and 9.8 per cent in 2011/12.

VI. TRADE & EXTERNAL SECTOR

66. In the February 2010 "Review of the Economy", the Council had projected a merchandise trade deficit of 9.8 per cent of GDP and a current account balance amounting to (-)2.2 per cent of GDP. It had estimated that there would be a surplus on the capital account amounting to 3.7 per cent of GDP which would result in accretion to reserves to the extent of $17.6 billion. The Balance of Payments (BoP) statement for the year 2009/10 was released by the Reserve Bank of India (RBI) on 30 June 2010. The merchandise trade deficit has been reported at a somewhat lower level of 8.9 per cent of GDP. However, receipts from net invisibles are nearly $20 billion lower than our estimates. As a result, the first provisional estimate of the current account deficit in 2009/10 stands at over $38 billion or 2.9 per cent of GDP. On the capital account side, the statement for the full year places a larger surplus of $53.6 billion or 4.1 per cent of GDP, while accretion to reserves at $13.4 billion is somewhat smaller than what the Council had expected in February 2010.

67. Statistics are always subject to revision on account of capture of fresh data and the BoP statement is no exception. The current account deficit has been revised downwards in previous years. If we were to compare the BoP statement for the first three quarters (released on 31 March 2010), with the statement for the complete year released three months later, we will observe that the current account deficit for the period is significantly lower because of revisions in individual components. The Council expects that as the underlying data are revised the overall current account deficit for 2009/10 would be smaller at around 2.5 per cent of GDP; that is around $33 billion, as against the provisional estimate of $38 billion.

Merchandise Trade

68. The DGCI&S reports that merchandise trade exports touched $176.6 billion in 2009/10 which was 4.7 per cent less than in 2008/09. Because of currency fluctuations, the value of exports show a smaller decline in rupee terms and the rupee value of merchandise exports in 2009/10 is actually almost the same as in 2008/09. The value of merchandise imports in 2009/10 was 8.2 per cent lower at $278.7 billion and 4 per cent lower in rupee terms. Crude oil and petroleum

products imports were valued at $85.5 billion in 2009/10, 8.7 per cent lower than in the previous year. In the first eleven months of 2009/10, the value of gold and silver imports showed an increase of 6.0 per cent to $23 billion and it is estimated that for the year as a whole this figure was $25 billion. Non-oil, non-bullion imports comprise of materials imported for the purpose of exports (notably diamonds) as well as other raw materials & intermediates and capital goods. In the first eleven months of 2009/10, the value of these products fell by 12 per cent in dollar terms and for the full year the value of such imports is estimated at $156 billion.

69. Provisional trade data available for the first two months of 2010/11 show that export growth was 35.7 per cent in dollar terms and 24.2 per cent in rupee terms. Merchandise imports during the same period registered a growth of 40.9 per cent in dollar terms and 29.1 per cent in rupee terms. The value of oil imports jumped sharply by nearly 69 per cent and this was due to largely a base effect since the international crude oil prices that prevailed during April/May 2009 were quite depressed. After this crude oil prices experienced a sharp recovery.

70. The commodity wise breakup of trade data is available up to February 2010. This shows that in the first 11 months of 2009/10 engineering goods were the hardest hit, with exports declining nearly 25 per cent, electronic goods following closely with a fall of 22 per cent. Textiles, as a group, fared better, as did gems & jewellery, chemicals and leather manufactures. While the provisional data for these products show a small decline of 3–6 per cent for the first eleven months, the revised and complete data for the year would probably show a small positive growth.

Estimates for 2010/11 and 2011/12

71. On the import side, crude oil prices are expected to be around 15 per cent higher than in 2009/10. The IMF in its April 2010 World Economic Outlook had based its projections on a price of $80 and $83 per barrel in 2010 and 2011 respectively for a basket comprising of a simple average of UK Brent, Dubai and West Texas Intermediate (WTI) crude oil prices. In its July 2010 update the IMF has reduced its projection for crude oil prices to $75.3 and $76.5 per barrel for 2010 and 2011 respectively.

72. Given that the average price of this basket for calendar year 2009 was

$61.78, the IMF's April 2010 projection implied an expected price increase of 29.5 per cent for calendar 2010 over calendar 2009. The lower crude oil prices projected in the July update imply a price increase of 22 percent in calendar 2010, followed by a mere 2 percent further rise in 2011.

73. However for 2009/10, the average price of Brent at $69.1, WTI,at $70.3 and Dubai at $69.2 per barrel, was higher than in calendar 2009. We have assumed that in 2010/11 there would be an average increase in international benchmark prices by 15 per cent. Unlike the IMF projections for 2011, that have visualised only a modest price increase, we see a strong likelihood that there will be a further increase of about 10 per cent in the international prices of crude oil during 2011/12 given more broad based economic recovery. Although, the IMF has lowered its price forecast of crude oil quite dramatically, the Council has preferred to retain its price assessment, which is comparable to projections contained in the April 2010 World Economic Outlook.

74. Along with the increase in prices there would also be an expansion in India of the quantity of total crude oil consumed and imported. A substantial amount of refined products are also imported. Overall, we expect the quantity element of petroleum imports to increase by 5 per cent in 2010/11 and by 6 per cent in 2011/12. The higher domestic crude output would be a factor in determining the quantum of crude oil imports. Higher domestic natural gas production will also have the effect of lowering consumption of naptha. This will in the aggregate result in an increase in the oil import bill by 21 per cent in 2010/11 and by 17 per cent in 2011/12. This would take the oil import bill in 2010/11 to $103 billion and in 2011/12 to $120 billion. While crude oil prices did increase quite rapidly in April 2010 to over $80 per barrel, they have since tended to fall back to between $70 and $75 per barrel. It is, therefore, possible that international prices may be slightly lower, in which case the oil import bill would be reduced to that extent. On the other hand, given the fact that world demand is at an estimated 85 to 86 million barrels per day in 2010 which is lower than what it was in 2007 or Q1 of 2008 (86–87 million barrels per day), it is unlikely that crude prices will be higher than that projected for 2010/11 and 2011/12. This is that based on the assumption that there would be no serious geo-political crisis in the oil producing regions.

Non - Oil Imports

75. Gold and silver imports may or may not show much growth after having risen 34 per cent in 2009/10. However, we are factoring in an increase in the value of such imports by 10 per cent in 2010/11 and by another 7.5 per cent in 2011/12. The value of imports of gems, diamonds and other precious stones, used by the gems & jewellery export industry, is expected to grow at the same pace as the exports of that sector, namely 25 per cent in 2010/11, and 15 per cent in 2011/12.

76. Non-oil, non-gold and non-gems imports dropped by about 12 per cent in 2009/10 although it did grow strongly in the second half of the year. In 2010/11, we expect the growth of such imports to be about 25 per cent, the rate of expansion declining to 20 per cent in 2011/12.

77. On this basis, overall merchandise imports on balance-of-payments basis are expected to rise to nearly $354 billion (up 18 per cent) in 2010/11 and $414 billion (up 17 per cent) in 2011/12.

Global Trade Prospects

78. In its update of July 2010, the IMF has significantly raised its projected growth at constant prices of exports and imports from the April 2010 World Economic Outlook. The current projections are reported here with the April 2010 number in parenthesis. The IMF has projected that exports at *constant prices* from emerging and developing economies would increase by 10.5 (8.3) per cent in 2010, inching up to 9.0 (8.4) per cent in 2011. This may be compared to a *contraction* of 8.5 per cent in 2009. Exports from advanced economies are also expected to rise by 8.2 (6.6) per cent in 2010, after a decline of 12.6 per cent in 2009. Imports into advanced economies are expected by the IMF to increase (again at constant prices) by 7.2 (5.4) per cent in 2010, compared to a decline of 12.9 per cent in 2009. Imports into emerging and developing economies are expected to grow much faster by 12.5 (9.7) per cent in 2010, and by 9.3 (8.2) per cent in 2011, compared to a decline of 8.3 per cent in 2009.

79. The World Trade Organisation (WTO) on 26 March 2010 had projected that global trade would grow by 9.5 per cent (at constant prices) in 2010. In a more recent press release, the WTO reports that for the first quarter (January

to March of 2010) global exports rose 27 per cent and imports 24 per cent, computed on year-on-year basis. Exports from the US increased 20 per cent, while imports into the US grew 25 per cent. Exports from the EU–27 area rose 18 per cent and imports, 16 per cent. Exports from China increased 29 per cent, while her imports grew 65 per cent. Exports from India expanded 33 per cent, while imports grew 55 per cent. In the second quarter of 2010 (which is the first quarter of fiscal 2010/11) this trend has continued. Export growth in April–May 2010 in Asia ranged from 34 per cent in Vietnam, 36 per cent in India and 39 per cent in China, to 44 per cent in Japan and 53 per cent in Taiwan. Exports from Brazil for the quarter ending June 2010 grew 29 per cent. Exports from US and the EU for the month of April 2010 showed growth of 26 and 19 per cent respectively.

80. During April and May 2010, imports into Asia greatly exceeded export growth. This difference ranged from 21 per cent in Vietnam, 36 per cent in Japan to 41 per cent in India, 49 per cent in China and 62 per cent in Taiwan. Brazil too showed much higher import growth in April to June 2010 quarter, at 56 per cent. In April 2010, imports into the US rose 28 per cent, while that into the EU increased 20 per cent, of which imports from outside EU grew 26 per cent. While the figures for imports and exports reported above are not at constant prices, but are all at nominal prices, the inescapable fact remains that trade growth during the first half of 2010 has been stronger, if not much stronger, than what was anticipated by either the WTO or the IMF previously. It is another matter whether this trend would last through the balance part of 2010 and in the first half of 2011. It is indeed quite possible that there would be moderation in the growth rate as has been suggested by the IMF in its July update.

Export Projections

81. On the export side, for India, the Council is projecting that in 2010/11 export growth of petroleum products would be slightly higher than that of imports at 24 and 16 per cent in 2010/11 and 2010/12 respectively. The value of exports of gems & jewellery would show growth of 25 per cent. Export of non-oil, non-jewellery products would rise by 20 per cent in 2010/11, and moderate slightly in 2011/12. Given that these growth numbers are lower than the actual outcome in the first five months of 2010, it is quite possible that exports may fare better than projected. The anecdotal evidence from export businesses on their order position

and trade enquiries suggest that a stronger growth may be possible, but there is some uncertainty about this. Overall, our projections for exports on balance-of-payments basis for 2010/11 amount to $216 billion and that for 2011/12 at $254 billion.

82. Overall, the merchandise trade deficit on balance-of-payments (BoP) basis in 2010/11 is thus estimated at $138 billion which is 18 per cent more than in the previous year. The projected trade deficit in 2011/12 is $160 billion, an increase of 16 per cent over the previous year. In both years, we are expecting the merchandise trade deficit to be around 9 per cent of GDP (see Table 6).

Invisibles including ITES and Remittances

83. Traditionally, both ITES (software exports and business process outsourcing) and private remittances have been experiencing growth ranging between 30 and 40 per cent per annum. In 2008/09, no doubt as a result of the global crisis, the rate of expansion fell to 20 and 7 per cent respectively, with net invisibles showing a growth of 19 per cent, as against an average of more than 25 per cent growth in the previous 14 years.

84. However, in 2009/10, private remittances showed a growth of 17 per cent while ITES exports showed a surprising *decline* of 7 per cent, on account of the large negative balance of $7 billion reported against business services. As a result of this, net invisibles showed a *decline* of 12 per cent for the first time in many years. The last occasion was in 2000/01 and 1998/99, following the dotcom bust and the Asian currency crisis respectively.

85. Further, in 2009/10, the quarterly BoP data show that net invisibles have progressively declined from $21.2 billion in Q1 to $20.4 billion in Q2 to $18.9 billion in Q3 and finally to $18.5 billion in Q4. The normal pattern is a steady increase through Q1 and Q2, to Q3 and Q4, with one of the two last quarters reporting the highest level of net invisible earnings. While 2008/09 showed aberrant behaviour, this was self-evidently on account of the global crisis which hit just before the second half of the year. In 2009/10, conditions were quite different and hence this outcome is surprising.

86. It is our assessment, as noted at the outset, that the process of revision would see changes in many components of the BoP. The current account deficit

Table 6: Balance of Payments

Unit: US$ billion

	2004/05	2005/06	2006/07	2007/08	2008/09	2009 / 10	2010/11	2011/12
Merch. Exports	85.2	105.2	128.9	166.2	189.0	182.2	216.1	254.0
Merch. Imports	118.9	157.1	190.7	257.6	307.7	299.5	353.9	414.3
Merchandise Trade	–33.7	–51.9	–61.8	–91.5	–118.7	–117.3	–137.8	–160.3
Balance	*–4.7%*	*–6.2%*	*–6.5%*	*–7.4%*	*–9.7%*	*–8.9%*	*–9.0%*	*–9.3%*
Net Invisible	31.2	42.0	52.2	75.7	89.9	78.9	96.0	109.7
Earnings	*4.3%*	*5.0%*	*5.5%*	*6.2%*	*7.4%*	*6.0%*	*6.3%*	*6.4%*
o/w ITES	14.7	23.8	27.7	37.2	44.5	41.3	46.2	53.1
Private Remittances	20.5	24.5	29.8	41.7	44.6	52.1	58.3	67.0
Investment Income	–4.1	–4.1	–6.8	–4.4	–4.0	–6.4	–6.5	–6.5
Current Account	**–2.5**	**–9.9**	**–9.6**	**–15.74**	**–28.7**	**–38.4**	**–41.8**	**–50.7**
Balance	*–0.3%*	*–1.2%*	*–1.0%*	*–1.3%*	*–2.4%*	*–2.9%*	*–2.7%*	*–2.9%*
Foreign Investment	13.0	15.5	14.8	45.0	3.5	52.1	55.0	65.0
o/w FDI (net)	3.7	3.0	7.7	15.4	17.5	19.7	30.0	30.0
Inbound FDI	6.0	8.9	22.7	34.2	35.0	31.7	50.0	55.0
Outbound FDI	2.3	5.9	15.0	18.8	17.5	12.0	20.0	25.0
Portfolio capital	9.3	12.5	7.1	29.6	–14.0	32.4	25.0	35.0
Loans	10.9	7.9	24.5	41.9	4.1	11.9	16.8	24.5
Banking capital	3.9	1.4	1.9	11.8	–3.2	2.1	0	0
Other capital	0.7	1.2	4.2	9.5	4.5	–12.7	0	0
Capital Account	**28.0**	**25.5**	**45.2**	**108.0**	**8.7**	**53.6**	**72.8**	**90.5**
Balance	3.9%	*3.0%*	4.8%	8.8%	0.7%	4.1%	4.8%	5.3%
Errors & Omissions	0.6	–0.5	1.0	1.2	1.1	–1.7		
Accretion to	26.2	15.1	36.6	92.2	–18.9	13.4	30.9	39.8
Reserves	*3.6%*	*1.8%*	*3.9%*	*7.5%*	*–1.5%*	*1.0%*	2.0%	2.3%

Note: Percentage figures proportion to GDP

which is now provisionally placed at 2.9 per cent of GDP is likely to come down on revision to around 2.5 per cent. The projections that are being made here in regard of 2010/11 and 2011/12 are on the basis that such revisions would indeed happen. ITES related export earnings are projected to increase by 12 per cent in 2010/11. This reflects the views of the industry association NASSCOM. We expect a stronger rebound in 2011/12 with ITES export earnings registering growth of 20 per cent. Private remittances are projected to grow at a lower rate of 12 and 16 per cent respectively in these two years.

87. This gives us a current account deficit of $42 billion (2.7 per cent of GDP) in 2010/11 and $51 billion (2.9 per cent of GDP) in 2011/12. It is entirely likely that merchandise exports would fare better than projected and the positive balance on net invisibles may also be slightly higher. This could give somewhat lower outcomes for the current account deficit in 2010/11 and 2011/12. However, the short point remains that on account of the strong recovery in the domestic economy in an environment where export growth may be limited, we are more likely than not to end up with a higher current account deficit that may be close to 3 per cent of GDP.

Capital Account

88. Inbound Foreign Direct Investment (FDI) was slightly lower at $32 billion in 2009/10 compared to $35 billion in the previous year. However, outbound FDI was lower in 2009/10 by a greater amount, as a result of which net FDI inflow at $20 billion was 11 per cent more in 2009/10 compared to the previous year. Portfolio capital inflows at $32 billion marked a big turnaround from (–) $14 billion in 2008/09, reflecting the big rebound in domestic and world asset markets during 2009/10. Almost all the portfolio inflows were in the form of investments by Foreign Institutional Investors (FIIs). Overseas equity issuance (GDR & ADR) by Indian corporates was quite subdued. Thus, total foreign (equity) investment topped a record high of $52 billion in 2009/10.

89. Inflows on account of loan capital stood at $12 billion. This comprises official external assistance (very small), External Commercial Borrowings (ECB), suppliers' credit and FII investment in the onshore gilt and corporate bonds. Although, ECB issuance was much larger, the redemption in 2009/10 was also quite large. Additionally, a significant part of ECB issuance may have been offset by the redemption and the buyback of Foreign Currency Convertible Bonds (FCCB).

90. In 2010/11 and 2011/12 we see a continued expansion of net inbound FDI to $30 billion in both years, portfolio capital inflows of $25 billion and $35 billion and a steady increase in net loan capital inflows to $17 and $25 billion respectively. Overall, our estimates for capital inflows are $73 billion in 2010/11 and $91 billion in 2011/12. This would be adequate to finance the large current account deficit in the two years and leave a modest $31 and $40 billion (2.0 and 2.4 per cent of GDP) to be absorbed in the foreign exchange reserves.

VII. PRICES AND INFLATIONARY PRESSURE

91. The second half of 2009/10 saw a sharp run-up in the Wholesale Price Index (WPI) inflation. In September 2009, the headline rate was a mere 0.5 per cent which jumped to 8.1 per cent by December 2009 and increased further to 11 per cent by March 2010. However, in the backdrop of the relatively low inflation in the headline rate, primary food product prices continued to rise sharply throughout the fiscal year. The low headline rate was the result of a combination of delays in revising petroleum fuel prices, as a result of which the energy sector showed a negative inflation of 8 per cent in September 2009, and manufactured goods inflation was also low at 0.5 per cent in September 2009. However, primary food product inflation was as high as 11 per cent in June, 2009, 14 per cent in September and rose further to 20 per cent in December . The price index for foodgrains showed inflation at 14 per cent in June 2009, 16 per cent in September and over 20 per cent in December. Within manufactured products, inflation in manufactured food products was running high, at 12 per cent in June 2009, 13 per cent in September and 27 per cent in December. The principal contributing factor to the latter was the runaway increase in sugar prices with the index for sugar, *khandsari* & *gur* reporting inflation of 36 per cent in June, 44 per cent in September and 53 per cent in December 2009. Aside from sugar, dairy products began to show a rising price trend with inflation averaging over 11 per cent in the quarter ending December 2009 and rising to 13 per cent in the last quarter of 2009/10. Grain-mill products also showed a pick up in inflation to 6 per cent and more in the second half (See Table 7.1).

92. However, upto September 2009, manufactured goods, other than food products, were quiescent on the price front. In the second half of the year, this changed dramatically. While inflation in manufactured goods, excluding food articles, registered inflation of (–) 1.9 per cent in September 2009, this number rose sharply to 5.4 per cent by March 2010. In other words, the contagion of inflation appears to have spread across a larger number of commodities.

93. By March 2010, WPI headline inflation rate was at 11 per cent, with primary food inflation at 17 per cent and foodgrain inflation at 14 per cent. Manufactured food price inflation was 16 per cent, of which sugar was 43 per cent. Inflation rates for food articles were broadly consistent with the consumer price inflation which was close to 15 per cent in March 2010.

Table 7.1: Composition of Inflationary Pressure in 2009/10

Unit: per cent

	2009/10		2010/11		
	Sep	**Mar**	**Apr**	**May**	**June***
All Products	**0.5**	**11.0**	**9.6**	**10.2**	10.5
Primary Goods	8.4	18.3	13.9	16.6	16.3
Primary Food	14.2	17.4	16.9	16.5	14.6
Foodgrain	16.1	13.7	11.9	9.6	9.1
Energy	**–8.2**	**12.7**	**12.6**	**13.0**	**14.3**
Manufactured Goods	**0.5**	**7.4**	**6.7**	**6.4**	**6.6**
Manufactured Foods	13.1	15.5	9.2	5.7	5.4
Special combinations					
Manufactured Goods Excl Manufactured Foods	–1.9	5.4	6.1	6.6	7.0
Manufactured Foods Excl Sugar	6.8	4.2	0.2	–2.1	–1.0
Primary & Manufactured Food Items					
Wheat	6.5	13.4	6.5	3.4	4.5
Rice	20.9	9.1	8.3	7.1	6.4
Coarse cereals	20.5	11.8	8.1	2.1	4.2
Pulses	20.8	32.6	30.6	31.9	32.6
Fruit & Vegetables	9.9	10.0	4.5	9.3	5.0
Eggs, Meat & Fish	21.4	31.5	32.7	37.0	30.7
Sugar, *gur* & *khandsari*	43.5	42.5	30.2	23.7	19.0
Dairy products	9.8	13.1	12.8	12.1	12.5
Contribution to the Headline Rate (percentage points					
Total	**0.46**	**11.04**	**9.59**	**10.16**	**10.50**
Primary Goods	1.93	4.37	3.36	4.01	3.91
Primary Food	2.20	2.86	2.81	2.74	2.57
Foodgrain	0.77	0.75	0.65	0.52	0.51
Energy	**–1.81**	**2.54**	**2.49**	**2.58**	**2.88**
Manufactured Goods	**0.29**	**4.13**	**3.75**	**3.59**	**3.74**
Manufactured Foods	1.34	1.72	1.05	0.65	0.60
Special combinations					
Manufactured goods Excl Foods	–1.05	2.42	2.70	2.94	3.14
Manufactured Foods Excl Sugar	0.14	0.33	0.02	–0.17	–0.07

Note: * June 2010 numbers are projections except for primary goods and energy

94. Consumer Price Index (CPI) inflation had continued unabated at 10 per cent, or close to that level, ever since September 2008. In July 2009, both CPI-IW (Industrial Workers) and CPI-UNME (Urban Non-Manual Employees) surged from the 9 per cent level to 12 and 13 per cent respectively. By December 2009, both indices were reporting inflation of around 15 per cent, which increased further to 16 per cent in January 2010. There has been a slight easing thereafter, with both indices reporting inflation of less than 15 per cent in March 2010. The CPI-IW inflation rate for May 2010 was less than 14 per cent.

95. The price of foodgrains stabilised in the last quarter of 2009/10, the value of the foodgrain price index falling from a peak level of 289.5 at the end of December 2009 to 281.9 by the end of March 2010, with most of the decline happening in February and March. It may be noted that in the run-up to the monsoon foodgrain prices often tend to rise. However, for the week ending 26 June 2010, the foodgrain index was at 279.3 which is slightly lower than the end-March value.

96. The price of pulses has risen sharply over the past several years (Table 7.2). This has been felt most strongly in the case of the three major *kharif* pulses (*Arhar/Tur, Moong and Urad*) and *masur* which is a *rabi* crop. In 2007/08 the output of the three *kharif* pulses was about 5.6 million tonnes which fell to 3.9 and 3.7 million tonnes in 2008/09 and 2009/10 respectively triggering the recent bout of price increase. Output is expected to be higher in the 2010/11 *kharif* season on account of special efforts taken and also more favourable rainfall conditions and this is expected to take the edge off prices, especially in *arhar/tur*. Price pressure on *masur* has already eased.

97. The broader primary food index is affected by the seasonal behaviour in the prices of fruits & vegetables. The value of this index declined in 2009/10 from a peak of 289.5 at the end of January 2010 to 287.9 at the end of March. In the first quarter of 2010/11, because of the seasonal increase in the prices of fruits & vegetables, eggs, meat & fish, milk, etc, the index of primary food has climbed back and the value for the week ending 26 June 2010 is 296.0. However, with the monsoon setting in, the seasonally variable indices are likely to ease. However, the fact remains, that even though there is an improvement in the situation in respect of food prices, especially foodgrains and sugar, food price inflation remains at unacceptably high levels.

Table 7.2: Price Change in Pulses

Unit: per cent

	Pulses	Gram	Arhar	Moong	Masur	Urad
Year on year increase (last week of the year / month)						
2004/05	–2.6	–1.1	–7.1	0.9	–3.5	–2.9
2005/06	33.2	24.9	9.4	45.7	6.7	69.1
2006/07	13.4	20.2	8.4	14.5	14.0	8.4
2007/08	–1.9	5.8	15.2	–16.5	30.1	–18.1
2008/09	9.4	–6.7	17.1	19.9	15.7	14.7
2009/10	32.6	–2.9	37.4	69.5	13.5	45.1
2010/11*	30.1	–0.4	20.9	55.1	2.5	62.1
Cumulative from 1 Jan 2005 to week ending						
27-Jun-09	67.1	43.5	71.2	82.4	85.7	73.8
26-Jun-10	117.4	42.9	106.9	183.0	90.3	181.8

Note : * Up to week ending 26 June 2010

98. The principal development in the last quarter of 2009/10 was the sharp increase in prices of manufactured goods excluding food articles. As may be seen from Table 7.1, inflation in manufactured goods, excluding food articles, which had increased from (–)1.9 per cent in September 2009 to 0.7 per cent in December of the year, jumped thereafter to 5.4 per cent by March 2010. A part of this can be attributed to the decline in the prices of non food manufactured goods in the last quarter of the previous year i.e. a base effect. But there was a significant increase in the prices of many products. The inflation rate for manufactured goods, excluding food articles, increased steadily to 6.1 per cent and 6.6 per cent in April and May 2010 respectively. The figure for June is likely to be close to 7 per cent. Within this category of goods, inflation has been most pronounced in the case of cotton textiles (May inflation is 21 per cent) and iron & steel (May inflation is 20 per cent). In the case of cotton textiles, the underlying reason is the shortage of raw cotton, both domestically and worldwide, that has resulted in an increase in cotton prices and hence of other products as well. In the case of iron & steel, there was a firming up of world prices and domestic prices followed suit. However, over the past few months the increase in domestic prices has run ahead of price developments in international markets, perhaps as a consequence of the strength of domestic demand. As a result, it is reported that users have

imported large quantities of steel, which should in turn result in some adjustment in the domestic price level.

99. Petroleum product prices, particularly automotive fuels, have been under administrative control for a great length of time. As a result, the subsidy burden has been extremely high, notwithstanding the fact that more than three quarters of our consumption is met from imports. Therefore, as crude oil prices recovered sharply from the first quarter of 2008/09, the counterpart increase in domestic selling prices was incomplete. As a result, energy prices continued to contribute negatively to the headline inflation rate upto December 2009. With the recent decision to decontrol the price of gasoline and partially free up the price of diesel and also revise the selling price of cooking fuels, the process of clearing the backlog in price adjustments has at last commenced. This will contribute to a larger rise in the headline rate than if price adjustments had been carried out in time.

Inflation outlook

100. The issue of having a streamlined and effective policy for managing the supply and prices of wheat and rice, as well as cotton, has been brought into sharp focus through 2009/10. The Council's views on the approach and components of such an approach are detailed in the two appendices to this section. These deal first with the issue of using official stocks to keep the market adequately supplied with wheat and rice so that inflation is appropriately managed. And second with how, in a scenario of expanding world trade, both adequate returns to farmers and stability in supply to the textile mills can be ensured.

101. With the monsoon expected to be normal, the supply position will ease and price expectations normalised in the course of this year, which should help stabilise food prices in general. Thus, we expect both primary food and manufactured food prices to show declining inflation and reach a level of 5–7 per cent in the third quarter of the current fiscal. However, price pressure in manufactured goods is likely to continue to remain high, even as some products like sugar will see inflation drop sharply.

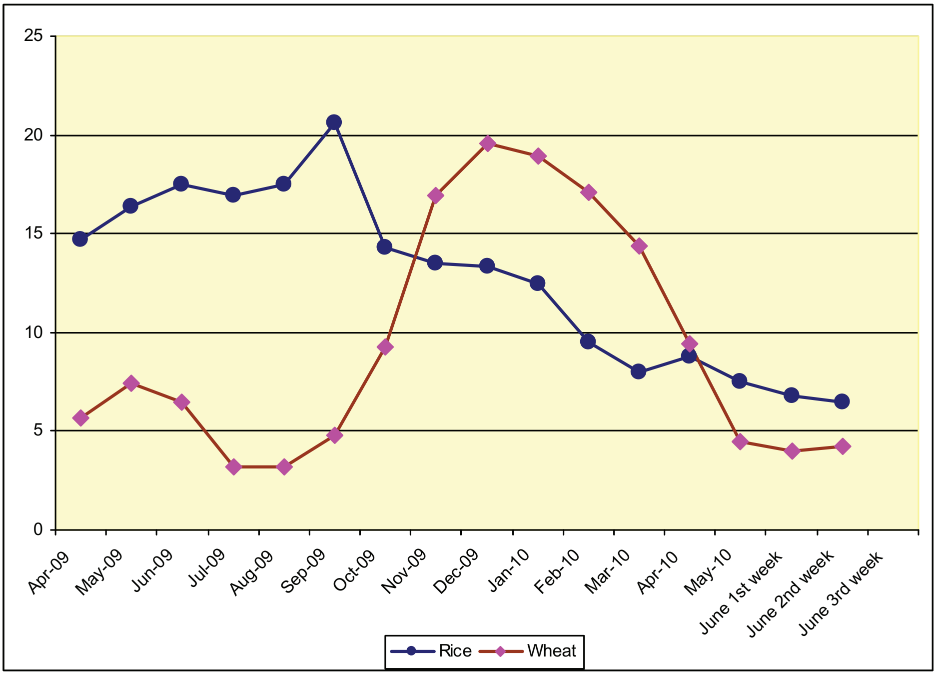
102. Overall WPI headline inflation rate is expected to remain high (7–8 per cent) at the end of December 2010, dropping to around 6.5 per cent by March 2011. The CPI inflation rate is expected to drop faster, in line with food price

inflation and fall to single digit level in the third quarter of the current fiscal and easing further in the last quarter of 2010/11.

Appendix I: Food Inflation – Policy Options for Wheat & Rice

I The current bout of inflation had its origin in rising food prices. In the food group, both wheat and rice displayed a significant increase in prices. In 2009/10, the headline inflation rate in wheat rose steadily from August 2009 and in just four months gained more than 16 percentage points, peaking at 19.6 per cent in December 2009. The next five months witnessed an equally sharp decline with the inflation rate dropping to 4.5 per cent in May 2010. In the first two weeks of June the inflation numbers were around 4 per cent but rose in the third week to 5.5 per cent. Inflation in rice remained in double digits through the whole of 2009 and only in the last week of January 2010, climbed down to the single digit level. As on June 26, 2010, the y-o-y inflation in rice was 5.8 per cent – a drop of 15 percentage points from its peak.

WPI inflation in wheat and rice



Per cent

WPI Inflation in Wheat and Rice		
Period	**Rice**	**Wheat**
Apr-09	14.7	5.7
Jun-09	17.5	6.5
Aug-09	17.5	3.2
Sep-09	20.6	4.8
Nov-09	13.5	16.9
Jan-10	12.5	18.9
Mar-10	8.0	14.4
May-10	7.5	4.5
June 1st week	6.8	4.0
June 2nd week	6.5	4.2
June 3rd week	5.8	5.5

I.1 Policy Options

I.1.1. In the case of both rice and wheat the supply position is quite comfortable with stocks being much larger than the mandated buffer norms. In the case of wheat there have been three bumper harvests in a row including 2009/10 where, according to the third advance estimates, production is expected to be 80.98 million tonnes. In the case of rice according to the third advance estimate the total shortfall in the production is expected to be 9.87 million tonnes which is lower than the earlier projections of a shortage of 11.6 million tonnes. Coupled with this the high procurement[1] of both rice and wheat has provided the government with enough cushion to leverage stocks to influence prices.

I.2 Wheat

I.2.1. In order to leverage public stocks, government should undertake a graduated release of stocks into the market at lower than market prices. There are two actions which can be immediately planned and operationalized.

[1] As on June 23, 2010, 22.49 million tonnes of wheat and 29.08 million tonnes of rice had been procured. The comparable figures for the previous year were higher at 24.52 million tonnes for wheat and 30.59 million tonnes of rice.

I.2.2. First, in the light of the larger availability of stocks, the allocation under the Targeted Public Distribution System (TPDS) could be raised from the current level of 47 million tonnes in 2010/11 to 50 million tonnes, which was the allocation made in 2009/10.

I.2.3. Second, liberal releases of wheat could be planned well in advance through the two schemes under the Open Market Sales Scheme (OMSS) operations, viz. (a) Direct sale to State/UT governments at a price equal to the Minimum Support Price (MSP) + Freight (b) Sale to bulk consumers[2], i.e. flour millers, at a price discovered through a tender (floor price is set by the government). In 2009-10 the lifting of wheat under the first scheme was not very encouraging. Out of an allocation of 20 lakh tonnes, states only picked up about 4.54 lakh tonnes of which more than 50 per cent was taken by just two states i.e. Delhi and Rajasthan[3]. This scheme has not taken off since most state governments do not have viable additional distribution channels (to the PDS) to reach the wheat to retail consumers. Currently, there appears to be a hesitation in selling OMSS allocations through the PDS network as there is an apprehension that some of the subsidy bearing PDS allocations will also be sold at the higher OMSS rates. However, even now the three schemes under the TPDS, viz. AAY (Antyodaya Anna Yojana), BPL (Below Poverty Line) and APL (Above Poverty Line) have different sale rates and are sold from the same shop. The Department of Food and Public Distribution may consider expressly permitting the States/UTs to use the PDS network to sell the OMSS wheat allotted to them.

I.2.4. In order not to overload and clog the existing PDS, it is also important for the states to develop/rejuvenate an additional distribution channel. Past experience has shown that some states like Tamil Nadu and Delhi, which had such networks, were able to successfully lift the grain under the OMSS (Retail) scheme and use it to increase availability and influence prices. Such a channel can be successfully leveraged to stock other essential commodities, apart from the foodgrains.

I.2.5. The second scheme under the OMSS (for bulk consumers) was a slow starter in 2009-10 because the floor price for accepting tenders, had initially been set

[2] The scheme is operationalized through FCI which floats tenders at a pre determined floor price which is set by the government.

[3] Even in 2008-09, offtake under this scheme was poor – out of an allocation of 9.1 lakh tonnes, merely 73,756 tonnes had been lifted till the end.

higher than the wholesale prices in most markets. In December 2009 the floor price was brought down[4] and the offtake improved substantially. Out of about 21 lakh tonnes allocated, 12.4 lakh tonnes had been lifted by June 28, 2010. It is important to note that in the October- December 2009 period, wheat inflation had surged but started declining from January 2010. Past experience also shows that effective OMSS operations have had a dampening impact on prices. In 2010/11 it is imperative we should leverage the large wheat stocks in the country and continue to release grain under the scheme through the year to prevent a price build up. In a welcome intervention under the OMSS (Bulk) scheme, the government has recently permitted the sale of wheat up to one truckload from FCI depots without the mandatory tendering process. Notably the futures prices somewhat softened after this policy decision. Close monitoring of the futures prices and use of the electronic spot market for periodic release of stocks could enable the government to keep the wheat prices within a desired range. The pilot scheme for e-auction run by the FCI in Delhi through the NCDEX and MCX could be scaled up for this purpose.

I.3 Rice

I.3.1. The rice budget drawn up by the Department of Food and Public Distribution (DFPD), shows that we will start fiscal 2010/11 with an opening balance of 26.7 million tonnes ie about 24 per cent higher than in the previous year. Even with a liberal off-take under TPDS and other schemes, DFPD expects the balance on October 01, 2010 to be significantly higher than in 2009. In view of this, release under the OMSS (Retail) scheme through the year should be operationalized. However, it needs to be noted that the off-take under this scheme has been stagnating for a while. Of the 10 lakh tonnes released in October 2009, about 6.5 lakh tonnes had been lifted by states till June 28, 2010. Though the scheme has been extended till September 2010, some pro active measures may be required to improve the off-take. One such measure is to expressly permit the state governments to use the PDS network to sell the OMSS rice. It is also important to monitor the off-take through the year to ensure that market availability increases. In addition to the PDS, if necessary, the states may think of development of an additional distribution channel.

[4] Acquisition Cost in 2008-09 + Freight, such that the average price for the country as a whole is not lower than Rs1250 per quintal, with a proviso that for states where the floor price works out to less than Rs. 1250 per quintal, the Food Corporation of India (FCI) would fix an appropriate lower floor price.

Appendix II: Cotton – Policy Options

II Context

II.1.1. Cotton is an important commercial crop and millions of farmers engaged in the production of cotton are benefiting from better technology, access to irrigation, higher yields and good prices. Exports have contributed significantly to incentivising the growth in production. Cotton is also an important raw material for the textile industry which has come to occupy a leading position in the export of cotton yarn, cotton knits, woven fabrics and cotton apparel. The textile industry is one of the largest employers in the organized manufacturing sector and also includes millions of handloom and power loom weavers.

II.1.2. In 2009/10, the global decline in production and increase in consumption of cotton drove prices to unprecedented high levels (an increase of 35.5 per cent in the period October 2009 to May 2010). Driven by global prices and revival of domestic demand, the price of cotton in India also increased by almost 30 percentage points between October 2009 and April 2010. However, global prices rose faster than domestic prices and the price differential made exports relatively more attractive. Exports increased from 35 lakh bales[5] in 2008/09 to 73.5 lakh bales in 2009/10[6] (up to May 2010).

II.1.3. The domestic cotton balance sheet for 2009/10 showed the opening stock on October 1, 2009 was quite high at 71.5 lakh bales and with production estimated[7] at 292 lakh bales, total availability was the highest since 2005/06. However, domestic consumption increased by more than 9 per cent during the year and exports (actual) grew by 108 per cent, leading to a rapid decline in stocks. By mid April 2010, potential exports of 85 lakh bales had been registered with the Textile Commissioner which would have taken the closing balance to 35.5 lakh bales. Physical exports were however lower.

[5] 1 Bale= 170 Kg.

[6] 85 lakh bales had been registered with the Textile Commissioner before exports were suspended.

[7] Estimates are by Cotton Advisory Board which is an interdepartmental body which includes representatives from the private sector across the cotton value chain.

II.1.4. In the background of the sharp rise in cotton exports and the large increase in the domestic price of cotton, the government decided to impose an export duty[8] on cotton and cotton yarn on April 09, 2010. Despite this, exports continued to increase due to the large differential between the domestic and international prices. This led to the Textile Commissioner (TXC) suspending, on April 19, 2010, the registration of new export contracts on raw cotton and cotton waste, including against applications already received. Even in cases where an EARC (Export Authorization Registration Certificate) had been issued, a revalidation by the TXC was mandated for unshipped quantities. This led to protests by some cotton growing states and the cotton trade. On May 21, 2010, cotton was transferred from the OGL to the restricted list and registered unshipped quantities were permitted to be exported under a license to be issued by the DGFT.

II.1.5. The cotton year 2009/10 thus witnessed a number of abrupt policy actions which introduced an element of uncertainty for the stakeholders. This is not desirable. On the one hand this would have an adverse impact on India's position as a reliable international supplier while on the other it would send negative signals to exporters and farmers that can potentially impact production in the long run. It is imperative that the policy architecture for cotton must find an even balance between the grower and the domestic user. In the light of the above policy makers must fix the target for exports based on the availability of cotton from domestic production, its use by industry, and the required stocks at the end of the cotton season. The export targets so arrived at may be relaxed only if domestic prices fall below a threshold level.

II.1.6. While for this year the policy actions already taken are adequate but it is important to decide on the policy regime for the next year. At the beginning of the next cotton season, based on the estimates of production, consumption and the desirable closing stocks, the policy maker should arrive at a figure for the exports. This exercise must include all the stakeholder ministries. One of the difficulties in doing this is the non availability of firm figures of cotton production on time, with each stakeholder quoting a different figure. The figures are reconciled only near the end of the season. This deficiency in data needs to be appropriately addressed. When the export registration/licenses approach the target level, a prohibitive export duty may be levied to discourage further exports. It

[8] Accordingly, the Department of Revenue vide notifications number 43/2010- Customs and 44/2010- Customs dated April 9, 2010, imposed export duties of Rs 2500/tonne on raw cotton and 3 per cent ad valorem on cotton waste.

may be noted that the current export duty of Rs 2500 per metric tonne amounts to about 2.7 per cent ad valorem and is far from being prohibitive. Levying a duty rather than imposing a *de facto* physical ban may be consistent with WTO regulations.

VIII. MONETARY CONDITIONS AND THE FINANCIAL SECTOR

International conditions

103. In the October 2009 Economic Outlook, the Council had noted that financial conditions had improved sharply across the world and risk perceptions had turned more favourable. The US dollar which had been treated as a safe haven during the Crisis had in consequence appreciated significantly against almost all other currencies but over the previous months (May to September 2009) had begun to give up much of those gains.

104. However, the same view cannot be taken in respect of developments over the last nine months. It would be quite a stretch to argue that global financial conditions as on July 2010 have shown any significant improvement over the situation prevailing in early October 2009. This is despite the fact that economic conditions have improved greatly in almost every economy of the world, including that of the US and EU.

105. This is due to the heightened risk perceptions that have began to flow from an entirely new quarter namely, sovereign debt. The implications of the extended state of government finances in Europe and in the USA have been discussed earlier in this report. It may be useful to recall here that the government of Greece restated its finances in the third week of October 2009 to reveal that its fiscal deficit was 12 per cent of GDP as against the previous perception that it was 3 per cent. In the weeks that followed, this information affected only Greek debt. This was perhaps in the expectation that the larger Euro-zone would intervene in some manner, perhaps bailing out the Greek government and certainly preventing any contagion. The Greek episode was followed shortly by the troubles of the government-owned Dubai World company and its subsidiary company Nakheel, in late November through early December 2009. This was perceived by many as the long awaited Asian element of the global crisis and asset markets in Asia were adversely affected. Through the intervention of the Government of Abu Dhabi, the Dubai crisis was quickly resolved.

106. However, the same did not hold true for the Euro-zone. In January 2010, as the difficulties facing the broader Euro-zone initiative to support Greek sovereign

debt began to run into a range of obstacles, a generalised lack of confidence developed with respect to sovereign governments in general and weaker members of the Euro-zone in particular. The latter included Portugal, Spain, Ireland and Italy, aside of course from Greece. The Credit Default Swap (CDS) spread which measures the market's perception of the likelihood of default (higher the CDS, higher is the expectation of default) soured for public and corporate debt issued by Greece and the other European economies perceived to be relatively weak. The CDS also increased for all emerging and developing economies. However, currency exchange rates did not show much movement till later.

107. As the problem of coordinated government action in regard to Greece and the more vulnerable members of the European Union dragged on, there was a further sharp drop in investment confidence. This time round, currency markets began to reflect the weakening of financial confidence.

108. In Table 8.1 exchange rates of 18 major currencies vis-à-vis the US dollar are reported at 5 points in time. These are:

i. On the last trading day of June 2008 before the onset of the crisis.

ii. The weakest exchange rate prevailing between the beginning of December 2008 and end-March 2009, which was the worst period of the crisis.

iii. The strongest point in the period between late October and December 2009, which marked the high point of recovery in exchange rates vis-à-vis the US dollar for most currencies.

iv. The point with the weakest rate in the first half of June 2010.

v. Exchange rates in the first week of July 2010.

As may be seen in the second part of the table, the weakening against the US dollar, as well as the recovery to autumn 2009 was not uniform across currencies. The retreat in the first half of June 2010 was also dissimilar.

109. European currencies retreated 20–35 per cent against the US dollar. Much of this retreat was made up in the post-crisis recovery, except for the British Pound (GBP), which remains significantly lower than its pre-Crisis highs. In the April–June 2010 period, the Euro, and to a lesser extent, the Swiss franc gave up their post-recovery gains while the GBP, Swedish and Norwegian currencies

Table 8.1: Variations in Exchange Rate

Unit: per 1 US dollar

		End June 2008	**Lowest Point** Dec 08 to Mar 09	**Highest Point** Late Oct-Dec 09	**Lowest Point** First half of June 2010	**Early July 2010 §**	**Change (-) Depreciation (+) Appreciation** End Jun 2008 to Lowest Point of Crisis	Recovery to Autumn 2009	Retreat to mid-June 2010	Recovery to July 2010
1	Euro	1.5748	1.2547	1.5100	1.1959	1.2683	–20.3%	20.3%	-20.8%	6.1%
2	Br. pound	1.9906	1.3658	1.6795	1.4422	1.5158	–31.4%	23.0%	-14.1%	5.1%
3	Swiss Fr.	1.0202	1.1893	0.9984	1.1614	1.0516	–14.2%	19.1%	-14.0%	10.4%
4	Swedish krona	6.0208	9.2863	6.7908	8.0593	7.4905	–35.2%	36.7%	-15.7%	7.6%
5	Norwegian krone	5.0899	7.2778	5.5369	6.6700	6.3620	–30.1%	31.4%	-17.0%	4.8%
6	Japanese yen	106.17	99.34	86.12	92.33	88.60	6.9%	15.4%	-6.7%	4.2%
7	Canadian dollar	1.0185	1.2995	1.0413	1.0537	1.0426	–21.6%	24.8%	-1.2%	1.1%
8	Australian dollar	1.0458	1.5870	1.0673	1.2207	1.1413	–34.1%	48.7%	-12.6%	7.0%
9	Brazilian real	1.5945	2.4420	1.6995	1.8651	1.7638	–34.7%	43.7%	-8.9%	5.7%
10	S. African rand	7.8035	10.6425	7.3050	7.7955	7.5532	–26.7%	45.7%	-6.3%	3.2%
11	Korean won	1,047	1,570	1,149	1,250	1,209	–33.3%	36.6%	-8.1%	3.5%
12	Mexico peso	10.304	15.406	12.632	12.920	12.766	–33.1%	22.0%	-2.2%	1.2%
13	Singapore dollar	1.3608	1.5565	1.3795	1.4156	1.3795	–12.6%	12.8%	-2.6%	2.6%
14	Indian rupee	42.93	51.96	46.00	47.08	46.76	–17.4%	13.0%	-2.3%	0.7%
15	Taiwan dollar	30.36	35.21	32.10	32.43	32.08	–13.8%	9.7%	-1.0%	1.1%
16	Malaysian ringitt	3.267	3.726	3.362	3.330	3.199	–12.3%	10.8%	1.0%	4.1%
17	Thai baht	33.37	36.25	33.10	32.63	32.35	–7.9%	9.5%	1.4%	0.9%
18	Chinese renminbi	6.8282	6.8480	6.8254	6.8323	6.7736	–0.3%	0.3%	-0.1%	0.9%

Note: § As on 8 July 2010

gave up a smaller part of their post-recovery gains. In the second half of June and early July 2010, all European currencies have recovered a little, especially the Swiss franc. Only the Euro remains at a level close to its crisis lows with a potential of further declines to levels even lower than that touched in the second week of June.

110. The Japanese Yen has been under systematic appreciation pressure over the past two years, being the only currency to have strengthened vis-à-vis the US dollar even during the worst of the crisis. This continues.

111. Big raw material exporters — Canada, Australia and Brazil — suffered depreciation against the US dollar by 22–30 per cent. But they came back in the recovery phase almost as strongly. Their exchange rates in autumn 2009 were not very much lower than before the onset of the crisis. The tremors in Europe in the April to June 2010 quarter caused Australian and Brazilian currencies to lose a large amount of ground, some of which they have recovered thereafter. However, the Canadian dollar was largely unaffected by the adverse developments in respect of the Euro.

112. The South African Rand, Korean Won and Mexican peso have behaved somewhat similarly to the major exporter country currencies. They suffered a large decline during the crisis, followed by a big come-back and then some retreat on account of the difficulties of the Euro in June 2010. The Rand is close to its pre-crisis levels, although for the other currencies the current exchange rates vis-à-vis the US dollar are significantly lower than pre-crisis highs.

113. The other Asian currencies — Singapore dollar, Indian Rupee, Taiwan dollar, Malaysian Ringgit and Thai Baht — behaved analogously and this was somewhat different from that of the other currency groups. All of them showed a decline against the US dollar during the crisis, but the order was somewhat smaller i.e. between 8 and 17 per cent. The recovery through autumn 2009 ranged between10–13, per cent with these currencies at a somewhat lower level than prior to the onset of the crisis. The extent to which they lost ground when the Euro plummeted in May and June 2010 was also muted. In fact, the Malaysian Ringgit and Thai Baht continued to gain ground vis-à-vis the US dollar.

114. China had linked its currency, the Renminbi, to the US dollar at the onset of the crisis and therefore there have been no changes in the exchange rate of the

Renminbi till the third week of June 2010, when Chinese authorities announced that they were removing this peg. Since then the currency has gained from a level of 6.83 to the dollar to 6.77.

Exit from extraordinary monetary easing

115. The extreme monetary easing during the crisis, in conjunction with some of the fiscal measures taken was quite effective in limiting the damage caused by contagion. Where there are structural problems the effect of the monetary and fiscal stimulus has been expectedly less pronounced than in those economies that do not suffer from underlying structural difficulties. It was always clear that the monetary, as well as the fiscal stimulus, would have to be rolled back as the economies gradually recovered.

116. The European Union and the US continue to face unsettled recovery conditions, with the possibility of recurrent crisis being particularly pronounced in the Euro-zone. Extremely high levels of fiscal deficit in the US and the EU also require a certain amount of monetary accommodation, in order to be financed. Conversely, there is also the problem of moving gradually towards more normal monetary conditions without first taking steps to curtail the fiscal deficit. In any case, it is understandable that the issue of a calibrated exit from the extremely low policy rates and other measures of monetary accommodation adopted by the central banks of the EU and the US is only prospective, with the likelihood of it materialising sometime in 2011, perhaps in the middle of that year.

117. In those economies where the effects of the crisis have clearly worn off and the recovery is strong, an early exit from both the monetary and the fiscal stimulus is called for. On the question of exit from the monetary stimulus, there is both a matter of the policy interest rate, as well as specific liquidity measures that were adopted at the time of the crisis.

118. The Reserve Bank of Australia, which had made the last cut in its policy rate in early April 2009, began to exit the monetary stimulus on 6 October 2009 with a 25 basis points (bps) increase in its Cash Rate, from 3.0 to 3.25 per cent. Since then, it has further raised its Cash Rate five times by 25 bps on each occasion, bringing its policy rate to 4.5 per cent. The Reserve Bank of India also began a graduated exit from the monetary stimulus in late October 2009. The People's Bank of China (PBoC) began a process of raising its reserve

requirements in January 2010 with a 25 bps increase followed by a similar hike in February. In late-April 2010 it made its third 25 bps increase in the reserve requirements, thus totalling a 150 bps increase in the reserve requirements of banks. However, the PBoC has not made any changes in its major policy interest rate. Brazil raised its policy rate at the end of April 2010 by 75 bps and again by the same amount on 10 June 2010, thereby raising the SELIC (*Sistema Especial de Liquidação e Custodia* target rate. This rate is the Banco Central do Brasil's overnight lending rate) from 8.75 to 10.25 per cent. The Monetary Authority of Singapore took steps towards monetary tightening in April 2010 by increasing the trading band and slope of its exchange rate, the instrument it normally uses for managing monetary policy.

Domestic conditions

119. The RBI had made several reductions in its Cash Reserve Ratio (CRR) during the crisis aggregating 4 percentage points and thereby released about Rs. 160,000 crore of funds to the banking sector. This, in conjunction with a sharp reduction in the interest rate corridor, brought short-term money market rates down precipitously. However, a large part of the funds released to the banking sector remained as excess liquidity, and came back to the RBI through the reverse repo window. This amount, for much of the period, was in excess of one lakh crore rupees and as a result overnight rates came down to below the reverse repo rate. Even as the RBI was removing some of the extraordinary liquidity measures after its policy statement in late October 2009, the quantum of excess liquidity remained large and the overnight rate continued to remain at low levels. In late January 2010, the RBI raised the CRR and also the policy rate corridor. In March 2010, the repo and reverse rates were increased further by 25 basis points and in late April the repo rate was again raised by 25 bps and the CRR also by 25 bps. On 2 July 2010, the RBI increased both the reverse repo and repo rate by 25 basis points to bring them to 5.5 and 4.0 per cent respectively.

120. Notwithstanding the increase in the CRR, excess liquidity conditions continued to prevail, though at lower levels up to May 2010. The situation changed in June when banks at the margin began borrowing at the repo window from the Reserve Bank and these borrowings became quite sizeable from 7 June onwards. It is believed this was in part due to payments made by winning bidders for the 3G auctions, as well as the general increase in credit off-take. With the reversal

in liquidity conditions, overnight interest rates also reverted to levels that have approached and even exceeded the upper end of the interest rate corridor i.e., the repo rate. To that extent liquidity conditions are taut enough for monetary policy signals to be appropriately transmitted to the financial sector.

121. Credit off-take has surged in the first quarter of 2010/11, as may be seen from Table 8.2. This has followed on the strong showing in the second half of 2009/10. For the period April to the fortnight ended 18 June 2010, bank credit flow to the commercial sector has been reported at over Rs. 65,000 crore which is larger than in the first quarter of the previous three years, including the pre-crisis year of 2007/08. With nearly an entire fortnight of June 2010 remaining to be reported, the actual figure of credit off-take by the commercial sector will undoubtedly turn out to be even stronger. In line with the higher credit off-take by the commercial sector, bank holding of government securities (adjusted for repo/reverse repo transactions) has risen by only Rs. 25,000 crore in the first quarter of the current year compared to over Rs. 130,000 crore in the first quarter of the previous year.

122. Funds flow from the capital market into the commercial sector has also been quite strong. Corporate bond issuance is estimated at Rs. 60,000 crore in the first quarter of 2010/11 which is much higher than in the corresponding period of the previous three years. Equity raising data is at presently available only for the month of April 2010, but even that is much larger than the figure for the first quarter of the previous two years. Understandably, it is smaller than the amount of issuance in the pre-crisis period of April–June 2007.

123. Thus, evidence on the funds flow side, as well as on the output side, clearly shows a strong economic recovery. In the backdrop of inflation rates that are more than twice the comfort-zone, it is important that monetary policy completes the process of exit and moves towards a bias on tightening, with respect to normal monetary conditions. This is essential to preserve price stability and create conducive conditions for sustainable growth in the medium term.

Exchange rate

124. The movement in the exchange rates through the Crisis and recovery has been briefly alluded to above. Our projections on the balance-of-payment side show that capital flows, after financing a fairly high level of current account deficit, are

Table 8.2: Fund Raising from Banking System and Capital Market

	Rs in Crore	2007/08	2008/09	2009/10	Apr–Sep 2008/09	Oct–Mar 2008/09	Apr–Sep 2009/10	Oct–Mar 2009/10	Apr–Jun 2007/08	Apr–Jun 2008/09	Apr–Jun 2009/10	Apr–Jun 2010/11
1	**Total Domestic Funds Available to Commercial Sector**	**677,338**	**621,082**	**804,884**	**262,302**	**335,472**	**257,810**	**509,281**	**20,042**	**50,612**	**45,451**	**132,343**
2	**Bank Sources of Funds**	**634,160**	**626,726**	**730,828**	**210,301**	**416,425**	**319,407**	**411,421**	**–9,483**	**73,940**	**125,805**	**90,747**
2.1	**Increase in Credit to Commercial Sector**	**446,299**	**431,393**	**491,936**	**193,870**	**237,523**	**110,901**	**381,035**	**–37,551**	**22,109**	**–6,156**	**65,492**
2.2	Increase in bank holding of Govt. securities *	187,861	195,333	238,892	16,431	178,902	208,506	30,386	28,068	51,831	131,961	25,255
3	**Capital Market – All Sources**	**231,039**	**189,689**	**312,948**	**68,432**	**97,949**	**146,909**	**128,246**	**57,593**	**28,503**	**51,607**	**66,851**
3.1	Debt (bonds) $	118,485	173,281	212,635	55,947	94,026	102,968	71,874	28,723	26,472	46,287	60,000
3.2	Capital Market Equity Raising (a+c)	112,554	16,408	100,313	12,485	3,923	43,941	56,372	28,870	2,031	5,320	6,851
a	IPO and FPO (public)	54,511	3,582	49,265	2,032	1,550	15,081	34,184	23,702	1,593	308	3,979
b	Rights	32,518	12,637	8,319	10,378	2,259	2,679	5,640	358	438	29	0
c	Q I P	25,525	189	42,729	75	114	26,181	16,548	4810	0	4,983	2,872

Note:
1. Credit off-take for April to June 2010 is up to the fortnight ended 18 June 2010
2. Bank holding of government securities is net of repo and reverse repo operations
3. Equity issuance data for 2010 is only for the month of April
4. Qualified Institutional Programme

Source: Reserve Bank of India and SEBI likely to leave a balance that can be readily absorbed by the financing needs of the faster growth process of the Indian economy. Thus expected capital inflows can be easily managed and they will not pose a serious problem to exchange rate management. The RBI is expected to continue to manage the exchange rate environment with the objective of reducing excessive volatility. The development of exchange rate futures, as well as other related financial instruments, will be of assistance in building an environment where exchange rate risks can be carefully managed by economic agents in a fashion that will, over a period of time, ease the burden on the RBI to contain volatility. Till these developments mature, the central bank will have to continue to interact with foreign exchange markets in a fashion that reduces volatility on the exchange rate. With moderate surplus on capital account after meeting the current account deficit, exchange rate variations will remain within acceptable range.

IX. GOVERNMENT FINANCES

125. With the Indian economy reviving faster than many had expected, there is a renewed focus on the fiscal consolidation process. The review by the Council in February 2010 had underlined the need to give up the expansionary fiscal policy stance and initiate a fiscal consolidation process to "…ensure fiscal sustainability, enable greater flexibility in monetary policy calibration, contain interest payments and avoid pressure on interest rates". The better- than-expected recovery of the economy has made initiating an exit from the expansionary stance not only feasible but also necessary.

126. According to the Thirteenth Finance Commission, despite significant corrections undertaken by the Centre and States, the consolidated Debt-GDP ratio in 2009/10 is estimated at 82 per cent which is well above the target set by the Twelfth Finance Commission (75 per cent). The Commission has recommended that the consolidated debt as a ratio of GDP should be brought down to 68 per cent by 2014/15. The outstanding liabilities of the Central government as a ratio of GDP should be brought down from 54.2 per cent in 2009/10 to 44.8 per cent in 2014/15 and that of the States from 27.1 to 24.3 per cent during the period. Correspondingly, the ratio of net fiscal deficit to GDP of the Centre should be brought down from 6.8 per cent in 2009/10, to 3 per cent in 2014/15 and that of the States from 2.8 per cent to 2.4 per cent during the period.

127. The Commission has also recommended that the Centre should progressively reduce the revenue deficit and have a revenue surplus by 2014/15. The general category States with the revenue surplus in 2007/08 but incurred deficit thereafter should eliminate the revenue deficit and should contain their fiscal deficits at 3 per cent of GSDP by 2011/12. Other general category States which had revenue deficits in 2007/08 (Kerala, Punjab and West Bengal) should eliminate their revenue deficits and contain their fiscal deficits at 3 per cent by 2014/15. The Commission had also specified the manner of deficit reduction for special category state.

128. The Central government has embarked on the fiscal consolidation programme in the 2010-11 budget itself. The percentage of fiscal deficit to GDP ratio was brought down to 2.6 per cent in 2007/08 in the first phase of consolidation, following the targets set by the Twelfth Finance Commission. However, it rose

sharply to 6.1 per cent in 2008/09 and 6.7 per cent in 2009/10 in the wake of increased spending and tax reductions that was part of the fiscal stimulus. The budget for 2010/11 proposes to initiate the consolidation process to bring the fiscal deficit down to 5.5 per cent of GDP. Similarly, the revenue deficit escalated sharply from 1.1 per cent of GDP in 2007/08, to 4.6 per cent in 2008/09 and further to 5.3 per cent in 2009/10. The budget proposes to bring it down to 4 per cent in 2010/11.

129. Progress in revenue collections in the first quarter of the year shows high buoyancy has returned to the direct and also indirect tax revenues and that is likely to help realize the target. More importantly, the much better-than-expected collections from telecom auctions (Rs. 106,000 crore as against the budgeted Rs. 49,800 crore), is likely to provide some additional cushion. As government has taken the decision to partially decontrol the prices of petroleum products, the subsidy bill is also not likely to escalate and in fact, fiscal and revenue deficits could be reduced even more than projected in the budget estimates.

130. At the State level too, the budget estimates for 2010/11 do not show serious fiscal imbalance. Following the additional borrowing space provided in the stimulus plans, the ratio of States' combined net fiscal deficit to GDP increased from 2.3 per cent in 2008/09, to 3.5 per cent in 2009/10. This is partly due to lower tax devolution and additional expenditures on account of pay revision in the States. The combined fiscal deficit of the States in 2010/11 is budgeted at about 2.9 per cent of GDP. Similarly, the States' revenue account position deteriorated from a surplus of about 0.2 per cent of GDP in 2008-09 to a deficit of about 1.0 per cent of GDP in 2009/10 and is budgeted to touch about 0.6 per cent in 2010/11.

131. Thus, the second phase of fiscal adjustment seems to have been set in motion at both Central and State levels. The budgeted consolidated fiscal deficit in 2010/11 stands at 8.4 per cent of GDP, almost 1.8 percentage points less than the revised estimate for 2009/10 and given the better realization of telecom revenues and prospects of containing oil subsidies, the fiscal deficit outturn may be even lower. Similarly, the revenue deficit as a ratio of GDP is expected to decline from 6.3 per cent in 2009/10 to 4.6 per cent. This order of fiscal adjustment will release substantial additional financial resources for private sector investment and provide greater space for monetary policy calibration. Nevertheless, the budgeted levels of revenue and fiscal deficits are still beyond the comfort zone and challenges to achieve fiscal consolidation in the coming years must have priority.

132. There are two major challenges in pursuing the fiscal restructuring plan detailed by the Thirteenth Finance Commission. First, a substantial proportion of the budgeted fiscal correction in 2010/11 was realised from the savings on account of lower-than-expected pay and pension arrears, loan waiver and higher telecom revenues and disinvestment proceeds. These items together enabled the adjustment of fiscal deficit by 1.2 percentage points. Such relatively easy options will not be available in coming years and serious policy measures to contain unproductive expenditures will have to be initiated. Second, the Thirteenth Finance Commission has put in several conditions to make the Fiscal Responsibility and Budget Management (FRBM) process transparent and comprehensive, capable of reacting to exogenous shocks and to ensure improved monitoring and compliance. The measures recommended include (i) preparation of a more detailed Medium Term Fiscal Plan (MTFP) to put forward detailed forward estimates of revenues and expenditures, to make it a statement of "commitment" rather than merely one of "intent"; (ii) presenting the economic and functional classification of expenditures as a part of MTFP; (iii) preparing a detailed statement on Central transfers to States; (iv) reporting compliance costs on the major tax proposals; (v) presenting the revenue consequences of capital expenditures and fiscal fallout of Public Private Partnerships (PPPs); and (vi) preparation of an inventory of vacant land and buildings valued at market prices by all departments and enterprises. The Commission has recommended that the values of parameters underlying the projection of revenues and expenditures in the MTFP and the band within which the parameters can vary, when there are exogenous shocks, while remaining within the FRBM targets, should be made explicit. It has also recommended that the nature of shocks warranting the relaxation of FRBM targets should be specified. Further, the stimulus for the States in the event of such shocks should be in terms of larger devolution rather than increased borrowing limits. Most importantly, the Commission has recommended the setting up of a committee which will eventually transform into an autonomous fiscal council to conduct an annual independent review and to monitor and report the FRBM process. The Council should report to the Ministry of Finance, which in turn should report to the Parliament on matters dealt with by the Council. The Government, in its Action Taken Report, has accepted these recommendations in principle and it remains to be seen how all these will be implemented.

133. Achieving fiscal consolidation recommended by the Thirteenth Finance Commission will depend upon both improving the revenue productivity of the

tax system and phasing out unproductive expenditures. The initiative to partially free prices of petroleum products is a significant measure and would not only help contain oil subsidies but also send out the right signals on the scarcity price. The government will have to initiate measures to rationalise food and fertilizer subsidies, also as indicated in the Economic Survey (2009/10). On the revenue side, two important initiatives relate to the passing of the Direct Taxe Code and replacement of domestic indirect taxes at the Central and State levels with the Goods and Services Tax (GST). The Government has put out a revised paper to elicit the opinion of the public before placing it in the monsoon session of the Parliament and it should be possible to implement the reform from April 2011. As regards GST, considerable work requires to be done before the reform is implemented. These include completing the "grand bargain" to determine the structure of the tax, carrying out the constitutional changes required, the mechanisms needed to deal with inter-state transactions, agreements to share revenue from services whose scope spans across States and administrative changes needed to effectively implement the new tax regime.

134. GST is a major tax reform agenda in the country replacing the plethora of domestic indirect taxes prevailing at present. The reform is necessary to secure seamless trade across the country and to ensure a common market within the federation. However, a lot of work needs to be done before the tax becomes operational. Both the first discussion paper put out by the Empowered Committee of State Finance Ministers and the paper by the Task Force of the Thirteenth Finance Commission are agreed on the levy of dual GST. Hopefully, the administrative processes including the forms and procedures will be harmonised and made uniform across states. However, final agreement on the list of indirect taxes to be subsumed within GST is yet to be finalized. To be comprehensive, ways have to be found to make the States agree to subsume purchase tax, octroi, entry tax in lieu of octroi and entertainment taxes within the state GST. Once the base is finalised, it is necessary to agree on the rates. However, even when the States levy revenue neutral rates in the aggregate, there will be gainers and losers and as there is no system for compensating the latter from the former, and the Central government will have to compensate the losers. Another critical area relates to the mechanisms to deal with inter-State transactions including the information system. Equally important is the agreement relating to the sharing of revenues from taxes on services of inter-State nature. In addition to all these, much remains to be done to reorient the administrative set up, train the officials and

extend taxpayer services. Above all, the Constitutional amendment to enable the states to levy taxes on services and empower the Centre to levy taxes on goods in stages beyond the manufacturing point will have to be made. Accomplishing all these tasks by April 2011 is a formidable task and it remains to be seen how the Centre and the States will proceed in accomplishing the reform.

135. As mentioned above, the government faces a formidable challenge in achieving fiscal consolidation because on the one hand there are no easy options available and on the other, the consolidation process must be comprehensive, transparent, sensitive to exogenous shocks and effective. The 2010/11 budget has initiated the process in a meaningful manner and hopefully, the process will be carried forward to achieve the required level of fiscal consolidation.

X. CONCLUDING COMMENTS AND SOME POLICY ACTIONS

Summing Up

136. In summary, the Indian economy would grow at 8.5 per cent in 2010/11. There will be a substantial jump in the growth rate of agriculture and allied activities. Given the present trends in the South West monsoon, it is reasonable to expect agriculture to grow at 4.5 per cent. Both industry and services will grow at a rate which is a shade higher than the previous year. The growth momentum will continue into 2011/12 and the expectation is that the economy would grow at 9.0 per cent in that year. The strengthening of the global economic recovery will help to sustain the higher growth rate.

137. The domestic savings rate which had fallen in 2008/09 is expected to pick up substantially in 2010-11. We estimate the savings rate at 34.3 per cent of GDP in 2010/11 and the corresponding investment rate will be 37.0 per cent. These savings and investment rates will further improve in 2011/12. These rates should enable the economy to grow in a sustained manner at 9 per cent.

138. The Reserve Bank of India has projected the current account deficit for 2009/10 at 2.9 per cent of GDP. There is every possibility that this may be revised downwards. We have projected the current account deficit for 2010/11 at 2.7 per cent of GDP. The merchandise trade deficit will be high at 9.0 per cent. But the invisibles including remittances will constitute 6.3 per cent of GDP. The expected capital inflows during 2010/11 will be $73 billion. This will be adequate to cover the current account deficit and add to the reserves by $31 billion. While the current account deficit in 2011/12 is projected at 2.9 per cent of GDP, the capital inflows may be stronger at $90.5 billion. Thus while we should focus on the efforts to contain the magnitude of merchandise trade deficit, given the expected level of capital flows, there will be no problem in financing the current account deficit. Since the capital flows are expected to be moderate, they should not pose any problem to the management of the exchange rate. Exchange rate variations will remain within an acceptable range.

139. Inflation has remained a major source of concern in the economy for more

than a year. The overall WPI inflation rate has remained at double digit levels for the past five months and the consumer price inflation for much longer. Inflationary expectations, particularly food inflation expectations, will be moderated because of the projected normal monsoon. Food prices have already begun to soften. Combined with the base effect, we expect inflation rate to fall to around 6.5 per cent by March 2011. The available food stock must be released in a manner that they have a dampening effect on prices. The behaviour of inflation will also be a major concern for monetary authorities. Against the background of inflation rates that are more than twice the comfort level, monetary policy has to operate with a bias towards tightening. This is essential to promote conditions for sustainable growth in the medium term.

Policy Action

140. In the area of economic policy, there are clearly three issues that are, and will continue to remain, of primary importance in ensuring sustainable economic growth at rates of 9 per cent or higher. The first is containing inflation, the second is ensuring steady improvement in farm productivity and incomes, and the third is closing the large physical infrastructure deficit, especially in the power sector.

Inflation

141. There is a strong linkage between the objective of containing inflation and increasing farm productivity. This is because high rates of inflation in India are most often connected to, and preceded by, high rates of food price inflation. The latter is inevitably linked to shortages of supply caused by the vagaries of the weather and other factors that cause output to fail to respond to rising demand. This has been clearly brought into focus, by developments over the past one-and-a-half years. The sharp increase in the price of rice and pulses through the second half of 2008/09 overlapped a period when the global crisis caused manufactured goods and energy prices to drop sharply and this declining trend was reflected in India also. The inflation in food items in the second half of 2008/09 ranged between 7.5 and 11.0 per cent, largely on account of the increase in prices of rice, pulses, coarse cereals and fruits & vegetables. The trend was sharply accentuated by the deficient monsoon of 2009 which led to sizeable output losses in rice, coarse cereals and pulses. It can be readily argued that the price increase in primary food articles starting from the summer of 2009 was on account of output losses

— both feared and actual — to the bad monsoon. However, it would be hard to explain the high inflation rates since September–October 2008, well before the weak monsoon of 2009, and in a year that had record foodgrain output on the grounds of shortfall in output.

142. Clearly there are demand factors also at work. There is strong evidence to show that economic growth in India since the early years of this decade has been quite broad-based across States, with formerly under-performing States registering strong growth. There is also evidence to show that rural development schemes, particularly MGNREGA and *Bharat Nirman,* as well as other initiatives taken to improve livelihood potential in rural India, have succeeded in raising employment and incomes. This is reflected in anecdotal evidence about lower incidence of migration from economically weaker areas, both as farm hands as well as unskilled manual labour in urban areas. While the increase in disposable income does not lead to proportionately higher expenditure on food at higher income levels, that is not necessarily the case at lower income levels on account of substitution of superior food, over (perceived) inferior ones, as well as higher physical consumption. It would, therefore, be reasonable to infer that higher disposable incomes amongst the poorer sections of rural India would have boosted demand for primary food and that would, in turn, have created pressure on prices. The primary means of responding to higher demand for food would have to be greater production, and also better distribution.

143. High rates of food inflation have been followed by an increase in inflation in non-food manufactured goods. This is, without doubt, in part a response to strong domestic demand riding on the robust economic recovery, which in the backdrop of improvement in world commodity prices has returned some pricing power to manufacturing firms. However, a major contributing factor, and perhaps the most important one, is the increase in money wages that is a direct consequence of higher food prices reflected in high double digit consumer price inflation.

Farm Productivity

144. Clearly the success in easing the pressure on food prices is inextricably linked to raising food output, that given the fixed supply of cultivable land, necessarily means raising productivity. India is a complex mosaic of agro-climatic regions. We must take this into account while developing a strategy for

sustainable growth in farm productivity that plays to the inherent strengths of these regions while mitigating the weaknesses. The management of water supply for irrigation is a critical element. Ground water has, over the decades, become the principal source of incremental irrigation, as well as of drinking water. Watershed management and recharging structures are vitally important to make, use of ground water sustainable. On the user side, technologies that provide irrigation with more economical use of water have to be encouraged. This includes drip irrigation wherever possible and sprinkler irrigation in other areas. Paddy is the most important crop in India and the System of Rice Intensification (SRI) holds encouraging potential for outcomes that combine high productivity with lower water use. Micro-nutrient management and increasing the organic content of the soil offer considerable scope for improving productivity on a sustainable basis. Horticulture, animal husbandry & fishery also offer significant potential to increase not only farm incomes, but also nutritional levels across the board.

145. Thus, the twin objectives of containing food price inflation and improving farm productivity and incomes can best be achieved by improved water and soil management techniques combined with better farm practices and cultivation of a wider range of crops. We need to develop an integrated approach to these issues.

Infrastructure

146. In the first three years of the Eleventh Plan, there were considerable shortfalls in the completion of infrastructure projects. In the power sector, as against a planned target for creating 78,740 mega watts (MW), it appears we would be lucky to get 62,000 MW by March 2012. This rests on large capacities being commissioned in 2010/11 and 2011/12. In the current fiscal, the target for capacity commissioning is 21,441 MW, of which over 6,600 MW is in the private sector, about 6,900 MW in the State sector and 7,900 MW in the Central Sector. In order to fulfil these annual targets, the projects need to be closely monitored. This aspect (of close monitoring) will continue to have great relevance in the years to come. The reality is that failure to create physical infrastructure in time has not only been persistent, but has also been a binding constraint on the expansion of manufacturing output, and this has been a significant contributor to lower competitiveness. On an average, medium and large manufacturing establishments use captive power for one-quarter to one-third of their requirement. In most cases

the cost of captive generation is much higher than grid-power, which in conjunction with the capital costs that are involved in setting up such captive power facilities, burdens manufacturing units with sizeable additional cost. This increases their manufacturing cost and erodes their competitiveness vis-à-vis producers in other countries. Small manufacturing enterprises which cannot afford captive generation have been pushed to the wall. Anecdotal evidence suggest that not only has there been a large number of closures of small enterprises on account of acute shortage of grid power, but it has prevented new, small manufacturing units from coming up. It is, therefore, imperative to rapidly improve power availability so that the industrial sector, including small enterprises, can expand in a manner commensurate with their underlying potential and go on to create the millions of industrial sector jobs that are necessary to realise 9% plus growth .

147. In previous reports, the Council has underscored the importance of accelerating the pace of capacity creation in the power sector and reforming the distribution set-up in order to attract greater private investment. Increasingly, it appears that the expansion and reform of the power sector must have primary importance in public policy. It is necessary that we tackle the problems inherent in this sector with determination and develop a timeline to realise our objectives.

148. In the power sector, fuel has increasingly become another limitation. In the medium to long term, we have to broadbase our fuel usage to encompass nuclear power, natural gas and renewable sources and reduce the proportion of coal.