

Economic Outlook 2011/12

ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER

NEW DELHI

JULY 2011

(Report submitted to the Prime Minister in July 2011)

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ECONOMIC OUTLOOK 2011/12

EXECUTIVE SUMMARY

ECONOMIC OUTLOOK FOR 2011/12

Executive Summary

Growth Prospects

I. In 2010/11, the 8.5 per cent growth rate achieved by the economy was in line with the Council's projections in the Economic Outlook of July 2010. There were some variations in the sectoral growth rates. The farm sector growth was relatively stronger at 6.6 per cent, while the industrial sector performance was below expectation. The services sector did well.

II. The Council had in its earlier projections in July 2010 and January 2011, placed the overall growth rate at around 9 per cent in 2011/12. However the inflationary situation and investment slowdown have necessitated a downward revision. The Council expects the economy to grow at 8.2 per cent in 2011/12 with agriculture growing at 3.0 per cent, industry at 7.1 per cent and services at 10 per cent. The projected growth rate of 8.2 per cent, though lower than the previous year, must be treated as high and respectable, given the current world situation.

Global Prospects

III. The international context is not entirely supportive of economic growth. In the post crisis period, the Council does not perceive any improvement in the global economic and financial situation in the light of (a) worsening fiscal conditions in the major western economies especially those in the euro zone (b) steep rise in commodity prices, particularly of crude oil, minerals and food items and (c) large volatility in the currency and equity markets due to monetary easing and huge fiscal deficits. In the update to the World Economic Outlook, growth in the advanced economies in 2011 and 2012 has been broadly projected at levels lower than that achieved in 2010.

Structural Factors

IV. The gross domestic fixed capital formation has weakened significantly, with initial estimates for 2010/11 placing it at 29.5 per cent. High rates of domestic inflation, excessive government debt, political instability and the global situation have eroded business confidence impacting asset creation adversely. It is important to

push through the reform agenda and generate conditions to increase the fixed investment rate to 33 per cent plus. This is imperative to achieve a stable 9 per cent rate of economic growth. The domestic savings rate has come down to 33.7 per cent in 2009/10 and is likely to be around 34.0 per cent in both 2010/11 and 2011/12. The principal factor for the worsening of the domestic savings rate is the increase in government negative savings. The surpluses of public sector companies as a proportion of GDP had declined in 2009/10 but some improvement in the public sector savings ratio is expected in 2010/11 and 2011/12. The savings of the private corporate sector is likely to remain at around 8 per cent of GDP and that of the household sector at a little below 23.5 per cent of GDP. The overall domestic savings rate is projected at 33.8 per cent of GDP in 2010/11, which is likely to go up marginally to 34.0 per cent in 2011/12.

Sectoral Growth Projections

V. Agriculture grew strongly in 2010/11 with record production in wheat, coarse cereals, pulses and cotton. Strong rainfall in June and better rains in the second and especially third week of July have improved the prospects of the *kharif* crop while the better reservoir position and the initiatives on rain water harvesting under MGNREGA have created suitable conditions for both *kharif* and *rabi* harvest in 2011/12. Coupled with this, strong domestic demand will drive the growth rates in horticulture, animal husbandry and fishery. The Council expects the agriculture sector to grow at 3 per cent in 2011/12.

VI. The new data series for the Index of Industrial Production based on 2004/05 has revised the industrial growth rate upwards to 8.2 per cent in 2010-11. In the current fiscal the mining sector output till now has been rather weak. In the manufacturing sector, the capital goods sector has been doing reasonably well but some other segments like electrical machinery, cement, apparels etc have shown weak output growth. While exports are strong, the domestic sales are somewhat impacted. Based on this the Council expects the growth rate in industry to be around 7.1 per cent in 2011/12.

GDP Growth - Actual & Projected

At constant 2004/05 prices

		Year-on-year rates of growth in per cent						
	ANNUAL RATES	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
						<i>QE</i>	<i>Rev</i>	<i>Proj.</i>
1	Agriculture & allied activities	5.1	4.2	5.8	-0.1	0.4	6.6	3.0
2	Mining & Quarrying	1.3	7.5	3.7	1.3	6.9	5.8	6.0
3	Manufacturing	10.1	14.3	10.3	4.2	8.8	8.3	7.0
4	Electricity, Gas & Water Supply	7.1	9.3	8.3	4.9	6.4	5.7	7.0
5	Construction	12.8	10.3	10.7	5.4	7.0	8.1	7.5
6	Trade, Hotels, Transport, Storage & Communication	12.2	11.6	11.0	7.5	9.7	10.3	10.8
7	Finance, insurance, real estate & business services	12.7	14.0	11.9	12.5	9.2	9.9	9.8
8	Community & personal services	7.0	2.9	6.9	12.7	11.8	7.0	8.5
9	Gross Domestic Product (factor cost)	9.5	9.6	9.3	6.8	8.0	8.5	8.2
10	Industry (2 + 3 + 4 + 5)	9.7	12.2	9.7	4.4	8.0	7.9	7.1
11	Services (6 + 7 + 8)	11.0	10.1	10.3	10.1	10.1	9.4	10.0
12	Non-agriculture (9 - 1)	10.5	10.8	10.1	8.2	9.4	8.9	9.0
14	GDP (factor cost) per capita	7.8	7.8	7.6	5.0	6.2	6.8	6.4
		Some Magnitudes						
15	GDP at factor cost - 2004/05 prices in Rs lakh crore (or Trillion)	32.5	35.7	39.0	41.6	44.9	48.8	52.8
16	GDP market & current prices in Rs lakh crore (or Trillion)	36.9	42.9	49.9	55.8	65.5	78.8	89.8
17	GDP market & current prices in US\$ Billion	834	949	1,241	1,223	1,385	1,732	1,994
18	Population in Million	1,108	1,126	1,145	1,164	1,183	1,202	1,222
19	GDP market prices per capita current prices	33,317	38,117	43,554	47,975	55,384	65,517	73,460
20	GDP market prices per capita in current US\$	753	842	1,084	1,051	1,171	1,441	1,632

Trade & External Sector

VII. In 2010/11 the merchandise exports and imports turned out to be higher than the Council's earlier expectations but the merchandise trade deficit at \$132 billion was close to the Council's projection of \$131 billion. Net invisible earnings were higher than expected and consequently the actual current account deficit at 2.7 per cent of GDP was lower than the Council's projection of 3 per cent of projected GDP.

VIII. Export growth has been excellent in the first quarter of 2011/12 and though imports have also shown strong growth rates, these have been lower than that of exports. Export growth will almost certainly slow down in the second half of 2011/12 while import growth is likely to be more or less the same in both the first and the second halves of the year. On this basis, the Council projects that merchandise exports at \$330 billion (BoP basis) will grow by 32 per cent in 2011/12, while imports at \$484 billion would expand by 27 per cent leaving a merchandise trade deficit of \$154 billion or 7.7 per cent of projected GDP.

IX. Service sector earnings and remittance inflows (ITES exports and private remittances) are projected to grow by 18 per cent in the first half of 2011/12 and by 11 per cent in the second. Overall, for the year, the increase is placed at 14 per cent. Net investment income outgo will be higher \$ (-) 16.0 billion. This yields a current account deficit of \$54 billion or 2.7 per cent of GDP.

X. In 2011/12 the Council expects that FDI inflows will increase to \$35 billion based on expectations of improved policy and other conditions in the domestic economy. If investment conditions improve significantly, the level of inflow can be even higher. FDI outflow is placed at \$17 billion and net FDI inflow will be around \$18 billion for 2011/12. Given the present international conditions, portfolio inflows are likely to be lower in 2011/12 as compared to the previous year. For 2011/12 as a whole, the Council expects FII investments in equity and other portfolio inflows to be \$14 billion. If domestic investment climate and international financial conditions improve the inflows may be somewhat higher. Loans, net of repayment, are being placed at \$35 billion in 2011/12, which is larger than that of last year (\$29 billion). Most of this will be on account of higher borrowings by the corporate sector from overseas markets, and some contribution coming from FII investment in domestic debt securities in the onshore market.

XI. On the basis of these projections, the Council expects that the surplus on the capital account would be \$72 billion, which after financing the \$54 billion of current account deficit, would leave about \$18 billion to be absorbed in the foreign currency assets of the RBI.

Balance of Payments

	Unit: US\$ billion										
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12			
Merchandise Exports	85.2	105.2	128.9	166.2	189.0	182.2	250.5	330.2			
Merchandise Imports	118.9	157.1	190.7	257.6	307.7	300.6	380.9	484.2			
Merchandise Trade Balance	-33.7	-51.9	-61.8	-91.5	-118.7	-118.4	-130.5	-154.0			
Net Invisibles	-4.7%	-6.2%	-6.5%	-7.4%	-9.7%	-8.5%	-7.5%	-7.7%			
o/w Software & BPO	31.2	42.0	52.2	75.7	89.9	80.0	86.2	100.0			
Private Remittances	4.3%	5.0%	5.5%	6.1%	7.4%	5.8%	5.0%	5.0%			
Investment Income	14.7	23.8	27.7	37.2	44.5	41.0	53.0	66.5			
Current Account Balance	20.5	24.5	29.8	41.7	44.6	53.5	53.4	55.5			
	-4.1	-4.1	-6.8	-4.4	-4.0	-5.5	-13.9	-16.0			
Current Account Balance	-2.5	-9.9	-9.6	-15.7	-28.7	-38.4	-44.3	-54.0			
	-0.3%	-1.2%	-1.0%	-1.3%	-2.3%	-2.8%	-2.6%	-2.7%			
Foreign Investment	13.0	15.5	14.8	45.0	3.5	51.2	37.4	32.0			
o/w FDI (net)	3.7	3.0	7.7	15.4	17.5	18.8	7.1	18.0			
Inbound FDI	6.0	8.9	22.7	34.2	35.0	33.1	23.4	35.0			
Outbound FDI	2.3	5.9	15.0	18.8	17.5	14.4	16.2	17.0			
Portfolio capital	9.3	12.5	7.1	29.6	-14.0	32.4	30.3	14.0			
Loans	10.9	7.9	24.5	41.9	4.1	13.3	29.4	35.2			
Banking capital	3.9	1.4	1.9	11.8	-3.2	1.5	5.9	6.3			
Other capital	0.7	1.2	4.2	9.5	4.5	-13.0	-10.4	-1.5			
Capital Account Balance	28.0	25.5	45.2	108.0	8.7	53.4	61.9	72.0			
	3.9%	3.1%	4.8%	8.7%	0.7%	3.9%	3.6%	3.6%			
Errors & Omissions	0.6	-0.5	1.0	1.2	1.1	-1.6	-2.4	—			
Accretion to Reserves	26.2	15.1	36.6	92.2	-18.9	13.4	15.2	18.0			
	3.6%	1.8%	3.9%	7.4%	-1.5%	1.0%	0.9%	0.9%			

Note: Percentages are with respect to GDP

Prices and Inflation Management

XII. The global inflationary situation for food, energy and other commodities has been bad and is getting worse. The domestic situation is no better as prices of vegetables, fruit, milk, eggs, meat & fish and manufactured food items have been at persistently high levels. Raw cotton and cotton textiles also witnessed a large price rise. Besides, the spiralling crude oil prices have had a large adverse impact on Central Government's fiscal balances. In 2010/11 the inflation on account of foodgrains was attenuated and the headline rate in March 2011 stood at 9.7 per cent.

XIII. Non-food manufactured inflation has marginally come down from 8.5 per cent in March 2011 to 7.0–7.3 per cent in April, May & June . However, this slight decline has been offset by an increase in the inflation rate of manufactured food items, particularly that of edible oil, processed tea & coffee and sugar.

XIV. Although primary food inflation has been at 8.4 per cent in May and June 2011, it still remains at a fairly high level and a possibility of a surge clearly exists. The rationalisation process in the pricing of automotive fuels and other subsidised petroleum products is still to be completed and this will have an impact on price levels in the coming months.

XV. Factoring all these issues, the Council expects that the headline WPI inflation rate would continue to be at 9 per cent or higher in the months of July–October 2011. There will be some relief starting from November, but even in December the headline numbers may remain high. However, there is likely to be further easing in the last quarter of the year and we expect inflation to be around 6.5 per cent in March 2012.

XVI. The government interventions in the foodgrain market, wheat and rice, last year helped to keep the foodgrain prices down. The present stocks are at an all time high level of 65.5 million tonnes (June 2011) and unless distributed quickly can create an upward pressure on prices. Liberal releases under the TPDS and Open Market Sale Scheme, development of alternate distribution channels and timely release will rein in inflation in wheat and rice and counteract shocks from other food items.

XVII. Fiscal policy can play a role in containing demand pressures by ensuring that the fiscal deficit does not exceed the budgeted level. This is not going to be an easy task.

XVIII. The RBI began to reverse the large monetary easing, raising the Cash Reserve Ratio (CRR) and policy interest rates several times in 2010/11. In May 2011 the RBI also

raised the deposit rates on savings bank accounts (the only regulated deposit rate) by 50 basis points, suggesting future increases. Commercial banks have begun to respond to the policy tightening over the past 6–8 months. It is certain that the RBI will have to continue to maintain a tight monetary policy stance for quite some time, given the combination of domestic inflationary situation, the international backdrop and the fairly strong growth that the domestic economy is experiencing.

Government Finances

XIX. Both Union and State governments have made considerable progress in the fiscal consolidation process. The Centre has managed to contain the fiscal deficit at 5.1 per cent in 2010/11(RE) as against a target of 5.5 per cent set by the Thirteenth Finance Commission. The revenue deficit at 3.4 per cent was lower than the budget estimates. The states have contained the fiscal deficit at 2.5 per cent and revenue deficit at 0.5 per cent. The consolidated fiscal deficit has come down from 9.4 per cent in 2009-10 to 7.6 per cent in 2010-11. Similar reductions are seen in the revenue deficit also. A substantial part of these reductions are on account of the one time revenue from the telecom spectrum and the phasing out of the salary arrears.

XX. However, achieving the targets set in the 2011/12 budget estimates will present a significant challenge and calls for structural reforms in the finances of the Centre and States. In the short term, the challenge in the case of the Centre, is the rising crude oil prices which are creating an upward pressure on the subsidy bill while lower taxes on crude and diesel are impacting revenues. In the case of state governments the deteriorating finances of the electricity utilities are creating substantial liabilities which need to be contained.

XXI. In the medium term, several social sector legislations will place a huge financial strain on the government. It is imperative for the government to undertake expenditure reforms and initiate steps to increase revenues. Introduction of the Direct Tax Code will be useful but the real revenue gain will come from the introduction of the Goods and Service Tax (GST). Both Centre and States should redouble their efforts to come to an agreement on this.

Some Key Issues

Convergence of Growth

XXII. It is expected that with economic development the per capita incomes of the states will converge. An analysis of the data for the periods 1993-94 to 1999-

00 and 1999-00 to 2008-09 does not show convergence. However, in the recent period there is strong evidence of ‘catching up’ by the lower income states. The median growth rate increased one and a half times in the recent period. States with low per capita GSDP’s (1999-00) like Assam, Orissa, UP and Bihar made significant gains in growth rates in the recent period 1999-00 to 2008-09. Notwithstanding these gains, convergence did not happen in the recent period mainly because some of the richer states, especially Gujarat, Kerala and Haryana which had high initial incomes also posted high growth rates in the range of 7 per cent and above. In other words what the recent data indicate is that while most of the lower income states have shown stronger growth rates, several of the richer states have also shown an increase in the period 1999-00 to 2008-09.

Sustainable Current Account Deficit and Foreign Flows

XXIII. The expectation of a large current account deficit in 2010-11 had led to worries about its sustainability. Even though the CAD in 2010-11 was lower but the question of sustainability is relevant in view of the slackening of capital flows. Sustainability of CAD depends on the underlying forces that are driving the increase in external imbalance. Given the current trends in the world economy we should strive to contain the CAD below 2.5 per cent of the GDP. This will itself mean a larger inflow of capital in absolute amount as our GDP keeps growing.

XXIV. The financing of the present CAD is largely by portfolio equity and FDI flows. Contrary to expectations in the 90’s when India opened its capital account, the volatility in the capital flows has been relatively modest. India’s success in attracting portfolio equity flows can be attributed to the absence of Quantitative Restrictions which need to be emulated. These flows have led to a reduction in cost of capital for Indian firms and have led to a deepening of the domestic financial system. In parallel we need to focus on enhancing FDI flows. Though a majority of sectors have been liberalized but there are a few issues whose resolution will pave the way for larger flows. As there are apparent signs of slowing down of foreign investment flows, we need to be proactive in promoting the flow of such investment.

Power Sector

XXV. If India is to maintain high rates of growth and provide universal and sustainable access to electricity, the power sector needs to grow and reform faster in all the three constituent areas of generation, transmission and distribution. In the XI Plan there have been major slippages in capacity creation especially in the central sector. The primary

impediments are uncertainty in fuel linkages, environmental clearances, land acquisition and shortage of equipment. Presently the transmission network covers only 80 per cent of the population with severe shortages in some regions. Poor private sector participation, problems in obtaining clearances on the Right of Way and inadequate indigenous manufacturing capacities are major bottlenecks in enhancing capacities. In the case of distribution, the large AT&C losses have discouraged private participation and prevented the state utilities from investing in the network.

XXVI. Some important policy interventions are, increase in domestic coal production by exploring new coal blocks, permitting exploratory mining in forest areas, imports of coal by CIL and introduction of a system of pool pricing. Besides, finalizing the legislation on land acquisition, expeditious clearances for pending projects and focus on non-conventional energy sources are some other important initiatives in the power sector.

Food Security

XXVII. India's determination to eliminate hunger has translated into a proposal to grant the poor a legal entitlement to food through an appropriate legislative enactment. Keeping in view the recommendation made by the National Advisory Council (NAC), a draft National Food Security Bill (NFSB) is under the consideration of the government. The NAC recommended entitlements translate into a foodgrain requirement of around 70 million tonnes while the maximum procurement till date has only been around 59 million tonnes. The Expert Committee appointed by the PM had suggested that it may be best to restrict the legal entitlement to the really needy households (priority category) and cover the rest (general category) through an executive order. As production and procurement improve, coverage can be increased. Alternatively the legal coverage can be extended to the general category with lower entitlements. Besides, it is important to bring about systemic improvements in the food distribution i.e. the PDS. Computerization, introduction of smart cards and using unique identification numbers for the beneficiaries are important interventions.

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ECONOMIC OUTLOOK FOR 2011/12

FULL REPORT

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I. ECONOMIC PERFORMANCE AND GROWTH OUTLOOK

1. In 2010/11, on the whole, the economy performed as per expectations. The principal departure from the general expectations was the continued high rate of inflation in the second half of the year and the lower rate of growth of manufacturing output and other industrial sub-sectors in the last quarter of the fiscal year. Overall, growth in 2010/11, as per the revised estimates of the Central Statistical Organization (CSO) released at the end of May 2011, was 8.5 per cent, exactly the same as had been projected in the Council's Economic Outlook of July 2010. However, there were departures in the constituents of this growth. Most significantly GDP arising in the farm sector grew much more strongly by 6.6 per cent, compared to the July 2010 projection of 4.5 per cent. The industrial sector on the contrary did much more poorly, growing by 7.9 per cent as against the projection made in July 2010 of 9.7 per cent. The services sector fared somewhat better than our projections.
2. In both the July 2010 Outlook as well as in the Review of the Economy made in February 2011, the Council had expected that overall economic growth in fiscal 2011/12 would be 9 per cent, provided there was a normal southwest monsoon. The developments, over the course of the last one-year, have resulted in an erosion of investor confidence with commensurate impact on the investment component of demand, especially in the medium-term. The higher than expected inflationary situation has necessitated tighter monetary conditions and that will have an impact on reducing leverage based demand in the short run, especially in consumer durables and in the housing sector. In the light of these developments, the Council feels that economic growth in 2011/12 will be significantly lower than forecast earlier (9 per cent) and a large part of the lower growth rate will be reflected in the manufacturing and construction sectors.
3. The South-West monsoon 2011 was initially forecast to be normal by the Indian Meteorological Department (IMD). In its second long range forecast released on 21 June 2011, the IMD has published an updated long range forecast that suggests that the monsoon may be slightly below normal at 90–96 per cent of the long period average (LPA) with July rainfall at 93 per cent and August at 94 per cent of LPA. The IMD saw much of this deficiency arising in the southern peninsular region (94 per cent of LPA) and Central India at 95 per cent of LPA. It also projected that rainfall in eastern and north-eastern India would be 95 per cent of LPA, but these are regions where rainfall is traditionally high. There should however be no hardship as long as distribution is not particularly skewed.

4. The South-West monsoon arrived and progressed more or less on time. By early July, it had covered most of India. Rainfall in June 2011 for the country as a whole was 11 per cent higher than the long period average (LPA). North-West India had a 72 per cent higher rainfall than LPA- the greatest positive departure from normal. Precipitation in the southern peninsula was marginally lower than normal and that in the eastern and north-eastern part of the country was 8 per cent below LPA. Although the IMD updated long range forecasts shows slightly below normal rainfall, the situation to-date (20 June 2011) covering 1 $\frac{3}{4}$ months of the monsoon season is reasonably positive, with as many as 29 of the 35 meteorological sub-divisions of the country having had normal or excess rainfall. The reservoir position is also good, with the storage in our reservoirs at 25 per cent greater than the average of the previous 10 years as on 14 July 2011. All the reservoirs in the northern, south and central river basins had very good storage position. Problems are confined to some reservoirs in three river basin areas where the catchment is restricted to Kutch and Gujarat. Both of these areas had very poor rainfall (88 and 77 per cent below LPA) till the end of the first week of July 2011.

5. The broad expectation is generally supportive of a reasonable *khariif* crop, which is borne out by field observations of the Ministry of Agriculture, as well as the sowing data, especially that from eastern and northern India.

6. In 2011/12, GDP arising in the farm sector is expected to continue to grow. Foodgrain output was at a record level in 2010/11 and the revised estimate stands at nearly 242 million tonnes. In the current fiscal, it is expected that output levels of foodgrains may continue to be at last year's levels. However, there will be continued growth in cash crops, horticulture, animal husbandry and fisheries. This would result in a growth of about 3 per cent in farm sector GDP, a figure that is less than the average of the last 4 years.

7. The Council feels that overall economic growth in 2011/12 is unlikely to exceed 8.2 per cent, which is a significant downscaling from both the July 2010 and the February 2011 forecasts. The reduction would primarily be on account of industry which is now forecast to grow by 7.1 per cent, down from the estimate of 9.2 per cent made in the February 2011 Review. Within industry, the manufacturing sector would show the largest scaling down to 7.0 per cent from the 9.0 per cent forecast previously, while the construction sector is expected to slow down to 7.5 per cent growth compared to the previous forecast of 10.5 per cent. GDP arising in mining & quarrying is also likely to show a reduction in growth to 6.0 per cent from the previous estimate of 7.5 per cent due to operational constraints, including restrictions arising from delays in environment and forest clearance. Growth in the service sector is also being scaled down slightly to 10 per cent from the previous estimate of 10.3 per cent. The projected overall growth rate of 8.2 per cent, though lower than the previous year, must be treated as high and respectable, given the current world situation.

Table 1: GDP Growth - Actual & Projected

At constant 2004/05 prices

		Year-on-year rates of growth in per cent						
	ANNUAL RATES	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
						<i>QE</i>	<i>Rev</i>	<i>Proj.</i>
1	Agriculture & allied activities	5.1	4.2	5.8	-0.1	0.4	6.6	3.0
2	Mining & Quarrying	1.3	7.5	3.7	1.3	6.9	5.8	6.0
3	Manufacturing	10.1	14.3	10.3	4.2	8.8	8.3	7.0
4	Electricity, Gas & Water Supply	7.1	9.3	8.3	4.9	6.4	5.7	7.0
5	Construction	12.8	10.3	10.7	5.4	7.0	8.1	7.5
6	Trade, Hotels, Transport, Storage & Communication	12.2	11.6	11.0	7.5	9.7	10.3	10.8
7	Finance, insurance, real estate & business services	12.7	14.0	11.9	12.5	9.2	9.9	9.8
8	Community & personal services	7.0	2.9	6.9	12.7	11.8	7.0	8.5
9	Gross Domestic Product (factor cost)	9.5	9.6	9.3	6.8	8.0	8.5	8.2
10	Industry (2 + 3 + 4 + 5)	9.7	12.2	9.7	4.4	8.0	7.9	7.1
11	Services (6 + 7 + 8)	11.0	10.1	10.3	10.1	10.1	9.4	10.0
12	Non-agriculture (9 - 1)	10.5	10.8	10.1	8.2	9.4	8.9	9.0
14	GDP (factor cost) per capita	7.8	7.8	7.6	5.0	6.2	6.8	6.4
		Some Magnitudes						
15	GDP at factor cost - 2004/05 prices in Rs lakh crore (or Trillion)	32.5	35.7	39.0	41.6	44.9	48.8	52.8
16	GDP market & current prices in Rs lakh crore (or Trillion)	36.9	42.9	49.9	55.8	65.5	78.8	89.8
17	GDP market & current prices in US\$ Billion	834	949	1,241	1,223	1,385	1,732	1,994
18	Population in Million	1,108	1,126	1,145	1,164	1,183	1,202	1,222
19	GDP market prices per capita current prices	33,317	38,117	43,554	47,975	55,384	65,517	73,460
20	GDP market prices per capita in current US\$	753	842	1,084	1,051	1,171	1,441	1,632

8. The Council is of the view that developments on the policy front have tremendous potential in determining the level of economic activity, not only in the second half of 2011/12, but more importantly in the next fiscal year and in the medium term generally. It is important that the investment climate is favourable for asset creation and risk taking by the commercial private and public sectors and in expanding the base of physical infrastructure—energy, especially electricity, and transportation—which are critical constraints that face the Indian economy. Simultaneously, it is vitally important to have a cogent medium-term plan for the farm sector which emphasizes improvement in productivity, efficiency, logistics, capacity building and increased livelihood opportunities in general for more than two third of our population that continue to live in rural India.

9. The international context is not entirely supportive of economic growth. The recovery process in the US and in the EU has run into distinct and separate difficulties. In Europe, the crisis in Greece, Portugal and Ireland, and as is widely expected in Spain, with some recent focus on Italy, has put enormous strains on the management of the European currency union. Conventional methods of resolving the fiscal difficulties in these countries are not possible, as long as these countries remain within the same currency union. There is a clear disinclination amongst the governments of stronger member countries to make changes in the nature of the present currency arrangements. At the same time, there is an enormous political tension that is brewing, both in the population of the stronger member countries about the perceived bailouts and also amongst the population of the bailout recipient countries as to the harsh policy measures that their governments are perceived to be signing up under duress. It appears unlikely that there will be at any time in the near future a clear-cut resolution and the greater likelihood is that this difficult situation will continue to persist unresolved for quite some time to come.

10. In the US, the recovery process, which was much weaker than what the architects of the fiscal and monetary stimulus had expected, is now showing signs of stress. While the latter may or may not be short-lived, the fact is that a strong economic recovery in the near-term is increasingly looking to be a difficult proposition. Further, the fiscal deficit in excess of 10 per cent of GDP and an extraordinary state of monetary easing have exhausted the capacity of both the two conventional sources to stimulate the economy any further. There are large political differences about how to proceed with the obvious need for fiscal consolidation. Thus, a recovery prospect in the US is also under a cloud.

11. European countries outside of the European Union like Sweden, Denmark and Switzerland, as well as Canada and Australia, are doing particularly well. However, their collective weight in the world economy is relatively small. Japan has had an unfortunate

setback in the form of an earthquake and tsunami in March and the disruption of its electricity network, with concomitant adverse effects on its manufacturing establishment. The reconstruction of Japan from the tsunami damage is going to be a large task, and to that extent Japan does not seem to provide any offset to the less than encouraging outlook in the principal advanced economies.

12. These developments in the global context have been colouring financial markets, with the price of risk going up and, therefore, on the behaviour of capital flows. Commodity prices have spiked in response to the weak outlook for both the US\$ and the Euro, as well as to robust demand from the developing world. Nevertheless, capital flows to developing economies have generally been quite strong in the first half of 2011, but it is clearly very sensitive to local contexts, particularly those that have a bearing on stability – price, fiscal, financial, political and investment conditions generally.

13. Inflation at home was expected to taper-off in the second half of 2010/11. However, this did not transpire, partly due to unexpected developments in vegetables, cotton and also because of continued pass-through of food price induced wage pressure into manufactured goods. As against our expectations in February 2011 that WPI inflation would moderate to about 7 per cent by the end of March 2011, the inflation rate was much higher at 9.7 per cent in that month. The revised estimates for April 2011, as well as the provisional estimates for May and June 2011 show WPI inflation still much above 9 per cent. Consumer Price Inflation CPI (IW) has come down below 9 per cent in most of the previous months. The new CPI series (with base 2010) show that in June 2011 year-on-year inflation moved up to 8.8 per cent at the all-India level, from 7.1 in May and 6.2 per cent in April 2011.

14. Further, there is a backlog in the adjustment of petroleum prices. The revisions to price of sensitive petroleum products made at the end of June 2011, and any further additions that may be made, directly and indirectly impact the level of headline inflation. At the same time, to rationalise fuel prices and reduce the drain on the massive fiscal resources, these prices need continued adjustment.

15. The combination of measures taken by the central bank, as well as other corrections that have been put in place, are likely to bring WPI headline inflation down in the second half of the year. The Council expects inflation in March 2012 to be 6.5 per cent.

16. On the external payments front, the sharp increase in merchandise exports in the second half of 2010/11 and in the first quarter of 2011/12 is extremely heartening. The

curtailment of the Current Account Deficit (CAD) in 2010/11 to 2.6 per cent of GDP as against our projections of 2.9 per cent made in July 2010, and 3.0 per cent made in February 2011, has been primarily on account of better than expected merchandise exports supported by a small improvement in service sector export earnings in the second half of the year. This has kept the merchandise trade balance at 7.5 per cent of GDP in 2010/11, compared to 8.5 per cent in 2009/10 and 9.7 per cent in 2008/09, notwithstanding the sharp increase in crude oil prices during the course of 2010/11. However, net earnings on invisibles as a proportion of GDP actually declined from 5.8 per cent in 2009/10 to 5.0 per cent in 2010/11. This clearly is a result of two sets of factors: First, a slowdown in the pace of growth of ITES related service exports due to the continued depressed economic conditions in major markets of US and Western Europe, and the slow growth in private remittances that are also reflective of economic conditions in the host countries for Indian expatriates. Second, an increase in the size of the net outflow on account of investment income that is a consequence of the larger stock of private debt, repatriation of profits on accumulated FDI and low earnings on the foreign currency assets of the RBI due to very low interest rates in the major reserve currency areas.

17. Capital flows were not strong in the second half of 2010/11. In July 2010, the Council had projected net capital flows at US\$ 90 billion, which reflected the inflow position and the investor sentiment at that point in time. In February 2011, the Council scaled down its projections of capital inflows to \$76 billion. The provisional estimates released by the RBI for 2010/11 show that capital flows were even smaller at only \$62 billion. The reduction in capital flows is on account of much lower direct investment and portfolio equity inflows.

18. For 2011/12, we expect that the strong performance of merchandise exports in the first quarter of the year will be broadly sustained in the second quarter. It is likely that such growth will ease in the second half of 2011/12. Available data suggests that not only overall imports are growing faster, but non-oil & non-bullion imports have also recorded sharp increase in the first half of calendar 2011. On this basis, the Council has projected exports (BoP basis) of \$330 billion and merchandise imports of \$484 billion, leaving a trade deficit of \$154 billion, which is equivalent to 7.7 per cent of projected GDP. The latter proportion is slightly higher than the 7.5 per cent realized in 2010/11. In the case of net invisible earnings our projections are placed at \$100 billion, which represents a 16 per cent growth over last year's level. As a proportion of GDP it is only marginally higher than that achieved in 2010/11. On this basis, the projected current account deficit in 2011 is expected to be \$54.5 billion or 2.7 per cent of projected GDP. The net balance of capital flows is expected to be little over \$72 billion leaving a small overall BoP surplus of about

\$18 billion. Within capital flows, net FDI is expected to be higher at \$18 billion (previous year \$7 billion) while portfolio equity flows are projected lower at \$14 billion compared to \$30 billion in the previous year.

19. On the fiscal side, the high subsidy outgo, especially on account of petroleum products, is placing a serious stress on the Centre's budgeted fiscal position. Both in the context of dealing with inflation, as well as in under-scoring the fiscal stability within India, it is desirable that the budgeted fiscal position is actually achieved.

II. INTERNATIONAL ECONOMIC AND FINANCIAL CONDITIONS

20. Both in the Economic Outlook of July 2010 and in the Review of February 2011, the Council had highlighted on the one hand the recovery process from the crisis and on the other hand underscored three elements in the post-crisis period that posed serious risks to the economic process, particularly to the developing economies. These were:

- i. The worsening of the fiscal conditions in the major Western economies, especially those in the Euro-zone and the likely impact of this on the rest of the world;
- ii. The steep rise in commodity prices, particularly of crude oil and also of minerals and food items, with the increase seemingly disproportionate to the degree of improvements in the underlying global economic conditions;
- iii. The large volatility in the currency markets and along with it, volatility in the equity markets as well, which to a great extent flow from the uncertainties caused by the very instruments that the Western economies had used to emerge from the crisis – namely, conditions of extraordinary monetary easing and huge fiscal deficits.

21. In this Economic Outlook, July 2011, the Council does not perceive any change in these elements for the better. If anything, they have worsened somewhat, since the February 2011 Review. The sovereign debt crisis in Europe continues to remain unresolved, while crude oil prices have gone up even further, on account of the intervention by the Western powers in Libya.

22. In the first half of 2011, conditions in Greece and Portugal continued to deteriorate. Major European governments led by Germany, as well as the European Central Bank and the IMF has provided some fiscal relief to Greece. However, it seems most likely that Greece and Portugal and, to some extent, the other weaker members of the Euro-zone will not be able to tap into the private capital market in any significant manner to finance their large fiscal needs. More importantly, there is widespread public disenchantment in the process amongst the population in the stronger European member countries. This is however greatly exceeded in intensity, by the anger of the general public in the affected countries. Even as the government in Greece was able to win a parliamentary vote to comply with the new austerity measures required of them in order to obtain fiscal relief, there were riots outside on the streets. Similarly, it is reported that as unemployment has soared in Portugal and Spain, there is enormous public opposition to the idea that their governments too are signing up for conditionalities, so that they can in their turn be bailed out.

23. In the normal course of events, the conventional solution for an economy in excessive debt is to devalue its currency. When this is combined by reducing the liabilities due to foreign lenders by the extent of devaluation (i.e. to treat the obligation as a local currency debt), it succeeds in protecting domestic banks and other savings institutions, which hold government paper. Devaluation also helps the affected economy by compressing import demand, helps exports and changes the external trade balance in a favourable direction. However, this course of action is not available to the affected European economies, as long as they remain within a single currency union. Therefore, what has been adopted as a course of action is being termed by many in Europe as an “internal devaluation”. That is a lowering of wages, which would in turn lead to lower costs for services and perhaps for manufactured goods too. The outcome, however, is to place the entire burden of adjustment on working people, while leaving asset holders protected. This is unsurprisingly attracting popular anger. It is also uncertain as to how long the affected Governments will be able to continue on this path, since an economic recovery for them, which might help ease the adjustment pain, is not in sight.

24. Inflation in the Euro-zone at 2.7 per cent is also well in excess of the comfort region (1.5 to 2.0 per cent) and this has caused the European Central Bank to raise interest rates for the second time in 2011. The total increase in policy rate by 50 basis points has also led the Euro to hold value against the US\$, at over the 1.40 level. Whether European policy makers are happy with this outcome is unclear. It is probable that in the absence of the increase in the interest rate differentials between the Euro and the US Dollar, the Euro may have settled at much lower levels.

25. Economic recovery in the US has been slower than previously expected. More recently data coming out is suggestive of further slackening in the recovery process. With extraordinarily easy monetary conditions continuing and the fiscal deficit at over 10 per cent of GDP, policy makers have a limited choice of instruments to use, should they wish to stimulate the economy further. Moreover, with control in the lower house of Congress (House of Representatives) passing to the Republicans, there is great pressure to contain the deficit and move towards fiscal consolidation. The US deficit was 10.6 per cent in 2010 and is projected to be 10.8 per cent in 2011. Large political differences have presently focused on raising the debt ceiling – a legislative requirement in the USA.

26. These developments seriously colour the outlook for the US\$ in the medium-term, and it is this which lies at the heart of the currency volatility. The US\$ has, since the end of the Second World War, been the principal reserve currency and the Euro has over the past ten years provided some choice. With the US\$ under a cloud and the Euro in obvious

difficulties, it is easy to understand why currency markets, and therefore all classes of global asset holders, are extremely nervous. The sharp run-up in the price of gold, oil and other commodities, is to some extent a reflection of the desire to hedge against the uncertainties facing the US\$ and the Euro, in a situation that there is really no other meaningful choice. Smaller currencies such as the Swiss franc, Canadian dollar, Australian dollar, Swedish *krona* and others have appreciated against both the US dollar and to a smaller extent vis-à-vis the Euro to an unprecedented extent.

Growth Prospects

27. World output growth in 2010 turned out to be much better at 5.1 per cent compared to the projections made of 4.2 per cent by the IMF in April 2010, and for that matter the 3.1 per cent projected in October 2009. This was primarily due to better than expected performance in (a) emerging and developing countries, including China, India, Brazil and sub-Saharan Africa (b) Japan, Korea, Hong Kong and Singapore and (c) Germany. The actual economic growth in the US of 2.9 per cent was lower than the projections made in April 2010 of 3.1 per cent. Further, actual growth in several European economies has turned out to be lower than what had been projected in April 2010.

28. In the *Update* to the World Economic Outlook (June 2011), the IMF expects world output to grow by 4.3 per cent in 2011 and by 4.5 per cent in 2012. Growth in the advanced economies in 2011 and 2012 has been broadly projected at levels lower than that achieved in 2010 and similar to the projections made in April 2010. Growth in emerging & developing economies, likewise, has also been projected at levels not very different from that made in April 2010. The IMF has raised its growth projections significantly for Germany and lowered it sharply for the UK. It has also made marginal reductions in the growth projections for most of the other advanced and developing economies, while raising its projections for Brazil and the Euro-zone (entirely because of Germany). It has expectedly lowered growth projections for Japan, which is recovering from the tragedy of its March tsunami.

29. A summary of the IMF's growth projections for major regions/countries is placed at [Table 2.1](#). Given the considerable discussion about re-balancing (namely, lowering of both the current account surpluses as well as deficits), the IMF projections for the current account balance are projected at [Table 2.2](#) (absolute levels) and [Table 2.3](#) (percentage of GDP). The fiscal picture is summarized at [Table 2.4](#).

Table 2.1: Economic Growth and Projections made by the IMF

Regions / Countries	2007	2008	2009	2010	2011	2012
World Output (at market exchange rates)	5.4	2.9	-0.5	5.1	4.3	4.5
Advanced Economies	2.7	0.2	-3.4	3.0	2.2	2.6
U.S.A.	1.9	0.0	-2.6	2.9	2.5	2.7
Eurozone	2.8	0.6	-4.1	1.8	2.0	1.7
Germany	2.8	0.7	-4.7	3.5	3.2	2.0
France	2.3	0.1	-2.5	1.4	2.1	1.9
Italy	1.5	-1.3	-5.2	1.3	1.0	1.3
Spain	3.6	0.9	-3.7	-0.1	0.8	1.6
Netherlands	3.9	1.9	-3.9	1.7	1.5	1.5
Japan	2.4	-1.2	-6.3	4.0	-0.7	2.9
U.K.	2.7	-0.1	-4.9	1.3	1.5	2.3
Canada	2.2	0.5	-2.5	3.2	2.9	2.6
Australia	4.6	2.6	1.3	2.7	3.5	3.5
Korea, South	5.1	2.3	0.2	6.1	4.5	4.2
Taiwan	6.0	6.0	-1.9	7.7	4.3	4.3
Singapore	8.8	1.5	-0.8	14.4	5.2	4.4
Emerging & Developing Economies	8.8	6.1	2.7	7.4	6.6	6.4
Developing Asia	11.4	7.7	7.2	9.6	8.4	8.4
Latin America	5.7	4.3	-1.7	6.1	4.6	4.1
Sub-Saharan Africa	7.2	5.6	2.8	5.1	5.5	5.9
China	14.2	9.6	9.2	10.3	9.6	9.5
India	9.9	6.2	6.8	10.4	8.2	7.8
Asean 5	6.4	4.7	1.7	6.9	5.4	5.7
Brazil	6.1	5.1	-0.6	7.5	4.1	3.6
Russia	8.5	5.3	-7.8	4.0	4.8	4.5
South Africa	5.6	0.7	-1.9	10.8	5.4	5.2

Note: Asean 5 are Indonesia, Thailand, Philippines, Malaysia and Vietnam

For all countries reference period is calendar year, not fiscal year

Source: Update to World Economic Outlook, IMF, June 2011 and WEO Database April 2011

Table 2.2: Current Account Balance in US dollars Billion*Projections for 2010 and 2011 by IMF**

	2007	2008	2009	2010	2011	2012
U.S.A.	-718	-669	-378	-470	-494	-451
Eurozone	27	-87	-24	12	4	7
Germany	254	246	167	176	181	164
France	-26	-55	-51	-53	-77	-76
Italy	-52	-68	-44	-72	-74	-66
Spain	-144	-156	-81	-63	-71	-69
Netherlands	53	37	36	56	66	70
Japan	211	157	142	195	134	139
U.K.	-73	-44	-37	-56	-60	-49
Canada	12	7	-38	-49	-49	-48
Australia	-59	-47	-42	-32	-6	-31
NIC - Asia*	131	88	129	133	135	136
<i>of which</i> Korea, South	22	3	33	28	12	12
Emerging & Developing Economies						
China	372	436	297	306	372	455
India	-8	-25	-36	-49	-63	-71
Asean 5	56	34	71	54	46	41
Brazil	2	-28	-24	-48	-63	-76
Russia	77	104	50	72	105	86
South Africa	-20	-20	-12	-10	-17	-21
OPEC countries	335	433	98	196	434	416
Major Oil Exporters	508	670	234	362	666	631

*Note:** The current account figures for 2010 onwards in case of other than developed economies are IMF staff estimates. Those for India are the Council's estimates for calendar years.

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 Bahrain, Brunei, Malaysia, Norway, Oman and Russia

Source: World Economic Outlook, IMF, April 2011 - publication & database

Table 2.3: Current Account Balance as percent of GDP*Projections for 2011 and 2012*

	2007	2008	2009	2010	2011	2012
Advanced Economies	-0.9	-1.3	-0.4	-0.4	-0.5	-0.5
U.S.A.	-5.1	-4.7	-2.7	-3.2	-3.2	-2.8
Euro-zone	0.2	-0.6	-0.2	0.1	0.0	0.0
Germany	7.6	6.7	5.0	5.3	5.1	4.6
France	-1.0	-1.9	-1.9	-2.1	-2.8	-2.7
Italy	-2.4	-2.9	-2.1	-3.5	-3.4	-3.0
Spain	-10.0	-9.7	-5.5	-4.5	-4.8	-4.5
Netherlands	6.7	4.3	4.6	7.1	7.9	8.2
Japan	4.8	3.2	2.8	3.6	2.3	2.3
U.K.	-2.6	-1.6	-1.7	-2.5	-2.4	-1.9
Canada	0.8	0.4	-2.9	-3.1	-2.8	-2.7
Australia	-6.2	-4.5	-4.2	-2.6	-0.4	-2.1
NIC – Asia ¹	7.2	5.1	8.0	7.1	6.3	6.0
of which Korea, South	2.1	0.3	3.9	2.8	1.1	1.0
Emerging & Developing Economies						
China	10.6	9.6	6.0	5.2	5.7	6.3
India	-0.7	-2.0	-2.8	-3.2	-3.7	-3.8
Asean 5	5.2	2.7	5.7	3.5	2.7	2.2
Brazil	0.1	-1.7	-1.5	-2.3	-2.6	-3.0
Russia	5.9	6.2	4.1	4.9	5.6	3.9
South Africa	-7.0	-7.1	-4.1	-2.8	-4.4	-5.1
OPEC countries	17.8	18.1	4.8	8.4	15.7	14.1
Major Oil Exporters	13.3	13.9	5.9	8.0	12.1	10.5

*Note:** The current account figures for 2010 onwards in case of other than developed economies are IMF staff estimates. Those for India are the Council's estimates for calendar years.

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 Bahrain, Brunei, Malaysia, Norway, Oman and Russia

Source: World Economic Outlook, IMF, April 2011 - publication & database

Table 2.4: Fiscal Balance as a proportion of GDP*Projections for 2011 and 2012 by IMF**

	2008	2009	2010	2011	2012
U.S.A.	-6.5	-12.7	-10.3	-9.9	-7.8
Eurozone	-2.1	-6.4	-6.1	-4.3	-3.4
Germany	0.1	-3.0	-3.3	-1.9	-1.1
France	-3.4	-7.6	-7.1	-5.8	-4.9
Italy	-2.7	-5.3	-4.5	-4.1	-3.2
Spain	-4.2	-11.1	-9.2	-6.2	-5.1
Netherlands	0.6	-5.4	-5.2	-3.8	-2.7
Japan	-4.2	-10.3	-9.6	-10.5	-9.1
U.K.	-4.9	-10.3	-10.2	-8.5	-8.1
Canada	0.1	-4.9	-5.6	-3.9	-2.6
Australia	-0.5	-4.1	-4.6	-2.5	-0.6
China	-0.4	-3.1	-2.6	-1.6	-0.7
India	-7.2	-9.7	-9.2	-8.5	-8.1
Brazil	-1.4	-3.1	-2.9	-2.8	-2.9
Russia	4.9	-6.3	-3.5	-1.4	-1.6
South Africa	-0.5	-5.2	-5.8	-5.7	-5.0

Note: * Figures for 2010 are estimates

Source: Fiscal Monitor Update, IMF, June 2011

III. STRUCTURAL FACTORS

30. We have Quick Estimates (QE) for 2009/10 and the Revised Estimates for 2010/11 for both GDP by industry of origin as well by expenditure classes. Gross Domestic Fixed Capital Formation (GDFCF) as a proportion of GDP has clearly come off from its peak level that was touched in 2007/08 of 32.9 per cent, to 30.8 per cent in 2009/10. The initial estimate for 2010/11 is 29.5 per cent. Even if this figure is revised upwards to some extent in the QE which will be released in end-January 2012, quite clearly there has been a significant weakening in the pace of fixed asset creation (GDFCF/GDP) by about 2–3 percentage points of GDP. This is a very significant number since its counterpart in terms of the rate of growth of the economy is about 0.75 to 1.0 percentage points of economic growth.

31. In July 2010, the Council had expected that the fixed investment rate would recover, and even slightly improve upon the pre-crisis numbers. It was on this basis that the Council had projected a recovery of economic growth to 9 per cent in 2011/12.

32. However, the recovery in the fixed investment rate has not transpired and the pace of economic growth is also slower¹. While quite clearly we were able to negotiate the global economic crisis quite well, we have been unable to find our way back to the path of rapid asset creation and growth. As a result, some of the momentum has gone out of the economy. Why that happened over the past two years is something that we need to reflect upon and understand if the situation is to be rectified. It is true that many economies, including the world's leading ones, are still embroiled in hard economic conditions and other developing countries like China are also facing difficulties. That, however, is not good enough reason to explain why we have not been able so far to do better than we have. The combined momentum of a stable government after the May 2009 general elections and the successful navigation through the crisis was a good opportunity to take those necessary steps to energetically get back to the imperatives: namely, of rolling out physical infrastructure, pushing through reforms and improving efficiency in public expenditure in the social sector. However, we have lost time. In part, the reasons were the apprehensions

¹Part of the reason for expecting the fixed investment rate to pick up soon was that the fixed investment rate was initially reported at 32.4 per cent in the Revised Estimate of 2009/10 but revised sharply down to 30.8 per cent in the Quick Estimate, in part due to the revision of the entire data series following the new price index with 2004/05 as base year.

that the exceptional drought of 2009 created and the unfounded concerns about a double dip recession in the West. As a result, we found ourselves on the back-foot, as inflation began to spiral on account of international and domestic factors and new concerns began to emerge in the global economic canvas. There are several factors that clearly were important impediments in our effort to return to the path of high rate of asset creation and economic growth:

- First, there was clearly considerable over-confidence in both business and in the government as we came out of the crisis well. Compounding matters, the South-West monsoon was the weakest in 28 years and initial apprehensions of what that may imply for food availability were quite dire.
- Second, there was a disinclination to roll back fiscal and monetary stimulus quickly.
- Third, flaring up of inflation in food and thereafter in non-food items made it difficult to focus on broader policy initiatives.
- Fourth, the spate of corruption related controversies that has emerged over the past one year, has consumed the energies of Government and has led to an unintended slowing down of initiatives to restore investment and economic confidence.

33. Asset creation in the private sector is always a matter of taking risk, since it expands the liabilities in the balance sheets and entails both greater market and financial risks into the enterprise. Therefore, for businesses to take these risks, the first precondition is the promise of stability – both financial and political. High rates of inflation are the antithesis of stability. Wild fluctuations in the price of assets – the exchange rate and, equity prices – are a symbol of lack of stability. Fear of crisis unleashed by the excessive debts of governments destabilizes the business environment. The last two years have seen all of this and also fears on account of political stability at home. The global canvas has been constantly jolted by the unhappy developments in the Euro-zone deriving from the sovereign debt crisis, as well as concerns about how the US is going to come out of its severe fiscal stress and halting pace of economic recovery.

34. The Council had a structured consultation with business representatives, as also discussions with people from different fields. Certain key points that emerged that are relevant for the attention of policy, were:

- Bottlenecks in infrastructure, particularly power, as also roads and the port sector, are emerging as a major constraint in the manufacturing sector.

- In the case of power, inadequacy of fuel supply linkages, especially domestic coal, as well as restrictions on mining in previously allocated coal blocks, is posing a major constraint.
 - Capital investment that is dependent on Government decisions, as also that on government funding, are experiencing difficulties on account of a slowing down in the approval process for projects.
 - Within the manufacturing sector, some sectors are facing limited excess capacity and new investments are not coming up fast enough.
 - Business sectors that are dependent on consumer expenditure are still doing reasonably well, but those which are dependent on capital expenditure are under pressure.
 - Cost increases are eroding profitability and to that extent are adversely impacting new investment prospects.
 - In the funding of infrastructure projects, commercial banks are reaching sectoral exposure caps and the limits for asset-liability mismatch. A corporate debt market for financing infrastructure has become vitally important.
 - Delays in forest and environmental clearances are causing time and cost over-runs.
 - A shortage of labour, especially skilled labour, is increasingly impacting negatively on the manufacturing sector.
 - The uncertainty arising from political developments has had a very negative impact on business confidence and investment outlook.
35. It was felt that Government could help in improving matters by a series of measures, which are purely within the policy domain. Key elements of these were:
- Pursuing fiscal consolidation, including rationalizing prices where there continues to be administrative control.
 - Bring inflation under control as quickly as possible.
 - Initiatives to improve the regulatory and governance framework and expediting the implementation of GST.
 - Ensuring greater continuity and predictability of both policy and regulatory regimes.
 - Providing clear evidence of taking the reform process forward, including modernization of the retail sector.

- Clearer emphasis on skill development, which is in any case a big social imperative, given the expected demographic dividend.
- Speeding up of clearances for projects that have got stuck.
- It will help if a clear announcement is made for projects which Government intends to take up in the balance of this financial year as well as in the next.

36. There is scope on the domestic front for taking policy and administrative initiatives that will improve the investment context in 2011/12. What happens overseas is outside our control and we must take it as a given. However, over what happens at home, we have much more control. It is absolutely imperative that active measures to improve the investment climate be taken. This includes clarity on policy, removal of uncertainties on both policy and administrative fronts, pushing through the reform agenda and taking all other measures to strengthen the competitive character of the market and dealing with unresolved issues that are required to facilitate the expansion and acceleration of private investment over the medium-term. If we were to do this, we can reasonably expect to generate conditions that will result in the fixed investment rate moving upwards to over 33 per cent and enable a return to the trajectory of a stable 9 per cent rate of economic growth.

37. The domestic savings rate reached a high point of 36.9 per cent of GDP in 2007/08. It has since come down to 33.7 per cent in 2009/10 and is likely to be around 34.0 per cent in both 2010/11 and 2011/12. The principal factor responsible for the worsening of the domestic savings rate is the increase in government negative savings which went from (+) 0.5 per cent of GDP in 2007/08 to (–) 3.3 per cent in 2008/09. In 2009/10, it recovered to (–) 1.2 per cent. However, the surpluses of public sector companies declined as a proportion of GDP to 2.9 per cent in 2009/10 compared to 3.9 per cent in 2007/08. This was in large measure due to the involuntary contributions made by the public sector oil companies towards subsidizing the retail price of petroleum products. In 2010/11 and in 2011/12, some improvement in the public sector savings ratio may be expected. The savings of the private corporate sector is, however, most likely to remain at around 8 per cent of GDP, below its peak value of 9.4 per cent reached in 2007/08. There is unlikely to be much variation in the savings of the household sector which is projected to be slightly less than 23.5 per cent of GDP. The overall domestic savings rate is thus being projected at 33.8 per cent of GDP in 2010/11, which is likely to go up marginally to 34.0 per cent in 2011/12.

Table 3: Broad Macro-economic Parameters

	Investment Rate	Gross Domestic Capital Formation	Gross Domestic Fixed Capital Formation	Domestic Savings Rate	Final Consumption Rate	Current Account Balance	Gross Domestic Capital Formation (GDCF)		GDCF Domestic Capital Only	Final Consumption Expenditure				
							Total	Pvt. Corp.		Total	Pvt. Corp.	Govt	Total	
					Private	Govt								
					Ratio to GDP at market prices									
					Growth rate at Constant Prices									
2000/01 *	24.3	24.2	22.7	23.7	64.0	12.6	-0.6	-4.0	-28.3	-0.0	-11.0	3.6	0.9	3.2
2001/02 *	22.8	24.2	23.6	23.5	64.5	12.4	0.6	3.8	8.6	7.4	3.6	5.7	2.3	5.2
2002/03 *	25.2	25.2	23.8	26.3	63.3	11.9	1.2	10.9	17.1	6.8	3.5	2.8	-0.4	2.3
2003/04 *	27.6	26.8	25.0	29.8	61.8	11.3	2.2	12.9	24.6	13.6	23.2	6.0	2.6	5.5
2004/05	32.8	32.5	28.7	32.4	59.4	10.9	-0.4	22.3 *	68.1 *	18.9 *	62.8 *	5.5 *	3.6 *	5.2 *
2005/06	34.7	34.3	30.3	33.5	58.5	10.9	-1.2	17.0	45.0	16.2	43.1	8.4	8.9	8.5
2006/07	35.7	35.9	31.3	34.6	58.0	10.3	-1.1	15.3	19.1	13.8	17.9	8.5	3.7	7.7
2007/08	38.1	38.0	32.9	36.9	57.2	10.3	-1.3	17.7	32.9	16.2	27.7	9.1	9.5	9.2
2008/09	34.5	35.4	32.0	32.2	58.5	11.0	-2.3	-3.9	-28.9	1.5	-22.0	7.4	10.7	7.9
2009/10 QE	36.5	35.8	30.8	33.7	57.7	12.0	-2.8	12.2	29.1	7.3	17.0	7.3	16.4	8.7
2010/11 Rev Est	36.4	35.4	29.5	33.8	57.2	11.5	-2.6	8.5	6.6	8.6	7.0	8.6	4.8	8.0
2011/12 Proj	36.7	35.7	30.5	34.0	57.0	11.5	-2.7	8.6	7.9	8.2	8.0	7.6	5.0	7.2

IV. MONSOON & FARM SECTOR

South-West Monsoon 2011

38. The 2011 monsoon was, in the revised long range forecast of the Indian Meteorological Department (21 June 2011), projected to be below normal and likely to be in the range of 90 to 96 per cent of Long Period Average (LPA). The shortfall in precipitation was projected to be 3 per cent in North-West India, 5 per cent in Central and Eastern & North Eastern India and 6 per cent over the Southern Peninsula. These forecast deficiencies were expected to be expressed in the months of July and August.

39. Precipitation was good in the month of June, with the all India average being 11 per cent over the LPA. It was strongest in the North-West part of India where June rainfall was 72 per cent higher than LPA. In Central India it was 14 per cent higher than LPA while in the southern region it was marginally (1 per cent) below LPA. In the Eastern & North Eastern parts of the country it was 8 per cent below LPA.

40. In the first two weeks of July for which data is available, the rainfall at the all-India level has been deficient. In the first week it was as much as 25 per cent below LPA while in the second week the shortfall was also high at 19 per cent. For the fortnight combined rainfall through the country was 21 per cent below normal. This should be viewed as serious, given the fact that July is an important month for the sowing calendar. However, in the third week of July rainfall has seen a big improvement and the departure up to 19 July 2011 was positive for the country as a whole. The total SW monsoon rainfall stood at only 1 per cent less than the LPA. North-West India and Central India had positive departures of 13 and 3 per cent respectively. Total monsoon rainfall in the southern peninsula was marginally above normal. In the eastern and north-eastern region the shortfall was 15 per cent. However, rainfall in Gangetic West Bengal was 24 per cent above normal and that in Jharkhand and Bihar, 2 per cent above LPA and normal respectively. The shortfall was thus concentrated in the north-eastern states.

41. The shortfall in the first two weeks of July was concentrated in those meteorological divisions, which had above normal rainfall in June, that is, there are off-setting factors. Gujarat and Kutch & Saurashtra were two meteorological divisions which had very deficient rainfall in June and also in the first week of July. However, precipitation in the second and third week of July was very strong and some of the rainfall shortage was mitigated. In

Marathawada too, good rainfall in the second and third week of July has provided considerable relief bringing down the seasonal shortfall to 5 per cent. However, in two important meteorological divisions of Maharashtra, namely Madhya Maharashtra and Vidharbha, both June and first half July rainfalls have been deficient, though better rains in the third week have reduced the seasonal shortfall to nil and 15 per cent respectively.

42. As on 19 July 2011, the agriculturally important divisions that have a serious shortfall in seasonal rain are Assam (–33 per cent), Gujarat (–36 per cent) and to a lesser extent Chhattisgarh (–18 per cent), Orissa and Vidarbha (–15 per cent for both) and Saurashtra & Kutch (–13 per cent).

43. Moreover, the reservoir position is quite good in all parts of the country barring those river basins, which have catchment areas in Kutch & Saurashtra. In fact, reservoir levels in north-eastern, central and southern India are also much better than that at the same point in time last year. Further, they are also as much as 25 per cent better than the average in the past ten years. This augurs well for irrigation potential offsets to inadequate precipitation. Further, the extensive rainwater harvesting structures that have been created in many parts of the country using MGNREGA funds, should have improved both surface and ground water availability in many areas. The reservoir storage status as on 14 July 2011 is at [Table 4.1](#).

Table – 4.1: Storage Position in Reservoirs – Basin Wise
Week ending 14 July 2011

Unit: Billion Cubic Meters

Name of Basin	Liv Cap. At FRL	This Year's Storage	Last Year's Storage	Last 10 Year's Avg. Storage	Departure wrt the Avg of Past 10 years
Ganga	28.09	6.06	2.32	4.14	46.3%
Indus	14.73	7.41	2.95	4.45	66.5%
Narmada	14.86	2.08	1.30	2.11	(-) 1.7%
Tapi	7.39	2.01	1.26	1.95	3.4%
Mahi	4.01	0.51	0.60	1.13	(-) 54.4%
Sabarmati	0.73	0.07	0.01	0.14	(-) 49.3%
Rivers of Kutch	0.88	0.07	0.07	0.22	(-) 67.7%
Godavari	14.52	3.31	1.82	1.88	75.7%
Krishna	31.54	12.76	8.70	10.27	24.2%
Mahanadi & Neighbouring EFRS	13.18	2.70	1.78	3.34	(-) 19.1%
Cauvery & Neighbouring EFRS	8.19	4.07	2.51	2.81	44.9%
West Flowing Rivers of South	13.60	4.60	2.92	4.14	11.1%
Total	151.76	45.70	26.30	36.63	24.8%

Source: Bulletin of the Central Water Commission

Agricultural Output

44. The Fourth Advance Estimates of crop output are reproduced at [Table 4.2](#). Foodgrain production was a record 241.6 million tonnes. Wheat output is placed at nearly 86 million tonnes, also a record. Rice production for the year is placed at over 95 million tonnes, the third highest level ever, while the *rabi* rice output at 14.7 million tonnes is a new record.

Table 4.2: Farm Crop Output

		2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11 4 th AE
Rice	million te (tonnes)	Kharif	72.23	78.27	80.17	82.66	84.91	80.65
		Rabi	10.90	13.52	13.18	14.03	14.27	13.18
		Total	83.13	91.79	93.35	96.69	99.18	89.10
Wheat		Rabi	68.64	69.35	75.81	78.57	80.68	80.80
Coarse Cereals		Kharif	26.36	26.73	25.61	31.89	28.54	23.83
		Rabi	7.10	7.33	8.31	8.87	11.49	9.72
		Total	33.46	34.06	33.92	40.76	40.03	33.55
Pulses		Kharif	4.72	4.87	4.80	6.40	4.69	4.20
		Rabi	8.41	8.52	9.40	8.36	9.88	10.46
	Total	13.13	13.39	14.20	14.76	14.57	14.66	
Foodgrains	Kharif	103.31	109.87	110.57	120.95	118.14	103.95	
	Rabi	95.05	98.73	106.71	109.83	116.33	114.16	
	Total	198.36	208.60	217.28	230.78	234.47	218.11	
Oilseeds (nine major)	lakh tonnes	Kharif	141.49	167.68	140.12	207.13	178.08	157.29
		Rabi	102.05	112.11	102.77	90.42	99.11	91.53
		Total	243.54	279.79	242.89	297.55	277.19	248.82
Cotton	Lakh bales of 170 Kg	164.3	185.0	226.3	258.8	222.8	242.25	334.25
Jute	Lakh bales of 180 Kg	94.0	99.7	103.2	102.2	96.3	118.2	99.95
Sugarcane	Lakh tonnes	2,371	2,812	3,555	3,482	2,850	2,923	3,392

45. Production of coarse cereals hit a new record in 2010/11 of over 42 million tonnes, as did that of pulses of over 18 million tonnes. *Kharif* pulses – where price increases have been the steepest in the past few years – hit a new output record and were 16 per cent higher than the previous highest output recorded in 2007/08, while total output of pulses was 23 per cent higher than the previous highest level (2007/08). Oilseed output at over 311 lakh tonnes is also a new record. Cotton production has been scaled back marginally from 339 lakh bales in the Third Advance Estimates.

Outlook for 2011-12

46. The shortfall in precipitation in the first half of July, even as it has been mitigated in the third week, is a matter of concern. However, the strong June rainfall, better rains in the second and especially third week of July, particularly in the more arid regions, tends to offset expectation of lower prospects for *kharif* 2011. The better reservoir position and the initiatives on water harvesting also hold out promise regarding both *kharif* and *rabi* harvest. *Kharif* foodgrain production is likely to be very strong in UP, Bihar and West Bengal, which have received excellent rainfall so far, but had suffered poor rainfall last year. This should offset output losses in Maharashtra and other parts of the country that may not fare so well in this year. In the *rabi* season, foodgrains, oilseeds and other crops should show growth since this is mostly fed by irrigation.

47. Horticulture, animal husbandry and fisheries have been the loci of farm sector output and incomes growth in recent years. There has been an excellent response from the farm sector to rising demands in both urban and rural areas. The improved road connectivity and better access to markets, as well as availability of quality seeds and good prices have powered horticulture – both fruits and vegetables. Initiatives for herd improvement and better milk collection facilities have been an important element in boosting the dairy sector. Strong urban demand has been increasing output in poultry. Fisheries, especially inland fisheries, have been showing strong output growth, again in response to increased domestic demand. There is every reason to believe that this growth will continue in this year also.

48. Overall, it would be reasonable to expect about 3 per cent increase in farm sector output, almost all of which would come from horticulture, animal husbandry and fisheries, with some improvement in *rabi* foodgrain output and that of *kharif* output in Eastern India, even as there may be slightly lower *kharif* production in parts of central and western India.

V: INDUSTRY & SERVICES

49. There is a new data series for the Index of Industrial Production based on 2004/05. The old series used 1993/94 as base year and was quite out of date. The revised series shows an output growth pattern that is fairly different from what the old series had indicated. If we were to focus on the last four years, it is quite clear, that output growth was grossly underestimated by the old series in 2007/08 and overestimated in 2008/09 and 2009/10. One of the clear implications of the new data series is that output growth in 2007/08 was much stronger at 15.5 per cent for the general index and 18.4 per cent for the manufacturing index, compared to what had been estimated using 1993/94 as base year. The second aspect highlighted by the new data series is that the impact of the Global Crisis on industrial output was much stronger than had been indicated by the old series. This is clearly brought out by [Chart 1.1 & 1.2](#).

Chart 1.1: Year on year monthly rates of growth for the General Index of IIP as per the old and new data series

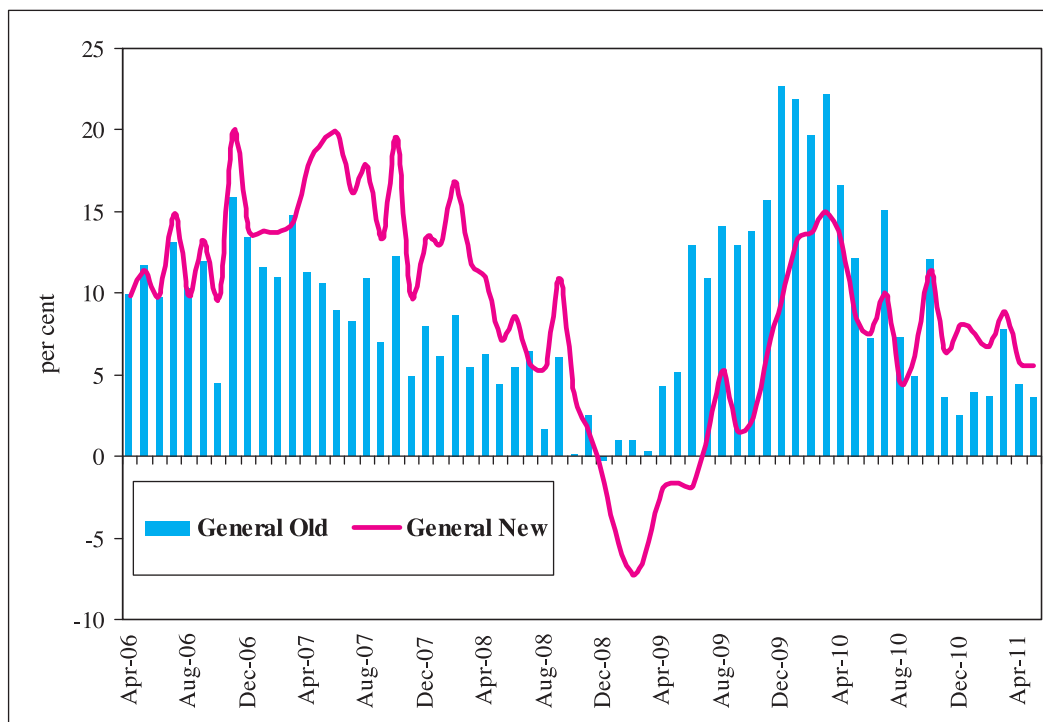
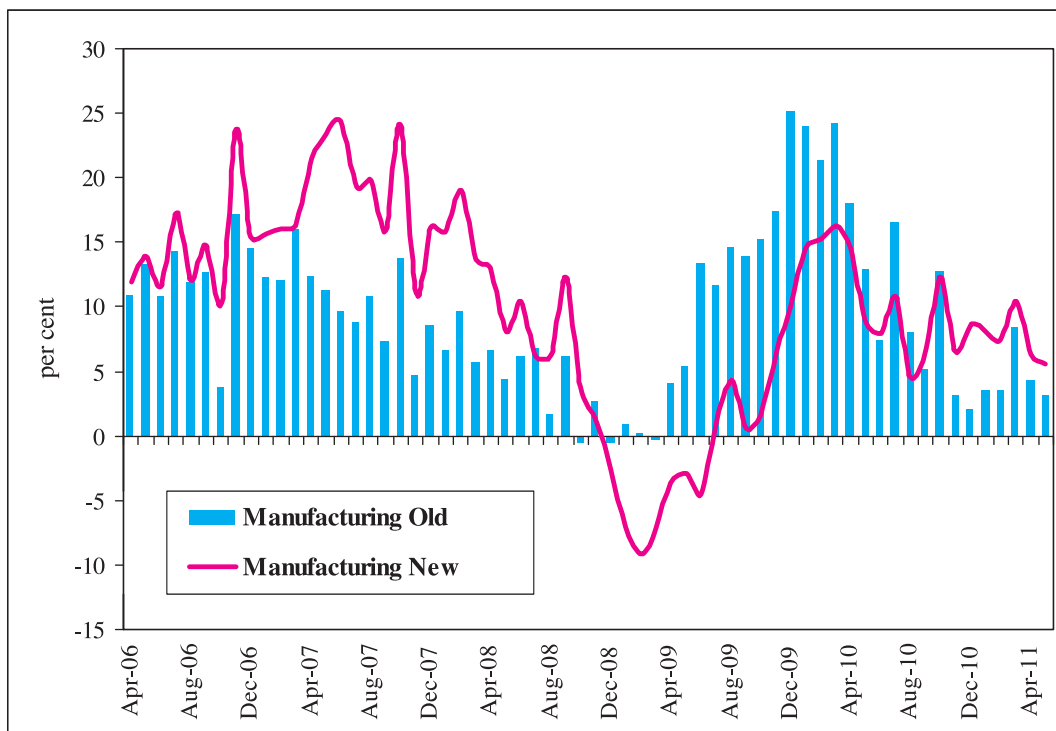


Chart 1.2: Year on year monthly rates of growth for the Manufacturing Index of IIP as per the old and new data series



50. The other fact thrown up by the new series is that the recovery was over-estimated by the old series, not so much because they got the general trend wrong, but because of outdated weights it had first understated output levels before the crisis, then failed to reflect the extent of output contraction at the depth of the crisis and as an extension of this over-estimated output levels in the second half of 2009/10. In 2010/11, the reported growth in the new series began to outpace that reported by the old one. Thus, what we see is a lateral displacement in the growth rates as projected by the new series as compared to that of the old series (see [Chart 1.1 & 1.2](#)) as initially the old series over-reported output growth because it had under-estimated the level before the crisis. Finally, the output growth in the second half of 2010/11 was actually stronger, going by the new series, than what had been indicated in the old one.

51. This clearly underlines the importance of regular updation of base year weighting diagrams. The suggestions that had been previously made by the National Statistical Commission, that such base years should be updated every five years is a recommendation that should be rigorously followed through in the case of economic data series.

Table 5: Key Growth Rates derived from the New, vis-à-vis the Old IIP Series

Unit: per cent

	General Index	Manufacturing Index	Basic Goods	Capital Goods	Intermediate Goods	All Consumer Goods	Durable Consumer Goods	Non Durable Consumer Goods
New IIP Data Series								
2005-06	8.6	10.3	6.1	18.1	6.6	10.7	16.2	8.6
2006-07	12.9	15.0	8.9	23.3	11.5	16.1	25.3	12.3
2007-08	15.5	18.4	8.9	48.5	7.3	17.6	33.1	10.2
2008-09	2.5	2.5	1.7	11.3	0.0	0.9	11.1	-5.0
2009-10	5.3	4.8	4.7	1.0	6.0	7.7	17.0	1.4
2010-11	8.2	8.9	6.0	14.9	7.3	8.4	14.1	4.1
Old IIP Data Series								
2005-06	8.0	8.9	6.6	14.2	2.8	11.6	13.6	10.8
2006-07	11.9	12.9	10.2	22.4	11.5	9.9	8.3	10.4
2007-08	8.7	9.2	7.0	19.1	8.8	5.9	-1.8	8.6
2008-09	3.2	3.3	2.7	8.2	-1.8	5.8	4.7	6.1
2009-10	10.5	11.0	7.2	20.9	13.6	6.2	24.6	0.4
2010-11	7.8	8.2	6.3	9.5	8.8	7.5	21.0	2.2

- Note:
1. Grey highlights are years where the old data series resulted in a very large under estimation of industrial growth;
 2. White highlights are years where the old data series resulted in a very large over-estimation of industrial growth

Industrial Output for 2011/12

52. In the mining sector, coal output as well as that of natural gas, is showing weak and negative output growth, respectively. Coal output growth was weak throughout 2010/11 and negative for four months, including each of the three months of the quarter ended March 2011. April output growth was a mere 2.8 per cent while that for May was 1.1 per cent.

53. Natural gas output that had grown strongly up to September 2010 turned negative since December of that year. This was due to the reduced production from the KG basin area of Reliance Industries. In March 2011 output was *lower* by 10.6 per cent year-on-

year and growth continued to be negative in both April and May 2011 at more than 9 per cent in each month. Thus even though crude oil output has registered double digit growth due to new production from the Barmer oil field, the average growth of the mining sector has been disappointing at 1.3 per cent and 1.4 per cent in April and May 2011 respectively. Clearly, in order to support higher level of industrial output, at least coal production must show a significant turn around in the short-term.

54. In the manufacturing sector, output growth in the last quarter of 2010/11 was 8.7 per cent, which cannot be considered to be particularly low. However, several components of the manufacturing sector, particularly electrical machinery, cement, apparel and petroleum refinery products show weak output growth. This pattern has been extended into the months of April and May and compounded by a slowing down in growth of consumer sectors particularly chemicals, rubber & plastics and textiles. While durable goods output has been lower in the first two months of 2011/12, the output growth for capital goods has however held up but at somewhat lower levels than in the quarter ended December 2010. Metals & metal products have held up reasonably well and so have output in the transport equipment at least up to May 2011. Production data for the automobile sector show that domestic sales have slowed sharply in June for passenger cars, though the sales for commercial vehicles have held up. Domestic sales for two-wheelers have softened slightly.

55. Strong export growth is holding up production at higher levels and hence output growth for cars (11.9 per cent) and two-wheelers (17.0 per cent) is still quite strong. It is reasonable to expect a slowing of domestic sales for passenger cars, other vehicles, white goods and other such items that are interest-rate sensitive. While the strong export growth is welcome, it may be expected that slower domestic sales is likely to impact output growth, as indeed has already happened in several areas.

56. However, the combination of a pick-up in the investment climate and activity levels and a stabilization of inflation should result in improved conditions, especially in the second half of 2011/12. The Council expects that there will be recovery from August 2011 onwards and more particularly towards the end of 2011 and the fourth quarter of the current fiscal year. Overall for 2011/12, the Council expects that manufacturing output growth will be around 7 per cent, as will that for the general index of IIP.

VI – TRADE AND EXTERNAL SECTOR

Current Account – Review of 2010/11

57. In February 2011, the Council had projected that in fiscal 2010/11 merchandise exports on Balance of Payments (BoP) basis would be \$230 billion, with imports at \$362 billion and the trade deficit at \$132 billion (7.7 per cent of projected GDP). In practice, the merchandise trade deficit turned out to be very close to that projected at \$131 billion (7.5 per cent of revised GDP). However, export levels were significantly higher at \$251 billion, as also were imports at \$381 billion.

58. Net invisible earnings in 2010/11 are reported to be \$86 billion (5 per cent of GDP), somewhat higher than had been projected by the Council in February 2011 at \$81 billion.

59. In consequence, the current account deficit for 2010/11 is reported by the RBI to be \$44 billion (2.6 per cent of GDP), vis-à-vis the projections made by the Council in February 2011 of \$51 billion (3.0 per cent of projected GDP).

60. The experience of 2010/11 underscores two important deviations from earlier expectations:

- o First, the merchandise trade growth has been faster than had been expected. In July 2010, in its Economic Outlook, the Council had placed merchandise exports at \$216 billion, which was revised upwards in February 2011 to \$230 billion. The actual figure has turned out to be even higher at \$251 billion. Imports had been projected in July 2010 at \$354 billion, slightly revised upwards in February 2011 to \$362 billion and has finally turned out to be \$381 billion. In consequence, the merchandise trade deficit was assessed at \$138 billion in July 2010 has come out at a much lower level of \$131 billion.
- o Second, service sector export & remittances growth has been as per expectations. The sum of software exports and private remittances was placed in July 2010 at \$105 billion, but scaled down to \$101 in February 2011. However, the actual number at \$106 billion was quite close to the Council's initial expectations for 2011/12.

- o Third, net investment income is becoming a larger negative number on account of higher stock of external debt, repatriation of profit on accumulated FDI, as also lower earnings on RBI's foreign currency assets— because of low interest rates in the major currency areas. Net investment income in 2009/10 was \$(-) 5.5 billion. In July 2010 this was estimated at \$(-) 6.5 billion and then sharply scaled up in February 2011 to \$(-) 13.9 billion. The actual figure for the year has turned out to be \$(-) 13.9 billion.
61. Towards the end of calendar year 2010, the sharp increase in merchandise trade deficits and the release of the balance of payments for the first quarter of 2010/11 showing a current account deficit (CAD) of \$13.7 billion (3.7 per cent of projected GDP) sharply raised concerns on the direction of the current account balance. Data for the second quarter of the year placed the CAD at \$15.8 billion or 4.1 per cent of GDP, while revising that for the first quarter slightly downwards to \$12.1 billion (3.2 per cent of projected GDP). This, further aggravated concerns. However, the merchandise trade data released by the Department of Commerce began to show a sharp pick up in exports and a reduction in the trade deficit from October 2010 onwards. This trend was reinforced as the second half unfolded
62. In the second half of 2010/11, merchandise exports (on BoP basis), picked up by 44 per cent, compared to the average of 30 per cent growth in the first half, while imports increased at the same rate in both the first and the second half (by 26–27 per cent). Software exports and private remittances increased by 18 per cent in the second half of 2010/11, compared to the 10 per cent in the first — jumping from \$49 billion in the first half to \$57 billion in the second. As a result of these developments, the current account deficit in the first half averaged 3.7 per cent of GDP, while that in the second half averaged only 1.6 per cent.

Table 6: Balance of Payments

	Unit: US\$ billion										
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12			
Merchandise Exports	85.2	105.2	128.9	166.2	189.0	182.2	250.5	330.2			
Merchandise Imports	118.9	157.1	190.7	257.6	307.7	300.6	380.9	484.2			
Merchandise Trade Balance	-33.7	-51.9	-61.8	-91.5	-118.7	-118.4	-130.5	-154.0			
Net Invisibles	-4.7%	-6.2%	-6.5%	-7.4%	-9.7%	-8.5%	-7.5%	-7.7%			
o/w Software & BPO	31.2	42.0	52.2	75.7	89.9	80.0	86.2	100.0			
Private Remittances	4.3%	5.0%	5.5%	6.1%	7.4%	5.8%	5.0%	5.0%			
Investment Income	14.7	23.8	27.7	37.2	44.5	41.0	53.0	66.5			
	20.5	24.5	29.8	41.7	44.6	53.5	53.4	55.5			
	-4.1	-4.1	-6.8	-4.4	-4.0	-5.5	-13.9	-16.0			
Current Account Balance	-2.5	-9.9	-9.6	-15.7	-28.7	-38.4	-44.3	-54.0			
	-0.3%	-1.2%	-1.0%	-1.3%	-2.3%	-2.8%	-2.6%	-2.7%			
Foreign Investment	13.0	15.5	14.8	45.0	3.5	51.2	37.4	32.0			
o/w FDI (net)	3.7	3.0	7.7	15.4	17.5	18.8	7.1	18.0			
Inbound FDI	6.0	8.9	22.7	34.2	35.0	33.1	23.4	35.0			
Outbound FDI	2.3	5.9	15.0	18.8	17.5	14.4	16.2	17.0			
Portfolio capital	9.3	12.5	7.1	29.6	-14.0	32.4	30.3	14.0			
Loans	10.9	7.9	24.5	41.9	4.1	13.3	29.4	35.2			
Banking capital	3.9	1.4	1.9	11.8	-3.2	1.5	5.9	6.3			
Other capital	0.7	1.2	4.2	9.5	4.5	-13.0	-10.4	-1.5			
Capital Account Balance	28.0	25.5	45.2	108.0	8.7	53.4	61.9	72.0			
	3.9%	3.1%	4.8%	8.7%	0.7%	3.9%	3.6%	3.6%			
Errors & Omissions	0.6	-0.5	1.0	1.2	1.1	-1.6	-2.4	—			
Accretion to Reserves	26.2	15.1	36.6	92.2	-18.9	13.4	15.2	18.0			
	3.6%	1.8%	3.9%	7.4%	-1.5%	1.0%	0.9%	0.9%			

Note: Percentages are with respect to GDP

Current Account – Outlook for 2011/12

63. Export growth has been excellent in the first quarter of 2011/12, with the Department of Commerce reporting quarterly exports of \$79 billion (year-on-year growth of 46 per cent) and imports of \$111 billion (34 per cent growth). The trade deficit stood at less than \$32 billion increasing by 12 per cent over the corresponding period in the previous year.

64. Export growth will almost certainly slow down in the second half of 2011/12. In the second quarter of last year, export levels had been rather depressed. Thus, even as the level of exports may show some softening in the second quarter of 2011/12, the growth rates may not. The Council projects that merchandise exports at \$330 billion (BoP basis) will grow by 32 per cent in 2011/12, while imports at \$484 billion would expand by 27 per cent leaving a merchandise trade deficit of \$154 billion or 7.7 per cent of projected GDP. Export growth in the first half is expected to be significantly higher than that in the second, while import growth is likely to be more or less the same in both the first and the second halves of the year. In projecting the merchandise trade levels, the value of oil imports is expected to grow by 43 per cent in 2011/12 reflecting an increase in prices of over 35 per cent, corresponding to an average reference price equivalent to \$117 per barrel for UK benchmark Brent crude. The final projected trade deficit of \$154 billion, which is equivalent to 7.7 per cent of GDP, is slightly proportionately higher than the 7.5 per cent realised in 2010/11.

65. Service sector earnings and remittance inflows (ITES exports and private remittances) are projected to grow by 18 per cent in the first half of 2011/12 and by 11 per cent in the second. Overall, for the year, the increase is placed at 14 per cent, which is the same as that in 2010/11.

66. Net investment income outgo is shown higher by about 15 per cent at a larger negative number of \$ (–) 16.0 billion compared to \$ (–) 13.9 billion in 2010/11.

67. This yields a current account deficit of \$54 billion or 2.7 per cent of GDP.

Capital Account – Review of 2010/11

68. The surplus on the capital account in 2010/11 was placed in the July 2010 Outlook at \$73 billion. This was substantially reduced in the February 2011 Review to \$65 billion. In the event a final number at \$72 billion has turned out to be close to the initial assessment made in July 2011.

69. FDI inflows had been assessed in July 2010 at \$50 billion. This was sharply scaled down to \$28 billion in February 2011. The actual figure has turned out to be even lower at

\$23 billion. Outbound FDI was assessed at \$20 billion in July 2010 and scaled down slightly to \$18 billion in February 2011. The actual figure was slightly lower at \$16 billion. The effect of this was that *net* FDI inflow has turned out to be much lower at \$7 billion in 2010/11 compared to the February 2011 assessment of \$9 billion and the July 2010 assessment of \$30 billion.

70. Portfolio inflows (FII and GDR/ADR) were \$30 billion in 2010/11. This was lower than the assessment made in February of \$39 billion, but higher than that made in July 2010 (\$25 billion)

71. Loan inflows have turned out higher, mostly because of larger loans/bond issuances by the corporate sector in overseas markets. Higher FII investment in the onshore corporate debt market has also contributed to this. Inflows on account of loans (net of repayment) has been assessed at \$17 billion in July 2010 and revised upwards to \$28 billion in February 2011. The final figure at \$29 billion is quite close to the February 2011 assessment.

72. The overall balance of payment surplus was \$15 billion in 2010/11, slightly higher than the February 2011 assessment of \$12 billion, but much lower than that envisaged in July 2010 (\$31 billion)

Capital Account – Outlook for 2011/12

73. Some data is available for the first quarter of 2011/12, in most cases only for the first two months and in the case of FII investments for the entire quarter, as well as part of July 2011. International investment conditions, as has been discussed previously, continue to be volatile and this is likely to persist through the year. Domestic conditions have a major role to play in influencing investment decisions and there is considerable potential to improve upon such conditions to facilitate higher levels of investment inflows into the country.

74. In April–May 2011, FDI inflows increased by 77 per cent to \$4.4 billion. This pace of increase is unlikely to be sustained during the year. For the full year, the Council expects that FDI inflows will increase to \$35 billion, which is about half as much higher than the \$23 billion recorded in the previous year. These forecasts are based on expectations of improved policy and other conditions in the domestic economy. In fact, if investment conditions improve significantly, the level of inflow can be even higher. FDI outflow is placed at \$17 billion, which is little higher than that of the previous year. Net FDI inflow is thus being placed at \$18 billion for 2011/12, which is more than twice that of the previous year's level.

75. Portfolio inflows are likely to be lower in 2011/12 compared to the previous year. The data issued by SEBI on FIIs, show that in the first quarter of the current fiscal, equity investments were \$1.2 billion which was about half of that in the corresponding period of the previous year (\$2.3 billion). Last year, there were very strong inflows in the second quarter (\$19 billion) and also in the third (\$7 billion). Given the present international financial conditions, it is not very likely that such a strong surge of investment will be forthcoming in the current year. For 2011/12 as a whole, the Council expects FII investments in equity and other portfolio inflows to be \$14 billion which is less than half that of last year (\$30 billion). It is possible that if domestic conditions improve with respect to investment and there is some easing in tensions arising from international financial conditions, inflows may be somewhat higher.

76. Loans, net of repayment, are being placed at \$35 billion in 2011/12, which is larger than that of last year (\$29 billion). Most of this will be on account of higher borrowings by the corporate sector from overseas markets, and some contribution coming from FII investment in domestic debt securities in the onshore market.

77. On the basis of these projections, the Council expects that the surplus on the capital account would be \$72 billion, which after financing the \$54 billion of current account deficit would leave about \$18 billion to be absorbed in the foreign currency assets of the RBI.

VII – PRICES AND INFLATION MANAGEMENT

Global Background

78. The global inflationary situation for food, energy and other commodities has been bad and is getting worse. The UN's Food & Agriculture Organisation (FAO) publishes a World Food Price Index. This shows that in June 2011, the annual increase in this broad based global food price index was a staggering 39 per cent, a jump from 28 per cent in January 2011. The cereal price index rose by a mind-numbing 71 per cent in June 2011, up from 44 per cent in January.

79. Inflation in the Consumer Price Index in the US and the Euro-zone in June 2011 at 3.6 per cent and 2.7 per cent respectively, are outside their own target range, but not wildly so. Excluding food & energy (so-called "core" inflation) the rate drops to 1.6 per cent in both cases, which may be comfort to some – but it is very cold comfort.

80. The CPI in the developing countries today does not give a sense of the underlying inflationary trend. The US Bureau of Labour Statistics reports the price indices of goods at the Producer Price Index (PPI) level. The annual inflation is staggeringly large. In June 2011, annual inflation in the PPI for all goods in the US was as high as 11.2 per cent, up from 5.9 per cent in January of this year. That for finished goods was 7.0 per cent in June, up from 3.6 per cent in January 2011. The price index for farm products, processed foods & feeds was at 17.7 per cent in June, compared to 10.2 per cent in January. In the broad Euro area (EU-27) the PPI for industrial goods showed an annual inflation of 7.1 per cent in May 2011, while that for the Euro-zone was 6.2 per cent.

81. The CPI in both US and EU are comparatively low, because services prices are flat. That is because nominal wages are not rising. The implication of low or non-existent nominal wage growth and high inflation in goods that enter the consumer basket is a powerful one. And it does not support an early recovery, especially in developed economies, where consumer demand is a prime mover of aggregate demand and therefore of levels of economic activity.

Domestic Situation in 2010/11

82. At home, the headline WPI inflation rate in April–July 2010 was over 10 per cent, which softened very slightly to around 9 per cent in August through October 2010. As

expected in November, it slid further to 8.2 per cent. However, at this stage, unexpected developments in the price of vegetables became a disruptive force for inflation management.

83. Between December and March of 2010/11 the average rate of inflation was 9.5 per cent and the headline rate in March 2011 stood at 9.7 per cent.

84. Between April and July 2010, the pressure came from primary foods, which was recording over 20 per cent rates of annual inflation. It began to come down thereafter, but reversed course in December 2010 and January 2011 on account of the wildly aberrant behaviour in vegetables, before falling back to 9.4 per cent in March 2011. Foodgrain inflation eased off after August 2010 and the average for the fiscal year was 5 per cent, with the figure at 2 per cent in March 2011.

85. Prices of fruit, milk, eggs, meat & fish have been persistently running at higher levels, with the average for the year at over 20 per cent. In the case of vegetables, the sharp pick up in onion prices in November 2010, on account of some damage to one of the three onion harvests that are taken over the year, sparked a runaway increase across all categories of vegetables. As a result, inflation in vegetables rose to 34 per cent in December 2010 and 67 per cent in January 2011. Normally, vegetable prices show a seasonal decline during the winter months, but this year in December and January, and also in the first half of February, the aberrant behaviour meant that seasonal vegetables were costing more than in the off-season. Hectic efforts that succeeded in improving domestic supply conditions resulted in a reduction in vegetable inflation to 8.6 per cent in March 2011. However, the developments in vegetable prices, which understandably grabbed headline attention, seem to have further loosened the anchors of inflationary expectations. Raw cotton prices reached record levels in the second half of 2010/11. The inflation was less than 15 per cent up to August 2010, but then went on to rise to over 100 per cent in February and March. The average inflation in raw cotton for the year was 43 per cent.

86. Despite spiralling crude oil prices that rose from \$78 per barrel in March 2010 to \$115 per barrel in March 2011, that is by 45 per cent, the average inflation for petroleum products for the year was 16 per cent and that in March 2011 was a mere 14.7 per cent. This was because the prices of several important products, including automotive fuels, were restrained by administrative decisions. The latter has had a large adverse impact on Central Government's fiscal balances and also on the operating and investible surpluses of the oil companies, especially the exploration and production companies.

87. During the first half of 2010/11 inflation in manufactured goods was primarily driven by that of manufactured food items, mostly dairy products, sugar and grain mill

products. This was a spill-over from the rise in the prices of primary food products. The inflation in manufactured goods other than food items was around 5.0–5.5 per cent. In the second half of 2010/11, while inflation in manufactured food products began to ease, that in other items rose to over 6 per cent in December 2010 and then to 7.6 per cent and 8.5 per cent in February and March 2011 respectively. This represented the generalisation of inflationary pressures to products that were not directly linked to primary items, transmitted by the impact of rising money wages and the perceived permissiveness in inflation management.

88. The runaway increase in the prices of raw cotton, cotton textiles (and hence of) man-made textiles, seriously displaced the direction of headline inflation. Had the pace of inflation in these items remained where they were in September 2010, the headline rate in March 2011 would have been at least one full percentage point less. The reversal of the normal seasonal decline in the price of vegetables, as also the suppression of the seasonal behaviour in fruit, milk, eggs, meat & fish, certainly added another percentage point to the headline rate in January 2011 and about half of that magnitude in March 2011. Thus, in the absence of the unusual behaviour in cotton & cotton products and vegetables, it is possible that the headline inflation would have been 1.5 percentage points less, that is, closer to 8 per cent instead of the actual 9.7 per cent.

89. The unusually high increases in the price of vegetable, fruit and other primary food products as also that in cotton and textiles served to dislocate inflationary expectations, paving the way for an elevation in the rate of inflation experienced in non-food manufactured goods in the closing months of 2010/11.

90. The new CPI price index (with 2010 as base year) is showing acceleration in the rate of inflation. From 6 per cent rate of annual inflation in January 2011, it climbed to 7 per cent in March and the most recent release show it at 8.8 per cent in June 2011. Clearly the argument that there is a hiatus between the WPI headline inflation rate and that in the consumer price index does not hold much merit.

Inflation Outlook in 2011/12

91. Non-food manufactured inflation has marginally come down from 8.5 per cent in March 2011 to 7.0–7.3 per cent in April (revised), and May & June (provisional). However, this slight decline has been offset by an increase in the inflation rate of manufactured food items, particularly that of edible oil, processed tea & coffee and sugar.

92. Although primary food inflation has been at 8.4 per cent in May and June 2011, it still remains at a fairly high level and a possibility of a surge clearly exists. Especially so, if

fears about rainfall adequacy in the current monsoon season, begins to feed back into prices.

93. The rationalisation process in the pricing of automotive fuels and other subsidised petroleum products is still to be completed and this will have an impact on price levels in the coming months.

94. Factoring all these, the Council expects that the headline WPI inflation rate would continue to be at 9 per cent or higher in the months of July–October 2011. There will be some relief starting from November, but even in December the headline numbers may remain high. However, we expect inflation to be at 6.5 per cent in March 2012

Policy Interventions

95. The government interventions in the foodgrains market last year helped to keep the foodgrains prices down. Luckily, a normal monsoon and aggressive procurement have left us with an all – time high foodgrains stock of 65.5 million tonnes as on June 01, 2011. Such high level of stocks unless distributed quickly can adversely impact open market availability and create an upward pressure on prices since government procures almost 50 per cent of the marketable surplus. Department of Food and Public Distribution have made liberal allocations under its two distribution channel i.e. TPDS and Open Market Sale Scheme (OMSS) in the previous and current fiscal years. While the offtake under the TPDS is quite satisfactory, the lifting under the OMSS scheme has been quite poor. As against an allocation of 3.5 million tonnes for the period January – September 2011, the lifting as on June 15, 2011 was only 0.697 million tonnes. State governments must be encouraged to develop alternate distribution channels in addition to the PDS and innovatively use the OMSS allocations to augment open market supply. Effective and timely release of foodgrains will tightly rein inflation in wheat and rice and counteract any unexpected shocks from other food items where our short-term maneuverability is limited.

96. Fiscal policy can play a role in containing demand pressures by ensuring that the fiscal deficit does not exceed the budgeted level. This is not going to be an easy task.

97. The RBI began to reverse the large monetary easing that it had undertaken in response to the global Crisis in January 2010. It raised the Cash Reserve Ratio (CRR) and policy interest rates several times thereafter. In response to the needs to pursue more effective inflation management, the RBI has begun to convene its monetary policy committee at intervals of one-and-a-half months instead of once in a quarter. The measures taken have included an aggregate increase in the CRR of 100 basis points and of the repo and

reverse repo rates by 275 and 325 basis points respectively. In May 2011 the RBI also raised the deposit rates on savings bank accounts (the only regulated deposit rate) by 50 basis points, suggesting that further increases of this may transpire in the future.

98. Commercial banks have begun to respond to the policy tightening over the past 6–8 months. It is hard to escape the conclusion that one factor that weakened the potential impact of monetary policy actions, was the voluble reluctance of commercial banks to transmit these actions through their deposit and lending activity. The change that has come about over the past few months is welcome.

99. It is certain that the RBI will have to continue to maintain a tight monetary policy stance for quite some time, given the combination of domestic inflationary situation and the international backdrop.

VIII – GOVERNMENT FINANCES

100. The fiscal situation in India gives mixed signal. While the budgets of both the Union and State governments have made considerable progress in containing the fiscal and revenue deficits and have continued the fiscal consolidation process, achieving the targets set in the 2011/12 budget estimates will present a significant challenge. In the case of the Centre, much of the fiscal adjustment was supposed to be achieved by containing subsidies which is budgeted to be lower than the revised estimate for 2010/11 by over Rs. 20,000 crore. However, high global prices of crude oil have posed difficulties in containing the subsidy bill at the budgeted level. Furthermore, elimination of customs duty on import of crude oil and reduction of excise duty on diesel combined with lower than expected growth in income tax collections compound the problem. In the case of the States while the budgeted estimates of revenue and fiscal deficits are well within the targets set by the Thirteenth Finance Commission, poor financial performance of state electricity utilities and their large borrowings from the financial system has created substantial liabilities for State governments. The financial performance of electricity utilities shows that in the aggregate, in 2008/09 itself, they had incurred a loss of Rs. 34,231 crore without subsidy (Rs. 52,623 crore with subsidy) which was over 0.6 per cent of GDP. The indications are that the finances of electricity utilities have deteriorated even more in subsequent years.

Fiscal Consolidation

101. The fiscal consolidation process based on the revised roadmap recommended by the Thirteenth Finance Commission was initiated in the budget of 2010/11. The objective was to bring down the Centre's fiscal deficit to 5.5 per cent in 2010/11 from 6.7 per cent in the previous year. The revised estimates for the year show substantial improvement, over even that of the budget estimates. Thanks to the revival of the economy, upward revision of GDP estimates and buoyed by substantial revenue collections from the telecom auction, the fiscal deficit of the Centre in the revised estimate was contained at 5.1 per cent and the revenue deficit was contained at 3.4 per cent, which was 0.7 percentage point lower than the budget estimate.

102. The Union budget for 2011/12 has continued the fiscal consolidation process. The fiscal deficit relative to GDP is budgeted at 4.6 per cent and including budget liabilities, the deficit is estimated at 4.7 per cent which is actually a marginal improvement over the target

set by the Finance Commission (4.8 per cent). In the case of revenue deficit however, the budgeted deficit of 3.4 per cent is much higher than the target (2.3 per cent), but the new concept of “effective revenue deficit” which excludes grants given for the creation of capital assets to states and implementing agencies is placed at 1.8 per cent in the Budget.

103. Most of the States have presented their budgets by now and the revised estimate of fiscal deficit aggregated for all the States in 2010/11 at 2.5 per cent of GDP conforms to the Finance Commission’s target of 2.6 per cent. Interestingly, despite larger borrowing space given to them (4 per cent of GSDP) as a part of the fiscal stimulus package, the States were able to contain their aggregate fiscal deficit at 2.5 per cent of GDP and their revenue deficit at 0.1 per cent. In fact, the improvement is better than envisaged in the budget estimate of fiscal deficit at 3 per cent of GDP and revenue deficit at 0.5 per cent. For the current year (2011/12), the budget estimate for the States in the aggregate shows a revenue surplus of about 0.3 per cent of GDP and the fiscal deficit is estimated at 2.1 per cent of GDP.

104. The consolidated fiscal deficit including off-budget liabilities in 2010/11 is estimated at 7.6 per cent and is budgeted at 6.8 per cent (Chart 2.1 & 2.2 and Table 7). The total revenue deficit for 2010/11 is estimated at 3.6 per cent of GDP and is budgeted at 3.2 per cent for 2011/12. Thus, substantial progress has been made in the process of consolidation in 2010/11. In fact, the fiscal deficit including off-budget liabilities relative to GDP was brought down by 1.9 percentage points from 9.4 per cent in 2009/10 to 7.6 per cent in 2010/11. Similarly, the revenue deficit was brought down by almost two percentage points from 2008/09 to 2010/11. Despite these improvements, both revenue, fiscal and primary deficits continue to be large and the fiscal situation remains precarious.

Chart 2.1
Revenue Deficit: Centre, States and Consolidated

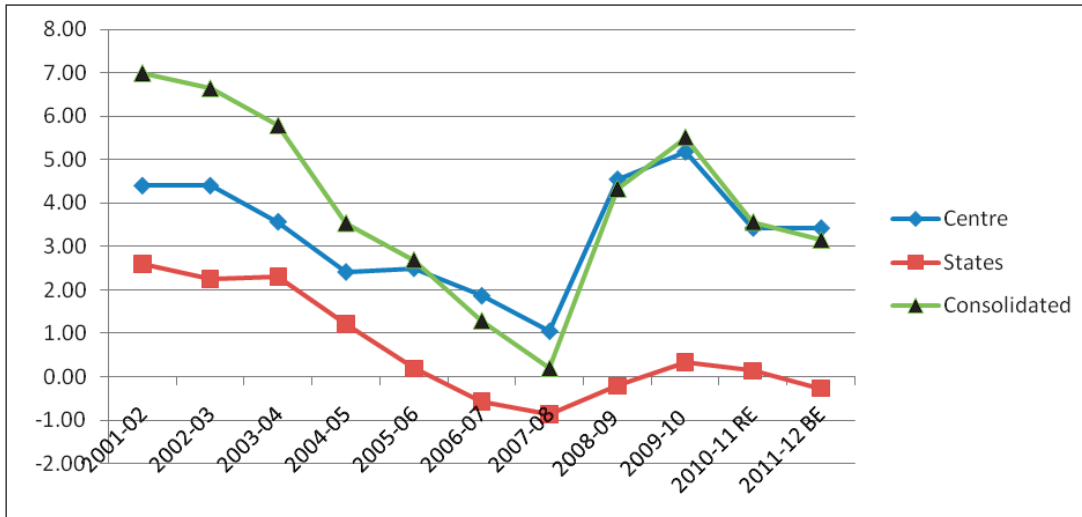
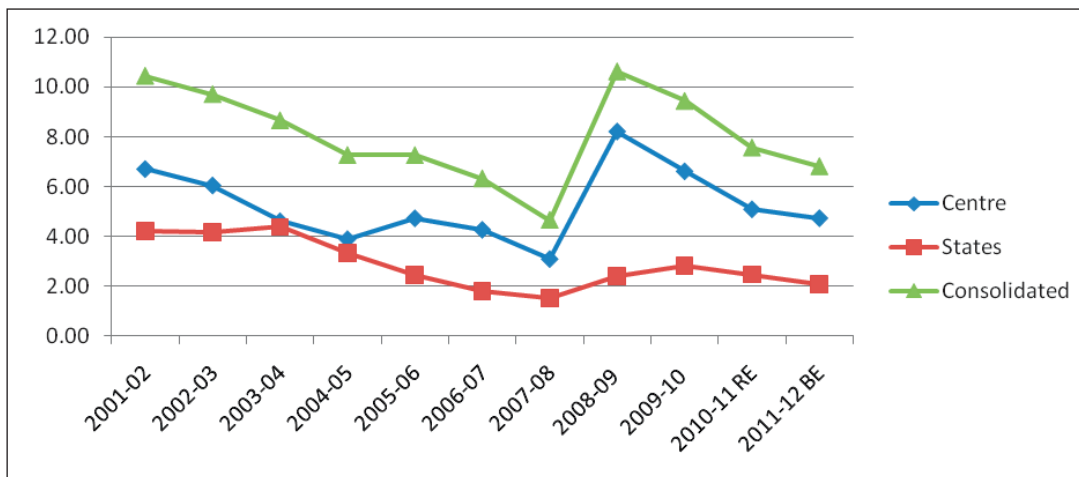


Chart 2.2
Fiscal Deficit: Centre, States and Consolidated



Note: Fiscal; deficit includes off budget liabilities.

Table: 7 Fiscal Imbalances in India: Centre, States and Consolidated

Year	Revenue Deficit			Fiscal Deficit*			Primary Deficit		
	Centre	States	Consolidated	Centre	States	Consolidated	Centre	States	Consolidated
2001-02	4.4	2.6	6.99	6.7	4.21	10.45	1.47	1.21	3.46
2002-03	4.4	2.25	6.64	6.04	4.16	9.71	1.11	1.18	3.02
2003-04	3.57	2.3	5.79	4.62	4.38	8.65	-0.03	1.33	1.95
2004-05	2.42	1.21	3.54	3.9	3.32	7.26	-0.04	0.38	1.12
2005-06	2.5	0.19	2.69	4.73	2.44	7.26	0.37	-0.01	0.79
2006-07	1.87	-0.58	1.29	4.27	1.81	6.32	-0.18	-0.4	-0.33
2007-08	1.05	-0.86	0.19	3.11	1.51	4.65	-0.88	-0.41	-1.02
2008-09	4.54	-0.21	4.33	8.2	2.4	10.62	2.59	0.57	3.38
2009-10	5.18	0.34	5.51	6.61	2.83	9.43	3.14	1.04	4.36
2010-11 RE	3.43	0.14	3.56	5.09	2.47	7.56	2.03	0.85	3.01
20011-12 BE	3.42	-0.27	3.15	4.74	2.07	6.81	1.61	0.49	2.3

* Fiscal deficit includes off budget liabilities

Source:

1. *Public Finance Statistics, Ministry of Finance, Government of India up to 2009/10.*
2. *For 2009/10 to 2011/12, estimated deficits for the states have been compiled from their budget documents and Centre's estimates have been taken from the Union Budget. The consolidated estimates have been worked out making appropriate adjustments.*

Short-term Outlook

105. The challenge of fiscal consolidation in the coming years is formidable. In the last two years, a substantial part of the adjustment was due to one-time revenue collections and phasing out of salary arrear payments arising from the past decisions. Taking the fiscal consolidation process further will call for structural reforms in the finances of the Centre and States. Even in 2011/12, the sluggish growth of revenues, an amount of lower collections from petroleum products, as well as from direct taxes and substantially higher than budgeted subsidy bill on oil and fertilizers, have raised questions on whether the revenue, fiscal and primary deficit targets can actually be met in 2011/12. The government will have to redouble its efforts to collect larger revenues, resolve cases to reduce tax arrears and save expenditures in other areas to conform to the targets. In the case of the States, the large and persisting losses of electricity utilities are worrisome and immediate reform initiatives are required to limit the liabilities of State governments.

Medium-term Outlook

106. The medium term challenges of achieving fiscal correction is even more formidable and systematic reforms have to be initiated if both Centre and States have to conform to the adjustment path recommended by the Thirteenth Finance Commission. The promised initiatives such as expansion of universal education to secondary level, universalising healthcare and expansion of food security are likely to increase the government expenditures substantially. Larger allocation to these sectors requires undertaking expenditure reforms to minimise avoidable expenditures and initiating measures to increase revenues. The governments will have to initiate reforms on the expenditure side, particularly in rationalising various types of subsidies and transfers. On the revenue side, the direct taxes code will be implemented from April 2012, but the revenue gain from this is unclear. The only important initiative that can bring about substantial revenue gains is by reforming the prevailing domestic trade taxes to introduce of Goods and Services Tax (GST), but the extent of gain will depend on the structure and operational aspects finally decided upon. It is therefore, important that both Central and State governments should redouble their efforts to come to an agreement on the structure of GST, administrative and other operational arrangements, technology to deal with inter-state transactions, the arrangements to ensure compliance by the parties concerned and mechanism to deal with Centre-State and inter-State disputes. Equally important are the reforms in the power sector distribution system to limit the liabilities to the state governments. Sustaining the fiscal consolidation process calls for these immediate structural reform measures.

IX. SOME KEY ISSUES

A. Convergence Of Growth

107. It is not without reason that regionally balanced growth has been an important development objective in India. The pure economic rationale is simple – unless all constituent units or states (in the case of India) grow to their full potential the coveted double digit growth rate will be difficult to achieve. Besides, an inclusive growth process significantly contributes to a sense of national integrity, political stability and social harmony – all of which are important goals for a large federal structure like ours. It is expected that with economic development the per capita incomes of the states will show a tendency to converge. In this paper we attempt to test whether convergence has indeed happened in India over the past two decades.

Analyzing GSDP

108. GSDP data from 15 states is used, four in the south Tamilnadu, Karnataka, AP, Kerala; three in the west Maharashtra, Gujarat, Rajasthan; three in the north Punjab, Haryana, UP; one in the center MP and four in the east Bihar, West Bengal, Assam, Orissa. These states account for 95 per cent of the population. The GSDP data from CSO is available in three series i.e. 1980-81 to 1993-94, 1993-94 to 1999-00 and 1999-00 to 2007-08. We use the unspliced GSDP data series and compare the Annual Trend Growth Rates (ATGR) in the period 1993-94 to 1999-00 with the ATGR in the period from 1999-00 to 2007-08.

109. In the first period, 1993-94 to 1999-00 the ATGRs of per capita GSDP, display large interstate variations ranging from 0.28 per cent (Assam) to 6.10 per cent (Karnataka). The median growth rate in this period is 3.90 per cent (Andhra Pradesh). Three states i.e. UP, Bihar and Assam had the lowest ranks in this period but in terms of growth rates Assam at 0.28 per cent was way behind the other two with 2 per cent plus growth rates. The three top ranking states in this period with 5 per cent plus growth rates were Karnataka, Gujarat and Rajasthan. In the second period, 1999-00 to 2008-09, the interstate variations continue to be large, and possibly higher than in the past, ranging from 3.38 per cent (Assam) to 7.61 per cent (Gujarat). However this is not necessarily bad news, since the median growth rate increases one and a half times to 5.69 per cent (Tamilnadu) and twelve

states show higher growth rates in the second period as compared to the first. The three states that fall behind are Karnataka, West Bengal and Rajasthan – the top rankers in growth rates in the first period. However despite a deceleration, the growth rates of these states are not low in the second period. Interestingly in eight out of the fifteen states under review, growth rates increased by one and a half times or even more and this result certainly points to the positive impact of reforms on growth rates in almost all the states under review. Practically identical results emerge if instead of using per capita GSDP, per capita incomes of these states are used. In this case the improvements are even more striking for the traditionally backward states like Assam, Bihar and UP. The evidence on the ‘catch up’ phenomenon for the poorer states is quite striking for these two periods. A similar exercise is attempted for the eighties i.e. 1980-81 to 1993-94. When this period is compared to the most recent period 1999-00 to 2008-09, the evidence of “catch up” is even stronger.

Table 8: Annual Trend Growth Rate of Per Capita GSDP and Per Capita Income

	ATGR Per Capita GSDP		ATGR Per Capita Income	
	1993-94 to	1999-00 to 1999-00	1993-94 to 2008-09	1999-00 to 1999-00
2008-09				
Andhra	3.90	6.60	3.86	6.51
Assam	0.28	3.38	0.09	3.19
Bihar	2.31	5.15	0.88	5.85
Gujarat	5.51	7.61	4.92	7.63
Haryana	3.11	6.79	2.88	6.76
Karnataka	6.10	5.72	5.86	5.63
Kerala	4.18	7.03	3.97	7.14
M.P	3.23	3.96	4.02	6.02
Maharashtra	4.00	5.81	3.7	5.69
Orissa	2.58	7.11	2.39	6.94
Punjab	2.86	3.08	2.67	2.89
Rajasthan	5.44	4.80	5.57	4.77
Tamil Nadu	5.02	5.69	4.76	5.69
U.P	2.10	3.49	0.94	3.25
West Bengal	5.33	5.13	5.41	4.96

Measuring Inequality

110. There are a number of measures which can be used to analyze regional inequality. We use three measures in this paper i.e. min-max ratio, coefficient of variation (CV) and Gini coefficient. In the period 1993-94 to 1999-00 the min-max ratio of the per capita GSDP of the 15 states under review, fell from 30.1 to 27.0 declining by 7.5 per cent indicating an increasing divergence. In the second period i.e. 1999-00 to 2008-09 the min-max ratios fell from 28.4 to 27.9. The min-max ratios yield a clear picture of divergence in both the periods. The coefficient of variation also shows an increasing divergence in the per capita GSDP's of the 15 states in both the periods. In the first period, 1993-94 to 1999-00, CV increased from 34.7 to 38.46 gaining 11.0 per cent while in the second period, 1999-00 to 2008-09, the CV rose from 35.5 to 40.1 gaining about 13 per cent, displaying a clear trend of divergence.

111. To understand the impact of growth on regional inequality a gini coefficient is constructed using the relative cumulative proportions of GSDP and population for the 15 states for the two periods under study. In the first period, 1993-94 to 1999-00 the gini coefficient rose, from 0.191 to 0.217, gaining 13.6 per cent – indicating a rise in regional inequalities. In the second period, 1999-00 to 2008-09, the gini coefficients remain at elevated levels rising from 0.202 to 0.227. A positive development in this period is that in the latter half the rising trend seems to have reversed with the gini coefficient in 2008-09 being lower than that in 2005-06. However the period is too small for this to be determined as a trend and data for the next couple of years will need to be examined to draw a stronger conclusion.

Test for Convergence

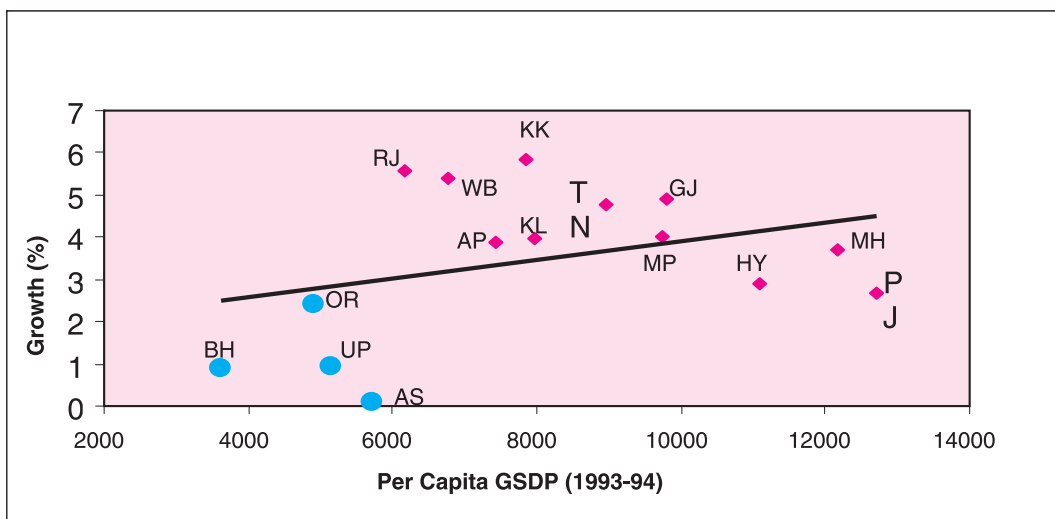
112. The absolute convergence between the 15 states under review is tested by regressing the growth in NSDP with the initial NSDP for three periods – 1980-81 to 1993-94, 1993-94 to 1999-00 and 1999-00 to 2008-09. Theoretically if the states were converging then the states with a low initial income would experience a faster growth than the states which start with a high initial income. In other words convergence would translate into a negative relationship between growth and initial income and a positive relationship would imply divergence.

113. The eighties presented a picture of absolute divergence with large variations in inter-state growth rates. In the period 1993-94 to 1999-00 the picture is still of divergence ([Chart 3.1](#)). Some states like Bihar, Assam, UP and Orissa continue to lag behind. However in this period we find that initial incomes for the states are no longer able to

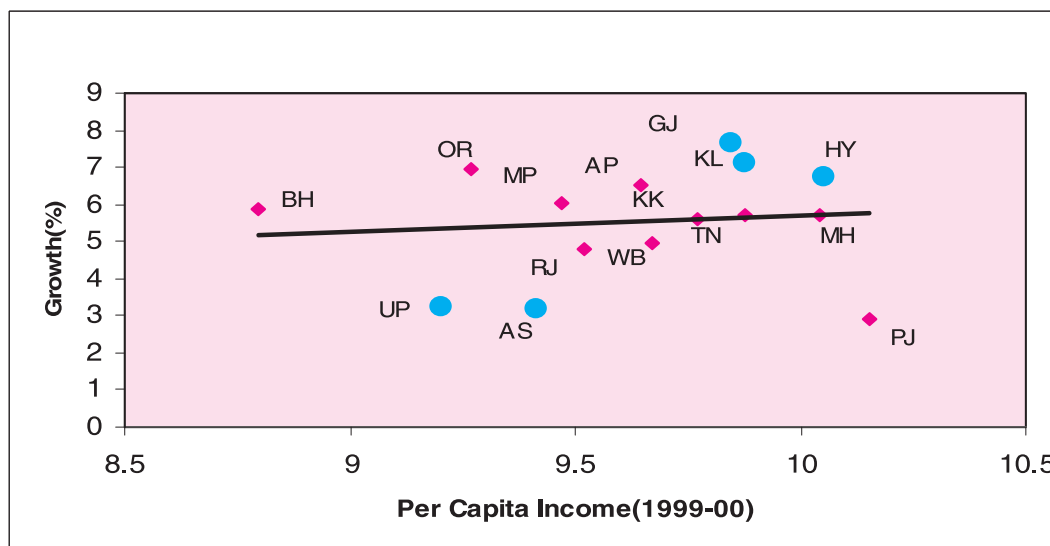
predict the growth rates by themselves unlike in the previous period. Interestingly the coefficient of the initial per capita NSDP decreases in this period indicating that the speed of divergence is somewhat attenuated.

114. In the period, 1999-00 to 2008-09, the low income states of the earlier period like UP and Assam show an increase in growth rates to around 3 per cent but these are inadequate for them to catch-up with others like Gujarat, Kerala and Haryana which grew at around 7 per cent despite starting out with high initial incomes². The major transformation happens in Bihar, Orissa and MP which manage to “catch-up” by growing at 5-7 per cent in this period. The growth rates of these states more than tripled as compared to the first period. However even in this period the relationship between initial per capita NSDP (in 1999-00) and the growth rate in per capita NSDP (in the period 1999-00 to 2008-09) continues to be positive though the relationship is no longer statistically significant (Chart 3.2).

Chart 3.1- Growth Rate and Initial Per Capita Income 1993-94 to 1999-00



² If we drop these states from our analysis we get a statistically significant convergence for the remaining states.

Chart 3.2- Growth Rate and Initial Per Capita Income 1999-00 to 2008-09

115. A comparison of the periods detailed above yields an interesting result. Even though through these two periods the per capita GSDP's of the 15 states does not show convergence but over time the tendency to diverge appears to be coming down. There is clear evidence of strong growth rates of the erstwhile lower income states in the recent period and if this trend continues there is high probability that we may witness convergence in the next few years.

Conclusion

116. A question that this analysis posed was – Is there any evidence on convergence? Strictly speaking the two periods i.e. 1993-94 to 1999-00 and 1999-00 to 2008-09 do not show convergence. However, in the recent period there is strong evidence of 'catching up' by the lower income states. The median growth rate increased one and a half times in the recent period increasing from 3.9 per cent in the period 1993-94 to 1999-00 to 5.7 per cent in the period 1999-00 to 2008-09. Twelve states out of the fifteen show higher growth rates in the recent period. States with low per capita GSDP's (1999-00) like Assam, Orissa, UP and Bihar have made significant gains in growth rates in the recent period 1999-00 to 2008-09. Notwithstanding these gains, convergence was subdued in the recent period mainly because some of the higher income states, especially Gujarat, Kerala and Haryana which had high initial incomes also posted high growth rates in the

range of 7 per cent and above. In other words, what the recent data indicate is that while most of the lower income states have shown stronger growth rates, several of the higher income states have also shown an increase in the period 1999-00 to 2008-09.

B. Sustainable Current Account Deficit and Foreign Flows

Background

117. The RBI estimates that the current account deficit (CAD) at US \$44.3 billion will be about 2.6 per cent of GDP during 2010-11 as against US \$38.4 billion and 2.8 per cent of GDP in the previous year. At some point in time during the previous financial year, there were fears that the CAD for 2010-11 may exceed 3 per cent of GDP raising some fears of a crisis of the 1991 kind, when the CAD stood at 3.4 per cent of the GDP. The subsequent sudden stop in capital flows to India led to worries that the expected level of the CAD may not be sustainable. The basis for these worries were essentially two-fold. First, if global trends in commodity prices continue their upward trend, this may lead to a worsening of the deficit. Second was the concern that the financing of the deficit poses a risk, if short-term capital flows to India are adversely impacted due to a faster global recovery which enhances the attractiveness of investment opportunities in the rest of the world.

118. Sustainability of the CAD depends on the underlying forces that are driving the increase in external imbalance. The current account deficit can be viewed from two angles: (1) the domestic view of consumption and investment spending or sources of the deficit; and (2) the international financial view of the global investor's portfolio of wealth or the mode of financing the deficit. These two perspectives will focus on different variables or economic relationships.

119. On both these views, the present situation is qualitatively different from 1991. The CAD of 1991 was the result of stagnation where as the CAD of 2011 is the result of growth and development. An economy continuously growing at 7 per cent per annum and double-digit annual growth in exports and imports is a different scenario altogether compared to the one in 1991. The present level of trade deficit in the region of 7 to 8 per cent of GDP and net invisible earnings of about 5 per cent of GDP point to an economy on a different trajectory than in 1991. While we should continue to improve the trade deficit, given our growth needs, a moderate trade deficit and CAD are inevitable. The critical question that needs to be answered is our ability to finance this CAD. It is this, which will determine the sustainable level of CAD – both in absolute terms and relative to GDP.

120. Given the current trends in the world economy and the behaviour of international capital markets, we should strive to contain the CAD below 2.5 per cent of GDP. This will itself mean a larger inflow of capital in absolute amount as our GDP keeps growing.

121. With regard to financing of the deficit, there has been a major change in the composition of financial inflows into India compared to the mid 80s/early 90s. The financing of the present CAD is largely by portfolio equity and FDI flows. For example these amounted to nearly \$ 62 billion and \$ 52 billion respectively in the year 2009-10 and 2010-11. This is to be contrasted with the composition of flows in 1991 when debt-creating flows were 73 per cent as opposed to 15 per cent now. The questions that therefore need to be answered are the nature and likelihood of continuance of FII and FDI flows to India

FII Flows

122. When India began to open up the capital account in the early 1990s, there was a great deal of concern about the volatility of capital flows. With 20 years of experience behind us, we now know that the volatility of capital flows to India has actually proved to be relatively modest. In the global crisis, the worst quarter for portfolio equity flows was an outflow of \$5.8 billion. In the case of loans – ECB (external commercial borrowing) and short-term loans, including trade credit – the worst quarter saw a net flow of \$3.6 billion. These are modest numbers (both in absolute terms and as a percentage of GDP) and can be easily absorbed by the very large scale of movements of foreign exchange in and out of the Indian economy (which now amount to gross flows of 120 per cent of GDP).

123. Careful microeconomic studies in India have examined the behaviour of foreign investors around specific events such as the Satyam scandal. This evidence shows that there was no generalized contagion. Foreign investors were net buyers of non-Satyam securities at the time that they were selling Satyam. The negative view did not spill over from Satyam to India as a whole. In a series of other crises, such as the Mumbai terrorist attacks, foreign investors have not been jittery. These experiences reassure us about the extent to which foreign investors can be the source of shocks which destabilize the Indian economy. A key element of this success can be ascribed to the absence of quantitative restrictions (QRs) in portfolio equity flows. With QRs, foreign investors invest a little in India, and then the limits are reached and investment is infeasible. When QRs are eliminated, foreign investors are always in business doing investment in India. From this perspective, it is important over time to emulate the successes of the FII framework where QRs were not

used. On the whole these flows have led to reduced cost of capital for Indian firms as well as contributed to the deepening of the Indian domestic financial system. Further gains can be harnessed by moving on the recommendations of the Working Group on Financial Flows, chaired by Mr. U. K. Sinha, 2010.

Foreign Direct Investment (FDI) Flows

124. In parallel, we need to be focusing on enhancing the FDI flows which currently form only about 6.5 per cent of the Gross Fixed Capital Formation of the country. FDI Policy in the country has come a long way from the very cautious opening before the 90's to one of calibrated liberalization thereafter. The pace has been most marked in the last decade. The majority of the sectors have been completely liberalized, even though with sectoral caps. A very few sectors require prior Government approval through the FIPB. On an annual basis, FDI flowing in from the approval route is now as low as 17% of the FDI flows and is a clear measure of the freer flows without intervention. Yet there are a few issues the resolution of which will pave the way for greater flows.

125. Department of Industrial Policy and Promotion (DIPP) has sought to make a distinction, for the first time, between '*ownership*' and '*control*'. It is felt that, under FDI policy, while '*ownership*' and '*control*' could be interrelated, they need not be identical. Both need to be looked at separately to assess the extent of domestic/foreign '*influence*' in a company. This distinction is relevant in the specific context of downstream investments made by Indian companies. As per the guidelines, the downstream investment of entities owned and controlled by resident Indian citizens shall not be counted as indirect FDI. This is a major departure from the earlier method of calculation on proportionate basis. The change recognises the fact that FDI equity caps are structured along the premise of '*control*' and that a '*proportionate*' methodology, though less complex, is inadequate to accurately reflect the extent of control exercisable by foreign investors in an Indian company. There is a clear case for permitting 49 per cent direct FDI in all sectors except where FDI is prohibited. However a clear distinction needs to be made for regulating downstream investments in these restricted/prohibited sectors to ensure that the spirit of the policy is not violated.

126. In conclusion, as there are apparent signs of slowing down of foreign investment flows, we need to be proactive in promoting the flow of such investment.

C. POWER SECTOR

127. The India growth story is inextricably linked to the power sector whose less than adequate performance in the past has adversely impacted productivity and competitiveness

cutting across sectors. The overall power shortage in the country as on March 2011 at 7.5 per cent in energy terms and 10 per cent in peak power terms is indicative of the demand – supply mismatch. However the good news is that these percentages were possibly the lowest in the past decade and the capacity addition in the XIth Plan is likely to be twice the achievement in the Xth Plan. Notwithstanding this, if India is to maintain high rates of growth and provide universal and sustainable access to electricity, the power sector needs to grow and reform faster in all the three constituent areas of generation, transmission and distribution.

128. According to the mid-term appraisal of the Eleventh Plan, as against a capacity creation target of 78,700 MW, only 44 per cent (34,462 MW) had been achieved in the first four years. Planning Commission is targeting an ambitious capacity addition of 17,600 MW in the terminal year of the Plan, which if achieved would raise the total achievement to 66 per cent of the target. The worst slippages till now have been in the central sector where only 28 per cent of the target was achieved and but for the performance of the private sector the overall slippages could have been worse.

Table 8 Capacity Creation in the Eleventh Plan – Category wise

(MW)					
Category	Hydro	Thermal	Nuclear	Total	11th Plan Targets
Central	1,350	8,220	880	10,450	36,874
State	2,579	10,392	0	12,971	26,783
Private	192	10,849	0	11,041	15,043
All India	4,121	29,461	880	34,462	78,700

129. The primary impediments to capacity creation presently are, uncertainty in fuel availability especially shortage of coal linkages (in the case of thermal), environmental clearances, land acquisition, resettlement and rehabilitation issues (especially in the case of hydro), shortage of power generation equipment and delay in equipment delivery. Capacity additions are significantly coal based and 50 per cent of the generation targets in the 12th Plan also have coal as the fuel source. Domestic production of coal showed *negative* growth of 0.3 per cent in 2010/11. Output growth in the first two months of 2011/12 has been sluggish at 1.9 per cent. However, a combination of policy directions and other measures may improve output growth in the second half of 2011/12. . It may be mentioned that the original plan target was 9.5 per cent³.

³ This was revised to 7.8 per cent per annum in the mid-term appraisal

130. Environment/forest clearances, land acquisition and lack of private sector presence in commercial mining operations are the major bottlenecks to increasing domestic production. The 2009 'No-go' policy of the environment ministry, which declared a significant percentage of the coal mining zones as out of bounds, halted mining activity in more than 200 blocks. The seriousness of the situation can be gauged by the fact that Coal India Limited the monopoly domestic producer is unable to sign any Fuel Supply Agreements creating uncertainty for long term planning by power plants. Imported coal is a high cost option which pushes up the cost of producing power rendering the power plant uncompetitive. Besides, in the long run heavy dependence on imports is not a viable strategy since stable coal prices beyond a few months are not available in the international market while power tariffs have to be committed for the long term. Moreover, limited domestic capacities for core equipment like boilers, turbines and generators coupled with limited global suppliers of components /modules like turbine forgings and castings, CC water pump, CRGO Steel etc. have held up commissioning of power projects in previous years. However, BHEL, which is a major supplier of equipment for power plants in the country, especially for public sector power plants, has recently been scaling up its capacity quite substantially. In addition, several private sector players have entered the picture, almost all of them being joint ventures with internationally established equipment manufacturers.

131. The transmission network in the country currently covers about 80 per cent of the population. Most importantly the North-East, where large hydroelectric generation capacities are going to come up has a poor transmission network. The XIth Plan target of transmission capacity of 88,515 CKm is not likely to be met, with the actual addition in the first four years being only 49,852 CKm. Enhancing transmission capacities and creating an efficient national grid is important to enable evacuation of power from surplus to deficit regions and also facilitate electricity trading. There is a large public sector presence in transmission and notwithstanding the Electricity Act 2003 and the National Tariff Policy of 2006, private investments in the transmission sector have been slow. The major bottlenecks in enhancing transmission capacities are the clearances for the Right of Way (RoW) and inadequate indigenous capacities in the manufacture of transmission equipment. In the case of the private sector an additional reason has been the delays in award of projects.

132. In the transmission and distribution space, it is important to encourage private participation since large investments are required here as also to co-ordinate the generation and development of transmission infrastructure. A special focus is required for developing

⁴ Restructured Accelerated Power Development and Reforms Programme

the transmission network in the case of renewable energy projects in view of the large infrastructure gaps here. Bringing down AT&C losses is crucial to the commercial viability of the distribution utilities. The recently launched R-APDRP⁴ could be an important step and it is important to create the IT backbone and automations envisaged under the programme. It may be noted that private investors are now starting to come-in into the business of power transmission. This provides an efficient means of expanding and strengthening the transmission network.

133. A crucial constituent, the distribution sector, is the most visible face of the power value chain. The reforms here have been slow as has been private sector participation. The Aggregate Transmission and Commercial (AT&C) losses have declined from 33.0 per cent in 2005-06 to 28.4 per cent in 2008-09 but final losses are still very large in absolute terms at Rs 70,000 crores. High technical losses are primarily due to inadequate investments and unplanned extensions of the distribution lines while the commercial losses are due to theft, pilferage and low metering efficiency.

134. The high AT&C losses compounded with the enormous lags in the revision of power tariffs are at the root of large commercial losses of the power distribution companies. This is not only a potentially important fiscal burden, but it also undermines the confidence of private investors in power generation, for they for the most part, have to sell their output to these distribution companies. Large commercial losses and financial weakness of the distribution companies cast a seriously negative shadow on the financial viability and prospects for the power generating business. The upsurge in generating capacity creation in the private sector during the Eleventh Plan was possible, because the distribution companies were not looking so financially stressed in earlier years as they are looking today. In order to maintain the pace of private sector investment in power generation and in the power sector generally speaking, very urgent steps are required to rectify the financial condition of distribution companies. Reduction in AT&C losses is one solution, but cannot be the only one. Revision of power tariff, which in many states has not happened since 2003, also needs to be taken up on an urgent basis. At the bare minimum, fuel costs “pass through” must be done on a regular basis, preferably quarterly. The other initiative which can be helpful to rectify the condition of the power distribution business is the expansion of the PPP model and/or the franchisee model as has been successfully attempted in several places.

135. There are some immediate policy interventions which can aid the removal of bottlenecks which are holding up growth in the sector. The most important of these is ensuring coal availability for existing plants and advance indication of coal linkage for a

planned power project. This will require increase in domestic coal production by exploring new coal blocks, expeditious forest clearances for captive coal blocks allotted to the power sector, permitting exploratory mining for coal on forest land with reasonable restrictions, expansion of underground mining by CIL and development of coal blocks under PPP model by CIL through competitive bidding, instead of auctioning of coal blocks, which raises the cost of coal and consequently the cost of power. Besides CIL could step up imports of coal and start the system of pooled pricing of coal to augment supplies for the power sector. A complementary action will be increasing the technical capacity of the power plants to use imported coal.

136. Land acquisition and environmental clearances have remained important constraints in setting up of new power generation capacities. This issue has become politically volatile and unless the Centre and State governments reach a consensus on this, timely implementation of projects appears difficult. There is a pending legislation on land acquisition, which needs scrutiny and expeditious disposal, to provide a breakthrough for various stakeholders in the public and private sector. The other contentious issue which inordinately delays power projects is that of environmental clearances, often involving multiple authorities. It may be useful to set up an empowered group consisting of senior officials from the concerned ministries to expedite clearances for pending projects. In the case of hydro projects, it is important to finalize all environmental, rehabilitation & resettlement and protection of flora/fauna or heritage sites before the project is allotted to any agency. Once the clearances have been obtained for a project, no further objections by any government agency involved earlier in the empowered committee, should be entertained during the implementation phase.

137. Nuclear Energy has the potential to become a cost effective, low carbon source of electricity in the long term. It is currently the fourth-largest source of electricity in India accounting for 3 percent of the electricity generated. The country has 20 nuclear power plants in operation generating 4789 MW. It is further likely to increase to over 10000 MWs by 2017 as several nuclear plants are likely to be commissioned in the XIIth five-year plan and more are in the planning or proposal stage. In many countries alternative sources of energy accounts for 15-18 per cent of the total energy production. In the context of climate change and environmental concerns it is all the more necessary to underline importance of these sources for power generation in the 12th Plan.

138. The Twelfth Plan has an ambitious target of adding 1,00,000 MW to the total capacity. This target cannot be achieved unless some impediments indicated earlier are removed. If for environmental or other considerations, this target cannot be reached, we must settle for a lower overall growth rate.

D. FOOD SECURITY

139. Global food security has been under threat in recent times translating into 1 billion plus under nourished people in 2009 according to Global-Hunger-Index (GHI) 2010. A similar story unfolds in India with 20 per cent of its population still under-nourished. While better health is an important goal by itself, its role as an “economic engine” provides an additional compelling rationale for public policy to support well- targeted nutrition- improving interventions.

140. As a concept, food security has evolved from being traditionally defined in terms of food availability and price stability to more recent definitions that encompass economic access and nutritional balance. In India policy initiatives on improving food security can be broadly categorized into two sets, measures to increase food availability and measures to improve access through employment generation programmes and providing physical access to food to vulnerable sections. Starting with the green revolution, input subsidies on fertilizer, water and electricity, irrigation projects and the more recent Rashtriya Krishi Vikas Yojana and National Food Security Mission have all helped boost agricultural production and increase food availability. The other set of interventions to improve access have inter alia included National Rural Employment Guarantee Act, Swarna Jayanti Grameen Swarozgar Yojana, Integrated Child Development Scheme (ICDS), *Antyodaya Anna Yojana* (AAY), Mid-Day Meal scheme for school going children and most importantly, the Public Distribution System (PDS), one of the largest safety net programmes in the world in terms of the population it covers for physical distribution of foodgrains. Besides this, a recent initiative of the government is the proposed National Food Security Act, which aims to provide the poor a legal entitlement to food.

141. India’s determination to eliminate hunger has translated into a proposal to grant the poor a legal entitlement to food through an appropriate legislative enactment. Keeping in view the recommendation made by the National Advisory Council (NAC), a draft bill is under the consideration of the government. As per the NAC’s recommendation, the National Food Security Bill (NFSB), to be implemented in two phases, proposes legal entitlement to subsidized foodgrains to 72% of the population in phase 1 and 75% of the population in phase 2. The NFSB divides the population into two categories – (a) Priority Households with a 7 Kg per capita grain entitlement per month at a subsidized price (Rs. 1/2/3 per Kg for millets/wheat/rice) and (b) General Households with 4 Kg per capita grain entitlement per month at a price not exceeding 50% of the current Minimum Support Price for millets, wheat and paddy. Besides, legal entitlements are proposed for child and maternal nutrition, destitute and other vulnerable groups.

142. The NAC has estimated the foodgrain requirement for phase 1 at 49.36 million tonnes (at 85 per cent offtake) and for the final phase at 55.59 million tonnes (at 90 per cent offtake). However if we adjust the requirement for the latest available population, assume 100 per cent offtake, provide for buffer stock and 8 million tonnes for other welfare programmes⁵ the total foodgrain requirement rises to 68.76 million tonnes in phase 1 and 73.98 million tonnes in the final phase. On these calculations, the subsidy implications are Rs. 85,584 crores in Phase I and Rs. 92,060 crores in the final phase.

143. As against these requirements of foodgrain the maximum public procurement of wheat and rice has been below 60 million tonnes for the production year 2008-09 and in subsequent years, the procurement has been lower. Higher levels of procurement without increase in production levels will be potentially inflationary and hit the poor adversely since the most vulnerable sections depend on the market for 25-30 per cent of their consumption requirement for wheat and rice.⁶ At this level of procurement the full recommendations of NAC cannot be implemented for either phase.

144. The Expert Committee (EC) appointed by the Prime Minister to examine the implications of NFSB felt that given the feasible level of procurement it is best to restrict the legally-assured delivery of foodgrains at Rs 2 per Kg. for wheat and Rs 3 per kg for rice, to the really needy households and cover the rest through an executive order with a varying quantum depending on availability of foodgrains. Really needy household can be defined as those falling below the official poverty line plus an additional population equal to 10 per cent of the BPL population which translates to 46 per cent rural and 28 per cent urban population. These percentages are the same as those recommended by the NAC for categorization as 'priority' households and capture not only the poor but also some at the margin. In addition, the EC recommended that, the legal entitlement should be extended to the other vulnerable categories covered by welfare schemes like Mid-day-meal, ICDS etc. After meeting statutory entitlements, the balance grain can be used for distribution to the remaining population at an issue price higher than that of the entitled category. As production and procurement improve, coverage can be increased. Alternatively the legal coverage can be extended to the general category, albeit with a lower entitlement. It is understood that the government is contemplating a scheme along these lines..

145. Besides the entitlement, the other important element in implementing a food security system is the distribution of foodgrains. The Public Distribution System with its network of about half a million Fair Price Shops (FPS) is the most obvious choice. However, it is well

⁵ Mid Day Meal Scheme, ICDS, Social Welfare Hostels and Natural Calamities

⁶ Based on NSSO Surveys.

documented that, in its current form, the PDS is inefficient with large scale leakages, unviable FPS's creating perverse incentives for diversion and general lack of accountability. There is a need for major systemic reforms in the PDS. Two interventions which can make considerable impact are comprehensive computerization of the PDS and introduction of smart cards for the beneficiaries. Several state governments have already undertaken a number of initiatives for computerizing PDS operations but each of these target a part of the system and are not comprehensive and replicable at the all India level. The computerization of the PDS network starting from the allocation of the grain to the final delivery to the targeted beneficiary is crucial to creating an efficient distribution system if food security is to be ensured.

146. As an improvement to the existing PDS, we may switch over to the use of smart cards. Keeping the current method of foodgrain allocation to the FPS unchanged we can introduce smart cards for the beneficiaries. These biometric cards may simply contain details of the beneficiary and his entitlement. Only when the beneficiary swipes the card at the FPS will it be deemed that the targeted grain has been delivered. Allocations to the FPS will depend on electronic proof of delivery of the grain to the targeted beneficiary. This will prevent large scale leakages of foodgrain which happens under the present system of manual record keeping at the Fair Price Shops. These cards can initially be linked to a FPS mandated to service the beneficiary and as the system stabilizes the beneficiary may be permitted to use the smart card at any FPS convenient to him. The advantage of this will be introduction of some competition amongst the Fair Price Shops making it easy for the migrant poor to access the entitled foodgrains irrespective of their location. The UID project which would make the unique identification of each beneficiary possible is under implementation. It is extremely important to explore the synergies between these two programmes which will go a long way to streamlining the food delivery mechanism.