Economic Outlook 2012/13

Economic Advisory Council to the Prime Minister

New Delhi

August 2012

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ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER

NEW DELHI

August 2012

(Report submitted to the Prime Minister in August 2012)

ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER

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ECONOMIC OUTLOOK 2012/13

EXECUTIVE SUMMARY

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ECONOMIC OUTLOOK 2012/13

Executive Summary

Understanding the performance in 2011/12

i. The Central Statistical Organization (CSO) has revised the growth rate for 2011/12 at 6.5 per centwhich is much below what Council has assessed in July 2011 i.e 8.2 per cent. The Council has some reservations about the preliminary estimates for 2011/12, particularly that for the fourth quarter. However, there is no doubt that the overall performance in 2011/12 was not only surprisingly disappointing, but of special concern was that the declining trend in fixed investment continued to be reinforced.

ii. In the farm sector, the growth rate is likely to be closer to the estimate made by the Council in July 2011i.e 3.0 per cent. The Council's expectations regarding output increase in the mining & quarrying sector at 6.0 per cent was belied by the continued decline in the production of natural gas from offshore fields in the Krishna–Godavari (KG) basin and large decline in coal output. In consequence the increase in GDP arising in that sector for 2011/12 turned out to be (–) 0.9 per cent. The principal reason for pushing the economy down flowed from the manufacturing sector. Manufacturing IIP growth of 3.0 per cent in 2011/12 is one of the lowest in the past two decades. In the crisis year of 2008/09 it had been lower at 2.5 per cent and in the gloomy tension ridden year of 2001/02 it was 2.9 per cent. Within the manufacturing sector, the three components that stand out for the extent of decline are (a) Capital goods-electric and non-electric machinery (b) textiles and to some extent apparels (c) Chemicals and products thereof. The May 2012 estimate of CSO placed GDP growth arising in manufacturing at 2.5 per cent. The effect of such a low manufacturing growth on estimates in the services sector caused the impact to be considerably larger-both as logical corollary and as a computational outcome.

iii. The inferences that unambiguously emerge – no matter what deficiencies the IIP data may suffer from – is that (a) investment demand has become a source of serious concern; (b) the textile industry where we should have a comparative advantage has industry-specific problems and (c) weak domestic demand and

output seem to characterize even areas such as durable consumer goods and non-durables such as apparel. Clearly policy needs to take explicit cognizance of these elements in search of the solution for the restoration of the economy to a higher growth path.

Estimates for 2012/13

iv. The available data on output for the month of April and May 2012 do not show significant improvement. The IIP for manufacturing came in at (–) 1.2 and 2.5 per cent for these two months. However, electricity generation has continued to grow and the rate in first quarter 2012 was 6.4 per cent. In the automotive sector, domestic sales of passenger vehicles and two wheelers have increased by 9.7 per cent and 10.5 per cent respectively. Output of steel and cement in April-June also were higher by 3.6 per cent and 9.9 per cent respectively.

v. It may be recalled that manufacturing growth in the first quarter of 2011/12 was fairly robust (IIP 7.7 per cent and GDP 7.3 per cent). In the second quarter last year there had been a sharp weakening (IIP 3.4 per cent and GDP 2.9 per cent). In the third and fourth quarters of 2011/12 it slid further towards zero. On the basis of all it is the view of the Council that if nothing else, the low growth of 2011/12 will lend itself to positive base effects in 2012/13. Further, the impact of positive policy developments in the course of the year is expected to benefit the economy,in particular the investment environment, and result in significantly improved output levels in the manufacturing sector. On this understanding the Council is of the opinion that while both output and GDP data for Q1 (Apr–Jun) of 2012/13 may continue to be disappointingly weak, significant improvement is expected to materialize in second quarter and sequentially develop through the third and fourth quarters of the year. The Council is of the opinion that in manufacturing, output is expected to be about 5.0 per cent for the year as a whole. This should translate to an increase in the GDP arising in manufacturing of 4.5 per cent.

vi. The South West (SW) monsoon 2012 has turned out to be weak. In the current year, the rainfall has been better in the month of July with the shortfall for the month at 10 per cent. Moreover there is pronounced geographical difference. On the basis of the impact of weak monsoon on agriculture and the current reservoir storage position as on 2 August 2012 which shows that the water levels

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**	**2012-13**
					P	*QE*	*Rev*	*Pro.j.*	
1	Agriculture & allied activities	5.1	4.2	5.8	0.1	1.0	7.0	2.8	0.5
2	Mining & Quarrying	1.3	7.5	3.7	2.1	6.3	5.0	–0.9	4.4
3	Manufacturing	10.1	14.3	10.3	4.3	9.7	7.6	2.5	4.5
4	Electricity, Gas & Water Supply	7.1	9.3	8.3	4.6	6.3	3.0	7.9	8.0
5	Construction	12.8	10.3	10.8	5.3	7.0	8.0	5.3	6.5
6	Trade, Hotels, Transport, Storage & Communication	12.0	11.6	10.9	7.5	10.3	11.1	9.9	9.3
7	Finance, insurance, real estate & business services	12.6	14.0	12.0	12.0	9.4	10.4	9.6	9.5
8	Community & personal services	7.1	2.8	6.9	12.5	12.0	4.5	5.8	7.0
9	**Gross Domestic Product (factor cost)**	**9.5**	**9.6**	**9.3**	**6.7**	**8.4**	**8.4**	**6.5**	**6.7**
10	Industry (2+3+4+5)	9.7	12.2	9.7	4.4	8.4	7.2	3.4	5.3
11	Services (6+7+8)	10.9	10.1	10.3	10.0	10.5	9.3	8.9	8.9
12	Non-agriculture (9–1)	10.5	10.8	10.1	8.1	9.8	8.6	7.1	7.7
13	**GDP (factor cost) per capita**	**7.8**	**8.0**	**7.8**	**5.2**	**6.9**	**6.9**	**5.1**	**5.3**
14	GDP at factor cost - 2004/05 prices in Rs lakh crore (or Trillion)	32.5	35.6	39.0	41.6	45.1	48.9	52.0	55.5
15	GDP market & current prices in Rs lakh crore (or Trillion)	36.9	42.9	49.9	56.3	64.6	76.7	88.6	100.8
16	GDP at market & current prices in US$ Billion	834	949	1,241	1,234	1,365	1,687	1,853	1,868
17	Population in Million	1,106	1,122	1,138	1,154	1,170	1,186	1,202	1,218
18	GDP at market prices per capita at current prices	33,394	38,277	43,823	48,787	55,191	64,706	73,676	82,727
19	GDP at market prices per capita in US$	754	846	1,090	1,069	1,167	1,422	1,541	1,534

are 19 per cent below the average of the last ten years, the Council expects to see a fall in food grain output especially in the kharif season and also possible decline in some commercial crops, particularly cotton and sugarcane. However, output of horticulture and products of animal husbandry are unlikely to be negatively impacted. In 2012/13, the Council is of the view that while there may be output losses on account of the weak SW monsoon, overall farm sector GDP would register positive growth of around 0.5 per cent.

vii. In the mining & quarrying sector, the Council expects a recovery. Even as there is a possibility that natural gas output may fall a bit below that of even the current depressed level of 123.2 million metric standard cubic metres per day (mmscmd), there is on the other hand likely to some increase in domestic output of crude oil and considerable improvement in coal production. With growth in the coal and lignite sector, and some recovery in iron ore, the projected growth in mining for the year as a whole is expected to be 4.4 per cent.

viii. Electricity generation is expected to continue to grow at an average pace of around 8 per cent. Construction is expected to show some improvement compared to last year as evidenced by the recent increase in the output of steel and cement. So also the services sector, in particular the large transport, trade, communications sector.

ix. Overall for the economy, the Council thus assesses that an average growth of 6.7 per cent in 2012/13 can be realistically expected. While agriculture growth rate will be lower than the last year, there can be a distinct improvement in the performance of the mining sector and a moderate improvement in the manufacturing sector.

Global Situation

x. There is a dark mood in the advanced economies, especially in Europe. Between 2008 and 2011, the US and the Eurozone economies have virtually stagnated – even in nominal terms. The US economy is certainly picking up, but the recovery is weaker than had been expected. The problems inherent in the European monetary union and fiscally overweight governments were prised open by the Crisis. Though matters appear to have been patched up for the moment, it is clear that it may take several years for the Eurozone economy to return to

health.Further from time to time, bad news out of the Eurozone can have – even if temporary – disproportionately large negative effects on the global financial world and ultimately on investor and business confidence.

xi. The slower growth in the US and in the EU will have an adverse impact on the expansion of these markets for India's exports, both of goods and services. This conclusion should be qualified slightly. While western government finances and consumers are under some pressure, most companies, especially in America are profitable. They will continue to try and use IT to push productivity up and keep costs down. That will to an extent help with Indian IT-related businesses. In addition to this, conditions in the EU has, and will continue to negatively impact Eurozone bank financing, which has been significant for Indian private sector infrastructure projects. This is likely to influence bank lending from other sources as well, which is reflected by the increase in credit spreads for Indian borrowing.

xii. Asia will be under pressure for the most part because of pressure on its final export markets in the West, and also from domestic factors including demand for higher wages and the rising burden of energy costs. However the growth rates in many Asian countries suggest that developing economy demand will remain reasonably buoyant. This may be seen from the IMF growth projections for the developing Asia, excluding China and India, for 2012 and 2013 which are 5.0 and 5.7 per cent respectively, while that for sub-Saharan Africa are around 5.4 per cent.

Energy & Commodity Prices

xiii. Oil consumption in OECD countries has seen a steady decline over the years. But economic growth in emerging economies and the resultant higher oil demand will continue to offset the declines in oil consumption in OECD countries, as it has in the past six years. Thus there will continue to be steady upward pressure on crude oil prices which will eventuallylift prices of other fossil fuels. Therefore, energy pricing policies must be shaped by the expectation that fossil fuel prices will continue to rise at a pace faster than other prices.

xiv. There are concerns on account of weather related events in the US, poorer than expected harvests in Russia and of course the weaker SW monsoon in India. Although world food prices are off the highs of 2011, they remain high and

therefore vulnerable to the kind of upward spike that happened after July 2010, as also after June 2007.

xv. The rush to gold – and to an extent that to other commodities – is a response to the desire to hedge against currency risk and also as a response to the record low interest rates and hence yields on bonds. The monetary environment has also encouraged leveraged positions, which has helped to run up prices and impart exceptional volatility in the prices of commodities.

xvi. Rising gold prices in combination with high domestic inflation and shortcomings in the marketing of financial savings instruments and on account of poor returns in equity marketshad over the past couple of years resulted in a huge increase in the import of gold into India for investment use. This factor has contributed to a great extent to the worsening of the external payments situation and the availability of financing savings for productive use at home. This entire issue in all of its dimensions has to be squarely addressed by policy.

Domestic Inflation

xvii. Inflation at home remains high at 7.3 per cent in June and is likely to be around 7.0 per cent in July 2012. The fact remains that the present level of inflation has to come down, in order to allow for stable conditions for healthy investment climate and equitable economic growth.

xviii. The particular difficulty in dealing with the persistence of domestic inflation has been the steep increase in the prices of primary food. In the initial period up to March 2010, following on the record poor monsoon of 2009 there was a spurt in the prices of rice and wheat, which was contained through open market intervention. Inadequate output also resulted in a sharp increase in the prices of pulses. Thereafter the increase in primary food prices has been driven for the most part by vegetables, fruit, milk, meat and other perishable goods. There has been significant output increase in vegetables, fruit, milk and other products of animal husbandry. The sharp rise in their prices speaks of the shortcomings in the supply chain that result in a lot of wastage and unjustifiably high mark ups. As a result of this both the consumer and the producer suffer.

xix. Manufactured goods inflation in the period up to March 2010 was subdued. However, thereafter it picked up influenced possibly by rising wage costs, as well

as that of other inputs. The rate of inflation for manufactured goods has dropped somewhat since January 2012 and is now around 5 per cent. The rate for manufactured goods excluding manufactured food items (which is more directly influenced by primary farm product prices) has also come down to below 5 per cent in the most recent two months. However, the fact remains that the huge subsidies being given to petroleum products, especially to diesel, has the effect of suppressing inflation at least in the short run.

xx. It is more likely than not that food prices will continue to remain under pressure this year, especially because of the poor SW monsoon and the combination of output losses and expectations that is likely to result. Accumulated inflation in manufactured goods at the end of July 2012 is most likely to have been around 1.7 per cent – which given the loss in the external value of the rupee and the consequential increase in import prices is possible evidence of some weakness in domestic demand and therefore of also pricing power of producers. For the year as a whole and factoring in some movement in the prices of "sensitive" refined petroleum products, WPI inflation at the end of 2012-13 should be contained within the range of 6.5 to 7.0 per cent.

External Payments

Current Account

xxi. The merchandise trade account expanded in 2011/12 to 10.2 per cent of GDP, the principal reason for the Current Account Deficit (CAD) to reach a record level of 4.2 per cent of GDP. This was the largest CAD ever; the previous highest being 3.1 per cent in 1990-91 The two principal factors that contributed to this record CAD were: (a) sharp increase in net (import less export of refined products) petroleum imports by $32 billion or by 1.7 per cent of GDP and (c) a huge expansion of net (total less gold jewellery export) gold imports by $16.6 billion or by 0.9 per cent of GDP over 2010/11. That is, between oil and gold the impact on the CAD amounted to as much as $49 billion or 2.6 percentage points of GDP. This was by itself 83 per cent of the total deterioration in the merchandise trade balance of $59 billion (3.2 per cent of GDP).

xxii. Even more interestingly, the higher value of net incremental imports of oil and gold was much larger than the total deterioration of the CAD of $32 billion or

1.7 per cent of GDP. Thus despite the sluggishness in external markets for IT related services, increase in net invisibles to a great extent succeeded in cushioning the impact of the spike in oil and gold imports on the CAD.

xxiii. In 2012/13 as a whole, the Council expects that merchandise exports on BoP basis will be about $334 billion, which is quite a bit lower than the target of $360 billion indicated by the Commerce Ministry in June 2012, but would nevertheless be 7.8 per cent more than that in 2011/12. On the import side, the assessment is that the total value of imports would on BoP basis be $515 billion (increase of 3.1 per cent), leaving a merchandise trade deficit of $181 billion or 9.7 per cent of expected GDP, some $9 billion less than that recorded in 2011/12.

xxiv. In 2011/12 export earnings from software & BPO grew very strongly by 21.2 per cent while private remittances grew by 19.5 per cent. Total of net earnings on invisibles expanded by 20 per cent. In 2012/13 a moderation in growth of service sector exports and of remittances are expected, while the large negative balance on net investment income may turn larger. Overall the net balance on invisibles is expected to grow by about $2.5 billion or 6.1 per cent of GDP. For 2012/13, the balance on net invisible is projected at $114 billion vis-à-vis the $111.6 billion in 2011/12.

xxv. The CAD projected for 2012/13 is thus $67.1 billion or 3.6 per cent of expected GDP. There is a potential upside to the CAD on account of the balances on net invisible (exports of ITES industry, remittances and tourism) to do better than has been projected. However, offsetting this is the potential of higher petroleum prices and continuance of gold imports at levels higher than projected.

Capital Account

xxvi. The surplus on the capital account in 2011/12 was $68 billion, slightly lower than the $72 billion estimated in July 2011 and again in February 2012. However, there was a compositional difference. The CAD was greater than was the balance on the capital account and there was a net drawdown of reserves amounting to nearly $13 billion.

xxvii. Some data is available for the first quarter of 2012/13, in most cases only for the first two months and in the case of FII investments up to the end of July 2012. Net FDI and FII (equity) inflows appear to have been less than that in the

corresponding quarter of last year. So also seems to have been the case of net commercial loans as well as investment in short-term credits. However, inflows into NRI deposits were much greater. Overall the net balance on capital flows is placed at $73 billion, which would be about just sufficient to service the projected CAD of $67 billion for the year as a whole. However, there are likely to be periods where the servicing needs of the CAD might run in excess of the capital flow position. In the thin market for rupee liabilities this may continue to put pressure on the exchange rate as it did last year.

xxviii. The first challenge in the management of the external account is the reduction in the magnitude of the CAD. On the import side there is urgent need to curb the domestic demand for gold by positioning financial instruments. Raising prices of refined petroleum products to match their cost of supply would encourage greater efficiency in their use and economy in demand. The fact that diesel consumption grew as rapidly as it did in 2011/12 and continues to grow strongly in the first quarter of 2012/13 is testimony in a way to the reality of the price elasticity of demand. Finally, there is need to improve the domestic supply of coal such that the imports do not happen only on account of the non-adequacy of domestic coal. The second challenge is of course to encourage and support the exports of both goods and services.

xxix. The third challenge is to improve capital inflows which are influenced by domestic investment confidence, prospect of economic growth and fiscal consolidation and upon the bedrock of policy predictability.

Fiscal Situation

xxx. Our expanding fiscal imbalance continues to be a major area of policy concern. The IMF Fiscal Monitor,April 2012, shows that among emerging market economies, India is the most stressed in terms of current borrowing needs of government, that is, the fiscal deficit. The large fiscal imbalance is an important factor contributing to the weakened investment climate in the country, as also the negative perception of foreign investors.The containment of the fiscal imbalance at the Centre is largely dependent on productively managing the subsidy bill, especially that on refined petroleum products.

xxxi. In some contrast to the Centre's finances, the fiscal health of the States isbetter. They have for the most part been able to eliminate their revenue deficits

and the aggregate fiscal deficit of the States in 2011/12 (RE) was 2.3 per cent of GDP and is budgeted to be 2.1 per cent in 2012/13, which is well within the targets set by the Finance Commission.

xxxii. The consolidated fiscal deficit of the Centre and State government for 2011/12 (RE) was 8.2 per cent of GDP. The consolidate deficit based on Budget Estimates for 2012/13 is estimated to be 7.2 per cent.

xxxiii. Introduction of the General Sales Tax on Goods & Services (GST)would be a very important milestone in the path of tax reform. The arguments for GST are based on the fact that (i) it will have a broader base and therefore, would require lower rate for generating the given amount of revenue; (ii) it will relieve the taxes on inputs and thus reduces cascading and will help to eliminate taxes on exports, (iii) it will help to create a national market by removing inter-state trade barriers; (iv) as a destination based tax, it will ensure that the revenues will accrue to the consuming state rather than producing state; and (v) the self-enforcing nature of the tax will enhance its compliance.

xxxiv. While the desirability of the tax is not in doubt, before the GST can be introduced, there is yet some ground that remains to be covered between the Centre and State governments. The issue is discussed in greater detail subsequently.

Structural factors

xxxv. Gross Domestic Fixed Capital Formation (GDFCF) as a proportion of GDP has continued to decline, falling from its highest level of 32.9 per cent in 2007/08, to 30.4 per cent in 2010/11 and as per initial estimates for 2011/12to 29.5 per cent.

xxxvi. Both in July 2010, as also in July 2011, the Council had expected that the fixed investment rate would recover. It was on this basis that the Council had projected a pick upin the pace of economic growth. However, the recovery in the fixed investment rate did not transpire and not surprisingly, the pace of economic growth was also slower.

Investment

xxxvii. Fixed investment rate has fallen from 32.9 to 30.4 per cent of GDP between 2007/08 and 2010/11, a decline of 2.5 percentage points, If we use the

preliminary estimates for 2011/12 the fall is of 3.4 percentage points. Within this, the biggest drop has come from private corporate investment which has dropped from 14.3 per cent of GDP in 2007/08 to 9.9 per cent in 2010/11, a decline of 4.4 percentage points of GDP, more than the overall decline in fixed investment. The number is probably slightly worse for 2011/12.

xxxviii. Partially offsetting the sharp fall in fixed investment by the private corporate sector is the increase by 1.8 percentage points, from 10.6 to 12.4 per cent of GDP, coming from fixed investment by households, which in India includes unincorporated businesses.

xxxix. The disposition of savings as investment in valuables – almost entirely in the form of gold – has increased dramatically. From 1.1 per cent of GDP 2007/08 to 2.8 per cent in 2011/12, a jump of 1.7 percentage points of GDP. One effect of this is that total capital formation (GDCF) has not fallen as sharply as have other ratios – going from 38.0 per cent in 2007/08 to 35.5 per cent in 2011/12, a drop of 2.5 percentage points. The other effect is to enlarge the trade and current account deficit by the same magnitude. If we look at GDCF excluding valuables, the drop is large – from 37.0 to 32.7 per cent of GDP or by 4.3 percentage points of GDP. In terms of loss in potential growth it amounts to over 1 per cent of GDP.

Savings

xl. First on account of the fiscal stimulus provided to protect the economy from the global crisis and subsequently due to spiralling subsidies, particularly that on refined petroleum products, there has been a huge increase in the negative savings of the government by as much as 2.1 percentage points of GDP between 2007/08 to 2010/11 and an estimated 3.2 percentage points of GDP up to 2011/12.

xli. The large improvement in domestic savings up to 2007/08 – from 26.5 per cent of GDP in 2001/02 to 36.8 per cent in 2007/08 – had to a great measure happened because of the progress of fiscal consolidation. Half of this gain has now been eroded by the continued fiscal stress of the past few years.

xlii. Second, margin pressures on corporates on account of rising wages and material costs, higher interest rates and difficult economic conditions, has also led a decline in the retained earnings of the private corporate sector, which dropped from 9.4 per cent of GDP in 2007/08 to 7.9 per cent in 2010/11 and may have

been at about that level in 2011/12 also. This margin pressure and consequential drop in retained earnings have made investment harder.

xliii. Third, the financial savings of the household sector has also fallen. Gross financing savings (being the increase in gross financial assets) was 15.4 per cent of GDP in 2007/08. This has fallen to 13.6 per cent in 2010/11 and possibly further to less than 12.0 per cent in 2011/12. Net of the financial liabilities incurred by households (mortgage and other personal loans) the net financial savings of households available for use by the rest of the economy fell from 11.6 per cent of GDP in 2007/08 to 10.0 per cent in 2010/11 and possibly to below 9.0 per cent in 2011/12. It should be noted that these are the lowest ratios for net financing savings in the past fifteen years.

xliv. The sharp drop in the financial savings by households is closely related to their increased disposition to allocate more of their investible resources to gold and also to direct physical assets, than to place it in the financial system. High inflation and the desire to protect the value of their savings was certainly a motivation. The problems plaguing industries that distribute financial instruments – mutual funds and life insurance – have possibly been the other factor contributing to the strange phenomenon of the weakening effect of modern financial intermediation and the reversion to more antiquated ones. This is a situation that policy must squarely address and resolve.

xlv. It is in this environment that the enlarged needs of government financing have been manifest. With the aggregate pool of financial savings shrinking, the additional needs to finance government has exacerbated matters and made the "crowding out" phenomenon particularly acute. There were of course other factors that acted as a drag on private investment, but the availability and cost of financing were certainly material.

Measures Suggested to Improve Economic Conditions

xlvi. While we were able to negotiate the global economic Crisis quite well, and saw an early recovery in domestic demand and in output, we have not been yet able to getinvestment back to the path of rapid asset creation and therefore sustainable higher growth. It is our assessment that if few immediate policy measures are taken, this will help in improving the domestic investment climate and help in raising the pace of asset creation and hence of economic growth.

Integrated decision-making on high-impact infrastructure projects

xlvii. There is a strong need for taking integrated view on clearances for high impact infrastructure projects which would enable consideration of trade-offs between various objectives like growth in jobs & incomes, sustainable development of environment resource bases, labour welfare measures, strategic objectives, etc. In case of high-impact infrastructure projects, which may be defined in terms of those having project cost in excess of a minimum threshold, say Rs 5,000 crore, a Cabinet Committee comprising of ministers in charge of concerned departments should take an integrated view. The Cabinet Committee on Infrastructure could be recast as the Cabinet Committee for Sustainable Development of Infrastructure for this purpose, and its composition as well as powers under the rules of business modified accordingly. This will not only help existing projects, but reduce the risk for future projects for potential investment in private, PPP or public modes, thereby attracting investment, reducing costs, and expediting execution.

Permitting FDI in multi-brand retail

xlviii. For channelling transfer of capital and technology, FDI in multi-brand retail up to 49 per cent may be allowed to attract investment in this sector. Such of the states as are receptive to this idea may implement this. This will improve the supply chain infrastructure for farm produce, processing businesses and related activities, and thus improve the efficiency of the supply chain, improve the terms of trade in favour of farmers and other producers, benefit the consumers, and create jobs for the educated youth, a lot of it in rural areas.

xlix. However, before coming out with the decision, its attractiveness may be ascertained with top international retailers, and it should be operationally so done that the announcement is met with investor announcements in favour of the same and filing of applications, approvals and early kick-off in some favourably inclined states.

FDI and other reforms in the Aviation sector

l. The 2005 decision of the Government to allow FDI in civil aviation to the extent of 49 per cent has not had the desired impact as foreign airlines are barred. The Indian aviation industry today has established players who have also made

their foray into international aviation and competing strongly at the national level. However, they need infusion of capital and technology to grow to the next level. Therefore, FDI in civil aviation may now be allowed to the existing extent of 49 per cent for foreign airlines as well. Given the current difficulties of the domestic airlines, which have high costs on account of taxation applicable to aviation turbine fuel, maintenance, repair & overhaul (MRO), etc., the immediate prospects for revival of the sector may depend on favourable consideration of concession on these by the Finance Ministry.

Containing petroleum products subsidies

li. Projections for petroleum product subsidy, taking average Indian basket crude price as $100 per barrel and an exchange rate per US$of Rs. 56, indicate a subsidy burden of over of Rs. 160,000 crore for the current financial year. Assuming that the cost recovery by national oil companies would remain at roughly last year's level in per barrel terms, the upstream compensation may be estimated as being of the order of around 80 per cent of that during 2011/12, i.e. Rs. 45,000 crore. This leaves a gap of about Rs. 115,000 crore, which would need to be met through budget provision.

lii. As against this, the existing budget provision is Rs. 43,580 crore. Therefore, supplementary provision of subsidy in excess of Rs. 70,000 crore would be needed, unless the level of subsidy is curtailed. Such a large subsidy provision would greatly strain the fiscal system and would also have significant adverse impact on the overall economy and eventually on inflation. Given that diesel subsidy projection for the current financial year is over Rs. 90,000 crore and that for domestic LPG is another Rs. 40,000 crore, and the two together accounts for over 80 per cent of petroleum product subsidies, priority and focus has to be on reduction of subsidy on account of both.

liii. Given this, priority consideration may be given to (i) a suitable increase in the price of diesel in one or more steps, and (ii) a cap on the level of consumption of subsidised domestic LPG close to what is currently being consumed by poorer households, i.e., 4 cylinders.

We need to focus further on the following issues :

1. **Policy predictability:** There is need to specifically focus and address the apprehensions that have been occasioned by perceptions of arbitrary actions on

tax and other fronts. Policy predictability is part of the bedrock of economic stability.

2. **Project clearance:** Significant progress has been made on this front over the last year and more perhaps needs to be done, so that investment can create new assets in infrastructure and manufacturing and allow the economy to produce in line with its huge unmet demand.

3. **Clearing payments:** Outstanding payments for infrastructure projects need to be cleared on time, as indeed has been the practice for so many years. This is particularly necessary to infuse equity into the infrastructure space and facilitate the ability of players in this area to take on more projects. It would also make the task of their financiers, namely banks, that much easier.

4. **Encouragement to investment:** In general the atmosphere must be seen as being encouraging of investment, rather than being fault-finding and antagonistic. The problem is larger than that of the attitudes within the government alone, but at least they can be sought to be remedied within the government system at least.

5. **Moving savings products:** This is an area that needs urgent redress. We have traditionally looked at government intervention in the financial space as "market development" where regulation and the expansion of the market are supposed to go hand in hand. However, over the past few years there have been serious setbacks in the distribution of savings products, especially mutual funds and life insurance. A country where income is rising, the habit of saving is well ingrained and the market is underdeveloped, such products should show strong sales growth, as indeed they had till 2009/10. One of the many positive results of this was that domestic financial institutions (DFI) came to be as important a player in our capital markets, as were the Foreign Institutional Investors (FII). However, sales of mutual fund products, especially to smaller investors and premium growth for new private sector life insurance companies have been negative. The jump in demand for gold as an investment vehicle is closely related to this setback in market development.

6. **Containing inflation:** The historical evidence clearly shows that stable high growth does not sit well with high inflation. High rates of inflation eventually

erode profits and adversely impact external payments, as indeed has been the case with us. Our particular problem has much to do with the high inflation in primary food which is mostly linked to the antiquated system of marketing and absence of modern handling and storage facilities for perishable products. It is to a lesser extent also a product of the large increases in minimum support price (MSP) that have been given effect to and the fact that procurement price and MSP have become conflated.

7. **Improving the CAD:** Lowering the magnitude of the CAD is of great importance. Given that net oil imports and gold have been the two fastest growing components of the import bill, and that these are not normal commodities where import demand could be compressed through depreciation of the currency, the task of improving the CAD is harder. In the case of oil, the sharp increase in domestic demand, especially that of diesel, clearly offers some amelioration through price reform which could serve to contain demand. In the case of gold, a quantum improvement in the regulatory context in which mutual funds and life insurance products are sold is of the utmost importance. The IT-related export business, which has done yeoman service to enlarging India's external earnings as also to provide hundreds of thousands of quality jobs to young people, also feel that significant improvement in the approach of government to a number of issues would make them much more competitive. These must be attended to.

ECONOMIC OUTLOOK 2012/13

FULL REPORT

I. ECONOMIC PERFORMANCE AND GROWTH OUTLOOK

Understanding the performance in 2011/12

1. The economic performance in 2011/12 has turned out to be much below expectations. In July 2011 the Council had assessed that growth in the year would be 8.2 per cent, slightly less than that in 2010/11. However, while the first quarter (Apr–Jun 2011) more or less followed the expected trajectory, output slowed down sharply in the subsequent quarters. The Council in its Review released in February 2012, expected that there would be a small improvement in the fourth quarter. Instead the initial estimates place performance in that quarter at the one of the lowest in the past many years. The revised data for 2011/12 released by the Central Statistical Organization (CSO) at the end of May 2012 place growth in 2011/12 at 6.5 per cent – lower than even that registered in the crisis year of 2008/09. The Council has some reservations, about the preliminary estimates for 2011/12, particularly that for the fourth quarter, that are discussed subsequently. However, there is no doubt that the overall performance in 2011/12 was not only surprisingly disappointing, but of special concern was that the declining trend in fixed investment continued to be reinforced.

2. The estimate made by the Council in July 2011 regarding output increase in the farm sector was 3.0 per cent in 2011/12. The revised estimate of May 2012 places this at 2.8 per cent. But it is likely that with fourth advance estimates released subsequently and other updates the final figure may be closer to the 3.0 per cent level.

3. Output increase in the mining & quarrying sector had been placed by the Council at 6.0 per cent in July 2011. This expectation was belied by the continued decline in the production of natural gas from offshore fields in the Krishna–Godavari (KG) basin apparently due to unexpected technical setbacks. This was compounded by large declines in coal output (on a relatively flat base in 2010/11 in which output growth had been a mere 0.2 per cent) up to October 2011, subsequent to which there was a commendable recovery in output trends. In consequence the

increase in GDP arising in that sector for 2011/12 turned out to be (–) 0.9 per cent. However, the sector has a relatively small weight in respect to the computation of GDP, and the departure from expectations made an impact of less than 0.15 percentage points to the growth of GDP. However, in sharp contrast the shortfall in domestic output had a greatly amplified impact on the economy in general on account of the large difference between domestic and import prices.

4. The principal reason for pushing the economy down flowed from the manufacturing sector. Till the data from the Annual Survey of Industries (ASI) is available – which is available after seven quarters after the end of the financial year and is factored in the next quarter – the estimates of manufacturing output are drawn from the Index of Industrial Production (IIP), adjusted for differences in the weighting diagram as between the National Account Statistics (NAS) and the IIP. The manufacturing component of IIP is estimated to grow at 3.0 per cent in 2011/12 as compared to 8.9 per cent in the previous year.

5. The data item that stands out as an anomaly, in relation to that on manufacturing output, is that on generation of electricity, which averaged growth of 8.2 per cent in 2011/12 and 8.2, 10.5 and 9.6 per cent in the first three quarters of the year, although fourth quarter growth slowed to 4.5 per cent. There is little reason to believe that additional power generation by utilities resulted in a significant substitution of (the much more expensive) diesel based captive power. Diesel consumption growth in 2011/12 averaged 8.2 per cent; in the first three quarters it was 7.1 per cent and 9.9 per cent in the fourth quarter. Incidentally diesel consumption is a good reflection of transportation activity, which too therefore makes it also a bit of an anomaly. Motor spirit (gasoline) consumption in 2011/12 also averaged 5.6 per cent – so, if the query were to be raised, then, no the high growth of diesel consumption was not because of a substitution away from motor spirit. Anyway the volume of diesel consumption is 4.3 times that of motor spirit.

6. Manufacturing IIP growth of 3.0 per cent in 2011/12 is one of the lowest in the past two decades. In the crisis year of 2008/09 it had been lower at 2.5 per cent and in the gloomy tension-ridden year of 2001/02 it was 2.9 per cent. Although manufacturing (base year 2004/05) has a weight only marginally more than 15 per cent it is used to validate some of the estimates in the services sector and therefore

if the IIP (manufacturing) yields a low estimate for growth, not only has it a profound (and rightly so) impact on perceptions about the larger economy, but it also has an amplified impact on the estimation of the domestic product.

7. The May 2012 estimate of CSO placed GDP growth arising in manufacturing at 2.5 per cent. The direct impact of the large departure of the trajectory of manufacturing growth from the Council's July 2011 estimate of 7.0 per cent and the eventual estimate of 2.5 per cent amounted to 0.67 per cent of GDP. The effect of such a low manufacturing growth on estimates in the services sector caused the impact to be considerably larger – both as a logical corollary and as a computational outcome. Of course if the manufacturing estimate was for some reason lower than what it should have been, the flaw, would likewise, also be amplified.

8. In any case, the locus of the slower growth in the economy in 2011/12 lay squarely in the industrial sector (mining, manufacturing and construction) and in particular in the manufacturing sector. Within the manufacturing sector, the three components that stand out for the extent of decline are (a) capital goods – electrical and non-electrical machinery; (b) textiles and to some extent apparels, and (c) chemicals and products thereof. Electrical machinery suffered average deceleration of 16 per cent and non-electrical machinery of 5 per cent. Textile output was lower by 1 per cent and chemicals by 0.3 per cent. In the second half of 2011/12 the numbers for capital goods was worse, with deceleration of 33 per cent for electrical machinery and 7 per cent for non-electrical equipment.

9. The inferences that unambiguously emerge – no matter what deficiencies the IIP data may suffer from – is that (a) investment demand has become a source of serious concern; (b) the textile industry where we should have a comparative advantage has industry-specific problems and (c) weak domestic demand and output seem to characterize even areas such as durable consumer goods and non-durables such as apparel. Clearly policy needs to take explicit cognizance of these elements in search of the solution for the restoration of the economy to a higher growth path.

10. The weak performance in the investment sector is also reflected in the NAS, where we can observe that the fixed investment rate has continued to slip to 29.5 per cent from 30.4 per cent in the previous year, much below the level of nearly 33 per cent in 2007/08 pre-crisis. Most of this decline is on account of a large decline

in investment by the private corporate sector – from above 14 per cent of GDP in 2007/08 to less than 10 per cent. This source of capital formation has been closely tied with asset creation in physical infrastructure and expansion in manufacturing capacity. This is matched by information on the weakening in the flow of new investment projects both in infrastructure and manufacturing.

11. There are various reasons for this and some of them are touched upon subsequently. The fact is that over the past several years, there has been significant investment and expansion in the capacity of the economy to build new capital assets – be it power plants, chemical plants or large infrastructure projects. Shifting the direction of the economy in a direction that encourages investment will be able to catalyze all of this accumulation of capabilities and experience in a manner that can return the economy to a path of more rapid growth.

Estimates for 2012/13

12. The available data on output for the month of April and May 2012 do not show significant improvement. The IIP for manufacturing came in at (–) 1.2 and 2.5 per cent for these two months. However, we do know that electricity generation has continued to grow and the rate in the first quarter (Apr–June) 2012 was 6.4 per cent, with most of the growth coming from thermal coal-based and lignite-based plants which recorded growth of 13.6 and 18.5 per cent respectively. This more than compensated for the fairly large declines in gas-based and hydro power generation.

13. We also know that in the important automotive sector, production of passenger vehicles in the first quarter was higher by 9.4 per cent (domestic sales by 9.7 per cent), while that of two wheelers increased by 9.7 per cent (domestic sales by 10.5 per cent). However, medium and heavy commercial vehicles, saw a decline of 21 per cent though the slump in domestic sales (12 per cent) was less pronounced

14. Output of steel and cement in the April–June period also were higher by 3.6 and 9.9 per cent respectively, which is not suggestive of extended stagnation. Petroleum refining throughout was higher by 3.2 per cent, with June output showing an increase of 6.1 per cent.

15. It may be recalled that manufacturing growth in the first quarter of 2011/12 was fairly robust (IIP 7.7 per cent and GDP 7.3 per cent). The weak IIP data for

Table 1: GDP Growth - Actual & Projected

At constant 2004/05 prices

	ANNUAL RATES	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
		Year-on-year rates of growth in per cent							
					P	*QE*	*Rev*	*Pro.j.*	
1	Agriculture & allied activities	5.1	4.2	5.8	0.1	1.0	7.0	2.8	0.5
2	Mining & Quarrying	1.3	7.5	3.7	2.1	6.3	5.0	–0.9	4.4
3	Manufacturing	10.1	14.3	10.3	4.3	9.7	7.6	2.5	4.5
4	Electricity, Gas & Water Supply	7.1	9.3	8.3	4.6	6.3	3.0	7.9	8.0
5	Construction	12.8	10.3	10.8	5.3	7.0	8.0	5.3	6.5
6	Trade, Hotels, Transport, Storage & Communication	12.0	11.6	10.9	7.5	10.3	11.1	9.9	9.3
7	Finance, insurance, real estate & business services	12.6	14.0	12.0	12.0	9.4	10.4	9.6	9.5
8	Community & personal services	7.1	2.8	6.9	12.5	12.0	4.5	5.8	7.0
9	**Gross Domestic Product (factor cost)**	**9.5**	**9.6**	**9.3**	**6.7**	**8.4**	**8.4**	**6.5**	**6.7**
10	Industry (2+3+4+5)	9.7	12.2	9.7	4.4	8.4	7.2	3.4	5.3
11	Services (6+7+8)	10.9	10.1	10.3	10.0	10.5	9.3	8.9	8.9
12	Non-agriculture (9–1)	10.5	10.8	10.1	8.1	9.8	8.6	7.1	7.7
13	**GDP (factor cost) per capita**	**7.8**	**8.0**	**7.8**	**5.2**	**6.9**	**6.9**	**5.1**	**5.3**
14	GDP at factor cost - 2004/05 prices in Rs lakh crore (or Trillion)	32.5	35.6	39.0	41.6	45.1	48.9	52.0	55.5
15	GDP market & current prices in Rs lakh crore (or Trillion)	36.9	42.9	49.9	56.3	64.6	76.7	88.6	100.8
16	GDP at market & current prices in US$ Billion	834	949	1,241	1,234	1,365	1,687	1,853	1,868
17	Population in Million	1,106	1,122	1,138	1,154	1,170	1,186	1,202	1,218
18	GDP at market prices per capita at current prices	33,394	38,277	43,823	48,787	55,191	64,706	73,676	82,727
19	GDP at market prices per capita in US$	754	846	1,090	1,069	1,167	1,422	1,541	1,534

April–May and possibly June too, must be seen in this light. In the second quarter last year there had been a sharp weakening (IIP 3.4 per cent and GDP 2.9 per cent). In the third and fourth quarters of 2011/12 it slid further towards zero. It is the view of the Council that if nothing else, the low growth of 2011/12 will lend itself to positive base effects in 2012/13.

16. Further, the impact of positive policy developments in the course of the year is expected to benefit the economy, in particular the investment environment, and result in significantly improved output levels in the manufacturing sector.

17. On this understanding the Council is of the opinion that while both output and GDP data for Q1 (Apr–Jun) of 2012/13 may continue to be disappointingly weak, significant improvement is expected to materialize in second quarter and sequentially develop through the third and fourth quarters of the year.

18. The South West (SW) monsoon 2012 has turned out to be weak. The accumulated departure from the long period average (LPA) for the country as a whole was 19 per cent as on 1 August 2012. As many as 18 of the 36 meteorological sub divisions were 'deficient' and in 4 the situation was more acute (i.e. 'scanty').

19. In the current year, the rainfall has been better in the month of July with the shortfall for the month at 10 per cent. Moreover there is pronounced geographical difference. The position in most of the eastern states (East Uttar Pradesh, Bihar, Jharkhand, West Bengal and North East), in much of the eastern peninsula (Coastal Andhra, Rayalseema and Telengana) and central regions (East Rajasthan, East & West Madhya Pradesh, Chhattisgarh and Vidharbha) rainfall in July has been normal in all, and heavy in some. On the contrary the situation in the western peninsula (all of Karnataka, Madhya Maharashtra, Marathawada, Saurashtra & Kutch, Gujarat) and the northern states (West Rajasthan, Haryana, Punjab and Himachal) has been severely deficient – coming on top of poor June rains. A sizeable part of the country thus seems to be headed for a particularly weak monsoon and the impact on agriculture in these areas, especially in those regions where irrigation facilities are not there or are weak, is likely to be negative. The reservoir storage position as on 2 August 2012 show that water levels are 19 per cent below the average of the last ten years, with the situation being particularly grave in the large reservoirs on the river Krishna.

20. The Council expects to see a fall in foodgrain output especially in the *kharif* season and also possible decline in some commercial crops, particularly cotton and sugarcane. However, output of horticulture and products of animal husbandry are unlikely to be negatively impacted. In may be recollected that in 2009/10 – the worst SW monsoon in 28 years – the GDP arising from the farm sector registered positive growth of 1 per cent. In 2012/13, the Council is of the view that while there may be output losses on account of the weak SW monsoon, overall farm sector GDP would register positive growth of around 0.5 per cent.

21. In the mining & quarrying sector, the Council expects a recovery. Even as there is a possibility that natural gas output may fall a bit below that of even the current depressed level of 123.2 million metric standard cubic metres per day (mmscmd), there is on the other hand likely to be some increase in domestic output of crude oil and considerable improvement in coal production. Coal output was higher by 3.8, 8.0 and 7.2 per cent in April, May and June 2012 respectively. The public sector companies recorded an increase of about 8 per cent in July, and for the year as a whole the increase in output should be of the order of 7 per cent. Some recovery in iron ore raisings is also expected, especially in the second half of the year. However, growth in this sector for the first quarter of 2012/13 may turn out to be negative on account of sharp declines in natural gas and small declines in crude oil. However, natural gas should bottom out towards the end of the second quarter and some improvement in crude oil should begin to kick in. With growth in the coal and lignite sector, and some recovery in iron ore, the projected growth in mining for the year as a whole is expected to be 4.4 per cent.

22. In manufacturing, output increase is expected to be about 5.0 per cent for the year as a whole, the increase is beginning to surface in the second quarter, with a strong showing in the third and fourth quarters. This should translate to an increase in the GDP arising in manufacturing of 4.5 per cent. This estimate is discussed in some more detail subsequently.

23. Electricity generation is expected to continue to grow at an average pace of around 8 per cent. Construction is expected to show some improvement compared to last year as evidenced by the recent increase in the output of cement and steel. So also the services sector, in particular the large transport, trade, communications sector.

24. Overall for the economy, the Council thus assesses that an average growth of 6.7 per cent in 2012/13 can be realistically expected. While agriculture growth rate will be lower than the last year, there can be a distinct improvement in the performance of the mining sector and a moderate improvement in the manufacturing sector. The estimated growth rate has several clear upsides, as also some downsides. The upsides are of a faster improvement in business and investment confidence on account of proactive policy and administrative action. The downside flows from a sudden and rapid deterioration in the international economic environment and also unexpected setbacks in delivering the domestic policy and administrative action.

25. It should be mentioned that most private sector estimates of growth in the Indian economy for 2012/13 is around 6 per cent. The IMF projections made in the WEO Update of July 2012 place growth in India for 2012 at 6.1 per cent and that for 2013 at 6.5 per cent. These are for the respective calendar year and also for GDP at market prices, not factor cost. The calendar year equivalent of the Council's estimate for 2012 is slightly higher than that of the IMF.

Global Situation

26. There is a dark mood in the advanced economies, especially in Europe. Between 2008 and 2011, the US and the Eurozone economies have virtually stagnated – even in nominal terms. The US economy is certainly picking up, but the recovery is weaker than had been expected. The problems inherent in the European monetary union and fiscally overweight governments were prised open by the Crisis. Though matters appear to have been patched up for the moment, it is clear that it may take several years for the Eurozone economy to return to health.

27. The IMF *World Economic Outlook* of April 2012 continues to emphasize the downside risks that can emerge, primarily from the Eurozone. The European Central Bank (ECB) has provided large amount of finance to the banking system through the Longer Term Refinancing Operations (LTRO) and together with the IMF appears to have constructed a "firewall" in excess of $1 trillion. The actual number is not as material as is the explicit determination to intervene on such a large scale. This offsets the potential risks that emanate from deleveraging of an estimated $2.6 trillion mostly by European banks. Many kinds of adaptive changes that limit damage can reasonably be expected to transpire. However, the Eurozone problems are likely to continue to be a problem for some years to come and further

from time to time, bad news out of the Eurozone can have – even if temporary – disproportionately large negative effects on the global financial world and ultimately on investor and business confidence.

28. In the US, there are clear signs that the economy is on the mend. The IMF has raised its growth estimate for 2012 to 2.1 per cent. Thereafter the advance estimates for GDP for June 2012 ending quarter came in at a disappointing 1.5 per cent tempering the perception of the recovery. Going forward, conditions are likely to improve in 2013. However, the US has the problem of adopting an internally consistent and non-disruptive path for fiscal consolidation, including the so-called "fiscal cliff" on account of lapsing legislation by the end of 2012 and normalizing its extended monetary stance.

29. The main concern however, should be about shocks – not persistent weakness in these economies. The shocks are not likely to happen because: (a) In the Eurozone, the direction that member countries under the leadership of Germany and France have taken, are expressly designed to keep things on hold for the next few years; (b) The large amount of liquidity that has been created by the US Federal Reserve, and more recently by the ECB, should prevent the financial system from entering into a shock – which is inevitably mediated by a sudden drying up of liquidity.

30. How will these conditions in the USA and in the Eurozone affect India? First, the slower growth in the US and in the EU will have an adverse impact on the expansion of these markets for our exports, both of goods and services. This conclusion should be qualified slightly. While western government finances and consumers are under some pressure, most companies, especially in America are profitable. They will continue to try and use IT to push productivity up and keep costs down. That will to an extent help with Indian IT-related businesses.

31. Second, and more materially, conditions in the EU have impacted, and will continue to negatively impact Eurozone bank financing, which has been significant for Indian private sector infrastructure projects. This is likely to influence bank lending from other sources as well, which is reflected by the increase in credit spreads for Indian borrowing.

32. Asia will be under pressure for the most part because of pressure on its final export markets in the West, and also from domestic factors including demand for

higher wages and the rising burden of energy costs. China has slowed somewhat and there may be continued difficulties in its path, as adjustments have to be made for rising wage costs and higher expectations. However, economic growth in China projected at 8.0 and 8.5 per cent in 2012 ands 2013 respectively, and that for the rest of developing East and South East Asia, as well as that in Africa, suggest that developing economy demand will remain reasonably buoyant. This may be seen from the IMF growth projections for the developing Asia, excluding China and India, for 2012 and 2013 which are 5.0 and 5.7 per cent respectively, while that for sub-Saharan Africa are around 5.4 per cent.

Energy & Commodity Prices

33. Oil consumption in OECD countries has seen a steady decline over the years. In the six year period (2005 to 2011) oil demand in the OECD region fell by 4.2 million barrels per day (mbpd), which was a contribution of minus 82 per cent vis-à-vis the aggregate increase in net global demand in the period of 5.1 mbpd. China accounted for 53 per cent of the net increase in total world demand. With domestic private consumption likely to go up further, it is likely that China will continue to be the main source of incremental demand for oil. Over the same period India accounted for 18 per cent of net incremental global oil demand, but this was well behind the Middle East, where oil consumption boosted by higher domestic incomes fuelled by higher oil prices, has accounted for 37 per cent of the net incremental oil demand.

34. Economic growth in emerging economies and the resultant higher oil demand will continue to offset the declines in oil consumption in OECD countries, as it has in the past six years. Thus there will continue to be steady upward pressure on crude oil prices. The world crude oil market is highly cartelized on account of: (a) 81 per cent of reserves being located in OPEC countries, (b) which proportionately account for a much lower share of output, namely 40 per cent, (c) all of the spare production capacity being in OPEC countries, mostly Saudi Arabia, and (d) most non-OPEC oil sources also being the costliest to produce.

35. Other fuel markets – natural gas and coal – are not as deeply cartelized as is the case for oil. However, increase in oil prices will eventually lift prices of other fossil fuels. Therefore, energy pricing policies must be shaped by the expectation that fossil fuel prices will continue to rise at a pace faster than other prices.

36. The FAO food price index fell a bit in June 2012 and stood at 15.4 per cent below that of its peak value registered in February 2011. The cereal price index was 16.8 per cent below the previous peak recorded in April 2011. However there are concerns on account of weather related events in the US, poorer than expected harvests in Russia and of course the weaker SW monsoon in India. Although world food prices are off the highs of 2011, they remain high and therefore vulnerable to the kind of upward spike that happened after July 2010, as also after June 2007.

37. World gold price in mid-2007, before the early signs of the global financial crisis started showing up, was barely $670 per ounce (oz). Since then it has steadily increased – except for some months in the depths of the crisis – to $1,900 per oz in September 2011. Since then it has steadily come down. After recovering to $1,700 in February and March 2012, it has moved to around $1,550–1,625 per oz, where it stands at present. The rush to gold – and to an extent that to other commodities – is a response to the desire to hedge against currency risk and also as a response to the record low interest rates and hence yields on bonds. The monetary environment has also encouraged leveraged positions, which has helped to run up prices and impart exceptional volatility in the prices of commodities.

38. Rising gold prices in combination with high domestic inflation and shortcomings in the marketing of financial savings instruments and on account of poor returns in equity markets had over the past couple of years resulted in a huge increase in the import of gold into India for investment use. This factor has contributed to a great extent to the worsening of the external payments situation and the availability of financing savings for productive use at home. This entire issue in all of its dimensions has to be squarely addressed by policy.

Domestic Inflation

39. Inflation at home remains high at 7.3 per cent in June and is likely to be around 7.0 per cent in July 2012. This is lower than that in the same month of last year. However, for more than three years in a row, we have had unacceptably high rates of inflation. The current bout of inflation is now already into its 32nd month. Although the headline rate (WPI) has dropped from the double-digit level and 7 per cent is significantly lower than 9 or 10 per cent, the fact remains that the present level of inflation has to come down, in order to allow for stable conditions for healthy investment climate and equitable economic growth.

40. The particular difficulty with dealing with the persistence of domestic inflation has been the steep increase in the prices of primary food. In the initial period up to March 2010, following on the record poor monsoon of 2009 there was a spurt in the prices of rice and wheat, which was contained through open market intervention. Inadequate output also resulted in a sharp increase in the prices of pulses. Thereafter the increase in primary food prices has been driven for the most part by vegetables, fruit, milk, meat and other perishable goods. There has been significant output increase in vegetables, fruit, milk and other products of animal husbandry. The sharp rise in their prices speaks of the shortcomings in the supply chain that result in a lot of wastage and unjustifiably high mark ups. As a result of this both the consumer and the producer suffer.

41. Manufactured goods inflation in the period up to March 2010 was subdued. However, thereafter it picked up influenced possibly by rising wage costs, as well as that of other inputs and remained elevated after April 2010 and December 2011, picking up especially after March 2011. The rate of inflation for manufactured goods has dropped somewhat since January 2012 and is now around 5 per cent. The rate for manufactured goods excluding manufactured food items (which is more directly influenced by primary farm product prices) has also come down to below 5 per cent in the most recent two months. However, the fact remains that the huge subsidies being given to petroleum products, especially to diesel, has the effect of suppressing inflation at least in the short run.

42. The Reserve Bank of India (RBI) in its April 2012 monetary policy statement placed WPI inflation at 6.5 per cent in March 2013, which it has since revised up to 7.0 per cent at the end of July 2012. The year-to-date inflation up to the end of July would be about 2.5 per cent, while that of primary food may be about 8 per cent. It is more likely than not that food prices will continue to remain under pressure this year, especially because of the poor SW monsoon and the combination of output losses and expectations that is likely to result. Cumulative inflation in manufactured goods at the end of July 2012 is most likely to have been around 1.7 per cent – which given the loss in the external value of the rupee and the consequential increase in import prices is possible evidence of some weakness in domestic demand and therefore of also pricing power of producers. For the year as a whole and factoring in some movement in the prices of "sensitive" refined petroleum products, WPI inflation at the end of 2012-13 should be contained within the range of 6.5 to 7.0 per cent.

External Payments

43. The merchandise trade account expanded in 2011/12 to 10.2 per cent of GDP, the principal reason for the Current Account Deficit (CAD) to reach a record level of 4.2 per cent of GDP. This was the largest CAD ever; the previous highest being 3.1 per cent in 1990-91 The two principal factors that contributed to this record CAD were: (a) sharp increase in net (import less export of refined products) petroleum imports by $32 billion or by 1.7 per cent of GDP and (c) a huge expansion of net (total less gold jewellery export) gold imports by $16.6 billion or by 0.9 per cent of GDP over 2010/11. That is, between oil and gold the impact on the CAD amounted to as much as $49 billion or 2.6 percentage points of GDP. This was by itself 83 per cent of the total deterioration in the merchandise trade balance of $59 billion (3.2 per cent of GDP).

44. Even more interestingly, the higher value of net incremental imports of oil and gold was much larger than the total deterioration of the CAD of $32 billion or 1.7 per cent of GDP. Thus despite the sluggishness in external markets for IT related services, increase in net invisibles to a great extent succeeded in cushioning the impact of the spike in oil and gold imports on the CAD. The growth in IT-related service exports plus private remittances was 20 per cent in 2011/12, which though less than the 35+ per cent recorded in some years prior to the crisis, was quite strong even going by the historical record.

45. Capital flows had over the years increased substantially, enabling the economy to live with a higher CAD, if necessary. Up to the crisis year of 2008/09, the capital flows were well in excess of the CAD, resulting in accumulation of foreign currency assets with the RBI. For the first time in 2008/09, when capital flows were understandably badly affected, the CAD could not be financed from the capital inflows and there was a sizeable drawdown of the reserves. The modest recovery in capital inflows in subsequent years to 3.5 to 4.0 per cent of GDP was adequate to finance the CAD, which though elevated did not exceed 2.8 per cent of GDP. That changed in 2011/12, with the CAD experiencing a large expansion with capital flows remaining at 3.7 per cent of GDP. In particular in the third and fourth quarters of 2011/12, the capital flows were quite insufficient to finance the CAD.

46. The first challenge in the management of the external account is the reduction in the magnitude of the CAD. On the import side there is urgent need to curb the

domestic demand for gold by positioning financial instruments that have in years past satisfied in considerable measure this investment demand. Raising prices of refined petroleum products to match their cost of supply would encourage greater efficiency in their use and economy in demand. The fact that diesel consumption grew as rapidly as it did in 2011/12 and continues to grow strongly in the first quarter of 2012/13 is testimony in a way to the reality of the price elasticity of demand. Finally, there is need to improve the domestic supply of coal such that the imports do not happen only on account of the non-adequacy of domestic coal. The second challenge is of course to encourage and support the exports of both goods and services.

47. The third challenge is to improve capital inflows which are influenced by domestic investment confidence, prospect of economic growth and fiscal consolidation and upon the bedrock of policy predictability.

Fiscal Situation

48. Our expanding fiscal imbalance continues to be a major area of policy concern. Besides claiming substantial portion of the revenues for interest payments, government borrowings have pre-empted substantial proportion of financial savings for funding public consumption and has constrained the space for calibrating monetary policy. The IMF *Fiscal Monitor*, April 2012, shows that among emerging market economies, India is the most stressed in terms of current borrowing needs of government, that is, the fiscal deficit. The large fiscal imbalance is an important factor contributing to the weakened investment climate in the country, as also the negative perception of foreign investors. The containment of the fiscal imbalance at the Centre is largely dependent on productively managing the subsidy bill, especially that on refined petroleum products.

49. In some contrast to the Centre's finances, the fiscal health of the States is better. They have for the most part been able to eliminate their revenue deficits and the aggregate fiscal deficit of the States in 2011/12 (RE) was 2.3 per cent of GDP and is budgeted to be 2.1 per cent in 2012/13, which is well within the targets set by the Finance Commission. There are certain States however, which continue to run substantial revenue and fiscal deficits, namely West Bengal, Punjab and Kerala.

50. The consolidated fiscal deficit of the Centre and State government for 2011/12 (RE) was 8.2 per cent of GDP. The consolidated deficit based on Budget Estimates for 2012/13 is estimated to be 7.2 per cent.

51. Introduction of the General Sales Tax on Goods & Services (GST) would be a very important milestone in the path of tax reform. The arguments for GST are based on the fact that (i) it will have a broader base and therefore, would require lower rate for generating the given amount of revenue; (ii) it will relieve the taxes on inputs and thus reduces cascading and will help to eliminate taxes on exports; (iii) it will help to create a national market by removing inter-state trade barriers; (iv) as a destination based tax, it will ensure that the revenues will accrue to the consuming state rather than producing state; and (v) the self-enforcing nature of the tax will enhance its compliance.

52. While the desirability of the tax is not in doubt, before the GST can be introduced, there is yet some ground that remains to be covered between the Centre and State governments. The issue is discussed in greater detail subsequently.

MEASURES SUGGESTED TO IMPROVE ECONOMIC CONDITIONS

Integrated decision-making on high-impact infrastructure projects

53. Currently, clearances for projects are being taken in ministerial silos. In case of high-impact infrastructure projects, an integrated view needs to be taken, which would enable consideration of trade-offs between various objectives like growth in jobs & incomes, sustainable development of environmental resource bases, labour welfare measures, strategic objectives, etc.

54. In case of such projects, which may be defined in terms of those having project cost in excess of a minimum threshold, say Rs 5,000 crore, a Cabinet Committee comprising of ministers in charge of concerned departments should take an integrated view, and in case the benefits and strategic interests substantially outweigh other considerations, they should be competent to permit departures from extant policies, rules, directives etc.

55. The *Cabinet Committee on Infrastructure* could be recast as the Cabinet Committee for Sustainable Development of Infrastructure for this purpose, and its composition as well as powers under the rules of business modified accordingly. This will not only help existing projects, but reduce the risk for future projects for

potential investment in private, PPP or public modes, thereby attracting investment, reducing costs, and expediting execution.

Permitting FDI in multi-brand retail

56. FDI is an important mechanism for channelling transfer of capital and technology and thus an important factor in promoting economic growth. At present, 100 per cent FDI in single-brand retail is allowed, whereas FDI is not allowed in multi-brand retail. FDI in multi-brand retail may serve to attract investment in and improve the supply chain infrastructure for farm produce, farm produce processing businesses and related activities, and thus improve the efficiency of the supply chain, improve the terms of trade in favour of farmers and other producers, benefit the consumers, and create jobs for the educated youth, a lot of it in rural areas.

57. Keeping in view the apprehensions against FDI in multi-brand retail, to begin with FDI up to 49 per cent may be allowed in this sector. Such of the states as are receptive to this idea may implement this. However, before coming out with the decision, its attractiveness may be ascertained with top international retailers, and it should be operationally so done that the announcement is met with investor announcements in favour of the same and filing of applications, approvals and early kick-off in some favourably inclined states. Though the quantum of investment that may be forthcoming immediately may not be large, permitting FDI in multi-brand retail will help send the right signals on the commitment of the Government to take the reform process forward.

FDI and other reforms in the Aviation sector

58. The 2005 decision of the Government to allow FDI in civil aviation to the extent of 49 per cent has not had the desired impact as foreign airlines are barred. The Indian aviation industry today has established players who have also made their foray into international aviation and are competing strongly at the national level. However, they need infusion of capital and technology to grow to the next level. Therefore, FDI in civil aviation may now be allowed to the existing extent of 49 per cent for foreign airlines as well. Given the current difficulties of the domestic airlines, which have high costs on account of taxation applicable to aviation turbine fuel, maintenance, repair & overhaul (MRO), etc., the immediate prospects for revival of the sector may depend on favourable consideration of concession on these by the Finance Ministry.

Containing petroleum products subsidies

59. Projections for petroleum product subsidy, taking average Indian basket crude price as $100 per barrel and an exchange rate per US$ of Rs. 56, indicate a subsidy burden of over Rs. 160,000 crore for the current financial year. Assuming that the cost recovery by national oil companies would remain at roughly last year's level in per barrel terms, the upstream compensation may be estimated as being of the order of around 80 per cent of that during 2011/12, i.e. Rs. 45,000 crore. This leaves a gap of about Rs. 115,000 crore, which would need to be met through budget provision.

60. As against this, the existing budget provision is Rs. 43,580 crore. Therefore, supplementary provision of subsidy in excess of Rs. 70,000 crore would be needed, unless the level of subsidy is curtailed. Such a large subsidy provision would greatly strain the fiscal system and would also have significant adverse impact on the overall economy and eventually on inflation. Given that diesel subsidy projection for the current financial year is over Rs. 90,000 crore and that for domestic LPG is another Rs. 40,000 crore, and the two together accounts for over 80 per cent of petroleum product subsidies, priority and focus has to be on reduction of subsidy on account of both.

61. The extent of under-recovery in diesel is Rs. 12.13 per litre and the subsidy per domestic LPG cylinder is Rs. 231 as on 1 August 2012. A Re 1 increase in diesel price would result in a subsidy reduction of about Rs. 7,800 crore. In addition to a suitable hike in diesel price, domestic LPG subsidy can be cut substantially if the number of cylinder refills is capped at a level of consumption close to that of poorer households. 29 per cent of LPG subscriber households use up to 4 cylinder refills annually, and if a cap for subsidised LPG refills is kept at this level, the corresponding reduction in subsidy would be roughly Rs. 18,000 crore.

62. Given this, priority consideration may be given to (i) a suitable increase in the price of diesel in one or more steps, and (ii) a cap on the level of consumption of subsidised domestic LPG close to what is currently being consumed by poorer households, i.e., 4 cylinders.

II. INTERNATIONAL ECONOMIC AND FINANCIAL CONDITIONS

63. Ever since October 2009, the Eurozone has been continually plagued by troubles that originated from the unexpectable book-keeping by the government in Greece which had grossly understated the desperate condition of its finances. Over the next two and a half years, the problems of the Mediterranean member countries of the Eurozone has aggravated, necessitating endless adjustment and enhanced commitments by its stronger members, mostly Germany.

64. Eurozone countries seem to have signed up for a coordinated move towards a fiscal union. It is unclear whether in the final analysis this fiscal union will indeed materialise. However, it would seem that notwithstanding reservations, amongst the stronger countries who would be obligated to transfer fiscal resources to the weaker ones, the Eurozone is likely to tread this path for the next few years. The hope undoubtedly is that this will give breathing space to two major Eurozone economies that are too large to be bailed out, namely Italy and Spain, to stabilize their finances.

65. Economic growth in the Eurozone has taken something of a backseat for the moment, notwithstanding the policies to "stimulate growth" that some member countries, especially France, have been seeking to institute. The IMF now puts Eurozone growth at (–) 0.3 per cent in 2012, with prospects of only a weak recovery of 0.7 per cent in 2013. Considering that in the first quarter of 2012, the Eurozone had registered zero growth, the expectation clearly is that conditions have worsened in the second quarter and would continue on that trajectory in the remaining three quarters. The British economy for its part had recorded positive growth in the first quarter but slipped to (–) 0.7 per cent in the second.

66. In the United States, the economic recovery has been weaker than had been projected by both the administration and by market participants. However, there are now signs that the economy is on the mend. The IMF has raised its growth estimate for 2012 to 2.0 per cent and for 2013 to 2.3 per cent. However, the

advance estimate for the quarter ending June 2012 places growth in the quarter at 1.5 per cent indicating the weakness of the recovery that is underway. On the positive side, American companies are sitting on cash and are well positioned to invest, while banks have cleaned up their balance sheets. There are also signs of increased hiring. However, the US will continue to have the problem of adopting an internally consistent and non-disruptive path for fiscal consolidation and for rolling back the extended monetary stance of easy money.

67. It is possible that the unprecedented extended easy monetary stance in the US and in the EU, which may continue for some years, may create problems for others, as indeed has been the case particularly in respect of commodity prices. However, the main concern is about shocks – not persistent weakness in the advanced economies. The shocks are not likely to happen because: (a) In the Eurozone, the direction that member countries, under the leadership of Germany and France, have taken, are expressly designed to keep things on hold for the next few years; (b) The large amount of liquidity that has been created by the US Federal Reserve, and more recently by the ECB, is positioned to prevent the financial system from entering into a shock.

68. How will these conditions in the USA and in the Eurozone affect us? First, the slower growth in the US and in the EU will have an adverse impact on expansion of these markets for our exports – of both goods and services. Second, and more materially, conditions in the EU have impacted, and will continue to negatively impact Eurozone bank financing, which has been significant for Indian private sector projects.

69. In time, the economies of the US and Eurozone will recover. The latter may be locked into a fiscal union or may break up to *status quo ante* or be a smaller union. But disastrous outcomes, that is, shocks, are unlikely to happen because the major players have too much to lose and a lot of preparation has gone into to expressly avoid such an event. However, there will be periodical upheavals in the financial markets because certain things will go wrong and some unexpected developments will happen. While these will be managed and contained, it is reasonable to expect sporadic volatility continuing in financial markets and investment sentiments, on account of bad news that will come out from time-to-time from the advanced economies.

70. Most emerging economies continue to show fairly strong growth. China may or may not slow to the extent that their leadership seem to want, namely 7 per cent. The IMF in its *World Economic Outlook Update*, July 2012, has put China's growth at 8.0 per cent in 2012 and at 8.5 per cent in 2013. In the first two quarters of calendar 2012, the Chinese economy registered growth of 8.1 and 7.8 per cent respectively.

71. How other emerging economies will do will flow from the appropriateness of their own respective policy stance and their ability to adapt to the changing circumstances. Greater differentiation in economic outcomes may become more pronounced. Sub-Saharan Africa is forecast to grow by about 5.3–5.4 per cent in both 2012 and 2013. Developing Asia excluding India and China is also expected by the IMF to grow by 5.0–5.7 per cent in 2012 and 2013.

72. The short point is that the global economic environment will continue to be under pressure. The expected improvements in the US economy, some improvement in Japan and strong conditions in some advanced economies such as Canada, Australia and Scandinavia provide some offsets to the continuation of difficulties in the Eurozone. Further steady growth in most of Asia and Africa provide opportunities for both trade and investment. Though conditions are difficult, opportunities for expanding business and growth do exist – provided the capacity to harvest them is there.

73. A summary of the IMF's growth projections for major regions/countries is at Table 2.1. Given the discussion about re-balancing (namely, lowering of both the current account surpluses as well as deficits), the IMF projections for the current account balance is placed at Table 2.2 (absolute levels) and Table 2.3 (percentage of GDP). The projections for India are based on the estimates of the Council for the calendar years 2012 and 2013. The fiscal picture is summarized at Table 2.4.

74. The outlook for 2012 and 2013 thus seems to be characterized by a moderation in economic growth – especially in Asia, which had seen a bounce in the aftermath of the crisis of 2008 and likewise, but less pronounced in Latin America. There may be a slight moderation in current account balances, but almost all of it will be coming out of China. Continued fiscal stress in currently stressed economies is likely, with some easing in the Eurozone and the US. The impact of the external situation on India has been dealt with in the earlier chapter.

Table 2.1: Economic Growth and Projections made by the IMF

Regions / Countries	2007	2008	2009	2010	2011	2012	2013
World Output (at market exchange rates)	**4.0**	**1.4**	**–2.2**	**4.2**	**2.8**	**2.7**	**3.1**
World Output (at PPP exchange rates)	**5.4**	**2.8**	**–0.6**	**5.3**	**3.9**	**3.5**	**3.9**
Advanced Economies	**2.8**	**0.0**	**–3.6**	**3.2**	**1.6**	**1.4**	**1.9**
U.S.A.	1.9	0.0	–2.6	3.0	1.7	2.0	2.3
Eurozone	3.0	0.4	–4.3	1.9	1.5	–0.3	0.7
Germany	3.4	0.8	–5.1	3.6	3.1	1.0	1.4
France	2.2	–0.2	–2.6	1.7	1.7	0.3	0.8
Italy 1.5	–1.3	–5.2	1.8	0.4	–1.9	–0.3	
Spain	3.6	0.9	–3.7	–0.1	0.7	–1.5	–0.6
Netherlands	3.9	1.8	-3.5	1.6	1.3	–0.5	0.8
Japan	2.2	–1.0	–5.5	4.4	–0.7	2.4	1.5
U.K.	2.7	–0.1	–4.9	2.1	0.7	0.2	1.4
Canada	2.2	0.5	–2.5	3.2	2.4	2.1	2.2
Australia	4.7	2.5	1.4	2.5	2.0	3.0	3.5
Korea, South	5.1	2.3	0.3	6.3	3.6	3.6	4.0
Taiwan	6.0	0.7	–1.8	10.7	4.0	3.6	4.7
Singapore	8.9	1.7	–1.0	14.8	4.9	2.7	3.9
Emerging & Developing Economies	**8.7**	**6.0**	**2.8**	**7.5**	**6.2**	**5.6**	**5.9**
Developing Asia	**11.4**	**7.8**	**7.1**	**9.7**	**7.8**	**7.1**	**7.5**
Latin America	**5.8**	**4.2**	**–1.6**	**6.2**	**4.5**	**3.4**	**4.2**
Sub-Saharan Africa	**7.1**	**5.6**	**2.7**	**5.3**	**5.2**	**5.4**	**5.3**
China	14.2	9.6	9.2	10.4	9.2	8.0	8.5
India	10.0	6.2	6.6	10.8	7.1	6.1	6.5
ASEAN 5	6.4	4.7	1.7	7.0	4.5	5.4	6.1
Brazil	6.1	5.2	–0.3	7.5	2.7	2.5	4.6
Russia	8.5	5.3	–7.8	4.3	4.8	4.0	3.9
South Africa	5.6	3.6	–1.5	2.9	3.1	2.6	3.3

Note: ASEAN 5 are Indonesia, Thailand, Philippines, Malaysia and Vietnam. For all countries the reference period is calendar year, not fiscal year

Source: Update to World Economic Outlook, IMF, July 2012 and WEO Database April 2012

Table 2.2

Current Account Balance in US dollars Billion

*Projections for 2012 and 2013 by IMF**

	2007	2008	2009	2010	2011	2012	2013
Advanced Economies							
U.S.A.	**–710**	**–677**	**–377**	**–471**	**–473**	**–510**	**–499**
Eurozone	27	–87	–24	12	4	4	7
Germany	**248**	**226**	**196**	**200**	**205**	**180**	**175**
France	–26	–50	–40	–45	–62	–52	–43
Italy	–26	–68	–44	–73	–70	–46	–32
Spain	–144	–154	–76	–64	–55	–30	–25
Netherlands	53	38	34	51	63	66	64
Japan	**211**	**157**	**142**	**196**	**120**	**130**	**166**
U.K.	–70	–36	–32	–75	–46	–42	–30
Canada	12	5	–40	–49	–49	–48	–50
Australia	–59	–46	–42	–35	–33	–73	–84
NIC - Asia*	**128**	**87**	**124**	**137**	**135**	**128**	**133**
of which Korea, S.	22	3	33	29	27	22	19
Emerging & Developing Economies							
China	**354**	**412**	**261**	**305**	**201**	**182**	**229**
India	–8	–31	–26	–52	–63	–69	–73
ASEAN 5	56	35	71	51	51	33	31
Brazil	2	–28	–24	–47	–53	–79	–80
Russia	77	104	50	70	101	96	44
South Africa	–20	–20	–12	–13	–20	–24	–26
OPEC countries	**336**	**439**	**91**	**223**	**429**	**513**	**460**
Major Oil Exporters	**503**	**670**	**217**	**383**	**652**	**738**	**627**

Note: * The current account figures for 2010 onwards in case of other than developed economies are IMF staff estimates. For previous years for India are as per RBI data and for 2012 and 2013 are based on the Council's estimates for calendar years.

1. NIC - Asia comprise of Korea, Taiwan, Singapore and Hong Kong
2. Asean 5 countries 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 2012 - publication & database

Table 2.3

Current Account Balance as percent of GDP

*Projections for 2012 and 2013 by IMF**

	2007	2008	2009	2010	2011	2012	2013
Advanced Economies							
U.S.A.	–5.1	–4.7	–2.7	–3.2	–3.1	–3.3	–3.1
Euro-zone	0.4	–0.7	0.0	0.3	0.3	0.7	1.0
Germany	7.4	6.2	5.9	6.1	5.7	5.2	4.9
France	–1.0	–1.7	–1.5	–1.7	–2.2	–1.9	–1.5
Italy	–1.2	–2.6	–2.1	–3.5	–3.2	–2.2	–1.5
Spain	–10.0	–9.6	–5.2	–4.6	–3.7	–2.1	–1.7
Netherlands	6.7	4.3	4.2	6.6	7.5	8.2	7.8
Japan	4.8	3.2	2.8	3.6	2.0	2.2	2.7
U.K.	–2.5	–1.4	–1.5	–3.3	–1.9	–1.7	–1.1
Canada	0.8	0.3	–3.0	–3.1	–2.8	–2.7	–2.7
Australia	–6.2	–4.3	–4.2	–2.8	–2.2	–4.6	–5.1
NIC – Asia[1]	7.0	5.0	7.7	7.2	6.5	5.9	5.7
of which Korea, South	2.1	0.3	3.9	2.9	2.4	1.9	1.5
Emerging & Developing Economies							
China	10.1	9.1	5.2	5.1	2.8	2.3	2.6
India	–0.7	–2.5	–2.1	–3.2	–3.4	–3.8	–3.3
ASEAN 5	5.2	2.7	5.6	3.2	2.8	1.7	1.4
Brazil	0.1	–1.7	–1.5	–2.2	–2.1	–3.2	–3.2
Russia	5.9	6.2	4.0	4.7	5.5	4.8	1.9
South Africa	–7.0	–7.2	–4.0	–2.8	–3.3	–4.8	–5.5
OPEC countries	17.6	18.1	4.3	9.4	15.1	16.2	14.0
Major Oil Exporters	13.0	13.8	5.5	8.3	11.7	12.1	9.5

Note: * The current account figures for 2010 onwards in case of other than developed economies are IMF staff estimates. For previous years for India are as per RBI data and for 2012 and 2013 are based on the Council's estimates for calendar years.

1. NIC - Asia comprise of Korea, Taiwan, Singapore and Hong Kong
2. Asean 5 countries 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 2012 - publication & database

Table 2.4

General Government Net Lending/Borrowing or
Fiscal Balance as a proportion of GDP

Projections for 2012 and 2013 by IMF*

	2007	2008	2009	2010	2011	2012	2013
U.S.A.	**–2.7**	**–6.7**	**–13.0**	**–10.5**	**–9.6**	**–8.1**	**–6.3**
Eurozone	–0.7	–2.1	–6.4	–6.2	–4.1	–3.2	–2.7
Germany	0.2	–0.1	–3.2	–4.3	–1.0	–0.8	–0.6
France	–2.8	–3.3	–7.6	–7.1	–5.3	–4.6	–3.9
Italy	–1.5	–2.7	–5.4	–4.5	–3.9	–2,4	–1.5
Spain	1.9	–4.2	–11.2	–9.3	–8.5	–6.0	–5.7
Netherlands	0.2	0.4	–5.6	–5.1	–5.0	–4.5	–4.9
Japan	–2.1	–4.1	–10.4	–9.4	–10.5	–10.0	–8.7
U.K.	–2.7	–4.9	–10.3	–9.9	–8.7	–8.0	–6.6
Canada	1.6	0.1	–4.9	–5.6	–4.5	–3.7	–2.9
Australia	1.3	–0.8	–4.1	–4.8	–4.3	–2.5	–0.6
China	0.9	–0.4	–3.1	–2.3	–1.2	–1.3	–1.0
India	–4.2	–7.2	–9.8	–9.2	–8.7	–8.3	–8.2
Brazil	–2.7	–1.4	–3.1	–2.8	–2.6	–2.3	–2.4
Russia	6.8	4.9	–6.3	–3.5	1.6	0.6	–0.3
South Africa	1.5	–0.5	–5.3	–4.9	–4.6	–4.3	–3.7

Note: * Figures for 2011 are estimates

Source: Fiscal Monitor, IMF, April 2012

III. STRUCTURAL FACTORS

75. We have the Quick Estimates (QE) for 2010/11 and the Revised Estimates for 2011/12, for both GDP by industry of origin as also by expenditure classes. Four distinctive threads stand out – which not surprisingly are inter-connected:

(a) Continued decline in investment in productive assets;

(b) Large increase in the draft on available domestic savings by Government's excessive expenditure, i.e. its negative savings;

(c) Decline in financial savings of households, and

(d) Large increase in the current account deficit.

76. Gross Domestic Fixed Capital Formation (GDFCF) as a proportion of GDP has continued to decline, falling from its highest level of 32.9 per cent in 2007/08, to 30.4 per cent in 2010/11 and as per initial estimates for 2011/12 to 29.5 per cent. Clearly there has been a significant weakening in the pace of fixed asset creation (GDFCF/GDP) by as much as 3.4 percentage points of GDP. This is a significantly large number, since its counterpart in terms of the potential reduction in the rate of growth of the economy, is about 0.8–0.9 percentage points.

77. Both in July 2010, as also in July 2011, the Council had expected that the fixed investment rate would recover. It was on this basis that the Council had projected a pick up in the pace of economic growth. However, the recovery in the fixed investment rate did not transpire and not surprisingly, the pace of economic growth was also slower.

78. While we were able to negotiate the global economic crisis quite well, and saw an early recovery in domestic demand and in output, we have not been able yet to get investment back to the path of rapid asset creation and therefore sustainable higher growth. Last year we had touched on some of the reasons why investment had been sluggish. It is our assessment that it is possible to take a number of policy measures that will succeed in improving the domestic investment climate and help in raising the pace of asset creation and hence of economic growth.

Investment

79. Fixed investment rate has fallen from 32.9 to 30.4 per cent of GDP between 2007/08 and 2010/11, a decline of 2.5 percentage points. If we use the preliminary estimates for 2011/12 the fall is of 3.4 percentage points. Within this, the biggest drop has come from private corporate investment which has dropped from 14.3 per cent of GDP in 2007/08 to 9.9 per cent in 2010/11, a decline of 4.4 percentage points of GDP, more than the overall decline in fixed investment. The number is probably slightly worse for 2011/12.

80. Partially offsetting the sharp fall in fixed investment by the private corporate sector is the increase by 1.8 percentage points, from 10.6 to 12.4 per cent of GDP, coming from fixed investment by households, which in India includes unincorporated businesses. In general the experience is that when the economy is doing well, household savings in the form of financial assets increase and the reverse occurs in not so good times. In a way, this phenomenon may be seen as a defensive measure by households who partially withdraw from the organized financial sector. It is a retrograde step insofar as it reduces the stock of savings that is available for use by the industrial and other modern sectors. In recent years this process ran parallel to the steep increase in the demand for gold for investment purposes, which additionally leads to the savings being denied altogether to the domestic economy and enlarges the trade deficit, save for value unlocked through gold loans on a portion of gold required.

81. The disposition of savings as investment in valuables – almost entirely in the form of gold – has increased dramatically. From 1.1 per cent of GDP in 2007/08 to 2.8 per cent in 2011/12, a jump of 1.7 percentage points of GDP. One effect of this is that total capital formation (GDCF) has not fallen as sharply as have other ratios – going down from 38.0 per cent in 2007/08 to 35.5 per cent in 2011/12, a drop of 2.5 percentage points. The other effect is to enlarge the trade and current account deficit by the same magnitude.

83. If we look at GDCF excluding valuables, the drop is large – from 37.0 to 32.7 per cent of GDP or by 4.3 percentage points of GDP. In terms of loss in potential growth it amounts to over 1 per cent of GDP.

Savings

83. First on account of the fiscal stimulus provided to protect the economy from the global crisis and subsequently due to spiralling subsidies, particularly that on refined petroleum products, there has been a huge increase in the negative savings of the government by as much as 2.1 percentage points of GDP between 2007/08 to 2010/11 and an estimated 3.2 percentage points of GDP up to 2011/12.

84. The large improvement in domestic savings up to 2007/08 – from 26.5 per cent of GDP in 2001/02 to 36.8 per cent in 2007/08 – had to a great measure happened because of the progress of fiscal consolidation. The negative savings of government which was 6.0 per cent of GDP in 2001/02 progressively reduced and became a positive savings of 0.5 per cent in 2007/08 – thereby increasing the overall savings rate by as much as 6.5 percentage of GDP. Half of this gain has now been eroded by the continued fiscal stress of the past few years.

85. Second, margin pressures on corporates on account of rising wages and material costs, higher interest rates and difficult economic conditions, has also led a decline in the retained earnings of the private corporate sector, which dropped from 9.4 per cent of GDP in 2007/08 to 7.9 per cent in 2010/11 and may have been at about that level in 2011/12 also. This margin pressure and consequential drop in retained earnings have made investment harder.

86. Third, the financial savings of the household sector has also fallen. Gross financing savings (being the increase in gross financial assets) was 15.4 per cent of GDP in 2007/08. This has fallen to 13.6 per cent in 2010/11 and possibly further to less than 12.0 per cent in 2011/12. Net of the financial liabilities incurred by households (mortgage and other personal loans) the net financial savings of households available for use by the rest of the economy fell from 11.6 per cent of GDP in 2007/08 to 10.0 per cent in 2010/11 and possibly to below 9.0 per cent in 2011/12. It should be noted that these are the lowest ratios for net financing savings in the past fifteen years.

87. The sharp drop in the financial savings by households is closely related to their increased disposition to allocate more of their investible resources to gold and also to direct physical assets, than to place it in the financial system. High inflation and the desire to protect the value of their savings was certainly a motivation. The

problems plaguing industries that distribute financial instruments – mutual funds and life insurance – have possibly been the other factor contributing to the strange phenomenon of the weakening effect of modern financial intermediation and the reversion to more antiquated ones. This is a situation that policy must squarely address and resolve.

88. It is in this environment that the enlarged needs of government financing have been manifest. With the aggregate pool of financial savings shrinking, the additional needs to finance government has exacerbated matters and made the "crowding out" phenomenon particularly acute. There were of course other factors that acted as a drag on private investment, but the availability and cost of financing were certainly material.

89. To assess the issues that may be discouraging corporate investment in new asset creation, the Council had a consultation with industry, banks and other segments of the financial sector. The principal points that made by the participants were:

- Heightened concern about government finances, enlarged subsidy bills and the predictability and stability of tax laws and regulation
- Poor sentiment hitting confidence across the board and the weakness of the currency compounding matters. Unlike past years proposals to make an investment in India being taken with much greater reservations and caution, even by companies who have long been invested in India.
- New projects not coming up and existing ones getting delayed because of delay and difficulties in obtaining clearances
- High cost and availability of finance, both from domestic and from overseas sources, the latter on account of substantial increase in credit spreads.
- Substantial payments due from government and its agencies primarily on account of the disinclination of officials to take decisions for fear of charges being made against them, and hence increasingly reference of matters for arbitration, adding to delays and costs
- Squeeze on corporate profitability, project delays and reduced access to equity, weakening credit quality. More than $7 billion of FCCB due for repayment.

- Non performing loans (NPL) in the banking system are rising, especially if restructured loans were to be included. Even though the level of NPL increase is far from being alarming, positive amelioration is only possible through an improvement in the general economic and investment climate.

- There is a keen desire and expectation that positive and energetic movement on the policy front, including FDI policy, movement of GST and other measures would serve to make a lasting positive impact on the business climate and investor confidence.

Current Account Deficit

90. The unprecedented enlargement of the CAD in the past few years, especially in 2011/12 is casting a shadow on the strength of the macro-economic fundamentals of the economy. It is combining with other negative elements to make investors hesitate to take more exposure to India and has caused weakness in the currency, which while on the one hand reflects the higher rate of domestic inflation, and on the other, is also feeding into the inflationary process. The weakness in the currency also impacts corporate balance sheets adversely to the extent that they have foreign currency liabilities and to that extent negatively influences the capacity of these corporates to invest in new assets.

91. As pointed out previously, the enormous increase in the import of gold over the past couple of years has been a major factor in the worsening of the CAD and is related to both higher inflation at home as also weakness in the distribution of financial instruments and on account of poor returns in the equity markets. In the two years between 2009/10 and 2011/12, the value of gold imports net of export of jewellery increased from $22 billion to $50 billion, an increase of $28 billion or 1.5 per cent of GDP. In other words had the net import of gold remained at 2009/10 levels, the CAD in 2011/12 would have been smaller by 1.5 percentage points – that is, a manageable 2.7 per cent instead of being a daunting 4.2 per cent of GDP.

92. While the negative impact of higher petroleum prices is a factor that is externally determined, the unusual expansion in the domestic demand for gold as an investment asset has flowed directly from domestic factors and to that extent can be rectified.

93. The CAD in itself has become a cause for concern and a structural shortcoming. Export growth of goods at 21 per cent in 2011/12 and that of non-petroleum, non-jewellery items at 14 per cent in the extant global environment was a reasonably good achievement. Software and BPO earnings growth of 21 per cent and that of remittances by 20 per cent was also stronger than might have been reasonably expected.

94. The problem lay entirely in the much faster expansion of merchandise imports which increased by 32 per cent overall, particularly that of gold which increased by 45 per cent. Net oil imports (total imports of crude and refined product less export of refined products) grew by 49 per cent. Of this as much as 32 per cent was on account of price increase and the balance 13 per cent on account of increase in quantity. The increase in the dollar value of non-oil, non-gold, non-gems import was 23 per cent, somewhat in excess of the growth of in non-oil, non-jewellery merchandise exports. But this includes coal, LNG and a variety of products whose imports have more to do with their limited availability at home, than relative cost competitiveness.

What Needs to be Done

95. Clearly a variety of initiatives are needed to be taken to address the various weaknesses that presently threaten the country's growth story and with it the promise of livelihoods and prosperity for the people. These supplement what has already been said in the previous chapter.

96. Policy predictability: The apprehensions that have been occasioned by perceptions of arbitrary actions on tax and other fronts need to be specifically focused and addressed. Policy predictability is part of the bedrock of economic stability.

97. Project clearance: Significant progress has been made on this front over the last year and more perhaps needs to be done, so that investment can create new assets in infrastructure and manufacturing and allow the economy to produce in line with its huge unmet demand.

98. Clearing payments: Outstanding payments for infrastructure projects need to be cleared on time, as indeed has been the practice for so many years. This is particularly necessary to infuse equity into the infrastructure space and facilitate the ability of players in this area to take on more projects. It would also make the task of their financiers, namely banks, that much easier.

99. Encouragement to investment: In general the atmosphere must be seen as being encouraging of investment, rather than being fault-finding and antagonistic. The problem is larger than that of the attitudes within the government alone, but at least they can be sought to be remedied within the government system at least.

100. Moving savings products: This is an area that needs urgent redress. We have traditionally looked at government intervention in the financial space as "market development" where regulation and the expansion of the market are supposed to go hand in hand. However, over the past few years there have been serious setbacks in the distribution of savings products, especially mutual funds and life insurance. in acountry where income is rising, the habit of saving is well ingrained and the market is underdeveloped, such products should show strong sales growth, as indeed they had till 2009/10. One of the many positive results of this was that domestic financial institutions (DFI) came to be as important a player in our capital markets, as were the Foreign Institutional Investors (FII). However, sales of mutual fund products, especially to smaller investors and premium growth for new private sector life insurance companies have been negative. The jump in demand for gold as an investment vehicle is closely related to this setback in market development.

101. Containing inflation: The historical evidence clearly shows that stable high growth does not sit well with high inflation. High rates of inflation eventually erode profits and adversely impact external payments, as indeed has been the case with us. Our particular problem has much to do with the high inflation in primary food which is mostly linked to the antiquated system of marketing and absence of modern handling and storage facilities for perishable products. It is to a lesser extent also a product of the large increases in minimum support price (MSP) that have been given effect to and the fact that procurement price and MSP have become conflated.

102. Fiscal consolidation: The massive increase in the subsidy bill, particularly on account of refined petroleum products, has prevented the fiscal consolidation process to go forward, despite declared intentions and efforts on other components such as revenue augmentation. It has also stripped upstream PSU producers like ONGC and OIL of funds that could have been productively used to explore and produce more crude oil and alleviate the country's enormous dependence on imports. Action on this front, however phased, is essential to preserve the trajectory

of fiscal consolidation, without which other efforts at making the climate more amenable for investment and asset creation will be undermined.

103. Improving the CAD: Lowering the magnitude of the CAD is of great importance. Given that net oil imports and gold have been the two fastest growing components of the import bill, and that these are not normal commodities where import demand could be compressed through depreciation of the currency, the task of improving the CAD is harder. In the case of oil, the sharp increase in domestic demand, especially that of diesel, clearly offers some amelioration through price reform which could serve to contain demand. In the case of gold, a quantum improvement in the regulatory context in which mutual funds and life insurance products are sold is of the utmost importance. The IT-related export business, which has done yeoman service to enlarging India's external earnings as also to provide hundreds of thousands of quality jobs to young people, also feel that significant improvement in the approach of government to a number of issues would make them much more competitive. These must be attended to.

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		
					Pvt.	Govt		Total	Pvt. Corp.	Total	Pvt. Corp.	Private	Govt	Total
	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	59.1	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	58.3	10.9	–1.2	17.0	45.0	16.2	43.1	8.5	8.9	8.6
2006/07	35.7	35.9	31.3	34.6	57.7	10.3	–1.1	15.3	19.1	13.8	17.9	8.7	3.8	7.9
2007/08	38.1	38.0	32.9	36.8	57.0	10.3	–1.3	17.7	32.8	16.2	27.7	9.2	9.6	9.3
2008/09	34.3	35.5	32.3	32.0	57.7	10.9	–2.3	–2.5	–29.5	3.5	–21.9	7.1	10.4	7.6
2009/10	36.9	36.1	31.6	34.1	57.4	12.0	–2.8	9.8	23.9	6.8	15.2	7.0	14.3	8.1
2010/11 QE	34.7	35.8	30.4	32.0	56.5	11.9	–2.7	9.9	8.0	7.5	4.7	8.1	7.8	8.1
2011/12 Rev	34.7*	35.5	29.5	30.4*	56.0	11.5	–4.2	5.2	3.9*	5.5	4.0*	5.5	5.1	5.4
2012/13 Proj	35.3	35.5	30.0	31.7	56.5	11.0	–3.6	6.1	5.9	5.9	6.0	6.5	5.5	6.3

Note: * Estimated. The rest of the figures are derived from the CSO Press Release on GDP, May 2012.

IV. MONSOON & FARM SECTOR

South West Monsoon 2012

104. The South West (SW) monsoon 2012 has been weak. Its onset in June across much of central, eastern and northern India was delayed and precipitation in both June and July was below normal. Comparisons have naturally been drawn with the monsoon of 2009 that was the worst in 28 years. As at the end of July, the negative departure from the Long Period Average (LPA) was 19 per cent in 2012, as it was in 2009.

105. However the distribution of rainfall in 2012 in terms of rain dependant regions is somewhat better in more meteorological divisions, than it was in 2009 and worse in less. Thus, in the eastern states of West Bengal, Bihar and Jharkhand rainfall in the month of July 2012 was normal and better than it had been in 2009. This is also true of the southern meteorological divisions of Coastal Andhra, Telengana and Rayalseema, as also that of Vidarbha, Chhattisgarh, East and West Madhya Pradesh of Central India.

106. Rainfall in 2012 has been extremely poor in Saurashtra and Gujarat which actually had good rains in July 2012. In the north, West & East Rajasthan and Punjab the monsoon in 2012 has been worse than that in 2009, while in Haryana it has been as bad. In the south the monsoon has been particularly poor in South Interior Karnataka and to an extent in North Interior Karnataka as well. Overall July rainfall in 2012 was deficient by 10 per cent, as against 2009, when it had been short by just 2 per cent, but on balance the number of better-off divisions at twelve (12) exceeds the number of worse-off ones at nine (9).

107. As on 1 August 2012, the agriculturally important divisions that have a serious shortfall in seasonal rain are Punjab (–66 per cent), Haryana (–71 per cent), East and West Rajasthan (–36 and –67 per cent), Saurashtra and Gujarat (–79 and –57 per cent respectively), South and North Interior Karnataka (–46 and –35 per cent respectively), Marathawada and Madhya Maharashtra (–31 and –26 per cent respectively). In most of these areas, there is varying degree of access to irrigation

especially Punjab, Haryana, Saurashtra, Gujarat and parts of Madhya Maharashtra and Karnataka.

108. In its release dated 2 Aug 2012, the Indian Meteorological Department stated that "rainfall during August is likely to be normal (96 ± 9% of LPA)" but September rains may be low on account of El Nino effects in the Pacific. As a result "rainfall for the country … August to September, 2012 is likely to be 91% of LPA with a model error of ±8%". Most affected would be North West India and the southern peninsula.

109. The reservoir position is 19 per cent below that of the average of the last 10 years. The most serious shortfalls are in the large storages in the Krishna and Godavari basins as may be seen from Table 4.1.

Table – 4.1: Storage Position in Reservoirs – Basin Wise

Week ending 2 August 2012

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	28.10	9.38	8.46	5.72	63.8%
Indus	14.73	3.65	8.97	6.62	(–) 44.8%
Narmada	16.96	6.31	6.74	4.80	31.5%
Tapi	7.39	3.15	3.13	2.89	9.0%
Mahi	4.01	2.02	0.87	1.64	23.4%
Sabarmati	0.73	0.24	0.09	0.19	29.2%
Rivers of Kutch	0.89	0.09	0.30	0.32	(–) 72.4%
Godavari	15.09	2.50	5.01	3.81	(–) 34.2%
Krishna	31.55	8.23	20.31	16.27	(–) 49.4%
Mahanadi & Neighbouring EFRS	13.18	4.63	4.58	4.94	(–) 6.3%
Kaveri & Neighbouring EFRS	8.19	2.45	4.74	3.85	(–) 36.5%
West Flowing Rivers of South	13.60	3.67	7.35	6.41	(–) 42.8%
Total	**154.42**	**46.32**	**70.55**	**57.46**	**(–) 19.4%**

Agricultural Output in 2011/12

110. The *Fourth Advance Estimates* of crop output in 2011/12 are summarised at Table 4.2. Foodgrain production was a record 257.4 million tonnes. Both rice and wheat production touched new records at 104.3 and 93.9 million tonnes respectively. Pulses were a little below last year's level but much higher than that of previous years. Oilseeds production in 2011/12 at 30.0 million tonnes were less than that of the record level of 32.5 million tonnes reached last year, but was better than any other previous year. Cotton output also hit a new record of 35.2 million bales.

Table 4.2
Farm Crop Output

			2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Rice	million (tonnes)	Kharif	72.23	78.27	80.17	82.66	84.91	75.92	80.69	91.53
		Rabi	10.90	13.52	13.18	14.03	14.27	13.18	15.29	12.79
		Total	83.13	91.79	93.35	96.69	99.18	89.10	95.98	104.32
Wheat		Rabi	68.64	69.35	75.81	78.57	80.68	80.80	86.87	93.90
Coarse Cereals		Kharif	26.36	26.73	25.61	31.89	28.54	23.83	33.37	32.26
		Rabi	7.10	7.33	8.31	8.87	11.49	9.72	10.32	9.75
		Total	33.46	34.06	33.92	40.76	40.03	33.55	43.68	42.01
Pulses		Kharif	4.72	4.87	4.80	6.40	4.69	4.20	7.12	6.16
		Rabi	8.41	8.52	9.40	8.36	9.88	10.46	11.12	11.05
		Total	13.13	13.39	14.20	14.76	14.57	14.66	18.24	17.21
Food-grains		Kharif	103.31	109.87	110.57	120.95	118.14	103.95	121.18	129.94
		Rabi	95.05	98.73	106.71	109.83	116.33	114.16	123.60	127.50
		Total	198.36	208.60	217.28	230.78	234.47	218.11	244.78	257.44
Oilseeds (nine major)	lakh tonnes	Kharif	141.49	167.68	140.12	207.13	178.08	157.29	219.22	207.87
		Rabi	102.05	112.11	102.77	90.42	99.11	91.53	105.57	92.25
		Total	243.54	279.79	242.89	297.55	277.19	248.82	324.79	300.12
Cotton	Lakh bales 170 Kg		164.3	185.0	226.3	258.8	222.8	242.2	330.0	352.0
Jute	Lakh bales 180 Kg		94.0	99.7	103.2	102.2	96.3	112.3	100.1	108.9
Sugarcane	Lakh tonnes		2,371	2,812	3,555	3,482	2,850	2,923	3,424	3,577

Outlook for 2011/12

111. The large shortfall in precipitation covering such a substantial part of the country is bound to negatively impact crop output in the *kharif* season and perhaps to some extent in the *rabi* season as well. We have seen that in 2009/10 the weak SW monsoon resulted in loss of crop output by 14 million tonnes in the *kharif* season and by another 2 million tonnes in the *rabi* season. Oilseed output was also lower by nearly 3 million tonnes and sugarcane was down by 63 million tonnes. Cotton output was however higher by 2 million bales. Horticulture, animal

husbandry and fisheries however had grown in 2009/10 as a result of which despite the crop output losses farm sector GDP increased by 1 per cent.

112. In 2012/13, a similar pattern is expected. Given that Eastern India, UP and Andhra are faring much better in this monsoon and much of Central India is also okay, rice output in the kharif season may fall much less than it had in 2009/10. Coarse cereal and possibly pulse output may however slip on account of deficient rainfall in Karnataka, Marathawada and Rajasthan. Saurashtra has emerged as a major producer of cotton. The very poor rains this year may impact output and it remains to be seen to what extent the irrigation system there will be able to hold up against this order of shortfall in precipitation.

113. It is certain that crop output would be hit on account of the weak SW monsoon, of which one and a half month yet remains to be seen. However, in the expectation that any shortfall in August rainfall will be along the same lines as in July 2012, the Council is of the view that the impact will be less severe than was the case in 2009. Extrapolating on the basis of the experience of 2009/10, the Council has placed farm sector GDP growth at the same level as that in 2009/10.

Important Reforms Required in the Agriculture & Allied Sector

114. For understandable reasons the pace of reforms in agriculture has been slow. At the macro-level distortions in agriculture in India were less serious than in several other countries, for instance in China. In any event, agriculture benefitted from reforms in non-agricultural sectors.

115. Two major reasons for the pace of reforms being slow were that (a) it was perceived that given that the largest number of agricultural producers being either small or marginal farmers, their capacity to absorb "shocks" was limited, and (b) agriculture being a state subject the responsibility of reforms in agriculture lay with the State governments. These arguments today need to be re-examined.

116. There are several measures, which will increase agricultural productivity and benefit all agricultural producers, including small and marginal farmers. Also, there are various forums where the Centre and States can have meaningful dialogue and agree on key reforms. This has happened in several instances in the past, and can happen again. There are certain areas of reforms in agriculture where a consensus has already emerged, and these need to be pursued more vigorously.

117. For giving boost to agricultural production and benefiting all sections of producers, following reforms require prior attention: liberalizing tenancy arrangements, reforming domestic markets for agricultural produce and, reducing input subsidies.

118. Legalizing Tenancy: Although officially only 7 per cent of the cropped area is shown as leased-in area, it seems to be gross underestimate. Field studies in several parts of the country have shown that area under informal tenancy varies between 15 to 35 percent of cultivated area; above 90 per cent of the total number of tenants belong to the category of landless labour and marginal farmers. They benefit from leasing-in, as it helps them in expanding their miniscule holdings and permits better use of their labour resources. The large farmers who would like to pursue non-farm activities may like to lease out their land if the risk of losing their ownership rights is averted. Such benefits can only accrue if leasing-in and leasing out is legally sanctioned. As it is, lease markets are heavily restricted in most of the states, while some states prohibit tenancy.

119. This closes the option of augmenting holding, and income for the small farmers, and occupational diversification, especially, though not exclusively, for the large farmers. Restrictions on land leasing have forced the poor tenants to enter into informal arrangements, which due to their weak bargaining power entail uncertainty about the period of lease and rack-renting. Even the lessor, generally larger farmers, are also at a disadvantage as they fear that they may not be able to claim their land back if they want to do so. In order to safeguard the rights of tenants as well as landowners states should legalize tenancy and register tenancy agreements. It is in the interest of agriculture that the states should remove all restrictions on leasing-in and leasing-out of land, and make the lease market function efficiently. In order to allay the fears that freeing of lease market may lead to concentration of land in bigger holdings, the provisions of ceiling on land may also apply to the ceiling on operational holdings.

120. Reforms in Agricultural Marketing: Agricultural production is largely free from state controls, but the same cannot be said about agricultural marketing. Legal provisions in most of the states restrict marketing arrangements. *Agricultural Produce Marketing Control Act* (APMC Act) prevailing in a number of states prohibits direct marketing of produce to traders or processors, gives state the exclusive right to establish markets and, makes it mandatory for the producers to

sell their produce in designated markets. These provisions were made with the good intention of protecting poor producers from the machinations of the traders and middlemen. However, Agricultural produce Marketing Committees have not been able to stop collusion among the traders, and opaque ways of price determination of the agricultural produce in these markets has not been replaced by open, competitive methods. Further, farmers are subjected to taxes and levies without receiving commensurate benefits.

121. On the other hand wherever the producers are given freedom to dispose of their products directly to the consumers, as is being experimented in a number of states, including Andhra Pradesh and Karnataka, they have benefited. More commonly where the processors are directly linked with farmers under one or other type of contract farming arrangements the producers have, generally, gained in terms of assured supply of qualitatively superior inputs, better prices and minimal market risks. We have long experience of different forms of contract farming starting with contract farming in sugar and milk and now covering a large number of commodities in different parts of the country. Suitable models for different commodities and different regions need to be encouraged. At the same time, symmetry in information and bargaining power, fair terms for the contracting parties and effective adjudication mechanism should be ensured.

122. Reducing Input Subsidies: A disturbing feature of agricultural policy in our country is the large and growing amount of input subsidies. These subsidies are progressively losing their relevance and are becoming an unbearable fiscal burden. Their role in contribution to productivity enhancement is fast disappearing. As a vehicle for increasing income of the producers they have proved to be an inefficient and inequitable instrument. Three areas where action needs to be taken with some urgency are subsidies on fertilizers, power and surface irrigation.

123. A beginning can be made in dismantling fertilizer subsidy. The issue has been complicated because the country wanted to be self sufficient not only in food but also in fertilizers. As a result fertilizer production in our country is not based on the comparative advantages. Agricultural producers are naturally reluctant to subsidize inefficient fertilizer industry. Among the various suggestions for reforming fertilizer sector, those offered by the Expenditure Reforms Commission and reiterated by this council need to be examined for implementation.

124. There is a growing consensus among experts on removing power subsidies after reforming the power sector. A number of states have started implementing the reforms, i.e. unbundling and corporatization of Electricity Boards, setting up regulatory commissions, privatization of the distribution of electricity and removal of cross subsidization in a phased manner. But so far no perceptible results have been obtained. The Achilles' heel in these reforms is inefficiency in power generation and huge transmission losses. Unless these are remedied it would be difficult to remove subsidies on power for agricultural purposes. However, "free" power to agriculture is not going to solve these problems, it will only make a bad situation worse.

125. While there is some thought, though not much action, on removing subsidies on fertilizers and electric power, removal of subsidies on canal water has not attracted serious attention of policy makers. Just like other subsidized inputs canal water is also used in grossly inefficient ways. State governments who are supposed to be responsible for canal irrigation are caught in a vicious cycle. Without adequate returns – at least to meet the recurrent costs through water rates – they are not in a position to improve Organization and Management (O&M) of canal systems, and without proper O & M, the case for enhancing water rates cannot be made persuasively. In some states attempts are made to resolve the problem by organizing Water Users Associations and entrust them with the responsibility of O & M as well as collection of water rates. Involvement of consumers both in water and power distribution has resulted in favourable outcomes and needs to be encouraged.

126. To sum up, a determined move needs to be made to dismantle the present subsidy regime in agriculture. It should be recognized, however, that the system has become addicted to subsidies and therefore, actions in this regard should aim to be a "retreat without disarray".

V. INDUSTRY

127. The Index of Industrial Production (IIP) used to have a base year 1993-94 which was been recently revised to base year 2004-05. The method of preparation of the index which is a combination of sample data on fixed frame basis and aggregate industrial data has shown some problems on account of which it is under examination by an expert committee. The IIP is a monthly index and a vitally important data input into the tracking of the economy. In the industrial sector the Annual Survey of Industries (ASI) is a much more comprehensive measure. However, it is first annual and comes out with a considerable lag. Till that point, the guidance for the computation of the national accounts remains the IIP. The latter is an output measure, not one of value added and that is also a problem in years when the two may not move in parallel, as for instance in 2008/09.

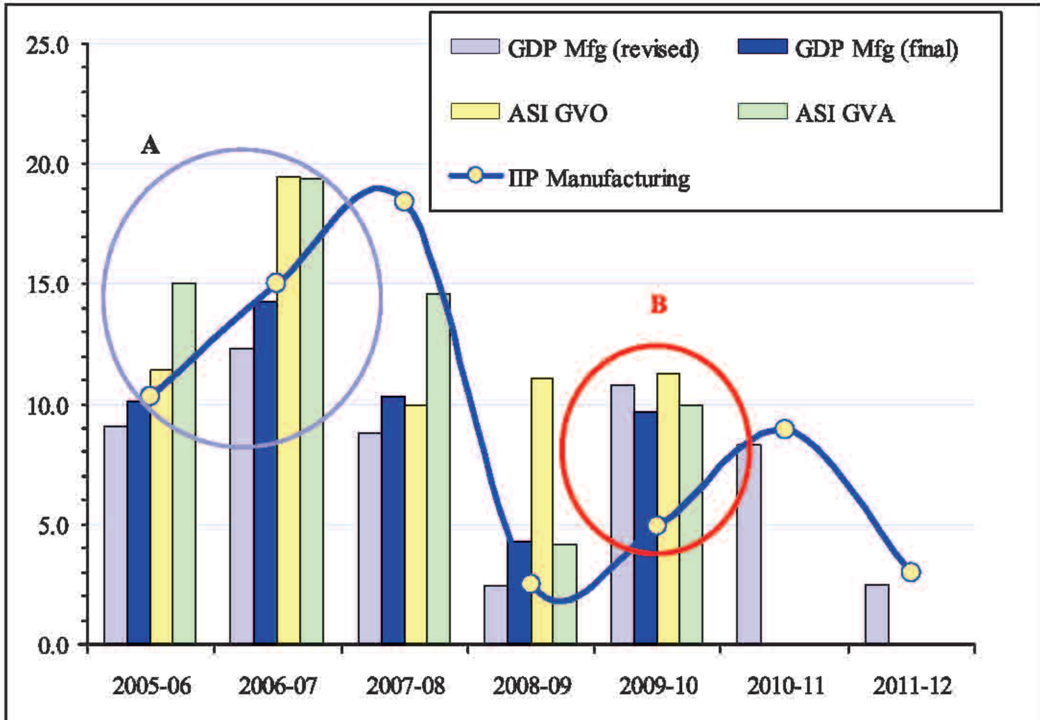
128. The IIP (along with other measures of the "real" economy, such as agriculture and mining is also used to validate the estimation of some of the service sector GDP estimates, that are first worked out on the basis of direct measures – which is in itself eminently sensible. However, if the estimates of the manufacturing sector for some reason are themselves somewhat off the mark, the error can become amplified.

129. The extent to which the IIP under or over measures manufacturing activity has become particularly acute of late in 2011/12. The national accounts data are periodically revised as per scheme and once the ASI data become available the GDP estimates in manufacturing are also appropriately adjusted. While such periodic revisions are the norm for all statistical data all over the world, the mismatch between IIP and ASI in recent years has made the implications somewhat troubling. At Chart 5.1, the annual growth estimates of IIP, GDP manufacturing (preliminary as per first estimate after the end of the year), GDP manufacturing (latest after ASI data is available) and that for Gross Value Output (GVO) and Gross Value Added (GVA) drawn from the ASI and suitably price deflated are presented.

Chart 5.1

Industrial Growth – Different Measures

Unit: per cent



130. The estimate of GDP arising in manufacturing has been moved up once ASI data has become available in 2005/06, 2006/07 and 2007/08. In 2009/10 the estimate was reduced slightly. It is interesting to note that in (circle "A") 2005/06 to 2007/08, both the GVO and GVA estimate was higher than of the final GDP estimate. In 2009/10 (circle "B"), the IIP estimate was much lower than all the others. In any case what is clear is that the IIP certainly moves in the same direction and with about the same amplitude as that of the ASI data, but there are significant variations.

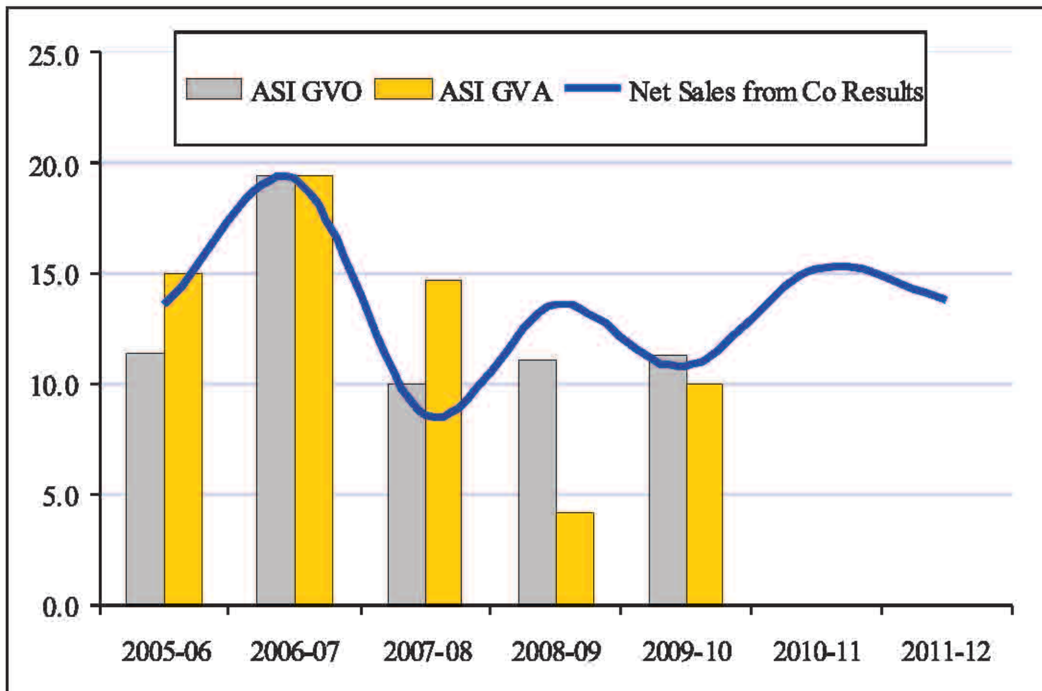
131. The next data item to look at is the net sales data as available from company accounts. There are two problems with this source, First, it is restricted to listed companies and second, many companies have multiple businesses. It is possible to

compute both GVO (net sales) and GVA measures from company results. The other advantage with company results is that they are available on a quarterly basis.

132. A comparison between the net sales of manufacturing companies from their financial results with that of the GVO and GVA from ASI is presented at Chart 5.2. It suggests that not unsurprisingly there is a fairly close correspondence between the net sales growth and that of GVO. It is possible that if the value added (factor incomes) are aggregated from the financial results of companies a similar close correspondence with GVA may become visible. The short point is that the company results after deflation may be see as a validating method for the estimation of GDP growth in the manufacturing sector.

Chart 5.2

Growth numbers from ASI and Company Financial Results suitably deflated



Unit: per cent

133. This would suggest that it is possible to look at the rates of growth drawn from the company financial results data for 2011/12 to get a sense of an alternate metric of real growth in manufacturing. Preliminary assessments suggest that the net sales of manufacturing companies after price deflation was for all quarters of 2011/12 significantly higher than that estimated by the IIP. This is particularly true for the second and third quarters where the IIP has reported virtually no growth at all.

134. It has been pointed out that the survey indicators as reflected in the Purchase Managers Index (PMI) have been suggesting a significant expansion of output in periods in 2011/12 when the IIP was suggesting little growth. The resolution may be found if indeed manufacturing output (and GDP) was actually growing somewhat close to what is suggested by the company results than by the IIP.

Industrial Output Projection for 2012/13

135. The Council feels that the data will show an improvement in manufacturing output starting from the second quarter (July–Sept) which will pick up momentum in the subsequent quarters. Overall for the year 2012/13 the estimate is that manufacturing GDP will increase by 4.5 per cent.

136. This estimate draws firstly from the fact that there will be a large base effect advantage as we moved into the period when last year's growth numbers were particularly poor. Secondly, as has been argued above, the situation is somewhat better than the perception. Thirdly, the Council expects that the initiatives taken by Government and also by industry will help improve the climate for investment and lead to a pick up in investment and in economic activity.

VI. TRADE AND EXTERNAL SECTOR

Current Account – Review of 2011/12

137. In February 2012, the Council had projected that in fiscal 2011/12 merchandise exports in Balance of Payments (BoP) basis would be $304 billion, with imports at $479 billion and the trade deficit at $175 billion (9.3 per cent of projected GDP). In practice, exports were $310 billion, imports much higher than expected at $500 billion and therefore so also the merchandise trade deficit which was $190 billion (10.2 per cent of revised GDP). This was much worse than what the Council had expected in July 2011 when it had placed imports at exports at $330 billion, imports at $484 billion and the merchandise trade deficit at $154 billion.

138. It is worth reviewing where did the unfolding of merchandise trade in 2011/12 go differently from what the Council had expected in July 2011. On the import side, the variation was first in the assessment of value of gold imports, which turned out to be as much as $22 billion higher than had been estimated in July 2011. Second in respect of imports of crude oil and petroleum products the import bill turned out to be higher by $16 billion, on account of two factors: (a) the estimation had been done on the then known import bill for 2010/11 which turned out to be an underestimate; (b) actual domestic demand growth for refined petroleum products in 2011/12 was stronger than had been expected, The estimates made in July 2011 for non-oil, non-gold imports were quite accurate. Finally, on the export side while the estimates for refined petroleum products, gems & jewellery were accurate, that for non-oil, non-gem exports made in July 2011 turned out optimistic in light of the flat growth in the second half of the year and the eventual number that materialized was $24 billion lower.

139. Net invisible earnings in 2011/12 were $111.6 billion (6.0 per cent of GDP), that turned out to be higher than the $100 billion projected by the Council in July 2011, and marginally over the $108 billion estimated in February 2012.

140. In consequence, the current account deficit for 2011/12 turned out to be a record $72 billion (4.2 per cent of GDP), as against the projections made by the

Council of $54 billion (2.7 per cent of GDP) in July 2011 and of $67 billion or (3.6 per cent of GDP) in February 2012.

Current Account – Outlook for 2012/13

141. Expectedly both the value of merchandise exports and of imports has been flat in the first quarter of 2012/13 and from early reports also in July 2012. This was a consequence of the unexpectedly strong expansion in exports and imports in the first half of 2011/12. Merchandise trade is expected to remain flat in the second quarter of the 2012/13. Thereafter in the second half of the year, non-oil, non-gem exports as also non-oil, non-gold imports are expected to show significant expansion.

142. The trade deficit as per DGCI&S was $40 billion in the first quarter of 2012/13 which was 12 per cent lower than that for the corresponding period of last year. The value of oil imports was higher by $2 billion, but that of gold & silver was lower by $8.7 billion and that of gems (mostly diamond roughs) was down by $3.5 billion. The value of non-oil, non-bullion, non-gems import was higher in the first quarter by about $2.8 billion or by 14 per cent. The $7.4 billion reduction in overall merchandise imports was due to the drop in the value of imports of gold and precious stones. On the export side, total value of exports was lower by $1.9 billion, on account of lower export volumes as well as lower prices of refined product export ($2.3 billion) and a reduction of $1.6 billion in export of gems & jewellery. Non-oil, non-gems & jewellery exports actually increased by $2 billion or by 4 per cent.

143. In 2012/13 as a whole, the Council expects that merchandise exports on BoP basis will be about $334 billion, which is quite a bit lower than the target of $360 billion indicated by the Commerce Ministry in June 2012, but would nevertheless be 7.8 per cent more than that in 2011/12. On the import side, the assessment is that the total value of imports would on BoP basis be $515 billion (increase of 3.1 per cent), leaving a merchandise trade deficit of $181 billion or 9.7 per cent of expected GDP, some $9 billion less than that recorded in 2011/12.

144. However, a change in the composition of both merchandise exports and imports is expected. As mentioned previously the domestic demand for petroleum products grew faster than expected in 2011/12. Diesel and gasoline consumption

grew by 8 and 6 per cent respectively last year. In the first quarter of 2012/13, diesel consumption grew by over 10 per cent and total refined product consumption was up by 5 per cent. Overall refinery throughput is expected to be higher by 5 million tonnes in 2012/13 and domestic crude oil output may also increase by some 2 million tonnes. However, on account of stronger domestic consumption, the net surplus refined products available for export is likely to be lower this year by about 3 million tonnes.

145. The average price of crude oil (UK Brent) that has been taken into the estimation is $112 per barrel, which is marginally lower than the $114.7 per barrel of last year. The average price of UK Brent in the first four months of 2012/13 was $103 per barrel and it is not expected that the drop in prices in June 2012 to a low of $88.69 will be repeated, unless market participants are terrified to the extent that Europe made them feel in June 2012. Going forward the Council expects that crude oil prices will rise steadily as winter approaches and be well above $115 in the last quarter (Jan–March 2013).

146. On the export side, the value of refined petroleum product exports are thus expected to be 8 per cent lower at $53 billion and gems & jewellery marginally higher by 4 per cent. Non-oil, non-gems & jewellery exports are expected to grow by nearly $29 billion or almost 15 per cent. Total exports are thus expected to be $330 billion on trade basis which on BoP basis is estimated at $334 billion.

147. On the import side, the value of crude and refined petroleum is expected to increase by 8 per cent to touch $168 billion. The value of net imports of crude petroleum and refined products would increase by 18 per cent to $115 billion. In addition there would be the import of LNG (liquefied natural gas), coking coal and thermal coal. The trade burden of energy dependence will thus get larger.

148. A large decline in the value of imports of bullion (mostly gold) is expected in the course of this year. The first quarter saw a sharp drop by 48 per cent. Smaller orders of decline is expected in the balance quarters and for 2012/13 as a whole, the value of bullion imports is expected to drop to $44 billion – a drop of nearly 29 per cent compared to last year and slightly greater than that recorded in 2010/11.

149. Non-oil, non-gold, non-gems imports are expected to increase by little over 10 per cent in the course of 2012/13. The value of import of gems is expected to

pick up in the second half, but overall levels are likely to slightly lower than last year.

150. The total value of imports is expected to thus be lower by 3 per cent in the first half of 2012/13 which would turn into positive 9 per cent in the second half of the year. In aggregate value of imports in 2012/13 would be higher by something in excess of 3 per cent.

151. The projected merchandise trade deficit for 2012/13 at 9.7 per cent of expected GDP is still very high, but it would be an improvement over the 10.2 per cent recorded in 2011/12. It is primarily this reduction in the magnitude of the merchandise trade deficit that is expected to ease the CAD down to 3.6 per cent of expected GDP.

152. In 2011/12 export earnings from software & BPO grew very strongly by 21.2 per cent while private remittances grew by 19.5 per cent. Total of net earnings on invisibles expanded by 20 per cent. In 2012/13 a moderation in growth of service sector exports and of remittances are expected, while the large negative balance on net investment income may turn larger. Overall the net balance on invisibles is expected to grow by about $2.5 billion or 6.1 per cent of GDP. For 2012/13, the balance on net invisible is projected at $114 billion vis-à-vis the $111.6 billion in 2011/12.

153. The CAD projected for 2012/13 is thus $67.1 billion or 3.6 per cent of expected GDP. There is a potential upside to the CAD on account of the balances on net invisible (exports of ITES industry, remittances and tourism) to do better than has been projected. However, offsetting this is the potential of higher petroleum prices and continuance of gold imports at levels higher than projected.

Capital Account – Review of 2011/12

154. The surplus on the capital account in 2011/12 was $68 billion, slightly lower than the $72 billion estimated in July 2011 and again in February 2012. However, there was a compositional difference. Equity inflows – FDI and FII equity investments – were larger than that projected and net inflow on loan account (after repayment) was much less. Banking capital inflows were higher than projected primarily on account of much higher NRI deposit inflow. The latter was a consequence of favourable changes in the policy regarding fixation of interest offered on such deposits. However, the CAD was greater than was the balance on

Table 5

Balance of Payments

Unit: US$ billion

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Merchandise Exports	85.2	105.2	128.9	166.2	189	182.4	250.5	309.8	333.8
Merchandise Imports	118.9	157.1	190.7	257.6	308.5	300.6	381.1	499.5	515.0
Merchandise	–33.7	–51.9	–61.8	–91.5	–119.5	–118.2	–130.6	–189.8	–181.1
Trade Balance	*–4.7%*	*–6.2%*	*–6.5%*	*–7.4%*	*–9.8%*	*–8.5%*	*–7.5%*	*–10.2%*	*–9.7%*
Net Invisibles	31.2	42	52.2	75.7	91.6	79.7	84.6	111.6	114.0
	4.3%	*5.0%*	*5.5%*	*6.1%*	*7.5%*	*5.8%*	*4.9%*	*6.0%*	*6.1%*
o/w Software & BPO	14.7	23.8	27.7	37.2	47.0	41.5	49.6	60.1	64.0
Private Remittances	20.5	24.5	29.8	41.7	44.6	53.5	53.1	63.5	66.0
Investment Income	–4.1	–4.1	–6.8	–4.4	–6.6	–5.5	–16.4	–16.5	–20.0
Current Account	–2.5	–9.9	–9.6	–15.7	–27.9	–38.5	–45.9	–78.2	–67.1
Balance	*–0.3%*	*–1.2%*	*–1.0%*	*–1.3%*	*–2.3%*	*–2.8%*	*–2.7%*	*–4.2%*	*–3.6%*
Foreign Investment	13.0	15.5	14.8	45.0	3.5	51.2	38.0	39.2	38.2
o/w FDI (net)	3.7	3.0	7.7	15.4	17.5	18.8	7.7	22.1	24.0
Inbound FDI	6.0	8.9	22.7	34.2	35.0	33.1	24.0	33.0	37.0
Outbound FDI	2.3	5.9	15.0	18.8	17.5	14.4	16.3	10.9	13.0
Portfolio capital	9.3	12.5	7.1	29.6	–14.0	32.4	30.3	17.2	14.2
Loans	10.9	7.9	24.5	41.9	4.1	14.3	27.9	19.3	21.0
Banking capital	3.9	1.4	1.9	11.8	–3.2	1.5	5.0	16.0	20.0
Other capital	0.7	1.2	4.2	9.5	4.5	–13.0	–10.4	–6.9	–6.0
Capital Account	28.0	25.5	45.2	108.0	8.7	53.4	60.0	67.8	73.2
Balance	*3.9%*	*3.1%*	*4.8%*	*8.7%*	*0.7%*	*3.9%*	*3.5%*	*3.7%*	*3.9%*
Errors & Omissions	0.6	–0.5	1.0	1.2	1.1	–1.6	–2.6	–2.4	–2.0
Accretion to Reserves	**26.2**	**15.1**	**36.6**	**92.2**	**–18.1**	**13.3**	**11.5**	**–12.8**	**4.0**

Note: Percentages are with respect to GDP

the capital account and there was a net drawdown of reserves amounting to nearly $13 billion. The shortfall in the capital account balance to service the CAD was non-existent in the first half of 2011/12 but was significantly large in the third quarter and to a somewhat lesser extent in the fourth quarter.

Capital Account – Outlook for 2012/13

155. Some data is available for the first quarter of 2012/13, in most cases only for the first two months and in the case of FII investments up to the end of July 2012. Net FDI and FII (equity) inflows appear to have been less than that in the corresponding quarter of last year. So also seems to have been the case of net commercial loans as well as investment in short-term credits. However, inflows into NRI deposits were much greater. Overall net capital inflows in the first quarter were perhaps about adequate to service the CAD but would not have left a significant surplus unlike the first quarter of 2011/12 when it had.

156. In the course of the year, both FDI inflows and outflows are expected to be a little higher than that of last year, with the net FDI position about $2 billion more than last year's $22 billion. Portfolio equity capital flows (mostly FII) are placed lower than that recorded last year, while loans net inflow on commercial loans would be a bit more. Inflows into NRI deposits are placed at $20 billion, about $8 billion more than that of the previous year.

157. Overall the net balance on capital flows is placed at $73 billion, which would be about just sufficient to service the projected CAD of $67 billion for the year as a whole. However, there are likely to be periods where the servicing needs of the CAD might run in excess of the capital flow position. In the thin market for rupee liabilities this may continue to put pressure on the exchange rate as it did last year.

158. However, the situation on the capital account, taking the external environment as a given, primarily develops from the perception regarding policy stance. If the latter is seen to improve the state and potential of the economy and appears to be receptive of foreign investment, financing conditions can greatly ease, even if with the same level of CAD. After all in 2011 there were 86 countries, not including India, that had a CAD of 4 per cent of GDP and higher. Just as there were 34 economies with a current account surplus of 4 per cent of GDP and higher. In fact the number that could be said to be within "desirable" limits of ±2 per cent of GDP was a minority of 32 nations.

159. Economies have asymmetric access to capital. The US has had little difficulty in accessing capital over the past four decades of extended periods of large current

account and fiscal deficits. In the Eurozone, till the present crisis broke out, several member nations were running enormous CAD or fiscal deficits or both – but continued to enjoy easy access to cheap capital. For developing economies access is harder and the penalties on account of increase in CAD and fiscal deficit accumulate all too quickly. It is therefore preferable if the CAD can be retained at a level where it's financing from capital flows is comfortable and causes no particular worry. In the nineties after the 1991 crisis this line used to be drawn at 2.5 per cent of GDP. Since then India has been able to drawn in much more capital. However, international financial conditions remain under stress and anything in excess of 2.5, certainly 3.0 per cent, is cause for concern.

160. Simultaneously capital inflows, especially equity capital, that is of risk capital needs to be cultivated. For the most part it is the private corporates that make the case for investment. The role of government creates the ground conditions for such cases to be made persuasively and further government acts as of the facilitator and regulator. It is this role that is brought into sharp relief when capital is scarce and seems to recede with great speed into the background when that is no longer the case.

161. The management of the capital account is as important as the current account–since we do have a managed capital account. If capital flowed in ever so readily between 2003 and 2007, dropping barely into the red in the crisis second half of 2008/09 and recovered to 3.5 and 4.0 per cent of GDP in the years thereafter, it was because of the extensive efforts that had gone in the preceding decade.

162. We should not presume for a moment that "where would capital flow but to us". Billions of dollars of capital can remain and are stuck at 10–15 basis points (bps) yields on US treasury bills and zero yield short dated German bunts. It certainly does not yield anything, but it preserves value. That is the meaning of "risk averse". So it is necessary for developing countries to realize that inadequate opportunity for investment in advanced economies does not mean that they will necessarily flow to them. Developing countries including India need to be proactive in attracting capital flows.

VII. PRICES, INFLATION MANAGEMENT & MONETARY POLICY

Global Situation

163. Consumer prices inflation has continued to remain subdued in most of the advanced world, mostly on account of flat labour costs. Commodity prices that had seen a big run up in late 2009 onwards have also tended to come off their highs. While crude oil prices are likely to harden, *albeit* more slowly, it is possible that other energy and material prices may level off. The FAO price index shows that most food prices are still high, relative to a few years back, but are lower than the peaks touched in February–April 2011. In sum the global inflation outlook at this point in time looks to be less troubling than it was a year or two back. However, given the volatility in markets, changes other than those expected are not improbable.

Domestic Inflation – Trends

164. At home, the headline WPI inflation rate in the current fiscal year is still staying above 7 per cent, though that is an improvement over last year when it was mostly over 10 per cent or close to it. The Consumer Price Inflation indices however continue to report inflation at 10 per cent or close. The nature and dynamics of the WPI inflation is however better understood and for immediate inflation management purposes, this is the one on which we may need to focus. If the WPI inflation rate comes down, the CPI inflation will also follow, sooner or later, and vice versa, even though there can be periods where there is substantial variation.

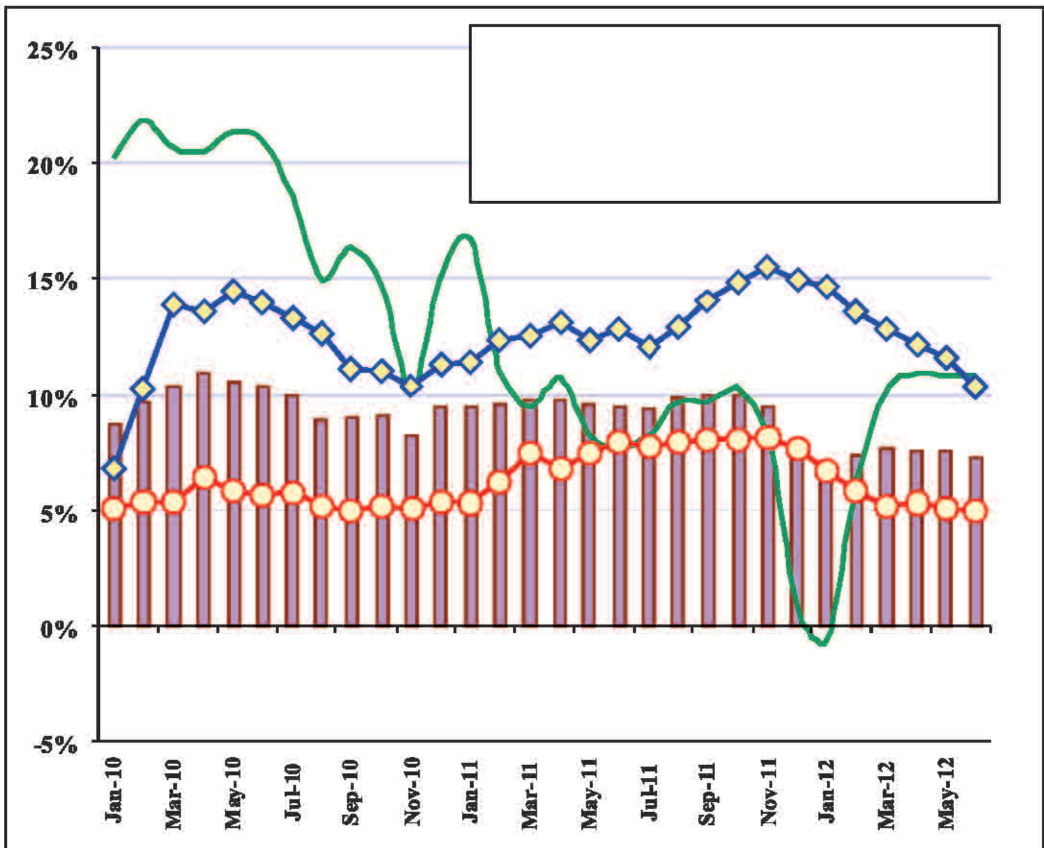
165. The principal driver of the rising momentum of WPI inflation has been primary food articles (Charts 7.1 and 7.2) on the one hand and energy on the other. In primary food, the present bout of high inflation started off with pulses and rice, and subsequently wheat. The price spike in rice and wheat following on the poor 2009 SW monsoon was managed by open market interventions using official cereal stocks. This eventually succeeded in smoothening out open market prices of rice and wheat. The increase in pulses output in 2010/11 helped to cap the increase in

price. Prices of perishables which followed that of foodgrains have been more resistant to normalization and continue to increase quite fast – especially that of vegetables. Unlike rice and wheat, government does not have any instruments at its disposal to directly deal with these products.

166. The average monthly rate of WPI inflation in 2011/12 was 8.9 per cent, with the March 2012 rate being 7.7 per cent. The average for primary food articles was 10 per cent, for energy 13.6 per cent and for manufactured goods 7.2 per cent. The pressure from primary food inflation began to come off through 2010, but manufactured goods took up the baton in late 2010 and 2011 as may be evident from Chart 7.1. Primary food inflation has recovered momentum in the last few months.

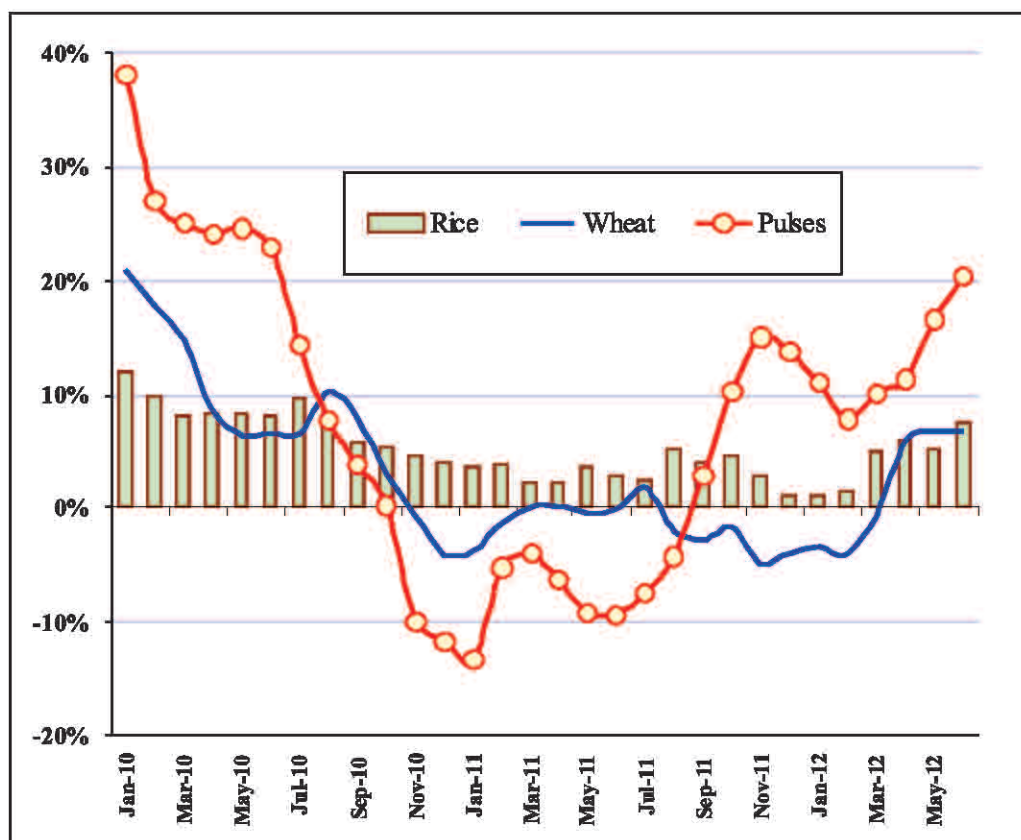
Chart 7.1

Major Components of the WPI Headline Inflation Rate



167. It is clear that inflationary pressures on rice still remain, partly on account of the increases made in the MSP as also because of nervousness in regard of the deficiency in the SW monsoon. The easing in prices of pulses has also worn off, mostly because the trend in output increase was not maintained. In fresh farm produce, inflation levels in milk and eggs, meat and fish remain high, while that for fruit has eased a bit. However, given the high volatility in fruit and vegetables, especially in the latter, sudden spikes in either direction – more worryingly on the high side will continue to be a matter of concern (Chart 7.2).

Chart 7.2
Inflation in Foodgrains

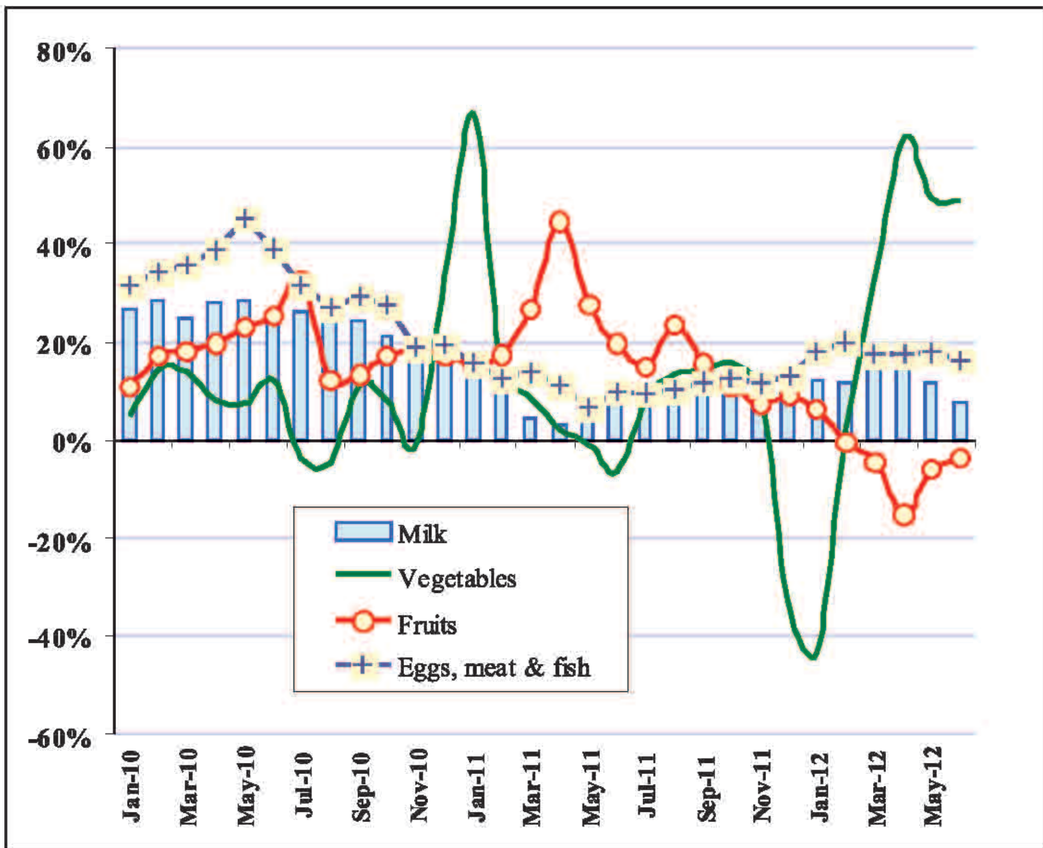


168. While the rate of inflation for primary food articles, especially fresh produce, continue to be high and vulnerable to spikes, the rate of output increase in these products have been quite strong, ranging from about 4.5 per cent per annum for

milk and 7 to 8 per cent for horticultural produce. With market access expanding on account of better road networks, production by the farmer for the market has expanded and will continue to expand, since such items embody more potential earnings and are well- suited for the small land holdings that are the norm in India. Almost every State government is encouraging farmers to pursue horticulture and animal husbandry by way of extension services, planting material and financing assistance for shade houses, micro-irrigation and other productivity enhancing measures. However, the supply chain and market structure remains antiquated and this results in huge wastage, high handling and transport costs and unjustifiably high mark ups. The farmer gets only a small fraction of the high price that the consumer eventually pays.

Chart 7.3

Inflation in Perishable Farm Produce



169. Despite the 25 per cent increase in petroleum prices during 2010/11 and the 32 per cent increase during 2011/12, with oil (UK Brent) going from $79 per barrel (/bbl) in March 2010 to $115/bbl barrel in March 2011 and $125/bbl in March 2012, average inflation for petroleum products in 2010/11 and 2011/12 were 16.0 and 16.9 per cent respectively (Chart 7.1). This was because the prices of automotive fuels were restrained by administrative decisions. Thus diesel prices in the absence of the restraint and the subsidy would have been about 20 per cent higher. The subsidy bill 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.

170. Inflation in manufactured goods picked up from February 2011 (6.3 per cent) and continued to rise up to October 2011 (8.0 per cent), before slowly easing off towards the 5 per cent level over the following months. The short-lived spike in cotton prices took it to an all time record of over US 200 cents per pound (in March 2011). This resulted an unprecedented increase in the prices of cotton textiles and by association that of man-made textiles to some extent. To a considerable extent the elevation in the inflation rate for manufactured goods was a consequence of this. In the first half of 2010/11, textiles added 1.4 to 1.9 percentage points to the inflation rate for manufactured goods.

171. The other significant contributors to the elevation in the inflation rate for manufactured goods were ferrous metals, chemicals, rubber & plastics and edible oil – all of them linked to the rising petroleum prices. In 2012/13 the categories showing high rates of inflation are sugar, edible oil, chemicals and metals, both ferrous & non-ferrous. However, the inflation rate for manufactured goods excluding manufactured food items is below 5.0 per cent and is a source of some comfort, given that the significant depreciation in the currency had the potential to cause manufactured goods prices to rise by more.

Inflation Outlook in 2012/13

172. The deficient SW monsoon in 2012 is likely to have an adverse impact on he prices of primary food items, especially on those where the ability of government stocks to play a moderating role is not there. However, on the positive side, the global price environment is somewhat better now than it was in the last few years.

Further, over the past few months it is possible to discern a moderation in the inflation rate of manufactured goods, especially that the non-food category.

173. Primary food inflation has averaged a little over 10 per cent since March 2012, up from 6 per cent in February 2012. The main reason for the change in direction was the pick up in the prices of vegetables (Chart 7.3). In recent months there has also been some upward movement in rice and pulses. Some more may be expected on account of the weak monsoon. Thus, there continues to be some vulnerability in the area of primary food prices and policy initiatives that creatively address this problem will need to be implemented.

174. In primary commodities, oilseeds have picked up, linked to the increase in edible oil prices and slightly lower output last year and prospects of some erosion in the current year. Cotton prices have been stable since coming off their 2010-11 winter highs, but prospects of crop losses may reinforce the weak price recovery that is already in evidence.

175. Inflation in energy prices have been around 10 to 14 per cent in the first three months of 2012/13, kept significantly suppressed because of the subsidies paid out on account of diesel and some other petroleum products. It is not likely that all of this subsidy will go, but it may be reasonably expected that some containment on this front would reflect itself in the price of energy – an outcome that has been built into the inflation projections made here. The projected average inflation in energy products is expected to be about 12 per cent for 2012/13 as a whole. Increases in diesel and power prices will have second order effects in manufacturing and other components.

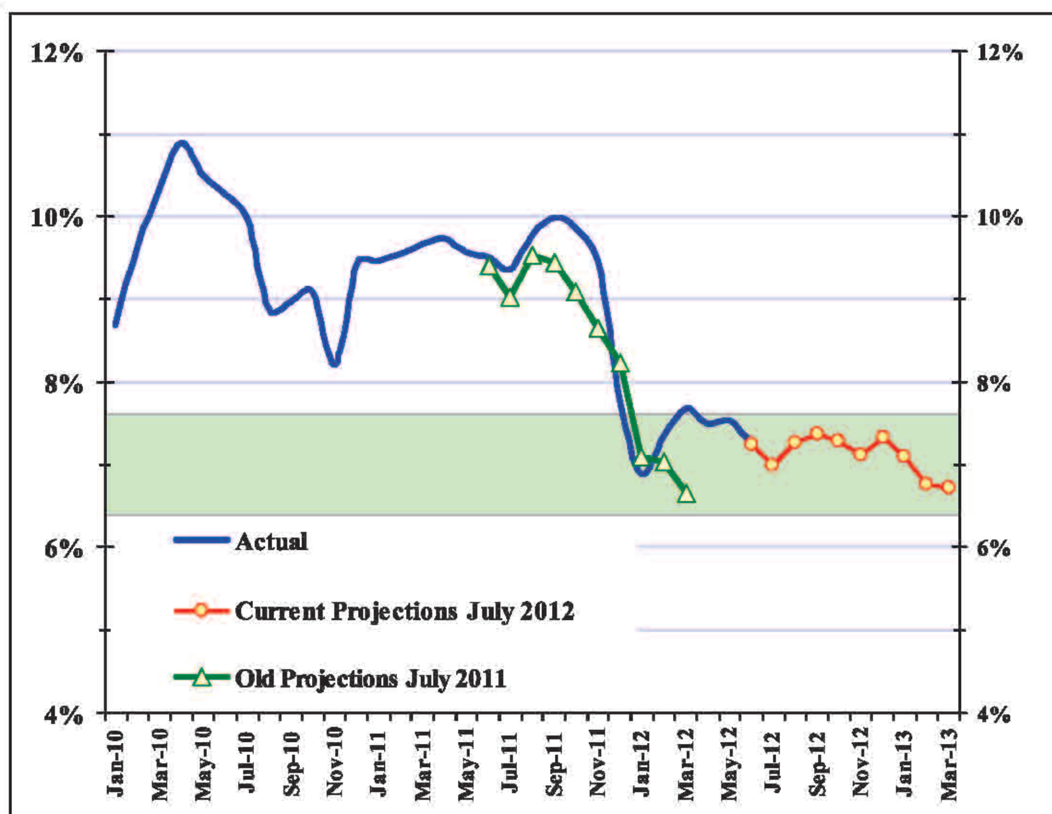
176. Manufactured goods inflation is expected to average just below 5.0 per cent inflation over the year, while that of manufactured products other than manufactured food is likely to be lower.

177. Overall for the year the WPI inflation rate is expected to average a little over 7 per cent, while that at the end of the year (March 2013) is expected to be less than 7 per cent in the range of 6.5 to 7.0 per cent. The actual and projected trajectory of WPI headline inflation rate, along with the estimates made by the Council last year is placed at Chart 7.4 and described as "current projections". The

chart also shows the projections that underlay the Council's estimates made in July 2011 described in the chart as "old projections"

Chart 7.4

Headline WPI Inflation Rate – Actual and Projected



178. The estimate presented here is not dissimilar to that made by the RBI in late July of expected March 2013 inflation at 7 per cent. The Council has factored in the proactive measures that will be needed to manage food prices given our recent historical experience.

Monetary Policy

179. The RBI began to reverse the large crisis occasioned by monetary easing in early 2010. It raised the policy interest rates 13 times between March 2010 and

October 2011, taking the repo rate from 4.75 to 8.50 per cent, an aggregate increase of 375 basis points (bps). It raised the Cash Reserve Ratio (CRR) twice, the first time in January 2010 and then again in April 2010, taking it from 5.0 to 6.0 per cent. It began easing a bit since January 2012 when it cut the CRR by 50 bps and then again by another 75 bps in March. This was followed by a cut of 50 bps in the repo rate in April 2012.

180. In May 2011 the RBI raised the deposit rates on savings bank accounts which was the only regulated deposit rate by 50 basis points. In October of that year it finally deregulated the rate of interest offered by banks on savings accounts.

181. In 2010/11, reserve money grew by 18 per cent and broad money by 16 per cent. In 2011/12, reserve money expansion was low at 5 per cent on account of draw down in foreign currency reserves, pushing down broad money expansion to 13 per cent. Liquidity conditions were resultantly tight.

182. Banks that were at the reverse repo (deposit) window to the extent of Rs 100,000 crore till March 2011, turned borrowers. Volumes at the repo window picked up a bit in June and then soared from October 2011 onwards. Repo borrowings between Oct 2010 and June 2011 were consistently large with a median value of Rs 78,000 crore and on half of the days (1st to 3rd quartile) was between Rs. 59,000 and 104,000 crore. After a short respite of two months, repo borrowings again shot up. Between mid-September 2011 and July 2012, the median repo borrowing rose to Rs 104,000 crore with Q1 and Q3 at Rs 84, 000 and 131,000 crore. This was despite the cuts in CRR made in January 2012 and again in March. Since July 2012 the repo window volumes have come off.

183. The tight liquidity conditions reflected the tight monetary stance. That the repo window and other liquidity facilities were active to such an extent speaks to the underlying strength of demand for credit. That inflation in manufacturing goods did ease off in the latter part of 2011/12 was reflective of the extant monetary policy.

184. Over the past year lending by both the central bank and commercial banks to the government has exceeded their lending to the commercial sector with respective growth in 2011/12 being 20 and 18 per cent respectively. That appears to be continuing into 2012/13 with the data for the fortnight ending 13 July 2012 showing

that net bank credit to government rose by 7.9 per cent as against growth of net bank credit to the commercial sector of 2.3 per cent.

185. In the most recent period, the rate of growth, as evidenced in quarterly GDP numbers, has weakened. At the same time although inflation has reduced from the level of last year it still remains uncomfortably high. The redeeming element is the reduction in the rate of inflation in manufactured goods, given especially the context of the 18 per cent drop in the nominal value (NEER) of the Indian rupee in the course of the current fiscal. The weak monsoon has fanned the fears that volatile price behaviour in the primary foods area may cause a flare-up once again. However, administrative and other facilitating initiatives have a better chance of limiting the degree of the monsoon's impact on food prices.

186. Measures to improve investment sentiment and augment output will help in maintaining price stability in manufactured goods. This can provide some elbow room for monetary policy to recalibrate their stance in order to accommodate the funding needs of industry and commerce. Doubtless to the extent that Government is able to contain its borrowing needs, it will be of great assistance to the process.

VIII. FISCAL POLICY AND MANAGEMENT

187. Escalating fiscal imbalance in the country continues to be a major area of policy concern. Besides claiming substantial portion of the revenues for interest payments, government borrowings have pre-empted substantial proportion of financial savings for public consumption and investment and have constrained the space for calibrating monetary policy. The IMF *Fiscal Monitor* April 2012, shows that India is amongst the most fiscally stressed country in Emerging Market Economies. The large fiscal imbalance is an important factor contributing to poor investment climate in the country.

188. As reported in the Review in February, 2012, it was expected that there will be slippage in the revenue and fiscal deficit targets of 2011/12. However, when the budget was presented in March, the slippage turned out to be much larger than expected. As against the budget estimate of 4.6 per cent of GDP, the revised estimate of fiscal deficit was 5.9 per cent (Table 8.1) and after tasking into the revision in GDP estimates, it works out to 5.7 per cent. Similarly, the revised estimate of revenue deficit relative to GDP was higher at 4.4 per cent as compared to the budget estimate of 3.4 per cent. The slippage in the deficit estimates has serious implications on medium term targets as well. The targets of both fiscal and revenue deficits in the rolling *Medium Term Fiscal Plan* (MTFP) were considerably revised upwards for the next two years and for 2014/15 (the terminal year of the Thirteenth Finance Commission recommendations), the target is now set at 3.9 per cent as against 3 per cent recommended by the Finance Commission. Besides the adverse consequences of high deficits, the sharp slippage in the deficit targets has raised questions about the commitment of the government. The Finance Commission had recommended that the fiscal targets in the MTFP should not be a mere statement but a commitment. Therefore, it is important for the government to substantially bring down the deficits expeditiously to ensure credibility of the targets.

189. The slippage in fiscal deficit estimate was mainly due to substantial increase in subsidies. The continued high prices of crude oil on the one hand and the

reluctance to increase the administered prices of oil products on the other have resulted in substantial losses by Oil Marketing Companies. Furthermore, as a significant proportion of expenditure increase undertaken during the last two years was irreversible, the budget estimate of fiscal deficit continues to be high at 5.1 per cent.

Table 8.1

Fiscal Position in India

Unit: per cent of GDP

	Centre			States			Consolidated		
Year	Rev. Deficit	Fiscal * Deficit	Primary Deficit	Rev. Deficit	Fiscal Deficit	Primary Deficit	Rev. Deficit	Fiscal * Deficit	Primary Deficit
2002-03	4.40	6.04	1.11	2.33	3.88	1.25	6.64	9.71	3.02
2003-04	3.57	4.62	–0.03	2.19	4.27	1.46	5.79	8.65	1.95
2004-05	2.42	3.90	–0.04	1.21	3.11	0.66	3.54	7.26	1.12
2005-06	2.50	4.73	0.37	0.19	2.33	0.16	2.69	7.26	0.79
2006-07	1.87	4.27	–0.18	–0.58	1.82	–0.37	1.29	6.32	–0.33
2007-08	1.05	3.11	–0.88	–0.86	1.49	–0.49	0.19	4.65	–1.02
2008-09	4.54	8.20	2.59	–0.21	2.40	0.57	4.33	10.62	3.45
2009-10	5.18	6.61	3.14	0.37	2.80	1.03	5.54	9.41	3.99
2010-11	3.29	4.87	1.82	–0.03	2.07	0.45	3.26	6.94	2.13
2011-12 RE	4.46	5.89	2.78	–0.06	2.28	0.74	4.40	8.18	3.41
2012-13 BE	3.45	5.06	1.91	–0.40	2.12	0.59	3.05	7.17	2.41

Note 1: Fiscal deficit includes off-budget liabilities; RE: Revised Estimate; BE: Budget Estimate. Provisional estimate of fiscal deficit for 2011/12 according to CGA is 5.7 per cent of GDP.

2: (–) indicates surplus.

Source: Public Finance Statistics, Ministry of Finance, Government of India; 2. Budget documents of central and State governments.

190. Even this is predicated on the assumption that (i) the outlay on subsidies will be reduced in absolute terms from Rs. 216,297 crore in 2011/12 (RE) to Rs. 190,015 crore in 2012/13 (BE) or by about 0.55 percentage point to GDP and (ii) increase in the tax-GDP ratio by about 0.5 percentage point which implies the Gross tax revenue of the centre will grow at 19.5 per cent during the current year over the revised estimate of 2011/12.

191. Containing subsidy at the budgeted level will crucially depend on realigning the administered prices of oil distillates. The price of motor spirit has been substantially decontrolled and that leaves decontrolling of diesel prices as an important policy initiative that must be taken without much loss of time and subsidies on account of LPG and kerosene must be reduced either by raising the prices or by reducing the quantity supplied at the subsidized price.

192. On the taxes front, the enhancing of the excise and service tax rates from 10 to 12 per cent and expanding the service tax base by taxing all services with a negative list instead of levying the tax only on selected services will certainly help to increase revenues. However, at a time when the manufacturing sector growth is decelerating, achieving the growth rate of 29 per cent in excise duties and 30.5 per cent in service tax over the revised estimates of the previous year as assumed in the budget is not easy to realize.

193. In contrast to central finances, the fiscal health of the states looks much better. They have been able to eliminate revenue deficits and the aggregate fiscal deficit of the states in 2011/12 is 2.3 per cent and is budgeted at 2.1 per cent for 2012/13 (Table 8.1), which is well within the targets set by the Finance Commission. Although this is true of most of the large general category states, as a ratio of GSDP, West Bengal has the highest revenue deficit (3.6 per cent) followed by Punjab (2.3 per cent) and Kerala (1.3 per cent). Similarly, West Bengal and Punjab had the highest fiscal deficit (3.9 per cent) followed by Kerala (3.5 per cent). While the deficits in Kerala were in conformity with the separate fiscal adjustment targets laid down by the Finance commission, the deficits in both Punjab West Bengal were well above the targets.

194. An important issue of concern in the case of state finances is the fiscal health of their power utilities. The losses of power utilities in 2010/11 are estimated at over one per cent of GDP and this is expected to be much larger in 2011/12. Even

after raising the tariffs by some power utilities in 2012/13, significant under-recovery is expected to continue. One estimate of projected losses of power distribution utilities for 2012/13 is about 0.8 per cent of GDP. The overall indebtedness by the utilities in 2009/10 was close to 4.7 per cent of GDP and this poses serious risk to the financial system. The previous attempts to reform the sector have not succeeded in ensuring financial viability and therefore, any restructuring plan for state power utilities should give sufficient weight to reforming the sector towards ensuring viability.

195. The Planning Commission is contemplating a restructuring plan for these utilities by issuing bonds on 50 per cent of their outstanding loans and restructuring the remaining 50 per cent. The utilities will be given a moratorium of 3 years and the repayment will be in seven years. While working out a plan for debt restructuring it is important to undertake effective reforms to ensure that they eliminate loses by reducing transmission and distribution losses and raise prices in keeping with the costs.

196. The consolidated fiscal deficit of central and state government as a ratio of GDP for 2011/12 works out to 8.2 per cent and is budgeted at 7.2 per cent for 2012/13 (Table 8.1). In order to adhere to Finance Commission's target for 2014/15, the central and state governments will have to compress their deficits by about 3 percentage points. There will be additional pressures to increase spending on food security and healthcare in the 12th Plan. Thus, the challenge of conforming to the fiscal targets set by the Finance Commission in the medium term is going to be formidable and immediate measures must be introduced to contain subsidies and transfers and increase revenues.

197. In the medium term, government will have to increase the tax-GDP ratio substantially. After reaching a peak of 17.6 per cent in 2007/08, the total tax-GDP ratio of central and state governments declined to 15.1 per cent in 2009/10 and gradually recovered to 16.3 per cent in 2011/12. This is low even by international standards. A study by Richard Bird and Eric Zolt showed that the tax-GDP ratio rose from about 17 per cent in the low-income countries (with less than US$ 1,000 per capita income), to 22 per cent in the medium-income group (per capita income between US$ 1,000–17,000) and 27 per cent in the high-income group (per capita income above US$. 17,000). The government can fulfil its role of providing

satisfactory levels of public services without burdening the future generation only when it is able to mobilize substantially higher volume of resources by way of taxes.

198. The two important tax reform measures that are on the table are the implementation of the Direct Taxes Code (DTC) and the Goods and Services Tax (GST). As far as DTC is concerned, the Standing Committee of Parliament has already submitted its recommendations to the Government and it is expected to be operational from April 2013. Although this is likely to simplify the tax code and bring in clarity, this may not increase the tax revenue substantially in the short term. Of course, some of the provisions of the DTC which the government sought to implement in the last budget, particularly the General Anti Avoidance Regulations (GAAR), have attracted criticism. Government has appointed an expert committee to make recommendations, and the issue should be settled soon.

199. Introduction of GST is the next stage of consumption tax reform. The arguments for GST are based on the fact that (i) it will have broader base and therefore, would require lower rate for generating the given amount of revenue; (ii) it will relieve the taxes on inputs and thus reduces cascading and will help to eliminate taxes on exports; (iii) it will help to create a national market by removing inter-state trade barriers; (iv) as a destination based tax, it will ensure that the revenues will accrue to the consuming state rather than producing state; and (v) the self-enforcing nature of the tax will enhance its compliance.

200. While the desirability of the tax is not in doubt, introduction of GST requires considerable negotiations, bargaining and preparatory work on both the structure and operation of the tax. Unlike in most other countries where the GST is a centralized tax, in India, it is proposed to be a dual GST that may be levied by both central and state governments. This implies both structure and administration of the levy will have to emerge after detailed negotiations and bargaining between the Union government and 28 States and 2 Union Territories with legislature. Given the sharp differences in the structure of the states' economies and sales tax revenues (as a ratio of GSDP) among the states, the interests of the states do not always coincide and considerable effort is needed to persuade the states to adopt a uniform structure and administrative system for the tax.

201. It is therefore, not surprising that despite the announcement by the Union Finance Minister in his 2007 budget speech that the GST will be implemented from April 2010, it has the reform is yet to be implemented. Of course, there has been considerable progress in placing the GST Constitution Amendment Bill in the Parliament and deciding the broad contours of the tax. The Bill has been taken up by the Standing Committee of the Parliament on Finance and after its recommendation, it will have to be passed by the Parliament as well as endorsed by the legislatures of half of the states. There has been a broad agreement that there will be a dual GST at central and state levels.

202. The Empowered Committee of State Finance Ministers has also agreed on the mechanism to ensure continuous input tax credit on cross border transactions. In this, the exporting dealer will pay the tax on inter-state sale or IGST which includes both central and state GST on his value added to a central agency after taking credit for input taxes paid by him; the input taxes will be transferred to the destination state by the exporting state and the importing dealer will continue the chain of transactions by claiming input tax credit. The central agency will work as a clearing house. The proposed creation of a special purpose vehicle to erect the technology platform with equity contributions by the technology partner (NSDL) and central and state governments is well under way. Extending the service tax to all the services with a negative list is an important measure that will help in the introduction of GST as the state will get a clearer idea about the size of the tax base they are likely to get when the tax is introduced.

203. While these are important steps, there are a number of measures which will have to be taken before the GST is implemented. These require negotiations between the central and state governments on the one hand and among the states inter se on the other. At present, the negotiations are stuck on the issue of paying compensation to the states for the revenue loss for the reduction of central sales tax.

204. The state governments reduced the central sales tax from 4 per cent to 3 per cent in April 2007 and further to 2 per cent in June 2008 and the centre agreed to compensate their loss of revenue. Since GST was not implemented according to the original plan in April 2010, the States have argued that the Union government should continue to compensate them for the loss of revenue until it is implemented.

There are also questions of the amount of compensation to be paid. The Empowered Committee has stated that the discussion on GST implementation can proceed only after the centre agrees to pay full compensation on this account.

205. There are a number of issues on which decisions have to be finalised which too would require negotiations, such as which taxes should be included in the GST, the thresholds to be adopted for registration, the list of exempted goods and services, the number of tax rates to be levied, what the rates of tax should be and whether the rates should be uniform or different, administrative arrangement for tax collection, and the mechanism to ensure compliance on agreed parameters by the centre and states.

206. The discussion paper put out by the Empowered Committee lists the taxes to be subsumed within GST. Ways and means will have to be found to include purchase taxes, octroi, entry tax in lieu of octroi in the proposed GST in the interest of ensuring a destination based tax, seamless trade across the country and minimising distortions. It is important to negotiate with the states to merge these in the proposed GST. The Constitution Amendment Bill proposes to keep High Speed Diesel (HSD), motor spirit as well as alcoholic beverages out of the GST fold. Conceptually, it is preferable to make them a part of GST and levy a separate excise for environmental and sumptuary reasons.

207. Finalising the thresholds for registration too needs to be negotiated. The states argue that the centre should maintain its threshold at the prevailing excise duty threshold of Rs. 1.5 crore for goods and Rs. 10 lac for services in the Central GST. Different thresholds for goods and services as well as for the centre and the states are likely to make the system complex, add to administrative burden and increase the compliance cost. If this is followed, the reform will limit the expansion in the tax base which is supposed to be one of the advantages of the reform. Final decision in regard to this issue will have to come out of negotiations.

208. The next issue to be decided is the rates of central and state GSTs to be levied. There has to be a convergence of views on the list of exempted goods and services and the number of tax rates to be levied and the list of goods and services to be included in different rate categories. This also requires the estimation of revenue neutral tax rates for the centre and for each of the states. Given the wide inter-state variations in the VAT collections, the revenue neutral rates is likely to

vary widely and converging on a common consensus rate will not be easy. Furthermore, most states prefer to have two rates rather than one and hopefully, besides the merit rate on a few essential items of consumption, there will be a general rate on goods and services.

209. There are also questions about the uniformity of tax rates across States. The states seem to prefer a floor rate rather than fixed rates. While the states may feel that they lose fiscal autonomy if uniform rates are mandated, there is much to be gained by having uniform rates in terms of ensuring simplicity and reducing compliance cost. The reform of moving from a system in which there are reasonably uniform rates of VAT to heterogeneous rates of GST will certainly be retrograde. Persuading the states to have a uniform tax system requires the Union government to compensate the revenue losses in the states and the mechanism for compensation will have to be agreed upon.

210. Another major area for negotiation is on the treatment of taxes on services with inter-state coverage. In respect of services such as transportation of passengers or goods in railways or telecom, the place of sale and payment and the place of consumption may not coincide and allocation of revenues will have to be negotiated and settled. Although general principles of allocation have been discussed and usually the appropriation is done according to the rules of origin, it is important to have clearly defined principles and rules for the allocation of revenues from transactions in such services.

211. One of the contentious issues relating to the GST Bill is the mechanism envisaged to ensure compliance of the decisions by all parties concerned. To achieve this, the Bill proposes to have a GST council comprising of the Union and State Finance Ministers and with the Union Finance Minister as the Chairman and the Chairman of the Empowered Committee as the Vice-Chairman. In order to have an effective dispute redressal mechanism, the Bill proposes to have a GST Tribunal headed by a retired judge of the High Court. This is an issue that needs to be discussed and settled with the states. The states feel that the attempt should be to build trust and understanding to ensure discipline and compliance to rules. In their view, the Empowered Committee of State finance ministers has done well so far in trying to persuade all the states to follow a disciplined to approach to VAT. According to them, rather than bringing about formal mechanisms, the existing arrangement should continue.

212. Another area where a lot of work is needed is in setting up an administrative system for GST and working out the transitional arrangements. Even if it is taken that every state and the centre will be involved in administering their respective GST, considerable work needs to be done to train the administrators in every aspect of administration and enforcement of the tax. Although the special purpose vehicle will be created to erect the technology plat-form, the technology must be developed and put in place. Equally important is the orientation and training of the taxpayers. It is also important to educate the tax payers on the new tax.

213. On the whole, considerable amount of work remains to be done in implementing the GST. Negotiation on all these issues would take time and will have to be done in the larger interest of having a competitive tax system in the country. Rather than considering the immediate loss to one state or another, it is necessary to look at the medium and long term gains from the national common market, efficient and export friendly tax regime.

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