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Economic Outlook for 2009/10

Economic Advisory Council to the
Prime Minister

New Delhi

October 2009

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ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER

NEW DELHI

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ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER

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ECONOMIC OUTLOOK FOR 2009/10
Executive Summary

Growth Performance and Outlook

i. Marking a distinct break from the past the economy grew at an average of 8.5 per cent and the per capita GDP at 6.9 per cent in the five-year period from 2004/05 to 2008/09, despite the crisis-affected year of 2008/09. The Indian economy weathered the financial turbulence well and grew at 6.7 per cent in 2008/09, which despite being 2 per cent lower than the average of the preceding three years, was still of a lower order than in most of the world. This achievement belongs to the common Indian citizen with credit being shared by the policy maker. The rapid adjustments in the monetary and fiscal policies were well calibrated and not excessive, enabling the Indian government to contemplate a return to fiscal consolidation in 2010/11 and an early normalisation of the monetary policy stance.

ii. The Indian economy escaped the global contagion primarily because the Indian banking sector was not exposed to the risky assets, similar to those financed in the advanced economies. The three important lessons to be drawn from this are, first, prudence is an essential virtue for financial and fiscal stability; second, deposit-based banking, as is practiced here, is perhaps the more solid foundation to bank lending than the one based on short-term borrowings from capital markets by banks; third, the financial regulators should be intimately conversant with the products and practices that they are enjoined to regulate.

iii. In 2009 and 2010, the principal factors detrimental to prospects of a sharp recovery in the growth rate of the Indian economy derive from the international situation. The recession in the developed economies will make recovery a slow and long drawn out process with negative implications for import demand for manufactured goods and services. The weakened state of these economies and the global financial system hold out the possibility that conditions could suddenly deteriorate in the wake of a negative shock, such as a payment crisis in a large bank or a crisis precipitated by a sovereign creditor. Though, the deficient monsoon will pull farm sector growth down, that should not be a handicap if the monsoon is normal in the following years.

iv. Internationally, oil and commodity prices have started rising and as economic growth picks up, there is a distinct possibility of further increases. The loose monetary and fiscal stance adopted across the world will support strong price gains, even as the real economic activity recovers at a slow pace. On the domestic front the sharp increase in the price of food grains, especially rice and pulses, other primary food products and of sugar is a major policy concern. Even in the winter of 2008/09, as world prices of manufactured goods and internationally traded basic foods were declining, the domestic prices were increasing. The weak monsoon rains and available acreage data suggest a lower *kharif* output rendering the management of inflation in food products a severe challenge in this fiscal year. While the current weather conditions favour a strong *rabi* (winter) crop, the possibility of adverse weather conditions in *rabi* cannot be completely ruled out.

v. The industrial sector is likely to show vigorous growth in the second half of the year and farm sector output and GDP growth are likely to be negative. Given the variability of the key elements, the Indian economy is likely to grow by about 6.5 per cent in 2009/10. It is unlikely that growth will be lower than 6.25 per cent but possible that it could reach 6.75 per cent. The projections by industry of origin, are presented at Table-A.

International Economic Conditions

vi. The global economic crisis had two separate components. The first derived from a five year period of above-trend economic growth. In the developed economies the unemployment levels fell to historic lows and commodity and asset prices rose while the developing economies were impacted by the worldwide demand boom in the area of commodities and assets. Ordinarily the necessary adjustment should have been brought about by a tightened monetary policy but this did not happen leading to the second component of the crisis flowing entirely out of the financial systems in the developed economies. The easy money and fiscal policies adopted to leverage the US economy out of recession in 2001 resulted in a large liquidity overhang, blurring risk perceptions. This, in combination with the highly inadequate regulatory oversight and large-scale dilution of standards by financial market players resulted in the creation of bad assets leading to the financial crisis and recession in the advanced economies. The outcome was worsened by the global structural imbalances - a large current account deficit in the US and a matching current account surplus of oil exporting nations, China and Japan.

Table A: Growth – Past Performance and Projections for 2009/10

Annual Rates	2004/05	2005/06	2006/07	2007/08 QE	2008/09 Rev	2009/10 Projected
Percentage change over previous year						
1. Agriculture & allied activities	0.0	5.8	4.0	4.9	1.6	–2.0
2. Mining & Quarrying	8.2	4.9	8.8	3.3	3.6	10.0
3. Manufacturing	8.7	9.1	11.8	8.2	2.4	7.7
4. Elect., Gas & Water Supply	7.9	5.1	5.3	5.3	3.4	7.4
5. Construction	16.1	16.2	11.8	10.1	7.2	8.8
6. Trade, Hotels, Transport, Storage & Communication	10.7	12.1	12.8	12.4	9.0	8.4
7. Finance, insurance, real estate & business services	8.7	11.4	13.8	11.7	7.8	8.0
8. Community & personal services	6.8	7.1	5.7	6.8	13.1	8.0
9. Gross Domestic Product (factor cost & constant prices)	**7.5**	**9.5**	**9.7**	**9.0**	**6.7**	**6.5**
Industry (2 + 3 + 4 + 5)	10.3	10.2	11.0	8.1	3.9	8.2
Services (6 + 7 + 8)	9.1	10.6	11.2	10.9	9.7	8.2
Non-agriculture (9 – 1)	9.5	10.4	11.2	9.9	7.8	8.2
GDP (factor cost, const. prices) per capita	5.8	7.8	8.2	7.5	5.2	5.0
Some Magnitudes						
GDP factor cost – 1999/00 prices (Rs trillion) (Rs lakh crore i.e. Rs trillion)	26.0	28.4	31.2	34.0	36.1	38.8
GDP market & current prices (Rs trillion)	31.5	35.9	41.3	47.2	53.2	58.6
GDP market & current prices (US$ Billion)	701	810	913	1,175	1,166	1246
Population (million)	1,089	1,106	1,122	1,138	1,154	1,170
GDP current & market prices per capita (Rs)	28,894	32,430	36,802	41,506	46,107	50056
GDP current & market prices per capita (US$)	**643**	**732**	**813**	**1,033**	**1,010**	**1065**

vii. The impact of the global economic and financial crisis on India operated through three channels – a) the financial channel which diminished the ability of Indian companies to mobilize equity and debt in foreign and domestic markets, b) the trade channel which operated by eroding the import demand in developed economies and c) the collapse of business and consumer confidence in the developed economies, which depressed sentiments worldwide, including in India. This was truer of the private corporate sector/consumers in the metropolitan centres than in semi-urban/ rural areas.

viii. The global economic outlook has improved over the past few months and major economies have come out of the recession or are poised to do so in the second quarter of calendar 2009. Thus in the second half of 2009 and in 2010 the developed economies would be in an expanding phase though growth rates in the coming years will be modest at 1 to 2 per cent. India will be impacted by the slow recovery of export demand from the developed economies.

ix. It is the Council's assessment that international economic conditions will strengthen further in the last quarter of 2009 and in 2010 and financial conditions, which have bounced back, will consolidate further. However, the low risk perception and ease in fund mobilization will not recur and the slow recovery of international trade will sharpen competitive conditions for exporters. The economic and financial conditions, while not being as supportive for rapid growth of the Indian economy, as in 2006 and 2007, will also not be adverse to growth as over the last year and a half.

x. The principal risk that emanates from the global economy for India is inflation contagion, with crude oil prices once again in the lead. The other risk is the possibility of another setback to the world of finance, where even a small failure has an amplified capacity for destabilization.

Structural Factors that Underpin Prospects of Recovery of Growth

xi. The Indian economy has witnessed a structural break from the past in respect of the generation of investible resources. During the past five years, the rate of domestic capital formation has climbed to 39 per cent in 2008/09 from 25 per cent, while the domestic savings rate has increased to nearly 38 % in 2007/08 from 26 per cent. The spurt in growth in the recent past was mainly driven by an increase in investment, especially private corporate investment. This was matched by an improvement in the savings rate, led by fiscal consolidation and a reduction in the negative savings by government.

xii. The economy, however, continues to be supply constrained, primarily in physical and social infrastructure- electricity, irrigation and drinking water, road and other transportation and rural-urban economic infrastructure, where the government plays a major role.

xiii. The large increase in domestic savings rate by nearly 10 percentage points of GDP permitted incremental investment of about the same order to be largely financed from domestic resources. It is estimated that primarily as a result of the large negative savings by Government the domestic savings rate which dropped by about 3 percentage points of GDP, is not likely to recover to the 2007/08 levels in the current fiscal.

xiv. The contribution of capital formation to growth was significant in the recent past. The aggregate contribution of domestic consumption expenditure to overall GDP growth has been fairly steady at around 4 percentage points while the contribution of capital formation peaked at close to 6 percent of GDP in 2005/06 and 2006/07. The large import component in the context of the accelerated growth is reflected by the large and sustained negative contribution of net exports in these years. Provisional data for 2008/09 suggest that private final consumption expenditure slowed sharply during the year. This was, however, partially offset by the large increase in public consumption expenditure.

xv. Over the past few years, private business has invested and expanded its productive capacity significantly in response to the increase in domestic demand. The fall in business confidence and the dislocations of the past year and a half have led to a hiatus, with firms reassessing their expectations about India's growth prospects. However, with an improvement in domestic economic conditions , it is expected that investment behaviour will pick up.

The Deficient SW Monsoon and Farm Prospects

xvi. The SW Monsoon has been deficient to the extent of 22.7 per cent in 2009 with major shortfall in July impacting the *kharif* prospects negatively. The subsequent recovery of the monsoon in August and September has however strengthened the prospects of the *rabi* harvest. The reported area sown up to September 30, 2009 showed a decline of 8 per cent, amounting to 5.4 million hectares, of which paddy contributed the largest acreage loss at 5.9 million hectares, which was partially offset by an increase in the acreage under pulses.

xvii. Based on the acreage data and other parameters, the Council's assessment is that the there will be a loss in *kharif* foodgrain production largely contributed by rice, with some offsetting output gains from pulses. The output of coarse cereals will remain unchanged. There will be some gains in the *rabi* output. It is expected that the total foodgrain production in 2009-10 will drop to 223 million tonnes from 234 million tonnes in 2008-09 and the output of oilseeds will decline to 276 million tonnes in 2009-10 from 282 million tonnes in 2008-09.

xviii. Water levels as on October 1, 2009 in the 81 major reservoirs that supply canal irrigation systems, were lower as compared to last year and the average for the past decade. However, continued rainfall during September is likely to have improved matters and lakhs of shallow tubewells dug to protect the *kharif* crop will support the *rabi* planting.

xix. Horticulture and animal husbandry account for an increasing proportion of the value of farm output and GDP. The impact of the drought on these activities will, however, be lower as compared to the impact on crops.

xx. Thus, it is expected that growth in farm output will be (–) 2.0 per cent. However, if the *rabi* crop is smaller than last year's and the non-crop sector suffers more than anticipated, the overall decline of farm sector GDP could be higher.

The Non-Farm Sector

xxi. With a restoration of normality in operating conditions, a strong bounce back is expected in the rates of output and GDP expansion in the non-farm sector in the second half of 2009/10, especially in the industrial sector.

Mining - Due to the substantial increase in production of crude oil and natural gas and coal , the GDP arising in this sector is expected to increase by 10 per cent this year.

Electricity – The period April to September 2009 witnessed an increase in cumulative power generation by 6.8 per cent. The output levels is likely to improve in the balance part of the year to average at least 7 per cent growth.

Manufacturing - Output growth in manufacturing has been sluggish since November 2007. However, manufacturing output bounced back in June 2009, growing by 7.8 per cent, then 7.4 per cent in July 2009 and 10.2 in August 2009. Though, export demand is yet to pick up, the recovery in manufacturing output is broad-based and strong enough to suggest a recovery based on domestic demand, improved business confidence and a stable operating environment. Manufacturing output growth is likely to recover to over 9 per cent in the second half of the fiscal and average 7.7 per cent growth in 2009/10.

Construction - Construction growth, which had slumped in the third quarter of 2008/09, has recovered since then. Strong output growth in cement, recovery in steel output and home loan disbursements suggests improved construction activity. It is expected that the GDP arising in the construction sector, will expand by around 8.8 per cent in the current fiscal.

Services - The larger part of services that are in the nature of intermediate services for industry will benefit from an upturn in industrial activity. Transport services have picked up. IT and ITES will have strong domestic demand, though exports will remain weak and government expenditure on services (salary and arrears) will continue to show growth in the first half of the year, but slow down in the second half. Overall services sector GDP growth is expected to be around 8 per cent this year.

Trade and Balance of Payments

Balance of Trade

xxii. In 2009/10, the export outlook will not be favourable to expansion. Exports after reaching their lowest point in the last quarter of 2008-09, have been steadily improving since June, 2009, reaching $14.3 billion in August, 2009. The Council expects strong growth in the second half of 2009-10, with the value of exports for the current fiscal reaching $183 billion as against the DGCIS figures of $182 billion in 2008/09. The value of imports in the first five months of 2009/10 was $102.3 billion - a decline of 33.4 per cent over the corresponding period of last year. This will reverse in the second half of the year and for 2009/10 the value of merchandise imports is projected at $281 billion, 4 per cent lower than 2008/09. The trade deficit corresponding to the DGCIS trade data system is projected at $107 billion, lower than the $109 billion recorded last year. Adjusting for this, on Balance of Payments basis, the merchandise trade deficit for 2009/10 is projected at $ 117 billion or 9.4 per cent of GDP (Table-B).

Invisibles

xxiii. The growth rate of net invisibles, declined to 3 per cent in the second half of 2008-09. In the current fiscal, of the two main components of net invisibles the first - service sector exports (software and BPO) is expected to grow by 5 per cent and the second – overseas remittances, which has recovered in the first quarter of 2009/10, is expected to be around $50 billion.

Current Account Deficit (CAD)

xxiv. The estimated Current Account Deficit (CAD) is thus placed at $25 billion i.e. 2.0 per cent of GDP. This is a drop from the CAD of 2.6 per cent in 2008/09 but a rise from the 1 per cent levels of the previous two years.

Capital Flows

xxv. In-bound foreign direct investment (FDI) has picked up in the first quarter of 2009/10 and will be sustained through the balance of the year to aggregate $37 billion in 2009/10. Outbound FDI is projected to be $14 billion. Portfolio inflows, a large negative number last year, are currently showing a rising trend which is expected to continue. Net inflows are projected at $25 billion in 2009/10. With improved global financial conditions, the overall inflow under the head of loans, is expected to be around $8.7 billion.

xxvi. Banking transactions including change in Non Resident bank deposits is expected to cause a net inflow of $3 billion while other capital is expected to be a negative $1billion. That makes for an overall positive balance on the capital account of a little over $57 billion. After financing the CAD of $25 billion, an amount of $32 billion is projected to be absorbed in the foreign currency assets of the RBI.

Table B. Balance of Payments						
US$ billion	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Merchandise Exports	85.2	105.2	128.9	166.2	175.2	188.9
Merchandise Imports	118.9	157.1	190.7	257.8	294.6	306
Merchandise Trade Balance	-33.7	-51.9	-61.8	-91.6	-119.4	-117.1
	-4.80%	-6.40%	-6.80%	-7.80%	-10.20%	-9.40%
Net Invisibles	31.2	42	52.2	74.6	89.6	92.2
o/w Software & BPO	14.7	23.8	27.7	37.3	45.2	47.3
Private Remittances	20.5	24.5	29.8	41.7	44	50.4
Investment Income	-4.1	-4.1	-6.8	-4.3	-4	-6.1
Current Account Balance	-2.5	-9.9	-9.6	-17.03	-29.8	-25
	-0.40%	-1.20%	-1.00%	-1.40%	-2.60%	-2.00%
Foreign Investment	13	15.5	14.8	45	3.5	46.9
o/w FDI (net)	3.7	3	7.7	15.4	17.5	22.8
Inbound FDI	6	8.9	22.7	34.2	35	36.9
Outbound FDI	2.3	5.9	15	18.8	17.5	14.1
Portfolio Capital	9.3	12.5	7.1	29.6	-14	24.1
Loans	10.9	7.9	24.5	41.9	5	8.7
Banking Capital	3.9	1.4	1.9	11.8	-3.4	2.9
Other capital	0	1.2	4.2	9.5	4.2	-1.1
Capital Account Balance	28	25.5	45.2	108	9.1	57.3
	4.00%	3.10%	5.00%	9.20%	0.80%	4.60%
Error& Omissions	0.6	-0.5	1	1.2	0.6	-0.8
Accretion & Reserves	26.2	15.1	36.6	92.2	-20.1	31.6
	3.70%	1.90%	4.00%	7.80%	-1.70%	2.50%
Memo						
GDP mp Rs crores	3149407	3586743	4129174	5321753	5321753	5856569
US$ billion	701	810	913	1166	1166	1246
Forex rate (Rs per US$)	44.93	44.27	45.25	45.63	4563	47

Prices

Wholesale Price Index (WPI)

xxvii. The year-on-year rate of inflation as measured by the Wholesale Price Index (WPI) was 0.8 per cent as at the end of March 2009 and then entered negative territory at the beginning of June 2009. However, this was due to the base effect and the price levels were actually rising since January 2009. In the first half of 2009/10 the overall WPI index has risen at an annualised rate of around 13 per cent, with a sharp increase in the foodgrain index, which is clearly outside the policy comfort zone of 4 to 5 per cent.

Consumer Price Index (CPI)

xxvii. All the CPI indices have been reporting high single digit, and of late some double digit, inflation numbers, on a year on year basis. This is in sharp contrast to the low positive and negative year-on-year WPI inflation rates reported during the same period. In July and August 2009, the year on year inflation rate for CPI (IW) was 11 per cent plus while it was12 to 13 per cent for CPI (AL) and CPI (RL). However, there has been a dramatic rise in the annualised rates of these indices after June 2009 with CPI (IW) rising by over 70 per cent in July 2009 and the CPI (AL) and (RL) increasing by 33 per cent.

Assessment

xxviii. Inflationary pressures are yet to surface in the developed economies, largely on account of the negative impact of lower energy prices. However, even as the developed economies come out of recession, inflationary pressures will increase and the open monetary and fiscal stance will fuel inflationary expectations. An unambiguously spelt out strategy and a clear timeframe for returning to more normal monetary and fiscal times will curb the inflationary pressures. In India, given the strength of inflationary pressures in the first half of 2009/10, due in part to the drought and expectations of lower supply, it is easy to envisage a situation in March 2010, where inflation is higher than 6 per cent. Inflationary pressures on the food front will be a major policy concern in 2009/10. A strong supply response - a more co-ordinated release of stocks through the public distribution system, open market sales of public stocks, precautionary arrangements for importing some foodgrain and attention to ensuring a strong *rabi* harvest will be an antidote to food price pressures.

Monetary Conditions and the Financial Sector

International Conditions

xxix. Financial conditions worldwide have improved sharply in the past several months benefiting India and other emerging economies. The accommodative monetary policies in the developed countries is expected to continue for some time though the quantum of support may come down. Lending conditions have improved considerably, as indicated by the drop in the London Inter Bank Offer Rate (LIBOR) and the credit default swap (CDS) spreads, which have now come down to levels prevailing at the beginning of 2007. This has increased the access of the Indian corporate sector to international loan funds. Stock markets have rebounded sharply enabling companies to raise fresh capital by the issuance of new shares, especially in the emerging, and particularly in the Asian markets.

Domestic Conditions

xxx. The 4 per cent cut in the Cash Reserve Ratio (CRR) during the crisis released almost Rs 1,60,000 crore in the banking system but a large part of this remained as excess liquidity and was parked with the RBI. To an extent this continues till date. Bank credit to the commercial sector was sluggish in the second half of 2008/09 and credit offtake continues to be sluggish in 2009/10. Up to the fortnight ending September 11, 2009, non-food credit was up only by 1.8 per cent on a year to date basis, the lowest in five years.

xxxi. Indian companies have, however, managed to raise large volumes of debt from the domestic capital market and in the current fiscal, the debt mobilised in the capital market has been significantly larger than the flow of bank credit to the commercial sector. The amount mobilised through equity issuance in the first five months of 2009/10 has also been high.

xxxii. Banks have added to their holding of government securities, both in the second half of 2008/09 and in the current fiscal. This, on the one hand, is a risk minimising response while on the other, it is a natural corollary of the large supply of government securities during this period to finance the larger than expected fiscal deficit. The funds sequestered under the Market Stabilization Scheme (MSS) have proved useful both in the previous year and in the current one to finance government expenditure. Out of the Rs. 178,000 crore with RBI in the beginning of the crisis, by mid- September 2009, only Rs 19,000 crore remained outstanding under the MSS.

xxxiii. With tangible improvement in economic conditions, the domestic demand for credit is likely to pick up. Deposit re-pricing by commercial banks and a more stable situation is also likely to see banks push lending more and overseas sources of borrowing are likely to improve. Mobilization of additional equity finance by Indian companies will also improve the capital structure of Indian companies and ease bank lending.

xxxiv. The highly accommodative and expansive monetary stance created due to exceptional circumstances, needs to be phased out. The timing and the pace of this will depend on the pace of expansion of the various sectors and the magnitude of inflationary pressures. Given the present inflationary pressures, we may have to act earlier than the US and European economies.

Government Finances

xxxv. Government finances have come under severe strain since 2008-09, which is a matter of concern. Though there is a need for continuation of the expansionary fiscal policy stance in the current year, it is necessary to get back to the path of fiscal correction to ensure an appropriate balance between a high growth rate and stability.

xxxvi. Government achieved substantial fiscal correction from 2003/04 to 2007/08 with the consolidated fiscal deficit declining from 8.51 per cent in 2003/04 to 4.17 per cent in 2007-08. However, this fiscal correction was mainly on the strength of high growth of revenues from taxes. A sharp increase in oil prices, pay revision, loan waiver and expansion in the coverage of NREGA in 2008/09 resulted in an increase of the fiscal deficit of the centre as a ratio of GDP, to 6 per cent. With the States being allowed higher fiscal deficits under the fiscal stimulus package, the consolidated fiscal deficit in 2008/09 as a ratio of GDP works out to 8.7 per cent. Adding to this, the off- budget liabilities of 1.8 per cent of GDP, the total government liabilities for 2008/09 are estimated at 10.4 per cent of GDP.

xxxvii. The above fiscal developments underscore four important points. First, increase in deficits was not due to the stimulus package but on account of additional outlay on subsidies, pay revision, loan waiver and increased coverage of NREGA. Second, the structural component of the deficit is substantial, though some part of it is cyclical. Third, the substantially higher revised expenditure over the budgeted figure, brings the poor expenditure management to sharp focus. Fourth, there was limited fiscal space for the stimulus package and it could not be directed to the desired sectors, particularly infrastructure.

xxxviii. The Central Government has continued its expansionary fiscal stance in the current fiscal, maintaining high levels of expenditure in the budget, additional cuts in excise duties and services taxes and increasing the borrowing room for the States to 4 per cent of GSDP. Adding the oil bonds of 0.2 per cent of GDP, the total increase in debt liabilities for the year work out to 10.3 per cent of GDP while the consolidated revenue deficit is estimated at 5.4 per cent of GDP. The outstanding liabilities of the Centre and the States as a ratio of GDP (after a marginal decline to 74 per cent in 2008/09 from the peak levels of 81 per cent in 2003/04 and 2004/05) are estimated to increase to over 77 per cent in 2009/10.

xxxix. The large government deficits during the last two years were unavoidable; but are unsustainable in future. It is important for the government to have an "exit strategy" and return to fiscal consolidation, carefully calibrating the timing and the magnitude of adjustment. Since liability on account of pay revision and loan waiver have been settled, if the expenditure on various schemes are kept constant in nominal terms, there could be a reduction of 1.5 per cent of GDP in the deficit next year. Perhaps, it may be possible to induct an element of counter-cyclicality to the fiscal consolidation process. The fiscal responsibility legislation should be followed by a Medium Term Fiscal Framework (MTFF) and a Medium Term Expenditure Plan (MTEP), to be updated every year.

Concluding Comments – Some Policy Options

xxxx. In the short term, managing inflationary risks, particularly food price inflation is the biggest challenge to policy makers. It is a matter of comfort and strength that we have an adequate supply of food grains in public stocks, of which about 18 million tonnes is rice. An appropriate policy response must draw from multiple sources. First, Government has invested considerable effort and resources to protecting the rabi crop. It must continue to do so right through the season. Second, it needs to focus on the Public Distribution System to reach food grains to different markets and locations, so that price pressures are contained. Third, as a matter of abundant precaution, the concerned agencies should be instructed to take measures to facilitate import of rice, if required.

xxxxi. In the medium term, the farm economy holds out many challenges, the principal one being the relatively low level of yield in major cereal crops and pulses. Necessary steps must be taken to revitalise traditional crop agriculture, which is vital to food security and farm income, even as this component has dropped to less than one third of farm sector GDP.

xxxxii. Today the Indian economy is constrained primarily by a shortage of physical infrastructure, of which the single most important item is electricity. Shortage of electric power not only leads to direct production losses, but also results in inefficiencies in a broad range of areas impacting profitability and competitiveness. Government is the largest player in the production, transmission and distribution of power and a high order of government intervention in capacity creation and other supportive components of the electricity business is crucial to sustaining a high growth rate of 8 to 9 per cent. Some important interventions could be a) To facilitate and encourage more private investment in power generation, b) have an “active” as opposed to an “indicative” plan for creating power capacity over the next 15 years, c) sustain the increase in the capacity for manufacturing power plant equipment by BHEL and private sector companies through an enabling policy regime, d) diversify our fuel sources and develop more natural gas and nuclear energy based power plants as opposed to the coal based capacities that currently exist, e) leverage the India – US Nuclear Agreement to rapidly enhance the scope of nuclear power generating capacity. Amendment of the Atomic Energy Act so as to permit the entry of reputable private companies into the business.

Economic Outlook For 2009/10

Full Report

1. GROWTH PERFORMANCE AND OUTLOOK

1. Economic growth in the five year period from 2004/05 to 2008/09, despite the crisis-affected year of 2008/09, was at an average of 8.5 per cent. This clearly represented an acceleration in the pace of growth and marks a distinct break from any previous five year period. Per capita GDP grew by an average of 6.9 per cent in these five years and by 7.8 per cent in the three years 2005/06 to 2007/08.

2. Under the severe impact of the global crisis, the Indian economy registered a growth of 6.7 per cent in 2008/09 after having registered over 9 per cent rates of growth for three successive years. By any standards, the Indian economy was able to protect itself reasonably well in the turbulent conditions of the financial crisis. Economic growth slowed from 7.7 per cent in the first half of 2008/09 to 5.8 per cent in the second half, and 6.1 per cent in the first quarter of 2009/10, that is, a loss of momentum of about 2 percentage points. The order of loss in growth momentum was not only much smaller than in the rest of the world, but the important point was, that the economy continued to grow at close to 6 per cent, which is itself higher than in many years past; for instance, the period of the late 90's and early years of the present decade.

3. This achievement is one that belongs to the average Indian citizen, the farmer, the industrial worker, managers and entrepreneurs. However, it would not be inappropriate for policy makers to take some of the credit, namely, the combination of rapid adjustments in monetary polices, taxation rates, special fiscal packages coupled with pointed administrative intervention which was able to protect the Indian economy from the worst effects of the collapse of global demand, activity and confidence. The calibration of the policy intervention was also such that it was not excessive and, thus, the Indian government is able to contemplate a return to fiscal consolidation in 2010/11 and an early normalisation of the monetary policy stance. It is also indubitably true that a key reason for the Indian economy to have avoided contamination was the fact that the Indian banking sector was not exposed to the risky assets that underpinned the financial collapse in the developed west.

4. There are many lessons that can be learnt from this, but a few may perhaps be underscored here. First, that prudence is an essential virtue for financial and

fiscal stability; second, deposit-based banking, as is practiced here, is perhaps the more solid foundation to bank lending than the one based on short-term borrowings from capital markets by banks; third, the financial regulators should be intimately conversant with the products and practices that they are enjoined to regulate.

5. The lessons that we should draw from the Crisis in regard to financial sector reform is that it is not reform or opening-up *per se* that has the potential of destabilising the financial markets, but it is the reckless pursuit of such ends without considering the possible risks and the instruments available that can contain such risks, which pose the danger. In a manner, the global crisis offers at one level an experience in the light of which we can learn and unlearn previously held views and positions. This will provide valuable lessons to us in our effort to deepen the financial sector, increase its efficiency, and widen its ability to service the needs of a rapidly growing economy.

6. It was expected that farm sector growth would rise to 4 per cent in the Eleventh Plan (2007-12). However, the disappointing South West (SW) Monsoon is likely to turn farm sector growth negative this fiscal year. In the five year period 2004/05 to 2008/09, farm sector growth rose to an average of 3.3 per cent with over 4 per cent growth in each of the three years 2005/06 to 2007/08. This is a signal improvement over the trend growth rate in the second half of the nineties and the turn of the century, when growth fell to about 2.5%. In 2008/09, however, farm sector GDP growth once again fell to 1.6 per cent, notwithstanding a new record foodgrain output. Clearly there is much to be done by way of focused efforts to improve rural infrastructure, improve the access to and the use of water in agriculture and provide technical and systemic support to realise higher productivity and superior market access for farm produce.

7. The manufacturing sector went into free fall after the onset of the financial crisis in September 2008. Output growth was virtually zero (0.4 per cent) in the second half of fiscal 2008/09 (October to March) compared to the same period of the previous fiscal year. This served to pull down overall manufacturing output growth in the last financial year to 2.8 per cent. Output growth in the mining and electricity sectors were also depressed. It may be noted that manufacturing output

growth had been on the slow track for some time even before the full force of the financial crisis erupted last September. It had come down from double-digit levels (10.0 per cent) in the first half of 2007/08 to 8.0 per cent in the second half and further to 5.3 per cent in the first half of 2008/09. This was a consequence of a combination of a slower pace of export demand, higher interest costs at home squeezing leveraged domestic demand and the rise in material and energy prices that affected profitability across most industries.

8. In 2009 and 2010, the principal factors detrimental to prospects of a sharp recovery in the growth rate of the Indian economy derive from the international situation. Of course, the deficient monsoon will pull farm sector performance down, but that should no longer be a handicap if the monsoon is normal in the years to come. However, the same cannot be said of the presently depressed state of the economies of the developed countries. For well over a year now, most of these economies have been reeling under a recession. The financial crisis has accentuated this recession and has dealt a severe blow to the strength of their financial systems as also to the financial health of their households and governments. The recovery process in these economies is likely to be a slow and long-drawn out one and to that extent import demand for both manufactured goods and services from emerging economies is also likely to show a slow recovery. The weakened state of these economies in conjunction with a global financial system that has been through a particularly nerve-wracking period does hold out the possibility that conditions could suddenly deteriorate in the wake of a negative shock, such as a payment crisis in a large bank or a crisis precipitated by a sovereign creditor.

9. Oil prices and to a lesser extent that of other commodities, have recovered some lost ground after the collapse of Lehman Brothers last September. Oil prices have hovered around \$65–70 per barrel through much of the summer of 2009 even as developed economies continued to be in recession. Global demand for crude oil was at 84.3 million barrels per day (mb/d), which is 2.1 per cent lower than what it was last summer and 1.4 per cent lower than what it was in the summer of 2007. The prospect of improvement in the state of economic health of the developed economies and elsewhere therefore clearly holds out the possibility of oil prices increasing further. Other commodities lack the ownership concentration of oil and may not react in the same fashion but some price gains are quite possible.

Moreover the very loose monetary and fiscal stance adopted across the world in dealing with the economic and financial crisis is supportive of strong price gains, even as real economic activity recovers at a slow pace.

10. A domestic development of considerable policy concern is the sharp increase in the price of food grains, other primary food products and of sugar. Even in the winter of 2008/09, as the global crisis saw a decline in the world prices of manufactured goods as also internationally traded basic foods, domestic prices were increasing. The price of rice began to rise rapidly from October 2008, despite the record harvest in the just completed *kharif* and the forthcoming *rabi* season. The increase in rice prices continued through the first half of 2009. Between the end of September 2008 and June 2009, the WPI index for rice had risen by more than 16 per cent, while that for pulses had gone up by more than 10 per cent. In comparison the increase in the index for wheat prices was only 2.5 per cent during this nine-month period. Towards the end of June as it became clear that the SW monsoon 2009 was likely to be disappointing, there was a spurt in the price of pulses (end of June and in August) and fruits and vegetables. Prices of wheat and rice did not increase much in this period. The price of sugar has increased 32 per cent in the course of 2009 and by as much as 26 per cent in the course of the first six months of fiscal 2009/10. The weak monsoon rains and available acreage data suggest lower output levels for rice and sugar, even though coarse cereal production may not be hit and pulses may gain slightly. The wheat crop is in the *rabi* season that lies ahead and it may turn out to be a good one. Managing inflation in food products is likely to be a particularly severe challenge in this fiscal year.

11. Against this backdrop, it is certain that the industrial sector is likely to show vigorous growth in the second half of the year and farm sector output and GDP growth are likely to be negative. A clearer picture on both scores will be available only later. It would appear that given the variability of key elements, the Indian economy is likely to grow by about 6.5 per cent in 2009/10. It is unlikely that growth will be lower than 6.25 per cent but possible that it will reach 6.75 per cent. The projections by industry of origin, along with the growth numbers for previous years and some broad magnitudes are presented at Table-1.

Table 1: Growth – Past Performance and Projections for 2009/10						
Annual Rates	**2004/05**	**2005/06**	**2006/07**	**2007/08 QE**	**2008/09 Rev**	**2009/10 Projected**
	Percentage change over previous year					
1. Agriculture & allied activities	0.0	5.8	4.0	4.9	1.6	–2.0
2. Mining & Quarrying	8.2	4.9	8.8	3.3	3.6	10.0
3. Manufacturing	8.7	9.1	11.8	8.2	2.4	7.7
4. Elect., Gas & Water Supply	7.9	5.1	5.3	5.3	3.4	7.4
5. Construction	16.1	16.2	11.8	10.1	7.2	8.8
6. Trade, Hotels, Transport, Storage & Communication	10.7	12.1	12.8	12.4	9.0	8.4
7. Finance, insurance, real estate & business services	8.7	11.4	13.8	11.7	7.8	8.0
8. Community & personal services	6.8	7.1	5.7	6.8	13.1	8.0
9. Gross Domestic Product (factor cost & constant prices)	**7.5**	**9.5**	**9.7**	**9.0**	**6.7**	**6.5**
Industry (2 + 3 + 4 + 5)	10.3	10.2	11.0	8.1	3.9	8.2
Services (6 + 7 + 8)	9.1	10.6	11.2	10.9	9.7	8.2
Non-agriculture (9 – 1)	9.5	10.4	11.2	9.9	7.8	8.2
GDP (factor cost, const. prices) per capita	**5.8**	**7.8**	**8.2**	**7.5**	**5.2**	**5.0**
Some Magnitudes						
GDP factor cost – 1999/00 prices (Rs trillion) (Rs lakh crore i.e. Rs trillion)	26.0	28.4	31.2	34.0	36.1	38.8
GDP market & current prices (Rs trillion)	31.5	35.9	41.3	47.2	53.2	58.6
GDP market & current prices (US$ Billion)	701	810	913	1,175	1,166	1246
Population (million)	1,089	1,106	1,122	1,138	1,154	1,170
GDP current & market prices per capita (Rs)	28,894	32,430	36,802	41,506	46,107	50056
GDP current & market prices per capita (US$)	643	732	813	1,033	1,010	1065

12. The Planning Commission in early September 2009 had indicated that GDP growth in the current fiscal would be 6.3 per cent in its “base case” scenario. Earlier, the Reserve Bank of India in its Policy Statement of July 28, 2008 had estimated economic growth in 2008/09 at “6 per cent with an upward bias”. The IMF in its September 2009 update of the World Economic Outlook (WEO) has indicated 5.4 per cent growth for India in the calendar year 2009 rising to 6.4 per cent in 2010. Private sector banks and other agencies, domestic and global, have projected growth rates between 5 and 6.5 per cent for 2009/10.

13. Aside from any adverse development on the security front, the primary downside risk to our growth expectations in 2009/10 is principally due to any new shock that may impact the world financial system, either from insolvency overtaking a major institution or a sovereign default. Both of these developments are much more unlikely now than they were over the past year. However, the risk of such a development is greatly amplified by the state of the global financial system which is barely recovering from the travails of the past couple of years. The negative impact of rising inflation cannot be underestimated, especially since the domestic trends cannot but be reinforced by any upward global movement in prices, especially of crude oil and other key commodities. In the present situation it would seem that in the domestic sphere conditions favour a strong *rabi* (winter) crop. However, it would not be wise to rule out the possibility that weather conditions can turn negative in the harvest season and even worse, the SW monsoon of 2010 may also turn out to be weak.

II. INTERNATIONAL ECONOMIC CONDITIONS

14. The global economic crisis had two separate components. The first derived from an extended period of above-trend economic growth that lasted five years and was widespread, encompassing almost the entire developing world, including sub-Saharan Africa. The advanced economies enjoyed an extended period of above-trend growth after 2003: as a group they averaged 2.9 per cent between 2003 and 2007; the US averaged 2.8, the Euro-zone 1.9 and the UK 2.7 per cent. In these mature economies with their well-established business cycles, as unemployment fell to historic lows and commodity and asset prices rose, there were clear signs of tightening resource use, suggesting that a correction was due. Developing economies, where business cycles are less well established, were also impacted by the consequences of the world wide demand boom in the area of commodities and assets. Here too a degree of slowing down was indicated. Ordinarily the necessary adjustment would have been brought about by a sequentially tightened monetary policy.

15. However, there was a second component to the crisis and this flowed entirely out of the financial systems in the developed economies, namely the USA and to some extent the UK and some parts of Europe. The extended easy money and fiscal policies that were adopted to leverage the US economy out of recession in 2001 resulted in a large overhang of liquidity that inadvertently helped blur perceptions of risk. This dangerous development operated in a charged atmosphere of highly inadequate regulatory oversight combined with large-scale dilution of standards by financial market players, including banks and credit rating agencies, to create bad assets and maturity mismatches on a catastrophic scale. In consequence, the impact was felt most severely in the financial sphere and greatly accentuated the recession in the advanced economies.

16. Finally the backdrop of serious global structural imbalances played host to both these elements. The large current account deficit in the US and the equally large current account surpluses of oil exporting nations and China and Japan, created a role in promoting a permissive atmosphere where questionable

assets and business practices flourished in an equally permissive regulatory atmosphere.

17. The impact of the global economic and financial crisis on India operated through three channels. The global crisis, it bears repetition, erupted in the background of an extended period of very high rates of inflation rooted in runaway prices of globally traded commodities through 2007 and much of 2008. This adversely affected the fiscal balances of a country like India which tried to shield its economy from the skyrocketing prices of oil and fertilizers. It impacted corporate balance sheets also as many corporates could not neutralise higher operational costs through proportionate adjustment of their sale prices. Notwithstanding the cushion extended by the fiscal stimulus by way of subsidies and tax reductions, household accounts were negatively impacted by the pace of rising prices. In economies where the adjustment was entirely on the household account, the adverse impact of the manifold rise in fuel and food prices on other expenditures was severe.

18. To return to the three channels through which the global crisis impacted India. First was the financial channel: the ability of Indian companies to mobilize equity and debt in foreign and domestic markets was severely diminished. Erosion of risk appetite resulted in lenders being reluctant to lend. Borrowers were focused on staying solvent and were therefore cautious in taking on additional debt liabilities, while equity investors preferred to remain temporarily invested in cash or government securities. From the moment of collapse of Lehman Brothers, financial markets went into seizure and were unable to support the financing needs of the real economy. Second was the erosion of import demand in developed economies and the dislocation in trade finance and related markets which resulted in a sharp decline in the external demand for Indian exports, of both goods and services. In this respect, developed country exporters, principally Germany, Japan and South Korea, as well as many other emerging economy exporters, were all adversely affected. Third was the collapse of business and consumer confidence in the developed economies which rapidly travelled across the globe, depressing sentiment world-wide, including in India. This was truer of the private corporate sector and consumers in the metropolitan centres than it was of businesses and consumers in the semi-urban and rural areas.

19. The global economic outlook has improved over the past few months. The world's major economies are poised to come out of the recession, or have already

done so, in the second quarter of calendar 2009. Thus in the second half of 2009 and in 2010 the developed economies would be in an expanding phase. However, the rate at which the advanced economies are likely to grow in the coming years is generally expected to be modest at 1 to 2 per cent. The IMF in its September 2009 update of the WEO, has moved 2010 growth prospects for the advanced economies up from 0.6 to 1.3 per cent.

20. One result of the slow pace of economic recovery is that the demand for imports from developing economies is likely to recover only slowly. Another may be a slower ramping up of commodity prices, especially that of oil and natural gas. But given the peculiarities of these markets it is difficult to be certain. The wide open stance on both the fiscal and monetary sides in force in the advanced economies is conducive to sustaining inflationary pressures even with mild economic growth. This is especially true, given that a shift towards adopting a tighter fiscal and monetary stance may be hard to pursue in the context of other policy commitments.

21. Financial conditions have undergone much improvement over the past few months. Risk spreads on credit instruments are mostly lower than they were immediately before the failure of Lehman Brothers and closer to where they were earlier in 2008. Under these conditions tapping the global credit market has clearly become more feasible for Indian corporates. Indian banks presently attract a Credit Default Spread (CDS) of about 120 basis point (bps), compared to one of over 240 bps in mid-September and 130 bps in January 2008. However, they are higher than the CDS of 70–80 bps at the end of September 2007. In fact *External Commercial Borrowings* (ECB) have bounced back to over $2 billion in both June and July 2009 and were over $1 billion in August 2009 aggregating to $5.8 billion in these three months.

22. Equity markets have also recovered considerably. Developed economy markets are now about 35 per cent lower than the peaks hit in 2007 and have experienced a recovery of 40- 50 per cent from the lows that they hit at the height of the crisis. Emerging economies in Asia (and Brazil, Russia and some commodity exporters like Canada and Australia) have done much better. Their equity markets are now 15–30 per cent off their peaks and have recovered 70 to over 100 per cent from their crisis lows. The Indian equity market is 18 per cent lower than peak levels and has recovered by 110 per cent from the lows hit in early March 2009.

23. Sluggish growth of international trade in 2009 and 2010 has been projected by both the IMF and the *World Trade Organization* (WTO). The IMF in its September 2009 update of the WEO has projected that world trade volume would decline by 11.9 per cent in 2009 and that it would stagnate in 2010 with growth of only 2.5 percent. It has also projected that imports into advanced economies would *fall* by 13.7 per cent and exports from emerging economies would *decline* by 7.2 per cent in 2009, with near stagnant conditions obtaining in 2010. The WTO in July 2009 had projected that global trade was likely to fall by 10 per cent in 2009, which is worse than its previous forecast of a decline of 9 per cent.

24. The continuing issue of excess household debt in the US and some of the West European countries may result in an extended period where households increase their savings and thus compress their consumption expenditure. Personal savings in the US were provisionally reported to be negative in 2005 and 2006. The revised data shows that personal savings as a proportion of disposable income was not negative, but had fallen to historically low levels of around 1 per cent in 2005. Since May 2008 the personal savings rate has been steadily increasing and has averaged nearly 4.5 per cent in 2009. This in the backdrop of massive job losses and loss in the value of homes, cannot but be seen as an important structural development; one that is likely to keep consumption expenditure growth from rising fast. Household debt levels are lower in Europe and personal savings much higher (15 per cent) and to that extent the compressive impact on personal expenditure is likely to be less marked in the US than across the Atlantic.

25. Slower growth of import demand from the advanced economies, even as their economies recover and begin to grow, is likely to cause some pressure on the export of consumer goods to these markets from emerging economies. Emerging economies may need to adapt to lower levels of export growth and adjust to operating conditions in these markets that are likely to become even more competitive as a result.

26. In the advanced economies, pressures on prices remained strong despite the recession, financial crisis and job losses. In the USA, the *Consumer Price Index (Urban)* in August 2009 was 1.5 per cent lower than in the same month of 2008. However, excluding food and energy, the index was actually 1.4 per cent *higher* than it had been in July 2008. The food index too was 0.4 per cent higher. Thus the prime reason for the decline in the headline price index was on account of lower

prices for petroleum products. In the Euro-zone, the headline CPI in August 2009 was 0.2 per cent lower than a year ago. Here too the decline was due to a decline in energy prices. Excluding food and energy, the price index (in July) was 1.3 per cent higher than a year ago. Global prices of foodgrain are lower today than in the first half of 2008. Wheat prices are projected to be lower in the coming months by 20 to 30 per cent compared to the average of the 2008/09 crop year, while rice prices may be lower by 15 to 20 per cent. However, these reductions are much smaller than the massive price increases in cereals during 2006 and 2007.

27. It is our assessment that international economic conditions that have already shown significant signs of improvement, will strengthen further in the last quarter of 2009 and in 2010. However, the advanced economies are likely to show a subdued pace of recovery. Financial conditions have already bounced back sharply and may consolidate further. However, the very low risk perception and associated ease in fund mobilization is not expected to recur, with investors likely to show greater discrimination and be more demanding. International trade will recover slowly and competitive conditions for exporters are likely to sharpen. Overall the improvement in economic and financial conditions, will not be as supportive of rapid growth of the Indian economy, as was the case in 2006 and 2007. Nor are global conditions as adverse to growth now as over the last year and a half.

28. The principal risk that emanates from the global economy for India is inflation contagion, with crude oil prices once again in the lead. This is of particular importance as there are clear domestic dynamics that have been lifting prices, especially of food products, in the absence of global triggers. There is also a risk that comes from the possibility of another setback in the world of finance, where even a small failure has an amplified capacity for destabilization.

III. STRUCTURAL FACTORS THAT UNDERPIN PROSPECTS OF RECOVERY OF GROWTH

29. The past five years have witnessed a structural break with respect to the generation of investible resources in the Indian economy. The rate of domestic capital formation has climbed over a period of five years to 39 per cent in 2008/09, an unprecedented increase of 14 percentage points over the 25 per cent rate that characterized the previous five years. In fact, the investment rate had remained virtually stuck at around 25 per cent ever since the closing years of the eighties. Domestic savings rate has also kept pace with the rising pace of investment. The domestic savings rate increased to nearly 38 per cent in 2007/08 from 26 per cent just five years earlier. This rate too had been stuck in the low twenties ever since the end of the eighties.

30. To reiterate, the spurt in growth over the past several years, with three successive years of 9 per cent and above growth rate, was driven primarily by an increase in investment, especially private corporate investment. Increased consumption played a decidedly subsidiary role. The increase in the level of investment activity was matched by an improvement in the savings rate, and the latter was brought about in large measure through fiscal consolidation and a reduction in the negative savings of government.

31. The economy, however, continues to be primarily supply constrained. This is felt most acutely in physical and social infrastructure, where the goods involved are in large measure dependent on execution by Government agencies or on facilitating measures on the part of the Government. These shortages are palpably evident in electricity, irrigation and drinking water, road and other transportation and urban and rural economic infrastructure. They also circumscribe our ability to extend the benefits of technology to harness the productivity gains of our farm sector and to create improved market access for farm produce.

32. The large increase in domestic savings rate by nearly 10 percentage points of GDP permitted the incremental investment of about the same order to be largely financed from domestic resources. The current account balance shifted from positive (2001/02 to 2003/04) to negative thereafter. However, the magnitude of

Table 2: Movement in some key macroeconomic parameters

Unit: per cent

	Investment Rate	Domestic Savings Rate	Growth rate at constant prices				
			Gross Domestic Capital Formation (GDCF)		GDCF in Fixed Capital only		Final Consumption Expenditure
			Total	Pvt. Corp.	Total	Pvt. Corp.	
2000/01	24.3	23.7	–4.0	–28.3	–0.0	–11.0	3.2
2001/02	22.8	23.5	3.8	8.6	7.4	3.6	5.2
2002/03	25.2	26.3	10.9	17.1	6.8	3.5	2.3
2003/04	27.6	29.8	12.9	24.6	13.6	23.2	5.5
2004/05	32.1	31.7	22.3	68.1	18.9	62.8	5.2
2005/06	35.5	34.2	20.0	36.1	17.6	34.1	6.7
2006/07	36.9	35.7	13.9	18.4	14.5	18.3	5.9
2007/08 QE	39.1	37.7	15.6	16.1	12.9	13.4	8.3
2008/09 Est.	36.5	33.9	7.7	–	8.2	–	5.4
2009/10 Proj.	36.5.	34.5	9.2	11.3	9.7	10.0	5.8

Note: 1.Figures for 2008/09 are estimated and drawn partially from provisional data releases
2.Figures for 2009/10 are projections

the Current Account Deficit (CAD) remained small and was contained at around 1 per cent of GDP till 2008/09 when it rose sharply to 2.6 per cent of GDP on account of a steep increase in the world price of crude oil. The jump in subsidy outgoes and increase in civil services pay has increased the revenue deficit of the Government, which was accentuated by the measures to fiscally support the economy after the outbreak of the global financial crisis last year, a policy stance that has continued into the current fiscal year. Though firm numbers for domestic savings are not available for 2008/09, we estimate that primarily as a result of the large negative savings by the Government, the savings rate dropped by about 3 percentage points of GDP. In the current fiscal year the savings rate is unlikely to recover to the levels registered in 2007/08 .

33. As a perusal of *Tables-2 & 3* will show, the contribution of capital formation to growth was significant. The aggregate (of private and public) contribution of domestic consumption expenditure to overall GDP growth has been fairly steady at around 4 percentage points. This is quite at variance with the big changes on account of capital formation which peaked at close to 6 percentage points of GDP

Table 3: Contribution to GDP growth by expenditure classes								
	2001 /02	**2002 /03**	**2003/ 04**	**2004 /05**	**2005 /06**	**2006 /07**	**2007 /08**	**2008 /09**
GDP (market prices) growth rate	5.22	3.77	8.37	8.28	9.24	9.69	9.03	6.08
Total Investment or total GDCF	–0.70	3.73	4.39	5.92	5.95	4.40	5.05	2.99
o/w GDCF in Fixed Capital	1.66	1.56	3.21	4.68	4.79	4.25	3.95	2.58
o/w Private Corp Sector	0.20	0.19	1.27	3.91	3.19	2.10	1.66	1.03
Domestic Final Consumption Exp.	3.95	1.79	4.13	3.84	4.79	4.13	5.60	3.62
o/w Private Final Consumption Exp	3.67	1.83	3.84	3.44	4.13	3.57	4.87	1.64
Net Exports of Goods & Services	0.19	1.13	–0.53	0.84	–3.83	–1.27	–1.27	–1.79
Discrepancies	1.78	-2.88	0.38	-2.32	2.33	2.43	-0.40	1.26

Note: Figures for 2008/09 are provisional based on the May 2009 release of CSO

in 2005/06 and 2006/07. The large import component in the context of accelerated growth is reflected by the large and sustained negative contribution of net exports in these years. Provisional data for 2008/09 suggest that private final consumption expenditure slowed sharply during the year and this appears to have been largely a consequence of deteriorating confidence that led to a dramatic slowdown in big ticket consumption items such as in automobiles and a less evident decline in the rate of expansion of personal consumption items such as apparel and electronics. The large increase in public consumption expenditure served to offset this to an extent.

34. Over the past few years, private business has invested and expanded its productive capacity significantly in response to the increase in domestic demand. The fall in business confidence and the dislocations of the past year and a half have led to a hiatus. First, it prompted many companies to put their new expansion programmes on the backburner as they strove to stay afloat. Most firms sought to make available funds for their ongoing projects but the severe stress on cash flow did not readily permit this for all firms. With the crisis continuing and leading global institutions and world leaders dwelling on the Great Depression,

survival became the dominant theme. It is evident that firms seriously revisited their previous expectations about India's growth prospects and their place in the unfolding of that process. The caution and acute risk perception that came to dominate business behaviour will delay transition to a more growth oriented and risk-taking investment behaviour, a process that will take a while. Fortunately, the fixation with the Great Depression, dire and sour forecasts was less pronounced in India, as indeed in much of Asia. Therefore, one can reasonably expect that investment behaviour will pick up as hard evidence of an improvement in domestic economic conditions starts showing up.

IV. THE DEFICIENT SOUTH WEST (SW) MONSOON AND FARM PROSPECTS

35. The SW Monsoon has been deficient to the extent of 22.7 per cent in the period June-September 2009. The month-wise precipitation and departure from the normal is presented at Table-5.

Table 4: Actual and Normal Precipitation in the four months of SW Monsoon 2009

Unit: millimetres

	June	July	August	September*	June to Sept
Actual	85.7	260.6	190.0	175.5	689.5
Normal	162.4	293.4	262.1	210.2	892.2
Deviation	–47.2%	–4.3%	–27.5%	-20.9%	-22.7%

Overall precipitation deficiency of 22.7 per cent was comparable to 2002 (–18 per cent). The most important difference between 2002 and 2009 is that in the former year precipitation in the month of July, a critical period for the sowing of the *kharif* crop, had a deficiency of 45 per cent, compared to the marginal one of 4 per cent in 2009. However, though rainfall was fairly good in August 2002 (4 per cent deficient) enormous damage had already been done. In 2009, all the deficiency for the month was concentrated in the first ten days of August (–65 per cent) with the remaining days of the month having near normal precipitation. The rainfall in the first few days in September 2009 was above normal and strengthened the prospects of the *rabi* harvest even though the rainfall for the month as a whole was somewhat deficient.

36. The reported area under sowing show very large acreage losses under *kharif* foodgrain, especially that under paddy. As per the acreage data released by the Agriculture Ministry on 30 September 2009 (Table 5), there was a 8.0 per cent decline amounting to 5.4 million hectares in the area sown under foodgrains in the current *kharif* season as compared to last year. Of this, paddy alone accounted for a 5.9 million hectares acreage loss amounting to a reduction of 15.5 per cent relative to the acreage sown in the corresponding period last year. The acreage under coarse cereals is reported to be roughly equal to last year while that under

pulses is higher by 5.2 per cent. The area sown with *kharif* oilseeds is lower by 5.3 per cent, which is almost wholly due to less area being sown with groundnut (–15.5 per cent). The acreage under cotton has risen by 11.6 per cent, while that under sugarcane is slightly less.

Table 5 Net Sown Area as on 30 September 2009

Unit: '000 Ha

30-Sep-09

	2008	2009	Change	Acreage
Paddy	38133	32205	-15.50%	-5928
Bajra	8509	8518	0.10%	9
Jowar	2934	3092	5.40%	158
Maize	7043	7097	0.80%	54
Others	2130	1917	-10%	-230
Total Coarse Cereals	20616	2624	0.00%	8
Arhar	3379	3489	3.30%	110
Urad	2070	2222	7.30%	152
Moong	2270	2398	5.60%	128
Others	1623	1716	5.80%	93
Total Pulses	9342	9825	5.20%	483
Groundnut	5245	4431	-15.50%	-814
Soyabean	9624	9604	-0.20%	-20
Others	3428	3287	-4.10%	-141
Total Oilseeds	18297	17322	-5.30%	-975
Cotton	8891	9925	11.60%	1034
Sugarcane	4379	4250	-2.90%	–
Jute	706	689	–	–
Total Foodgrains	68091	62654	-8.00%	-5437
Total Cereals	58749	52829	-10.10%	-5920
Grand Total	100364	94840	-5.50%	-5524

Table 6: Agricultural Output – Foodgrain & Oilseeds

	Final Estimate 2002/03			Final Estimate 2007/08			4th Adv. Est. 2008/09		
	Kharif	*Rabi*	Total	*Kharif*	*Rabi*	Total	*Kharif*	*Rabi*	Total
	Million Tonnes			Million Tonnes			Million Tonnes		
Rice	63.1	8.7	71.8	82.7	14.0	96.7	84.6	14.6	99.2
Wheat	–	65.8	65.8	–	78.6	78.6	–	80.6	80.6
Coarse Cereal	20.0	6.1	26.1	31.9	8.9	40.8	28.3	11.1	39.5
Pulses	4.2	7.0	11.1	6.4	8.4	14.8	4.8	9.9	14.7
Foodgrain	**87.2**	**87.6**	**174.8**	**121.0**	**109.8**	**230.8**	**117.7**	**116.2**	**233.9**
Jowar	4.2	2.8	7.0	4.1	3.8	7.9	3.1	4.2	7.3
Bajra	4.7	–	4.7	10.0	–	10.0	8.8	–	8.8
Maize	9.3	1.9	11.2	15.1	3.9	19.0	13.9	5.4	19.3
Ragi	1.3	–	1.3	2.2	–	2.2	2.1	–	2.1
Small millets	0.5	–	0.5	0.6	–	0.6	0.5	–	0.5
Barley	–	1.4	1.4	–	1.2	1.2	–	1.5	1.5
Coarse Cereal	20.0	6.1	26.1	31.9	8.9	40.8	28.3	11.1	39.5
Tur (Arhar)	2.2	–	2.2	3.1	–	3.1	2.3	–	2.3
Gram	–	4.2	4.2	–	5.8	5.8	–	7.1	7.1
Urad	1.0	0.5	1.5	1.1	0.3	1.5	0.8	0.3	1.1
Moong	0.6	0.2	0.9	1.3	0.3	1.5	0.8	0.2	1.0
Others	0.3	2.0	2.4	1.0	2.0	3.0	0.9	2.3	3.2
Pulses total	4.2	7.0	11.1	6.4	8.4	14.8	4.8	9.9	14.7
	Lakh Tonnes			Lakh Tonnes			Lakh Tonnes		
Groundnut	31.0	10.3	41.2	73.6	18.2	91.8	56.4	17.0	73.4
Castorseed	4.3	–	4.3	10.5	–	10.5	11.2	–	11.2
Sesamum	4.4	–	4.4	7.6	–	7.6	7.3	–	7.3
Nigerseed	0.9	–	0.9	1.1	–	1.1	1.2	–	1.2
Rape/Mustard	–	38.8	38.8	–	58.3	58.3	–	73.7	73.7
Linseed	–	1.8	1.8	–	1.6	1.6	–	1.6	1.6
Safflower	–	1.8	1.8	–	2.3	2.3	–	1.8	1.8
Sunflower	2.7	6.0	8.7	4.6	10.0	14.6	3.8	8.7	12.5
Soybean	46.6	–	46.6	109.7	–	109.7	99.0	–	99.0
Total Oilseed	**89.8**	**58.6**	**148.4**	**207.1**	**90.4**	**297.6**	**178.8**	**102.8**	**281.6**

37. The *First Advance Estimates* for *kharif* production have not been released yet, but based on the available acreage data and other parameters, the Council's assessment is that the there will be a loss in *kharif* foodgrain production largely contributed by rice, with some offsetting output gains from a higher production of pulses. We expect the output of coarse cereals to remain unchanged. However, the loss in *kharif* output will be partially offset by some gains in the *rabi* output. Overall we expect the total foodgrain production in 2009-10 to drop to 223 million tonnes from 234 million tonnes in 2008-09. In the case of oilseeds, the total output will decline to 276 million tonnes in 2009-10 from 282 million tonnes in 2008-09, with the largest share of the decline being contributed by groundnut.

38. There is reason to believe that barring some serious setback at the time of the harvest owing to inclement weather conditions, the *rabi* harvest in 2009/10 should be a normal one. As may be seen from Table-6, foodgrain output in the *rabi* season has come to be almost as large as that in *kharif* . The good rainfall in late August and September has created favourable conditions for the *rabi* harvest. Government and its agencies have proactively initiated many steps to protect and reinforce the *rabi* crop including promoting early sowing and distribution of appropriate types of seeds.

39. Water levels in the 81 major reservoirs that supply canal irrigation systems as on October 1, 2009 were lower than last year, as well as in comparison to the average of the past decade (see Table-7). However, continued rainfall during the last three weeks of September is likely to have improved matters somewhat. Lakhs of shallow tube-wells have been dug to mitigate the damage to the *kharif* crop and this will also help support the *rabi* planting. The shortfall in the impounded reservoir storage is broadly parallel to the deficiency of rainfall during the SW Monsoon of 2009. The shortfall is more pronounced in the northern reservoirs than in the central and southern regions, which again reflects the geographical variation in the deficiency of rainfall this year.

40. The persistent shortfall in the quantity of stored water- not just this year but even in 2008 which had above-normal precipitation, as also the average for the past 10 years, from the Full Reservoir Level (FRL), is a point worth noting. In fact even in the best of years, major reservoir capacity remains 40 per cent and more below the FRL, that is, the designed storage level. The 10-year average is short of the designed levels by as much as 50 to 60 per cent. Given the investment

Table 7: Water Level in 81 Major Reservoirs as on 01 October 2009							
Name of River Basin	**Live Capacity at FRL***	**This Year storage**	**Last year Storage**	**Last 10 year Average Storage**	**Deviation from FRL**	**Deviation from Last Year**	**Deviation from 10 Year Average**
	in Million Cubic Metres				***Per cent***		
Ganga	28,096	11118	15585	13870	-60%	-29%	-20%
Indus	14,730	7328	13469	10918	-50%	-46%	-33%
Narmada	14,869	10943	8814	8299	-26%	24%	32%
Tapi	7,394	3964	5682	5869	-46%	-30%	-32%
Mahi	4,012	2257	2320	2427	-44%	-3%	-7%
Sabarmati	735	230	260	321	-69%	-12%	-28%
Rivers of Kutch	887	253	521	393	-71%	-51%	-36%
Godavari	14,526	4064	9609	9659	-72%	-58%	-58%
Krishna	31,548	25641	30147	24160	-19%	-15%	6%
Mahanadi & neighbouring rivers	13,181	9020	12057	11001	-32%	-25%	-18%
Kaveri & neighbouring rivers	8,190	5085	5509	4224	-38%	-8%	20%
West flowing rivers of South	13,600	10573	9764	9806	-22%	8%	8%
Total	**151,768**	**90476**	**113737**	**100947**	**-40%**	**-20%**	**-10%**

Note: * FRL denotes Full Reservoir Level

that has been made in the construction of these reservoirs and the displacement of people and inundation of valley systems involved, this can hardly be considered to be a satisfactory state of affairs.

41. Aside from crops, horticulture and animal husbandry (fruits & vegetables, dairy etc.) have come to account for an increasing proportion of the value of farm output and hence of farm GDP. While the rainfall deficiency is likely to have an impact on the output of these activities as well, the impact is not likely to be on a scale equivalent to land remaining fallow for an entire season.

42. If we insert the expected changes in 2009/10 (based on the emerging scenario of *kharif* and the broad expectations that the projected *rabi* harvest will show a

little improvement over last year's level, with an overall small annual contraction in the rest of the farm sector), to a list of farm products and their attendant weights in farm output/incomes in 2008/09, the final change in annual farm output works out to (–) 2.0 per cent. However, it is possible that despite the best of efforts, the *rabi* crop may be smaller than last year's and the non-crop sector (spices, fruits & vegetables, animal husbandry, fishing) may also suffer more than anticipated.

43. This must be seen in light of two facts. First, the decline rather than positive growth is the consequence of a sub-normal SW monsoon. Second, farm GDP growth in the previous year (2008/09) at 1.6 per cent was significantly below the trend of the previous three years. Thus, the outcome of a *negative* 2.0 per cent should be contrasted with a possible *positive* 4 per cent or higher growth that would have resulted had the monsoon of 2009 been normal. In other words, the current fiscal year will see farm sector GDP at 6 to 7 per cent below its potential and this would primarily be the consequence of the poor monsoon of 2009.

V. THE NON-FARM SECTOR

44. Output expansion in the non-farm sector is likely to show a strong recovery in the current fiscal. Both industrial production and GDP arising from this sector suffered a severe loss of momentum in the second half of 2008/09 following the onset of the financial crisis. Industrial GDP growth fell from 6.1 per cent in the first half to 2.2 per cent in the second half of the year. Growth of GDP in manufacturing, plummeted to a mere 0.4 per cent, from 5.5 per cent in the first half. Services sector GDP expansion, other than in the government sector, also slowed down: from 10.4 per cent in the first half to less than 7 per cent in the second half. With a restoration of normality in operating conditions, we expect a strong bounce back in the rates of output and GDP expansion in the non-farm sector in the second half of 2009/10, especially in the industrial sector.

Industry – Mining

45. Crude petroleum output has stagnated at 2.7–2.8 million tonnes per month over the past several years. In the first quarter of 2009/10 output further fell by 1.3 per cent, compared to the same period of last year. The oilfields in Rajasthan operated by Cairns India have gone on-stream at the end of August and are likely to produce about 50,000 barrels per day (b/d) in the course of the balance seven months of 2009/10. In consequence, crude oil output will be boosted by more than 7 per cent fromlast year's levels. A few smaller fields are also likely to start production this year. The full year impact in 2009/10 of these developments will be to increase the output level by over 4 per cent relative to last year. Likewise the production of natural gas from the Krishna-Godavari (KG) basin operated by Reliance Industries will boost domestic production by about 40 million cubic metres per day, increasing domestic output by about 50 per cent. Production of coal has also registered a growth of 12.1 per cent in the first five months of 2009/10, a signal improvement over the corresponding periods of the previous two years. Sustained expansion of output is expected during the course of this year.

46. The *Index of Industrial Production* (IIP) for the mining sector reported output growth expansion by 14.2 per cent in June and 9.9 per cent in July 2009. Due to the substantial increase in production of crude oil and natural gas, as also improvement in the growth of coal output, the GDP arising in the mining &

quarrying sector is expected to increase by 10 per cent this year.

Table 8: Level of Output – Crude Oil, Natural Gas, Coal and Electricity

		Crude Oil		Natural Gas		Coal		Electricity	
		M.t.	**%change**	**Msmcd**	**%change**	**M.t.**	**%change**	**GWhr**	**%change**
2006/07	Q1	8,439	–	8106	–	96.7	–	161.3	–
	Q2	8,366	–	7388	–	88.8	–	162.0	–
	Q3	8,663	–	8187	–	108.7	–	167.7	–
	Q4	8,500	–	7874	–	128.6	–	168.5	–
2007/08	Q1	8,383	-0.7	7776	-4.1	97.3	0.7	175.9	9.0
	Q2	8,559	2.3	8086	9.4	93.6	5.4	174.2	7.6
	Q3	8,628	-0.4	8470	3.5	118.6	9.1	175.8	4.8
	Q4	8,548	0.6	8070	2.5	142.2	10.6	178.5	5.9
2008/09	Q1	8,371	-0.1	8310	6.9	105.5	8.4	179.4	2.0
	Q2	8,431	-1.5	8306	2.7	100.5	7.4	179.7	3.2
	Q3	8,627	0.0	8385	-1.0	130.4	9.9	180.8	2.9
	Q4	8,076	-5.5	7848	-2.8	150.5	5.8	183.8	3.0
2009/10	Q1	8,265	-1.3	9929	19.25	118.9	12.7	189.7	5.8
	July	2,790	-0.4	3758	35.5	35.9	9.7	62.9	3.3
	Aug	2,850	0.1	3869	37.9	36.2	8.5	65.6	9.8
	Sept	2900	4.3	3787	38.9			63.6	7.5

Electricity

47. Power output from utilities increased by 6 per cent in the first quarter of 2009/10 and by 8 per cent in June. While July 2009 generation growth was poor at 3.4 per cent, it picked up in August to 9.8 per cent and was 7.5 per cent in September 2009. The availability of natural gas contributed greatly by bringing into operation completed gas based plants that were lying idle on account of the non-availability of gas. For the period April to September 2009, cumulative power generation increased by 6.8 per cent, notwithstanding much lower availability of hydroelectric power because of poor rainfall. Thermal generation also increased by 10 per cent and nuclear generation by more than 15.1 per cent. Power generated by gas based plants increased by 32 per cent during this period, compared to last year. In the months of August and September 2009, gas based generation increased by 65 per cent.

48. It will not be easy to sustain high levels of generation growth despite the better availability of fuel – coal, natural gas and nuclear fuel – as evident from the fact that generation in September 2009 was more than 5 per cent below programme levels, which was partially offset by nuclear generation being 7 per cent higher than programmed. Coal based thermal generation in September was 2.7 per cent below the programme and the counterpart deviation for the first six months was also of a similar magnitude of -2.8 per cent. It is thus up to the administrative ministry to ensure that thermal and nuclear generation targets are not only achieved but exceeded so as to offset the shortfall from hydroelectric sources. It is possible for the electricity sector to improve output levels in the balance part of the year so as to average at least 7 per cent growth over last year.

Manufacturing

49. Output growth in manufacturing, even prior to October 2008, had been sluggish since November 2007, with the exception of the odd month. During the ten month period November 2007 to September 2008, output growth averaged 6.1 per cent, compared to 11.6 per cent in the preceding twelve months. This sluggishness derived from several factors: lower output of consumer durables mostly derived from a slowing demand on account of tighter monetary policy; a slowdown in the production of intermediate and basic goods deriving from capacity constraints (direct or indirect because of power shortages); while slower growth in consumer non-durables reflected a loss of momentum in the exports of textiles and footwear.

50. From October 2008 exports began to contract, consumers slowed down expenditure on deferrable items and corporates began to conserve cash. Many companies were hit by inventory losses as commodity prices plummeted and they were left holding previously purchased expensive raw materials. Others cut back production and drew down their raw materials inventory for it was not certain how much further the commodity prices would plunge. All this sharply depressed domestic manufacturing activity. The average growth of manufacturing output during the eight month period October 2008 to May 2009 was a mere 0.6 per cent and in three of these months, growth was actually negative.

51. However, manufacturing output bounced back in June 2009 registering a growth of 7.8 per cent, followed by 7.2 per cent growth in July 2009 and 10.2 per cent

in August 2009. Several components combined to give this fillip to manufacturing output. At Tables-9 & 10 output growth in the quarters preceding the onset of the crisis, during the crisis and the most recent periods have been presented.

52. In some cases, most notably consumer durables, there was a slackening of growth in 2007/08 itself, which may be attributed to the combination of demand being squeezed out by tightening monetary policy and higher interest rates. After registering negative growth in the last quarter of 2008/09, demand and output have both bounced back in the first quarter of 2009/10, especially in June and July. Data available for August 2009 show that passenger car output rose by 22 per cent and domestic sales increased by 26 per cent. In August 2009, the production of two-wheelers increased by 15 per cent while domestic sales rose by 25 per cent. It seems that consumer durables are likely to continue to expand at a fairly strong pace during the rest of the financial year and given the depressed output levels of the second half of 2008/09, the current year expansion rates will be strong.

Table 9: Changes in Industrial Output

Quarters before, during and after the Financial Crisis: Year-on-year output growth

Unit: per cent

	2007/2008				2008/2009				2009/2010		
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**June**	**July**
Basic goods	9.4	9.3	5.0	4.7	3.1	4.7	2.4	0.4	6.3	10.6	4.8
Capital goods	19.1	21.3	20.8	12.2	7.9	13.2	3.8	5.0	2.0	13.3	2.0
Intermediate goods	9.3	10.5	8.9	7.1	2.6	–1.7	–5.8	–3.2	7.3	7.6	9.0
Consumer durables	–0.7	–5.5	2.1	0.1	3.5	10.8	–1.8	5.6	15.3	16.1	19.8
Consumer Non-durables	12.4	5.1	7.6	8.9	10.1	5.1	4.9	–0.1	–4.9	0.7	5.0

Note: Highlighted sections indicate period of depressed or negative growth

53. In most other cases, the loss of growth momentum overlaps the period of the crisis. Capital goods output reached fairly low levels from the third quarter of 2008/09 and this is attributable to a slowdown of domestic capital expenditure. The sector showed strong recovery in June 2009, but as the low number for July suggests, investment activity is yet to gather pace.

54. The problem with consumer non-durables derives from two separate sources: First, goods such as apparel, jewellery and leather products including footwear are mostly exported and a weakness in exports was one factor. Second, the big decline in sugar production was the other factor that in all probability pushed output down as may be seen from the large negative growth numbers for food products reported in Table-10. Exports are yet to recover, though there has been some improvement in recent months, and to that extent the bounce back is likely to be subdued at least on this score. However, with the end of the sugar crushing season, the output growth for food products has turned positive and is likely to remain positive and will thus no longer be such a large drag on growth.

Table 10: Changes in Output in Select Manufacturing Groups

Quarters before, during and after the Financial Crisis: Year-on-year output growth

Unit: per cent

		2007/2008				2008/2009				2009/2010		
		Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**June**	**July**
20-21	Food Prod.	26.8	–1.7	–4.9	9.9	–7.1	7.6	0.6	–25.2	–17.2	0.2	2.2
23	Cotton textiles	7.3	5.6	2.0	2.9	3.5	–3.2	–3.5	–4.3	–1.6	–2.1	–0.4
24	Wool, silk & manmade fibres	3.3	7.7	0.4	9.4	7.3	–8.8	1.3	0.5	5.1	5.3	30.4
26	Text. prod. incl RMG	5.9	0.2	6.1	2.3	6.3	4.0	3.8	8.7	8.7	8.9	3.8
29	Leather prod.	8.5	12.1	11.4	16.2	5.8	–8.7	–10.5	–13.0	–3.7	10.7	15.2
30	Basic chemicals	6.9	10.5	14.9	10.4	11.2	1.2	–4.6	8.8	1.5	3.8	5.2
33	Basic metals	20.1	17.2	6.8	6.8	4.9	8.4	5.0	–2.0	7.7	12.8	3.7
34	Metal products & parts	–0.1	–0.6	–16.9	–2.2	2.0	1.8	–0.4	–16.8	–5.4	–8.4	10.1
35-36	Machinery & Equipment	14.3	9.3	13.5	6.6	7.9	12.3	4.7	10.3	7.2	12.7	11.2
37	Transport equip	1.5	2.3	5.3	2.6	10.3	13.9	–10.9	–1.5	7.0	12.1	10.9
Some specific large industries												
	Refined petro. products	15.3	7.1	3.4	3.9	3.3	5.7	2.3	0.8	–4.1	–3.7	–14.4
	Cement	7.8	11.7	6.0	10.2	5.8	6.4	8.8	9.0	12.1	12.8	10.6

55. Basic and intermediate goods were hit first by the depressed level of activity in the rest of the economy. Second, by virtue of the fact that a large share of our exports belong to this category (from cotton yarn & fabrics to chemicals and metals). Third, by the very low rates of increase in electricity generation and the output of fuels- all intermediate products. These components of industry have all shown recovery in output levels and are likely to register reasonably strong growth even as expectations from export demand remain modest. Wool, silk & manmade fibre textiles category is largely manmade fibres by weight, which after taking a beating for three successive quarters, appears to have bounced back in the first quarter of 2009/10, especially in July 2009. Leather manufactures – footwear, garments and travel accessories – also appear to be on the path of recovery in June and July 2009. Basic chemicals and metal products, two products that have a sizeable export share too appear to be on the path of recovery since June 2009.

56. The decline in refined petroleum products has a lot to do with depressed crack margins (refinery profit margins) worldwide. This has caused refiners worldwide to temporarily reduce their throughput (refinery runs) and does not therefore derive from domestic economic developments. However, to the extent petroleum refinery throughput remains depressed, it will impact overall manufacturing output growth. The strong growth in cement output, which continued even in the second half of 2008/09, is indicative of the fact that construction activity did not grind to a halt, which is perhaps due to high levels of public and publicly funded investment.

57. Cotton textiles (Table-10) mostly comprise cotton yarn and the decline in exports continues to take a toll in output levels. Machinery & equipment seems to have recovered in the last quarter of 2008/09 itself and has shown strong growth in the first quarter of 2009/10 and also in the month of July. Textile products including apparel (RMG) is mostly hosiery (knit) fabric and apparel and seems to have fared reasonably well even at the height of the crisis, perhaps on the strength of domestic demand. The first quarter growth number for 2009/10 was strong, even though the provisional growth estimate for July 2009 was under 4 per cent.

58. Thus, while export demand is yet to recover, the recovery in manufacturing output is broad-based and strong enough to suggest a recovery based on domestic demand and improved business confidence and a stable operating environment. On this basis we assess that manufacturing output growth will recover from the average 3.3 per cent registered in the first quarter of 2009/10 and the 7.8 and 6.8

per cent growth in June and July 2009, to over 9 per cent in the second half of the fiscal, assisted by the low base of last year. For the year as a whole, GDP arising in the manufacturing sector is thus expected to grow by over 7.7 per cent.

Construction

59. Construction growth slumped in the third quarter of 2008/09 to 4 per cent from an average of 9 per cent in the first half of the year. There was a recovery in the last quarter to 6.8 per cent and a stronger one in the first quarter to 7.1 per cent. It should be noted that this expansion was relative to a base period which had high growth (6.9 and 8.4 per cent respectively in the last quarter of 2007/08 and the first quarter of 2008/09). Activity levels, as derived from production and sales of cement, picked up in the first quarter of 2009/10 and continued to do so in July and August. Cement output in the first five months of 2009/10 was higher by 12.8 per cent over the corresponding period of last year. This was a stronger performance than in any of the quarters of the previous two years. Steel output has also shown some recovery as has that of bank disbursement of home loans. Overall GDP arising in the construction sector is expected to expand by around 8.8 per cent in the current fiscal.

Services

60. It should be noted that the larger part of services are in the nature of intermediate services associated with production, distribution and financing activities of primarily the industrial and to a lesser extent the agricultural sector. Hence, an upturn in industrial activity will bring in its wake an increase in the activity level of such services. Railway cargo movement in the first quarter of 2009/10 was 3 per cent over that of last year, but showed significant growth in July. Port cargo movement had contracted by 3.4 per cent in the Oct–Dec quarter of 2008/09 and by 1.4 per cent in the Jan–March quarter. In the current fiscal year, port cargo volumes were slightly lower in April and May but showed positive growth in June and July. Import container cargo volumes increased in June 2009, suggesting improvement in economic activity. Cellular subscriptions continued to show strong growth in the first few months of the year. According to the industry association, NASSCOM, the Information Technology Enabled Services (ITES) sector saw export revenues grow by 16 per cent last year, but growth is not expected in excess of 4 to 7 per cent in 2009/10. However, strong

growth is expected in the domestic sector for ITES, running into double digits, in part because of heightened activity levels in government related e-governance and other programmes. Finally, government expenditure on services (salary and arrears) will continue to show growth in the first half of the year, though it will revert to a lower trajectory in the second half. Overall services sector GDP growth is expected to be about 8 per cent this year, a little below the level recorded in the previous year.

VI TRADE AND BALANCE OF PAYMENTS

BoP – 2009/10: The Outlook

61. In 2009/10, the export outlook as discussed previously will not be favourable to expansion. In the first five months of this fiscal year the value of exports in US dollars has shown negative growth in each month, but the magnitude of this decline has been diminishing. More importantly the value of monthly exports has climbed back from the $11 billion level reached at the lowest point in the final quarter of 2008/09 and the first few months of 2009/10. It has improved to $12.8 billion in June, then to $13.6 billion in July and to $14.3 billion in August. We expect this trend to continue in September and in the second half of the fiscal year. As a result, strong growth will be reported in the second half of the year, as monthly levels recover to roughly where they were in the same period of 2007/08. Overall, as against the Directorate General of Commercial Intelligence and Statistics (DGCIS) reported export levels of $182 billion in 2008/09, the Council feels that the value of exports in 2009/10 is likely to be marginally higher at about $183 billion.

62. The value of exports of refined petroleum products has been registering large negative growth in the first few months of 2009/10. This is expected to change to positive growth in the second half of the year. However, for the year as a whole, the value of exports of refined petroleum products is expected to be lower by 20 per cent compared to last year. Gems & jewellery exports were hit hard in the second half of last year but they seem to have recovered since June, with the average *decline* (for same exporting ports) for the three months of June, July and August 2009 exports being 7.3 per cent.

63. In the first quarter of 2009/10, different components of textiles showed varying trends. Thus, the dollar value of exports of cotton yarn, fabrics & made-ups fell 35 per cent, while exports of apparel suffered a smaller decline of 10 per cent – and indeed grew in rupee terms. Somewhat similarly, the value of exports of manmade fibres & fabrics fell 17 per cent in dollar terms and 3 per cent in rupee terms. Exports of engineering products declined 32 per cent in the first quarter in dollar terms as did exports of leather manufactures.

64. The partial data available for the second quarter of 2009/10 show that within textiles, only manmade fibres & fabrics have fully broken out to register positive growth in dollar terms. Apparel exports continue with the first quarter trend of showing modest growth in rupee terms, but negative growth in dollar terms. Exports of cotton yarn, fabrics & made-ups show the decline becoming smaller (25 per cent) than in the first quarter. However, engineering goods and leather manufactures continue to decline at high rates in the second quarter similar to the first quarter. Overall non-oil, non-gems & jewellery exports went down 13 per cent in the first quarter and is expected to decline 10 per cent in the second. However, it is projected to grow 20 and 25 per cent in the third and fourth quarters of 2009/10.

65. The value of imports in the first five months of 2009/10 was $ 102.3 billion which represented a decline of 33.4 per cent over the corresponding period of last year. The direction of change will reverse in the second half of the year. For 2009/10 the value of merchandise imports is being projected at $281 billion, 4 per cent lower than the $291 billion registered in 2008/09. As against an expected decline of 27 per cent in the first half of 2009/10, it is projected that the second half will see imports grow by 29 per cent – largely as a result of the recovery of the industrial economy and a rise in the demand for imported intermediates and capital goods.

66. On the basis of actual imports of petroleum crude and products made in the first five months of 2009/10 and estimates of domestic demand for refined products and of world crude oil price staying above $72 per barrel for the rest of 2009 and rising to $75 per barrel in early 2010, the Council projects the oil import bill for 2009/10 at $78 billion (15 per cent less than last year). Import of gold and silver is expected to be short of $13 billion, a 30 per cent reduction from last year's level. Import of precious stones is expected to largely mirror the improvement in the exports of gems & jewellery.

67. The value of imports of non-oil, non-bullion, non-gem items – that is, mostly industrial raw materials & intermediates, capital goods and some food products, is thus likely to increase by 10 per cent in the course of the full year, after having marginally declined in the first half of 2009/10.

68. On the basis of this projection of overall exports and imports of $ 183 billion and $290 billion respectively, the trade deficit is projected at $107 billion, smaller than the $109 billion recorded last year. This corresponds to the DGCI&S trade data system. After adjusting this, on Balance of Payments (BoP) basis, the merchandise trade deficit for 2009/10 is projected to be $ 117 billion or 9.4 per cent of GDP (see Table-11).

Invisibles

69. Net invisibles, including non–factor service exports, worker remittances, income from tourism & travel and investment income flows aggregated $89.6 billion in 2008/09, an increase of 21 per cent over the previous year, though representing a slow down after two successive years of 30 per cent plus growth. Here, as in the case of merchandise trade, there was a big difference between performance in the first and second halves of the year. In the first half, net invisible earnings grew by 54 per cent and then went on to decline by 3 per cent in the second half.

70. The two main components of net invisibles are service sector exports (software & business process out-sourcing or BPO) and remittances from Indians working overseas. A part of the latter derives directly from activities of Indian software and BPO companies in overseas locations. The industry association, NASSCOM has estimated in July 2009 that export earnings in 2009/10 would be 4 to 7 per cent higher in dollar terms than last year. The projections for 2009/10 as presented in Table-11 build in a growth of 5 per cent for IT and ITES earnings.

71. The economic downturn had a negative impact on the level of remittances and in the second half of 2008/09 they dropped by 19 per cent compared to the same period of the previous year. However since then the remittances have recovered and in the first quarter of 2009-10 were at $12.9 billion. Remittances for the remaining three quarters will be around this level and the Council expects the total remittance figure for 2009-10 to be around $50 billion.

72. The estimated *Current Account Deficit* (CAD) is thus placed at $ 25 billion equivalent to 2.0 per cent of GDP. This is a drop from the CAD of 2.6 per cent

of GDP in 2008/09 but a rise from the 1 per cent levels of the previous two years.

Capital Flows

73. In-bound foreign direct investment (FDI) has picked up in the first quarter of 2009/10 touching $9.5 billion, which is more than what came in over the entire six months between October 2008 and March 2009. However, it is less than the $11.9 billion that had poured into the country in the first three months of 2008/09. It is expected that FDI inflows will be sustained through the balance period of the year to aggregate $37 billion in 2009/10, which is higher than in the previous year. Outbound FDI in the current fiscal is projected to be $14 billion, which is less than last year.

74. Portfolio inflows were a large negative number last year, but this trend has now reversed. The current rising trend is expected to persist and yield substantial net inflows estimated at $ 24 billion, including overseas equity issuance by Indian companies, of which a larger share would have occurred in the first half of 2009-10.

75. With improvement in global financial conditions, Indian corporates have been increasingly able to raise loan finance, with both June and July 2009 yielding over $ 2 billion of funds each month. In August 2009, the figure was above $1 billion. The total for the three months is a little less than $6 billion. This trend is likely to continue for most of this year and fund raising through ECB, net of the significant repayment of outstanding obligations due to mature in this fiscal year, is expected to be about $6 billion. With multilateral and bilateral loans not changing much and some further tightening of short-term credit and other liabilities, the overall inflow under the head of loans is expected to be $ 8.7 billion.

76. Banking transactions including a change in Non Resident bank deposits is expected to cause a net inflow of $3 billion while other capital inflows is expected to be a negative $1billion. That makes for an overall positive balance on the capital account of a little over $ 57 billion. After financing the CAD of $ 25 billion, it will leave an amount of $32 billion to be absorbed in the foreign currency assets of the RBI.

Table 11. Balance of Payments

US$ billion	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Merchandise Exports	85.2	105.2	128.9	166.2	175.2	188.9
Merchandise Imports	118.9	157.1	190.7	257.8	294.6	306
Merchandise Trade Balance	-33.7	-51.9	-61.8	-91.6	-119.4	-117.1
	-4.80%	-6.40%	-6.80%	-7.80%	-10.20%	-9.40%
Net Invisibles	31.2	42	52.2	74.6	89.6	92.2
o/w Software & BPO	14.7	23.8	27.7	37.3	45.2	47.3
Private Remittances	20.5	24.5	29.8	41.7	44	50.4
Investment Income	-4.1	-4.1	-6.8	-4.3	-4	-6.1
Current Account Balance	-2.5	-9.9	-9.6	-17.03	-29.8	-25
	-0.40%	-1.20%	-1.00%	-1.40%	-2.60%	-2.00%
Foreign Investment	13	15.5	14.8	45	3.5	46.9
o/w FDI (net)	3.7	3	7.7	15.4	17.5	22.8
Inbound FDI	6	8.9	22.7	34.2	35	36.9
Outbound FDI	2.3	5.9	15	18.8	17.5	14.1
Portfolio Capital	9.3	12.5	7.1	29.6	-14	24.1
Loans	10.9	7.9	24.5	41.9	5	8.7
Banking Capital	3.9	1.4	1.9	11.8	-3.4	2.9
Other capital	0	1.2	4.2	9.5	4.2	-1.1
Capital Account Balance	28	25.5	45.2	108	9.1	57.3
	4.00%	3.10%	5.00%	9.20%	0.80%	4.60%
Error& Omissions	0.6	-0.5	1	1.2	0.6	-0.8
Accretion & Reserves	26.2	15.1	36.6	92.2	-20.1	31.6
	3.70%	1.90%	4.00%	7.80%	-1.70%	2.50%
Memo						
GDP mp Rs crores	3149407	3586743	4129174	5321753	5321753	5856569
US$ billion	701	810	913	1166	1166	1246
Forex rate (Rs per US$)	44.93	44.27	45.25	45.63	4563	47

VII. PRICES

Wholesale Price Index (WPI)

77. The year-on-year rate of inflation as measured by the Wholesale Price Index (WPI) index was 0.8 per cent at the end of March 2009 and then entered negative territory in the beginning of June 2009. However, the decline in the index had occurred in the last quarter of 2008 and the first two months of 2009. Thereafter, price levels actually rose. Beginning January 21, 2009 the index for manufactured goods began to rise steadily, registering an increase of 0.8 per cent by the last week of March 2009, which is a fairly steep annualised rate of 8.7 per cent. The foodgrain price index hit bottom on January 3, 2009 and climbed steadily thereafter by 3.7 per cent to the end of March 2009, a rapid annualised rate of 17.2 per cent. The overall WPI index, touched a low on February 14, 2009, and rose thereafter by 0.5 per cent to the end of March, an annualised rate of 4.7 per cent. These rising trends were masked by the second dip in petroleum product prices in the last week of January 2009, which saw the petroleum product index drop by 4.1 per cent between January 24, 2009 and the end of March, a decline corresponding to an annual rate of (–) 21.5 per cent.

78. In the current fiscal beginning April 2009, prices reported in the WPI continued to increase – the most rapid increase being in food grain and other food products. In the first quarter ending June 2009, the overall WPI index rose by 3.1 per cent or at an annualised rate of 13.2 per cent (see Table-12). The food grain price index increased by 3.3 per cent or at an annualised rate of 13.9 per cent. Fruit & vegetable and other primary food prices rose faster than foodgrains, as a result of which the primary food index jumped 7.7 per cent in the first quarter alone, equivalent to an annualised rate of 34.3 per cent. The manufactured goods price index also increased by 2.4 per cent in the first quarter making for an annualised rate of nearly 10 per cent; all this, it needs to be noted, happened even as the year-on-year headline inflation rate continued to be negative.

Table 12: Movement in WPI Price Index Major Product Group-wise in 2009/10							
	Index value week ending			**Q1 (Apr to June)**		**Q2 (to mid Sept)**	
	28-Mar-09	**27-Jun-09**	**19-Sep-09**	**Increase**	***Annualized Rate***	**Increase**	***Annualized Rate***
Overall	**228.6**	**235.8**	**243.3**	**3.1%**	13.2%	3.1%	12.8%
Primary Foods	244.1	262.0	281.7	7.7%	34.3%	7.2%	32.0%
o/w Foodgrain	247.7	255.9	262.6	3.3%	13.9%	2.6%	10.9%
Petroleum Products	378.9	393.0	419.2	3.7%	15.7%	6.7%	295%
Manufactured goods	**200.9**	**205.7**	**208.5**	**2.4%**	9.9%	1.4%	5.6%
o/w Sugar etc.*	188.7	213.8	237.7	13.3%	64.8%	11.2%	52.8%
Excl. Sugar etc*	201.7	205.2	206.6	1.7%	7.1%	0.7%	2.8%

Note: * Sugar, *gur* and *khandsari*

79. In the second quarter of 2009/10 (up to September 26, 2009), the overall index has gained another 3.1 per cent, that is, an annualised rate once again of nearly 13 per cent, which is similar to the first quarter. The foodgrain price index has added 2.6 per cent (annualised rate of 10.9 per cent) and primary food 7.2 per cent (annualised rate of 32.0 per cent). The manufactured goods price index has added 1.4 per cent (annualised rate of 5.6 per cent). Thus, in the first half of 2009/10, the overall WPI index has risen at an annualised rate of around 13 per cent, the food price indices by much more and even the manufactured goods price index by 7.7 per cent. All of these numbers lie clearly outside the policy comfort zone of 4 to 5 per cent.

80. A mitigating factor in the rise of the manufactured goods price index is the fact that soaring sugar prices have been disproportionately responsible for driving this index upwards. Were the sub-index for sugar, *gur* & *khandsari* to be separated, the rest of the manufactured goods sector would be found to have experienced a smaller degree of price pressure – at an annualised pace of 7 per cent in the first quarter and 2.8 per cent in the second quarter, averaging 4.9 per cent in the first half of 2009/10. However, that too falls outside the comfort zone.

Consumer Price Index (CPI)

81. There are several consumer price indices – the CPI (Industrial Worker or IW), the CPI (Urban Non-Manual Employees or UNME), the CPI (Agricultural Labourers or AL) and the CPI (Rural Labourers or RL). The CPI (UNME) is

under re-construction and is expected to be re-launched as CPI (Urban All-India). All the other CPI indices have been reporting high single digit, and of late some-double digit, inflation numbers on a year-on-year basis. This stood out in very sharp contrast to the very low positive and negative year-on-year WPI inflation rates being reported during the same period. The CPI (IW) reported year-on-year inflation at 11.9 per cent for July 2009 and 11.74 per cent in August 2009; the average for the first four months of 2009/10 was 9.6 per cent. The CPI (AL) and CPI (RL) reported year-on-year inflation rates of 12 to 13 per cent for both July and August 2009.

82. The movement in the the Consumer Price Indices after June 2009 has been dramatic. In the January to March quarter of 2008/09, the annualised rate of inflation for CPI (IW) was 2.7 per cent, for CPI (AL) was 3.5 per cent and for CPI (RL) it was 4.4 per cent. In the first quarter of 2009/10, the annualised rates for the quarter rose sharply to 14.2 per cent for CPI (IW), 19.4 per cent for CPI (AL) and 18.4 per cent for CPI (RL). This was quite in line with the rate of change in food products – primary & manufactured – in the WPI basket (Table- 12). However, the rate of change in the CPI indices soared in July and August 2009. The CPI (IW) increased by 4.6 per cent in the month of July alone (which is equivalent to an annualised rate of over 70 per cent) and the CPI (AL) and (RL) increased by about 5 per cent in July and August – which again corresponds to 33 per cent annualised rates of inflation.

Independent Movements of the WPI and CPI

83. The independent movements of the WPI and the CPI are explained by the difference in the composition of the two price indices. If consumer goods in the WPI, which account for 53 per cent of the commodity basket, are looked at separately, the computed year-on-year inflation rates for this sub-group is in high single digit numbers for each of the past eight months and is comparable in magnitude to the rates reported in the consumer price indices. Thus for the seven month period January through July 2009, the average year-on-year inflation rate reported by the CPI (IW) was 9.5 per cent. For the consumer goods component of WPI, the comparable figure was 7.0 per cent and for the non-consumer goods component it was –3.2 per cent and thus, the average for the overall WPI was –1.4 per cent. Likewise for the first four months (April to July) of 2009/10, the consumer goods component averaged 7.2 per cent inflation as against the 9.6 per

cent recorded by the CPI (IW). The comparable figure for the non-consumer goods component of WPI was –5.8 per cent and overall WPI averaged –0.03 per cent.

Foodgrain prices

84. Foodgrain and other primary food prices have been the fastest rising component of inflation. It is fairly easy to understand the upward movement in these prices after the South West monsoon began to show signs of significant weakness. However, much of the increase in the prices of rice and pulses had actually commenced in October 2008, as is evident from Chart-1, where the shaded portions represent periods when prices had shot up.

85. Between the end of September 2008 and May 2009, much before there was any information about the SW monsoon of 2009, rice prices had risen by 15.7 per cent. Thereafter, they have barely risen by 1 per cent. The rice harvest of 2008 was a record one at over 99 million tonnes, some 3 million tonnes more than in the previous year, which had also been a record harvest. In fact, rice output has been increasing at a steady trend rate of about 3 per cent over the past five years. Public stocks of rice were over 20 million tonnes in April and May 2009 and procurement levels were running close to 20 per cent more than in 2008. The restrictions on exports of non-basmati rice continued. It is not easy to understand the dynamics behind the increase in rice prices between October 2008 and May 2009, other than in terms of a substantial upward shift in domestic demand – possibly a consequence of improved money incomes in the economically weaker sections (who are likely to have a higher disposition towards basic food expenditure) in both the agrarian and urban economy.

86. The increase in the prices of pulses was a more drawn-out process. The first part transpired during the monsoon season (June to September) of 2008 when the price index for pulses rose 9 per cent, which was in part a compensation for price declines that had occurred in 2007. The second part was the 8 per cent increase in the price index between October 2008 and May 2009. The last part amounting to 12 per cent was from June 2009 onwards. In the case of pulses there are clearer signs of supply constraints. Over the past fifteen years, the output level of pulses has remained virtually stagnant at between 13 and 15 million tonnes. In fact

Chart 1: Rise in Prices of Foodgrains (expressed as index 1993/94 = 100)

Note: Shaded areas depict periods of exceptional price gains

since 1970/71, the production of pulses has risen a mere 27 per cent, even as the country's population has increased by 110 per cent. The few million tonnes of pulses that we are able to import barely compensates for such a precipitous fall in per capita availability of pulses over the past four decades.

Assessment

87. Inflationary pressures are yet to be noted in the developed economies. However, in part the reason for the developed country headline rates to remain low is the large negative impact of lower energy prices. Thus, in the USA for instance, the *Consumer Price Index (Urban)* [CPI (U)] in August 2009 was 1.5 per cent lower than it had been a year ago. However, excluding food & energy (that

is, "core" inflation) the index showed *positive* inflation at 1.4 per cent. Changes in import price resulting from deterioration in exchange rates[1] may be ruled out as an explanatory factor of consequence and one must view the core inflation rate of 1.4 per cent as being the starting point for inflation at the beginning of the US economy's recovery path. The situation is not much different from the Euro-zone where August 2009 saw headline inflation at a negative 0.2 per cent, but excluding food & energy ("core") rate, at a positive 1.3 per cent. Thus, the fact that prices have largely continued to rise, notwithstanding the severe contraction in incomes in the six months of October 2008 to March 2009, is worthy of note.

88. It is hard to escape the conclusion, that even as developed economies come out of recession, inflationary pressures are going to continue and the very open monetary and fiscal stance adopted to mitigate the effects of the crisis today represents a tangible reason for inflation and inflationary expectations to be much higher than over the past two decades. A convincing strategy that is unambiguously spelt out and a clear timeframe for returning to more normal monetary and fiscal times are necessary to act as counterweights to rising inflationary pressures. In the absence of such a time-bound strategy, price pressures can jeopardise the path of a steady economic recovery. The fact that crude petroleum prices are around $70 per barrel even as developed economies are emerging from recession in a year in which the IMF estimates world output will shrink, should be an adequate pointer to the very real danger of a rise in global inflationary pressure.

89. In its July 2009 monetary policy statement, the RBI has stated: "WPI inflation for end-March 2010 is projected at around 5.0 per cent … higher than the projection of 4.0 per cent made in the Annual Policy Statement of April 2009". Given the strength of the inflationary pressure in the first half of 2009/10, due in part to the drought and expectations of lower supply, it is easier to envisage a situation in March 2010 where inflation is higher than 6.0 per cent.

90. Inflationary pressures on the food front will continue to be a major problem for policy formulation for the rest of 2009/10 and up to the beginning of the next

[1] One should note that over this period (August 2008 through August 2009) the US dollar gained strength with respect to every other major currency, barring the Japanese *yen* and Chinese *renminbi*. It is true that the Euro and other West European currencies have seen declines over the one year to August 2009, vis-à-vis the US dollar. However, it is also true that the European consumer basket, with the exception of energy, has a relatively smaller (net) component of imported goods and in many areas including agricultural products, EU price stabilization (subsidy) policies keep domestic prices somewhat elevated.

monsoon season, which will hopefully be a normal one. The supply response will have to be a more co-ordinated release of stocks through the public distribution system combined with some open market sales of public stocks if the need is felt. Precautionary arrangements for importing some rice to replenish public stocks must be considered. Considerable attention needs to be paid to the *rabi* season to try and ensure a strong harvest which will be the surest antidote to food price pressures.

IX. MONETARY CONDITIONS AND THE FINANCIAL SECTOR

International Conditions

91. Financial conditions worldwide have improved sharply over the past several months and India, as also other emerging economies, have benefited from the improvement. Loan and equity markets have both recovered much of the ground lost over the course of the financial crisis. As a result of altered risk perceptions and consequent capital movement, exchange rates have also begun to move in a direction opposite to what happened during the crisis; that is, dollar strengthening to dollar weakening – particularly since the middle of 2009. But the pace of movement is uneven and not pronounced except for commodity exporters (e.g. Australia, Canada, Brazil, South Africa) and economies with large and persistent current account surpluses (e.g. Norway). Established alternate currencies have also recovered much of the ground they had yielded to the US dollar – such as the Swiss franc, Swedish and Danish kroner and of course the Euro and Japanese yen.

92. Monetary policies in developed countries continue to be very accommodative and this is likely to continue for some time, even as the extent of support that the banking sector is drawing from the respective central banks is likely to diminish. The US Federal Reserve has continued with most of its programmes to support the banking sector and other financial institutions. The size of its balance sheet expanded from $870 billion at the end of 2007 to over $2,200 billion at the peak of its various operations including purchase of government securities in January 2009. It stood somewhat smaller at $2,100 billion at the end of September 2009 but is still very much larger than it was at the beginning of the crisis. The European Central Bank which provided considerable reserve support over the course of the last one year has seen its most recent tender offers (for loans to banks) subscribed at lower levels. However, the financial sector of the developed world remains fragile and in need of continued support that their respective central banks remain committed to. The recently concluded G20 meeting in the last week of September 2009 stated:

"10. We pledge today to sustain our strong policy response until a durable recovery is secured. We will act to ensure that when growth returns, jobs do too. We will avoid any premature withdrawal of stimulus. At the same time, we will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support in a cooperative and coordinated way, maintaining our commitment to fiscal responsibility"

93. Lending conditions have improved considerably as may be deduced from the drop in the London Inter Bank Offer Rate (LIBOR) which for US dollars 3- month duration presently stands at a little over 28 basis point (bps) after having remained well over 100 bps through the winter of 2008/09, notwithstanding the reduction in US policy rates to virtually zero. *Credit Default Swap* (CDS) spreads that had shown manifold increase during the height of the crisis have now come down to levels that prevailed at the beginning of 2007. This is illustrated by the sovereign CDS spreads at Table-13. One consequence of this has been the increased access to international loan funds by corporates as evidenced by Indian corporates being able to raise loans of nearly $6 billion between June and August 2009.

94. Stock markets have rebounded sharply after hitting new lows in March 2009. A summary of the movement in major stock indices is at Table-14. Most emerging market stock indices are now between 12 and 25 per cent lower than their all time peaks hit in late 2007 and early 2008 and mostly well above the point just prior to the failure of Lehman Brothers in mid-September 2008. Developed market indices have also recovered, but to a lesser extent, being 30 to 45 per cent below their all time highs. The improvement in conditions has enabled companies to raise fresh capital by the issuance of new shares, especially in the emerging, and particularly in the Asian markets.

Domestic Conditions

95. The several cuts made by the Reserve Bank of India (RBI) in the Cash Reserve Ratio (CRR) during the crisis, aggregating 4 percentage points, released a large amount of funds (about Rs 160,000 crore) for the banking sector. A large part of this remained as excess liquidity in the banking system and was parked with the RBI under its liquidity adjustment facility through reverse repos. To an extent this continues to date. The release of lendable reserves and the reduction

Table 13: Sovereign CDS Spreads over the recent past							
Unit: Basis Points (bps), i.e. hundredths of percentage points							
	Jan-07	**Jan-08**	**Aug-08**	**Oct-08***	**Jan-09**	**Mar-09**	**Aug-09**
Advanced Economies							
Australia	9	14	20	100	115	171	125
Germany	3	7	8	38	45	77	23
Greece	7	22	51	139	230	226	115
Italy	9	20	40	132	168	177	75
Ireland	9	13	30	125	190	304	151
Korea, South	16	50	116	700	300	415	140
Japan	11	9	16	63	43	113	38
Spain	3	18	38	109	101	130	69
Sweden	10	5	10	65	115	133	58
Singapore	4	25	55	160	135	164	35
UK	25	9	17	68	115	142	59
Emerging Economies							
Brazil	99	103	130	584	290	367	134
Chile	17	30	62	315	201	260	80
China	11	29	65	297	176	215	80
Colombia	115	130	160	613	300	435	163
Czech Republic	6	16	44	228	165	256	92
Hungary	21	55	124	605	406	537	267
India (SBI)	**45**	**118**	**238**	**740**	**354**	**474**	**152**
Indonesia	116	170	261	1,257	624	654	220
Malaysia	18	44	127	520	210	294	95
Poland	13	26	68	270	242	320	138
Russia	44	88	132	1,117	728	650	306
South Africa	40	78	173	683	386	436	185
Turkey	164	167	265	786	396	426	226

Note: * At the worst point

Table 14: Movement of Stock Indices before & during Crisis & Subsequently : Major Markets (Start of October 2009)

Index	Gain from trough after last boom at most recent peak	This peak vis-à-vis last peak	Maximum Loss from most recent peak	Current Loss(–) vis-à-vis most recent peak	Current Loss (–) / Gain (+)since Lehman Failure	Recovery from the lowest point in the Crisis	Current level vis-à-vis trough after last boom
Dow DJIA	89%	21%	–54%	–33%	–17%	45%	30%
Swiss SMI	159%	14%	–55%	–36%	–15%	14%	66%
S&P 500	101%	3%	–57%	–35%	–15%	43%	67%
Germany Dax	124%	0%	–55%	–33%	–14%	18%	49%
U.K. FTSE	81%	–3%	–48%	–26%	–8%	42%	34%
Italy Mibtel	112%	–8%	–67%	–46%	–21%	63%	14%
France CAC	93%	–12%	–59%	–40%	–16%	45%	15%
Australia	150%	98%	–54%	–32%	–7%	48%	70%
Canada	165%	97%	–50%	–27%	–14%	45%	92%
Russia	1.445%	789%	–74%	–35%	6%	148%	897%
Brazil	774%	309%	–60%	–16%	17%	108%	631%
Mexico	482%	295%	–49%	–13%	12%	71%	408%
Argentina	1,052%	263%	–64%	–13%	23%	141%	908%
Japan	92%	–15%	–60%	–44%	–20%	38%	7%
South Korea	308%	94%	–54%	–19%	13%	77%	230%
Hong Kong	244%	73%	–65%	–36%	6%	85%	121%
Singapore	207%	47%	–62%	–32%	1%	79%	110%
Taiwan	185%	–4%	–57%	–24%	17%	78%	115%
Indonesia	706%	302%	–61%	–12%	37%	123%	606%
India BSE	703%	255%	–61%	–18%	22%	110%	559%
China SSEC	304%	175%	–72%	–54%	34%	63%	84%
Malaysia	174%	50%	–45%	–22%	13%	42%	113%

in the policy rates brought money market rates down sharply and more often than not, the overnight rates hovered below the reverse repo rate. However, in the last few days of September 2009, the amount deposited with the RBI had dropped to between Rs 60,000 to 80,000 crore, but it has since reverted to deposit levels of well over Rs. 1,00,000 crore. This is notwithstanding the jump in the disbursal of advances in the last fortnight of September 2009.

96. Bank credit to the commercial sector was sluggish in the quarter ending December 2008 but picked up in February and March 2009. Non-food credit increased by Rs. 2,26,500 crore (9 per cent) in the second half of 2008/09 as compared to an increase of Rs. 3,17,000 crore (16 per cent) in the corresponding period of 2007/08 (see Table-15)

97. The reasons for the sluggishness in credit off-take in the second half of 2008/09 are many. First, banks were cautious in making additional or new advances in a situation where leading global banks were teetering on the edge. Second, depressed economic conditions, big losses due to lower inventory valuations and foreign exchange derivative contracts made companies cautious. Third, many

Table 15: Volume of Funds Raised from the Banking System and the Capital Market

Unit: Rs in crore

		2007/08	2008/09	April-Aug 2007/08	April-Aug 2008/09	Sep-Mar 2008/09	April-Aug 2009/10
1	**Bank Sources of Funds $**						
1.1	Increase in Credit to Commercial Sector	446,299	431,393	58,473	137,018	294,375	62,275
1.2	Increase in bank holding of Govt securities *	187,861	195,333	113,036	22,003	173,330	183,558
2	**Capital Market Sources All**	241,444	222,072	85,243	41,270	180,802	121,158
2.1	**Debt (bonds)**						
a	Private Placement of Bonds	128,644	207,164	48,526	38,500	168,664	87,999
b	Public Issue of Bonds						2,000
2.2	**Capital Market Equity Raising**	112,800	14,908	36,717	2,770	12,138	31,159
a	IPO and FPO (public)	54,511	2,082	27,800	1,984	98	9,693
b	QIP **	25,525	189	8,208	75	114	21,239
c	Rights	32,518	12,637	708	712	11,925	227

Note: $ Up to fortnight ended 11 September 2009

* This includes reverse repo deposits because in this transaction banks are buying securities overnight from RBI

** Qualified Institutional Programme

companies having raised substantial leverage prior to the crisis, were cautious about taking on additional loan liabilities in an atmosphere where the direction of change was as yet unclear. Fourth, retail demand for loans was down because home-builders and buyers of automobiles were uncertain about the economic outlook, in particular about how much more real estate prices would correct and how much interest rates would decline.

98. Credit off-take has continued to be sluggish in the first half of 2009/10. In the first quarter of 2009/10, non-food credit was up 0.4 per cent, though it must be mentioned that most years see a decline in the level of credit in the first quarter. Up to the fortnight ending 11 September 2009, non-food credit was up 1.8 per cent on a year-to-date basis, the lowest in five years. In 2008/09, for the same period, the increase was 5.7 per cent (in an environment of tight monetary conditions) and the year before that it was 2.8 per cent. In 2004/05 and 2005/06, years which were at the base of the enormous pick up in leverage, the growth numbers were much higher at 6.8 and 7.2 per cent respectively.

99. It needs to be mentioned here that while external sources of finance dried up after the onset of the crisis, large volumes of debt were raised by Indian companies from the domestic capital market in the immediate aftermath of the shock of the global financial crisis. Between November 2008 and March 2009, a sum of Rs 141,000 crore was raised by Indian companies through private placement of bonds, with December 2008 and February 2009 seeing volumes of Rs 34,500 and 40,000 crore respectively. A large part of the liquidity seems to have come from the mutual fund industry. In the first five months (April to August) of 2009/10, an additional Rs. 88,000 crore has been raised through this channel. This is nearly Rs. 50,000 crore more than in the corresponding period of the previous year.

100. It is significant to note that the quantity of corporate bonds raised from the capital market in the second half of last year was 60 per cent of the credit extended by banks (measured in terms of flow of credit). In the current fiscal (up to August 2009), debt mobilised in the capital market has been significantly larger than the flow of bank credit to the commercial sector.

101. Supply of equity from the capital markets had virtually dried up after February 2008. The total quantum raised in 2008/09 was just about one tenth of that raised in the previous year. The situation has changed considerably in the current fiscal with the amount mobilized through equity issuance in the first

five months of 2009/10 comparing well even with the corresponding period of 2007/08. Some of the recent mobilisations include issuances deferred over the past one and a half years, which will help rebalance the capital structure of companies, enabling them to expand their balance sheets by stepping up investments in the coming period if they choose to do so. In other words, the improvement in capital market conditions, while not sufficient to enable a stepping up of private corporate investment, is indeed a necessary one.

102. Banks have added to their holding of government securities, both in the second half of 2008/09 and in the current fiscal as well. In the second half of last year banks added Rs. 1,73,000 crore of government securities and another Rs 1,84,000 crore in the current year (to date). This may be construed as a risk minimizing response. But the counterpoint is the large supply of government securities during this period as a result of the much larger-than-expected fiscal deficit – both on account of the designed fiscal stimulus and as a consequence of higher civil service pay and oil and fertilizer subsidies.

103. Going into the crisis, the RBI had Rs. 1, 78,000 crore of funds sequestered under the *Market Stabilization Scheme* (MSS). At the end of March 2009, half of this had been released to finance the expenditure of government. By mid-September 2009 only Rs 19,000 crore remains outstanding under the MSS. These pre-empted funds mobilized from the market have proved useful both in the previous year and in the current one. It is hard to imagine what plausible recourse would have been available to finance the expenditure of government during the past twelve months in the absence of these previously sequestered funds.

104. With tangible improvement in economic conditions, the domestic demand for credit is likely to pick up. Deposit re-pricing by commercial banks and a more stable situation is also likely to see banks push lending more. The opening up of overseas sources of borrowing is likely to hasten the process. Mobilization of additional equity finance through fresh issuance by Indian companies will also improve the capital structure of Indian companies and ease bank lending. So will the improvement in corporate profitability this year. According to a study of non-financial companies by the RBI, net profits were down 14 per cent (before tax) and 4 per cent (before interest and tax) last year.

105. The highly accommodative and expansive monetary stance that was created because of exceptional circumstances needs to be phased out, as those exceptional circumstances have passed and the economy is entering a more normal phase of expansion. The timing, the pace and the manner in which the monetary stance is gradually brought back to a relatively neutral stance will depend on the pace of expansion that various sectors of the economy exhibit and the magnitude of inflationary pressures. Given the present signs of inflationary pressures, we may have to act earlier than the US and European economies.

X. GOVERNMENT FINANCES

106. Government finances have come under severe strain since 2008-09, which is a matter of concern. After a steady improvement, particularly since legislating the Fiscal Responsibility and Budget Management Act (FRBMA) in 2003-04, the fiscal situation deteriorated sharply in 2008/09. The continued global recession and economic slowdown in the country called for a continuation of the expansionary fiscal policy stance in the current year. However, it is necessary to get back to the path of fiscal correction not only because of the problems associated with high levels of fiscal and revenue deficits, but also due to the role financing of deficits plays in calibrating monetary policy. Keeping a close watch on government finances is, therefore, important to ensure an appropriate balance between stimulating the economy to maintain a high growth rate while ensuring stability.

107. As was stated in our Review of the Economy 2008/09, the government was successful in achieving substantial fiscal correction from 2003/04 to 2007/08. The consolidated fiscal deficit declined from 8.51 per cent in 2003/04 to 4.17 per cent in 2007/08 (Table-16). Similarly, the consolidated revenue deficit relative to GDP was compressed from 5.79 per cent to 0.2 per cent during this period and the primary deficit moved into a surplus of 1.3 per cent of GDP in 2007/08 to provide a cushion in achieving debt sustainability. At the same time, it should be noted that fiscal correction was mainly on the strength of high growth of revenues from direct taxes and service taxes. A sharp increase in oil prices and the requirement to provide for civil services pay revision, loan waiver and expansion in the coverage of NREGA resulted in the revision of revenue and fiscal deficits to much higher levels. Thus, the revised estimate of expenditures for 2008/09 was higher than the budget estimate by 20 per cent, mainly due to 22 per cent higher revenue expenditures.

108. The fiscal deficit of the Centre as a ratio of GDP increased to 6 per cent as compared to the budget estimate of 2.5 per cent and the revenue deficit had to be revised to 4.4 per cent as against the budget estimate of one per cent. As the States were also allowed to have higher fiscal deficit amounting to half a per cent of GDP as a part of the fiscal stimulus package, the revised estimate of consolidated revenue deficit in 2008/09 as a ratio of GDP works out to 4.3 per cent and the

Table 16: Fiscal Indicators of Central and State Governments (Percent of GDP)									
	State			Centre			Consolidated		
	Revenue Deficit	Primary Deficit	Fiscal deficit	Revenue Deficit	Primary Deficit	Fiscal deficit	Revenue Deficit	Primary Deficit	Fiscal deficit
2000-01	2.63	1.76	4.18	4.05	0.93	5.65	6.60	3.57	9.51
2001-02	2.65	1.43	4.14	4.40	1.47	6.19	6.99	3.69	9.94
2002-03	2.33	1.25	4.06	4.40	1.11	5.91	6.64	3.09	9.57
2003-04	2.30	1.46	4.38	3.57	-0.03	4.48	5.79	2.07	8.51
2004-05	1.24	0.68	3.42	2.49	-0.04	3.99	3.64	1.35	7.45
2005-06	0.20	0.17	2.51	2.57	0.38	4.08	2.77	0.99	6.68
2006-07	-0.6	-0.4	1.9	1.94	-0.2	3.4	1.34	-0.01	5.58
2007-08	-0.98	-0.6	1.45	1.11	-0.93	2.7	0.19	-1.28	4.17
2008-09 *	-0.13	0.72	2.64	4.4	2.5	6.0	4.30	3.42	8.66
2009-10**	0.63	1.4	3.34	4.8	3.0	6.8	5.42	4.52	10.09

* Revised Estimates.

** Budget Estimates.

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

Note: Data from 2007-08 pertain to 27 States.

corresponding fiscal deficit is estimated at 8.7 per cent. In addition, the Central government issued bonds for oil marketing companies and fertilizer companies amounting to 1.8 per cent of GDP. Thus, the total government liabilities for 2008/09 are estimated at 10.37 per cent of GDP (Table- 17).

109. The above fiscal developments underscore four important points. First, increase in deficits in the revised estimate over the budget estimate did not occur due to the stimulus package but on account of additional outlay on subsidies, pay revision, loan waiver, financing the increased coverage of the NREGA etc. Second, the structural component of the deficit is substantial though a part of it is cyclical. The deficit on account of reduction in taxes on account of the economic

Table 17: Fiscal Imbalance in India 2000-10 (Percent of GDP)			
	Consolidated Fiscal deficit	Oil/Fertilizer Food Corp/Other Bonds	Total Liability
2000-01	9.51	0.04	9.55
2001-02	9.94	0.46	10.40
2002-03	9.57	0.09	9.67
2003-04	8.51	0.09	8.61
2004-05	7.45	0.01	7.46
2005-06	6.68	0.50	7.17
2006-07	5.58	0.98	6.56
2007-08	4.17	0.81	4.98
2008-09 *	8.66	1.76	10.43
2009-10**	10.09	0.17	10.27

* Revised Estimates

** Budget Estimates

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

Note: Data from 2007-08 pertain to 27 States.

slowdown as well as the tax cuts in excise and service taxes is estimated at about one per cent of GDP. The gross tax revenue of the Central government as a ratio of GDP declined from 12.5 per cent in 2007/08 to 11.5 per cent in 2008/09. This includes the impact of the economic slowdown as well as that of a six percentage point cut in excise and two percentage point cut in service tax rates. The remaining expansion is largely on account of an increase in expenditures on the items indicated above. Third, the substantially higher revised expenditure over the budgeted expenditure, brings to the fore the poor expenditure management. While the fiscal deficit in 2008/09 was budgeted to conform to the FRBMA, approval for large amounts had to be secured through supplementary demands for grants. This adversely impacts expenditure management and allocative and technical efficiency in public spending. Fourth, as the increase in expenditures was due to the reasons mentioned above, there was limited fiscal space for the stimulus package. In addition, the package could not be directed to the desired sectors. In particular, the stimulus package could have been used to augment expenditures on much needed infrastructure sectors, but large increases in current expenditures pre-empted this.

110. Considering the continued economic slowdown and global recessionary conditions, the Central government had to retain the expansionary fiscal stance during 2009/10 as well. The Union Budget for 2009/10 continues to maintain a high level of expenditure and has provided additional cuts in excise duties and services taxes besides increasing the borrowing room for the States to 4 per cent of GSDP or about 3.4 per cent of GDP. Thus, the fiscal deficit at the Central level as a ratio of GDP is estimated at 6.8 per cent and the consolidated deficit for the year is estimated at 10.1 per cent. As the government proposes to issue bonds to oil marketing companies amounting to Rs. 10306 crore or 0.2 per cent of GDP, the total increase in debt liabilities for the year works out to 10.3 per cent of GDP. Similarly, the revenue deficit of the Central government is budgeted at 4.8 per cent of GDP. As a number of States are expected to revise their civil service pay scales, after a brief period of generating a revenue surplus, these States are expected to incur a deficit of about 0.6 per cent of GDP. Thus, the consolidated revenue deficit is estimated at 5.4 per cent of GDP. The outstanding liabilities of the Centre and the States as a ratio of GDP (after a marginal decline to 74 per cent in 2008/09 from peak levels of 81 per cent in 2003/04 and 2004/05) are estimated to increase to over 77 per cent in 2009/10.

111. While the magnitude of the deficit is surely a matter of concern, it is important to note that the estimates for 2009/10 seem to be realistic as all expenditure commitments seem to have been budgeted and the revenue estimates do not seem to be overestimates. Although the drought situation in the country would require some additional expenditure both in terms of food subsidy and NREGA, it is not likely to alter the deficit estimates in any significant manner. Furthermore, moderate levels of prices of crude oil have obviated the need to have oil bonds and if the fertilizer subsidies are targeted as promised in the budget, the expenditure on this account can not only be contained at the budgeted level but the policy can be directed to improve efficiency in the use of fertilizers.

112. The large government deficits during the last two years were unavoidable; but it is not possible to sustain them in future. Given that the household sector's financial savings in 2008/09 was estimated at 10.9 per cent of GDP and is expected to be lower in 2009/10, continued borrowing of this magnitude is likely

to put upward pressure on the interest rates and may financially crowd out private investment. Large fiscal deficits combined with large revenue deficits lead to using borrowed funds for current consumption and making transfer payments rather than creation of productive assets to generate externalities. Such large borrowings pre-empt a significant proportion of revenues for servicing the debt. In 2009/10, the spending on interest payment at 3.7 per cent of GDP is estimated at 36.6 per cent of the revenues accruing to the Centre and 19 per cent of Centre's expenditures. The build up of outstanding liabilities – estimated to be over 77 per cent of GDP in 2010 - also involves inter-generational equity as these have to be extinguished by raising taxes in future.

113. The macroeconomic environment depends not only on the volume of deficits but also the way they are financed. The annual monetary policy statement of the RBI estimates net market borrowings for the central and state governments for 2009/10 at Rs. 4,34,647 crore or about 7.2 per cent of GDP. Almost 48 per cent of this is being mobilised in the first half of the year and about 58 per cent of this is done through MSS unwinding and Open Market Operations and the remaining through the issuance of fresh securities. Thus a significant proportion of the borrowing during the year is expected to be made by monetising the deficit. In a year when the country is facing one of its severest droughts, this could portend fuelling inflationary expectations unless the supply management is carefully calibrated. While a reasonably comfortable stock of foodgrains provides security against an increase in the prices of basic food items, in respect of some commodities such as pulses, sugar, edible oils, it may not be possible to augment supplies in the short run from domestic production and the government will have to maintain a close vigil on the price front.

114. As the government starts preparations for the next budget, one important issue which needs to be addressed, is the appropriate "exit" strategy. It is important to return to fiscal consolidation and in determining this, both the timing and magnitude of adjustment in the coming years is extremely important. Indeed, given that the Centre would have paid out the salary arrears and the liabilities on account of loan waiver will be considerably lower, even if the expenditures on various schemes are kept constant in nominal terms, there could be a reduction in the deficit of 1.5 per cent of GDP next year. In any case, the government will have to wait for the recommendations of the 13th Finance Commission to determine the fiscal adjustment path. But it is important to return to the path of fiscal rectitude at the earliest.

115. The experience with FRBMA provides some useful lessons and the next stage of fiscal adjustment should be designed to incorporate them. Perhaps it may be possible to induct an element of counter-cyclicality to the fiscal consolidation process. The fiscal responsibility legislation should be followed by a Medium Term Fiscal Framework (MTFF), which should specify the targets on both revenue and expenditure sides. It is important to note that fiscal discipline is not the function of the finance ministry alone; all spending departments should be involved in its implementation. Based on the MTFF, indicative expenditure targets should be given to each of the spending departments based on which, they should prepare a Medium Term Expenditure Plan (MTEP). Both MTFF and MTEP should be initiated as a part of the FRBMA exercise to be updated every year.

XI. CONCLUDING COMMENTS – SOME POLICY OPTIONS

116. In the short term, managing inflationary risks, particularly food price inflation is the biggest challenge to be faced by our policy makers. It is a matter of comfort and strength that we have an adequate supply of food grains in public stocks, of which about 18 million tonnes is rice. An appropriate policy response to contain food inflation, must draw from multiple sources.

First, the Government has invested considerable effort and resources to protect the *rabi* crop. It must continue to do so right through the season.

Second, it needs to focus on the Public Distribution System to reach foodgrains to different markets and locations, so that price pressures are contained.

Third, as a matter of abundant precaution, the concerned agencies should be instructed to take measures to facilitate import of rice, if required.

117. In the medium term, the farm economy holds out many challenges, the principal one being the relatively low levels of yield of major cereal crops as compared to other Asian economies, particularly China, as well as stagnation in the yield improvement of traditional dryland crops like pulses, and others. We have a large science and technology establishment for agricultural research. But the results on the ground in terms of productivity gains and productivity stagnation should cause serious discomfort to policy makers. Necessary steps must be taken to revitalise traditional crop agriculture even as this component has dropped to less than one third of farm sector GDP.

118. One must remember that traditional crop agriculture (rice, grain and oilseeds) accounts for most of the arable land utilisation, irrigation water usage and fertiliser consumption. Even though its relative importance in the farm economy has fallen, it is still vitally important for food security and offers fairly low-hanging-fruit in terms of the scope to increase productivity from the current low levels, as has been done with considerable success by China. Significant income improvement in the farm sector and therefore in the rural economy will then be achieved.

119. Today the Indian economy is constrained primarily by a shortage of physical infrastructure, of which the single most important item is electricity. Shortage of electric power not only leads to direct production losses, but results in inefficiencies in a broad range of areas. Captive power is expensive, and since it is mostly generated by using diesel and furnace oil, it is also prohibitively expensive. It makes our industries uncompetitive and their profitability lower. Having to build captive power generation capacity, increases the capital cost of our factories and for that matter even of our commercial building spaces.

120. Government has the largest role to play in the electricity sector, being the dominant producer with a virtual monopoly on the transmission side and also on the distribution side through State Government utilities. Thus, without a high order of government intervention in capacity creation and other supportive components of the electricity business, we will not be able to make the necessary improvements in the electricity sector, which is so vital for the economy to maintain a high rate of growth of 8 to 9 per cent. It is equally important to facilitate and encourage more private investment in power generation. Most of the private sector projects are being or are due to be completed in or before time and the sector's contribution to additional capacity commissioned in the Eleventh Plan (2007-12) period is likely to be in excess of what had been planned.

121. The Eleventh Plan had envisaged capacity creation of about 78,000 MW. There has been considerable slippage and it is expected that even under optimistic conditions perhaps 70,000 MW would actually be completed during the Plan period. We cannot afford slippages to persist in future years. Given the centrality of electricity and the lead time needed for both plant execution and finalising fuel linkages and production, we must have a longer time horizon of 15 years. In other words, we must have an "active" as opposed to an "indicative" plan for creating power capacity over the next 15 years.

122. We have been able to increase the capacity for manufacturing power plant equipment by BHEL and there are private sector companies led by major Indian corporates with foreign collaboration that are also entering the field. Thus we shall have the required engineering capacity to support generating and transmission capacity creation of the order of more than 25,000 MW per annum in the years to come.

123. Most of the capacity now being executed, or in an advanced stage of planning, is coal-based. We should diversify our fuel sources, particularly with respect to natural gas, using both domestic and imported natural gas, Liquefied Natural Gas (LNG), and develop more nuclear power plants. Natural gas is inherently more technically efficient, has a smaller carbon foot print and is an established technology. We should seek to dramatically increase the share of natural gas / LNG based power generating capacity in the next 15 year period.

124. Simultaneously, the change in the nuclear power environment, arising out of the India-US Nuclear Agreement and the endorsement by the Nuclear Suppliers Group has to be operationalized by rapidly enhancing the scope of nuclear power generating capacity. Government has stated that it would amend the Atomic Energy Act to allow reputable private companies into the business and many corporates have expressed much interest and tied-up with leading technology suppliers. Necessary legislative changes will have to be made to allow the entry of such companies within an appropriate regulatory framework, aside from giving a further impetus to the activities of state-owned companies like the Nuclear Power Corporation and other public sector power companies that plan to enter the business. For historical reasons of isolation in the nuclear field, India has been a laggard in nuclear power with barely 2.0 to 2.5 per cent of our power needs coming from this source as compared to over 10 per cent for the US and nearly 80 per cent for France. It would give the entire effort of accelerating expansion in the power sector great momentum, if Government were to consider an ambitious program for capacity creation in the nuclear power sector, of say 150,000 MW, over the next 15 years. Work on initiating the move towards a more aggressive path of capacity creation, particularly in respect of nuclear power, must start immediately.