भारतीय रिज़र्व बैंक

वार्षिक रिपोर्ट 2005-06
सारांश

जून 2006 को समाप्त वर्ष के लिए भारतीय रिज़र्व बैंक की कार्यप्रणाली पर केंद्रीय निदेशक मंडल की रिपोर्ट का सारांश

पूरी वार्षिक रिपोर्ट इंटरनेटपर भी देखी जा सकती है।

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THE ANNUAL REPORT ON THE WORKING OF THE RESERVE BANK OF INDIA

*For the Year July 1, 2005 to June 30, 2006**

PART ONE : THE ECONOMY : REVIEW AND PROSPECTS

I ECONOMIC REVIEW

I. MACROECONOMIC POLICY ENVIRONMENT

I.1.1 The global economy recorded strong growth of 4.8 per cent in 2005 on top of a three-decade high growth of 5.3 per cent in 2004, thus remaining well above its long-run average, and exhibited considerable resilience despite the record high international crude oil prices. Economic activity during 2005 continued to be supported by benign financial market conditions and still accommodative macroeconomic policies, notwithstanding continuing tightening of monetary policies in a number of economies. The above average performance of the global economy was mainly driven by strong activity in the US and the emerging market economies led by China and India. Reflecting the impact of record high oil prices, headline inflation firmed up around the world. Although inflation expectations have been contained till recently, there are signs of some firming up of inflationary expectations globally. The possibility of higher second order effects of oil prices, therefore, continues to be a cause of policy concern internationally. Looking ahead, the global economy is expected to grow in 2006 and 2007 at broadly at the same pace as in 2005. However, firming up of inflationary expectations, high and volatile crude oil prices, the probability of disorderly and rapid adjustment of large and growing current account imbalances, and the recent volatility and re-pricing of risks in international financial markets are key downside risks to global growth prospects.

I.1.2 In the backdrop of these global developments, the Indian economy built upon its recent phase of high growth in 2005-06 led by strong performance of the industry and services sectors. Growth in real GDP accelerated from 7.5 per cent in 2004-05 to 8.4 per cent in 2005-06. The Indian economy has, thus, recorded an average growth of over eight per cent for the last three years. A noteworthy feature of this outcome is that it has been achieved in an environment of macroeconomic and financial stability. Despite continued pressure from international crude oil prices, headline inflation was lower than projected and inflation expectations remained well-contained though underlying pressures remained. Strong macroeconomic

* While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated beyond March 2006. For the purpose of analysis and for providing proper perspective on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

performance during 2005-06 was underpinned by robust export growth for the fourth successive year, sustained non-oil import demand, continued fiscal consolidation, high domestic savings, buoyant investment activity, acceleration in credit growth and some expansion in current account deficit. Timely and calibrated macroeconomic policy measures during the year ensured that growth momentum was maintained during 2005-06 while ensuring macroeconomic and financial stability.

I.1.3 In order to maintain and further improve upon the current growth momentum, various macroeconomic policy measures have been initiated, as discussed below, encompassing the real, fiscal, external, monetary and financial sectors.

REAL SECTOR POLICIES

I.1.4 A number of measures were taken during 2005-06 to improve the productivity and competitiveness of the economy for ensuring and maintaining the high growth momentum. Simultaneously, the objective of increasing gainful employment for vast sections of population in the rural areas was pursued through the passage of National Rural Employment Guarantee Act.

Agriculture and Allied Activities

I.1.5 In order to strengthen the agricultural sector, the Union Budget 2006-07 identified assured irrigation, access to credit, diversification and creation of markets for agricultural products as thrust areas for growth. The Union Budget also provided for an enhanced outlay of Rs.7,121 crore in 2006-07 (Rs.4,500 crore in the previous year) to give a boost to irrigation. The programme for repair, renovation and restoration of water bodies is being implemented through pilot projects in 23 districts in 13 States. The design of the programme has been finalised in consultation with the States. Restoration of water bodies is expected to give an element of stability to agricultural production and thereby give a boost to yields.

I.1.6 The findings of the National Sample Survey Organisation (NSSO) 59th Round (2003) reveal that only 27 per cent of the total number of cultivator households received credit from formal sources while 22 per cent received credit from informal sources. The remaining households, mainly small and marginal farmers, have virtually no access to credit. The Government has, therefore, appointed a Committee on Financial Inclusion to identify the reasons for exclusion of vulnerable groups and suggest a strategy to extend financial services to such vulnerable groups.

I.1.7 The Reserve Bank in its Annual Policy Statement for 2006-07 announced a set of measures to further improve the flow of credit to agriculture. These, *inter alia*, include: setting up of a Working Group to suggest measures for assisting distressed farmers, including provision of financial counselling services; introduction of a specific credit guarantee scheme under the DICGC Act for distressed farmers; constitution of a Technical Group to review the efficacy of the existing legislative framework governing money lending and its enforcement machinery in different States and make recommendations to the State Governments for improving the legal and enforcement framework in the interest of rural households; and, advising the State Level Bankers Committee convenors in all States/UTs to identify at least one district in their area for achieving 100 per cent financial inclusion by providing a 'no-frills' account and a general purpose credit card (GCC).

I.1.8 *Bharat Nirman* programme covering six components of infrastructure development - accelerated irrigation benefit programme, accelerated rural water supply project, construction of rural roads, rural houses, providing rural electrification and telephone connectivity in the villages - was launched during 2005-06. The Union Budget for 2006-07 has proposed to enhance the allocation to Rs.18,696 crore from Rs.12,160 crore provided in the preceding year.

I.1.9 The National Rural Employment Guarantee (NREG) Act was notified in September 2005 and the Scheme - subsuming the earlier programmes of *Sampoorna Grameen Rozgar Yojana* (SGRY) and National Food for Work Programme (NFFWP) - was launched in February 2006, in 200 districts. All the districts would be covered under the Scheme within five years. The Act envisages that every State Government would make a scheme for providing not less than 100 days of guaranteed employment in a year to every household in rural areas whose adult members volunteer to do unskilled manual work. The Union Budget for 2006-07 has announced a total allocation of Rs.14,300 crore for rural employment during 2006-07. Of this, Rs.11,300 crore would be under the NREG Act and Rs.3,000 crore would be under the SGRY.

Manufacturing and Infrastructure

I.1.10 The high growth rate of the Indian economy witnessed in the past three years has been driven, *inter alia*, by strong manufacturing activity. In order to sustain higher manufacturing growth, a number of steps have been taken.

I.1.11 A High Level Committee on Manufacturing was constituted in April 2006 with the Prime Minister as the Chairman. The Committee would initiate steps to make India a manufacturing hub in industries having potential for global competitiveness such as textiles, automobiles, leather, food processing, steel, metals, chemicals and petroleum products. It would also address macroeconomic issues impinging on growth and competitiveness of the manufacturing sector in India, and create a policy framework for necessary reforms covering all the aspects of manufacturing competitiveness to achieve the objective of 12 per cent growth in manufacturing sector.

I.1.12 In order to promote infrastructure development, a Special Purpose Vehicle (SPV), *viz*., India Infrastructure Finance Company Limited (IIFCL), was incorporated in January 2006, with a paid up capital of Rs.10 crore and an authorised capital of Rs.1,000 crore, to meet the long term financing requirements of potential investors. In addition, in order to leverage public funds through public-private partnership (PPP), a scheme for viability gap funding was also approved. The viability gap funding will normally be in the form of a capital grant at the stage of project construction, not exceeding 20 per cent of the total project cost. In order to be eligible for funding under this viability gap support scheme, the PPP must be implemented by an entity with at least 51 per cent private equity.

FISCAL POLICY

Central Government

I.1.13 Fiscal policy continued to pursue the objectives of economic growth, stability and equity in 2005-06 while staying on the course of fiscal consolidation. In the wake of higher fiscal devolution to the States as recommended by the Twelfth Finance Commission (TFC), the Central Government indicated a 'pause' in its fiscal correction in terms of targets prescribed under the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004. The provisional accounts indicate that the Centre could contain revenue deficit (as per cent to GDP) at its budgeted level while gross fiscal deficit and primary deficit (as per cent to GDP) turned out to be below the budget estimates. With the purpose of enhancing the efficiency in the delivery mechanism and to stress on "outcomes" rather than "outlays", an Outcome Budget providing monitorable performance indicators for the Plan programmes was brought out for the first time by the Government in August 2005. The Government stressed upon the need to avoid ostentatious expenditure. In case of non-tax revenues, the need for timely collection of various user charges was also emphasised.

Union Budget, 2006-07

I.1.14 The Union Budget 2006-07 proposed to resume the process of fiscal correction in 2006-07 as stipulated in FRBM Rules, 2004. The Budget sought to increase spending on social sectors (specifically rural employment, education and health) and in improving the infrastructure in rural and urban areas with the aim of making economic growth more inclusive, while lowering non-Plan expenditures. On the basis of the measures aimed at widening of tax base and improvements in the efficiency of tax administration, the gross tax/ GDP ratio is budgeted to reach a peak of 11.2 per cent in 2006-07.

State Governments

I.1.15 The State Governments continued to pursue fiscal correction and consolidation programme during 2005-06. Fiscal responsibility legislations (FRLs) have been enacted by 22 State Governments (as of end-March 2006). By April 1, 2006 all States barring two (Tamil Nadu and Uttar Pradesh) implemented value added tax (VAT) in lieu of sales tax. The year 2005-06 happened to be the first year of the award period of the TFC. The improvement in fiscal position of the States was facilitated by the larger grants and shareable Central taxes, as recommended by the TFC. The State Governments also initiated measures to restructure their finances in terms of the path prescribed by the TFC.

I.1.16 The State Governments in their budgets for 2006-07 have proposed various policy initiatives to carry forward the process of fiscal correction and consolidation. The States have emphasised fiscal empowerment through broadening and rationalising tax system. Simultaneously, they have laid stress on improvement in tax administration, streamlining and strengthening existing tax and non-tax collections and plugging of revenues leakages and loopholes. One State has proposed to constitute a Task Force in this regard. With a view to improving transparency and efficiency in transactions of the Governments, many States have proposed to complete computerisation of their treasuries and also to introduce e-transfer for their transactions. With a view to improving accountability of budget proposals, some States have proposed to introduce 'Outcome Budget', on the lines of the one initiated by the Central Government. Furthermore, several State Governments have proposed to introduce 'Gender Budgeting'. Some States have proposed comprehensive restructuring of their public sector undertakings including closure of chronically loss making units for reducing budgetary support for them. A number of States announced introduction of new pension schemes based on defined contribution to restrict their rising pension obligations. Some States proposed curtailment of unwarranted expenditure by doing away with vacated posts, adoption of austerity measures and reduction of non-plan expenditure. Many States have proposed to improve spending on education and health under the social sector while also implementing the centrally sponsored schemes such as rural employment guarantee, urban renewal mission and roads. On the whole, the State Governments in their budgets for 2006-07 have stressed the need for revenue optimisation, improved tax administration and effective expenditure management.

EXTERNAL SECTOR POLICIES

I.1.17 In April 2006, the Government of India announced the Annual Supplement 2006 to the Foreign Trade Policy (2004-09). The Annual Supplement, 2006 envisaged the twin objectives of putting country's exports on a trajectory of quantum growth by doubling the share of India in global merchandise trade within the next five years and creating employment opportunities, especially in the rural and semi-urban areas. Towards these objectives, the Annual Supplement introduced two incentive schemes, Focus Product Scheme (FPS) and Focus Market Scheme (FMS). While the FMS emphasises on promotion of exports to markets where India's share is low, the FPS stresses on promoting products having high employment potential.

I.1.18 In order to instil confidence in investors and signal the Government's commitment to a stable Special Economic Zone (SEZ) policy regime, a comprehensive Special Economic Zones Act, 2005, has been enacted. The SEZ Act 2005, which came into force on February 10, 2006, is expected to facilitate large flow of foreign and domestic investment to the SEZs, and contribute to improvements in infrastructure and productive capacity, generation of additional economic activity and creation of employment opportunities.

Foreign Exchange Transactions

I.1.19 Various policy initiatives were taken to further liberalise cross-border capital flows in the area of foreign investment and external commercial borrowings (ECBs). With a view to promoting Indian investment abroad and to enable Indian companies to reap benefits of globalisation, the limit of investment overseas under the automatic route was raised from 100 per cent of net worth of the investing Indian entity to 200 per cent of its net worth.

MONETARY POLICY FRAMEWORK

I.1.20 The Annual Policy Statement for 2005-06 (April 2005) indicated that the stance of monetary policy during 2005-06 would depend on several factors, including macroeconomic prospects, global developments and the balance of risks. The Statement stressed that the system has to recognise interest rate cycles and strengthen risk management processes to cope with eventualities so that financial stability could be maintained and interest rate movements could be transited in a non-disruptive manner. In this regard, as the Statement added, it would be instructive to observe global trends as the Indian economy is progressively getting linked to the world economy. It was also noted that while there is an overhang of domestic liquidity, partly mirroring abundant global liquidity, the trends in global interest rates, inflation expectations and investment demand would also have some relevance in the evolution of the domestic interest rates.

I.1.21 The Reserve Bank increased the reverse repo rate under the liquidity adjustment facility (LAF) by 25 basis points to 5.00 per cent effective April 29, 2005 to moderate inflationary expectations.

I.1.22 In its First Quarter Review of Annual Statement on Monetary Policy for 2005-06 (July 2005), the Reserve Bank indicated that while global factors were getting to be increasingly significant for India, domestic factors still dominate and the latter pointed to favouring stability to maintain growth momentum. Accordingly, while continuing with the overall stance of monetary policy for the remaining part of the year 2005-06 as set out in the Annual Policy Statement of April 2005, the Reserve Bank indicated that it would respond, promptly and effectively, to the evolving situation depending on the unfolding of the risks.

I.1.23 In its Mid-term Review of Annual Policy Statement (October 2005), while noting that, on balance, macroeconomic and financial conditions have evolved as anticipated, the Reserve Bank pointed to the emergence of several factors posing risks to the outlook on growth and inflation. While reaffirming the stance of monetary policy set out in the Annual Policy Statement, the priorities assigned to policy objectives were rebalanced in the context of the assessment of the economy and, particularly, the outlook on inflation. The fixed reverse repo rate under the LAF was increased by 25 basis points to 5.25 per cent while retaining the spread between reverse repo and repo rates at 100 basis points.

I.1.24 In its Third Quarter Review of Annual Statement on Monetary Policy for 2005-06 (January 2006), the Reserve Bank observed that macroeconomic and financial developments remain in support of the monetary policy stance. In view of the remaining pass-through of international crude oil prices in to domestic prices of LPG and kerosene, the monetary policy stance was articulated in favour of a greater emphasis on price stability through measured but timely and even pre-emptive policy action to anchor inflation expectations. Accordingly, the reverse repo rate and the repo rate under the LAF were increased by 25 basis points each.

I.1.25 The Annual Policy Statement for 2006-07 (April 2006) emphasised that the stance of monetary policy for 2006-07 would depend on macroeconomic developments including the global scenario. The Statement added that the balance of risks was tilted towards the global factors. The adverse consequences of further escalation of international crude oil prices and/or of disruptive unwinding of global imbalances are likely to be pervasive across economies, including India. Moreover, in a situation of generalised tightening of monetary policy, India can not afford to stay out of step. The Statement added that it was necessary, therefore, to keep in view the dominance of domestic factors as in the past but to assign more weight to global factors than before while formulating the policy stance.

I.1.26 In its First Quarter Review of the Annual Statement on Monetary Policy (July 2006), the Reserve Bank noted that demand pressures, especially continuing high credit growth, could exert upward pressure on prices when associated with supply shocks such as from oil. The global outlook for growth is positive but downside risks in regard to inflation and re-pricing of risks in financial markets need to be recognised. These pressures have the potential for impacting stability and inflation expectations. Accordingly, the Reserve Bank increased the reverse repo rate and the repo rate by 25 basis points each to 6.00 per cent and 7.00 per cent, respectively, effective July 25, 2006.

Credit Delivery System

I.1.27 The Reserve Bank continued with its efforts to improve flow of credit to different sectors of the economy particularly to the agriculture and small scale industries sector at reasonable rates without procedural impediments. The policies relating to rural credit are being redesigned to bring about maximum financial inclusion of the poorer sections of the society.

FINANCIAL SECTOR POLICIES

I.1.28 The Reserve Bank took various supervisory and regulatory measures during 2005-06 to further strengthen the financial sector covering the scheduled commercial banks, urban cooperative banks and NBFCs. The measures aimed at strengthening the financial sector with a view to ensuring financial stability included aspects relating to corporate governance practices, risk management and pricing techniques and counter-cyclical prudential norms. In the context of the rapid expansion of bank credit, banks were urged to undertake a comprehensive assessment of segment-wise credit with special reference to those sectors in which credit has been expanding rapidly. The prudential measures were tightened to ensure safety of the health of the financial sector. In order to augment the capital of the banks in view of the enlarged capital requirement under new capital adequacy framework of Basel II, the Reserve Bank permitted banks to raise capital through new instruments. Simultaneously, the focus was on financial inclusion to reorient financial intermediation to cover the widest sections of society.

Polices for Financial Markets

I.1.29 The Reserve Bank continued to take measures to increase depth and liquidity in the money, Government securities and foreign exchange markets during the year in order to improve the price discovery mechanism. These efforts were intensified during the year in view of the FRBM provision which prohibits the Reserve Bank from participating in the primary market for Central Government securities with effect from April 2006 onwards. The implementation of FRBM Act necessitated a review of the Reserve Bank’s market operations, including introduction of new instruments and refining existing instruments in the context of the evolving scenario. Within the Reserve Bank, a clearer assignment of functional responsibilities has been sought to improve operational effectiveness by minimising overlaps and conflict of interest. A Financial Markets Department (FMD) was set up in July 2005 with a view to strengthening monetary, debt and reserve management functions by moving towards functional separation in these objectives within the Reserve Bank. By January 2006 the Reserve Bank operations in financial markets were fully integrated with FMD conducting all domestic market operations in money, Government securities and foreign exchange markets. A high level Committee on Fuller Capital Account Convertibility (Chairman: Shri S.S. Tarapore) was constituted to set a road-map for fuller convertibility on the capital account. The Committee submitted its Report to the Reserve Bank on July 31, 2006. The Reserve Bank will place the Report in public domain in due course.

Legal Framework

I.1.30 Institutional and policy measures to improve the legal system continued during the year. The Credit Information Companies (Regulation) Bill, 2005 has been enacted as the Credit Information Companies (Regulation) Act, 2005 (Act No. 30 of 2005) and would come into force with effect from the date as may be notified by the Government in this behalf.

I.1.31 In order to provide the Reserve Bank greater flexibility in the conduct of monetary policy, the Reserve Bank of India Act, 1934 has been amended by the Reserve Bank of India (Amendment) Act, 2006. The Amendment Act includes provisions for (i) empowering the Reserve Bank to deal in derivatives, to lend or borrow securities and to undertake repo or reverse repo operation; (ii) defining the expressions 'derivative', 'repo' and 'reverse repo'; (iii) removing ambiguity regarding the legal validity of derivatives; (iv) removing the floor and ceiling of cash reserve ratio (CRR) for scheduled banks so as to provide flexibility to the Reserve Bank to specify CRR; and (v) empowering the Reserve Bank to lay down policy relating to interest rates or interest rate products and issue directions to any agency dealing in securities, money market instruments, derivatives, *etc.*, and to inspect such agencies.

I.1.32 The Banking Regulation (Amendment) Bill, 2005, introduced in the *Lok Sabha* on May 13, 2005, seeks to amend some of the provisions of the Banking Regulation Act, 1949 with a view to strengthening the regulatory powers of the Reserve Bank.

I.1.33 The Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Bill, 2005 mainly seeks to amend the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

I.1.34 The Securities Contracts (Regulation) Amendment Bill, 2005 seeks to amend the Securities Contract (Regulation) Act, 1956 so as to provide a legal framework for trading in securitised debt including mortgage backed debt.

I.1.35 The Government Securities Bill, 2004 has been passed by *Lok Sabha* on August 7, 2006, and by *Rajya Sabha* on August 14, 2006. The Bill proposes to consolidate and amend the law relating to issue and management of Government securities by the Reserve Bank.

II. THE REAL ECONOMY

I.2.1 The Indian economy continued to record strong growth during the fiscal year 2005-06, backed by sustained manufacturing activity and impressive performance of the services sector with reasonable support from the recovery in agricultural activity. According to the revised estimates released by the Central Statistical Organisation (CSO) in May 2006, real gross domestic product (GDP) increased by 8.4 per cent during 2005-06 on top of growth of 7.5 per cent in 2004-05. Thus, real GDP growth has averaged at above 8 per cent in the past three years, reviving interest in the country's potential output growth. It may be mentioned that the CSO, on January 31, 2006, changed the base year of National Accounts Statistics from 1993-94 to 1999-2000. This is the fifth time that the CSO has changed the base year to factor in the structural changes taking place in the economy in order to reflect a more realistic picture of the economy. Apart from changing the base year, improvements were also made in terms of coverage following the recommendations of the United Nations System of National Accounts, 1993 (UNSNA, 1993).

AGGREGATE SUPPLY

Agriculture

I.2.2 Real GDP growth originating from agriculture and allied activities registered a growth of 3.9 per cent during 2005-06, recovering from a low of 0.7 per cent in 2004-05. The improvement in agricultural sector was enabled by both foodgrains and non-foodgrains production. Furthermore, improvement in respect of horticulture, livestock, fisheries and plantation crops has imparted some resilience to the real GDP growth originating from agricultural and allied activities. Backed by a normal monsoon and post-monsoon rains, agricultural production, as measured by the Index of Agricultural Production, is estimated to have staged a recovery of 7.9 per cent during 2005-06 in contrast to a decline of 2.7 per cent during the preceding year.

I.2.3 Reflecting the increased area coverage as well as better monsoon conditions, the total foodgrains production during 2005-06 is estimated at 208.3 million tonnes, almost five per cent higher than the previous year's level. The improvement was on account of both *kharif* and *rabi* foodgrains production. Crop-wise, the higher production was mainly on account of rice. Among the cash crops, the production of sugarcane showed a smart recovery (17.4 per cent) along with oilseeds. Production of cotton continued to record strong growth.

I.2.4 The production of cereals in the country has witnessed a stagnation since late 1990s. Rice production has generally fluctuated in the range of 83-90 million tonnes during the last decade. Wheat production witnessed a rising trend during the early 1990s and touched a peak (76 million tonnes) in 1999-2000, but since then it has moved around 70 million tonnes. The production of pulses has also been range-bound (around 11-14 million tonnes). Stagnancy in yields, limited varietal improvements, low resilience to moisture stress and pest infestation amidst decline in agricultural investment have held down cereal production despite consecutive good monsoons.

Industrial Performance

I.2.5 According to the CSO's advance estimates, real GDP growth originating from the industrial sector increased from 7.4 per cent in 2004-05 to 7.6 per cent in 2005-06, driven by strong manufacturing activity. Sustained expansion in domestic as well as export demand, increased capacity utilisation, augmentation of capacities and positive business and consumer confidence underpinned the strength of the manufacturing sector.

I.2.6 Industrial production, based on the movements in the index of industrial production (IIP), recorded a strong growth of 8.1 per cent during 2005-06 – *albeit* marginally lower than that of 8.4 per cent during 2004-05 – led by sustained manufacturing activity. The marginal deceleration was largely the reflection of a sharp slowdown in the mining sector, which recorded negative growth between July and December 2005 on account of decline in crude oil production due to break-out of fire at Mumbai High oil field in July 2005. The electricity sector continued to record subdued growth reflecting, *inter alia*, inadequate availability of coal in the Eastern region and insufficient supply of gas. The pick-up in manufacturing sector, which began in April 2002, sustained its momentum during 2005-06. Manufacturing activity was broad-based, supported by both investment and consumption demand.

I.2.7 In terms of use-based classification, acceleration in growth was observed in respect of all sectors except intermediate goods sector. Capital goods sector logged double-digit growth even as there was a sharp rise in imports, reflecting high investment demand on account of fresh investments in various sectors such as power equipment, metals, oil and gas, and petrochemicals. Higher spending on infrastructure also boosted domestic capital goods production. As a result, the capital goods sector recorded a growth of 15.7 per cent during 2005-06 – the highest rate of growth since 1993-94. Impressive performance of both the durable and non-durable segments aided the strong growth of consumer goods sector.

Services Sector

I.2.8 The services sector recorded growth of 10.3 per cent during 2005-06, maintaining the double digit growth recorded in the previous year – and, notably higher than the average growth of 8.6 per cent during the last five years. The sector, thus, remained the key driver of growth during 2005-06, contributing almost three-fourths to the overall real GDP growth. The robust performance of the services sector during 2005-06 was led mainly by 'trade, hotels, transport and communication', which contributed almost one-half of the sector's growth. 'Trade, hotels, transport and communication services' continued to grow at double-digit rates for the third successive year. Activity in the hotel industry improved significantly, aided by rise in domestic and international tourism, both business as well as leisure. Growth in 'financing, insurance, real estate and business services' benefited from sustained growth in bank credit and deposits, progressive expansion of insurance activity and continued buoyancy in exports of software and other business services. The construction sector exhibited double-digit growth for the third consecutive year, reflecting the focus on infrastructure development and supported by housing activity. Capacity addition across various industries also strengthened the demand for construction services. 'Community, social and personal services', however, recorded deceleration during 2005-06, reflecting the process of fiscal consolidation and increased efficiency in expenditure management.

I.2.9 Reflecting the sustained growth, the share of the services sector (including construction) in the overall GDP of the economy has increased from 46 per cent in 1990-91 to over 60 per cent during 2005-06. The rising share of the services sector in the GDP corresponds to general pattern of growth observed in developed and in some of the emerging market economies. Although the share of services activity in overall activity has increased in India in line with the international experience, the Indian experience is somewhat atypical, since the share of manufacturing in GDP has remained broadly unchanged. India has, however, a unique opportunity to be a major global player in both knowledge-based services as well as knowledge-based manufacturing. With a massive human resource base, a large proportion of young people and a strong foundation in technical education, India is well positioned to capitalise on the worldwide potential in the knowledge economy and the services sector is expected to continue to remain the driver of economic growth in India.

I.2.10 The Indian software services sector, including ITES and BPO segments, continued to record strong growth during 2005-06. According to the National Association of Software and Services Companies (NASSCOM), the revenues of the Indian IT sector (including software services, IT-enabled services and hardware) exceeded US $ 36 billion during 2005-06, almost 4.8 per cent of India's GDP. These revenues were mainly on account of exports of software and services which grew by 33 per cent to reach US $ 23.6 billion during the year. The revenues of the Indian IT sector are largely on account of export revenues; domestic market now accounts for 20 per cent of the total revenues of the Indian industry from software and ITES-BPO services. The total global software and IT services market is estimated to be about $ 1.2 trillion. As India's share is about two per cent, it suggests a strong growth potential. As a result of sustained high growth in software exports as well as other services, India's share in world export of services has trebled from 0.6 per cent in 1995 to 1.8 per cent in 2004.

Saving and Capital Formation

I.2.11 The domestic savings rate increased further during 2004-05, driven mainly by improvement in public saving. Gross domestic saving (GDS), as per cent of GDP at current market prices, increased from 28.9 per cent in 2003-04 to 29.1 per cent in 2004-05. Public sector saving – which had witnessed a turnaround in 2003-04 – improved from 1.0 per cent of GDP in 2003-04 to 2.2 per cent in 2004-05, due to lower dis-saving by public authorities as well as increase in savings of non-departmental enterprises. While dis-saving by Government administration declined from 3.7 per cent of GDP in 2003-04 to 2.7 per cent in 2004-05, saving by non-departmental enterprises increased from 4.2 per cent to 4.4 per cent over the same period. The private corporate savings rate improved for the third consecutive year. From a low of 3.6 per cent in 2001-02, it increased to 4.8 per cent of GDP in 2004-05, reflecting higher retained earnings.

I.2.12 While the domestic savings rate improved by 0.2 percentage points of GDP during 2004-05, domestic investment registered a much higher increase of 2.9 percentage points of GDP, reflecting an increased recourse to foreign savings. There was a turnaround in foreign savings – net capital inflows amounted to 1.0 per cent of GDP during 2004-05 as against an outflow of 1.6 per cent of GDP during 2003-04. As a result, domestic investment rate crossed 30 per cent of GDP in 2004-05.

III. MONEY, CREDIT AND PRICES

I.3.1 Demand for bank credit remained strong for the second successive year in line with buoyant economic activity. In view of strong credit demand, banks reduced their investments in Government paper. Higher mobilisation of funds through both deposit and non-deposit sources also helped banks to support the enhanced demand for commercial credit. Due to some tightness in the liquidity position during December 2005-March 2006, partly due to the redemption of the India Millennium Deposits (IMDs), the Reserve Bank injected liquidity in the system through Liquidity Adjustment Facility (LAF) operations, unwinding of the balances under the Market Stabilisation Scheme (MSS) and some private placement of Central Government securities. Reflecting the liquidity injection operations, reserve money recorded a higher rate of expansion during 2005-06. Broad money (M_3) growth also recorded acceleration in consonance with higher credit growth and acceleration in overall economic activity. Inflation was contained within the desired trajectory, despite continued pressures from record high international crude oil prices. Pre-emptive monetary policy measures helped to keep inflation expectations low and stable during the year. Less than complete pass-through of higher oil prices, productivity gains and increased competition also enabled to keep inflationary pressures under control.

RESERVE MONEY

I.3.2 Reserve money expanded by 17.2 per cent during 2005-06 as compared with 12.1 per cent during 2004-05. The higher order of reserve money growth reflected the Reserve Bank's liquidity injection operations through LAF repos, unwinding of balances under the MSS and some private placement in an environment of strong credit demand and some tightness emanating from the IMD redemption on December 29, 2005. As a result, the Reserve Bank's net domestic assets (NDA) expanded by Rs.23,737 crore during 2005-06 in contrast to a sizable contraction (Rs.75,754 crore) during the previous year. Foreign currency assets (FCA) (adjusted for revaluation) of the Reserve Bank increased by a lower order (Rs.68,834 crore) during 2005-06 as compared with Rs.1,15,044 crore in 2004-05, partly due to the impact of IMD redemption. Thus, unlike the previous few years, when reserve money growth was driven largely by sizable accretions to foreign exchange reserves, the higher order of reserve money growth during 2005-06 could be attributed largely to a turnaround in net domestic assets. Nonetheless, as at end-March 2006, the Reserve Bank's net foreign exchange assets (NFEA) continued to dominate its asset portfolio.

I.3.3 The Reserve Bank's net credit to the Centre increased by Rs.28,417 crore during 2005-06 in contrast to a decline of Rs.60,177 crore during 2004-05. The increase during the year was mainly on account of the liquidity management operations, rather than passive financing of the Centre's fiscal gap. First, unwinding of the balances under the MSS following the suspension of the issuances under the Scheme from mid-November 2005 led to a decline of Rs.14,541 crore in the Centre's deposits with the Reserve Bank during 2005-06 in contrast to an increase of Rs.72,558 crore on account of large issuances under MSS during 2004-05. Second, the balances under the LAF reverse repos declined by Rs.12,080 crore during 2005-06. Finally, the private placement of Rs.10,000 crore in March 2006 with the Reserve Bank resulted in an increase in the Reserve Bank's holding of dated securities.

MONETARY SURVEY

I.3.4 Broad money (M_3) registered a growth of 17.0 per cent during 2005-06 – higher than that of 12.1 per cent during the previous year and above the growth rate of 14.5 per cent projected in the Annual Policy Statement in April 2005. In this context, it may be noted that data on fiscal year variations in monetary and banking indicators for 2005-06 have been worked out with respect to April 1, 2005 as the base date. Conventionally, the Reserve Bank publishes data on monetary and banking aggregates on a fortnightly basis on alternate Fridays. Variations in monetary and banking aggregates for a particular financial year are worked out in relation to the last reporting Friday of the previous financial year. Thus, variations for banking data during 2005-06 would have been conventionally calculated from March 18, 2005, which was the last reporting Friday of the previous financial year. This would have resulted in the incorporation of data for an additional fortnight in the variations in monetary and banking aggregates for 2005-06 in relation to the same for 2004-05. For meaningful comparison of variations in monetary and banking variables in 2005-06 with those of other years on a financial year basis, April 1, 2005 has been taken as the base date for 2005-06. The expansion of residency-based new monetary aggregate NM_3, at 18.1 per cent during 2005-06, was higher than that in M_3, reflecting the impact of IMD redemption. Based on the recommendations of the Working Group on Money Supply (Chairman: Dr.Y.V. Reddy, 1998), NM_3 is compiled on a residency basis and, therefore, banks' non-resident foreign currency deposits such as FCNR(B) and IMDs are not directly reckoned. Banks' non-resident foreign currency deposits declined by Rs.16,876 crore during 2005-06 as against an increase of Rs.802 crore during 2004-05. The decline during 2005-06 was entirely due to the IMD redemption (US $ 7.1 billion or Rs.31,959 crore) in December 2005. The redemption of the IMDs, therefore, did not have any direct impact on NM_3, and growth in NM_3 was accordingly higher than that in M_3. Liquidity aggregates (L_1, L_2, L_3) also registered a stronger growth during 2005-06 compared with the previous year, mirroring the movements in NM_3. Apart from monetary liabilities of the banking sector, liquidity aggregates include select liabilities of non-bank institutions such as postal department, financial institutions and NBFCs.

I.3.5 Both demand and time deposits registered higher growth during 2005-06. Acceleration in demand deposit growth could be attributed to a variety of factors such as sharp rise in non-food credit, higher resource mobilisation through the primary capital market, and large mobilisation by domestic mutual funds, with funds getting temporarily parked in demand deposits pending utilisation. Growth in time deposits picked up from the second quarter of 2005-06, benefiting from the rise in deposit rates over the course of the year as well as the base effects. The blip in the growth rate of time deposits in the month of January 2006 reflected the bullet repayment of the maturity proceeds of the IMDs. Concomitantly, growth in postal small savings moderated to 14.6 per cent as at end-March 2006 from its recent peak of 23.3 per cent in December 2004. The increase in time deposits during 2005-06 was mainly on account of short-term wholesale deposits of up to one year maturity. Banks' deposit mobilisation efforts during the year thus seem to have turned in favour of non-core bulk deposits of corporates instead of core retail deposits, with a potential for adverse consequences for balance sheet management and profitability.

I.3.6 Sustained acceleration in demand for bank credit from the commercial sector on top of a high base was witnessed during 2005-06. Growth in bank credit to the commercial sector accelerated from 22.8 per cent during 2004-05 to 27.0 per cent during 2005-06. Scheduled commercial banks' (SCBs') non-food credit increased by 31.8 per cent in 2005-06, after having recorded an increase of 27.5 per cent in 2004-05. Food-credit increased by Rs.675 crore during 2005-06. Although, as noted above, deposit growth picked up during the year, credit growth still outpaced deposit growth during 2005-06. As a result, incremental credit deposit ratio of SCBs remained mostly above 100 per cent during 2005-06. With credit growth outpacing nominal GDP growth by a large margin for the second successive year, credit-GDP ratio continued with its upward trend. Credit-GDP ratio has increased from 30 per cent as at end-March 2000 to 41 per cent at end-March 2005 and further to 48 per cent at end-March 2006. While availability of bank credit is critical to support investment and growth, evidence suggests that sharp growth in credit can be a cause of policy concern. Cross-country analysis indicates that credit-GDP ratio in India is lower than major advanced economies as well as most East Asian economies. On the other hand, the ratio in India is higher than that of some EMEs such as Indonesia, Brazil, Mexico, Philippines, Russia and Sri Lanka. Since 2000, the increase in credit-GDP ratio in India has been, however, higher than many East Asian economies.

I.3.7 Sectoral deployment of credit indicates that demand for retail credit is emerging as a major component of bank credit. During 2005-06, almost 27 per cent of the incremental bank credit was absorbed by the retail sector (mainly on account of loans for housing). Industry accounted for another 30 per cent of the incremental credit while agricultural sector absorbed 12 per cent of the incremental credit.

PRICE SITUATION

I.3.8 Headline inflation firmed up in 2005-06 in a number of economies led by record high international crude oil and elevated metals prices. Compared to earlier oil shocks, however, inflation pressures remained modest reflecting a variety of factors such as stable inflationary expectations, fall in intensity of oil usage, and, in case of many emerging market economies, less-than-complete pass-through of oil prices. Lower trade barriers, increased deregulation, innovation and competition all over the world arising out of the force of globalisation have also contained inflation. With the rapid expansion in tradables, domestic economies are, therefore, increasingly exposed to the rigours of international competition and comparative advantage, reducing unwarranted price mark-ups. Productivity growth in a number of sectors, partly due to IT investments combined with restructuring, has also enabled absorption of higher costs. Inflationary expectations remained largely anchored in view of continuous pre-emptive monetary tightening. In India, headline inflation during 2005-06 turned out to be within the indicative trajectory, despite continued dominance of supply-side factors. This could be attributed largely to inflation expectations, which remained stable in view of timely fiscal and monetary measures. Increased competition, strong corporate balance sheets and productivity gains in several sectors of the economy also restrained the second-order effects of higher oil prices. Incomplete pass-through of international crude oil prices also helped to contain headline inflation during 2005-06.

Global Inflation Environment

I.3.9 Global headline inflation firmed up during the second half of 2005 in response to pressures from international crude oil prices reaching record highs. According to the International Monetary Fund's *World Economic Outlook*, April 2006, consumer price inflation in advanced economies increased from 2.0 per cent in 2004 to 2.3 per cent in 2005. In many Asian emerging markets also, inflation firmed up as these economies passed on higher international crude oil prices to domestic prices of petroleum products in a phased manner. However, for the group 'other emerging market and developing countries' as a whole, inflation fell from 5.7 per cent in 2004 to 5.4 per cent in 2005, partly reflecting incomplete pass-through of higher international oil prices to domestic prices. Core inflation and inflation expectations after remaining relatively stable during 2005 have shown signs of increase in recent months.

Global Commodity Prices

I.3.10 International commodity prices rose further during 2005-06, led by crude oil and metals prices, reflecting robust economic activity and supply constraints. Crude oil prices, which witnessed a record high during 2005-06, continue to touch newer peaks reflecting tight supply conditions and geo-political factors. Non-fuel commodity prices also increased led by metals reflecting strong demand, higher energy prices, lags in supply and interest by investors in commodity markets. In real terms, while oil prices have risen sharply, they remain still lower than the peak of 1980; non-oil commodity prices in real terms, notwithstanding the recent increases, have been on a downward trajectory since mid-1970s.

INFLATION CONDITIONS IN INDIA

I.3.11 Headline inflation, measured by year-on-year (y-o-y) changes in the wholesale price index (WPI), fell to 4.1 per cent by end-March 2006 from 5.1 per cent a year ago. Pre-emptive monetary actions by the Reserve Bank in the form of hike in policy reverse repo rates of 25 basis points each in October 2004, April 2005, October 2005 and January 2006 and 50 basis points hike in cash reserve ratio in September-October 2004 helped stabilise inflation expectations in the face of spurt in international oil prices and rising domestic demand. The average WPI inflation rate eased to 4.4 per cent during 2005-06 from 6.4 per cent a year ago.

I.3.12 Fuel prices dominated the inflation outcome during 2005-06. Mineral oils inflation alone contributed about 40 per cent to the headline inflation. Accordingly, the y-o-y WPI inflation excluding the fuel group at 2.7 per cent remained well below the headline rate.

I.3.13 Although fuel prices were the key driver of domestic inflation during 2005-06, domestic petroleum products prices still lag the increase in international crude oil prices. The pass-through of higher international oil prices has been restricted mainly to petrol and diesel (hike of 7-8 per cent each in June and September 2005, and 6-9 per cent in June 2006). Domestic prices of liquefied petroleum gas (LPG) have remained unchanged since November 2004 while kerosene prices have been unchanged since April 2002. In view of international oil prices remaining high and volatile, the outlook on inflation as well as the choice of the appropriate manner of dealing with the pass-through of oil prices remains clouded.

I.3.14 Apart from petroleum product prices, prices of primary food articles posed some upward pressures on inflation during 2005-06. Wheat prices firmed up during the second half of 2005-06 on reports of fall in stocks. Vegetables prices remained high for most part of the third quarter of 2005-06 due to damage to the standing crops from excessive rains/floods in various parts of the country. Prices of pulses, and eggs, fish and meat also edged higher during 2005-06. Raw cotton prices after remaining flat during the first half of the year increased marginally during November-December 2005 reflecting international trends. Oilseeds prices, which had hardened somewhat during the first half of 2005-06, reflecting last year's shortfall in domestic *kharif* production and worries about a poor ensuing crop due to the unsatisfactory progress of the South-West monsoon, moderated from November 2005 on account of improved crop prospects. Overall, primary articles' contribution to headline inflation increased to 28.3 per cent during 2005-06 (5.5 per cent a year ago).

I.3.15 Manufactured products inflation, on the other hand, remained modest. It eased to 1.7 per cent (y-o-y) at end-March 2006 from 4.6 per cent a year ago, reflecting stable inflation expectations, productivity gains as well as increased competition. Strong corporate profitability also provided firms the flexibility to absorb higher input prices into their profit margins. Commodity-wise, upward pressures from sugar and other food products, cement and non-ferrous metals were offset by easing of manmade fibres, edible oils, oil cakes and, in particular, iron and steel prices. Domestic sugar prices have remained firm in line with international trends, notwithstanding higher sugarcane output in the country. Non-ferrous metal prices rose sharply - prices of copper and zinc increased, y-o-y, by about 41 per cent and 50 per cent, respectively, during 2005-06 in line with international trends. In contrast, iron and steel prices witnessed a large turnaround during 2005-06 – a decline of 7.5 per cent, y-o-y, as at end-March 2006 as against a sharp increase of 21.3 per cent a year ago – and this contributed to a moderation in headline inflation. However, since end-March 2006, domestic iron and steel prices have again increased by 10.7 per cent (up to August 5, 2006) in tandem with international price movements.

Developments during 2006-07

I.3.16 Headline WPI inflation eased initially during 2006-07 to 3.7 per cent as on April 15, 2006 from 4.1 per cent at end-March 2006, reflecting partly the base effect of higher prices last year. Inflation rate edged up in May-June 2006 to reach 5.4 per cent on June 17, 2006 reflecting higher prices of petrol and diesel, milk, vegetables and metals. Subsequently, inflation moderated to 4.8 per cent as on August 5, 2006 on account of decline in the prices of fruits, vegetables and milk and base effects. The average WPI inflation rate eased to 4.3 per cent as on August 5, 2006 from 6.0 per cent a year ago. Consumer price inflation edged higher during the first quarter of 2006-07 reflecting higher food prices – CPI for Industrial Workers rose from 4.9 per cent in March 2006 to 7.7 per cent in June 2006. Consumer price inflation for agricultural and rural labourers also rose during the quarter ended June 2006 but eased in July 2006.

IV. GOVERNMENT FINANCES

I.4.1 The combined finances of the Central and State Governments showed improvement in 2005-06 in the revenue account. The revenue deficit (RD) was placed lower than the preceding year, led by a significant increase in tax revenues. The 'pause' in fiscal consolidation by the Central Government due to implementation of the Twelfth Finance Commission (TFC) recommendations was offset by faster progress in fiscal consolidation of the State Governments.

Central Government Finances – 2005-06

I.4.2 The revised estimates (RE) of the Central Government finances for 2005-06 indicate an improvement *vis-à-vis* the budget estimates (BE). The key deficit indicators, *viz*., revenue deficit, gross fiscal deficit (GFD) and primary deficit were placed lower than the budgeted levels. The progress in fiscal consolidation in terms of the reduction in deficit indicators needs to be seen in the light of the 'pause' taken by the Government in its Union Budget for 2005-06. It may be recalled that 'pause' was taken from effecting the minimum annual deficit reductions prescribed under the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004 on account of increased commitments in devolution of taxes and grants to States in pursuance of the recommendations of the TFC.

I.4.3 The provisional accounts for 2005-06 released by the Controller General of Accounts revealed that the Central Government finances during 2005-06 were generally in line with the revised estimates. The revenue deficit widened marginally to 2.7 per cent of the GDP in the provisional accounts for 2005-06 from the revised estimate of 2.6 per cent on account of lower tax revenues. The fiscal deficit was broadly in line with the revised estimates. Net market borrowings in the provisional accounts, at Rs.1,06,242 crore, financed 72.6 per cent of GFD as compared with 69.2 per cent in the revised estimates[1].

Debt Position of the Central Government

I.4.4 The fiscal consolidation process enabled a decline in the outstanding domestic liabilities of the Central Government to 60.2 per cent of GDP at end-March 2006 from 61.9 per cent at the end of the preceding fiscal year. Internal debt, as per cent of GDP, declined to 38.4 per cent at end-March 2006 from 40.9 per cent at end-March 2005. The reduction in internal debt was facilitated by unwinding of balances under the Market Stabilisation Scheme during the year. Of the total outstanding debt of the Central Government, internal debt accounted for 61.8 per cent while small savings and provident funds constituted 22.1 per cent at end-March 2006. The total debt of the Centre is, however, still high by global standards.

State Government Finances - 2005-06

I.4.5 Consolidated fiscal position of State Governments for 2005-06 indicates that the States are pursuing fiscal correction and consolidation. The year 2005-06 was the first year of the award period of the TFC. The revised estimates for 2005-06 indicate a decline in the revenue deficit-GDP ratio to 0.5 per cent from 0.7 per cent in the budget estimates. The reduction in revenue deficit was possible due to higher revenue receipts (5.6 per cent above budgeted level) offsetting the slippage in revenue expenditure (3.6 per cent). The higher revenue receipts in 2005-06 (RE) compared to the budgeted level were due to an increase in grants from the Centre (14.8 per cent) and increase in States' own tax receipts (4.4 per cent). There was, however, slippage with regard to GFD from its budgeted level on account of enhanced capital outlay (11.2 per cent) mainly in respect of irrigation, energy and transport sectors. Capital outlay, as a ratio to GDP, rose to 2.4 per cent from the budgeted level of 2.2 per cent. All the major deficit indicators, as per cent of GDP, were placed much lower in the revised estimates of 2005-06 than their average levels during the period 2000-04 as well as the second half of 1990s.

Combined Budgetary Position Of The Centre and The States – 2005-06

I.4.6 An overview of the combined finances of the Centre and States during 2005-06 reveals improvement in all the key deficit indicators *vis-à-vis* the budget estimates. Buoyant tax collections, both direct and indirect, and significantly higher non-tax receipts enabled a lower revenue deficit than was budgeted. Aggregate expenditure was higher than budgeted due to an increase in development expenditure. This was largely on account of higher expenditure on relief for natural calamities, transport and communications and energy. Expenditure on medical and health services in terms of GDP improved over the budgeted levels.

FISCAL OUTLOOK FOR 2006-07

Central Government

I.4.7 The Union Budget 2006-07 committed to take forward the fiscal correction process as prescribed under the FRBM Rules, 2004 in a conducive macroeconomic environment. Accordingly, the GFD is budgeted to decline by 0.3 percentage point of GDP to 3.8 per cent of GDP during 2006-07 while the revenue deficit is budgeted to decline by 0.5 percentage point to 2.1 per cent of GDP. The budgeted reductions in revenue and fiscal deficits match the minimum threshold reductions stipulated in the FRBM Rules, 2004. The primary deficit is also budgeted to decline to 0.2 per cent of GDP from 0.5 per cent in 2005-06. The reduction in the deficit indicators is expected to be primarily on the basis of improved revenue performance and reprioritisation of expenditure.

State Budgets 2006-07

I.4.8 State budgets for 2006-07 have committed to carry forward the process of fiscal correction and consolidation. Notwithstanding the variation across the States, the consolidated position indicates that the State Governments have budgeted to achieve near revenue balance during 2006-07. The budgeted reduction in RD will facilitate a decline of 0.5 percentage point in GFD-GDP ratio during the year. Primary deficit is also budgeted to decline sharply to 0.2 per cent of GDP. It may be mentioned that the TFC had indicated a restructuring path for the State Governments so as to achieve revenue balance by 2008-09.

Combined Budgets for 2006-07

I.4.9 With the Central Government resuming fiscal consolidation as stipulated under the FRBM Rules and the State Governments increasingly adopting fiscal responsibility legislations, all the key deficit indicators are budgeted to decline during 2006-07, both in absolute terms as well as in terms of GDP.

I.4.10 Market borrowings are budgeted to finance a higher proportion of the combined gross fiscal deficit during 2006-07 than in the preceding year. The contribution of small savings to GFD financing is budgeted to decline marginally during 2006-07.

V. FINANCIAL MARKETS

I.5.1 Global financial markets remained generally benign during 2005-06 notwithstanding a sharp rise in international crude oil prices and growing global financial imbalances. Although short-term interest rates moved up in a number of economies, financing conditions were favourable as real long term rates remained at very low levels and equity prices recorded large gains. Financing conditions in emerging market economies (EMEs) also benefited from record low spreads, reflecting shortage of foreign currency denominated bonds on account of improvements in the fiscal position of many EMEs as well as buybacks of outstanding bonds. Global financial markets, however, exhibited large volatility during May-June 2006 on concerns over rising inflation and expectations that central banks might tighten monetary policy further. Risk spreads widened as investors re-priced risk. Foreign investors pulled out from EMEs, even as fundamentals remained largely strong.

I.5.2 Indian financial markets remained on the whole orderly during 2005-06 even as interest rates edged up across the spectrum in the second half of the financial year. Liquidity conditions were generally comfortable except for some tightness in the fourth quarter due to the redemption of the India Millennium Deposits (IMDs) amidst sustained credit growth and build-up of cash balances by the Government of India. Call money rates remained generally close to the reverse repo rate for most part of the first half of 2005-06, while remaining close to/ exceeding the repo rate in the fourth quarter. Interest rates in the collateralised segment of the money market – which now dominates the turnover in the money market – also edged up, but remained below the repo rate during the fourth quarter. The foreign exchange market remained by and large orderly, exhibiting two-way movements. Yields in the Government securities market hardened during 2005-06 and the yield curve flattened. In the credit market, deposit and lending rates edged up during the year as credit demand accelerated further. Capital markets remained buoyant during 2005-06. The stock indices reached record highs, driven by increased interest by domestic as well as foreign investors on the back of strong macroeconomic fundamentals. Buoyancy in secondary markets enabled a substantial increase in resources raised by the Indian corporates through domestic as well as euro issues.

I.5.3 There was a sharp increase in issuances of certificates of deposit (CDs) during 2005-06 – the amount of CDs outstanding increased from Rs.12,078 crore at end-March 2005 to Rs.43,568 crore by end-March 2006. As on July 7, 2006, the outstanding amount of CDs increased further to Rs.57,256 crore. The large recourse to CDs could be attributed to banks' demand for funds in the wake of acceleration in demand for bank credit. Outstanding CDs constituted 4.8 per cent of aggregate deposits of issuing banks at end-March 2006, marginally higher than that of 4.1 per cent a year ago. Private sector banks were the major issuers of CDs. Reflecting the competitive pressures on banks to offer competing returns to attract wholesale corporate and mutual fund surpluses in an environment of tight liquidity, the issuance costs recorded a sharp rise during 2005-06. The typical discount rate for 3-month maturity on CDs increased from 5.87 per cent in March 2005 to 8.72 per cent in March 2006. The discount rate has since eased to 7.20 per cent as on July 7, 2006.

I.5.4 Issuances of commercial paper (CP), which had exhibited sustained increase till mid-September 2005, witnessed a slowdown during the second half of 2005-06. Outstanding CPs after increasing from Rs.14,235 crore at end-March 2005 to Rs.20,019 crore by mid-September 2005 declined to Rs.12,718 crore by end-March 2006. The weighted average discount rate (WADR) on CPs increased from 5.84 per cent on March 31, 2005 to 8.59 per cent on March 31, 2006. Following the easing of liquidity conditions, issuances under CPs have increased during 2006-07 so far and the outstanding amount of CPs was Rs.20,602 crore as on July 31, 2006; concomitantly, the WADR eased to 7.34 per cent.

GOVERNMENT SECURITIES MARKET

I.5.5 Yields in the Government securities market hardened during 2005-06. The increase in yields for longer-term maturities was, however, less than for shorter-term maturities, reflecting relatively stable inflation expectations. Intra-year movements in yields were influenced by domestic liquidity conditions, inflationary expectations, volatility in crude oil prices and movements in the US yields. On April 30, 2005 the yields on 10-year paper firmed up sharply by 70 basis points to 7.35 per cent over end-March 2005 on fears of higher inflation in the backdrop of rising global crude oil prices and announcement of hike in the reverse repo rate by 25 basis points in the Annual Policy Statement on April 28, 2005. The yields, however, eased during May and June 2005 to reach 6.89 per cent on June 30, 2005 amidst comfortable liquidity position, benign inflation and fall in the

US treasury yields. The markets rallied briefly in July 2005 and yields softened as the reverse repo rate was left unchanged in the First Quarter Review of the Annual Statement on Monetary Policy on July 26, 2005. Yields remained broadly stable between August and December 2005.

I.5.6 Yields, however, edged up in the last week of January 2006 following the increase of 25 basis points in both the reverse repo and the repo rates in the Third Quarter Review of the Annual Statement on Monetary Policy on January 24, 2006. The 10-year yield reached 7.41 per cent on January 27, 2006 before declining somewhat to 7.28 per cent on January 31, 2006. For most part of February-March 2006, yields were range-bound. However, in end-March, rise in US yields led to a rise in the yields in the Indian market with the 10-year yield reaching 7.52 per cent on March 31, 2006. The spread between 1-year and 10-year yields narrowed to 98 basis points at end-March 2006 (from 114 basis points at end-March 2005), mirroring liquidity tightness in money markets. The spread between 10-year and 30-year yields narrowed to 30 basis points (from 54 basis points at end-March 2005), reflecting increased appetite for long-term securities from non-bank participants such as insurance companies and pension funds.

CREDIT MARKET

I.5.7 As discussed earlier in this Chapter, demand for bank credit accelerated during 2005-06. In order to meet the higher credit demand, banks, *inter alia*, intensified efforts to mobilise deposits. This was reflected in upward movement in deposits as well as lending rates. During the second half of 2005-06, banks increased their deposit rates by about 25-150 basis points across various maturities. As regards lending rates, many banks revised upwards their sub-Benchmark Prime Lending Rates (BPLRs), while keeping their BPLRs unchanged. Some private sector banks increased their BPLRs as well. The band of BPLRs for private sector banks and foreign banks remained wider than that of public sector banks, although for a majority of banks, the BPLRs lie in a relatively narrow range. For instance, in regard to private sector banks, more than half of banks (16 out of 29 for which comparative data are available) had BPLRs in a range of 11-12 per cent at end-March 2006, while five banks had BPLRs in a range of 10-11 per cent. As regards foreign banks, nine of them had BPLRs in a range of 12-13 per cent, while five each had BPLRs in a range of 10-11 per cent and 11-12 per cent. Deposit as well as lending rates of banks increased further during the first quarter of 2006-07. Deposit rates increased by about 25-100 basis points across various maturities between March 2006 and June 2006. On the lending side, banks revised upwards their BPLRs by 25-50 basis points.

EQUITY AND DEBT MARKETS

I.5.8 The capital market exhibited buoyancy during 2005-06. Resources raised by the Indian corporates through public offerings, private placements and euro issues increased significantly. Resource mobilisation by mutual funds through various schemes also increased sharply. The secondary market registered sharp gains during 2005-06 and continued to surge during early part of 2006-07 with the benchmark indices recording all time high levels. Large investments by foreign institutional investors (FIIs) and domestic mutual funds on the back of robust macroeconomic fundamentals, congenial investment climate and strong corporate profitability buoyed the stock markets.

I.5.9 The stock markets witnessed bullish conditions during 2005-06 with the benchmark indices touching all time high levels. The BSE Sensex rose by 73.7 per cent between end-March 2005 and end-March 2006, while the S&P CNX Nifty increased by 67.1 per cent. The stock market gains were driven mainly by continued investments by both FIIs and domestic institutional investors on the back of strong macroeconomic fundamentals, sound business outlook and robust corporate earnings.

VI. EXTERNAL SECTOR

I.6.1 India's balance of payments position remained comfortable during 2005-06, notwithstanding pressures posed by record high oil prices. Balance of payments developments during 2005-06 showed a number of positive features. First, merchandise exports remained robust for the fourth year in succession, reflecting increasing competitiveness of technology intensive domestic manufacturing. Second, non-oil import demand recorded strong growth led by imports of capital goods, on account of large investment activity in the economy. Imports of gold and silver, on the other hand, were almost unchanged from the previous year. Third, invisible earnings from services and transfers continued to grow at a stable pace and thereby financed a large part of the trade deficit. Fourth, the current account deficit widened during 2005-06. As a proportion to GDP, the current account deficit, however, remained modest. Fifth, sustained appetite for domestic financial assets was maintained in view of growth prospects of the Indian economy. This led to capital inflows remaining well in excess of the current account deficit. Sixth, the redemption of India Millennium Deposits (IMDs) amounting to US $ 7.1 billion was completed smoothly. Seventh, notwithstanding the large outgo on IMD redemption and higher current account deficit, the overall balance of payments recorded a substantial surplus, leading to a further increase in foreign exchange reserves. Finally, external debt (as a proportion to GDP) continued to decline. Annual current receipts and the stock of foreign exchange reserves exceed the country's stock of external debt.

I.6.2 India's merchandise exports increased by 23.0 per cent during 2005-06 on top of 30.8 per cent during 2004-05. As a result, exports crossed US $ 100 billion during 2005-06, surpassing the annual target of US $ 92 billion set by Government of India for 2005-06. Export growth was broad-based. Exports of primary products benefited, *inter alia*, from the strengthening of commodity prices. Agricultural and allied commodities exports witnessed a sharp acceleration, driven by coffee, rice, cotton, oil meal and spices. Ores and minerals, especially iron ore, continued to post high export growth, although there was some deceleration partly due to strong domestic demand for metals.

I.6.3 Imports maintained high growth at 27.7 per cent during 2005-06 (42.7 per cent growth a year ago), reflecting higher oil prices as well as strong overall domestic demand. Oil imports at US $ 44.0 billion increased by 47.3 per cent during 2005-06. This was mainly on account of elevated international oil prices as in volume terms, the growth of oil imports decelerated from 5.5 per cent during 2004-05 to 4.2 per cent in 2005-06. India's oil import bill has increased from 2.9 per cent of GDP in 2001-02 to 5.5 per cent of GDP in 2005-06, mirroring the surge in international crude oil prices.

I.6.4 Non-oil non-gold imports maintained the momentum of growth, increasing by 23.7 per cent during 2005-06 as compared with 39.0 per cent a year ago. Imports of industrial inputs (non-oil imports net of gold and silver, bulk consumption goods, manufactured fertilisers and professional instruments) recorded strong growth of 24.7 per cent (41.4 per cent increase a year ago). Imports of capital goods were the mainstay, accounting for 39.1 per cent of the imports of industrial inputs. Imports of capital goods increased by 26.0 per cent during 2005-06 (37.5 per cent a year ago) in consonance with acceleration in domestic production of capital goods, reflecting large investment demand and continued expansion in capacity. Growth in imports of gold and silver, however, decelerated to 0.4 per cent in 2005-06 from 62.6 per cent a year ago, which could be attributed to the surge in gold prices. Among bulk commodities, imports of manufactured fertilisers, metalliferrous ores and scraps, non-ferrous metals, and iron and steel rose steeply while imports of bulk consumption goods such as edible oils witnessed a decline during 2005-06.

Invisibles

I.6.5 The sustained rise in invisibles surplus during 2005-06 – net balance under services, transfers and income – continued to moderate the impact of growing merchandise trade deficit. Net surplus under invisibles expanded from US $ 31.2 billion during 2004-05 to US $ 40.9 billion during 2005-06. As in recent years, growth in invisible receipts during 2005-06 was led mainly by significant expansion in software exports, other professional and business services and remittances from overseas Indians. This has led to a rise in the share of invisibles in the current receipts from 29 per cent in 1990-91 to 47 per cent in 2005-06. Reflecting the sustained growth since the early 1990s, gross invisible receipts have expanded sharply from 2.4 per cent of GDP in 1990-91 to 11.5 per cent in 2005-06. Gross invisible payments have expanded at a relatively modest pace over the same period from 2.4 per cent of GDP to 6.4 per cent. Consequently, the net surplus under invisibles – which recorded a modest deficit of 0.1 per cent in 1990-91 – has turned out to be quite substantial in recent years to reach 5.1 per cent of GDP in 2005-06.

Current Account

I.6.6 Merchandise trade deficit, on balance of payments basis, increased from US $ 36.6 billion during 2004-05 to US $ 51.6 billion during 2005-06, led by higher imports. Net invisibles surplus also expanded during the year, financing a substantial part – about 79 per cent – of trade deficit during 2005-06. With the expansion in merchandise trade deficit, however, in excess of the expansion in the invisibles surplus, the deficit on the current account increased from US $ 5.4 billion during 2004-05 to US $ 10.6 billion during 2005-06. As a proportion to GDP, the current account deficit increased from 0.8 per cent during 2004-05 to 1.3 per cent in 2005-06. Thus, unlike many other emerging markets, which continue to record surpluses, India's current account balance shows a deficit. Current account developments during 2005-06 point towards growing openness and integration of the Indian economy with the global economy. The ratio of current receipts to GDP increased from 22.0 per cent in 2004-05 to 24.5 per cent in 2005-06. Similarly, trade openness – the ratio of merchandise exports and imports to GDP – has increased from 28.9 per cent during 2004-05 to 32.7 per cent during 2005-06.

Capital Account

I.6.7 Both direct and portfolio foreign investment flows increased during 2005-06. Foreign direct investment (FDI) flows into India were 37 per cent higher during 2005-06 on the back of positive investment climate, improved growth prospects and initiatives aimed at rationalising and liberalising the FDI policy and simplifying the procedures.

I.6.8 Portfolio equity flows increased further during 2005-06, led mainly by higher inflows from foreign institutional investors (FIIs). Net inflows by FIIs in the Indian stock markets increased by 14 per cent to US $ 9.9 billion, driven by strong corporate profitability and better growth prospects. The number of FIIs registered with the SEBI increased from 685 at end-March 2005 to 882 by end-March 2006. Capital inflows through the issuances of American depository receipts (ADRs)/ global depository receipts (GDRs) were also substantially higher as booming stock markets offered corporates the opportunity to issue equities abroad. India remained one of the largest recipients of portfolio inflows during 2005.

I.6.9 Following the phased liberalisation in the regime for Indian investments overseas, investments in joint ventures (JV) and wholly owned subsidiaries (WOS) abroad have emerged as important avenues for promoting global business by Indian entrepreneurs. They are also a source of increased exports of plants and machinery and goods from India. Joint ventures have also been perceived as a medium of economic cooperation between India and other countries. Transfer of technology and skill, sharing of results of R&D, access to wider global markets, promotion of brand image, generation of employment and utilisation of raw materials available in India and in the host country are other significant benefits arising out of such overseas investments. Overseas investments which started off initially with the acquisition of foreign companies in the IT and related services sector have now spread to other areas, particularly pharmaceuticals and petroleum. Overseas investment is being funded through a variety of sources such as drawal of foreign exchange in India, capitalisation of exports, balances held in EEFC accounts and swap of shares. A part of overseas investment is also financed through funds raised abroad such as external commercial borrowings, foreign currency convertible bonds and ADRs/GDRs. Overseas investment also takes place through leveraged buyout by way of setting up of special purpose vehicles (SPVs) abroad. These SPVs typically raise funds from international markets to finance the buyout and such transactions are not captured in the overseas investment statistics.

EXTERNAL DEBT

I.6.10 India's total external debt increased by about US $ 2 billion during 2005-06 and was placed at US $ 125.2

billion at end-March 2006. The increase in the external debt during 2005-06 was mainly on account of a rise in NRI deposits and trade credit (up to 1 year maturity). The rise in NRI deposits, as noted earlier, could be attributed partly to the upward revision in interest rates on NRE term deposits, while higher short-term trade credit reflected rising import financing requirements. The decline in the stock of external commercial borrowings was mainly due to the one-off effect of the repayment of IMDs. The valuation effect, on account of appreciation of the US dollar against other major international currencies, had a moderating impact on the stock of external debt. The US dollar continues to dominate the currency composition of external debt.

I.6.11 Indicators of sustainability suggest continued improvement in India's external debt position. The ratio of external debt to GDP has recorded a steady decline to 15.8 per cent at end-March 2006 from 30.8 per cent at end-March 1995. Amongst the top 15 debtor countries, India had the lowest debt-GDP ratio, next only to China. India's foreign exchange reserves continued to exceed the external debt stock. Current receipts also exceed the external debt stock. This reflects the sustained robust growth in exports of goods, services and remittances. The ratio of the short-term debt to total external debt, notwithstanding some increase during the year, remains modest. The increase in debt service ratio during 2005-06 was on account of redemption of the IMDs during the year.

FOREIGN EXCHANGE RESERVES

I.6.12 With capital flows remaining in excess of the current account deficit, the balance of payments continued to record an overall surplus during 2005-06. As a result, India's foreign exchange reserves – comprising foreign currency assets, gold, SDRs and the reserve tranche position with the IMF – increased by US $ 10.1 billion during 2005-06 to reach US $ 151.6 billion at end-March 2006. The increase in the value of gold holdings mirrored the increase in global prices of gold. India which had turned a creditor to the IMF under the Financial Transactions Plan (FTP) in 2003 provided SDR 34 million during 2005-06 to countries like Turkey and Uruguay. The total quantum of India's contribution under FTP has been SDR 493 million as at end-March 2006. At end-March 2006, India held the fifth largest stock of international reserve assets among EMEs. India's foreign exchange reserves were US $ 165.4 billion as on August 18, 2006, an increase of US $ 13.7 billion over end-March 2006.

II ASSESSMENT AND PROSPECTS

ASSESSMENT OF 2005-06

II.1 The Indian economy recorded strong growth for the third successive year during 2005-06 in an environment of macroeconomic and financial stability, notwithstanding sustained pressures from record high international crude oil prices. Real GDP growth accelerated from 7.5 per cent during 2004-05 to 8.4 per cent during 2005-06 on the back of buoyant manufacturing and services activity supported by a recovery in the agricultural sector. Real GDP growth has, thus, averaged over eight per cent during the last three years and over seven per cent in the first four years (2002-03 to 2005-06) of the Tenth Five Year Plan.

II.2 Growth in real GDP originating from the agricultural sector recovered to 3.9 per cent in 2005-06 from 0.7 per cent in 2004-05 led by improvement in the production of foodgrains as well as non-foodgrains. Growth in the production of foodgrains was almost entirely on account of recovery in the production of rice to 91.0 million tonnes (mt) in 2005-06 from 83.1 mt in 2004-05; the growth in 2005-06 partly reflected the base effect as rice output had dipped in 2004-05 from 88.5 mt in 2003-04. As regards other major foodgrains, wheat output in 2005-06 (69.5 mt) was only marginally higher than that in 2004-05 (68.6 mt) but lower than that two years earlier (72.2 mt in 2003-04). Similarly, the production of coarse cereals in 2005-06, although higher than the preceding year, was lower than it was two years earlier. The production of pulses at 13.1 mt in 2005-06 was unchanged from a year earlier, but lower than that in 2003-04. Overall, the total production of foodgrains at 208.3 mt in 2005-06, *albeit* higher than that in 2004-05 (198.4 mt), was lower than that in 2003-04 (213.2 mt).

II.3 A noteworthy aspect of economic activity during 2005-06 was the continued recovery of manufacturing activity, led by both investment and consumption demand. The industrial recovery that set in during 2002-03 has been sustained on the back of expansion in domestic as well as export demand, increased capacity utilisation, augmentation of capacities and positive business and consumer confidence. An impressive feature during 2005-06 was the double-digit expansion in both capital and consumer goods. The basic goods sector also picked-up, benefiting from strong growth in cement, basic metal and alloy industries. Growth in the intermediate goods sector, however, decelerated, which could be attributed to a variety of factors such as competition from the unorganised sector and larger imports of goods such as yarn. Deceleration in production of petroleum products also contributed to deceleration in intermediate goods production. The infrastructure sector continued to record subdued performance. Growth in the generation of electricity remained sluggish during 2005-06, possibly hampered by inadequate availability of gas and coal. It may be noted with some concern that average growth in electricity generation during 2004-05 and 2005-06 at 5.1 per cent has been significantly lower than that of manufacturing growth of 9.1 per cent over the same period.

II.4 The services sector maintained double-digit growth for the second successive year, and remained the key driver of growth during 2005-06 by contributing almost three-fourths to the overall real GDP growth. The buoyant growth in the services sector during 2005-06 was largely supported by the strong performance of trade, hotels, transport and communication sub-sector. The construction sector witnessed double digit growth for the third successive year benefiting from the focus on infrastructure and supported by housing activity. The high-growth components of the services sector such as information technology (IT), and business process outsourcing (BPO) provided a stable anchor to the economy in face of risks emanating from high oil prices. A favourable market is emerging for services products from India as evident by the trebling of India's share in world export of services from 0.6 per cent in 1995 to 1.8 per cent in 2004.

II.5 The strengthening of economic activity in the recent years has been supported by a consistent increase in the gross domestic investment rate from 23.0 per cent of GDP in 2001-02 to 30.1 per cent in 2004-05. The gross domestic saving rate has improved from 23.6 per cent to 29.1 per cent over the same period, led by a turnaround of 4.2 per cent of GDP in public savings – from a dissaving of 2.0 per cent of GDP in 2001-02 to positive savings of 2.2 per cent of GDP in 2004-05 – mainly reflecting the fiscal consolidation process.

II.6 Non-food credit extended by scheduled commercial banks increased by 31.8 per cent during 2005-06 on top of growth of 27.5 per cent a year ago. Almost 30 per cent of incremental non-food credit during 2005-06 went to the industrial sector, while over 14 per cent of incremental non-food credit was on account of housing loans and another 12 per cent of incremental non-food credit was absorbed by the agricultural sector and allied activities. In order to fund high credit demand, banks, apart from mobilising higher deposits, restricted their incremental investments in Government securities taking advantage of their excess SLR holdings. Internal reserves as well as recourse to raising of capital through equity issuances also enabled banks to fund credit demand. Notwithstanding the large order of increase in bank credit, monetary and liquidity conditions remained largely comfortable during 2005-06 reflecting proactive liquidity management operations by the Reserve Bank under the liquidity adjustment facility, flexible management of issuances under the market stabilisation scheme, and some private placement of Government securities.

II.7 Reflecting the large order of growth in bank credit, broad money (M_3) growth (17.0 per cent) during 2005-06 was higher than in the previous year (12.1 per cent) as well as the expansion of 14.5 per cent projected in April 2005 in the Annual Policy Statement for 2005-06. Growth in residency-based monetary aggregate (NM_3) at 18.1 per cent was even higher than that in M_3. It may be noted that residency-based monetary aggregate (NM_3) does not directly reckon non-resident foreign currency deposits such as India Millennium Deposits (IMDs). The redemption of IMDs depressed the growth rate of M_3, but did not have any direct impact on NM_3. Accordingly, NM_3 growth turned out to be higher than M_3. The above trend growth in monetary aggregates was indicative of strong aggregate demand conditions during the year. Reflecting the liquidity injection operations by the Reserve Bank during the year, growth in reserve money accelerated from 12.1 per cent in 2004-05 to 17.2 per cent in 2005-06.

II.8 Inflation was contained to 4.1 per cent by end-March 2006 within the indicative trajectory of 5.0-5.5 per cent during 2005-06. The actual inflation was considerably lower than the indicative trajectory and this could be mainly attributed to the deferred pass-through of even the cognisable permanent component of international crude oil prices. Notwithstanding the incomplete pass-through, mineral oil prices dominated the inflation outcome, contributing almost 40 per cent to the headline inflation. Prices of primary articles also posed upward pressures, led by higher prices of wheat, pulses and 'eggs, fish and meat'. On the whole, primary food articles contributed almost 24 per cent to headline inflation. In order to stabilise inflationary expectations, the Reserve Bank raised the reverse repo rate by 75 basis points during 2005-06 – 25 basis points each in April 2005, October 2005 and January 2006. These pre-emptive monetary policy measures by the Reserve Bank coupled with productivity gains and increased competition helped to contain inflationary expectations. However, underlying inflationary pressures continue to remain in view of the incomplete pass-through of permanent component of higher international crude oil prices to domestic prices.

II.9 The Centre's provisional accounts for 2005-06 indicate that revenue deficit and gross fiscal deficit, as per cent to GDP, at 2.7 per cent and 4.1 per cent, respectively, were higher by 0.2 percentage point and 0.1 percentage point than their levels in 2004-05. The 'pause' taken from attaining the minimum stipulated reductions under the Fiscal Responsibility and Budget Management (FRBM) Rules in 2005-06 has resulted in a departure from the FRBM path. Adherence to the FRBM path would have required revenue and fiscal deficits at 2.0 per cent and 3.7 per cent of GDP, respectively, in 2005-06. During 2005-06, the Centre continued with its efforts to rationalise the direct tax structure. A downward adjustment of tax slabs and lowering of rates were complemented by appropriate base enhancing measures which included introduction of new taxes, reduction of depreciation rates and removal of certain tax concessions. Indirect tax reforms focused on moving towards ASEAN levels for customs tariff and CENVAT rate for excise duties. Gross tax/GDP ratio continued its rising trend, crossing 10 per cent. Expenditure management laid emphasis on reducing non-plan expenditure and providing adequately for meeting pressing social and infrastructural needs of a growing economy. Capital outlay, however, continued to be low, at around 1.5 per cent of GDP.

II.10 The consolidated fiscal position of the State Governments during 2005-06 (revised estimates) reflected commitment by most State Governments to carry forward the process of fiscal correction and consolidation. The buoyancy in States' own tax revenue based on tax rationalisation and improved administration, higher transfer and devolution of resources from the Centre and deceleration in revenue expenditure facilitated the correction of the revenue deficit and consequently the gross fiscal deficit. The proportion of revenue deficit to gross fiscal deficit declined sharply in 2005-06 and this allowed an increase in the proportion of capital outlay, indicating improvement in the quality of expenditure of the State Governments. Furthermore, the States maintained large cash surplus position during 2005-06 following a surge in accruals from the National Small Savings Fund (NSSF). During 2005-06, the slippage in fiscal consolidation at the Centre was made good by the States, resulting in a reduction in the combined revenue deficit by 0.6 percentage point of GDP over its level in 2004-05 while the combined fiscal deficit remained unchanged at 7.5 per cent.

II.11 The balance of payments position remained comfortable during 2005-06 despite pressures imposed by higher international crude oil prices and outgo on account of redemption of IMDs. Merchandise export growth remained robust for the fourth successive year, reflecting growing competitiveness of the Indian industry. The expansion in merchandise exports (in US dollar terms) during the last four years (2002-03 to 2005-06) at a rate of 24 per cent, on average, has been an important source of growth in domestic manufacturing activity and in sustaining higher overall growth. Manufactured products such as engineering goods, chemicals, gems and jewellery and petroleum products were the major drivers of export growth during 2005-06. A redeeming feature during 2005-06 was the resurgence in exports of textiles and agricultural products. Non-oil import demand growth remained buoyant in consonance with higher investment activity. Oil imports increased sharply by 47 per cent during 2005-06 to US $ 44 billion. This increase was mainly on account of record high international crude oil prices as, in volume terms, the increase was only 4.2 per cent during the year. Reflecting the sustained hardening of international crude oil prices in the past few years, oil imports have increased from 2.8 per cent of GDP in 1999-2000 to 5.5 per cent of GDP in 2005-06. Net oil imports – oil imports net of oil exports – have increased from 2.8 per cent of GDP to 4.1 per cent of GDP over the same period. The merchandise trade deficit, on balance of payments basis, widened to 6.5 per cent of GDP in 2005-06, the highest level recorded in the last three decades, surpassing the peak of the second oil price shock. The current account deficit, nonetheless, remained modest during 2005-06 (1.3 per cent of GDP) as the surplus under invisibles continued to remain buoyant, benefiting from the sustained growth in exports of services such as software and other business services, and remittances. Growth in gross invisible receipts has outpaced growth in merchandise exports since the early 1990s. As a result, gross invisible receipts are now nearing the levels of merchandise exports – for instance, during 2005-06, invisible receipts were nearly 87 per cent of merchandise exports as compared with only 40 per cent in 1990-91. Concomitantly, the current receipts-GDP ratio has trebled from 8.0 per cent in early 1990s to 24.5 per cent in 2005-06.

II.12 Capital flows remained significant during 2005-06, exceeding the current account deficit. Foreign investment flows, both direct and portfolio, increased reflecting mainly the foreign appetite for domestic financial assets on the back of strong fundamentals and robust corporate performance. Debt flows also remained large primarily on account of growing investment demand in the economy. The gross disbursements under external commercial borrowings issues showed expansion of 57 per cent. Growing investment interest by Indian companies in the overseas markets continued during 2005-06, as these entities took advantage of the congenial policy regime. Thus, despite some expansion of the current account deficit as well as large outgo (US $ 7.1 billion) on account of the redemption of the IMDs, India's balance of payments recorded a surplus and the foreign exchange reserves increased by US $ 10.1 billion during the year. External debt, as a proportion of GDP, continued its declining trajectory.

II.13 Domestic financial markets remained largely orderly during 2005-06 even as interest rates edged up in various market segments during the year. Some tightness was observed in liquidity conditions between December 2005 and March 2006 and the Reserve Bank undertook appropriate liquidity management operations. There was a substantial migration of money market activity from the uncollateralised segment to the collateralised segment in response to policy measures. In the foreign exchange market, the rupee exhibited two-way movements. Yields in the Government securities market edged up reflecting higher domestic policy rates, higher crude oil prices, strong credit demand and global monetary tightening. Domestic stock indices reached record highs during 2005-06 reflecting increased interest by domestic as well as foreign investors on the back of strengthening growth prospects.

II.14 The Reserve Bank continued with its initiatives to strengthen the financial sector with a view to maintaining financial stability. In order to maintain asset quality, prudential measures were tightened by raising risk weights for specific sectors such as real estate where credit expansion was observed to be extremely high. In addition, the provisioning requirement for standard assets was increased. In November 2005, the provisioning requirement on standard assets, with the exception of direct advances to agricultural and small and medium enterprises (SME) sectors, was raised from 0.25 per cent to 0.40 per cent of the funded outstanding on global loan portfolio basis. Following the announcement in the Annual Policy Statement for 2006-07 (April 2006), the provisioning requirement on standard advances in specific sectors, *i.e.*, personal loans, loans and advances qualifying as capital market exposures, residential housing loans beyond Rs.20 lakh and commercial real estate loans was raised from 0.40 per cent to 1.0 per cent. Guidelines were issued to permit banks to raise capital through new instruments to provide them greater flexibility to meet the enlarged capital requirements under Basel II. Concomitantly, the Reserve Bank laid increasing emphasis on financial inclusion and improvement in customer services. Initiatives to strengthen other segments of the banking system included focus on amalgamations in the case of regional rural banks to improve the efficiency of their operations and signing of memoranda of understanding with a few State Governments in the case of urban cooperative banks to overcome, to an extent, the problem of dual control. The Government of India, after consultations with State Governments, has accepted the package for revival of short-term cooperative credit structure.

II.15 In its endeavour to provide a safe, secure, efficient and integrated payment and settlement system, the Reserve Bank continued to strengthen the institutional framework for payment and settlement systems during 2005-06. Key initiatives during the year included the laying down of a road map for the medium-term through the release of the Payment and Settlement Systems Vision Document (2005-08) and focus on promoting electronic funds transfer. Concomitantly, the Reserve Bank published the 'Financial Sector Technology Vision Document' in July 2005 for facilitating smooth and orderly change in the technological upgradation of the financial sector.

OUTLOOK FOR 2006-07

II.16 Developments during 2006-07 so far suggest that the growth momentum of recent years is likely to continue during the year. High growth in the last three years has been led by strong performance of the services activity and manufacturing sector with some support from agricultural activity. This suggests that the growth momentum mainly reflected structural factors, although supported by cyclical and seasonal components. Early trends from the industrial production, services sector indicators, trends in *kharif* sowing, business confidence surveys, corporate performance, external trade, monetary and credit indicators and financial market conditions support an overall optimistic near-term outlook.

II.17 The India Meteorological Department (IMD) in its forecast on June 30, 2006 indicated that the rainfall during the South-West monsoon season (June-September) 2006 for the country as a whole is likely to be 92 per cent of the Long Period Average (LPA) with a model error of +/- 4 per cent. The cumulative rainfall during the South-West monsoon season 2006 so far (June 1 to August 16, 2006) has been two per cent below normal; the shortfall was the same as during the comparable period of 2005. Of the 36 meteorological sub-divisions, cumulative rainfall was deficient/scanty/ no rain in 14 sub-divisions. On the positive side, the total live water storage in the 76 major reservoirs as on August 4, 2006 was 56 per cent of the Full Reservoir Level, higher than that of 52 per cent a year ago. *Kharif* sowing picked up in July 2006 and as of July 31, 2006, around 67 per cent of normal area had been sown. The area sown under *kharif* crops up to July 31, 2006 was 2.4 per cent higher than a year ago. The total stock of foodgrains with the Food Corporation of India (FCI) and the State Government agencies at 22.3 million tonnes as on June 1, 2006 was almost 20 per cent lower than a year ago, but higher than the buffer stock norms (16.2 million tonnes).

II.18 Industrial production continued with its momentum during April-June 2006 (growth of 10.1 per cent as compared with 10.4 per cent in the corresponding period of 2005) led by the double-digit growth in manufacturing activity. The upturn in the industrial sector appears to be entering its fifth year of expansion in 2006-07. The manufacturing sector recorded growth of 11.2 per cent during April-June 2006, the same rate as a year ago. Electricity and mining sectors, however, continued to exhibit subdued growth. In terms of use-based classification, capital goods production recorded high growth, even on a high base, reflective of strong investment activity in the economy. Basic goods production also recorded an improvement. The intermediate goods sector, after recording subdued growth during most of 2005-06, witnessed improvement. Consumer goods continued to record high growth, *albeit* with some deceleration. The six infrastructure industries recorded growth of 6.3 per cent during April-June 2006 as compared with 7.5 per cent in the corresponding period of 2005.

II.19 Lead indicators of services sector activity suggest continued growth momentum during 2006-07 so far. Revenue generating traffic of railways, tourist arrivals, cargo and passenger handled by civil aviation, export earnings from software and other IT-enabled services, telecommunications and bank deposits and credit have recorded strong growth in 2006-07 so far. In the road sector, completion of about 92 per cent of the Golden Quadrilateral (5,846 km) by December 2005 would provide the necessary impetus to basic infrastructure development, particularly to the transportation sector. The targeted completion of North-South and East-West corridors (7,300 km) by December 2008 would lead to further improvement in the extent and quality of connectivity in the country and thereby contribute to overall productivity growth. India's competitiveness in IT and BPO segments has been aided by substantial investment in telecommunications infrastructure. The synergy between the manufacturing and the services sector creates strong multiplier effects on the growth of the services sub-sectors like traditional trading, banking, transport and *vice versa*. The services sector is, therefore, expected to continue to lead the economy, drawing from its linkage with the well performing industrial sector and expanding international trade.

II.20 Assuming trend growth in agriculture under normal monsoon conditions and barring domestic or external shocks, the Reserve Bank in its Annual Policy Statement for 2006-07 (April 2006) placed real GDP growth, for policy purposes, in the range of 7.5-8.0 per cent during 2006-07. The Reserve Bank reaffirmed its forecast for GDP growth in July 2006 in its First Quarter Review of the Annual Statement on Monetary Policy. Growth prospects are, however, subject to a number of downside risks. The risks emanating from the global economy are: potential escalation and volatility in international crude oil prices, a disorderly unwinding of the macroeconomic imbalances of the major economies, firming up of overall inflationary pressures and expectations, and a hardening of international interest rates along with the withdrawal of monetary accommodation. In the wake of rising inflationary pressures, central banks continue to tighten monetary policies. For instance, during the first fortnight of August 2006, monetary policy was tightened in Australia, euro area, United Kingdom, South Korea and South Africa. The US Federal Open Market Committee left its Federal Funds target rate unchanged in its latest meeting held on August 8, 2006, after having raised it by 425 basis points – 25 basis points hike each on 17 successive occasions – between June 2004 and June 2006. Furthermore, the recent re-pricing of risks in global financial markets needs to be recognised. The risk factors from domestic conditions relate to the progress of the monsoon, infrastructural bottlenecks, emerging apprehensions regarding the fiscal outlook and possible hardening of inflation expectations.

II.21 Bank deposits as well as credit have recorded strong growth during the fiscal year 2006-07 so far. Bank deposits and bank credit to the commercial sector have increased by Rs.1,11,750 crore (4.8 per cent) and Rs.61,343 crore (3.6 per cent), respectively, during the fiscal year 2006-07 so far (between March 31, 2006 and August 4, 2006) as compared with Rs.55,873 crore (2.8 per cent) and Rs.43,307 crore (3.3 per cent), respectively, during the corresponding period of 2005-06 (between April 1, 2005 and August 5, 2005). Acceleration in deposit growth could be attributed to higher interest rates on time deposits as well as base effects. Demand for bank credit continued to remain high in consonance with strong economic activity. Scheduled commercial banks' non-food credit, on a year-on-year basis, exhibited growth of 32.2 per cent as on August 4, 2006 on top of a high base of 31.2 per cent a year ago. Provisional information on sectoral deployment of bank credit indicates that retail lending rose by 47 per cent at end-June 2006, year-on-year, with growth in housing loans being 54 per cent. Loans to commercial real estate rose by 102 per cent. The year-on-year growth in credit to industry and agriculture was 27 per cent and 37 per cent, respectively, at end-June 2006.

II.22 Concomitantly, growth in broad money (M_3), y-o-y, accelerated to 19.1 per cent as on August 4, 2006 from 14.4 per cent a year ago. The sustained high growth in money supply and credit indicates that aggregate demand conditions continue to remain strong. Reflecting higher order of expansion in deposits, banks' incremental investments in Government securities have turned positive in the fiscal 2006-07 so far; banks had liquidated a part of their gilt investments in the second half of the preceding fiscal year to fund demand for credit from the commercial sector. Commercial banks' holding of Government securities has declined from 37.5 per cent of their net demand and time liabilities (NDTL) as on August 5, 2005 to around 31 per cent as on August 4, 2006, but still remain above the statutory minimum of 25 per cent. Despite sustained growth of bank credit, monetary and liquidity conditions have remained comfortable during 2006-07 so far.

II.23 During 2006-07 so far, headline inflation has continued to be driven by supply shocks as pressures from higher primary articles prices augmented sustained pressures from record high international crude oil prices. Pressures from primary articles prices emanated from higher prices of wheat, pulses and milk. Primary articles inflation, year-on-year, rose to a high of 7.7 per cent as on June 17, 2006 under the impact of the seasonal spike in prices of vegetables; it eased to 4.8 per cent as on August 5, 2006, partly on account of base effects. As regards fuel prices, while domestic prices of petrol and diesel have been increased in phases, the pass-through of higher international crude oil prices to domestic prices remains incomplete. Furthermore, LPG and kerosene prices have remained unchanged since November 2004 and April 2002, respectively. Notwithstanding the incomplete pass-through, mineral oil prices contributed 38 per cent to headline inflation as on August 5, 2006. Manufactured products inflation has remained modest, attributable to a variety of factors such as open trade, higher competition, productivity gains and stable inflation expectations. Headline inflation measured in terms of variation in wholesale prices was 4.8 per cent as on August 5, 2006 as compared with 3.8 per cent a year ago. Measures of consumer price inflation – which have a greater weight on prices of food articles – remain higher than that of wholesale price inflation with implications for inflation perceptions and expectations. During June 2006, various measures of CPI inflation, year-on-year, rose to above seven per cent; however, there was some easing during July 2006.

II.24 In the context of inflation, it may be noted that, globally, consumer price inflation is the preferred indicator of central banks for assessing inflationary conditions. On the other hand, in India, wholesale price inflation has emerged as the key measure of assessing inflationary pressures, partly due to its availability on a higher frequency (weekly basis) and partly due to the absence of a comprehensive measure of consumer price inflation in the country. At present, there are four measures of consumer price inflation in India; these measures, compiled on the basis of occupational classification and residence, cater to the specific needs of the user groups. The multiple consumer price indices, in view of differences in weighting diagrams of the commodity baskets, can lead to divergences in inflation numbers, especially in the short-run, and this constrains the assessment of inflationary pressures in the economy. At the same time, the limitations of the wholesale price index are well-recognised; in particular, its coverage is restricted to prices of goods while the growing services sector is excluded. In recognition of these limitations, the Reserve Bank attempts to extract information available from all the price indices; moreover, other indicators such as output, monetary and credit aggregates, rates of return in different financial market segments, fiscal position, merchandise trade, capital flows and exchange rates are also analysed for drawing policy perspectives.

II.25 In view of the developments in the real economy, and also taking in to account monetary and global factors having a bearing on domestic prices, the Reserve Bank in its Annual Policy Statement for 2006-07 (April 2006) indicated that containing inflationary expectations would continue to pose a challenge to monetary management. Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the prevailing assessment of the economy including the outlook for inflation, the Annual Policy Statement indicated that the overall stance of monetary policy will be to ensure a monetary and interest rate environment that enables continuation of the growth momentum consistent with price stability while being in readiness to act in a timely and prompt manner on any signs of evolving circumstances impinging on inflation expectations; to focus on credit quality and financial market conditions to support export and investment demand in the economy for maintaining macroeconomic, in particular, financial stability; and, to respond swiftly to evolving global developments.

II.26 There was widespread and simultaneous monetary policy tightening in several countries in early June 2006, against the backdrop of marked and heightened volatility in the international financial markets. Though not entirely unanticipated, the virtual global coverage, nature and timing of these developments posed a serious threat to the domestic economy which, thus far, had been spared of turbulence in the debt and foreign exchange markets. These developments, viewed in the light of the prevailing monetary and credit environment underscored compulsions of swift action, as indicated in the Annual Policy Statement. Accordingly, on June 8, 2006, the LAF reverse repo and repo rates were increased by 25 basis points each to 5.75 per cent and 6.75 per cent, respectively.

II.27 As noted earlier, prices of food articles such as wheat, pulses and sugar posed upward pressures on domestic inflation during the first quarter of 2006-07. In order to improve domestic supplies of these commodities so as to stabilise inflation expectations, the Government also took fiscal measures such as exempting imports of pulses and sugar from customs duty, reduction in customs duty on wheat and palm oils and restriction on exports of pulses.

II.28 In its First Quarter Review of the Annual Statement on Monetary Policy (July 2006), the Reserve Bank observed that containing inflation in the range of 5.0 - 5.5 per cent warrants appropriate priority in policy responses. Accordingly, the Reserve Bank raised the reverse repo rate and the repo rate by 25 basis points each to 6.00 per cent and 7.00 per cent, respectively, on July 25, 2006 while continuing to keep Bank Rate and cash reserve ratio unchanged. In the context of sustained high growth in bank credit, the Reserve Bank again laid stress on the need to ensure asset quality in order to maintain financial stability.

II.29 The revenue and fiscal deficits in 2006-07 of the Central Government are budgeted to be reduced by the minimum annual thresholds as stipulated under the FRBM Rules. The progress in Central Government finances during 2006-07 so far (April-June 2006) indicates that the key deficit indicators departed from the past trend, both in terms of proportion to budget estimates as well as growth rates. Revenue deficit during April-June 2006 registered growth of 49.4 per cent (as against growth of only 2.0 per cent a year ago), and constituted 83.4 per cent of the budget estimates for 2006-07. The fiscal deficit increased by 42.6 per cent during the first three months of the current fiscal year as compared with a growth of 30.8 per cent a year ago. The Government has, however, reiterated that the deficit targets set under the FRBM would be met with an evening out of revenues and expenditures over the course of the year. The widening of deficits was essentially on account of increase in revenue expenditure which more than offset the buoyant tax collections under corporation tax, income tax and customs duties and the significant increase in non-tax revenue. Substantial increases in plan revenue expenditure, interest payments, food and fertiliser subsidies and grants to States contributed to the sharp increase in expenditure.

II.30 Gross market borrowings of the Centre (net of market stabilisation scheme) during 2006-07 are placed at Rs.1,81,875 crore, Rs.21,857 crore higher than in the previous year. During 2006-07 so far (up to August 21, 2006), 51.6 per cent of the gross market borrowings budgeted for the year have been completed as compared with 46.4 per cent during the corresponding period of the preceding year. The weighted average yield on fresh borrowings has increased to 7.92 per cent during 2006-07 so far (up to August 21, 2006) from 7.27 per cent in the corresponding period of 2005-06; the weighted average maturity decreased to 12.73 years from 14.04 years over the same period. In this context, it may be noted that the Reserve Bank has stopped participating in the primary issues of the Central Government securities effective April 1, 2006 following the implementation of the provisions of the FRBM Act prohibiting the Reserve Bank's participation in the primary market.

II.31 Continuing the fiscal correction and consolidation process, the State Governments have budgeted to further reduce revenue and fiscal deficits in 2006-07. The revenue deficit, relative to GDP, is estimated to reach near zero level in 2006-07, brought out by higher growth in revenue receipts compared to that in revenue expenditure. The States have committed to continue their tax simplification measures while restricting current expenditures. In the backdrop of States having achieved budgetary targets on deficit indicators in 2005-06, the final targets of the Twelfth Finance Commission (TFC) on these deficit indicators are likely to be achieved ahead of the recommended schedule. The incentives provided by the recommendations of the TFC, particularly those relating to debt relief, have enabled the State Governments to restructure their finances, primarily through the revenue account. The process of fiscal correction adopted by the States is, however, not without some concerns. Development expenditure, as ratio to GDP, is budgeted to decline by 0.6 percentage point to 9.7 per cent in 2006-07 while non-development expenditure is estimated to be stagnant at 5.8 per cent.

II.32 The higher accrual of NSSF funds than budgeted has enabled the State Governments to maintain a high level of cash surplus on a continuous basis during 2006-07 so far. In such a scenario, the States would have less pressure for resorting to market borrowings and loans from other financial institutions during 2006-07. The cash surplus would also provide the State Governments the flexibility to raise the level of development expenditure.

II.33 Indian financial markets have remained largely orderly during 2006-07 so far though some pressures have been observed in the Government securities market. Call money rates have eased by 54 basis points in the current fiscal year so far from 6.64 per cent as at end-March 2006 to 6.10 per cent as on August 18, 2006, reflecting the easing of liquidity conditions. Call money rates remained generally close to the reverse repo rate. Yields on 10-year Government securities, on the other hand, have increased by 50 basis points so far (from 7.52 per cent as at end-March 2006 to 8.02 per cent as on August 18, 2006) reflecting a variety of factors such as unsettled inflation expectations in the wake of soaring international crude oil prices feeding into interest rate uncertainty; sustained credit growth and competing demand for funds between public and private sectors; some spill over from global markets; and apprehensions of additional pressures on market resources from perceptions of possible higher borrowings by the Centre in the second half of the year coupled with announcement of issuances of bonds to oil companies. In the foreign exchange market, some indications of pressure from mid-May 2006 due to the sharp decline in stock indices and currencies worldwide were observed. Market sentiment corrected by June 2006 and orderly conditions have prevailed since then. The Indian rupee has depreciated by 4.0 per cent *vis-à-vis* the US dollar in 2006-07 so far (from Rs.44.61 per US dollar at end-March 2006 to Rs.46.48 per US dollar as on August 18, 2006). In the credit market, deposit and lending rates have edged up as credit demand remained strong. Banks increased their deposit rates by about 25-100 basis points across various maturities between March 2006 and June 2006. Many banks increased their benchmark prime lending rates by 25-50 basis points over the same period. The stock markets witnessed correction during May-June 2006 in line with the trends in major international markets. The markets recovered some of the losses thereafter and the BSE Sensex, as on August 18, 2006, was 1.6 per cent higher over its March 31, 2006 level.

II.34 Global economic growth has remained strong in 2006 so far, exhibiting continued resilience to high oil prices. In the US, after transient impact of hurricanes on economic activity, growth bounced back in early 2006. There are, however, incipient signs of deceleration in spending in the US attributable to higher interest rates, gasoline prices and a cooling housing market. Global growth has become more broad-based with continuing recoveries in Japan and in the euro area. Emerging economies led by China and India continue to record high growth. The near-term outlook for the world economy remains benign, in view of still accommodative macroeconomic policies in many countries, favourable financing conditions, healthy corporate profits, and strong consumer confidence. The IMF projects the world economy to grow by 4.9 per cent in 2006, marginally higher than that of 4.8 per cent in 2005; growth is projected to moderate to 4.7 per cent in 2007. However, it is widely recognised that several features of the current global upswing are causes for concern: large fiscal deficits, low household savings and low investment in some large economies; unprecedented and growing current account imbalances; narrowing or closing in of output gaps in many economies; record highs in oil prices accompanied by uncertainties about their future evolution; and the outlook for inflation firming up. The recent volatility in international financial markets poses additional downside risks to global growth prospects.

II.35 India's merchandise exports continued to post strong growth during April-July 2006 *albeit* with some deceleration (20.8 per cent as compared with 34.6 per cent a year ago). Non-oil imports recorded a much lower growth of 9.9 per cent (52.0 per cent a year ago). Commodity-wise data available for April-May 2006 indicate that imports of gold and silver declined by 33.7 per cent as against an increase of 55.6 per cent during April-May 2005. Imports of capital goods continued to record strong growth (37.2 per cent during April-May 2006, *albeit* lower than that of 55.9 per cent during April-May 2005). Oil imports posted acceleration in growth during April-July 2006 (43.2 per cent on top of 36.5 per cent a year ago) on the back of further hardening of international crude oil prices. The trade deficit widened from US $ 14.4 billion during April-July 2005 to US $ 16.7 billion during April-July 2006. The buoyancy witnessed in the capital inflows to India during the year 2005-06 appears to have continued in the current year as well. Inflows under FDI, NRI deposits and issuances under ADRs/

GDRs during April-May 2006 were higher than that in the corresponding period of 2005. On the other hand, foreign institutional investors (FIIs) recorded net outflows during April-June 2006 (US $ 1.8 billion) as against net inflows of US $ 0.5 billion during the corresponding period of 2005. India's foreign exchange reserves have increased by US $ 13.5 billion in the current fiscal year so far to US $ 165.1 billion as on August 11, 2006. On the whole, despite the growing oil import bill, the anticipated current account deficit in 2006-07 is manageable, as in the past, due to the continuing underlying strength of merchandise exports, invisibles and capital flows. The balance of payments is, therefore, expected to remain comfortable during 2006-07. Assessed in terms of a medium-term perspective taking into account the possible levels of the current account deficits, the composition of capital flows, the level of international confidence in the ability of the country's payment position and pace and quality of growth, the current level of reserves continues to be comfortable. In this context, it is relevant to note that two major international rating agencies have upgraded India's foreign currency rating to investment grade. The continuous strength of the external sector and, in particular, the recent fiscal consolidation efforts are among the important factors that have led to upgrading of external ratings in the recent past.

II.36 Since May 2006, global financial markets have been characterised by significant re-pricing of risks on concerns over higher inflation in the US and the possibility of larger than anticipated monetary tightening. As a result of the increased risk aversion, the prices of highly rated government bonds rose, while those of riskier assets fell. The mid-May correction was felt acutely by emerging market economies – especially in equity markets – including India. Currencies of some emerging market economies depreciated significantly against the US dollar. It is clear that fundamentals could not have changed in such a dramatic fashion in a short time and, hence, it is reasonable to suggest that those economies that had gained most from lower pricing of risks in recent years felt the impact of reversal in direction since mid-May the most. The overall macroeconomic and geopolitical global environment is admittedly indicative of marked downside risks.

II.37 To sum up, for the Indian economy, the evolving economic and business environment exhibits a number of encouraging signs that suggest reinforcement of the robust economic growth exhibited in recent years. First, increase in the gross domestic saving rate to levels around 30 per cent, coupled with sustained absorption of external savings of 2 to 3 per cent of GDP, would provide the potential for attainment of an accelerated growth trajectory. Second, productivity growth in both the real and financial sectors bodes well for consistent economic growth with price stability. Third, there is evidence of improvement in business confidence corroborated by some signs of enhanced levels of foreign direct investment, both inward and outward. The robust performance of Indian merchandise exports in recent years also testifies to the attainment of higher competitiveness of Indian manufacturing, which itself promotes business confidence. The containment of inflation, and particularly inflation expectations, has boosted growth prospects in an environment of stability and confidence. Timely and even pre-emptive monetary measures reinforcing the policy stance paid dividends in terms of low and stable inflation which, in turn, provided conducive conditions for the undisrupted expansion of economic activity while maintaining macroeconomic and financial stability. The successes gained in external sector management in the context of the large trade deficit have also demonstrated the resilience of the Indian economy. In addition to persevering with monetary policy aimed at containing inflation expectations and preserving macroeconomic stability, in particular, financial stability, the maintenance of the current growth momentum will depend, *inter alia*, on policy improvements in agriculture, improved quantity and quality of physical infrastructure and progress in fiscal consolidation.

REAL SECTOR

Agriculture

II.38 For the Indian economy to maintain its growth momentum on a sustained basis, the agriculture sector would have to play a more important role than it has in recent years. Real GDP growth in the agricultural sector in recent years has been low and volatile. For instance, the actual growth in the agricultural sector during the first four years of the Tenth Five Year Plan has averaged only two per cent per annum as against four per cent envisaged in the Plan period (2002-07). While the share of agriculture in the overall GDP has declined from around 35 per cent in 1980-81 to around 20 per cent at present, the fall in the proportion of population dependent on the sector has been small. Thus, a majority of the workforce is still dependent on agriculture while the GDP growth due to agriculture is marginally above the rate of growth of the population, in contrast to strong growth in the non-agriculture sector. While the scope for better terms in the global trading environment is still elusive, India has a large enough domestic market to facilitate a more rapid growth in agriculture. Legislative, institutional and attitudinal changes to supplement enhanced public and private investment may be needed. The Reserve Bank, for its part, is intensifying its efforts in revitalising the rural cooperative credit system, strengthening regional rural banks, providing incentives to commercial banks for investments in rural economy and ensuring an adequate and timely delivery of credit at an appropriate price. The Reserve Bank is also mounting a study of legislation and implementation of non-institutional money lending.

II.39 The slow growth in agriculture in recent years is characterised by the stagnation in domestic production in the case of commodities like wheat, sugar and pulses. Illustratively, the production of wheat after touching a peak of 76 million tonnes (mt) in 1999-2000 has since then been range-bound at around 70 mt. Similarly, the production of pulses has not been able to exceed the peak of 14.9 mt reached in 1998-99. The production of pulses at 13.1 mt in 2005-06 was even lower than the level achieved more than 15 years back (14.3 mt in 1990-91). As a result, the share of pulses in total foodgrains output has declined consistently from 8.1 per cent in 1990-91 to 6.3 per cent in 2005-06. At constant (1999-2000) prices, investment in agriculture has been stagnant in recent years: Rs.43,123 crore in 2004-05 as compared with Rs.43,473 crore in 1999-

2000. As a result, the ratio of investment to GDP fell from 2.2 per cent in 1999-2000 to 1.7 per cent in 2004-05. The decline is mainly on account of private investment which has fallen from Rs.35,719 crore to Rs.30,532 crore over the same period. On the other hand, public sector investment in agriculture has shown signs of revival, increasing from Rs.7,018 crore in 2000-01 to Rs.12,591 crore in 2004-05. Revival of rural cooperative credit institutions through legal and institutional reforms will help in improving the flow of credit to the agricultural sector and this could, in turn, encourage investment in the sector. While increase in investment is essential for improving the prospects of the agricultural sector, the composition of investments, the quality of facilities created and the efficacy with which these facilities are used are also important.

II.40 Reflecting the decline in overall investment in the agricultural sector, infrastructure bottlenecks, particularly in regard to irrigation facilities, continue to impede speedy adoption of improved technology. Indian agriculture continues to be heavily dependent on the vagaries of the monsoon. In the case of principal crops, the coverage of irrigated area is only about 40 per cent. Furthermore, water use efficiency in Indian agriculture is one of the lowest in the world. Apart from increasing outlays on irrigation, efficient use of water resources is also important. In this context, appropriate pricing of power can be helpful in avoiding the excessive use of ground water.

II.41 Promotion of micro-irrigation technology comprising drip and sprinkler irrigation on a large scale also deserves priority attention. About 1.2 million hectares have been covered under micro-irrigation so far, and the plan is to increase the coverage to 3 million hectares by the end of the Tenth Plan and to 14 million hectares by the end of the Eleventh Plan. In order to improve the pace of implementation of Accelerated Irrigation Benefit Programme (AIBP), the Union Budget for 2006-07 increased the outlay in irrigation from Rs.4,500 crore to Rs.7,121 crore. Restoration of water bodies is a cost effective way of enhancing irrigation capacities and can be expected to give an element of stability to agricultural production and yields. Improvement in State finances witnessed in the past couple of years, if sustained, could provide the States greater flexibility to increase outlays on irrigation and other infrastructural facilities. This would also help in reducing the dependence of agriculture on monsoon and provide stability to agricultural production.

II.42 Given the several risks that farmers face such as future price and monsoon conditions, there is a need to put in place proper risk mitigation policies. Even in regard to price risk, although the minimum support price mechanism in respect of rice, wheat and, to a limited extent, cotton has served the country well, its effectiveness could be an issue. Accordingly, a comprehensive public policy on risk management in agriculture could act as an ingredient for more efficient commercialised agriculture and also provide relief to distressed farmers.

II.43 Rural infrastructure, which includes agriculture research and extension, transport, electricity, storage structures, not only enhances the productivity of physical resources, but also helps in supply chain management and value addition in agriculture. In this context, the focus on rural infrastructure development under *Bharat Nirman* – covering irrigation, rural water supply, construction of rural roads, rural houses, rural electrification and telephone connectivity in the villages – would help in improving infrastructure facilities in rural areas and provide productivity gains. Improvements in rural infrastructure will also facilitate food processing and other agro-based industries. The Union Budget 2006-07 has identified access to credit, diversification and creation of market for agricultural products as thrust areas and several initiatives have been taken. These measures are expected to provide boost to the agriculture sector.

II.44 The Green Revolution has been the cornerstone of India's agricultural development, transforming the country from one of food deficiency to self-sufficiency. The time is now ripe for a second Green Revolution with an emphasis on diversifying agricultural sector further in order to capture new market opportunities. Globalisation, rising income, and urbanisation call for increasing diversification and value addition in Indian agriculture. The shifts in consumption pattern warrant a shift of land and other resources to crops with higher potential for value addition. India has tremendous export potential in the areas of dairying, sericulture, floriculture, horticulture and the like. A National Horticulture Mission has been launched as a Central Sector Scheme to promote holistic growth of the horticulture sector through area based regionally differentiated strategies.

II.45 Going forward, agricultural growth would largely accrue from improvements in productivity of diversified farming systems with regional specialisation and sustainable management of natural resources, especially land and water. Effective linkages of production systems with marketing, agro-processing and other value added activities would play an increasingly important role in diversification of agriculture. Improvements in marketing infrastructure would help in agricultural production by enhancing market efficiency, promoting exports and encouraging processing industry. Amendment of State Agricultural Produce Marketing Committee (APMC) Acts in line with the Model Act (2003) is expected to provide the necessary marketing infrastructure in place. The model legislation, *inter alia*, provides for direct sale, promotion of public-private partnership in the management and development of agricultural markets, promotion of contract farming, pledge financing, trading, export, and introduction of a negotiable warehousing receipt system in respect of agricultural commodities.

II.46 More focus needs to be placed on agricultural research in the coming years as the success so far has been restricted to select crops. A growing disparity between the actual and the potential yields points to a crucial gap between research and extension. There is, thus, a need to evolve and put in place appropriate agricultural technologies and agro-management practices to respond to food and nutritional security, poverty alleviation, diversifying market demands, export opportunities, and environmental concerns. The public extension system needs to become more demand driven, with stronger synergies between public and private extension efforts.