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 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

* 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.

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 In order to set up terminal markets in different parts of the country by employing the public-private Partnership (PPP) model, an amount of Rs.150 crore has been earmarked under the National Horticulture Mission. During 2005-06, a scheme for Marketing Research and Information Network, AGMARKNET, was implemented to provide electronic connectivity to important wholesale markets in the country for collection and dissemination of price and market related information. These markets are reporting daily prices in respect of more than 300 commodities. More than 1,000 markets from all over the country have been linked to a central portal and the number is expected to increase to 2,700 by end-March 2007.

I.1.7 The Union Budget 2006-07 provided relief to the farmers who had availed crop loans from scheduled commercial banks, regional rural banks (RRBs) and primary agricultural co-operative societies (PACS) for *Kharif* and *Rabi* 2005-06. Accordingly, an amount equal to two percentage points of the borrower's interest liability on the principal amount, up to Rs.1,00,000, was required to be credited to their bank accounts before March 31, 2006. For this, the Budget provided a sum of Rs.1,700 crore. Furthermore, to provide farmers loans at a reasonable rate, the Government has decided to ensure that the farmer receives short-term credit at 7 per cent on loans up to Rs.3 lakh on the principal amount with effect from *Kharif* 2006-07. The Budget has proposed to provide budgetary subventions for this purpose.

I.1.8 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.1.9 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.1.10 *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.1.11 In order to meet the rising requirements for creation of rural infrastructure, the Union Budget for 2006-07 proposed to increase the corpus of Rural Infrastructure Development Fund (RIDF) XII to Rs.10,000 crore. It also proposed to allow specified projects under the PPP model to access RIDF funds. As rural roads component of *Bharat Nirman* requires large funds, it has been decided to open a separate window under RIDF XII for rural roads with a corpus of Rs.4,000 crore during 2006-07.

I.1.12 In order to provide further fillip to micro finance programme, the Union Budget 2006-07 announced various measures. These include: introduction of a Bill to provide a formal statutory framework for the promotion, development and regulation of the micro finance sector; advising the banking sector to credit-link another 3,85,000 self-help groups (SHGs) in 2006-07 over and above 2 million SHGs credit-linked as at end-March 2006; and advising NABARD to open a separate line of credit for financing farm production and investment activities through SHGs.

I.1.13 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.

I.1.14 With a view to giving a fillip to the food processing industry, the Union Budget 2006-07 announced fiscal incentives, *viz.*, reduction of duty on packaging machines from 15 per cent to 5 per cent; complete exemption from excise duty on condensed milk, ice cream, preparations of meat, fish and poultry, pasta and yeast; and reduction of excise duty on ready-to-eat packaged foods and instant food mixes from 16 per cent to 8 per cent. These measures are expected to give a boost to the agriculture sector.

Manufacturing and Infrastructure

I.1.15 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.1.16 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.1.17 The Government approved the constitution of National Investment Fund (NIF) in 2005. Under the arrangements, the proceeds from disinvestment of central public sector enterprises are to be channelised into NIF, which is to be maintained outside the Consolidated Fund of India. NIF is to be professionally managed to provide sustainable returns to the Government, without depleting the corpus. Public sector mutual funds are to be entrusted with the management of the corpus of NIF. The income from NIF is to be used for financing specific schemes for investment in social sector projects and for capital investment in selected profitable and revivable central public sector enterprises that yield adequate returns.

I.1.18 In compliance with the Electricity Act 2003, the Government of India notified the Tariff Policy in January 2006 with the objectives of (i) ensuring availability of electricity to consumers at reasonable and competitive rates; (ii) ensuring financial viability of the sector and attract investments; and (iii) promoting transparency, consistency and predictability in regulatory approaches across jurisdictions and minimise perceptions of regulatory risks.

I.1.19 In order to make the Indian steel industry globally competitive, the National Steel Policy was approved in November 2005. The Policy envisages that India should have a modern and efficient steel industry of world standards, catering to diversified steel demand. This will require indigenous production of over 100 million tonnes per annum by 2019-20 from the level of 38 million tonnes per annum in 2004-05.

I.1.20 The Scheme for Integrated Textile Parks (SITP) was launched in October 2005 with the intention of creating 25 textile parks. About 7 parks have been sanctioned and 10 parks have been identified for development.

I.1.21 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.

I.1.22 All States have signed memoranda of understanding to implement the Rajiv Gandhi *Grameen Vidyutikaran Yojana*. Under this scheme, 10,000 villages were to be electrified during 2005-06

and 40,000 more villages are to be electrified in 2006-07. The key to the success of this programme is the engagement of franchisees and proper commercial and contractual arrangements for distribution, billing and collection.

I.1.23 The investment limit in plant and machinery has been increased to Rs. five crore from Rs. one crore in respect of 61 items in the drugs and pharmaceutical sector reserved for exclusive manufacturing by the Small Scale Industries (SSIs) sector. Continuing the policy of gradual dereservation of items reserved for exclusive manufacturing by the SSI sector, the Ministry of Small Scale Industries dereserved another 108 items in March 2005. Consequent upon the announcement made in the Union Budget 2006-07, further 180 items were dereserved in May 2006. This has reduced the number of items reserved for exclusive manufacturing by the SSI sector to 326.

I.1.24 On a review of the foreign direct investment (FDI) policy in February 2006, the Government of India decided to allow FDI up to 100 per cent under the automatic route for distillation and brewing of potable alcohol; manufacture of industrial explosives; manufacture of hazardous chemicals; setting up of greenfield airport projects; laying of natural gas/LNG pipelines, market study and formulation and investment financing in the petroleum and natural gas sector; and cash and carry wholesale trading and export trading. Furthermore, the FDI caps were raised to 100 per cent under the automatic route for coal and lignite mining for captive consumption. The Government also allowed FDI up to 100 per cent under the automatic route in power trading, subject to compliance with regulations under the Electricity Act, 2003.

I.1.25 In the Union Budget 2006-07, the customs duty structure was reduced/rationalised for many industrial commodities. The duty on naptha for plastics has been reduced to nil. The duty on ores and concentrates, 10 anti-AIDS and 14 anti-cancer drugs was reduced to 2 per cent. The duty on mineral products, cyclic and acyclic hydrocarbons and their derivatives, major bulk plastics like PVC, LDPE and PP, certain life saving drugs, kits and equipment, and packaging machines was reduced to 5 per cent. The duty on alloy steel, non-ferrous metals, catalysts and refractories was reduced to 7.5 per cent. Duty on basic inorganic chemicals, all man-made fibres and yarns, and raw materials such as DMT, PTA and MEG was reduced to 10 per cent. Similarly, the excise duty on all man-made fibre yarn, filament yarn, aerated drinks, small cars and footwear was reduced.

FISCAL POLICY

I.1.26 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.

I.1.27 The tax reforms in 2005-06 were mainly centred on improving the tax to GDP ratio, expanding the tax base, increasing tax compliance and making tax administration more efficient. There was a major overhaul of direct tax rates with the exemption limit for income tax rates raised to Rs. one lakh, reduction in the effective income tax rates through scaling up of tax brackets and the removal of sectoral caps in tax savings to allow for a consolidated limit of Rs. one lakh. The corporation tax rate was reduced to 30 per cent from 35 per cent. With the aim of bringing the perquisites (excluding transport and canteen services) that are enjoyed collectively by employees (which cannot be collected individually under the tax net), a Fringe Benefit Tax (FBT) was introduced with a rate of 30 per cent on an appropriately defined base. In order to check tax evasion, tax on cash withdrawal (on a single day) of Rs.25,000 and above in case of individuals and Rs.one lakh and above for corporates from accounts other than savings accounts was introduced. In the case of indirect taxes, the peak customs rate on non-agricultural imports was reduced to 15 per cent from 20 per cent with a few exceptions. With the aim of increasing the Central Value Added Tax (CENVAT) coverage, three more items were brought under the CENVAT excise duty rate of 16 per cent. In the case of service tax, the existing tax rate of 10 per cent was retained while

the base was expanded by bringing nine additional items under the tax net.

Union Budget, 2006-07

I.1.28 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.

I.1.29 The Union Budget 2006-07 kept the rates of income and corporation taxes unchanged and no new taxes were introduced. The tax base was, however, widened by removing some exemptions. In a bid to narrow the differential of the minimum alternate tax (MAT) with corporation tax rate, the MAT rate was increased from 7.5 per cent of book profit to 10 per cent. The rate of securities transaction tax (STT) was raised by 25 per cent across the board on account of the increase in implicit capital gains in securities transactions. The FBT was rationalised by exempting expenditures on free sample of medicines and medical equipment for doctors, expenses on brand ambassador and celebrity endorsement, free or subsidised transport and allowances for the employees to their place of work and back, and employer contributions up to Rs. one lakh per annum per employee to an approved superannuation fund. Furthermore, valuation of benefits with respect to 'tour and travel' and 'hospitality, hotel boarding and lodging' provided by airline and shipping industry was reduced from 20 per cent to 5 per cent for application of the FBT. The 'one-by-six' scheme, which had mandated the filing of income tax returns if the person falls under any one of the expenditure/asset criteria even if his/ her total income was below the threshold limit, has been abolished from April 2006. Expressing concerns over build up of tax and non-tax arrears, the Union Budget 2006-07 introduced statements on tax revenue raised but not realised and arrears on non-tax revenues. In order to provide information on revenue forgone on account of various tax exemptions, the Budget also provided statements on tax expenditures under various taxes.

I.1.30 In line with the objective of bringing customs duty to the level of East Asian countries, the peak rate on non-agricultural products was reduced from 15 per cent to 12.5 per cent. In order to make the input tariff rates lower than output tariff rates, customs duties on capital goods and raw materials were reduced to ensure that inputs are available at competitive rates to domestic manufacturers. In pursuance of the Government's objective of converging the excise duty rates to the CENVAT rate of 16 per cent, the rate on aerated drinks and small car was reduced from 24 per cent to 16 per cent. An excise duty of 12 per cent on computers was reintroduced to enable domestic manufacturers to take CENVAT credit as well as to face competition from imports.

I.1.31 In recent years, the Government has taken a number of measures to widen the service tax net to include greater number of services in line with the rising share of services in GDP. With a view to carrying forward this process, the service tax rate was increased from 10 per cent to 12 per cent, thereby moving further towards the CENVAT rate. The base of service tax was also widened by including 15 new services under the tax net including certain financial services (Box I.1). Furthermore, the Union Budget underlined the need to move towards a national level Goods and Services Tax (GST) and set April 1, 2010 as the date for introducing GST.

I.1.32 The expenditure policy, in the backdrop of the efforts underway at fiscal consolidation, is to curtail non-development expenditure while providing adequate funds for social and infrastructural sectors. The Union Budget 2006-07 sought to increase expenditure on social sectors, primarily on rural health care and education by means of the *National Rural Health Mission*, *Sarva Shiksha Abhiyan* and *Mid-day Meal Scheme*. The *National Rural Health Mission* seeks to address the gaps in providing effective health care in rural areas with special focus on 18 States. The programme is a shift away from vertical health and family welfare programmes to a new architecture of all inclusive health development which merges societies under different programmes and pools resources at the district level. The *Sarva Shiksha Abhiyan* aims to provide universal elementary education and bridge all social, gender and regional gaps with the active participation of the community in the management of schools. The *Mid-day Meal Scheme* compliments these efforts by helping to increase school attendance and improve the children's nutritional status through micro nutrient supplementation. In order to augment the infrastructure, additional funds for *Bharat Nirman* for

Box I.1
Taxation of Financial Services

Financial institutions provide a host of services such as asset management, investment advice and insurance products in addition to discharging their primary function of intermediating between depositors and lenders. Some of these services may be bundled with the intermediation services, while others may be rendered for explicit fees. Differing views exist as to whether these financial services should be taxed. Taxation of financial services under a consumption tax is opposed on the ground that financial services by themselves are not an object of final utility to consumers but merely a form of intermediate transaction. A contrary view, however, is that the issue is not whether financial services appear in the utility function of the consumer, but on how they enter into the pattern of observable net trades. In such a context, as a matter of principle, financial services charged through a fixed fee should be taxed while the implicitly priced financial services charged through a spread should not be taxed. In practice, implicit fee based financial services are difficult to observe and apportion for the purpose of taxation.

Cross-country experience shows that countries which have a value added tax (VAT) system for taxation on consumption of goods and services, in general, exempt financial services from taxation due to the lack of an explicit measure of consideration. Most countries in the European Union (EU) exempt core financial services that relate to lending, bank accounts, insurance and dealings in money, share and bonds from taxation, but tax explicit fee-based secondary services such as financial advisory services and safe deposit lockers. South Africa imposes taxes on almost all explicit fee-based financial services, including non-life insurance, although exported services are zero rated. In Singapore, all core financial services supplied domestically are exempted from service tax but all agency services are taxable. Financial institutions can claim input tax credit for exempted services which are used as business inputs so as to reduce the cascading effect. Australia follows the EU approach but provides input tax relief with a view to limit vertical integration of services. Argentina imposes VAT on gross interest on loans in order to curtail inflation by restricting consumer demand. Israel taxes the full value of financial services on the basis of addition method and does not allow for input tax credit.

In India, while service tax was introduced in 1994-95, financial services were brought within the ambit of service tax in July 2001, with the inclusion of banking and other financial services. Progressively, the service tax net has been widened to include the insurance sector, corporate bodies and other concerns providing services similar to financial intermediaries, and brokers, including sub-brokers dealing in stocks and foreign exchange. Transactions which are subject to service tax include, *inter alia*, lending, operation of bank accounts, issue of negotiable instruments, provision of bank guarantee, overdraft facility and safe deposit lockers/vaults. Interest amount is, however, excluded from the purview of service tax. The Union Budget 2006-07 imposed service tax on financial services like ATM operations, share transfer agents and bankers to an issue among others and widened the coverage of certain existing financial services. At present, services are not under the VAT system in India. However, with the operationalisation of the integrated VAT based goods and services tax, the issues emerging from international experience on VAT-based financial services taxation would become relevant.

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infrastructure development in rural areas and *Jawaharlal Nehru National Urban Renewal Mission* for urban areas have been allocated. The *Bharat Nirman* programme seeks to impart a sense of urgency to the goals set for building rural infrastructure by making it time bound, transparent and accountable. The *Jawaharlal Nehru National Urban Renewal Mission* envisages providing focussed attention on integrated development of infrastructural services in 63 selected cities so as to secure effective linkages between asset creation and asset management to ensure adequate investment of funds, to scale up delivery of civic amenities and to encourage planned development of cities.

I.1.33 The Government reiterated its commitment to target subsidies effectively at the poor and the truly needy and sought to evolve a consensus on the issue. In a bid to delegate greater authority to administrative ministries in managing their financial affairs, a revised and updated “General Financial Rules” has been implemented. To avoid rush of expenditure and promote a sound cash management system, a quarterly exchequer control based expenditure

management system which releases funds in a time-sliced manner is being implemented in respect of 14 demands from grants. The Ministry of Finance presented its Outcome Budget for 2006-07 in March 2006. This sets out the outlays, quantifiable outputs, projected outcome, time line and the risk factors associated with the Plan schemes and select non-Plan schemes under the four departments in the Ministry. The other Ministries/Departments would individually present their own Outcome Budgets for 2006-07.

State Governments

I.1.34 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.1.35 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.1.36 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.1.37 In order to promote exports of rural and agro products and to bring the benefits of foreign trade to rural areas, the *Vishesh Krishi Upaj Yojana,* renamed as *Vishesh Krishi Upaj aur Gram Udyog Yojana*, has been expanded to include village industries-based products. The products under this Scheme are entitled for duty free credit scrip equivalent to 5 per cent of free on board (fob) value of exports. Furthermore, in the sphere of services, the ‘Served from India Scheme’, which was introduced to encourage exports of services, was extended to allow transfer of both scrip and the imported input to the Group Service Company, whereas earlier only transfer of imported material was allowed. The Annual Supplement has also introduced various measures to promote India as a hub of auto components, gems and jewellery and to tap the business opportunity in supplies of stores (food, beverages and other supplies) and refuelling of long distance flights.

I.1.38 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,

Box I.2

Special Economic Zones Act, 2005

The SEZ Act 2005 provides several incentives to reduce transaction costs and improve the competitiveness of exports. The simplification of procedures and tax breaks as envisaged by the Act are expected to attract investments of about Rs.1,00,000 crore and help create 500,000 jobs. For streamlining regulations pertaining to the SEZs, the new guidelines have brought into effect a uniform set of regulations for setting up units with single window clearance with matters relating to State as well as Central governments. Developers are allowed to set up sector specific and multi-product SEZs. The Act provides for a minimum area requirement of 1000 hectares for multi-product and 100 hectares for service sector SEZs. Exemptions to the area requirement are allowed to support sectors where India has a comparative advantage, such as gems and jewellery, information technology and bio-technology. For these sectors, the minimum area requirement is stipulated at 10 hectares. The Act provides for: (i) simplification of procedures for development, operation, and maintenance of SEZs and for setting up and conducting business in SEZs; (ii) single window clearance for setting up a unit in SEZs; (iii) simplified compliance procedures and documentation with an emphasis on self certification; (iv) dispensing the requirement for bank guarantees to reduce transaction costs; and (v) allowing contract manufacturing for foreign principals and option to obtain sub-contracting permission at the initial approval stage.

The SEZ Act 2005 also incorporates fiscal incentives for exporters in order to provide stability of policy regime to SEZ units. The Act, *inter alia*, provides for: (i) full income tax exemption to SEZ units for the first five consecutive years, and 50 per cent exemption for further five years; and, (ii) exemption of SEZ units and developers from payment of customs duty on all imported inputs and excise duty on products sourced from domestic market.

The SEZs are envisaged to act as catalysts for growth. The simplification of the procedures for development, operation and maintenance of the SEZs and the fiscal incentives are expected to spur investment and promote industrial activity. At the same time, there are concerns that the SEZs could aggravate the uneven pattern of development by pulling out resources from less developed areas. Revenue implications of taxation benefits would also need to be factored. The revenue loss for the Government in providing incentives may be justified only if the SEZ units ensure forward and backward linkages with the domestic economy.

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 (Box I.2).

Foreign Exchange Transactions[1]

I.1.39 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.

I.1.40 Foreign direct investment (FDI) in petroleum sector, air transport services (domestic airlines) sector, print media sector, construction development sector was further liberalised. Persons/entities eligible under the FDI route were permitted to invest in the equity capital of Asset Reconstruction Companies (ARCs) registered with the Reserve Bank of India. Foreign Institutional Investors (FIIs) were permitted to invest up to 49 per cent in security receipts issued by ARCs under the Government approval route. The ECB policy was further liberalised, *inter alia*, to permit Authorised Dealer banks to allow prepayment of ECBs up to US $ 200 million against the existing limit of US $ 100 million. Non-banking financial companies (NBFCs) satisfying certain criteria were allowed to raise ECBs under approval route. Domestic rupee denominated structured obligations credit enhanced by international banks/international financial institutions/joint venture partners, which earlier required approval of Government of India, would be considered by the Reserve Bank under the approval route.

I.1.41 In regard to current account transactions, procedures were further simplified in order to improve customer services. In view of the increased concerns

[1] A detailed discussion of foreign exchange management is presented in Chapter IV (“Development and Regulation of Financial Markets”) of the Report.

regarding money laundering activities and to prevent Authorised Money Changers (AMCs) from being misused for such activities, the Reserve Bank has brought out detailed Anti-Money Laundering (AML) guidelines to enable AMCs to put in place the policy framework and systems for prevention of money laundering while undertaking money exchange transactions.

MONETARY POLICY FRAMEWORK[1]

I.1.42 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. Against this backdrop, barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the inflationary situation, the overall stance of monetary policy for the year 2005-06 was stated as follows:

- Provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability.
- Consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth.
- To consider measures in a calibrated manner in response to evolving circumstances with a view to stabilising inflationary expectations.

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.1.43 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.1.44 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.1.45 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.1.46 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

[1] A detailed discussion of monetary management is presented in Chapter III (“Monetary and Credit Policy Operations”) of the Report.

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. The overall stance of monetary policy was stated as: 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; 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 respond swiftly to evolving global developments. On a review of macroeconomic developments and overall monetary conditions, the Reserve Bank increased the reverse repo rate and the repo rate by 25 basis points each to 5.75 per cent and 6.75 per cent, respectively, effective June 9, 2006.

I.1.47 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.1.48 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[1]

I.1.49 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.

I.1.50 In order to facilitate a macro level assessment of large non-deposit taking NBFCs at more frequent intervals, the periodicity of the returns was changed from quarterly to monthly. The reporting format has been amended to incorporate additional information relating to capital market exposure. In the case of urban cooperative banks (UCBs), memoranda of understanding (MoU) were signed between the Reserve Bank and five State Governments, *viz*., Andhra Pradesh, Gujarat, Karnataka, Madhya Pradesh and Uttaranchal to sort out issues relating to regulation and supervision.

Polices for Financial Markets

I.1.51 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

[1] A detailed discussion of financial market and financial sector policies is presented in Chapter IV (“Development and Regulation of Financial Markets”) and Chapter V (“Financial Regulation and Supervision”).

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.

I.1.52 During 2005-06, policy initiatives in the capital market were directed towards further broadening and deepening of the capital market. In order to make Indian primary market more efficient and transparent, Securities and Exchange Board of India (SEBI) amended the SEBI (Disclosure and Investor Protection) {DIP} Guidelines, 2000 with reference to rationalisation of disclosure requirements for listed companies, disclosure of issue price, further issue of shares and lock-in provisions. SEBI also decided to fix five per cent specific allocation for mutual funds within the Qualified Institutional Buyer (QIB) category in book built issues and extended the existing provisions of the proportionate allotment as applicable for retail individual investors and non-institutional investors to the QIB category. SEBI prescribed a margin of 10 per cent for QIBs for applying in book built issues. In order to provide an additional route for raising funds in the domestic market, SEBI permitted listed companies to raise funds in the form of 'Qualified Institutional Placement' (QIP). The aggregate funds that can be raised through QIP route in a financial year should not exceed five times the net worth of the issuer at the end of previous financial year and there should be a gap of at least six months between each placement. The minimum number of allottees for each placement can not be less than two in case of issue size of up to Rs.250 crore and not less than five in case of issue size of more than Rs.250 crore. SEBI amended the SEBI (DIP) Guidelines to permit unlisted companies to opt for grading of IPO from credit rating agencies and to ensure disclosure of all grades obtained by it, including unaccepted grades. Furthermore, to enable foreign companies to raise capital from India and to give an opportunity to the domestic investors to invest in the equity of reputed foreign firms, SEBI introduced guidelines for issue of India Depository Receipts (IDRs). IDR is an instrument in the form of a depository receipt against the underlying equity of the issuing company (a foreign company, in this case). QIBs can make investments in IDRs. However, NRIs/FIIs can not purchase IDRs and automatic fungibility of IDRs is not permitted.

I.1.53 In order to ensure availability of floating stock on a continuous basis and to bring about greater transparency in respect of disclosure of shareholding pattern of companies, SEBI amended the Clause 40A and 35 of equity listing agreement and decided that all listed companies are required to ensure a minimum level of public share holding at 25 per cent of the total number of issued shares. In order to facilitate execution of large trades, SEBI changed the definition of block deals on the stock exchanges, while permitting the stock exchanges to provide a separate trading window. A trade with a minimum quantity of 5,00,000 shares or minimum value of Rs.5 crore executed through a single transaction on this window will constitute a "block deal" as distinguished from "bulk deal" defined earlier.

I.1.54 SEBI permitted the mutual funds to participate in the derivatives market at par with FIIs in respect of position limits in index futures, index options, stock options and stock futures contracts. SEBI amended the SEBI (Mutual Funds) Regulations, 1996 to introduce gold exchange traded funds, thereby permitting mutual funds to invest in gold and gold related instruments.

I.1.55 The Union Budget 2006-07 laid strong emphasis on strengthening the Indian capital market. With a view to developing the debt market, FII investment limit in the Government securities was increased from US $ 1.75 billion to US $ 2 billion. FII investment limit in corporate debt was also increased from US $ 0.5 billion to US $1.5 billion. Ceiling on aggregate investment by mutual funds in overseas instruments was raised from US $ 1 billion to US $ 2 billion and the requirement of 10 per cent reciprocal share holding was removed.

Legal Framework

I.1.56 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. The Act regulates credit information companies to facilitate efficient distribution of credit. A Working Group was constituted to provide draft of the Rules and Regulations for the purpose of implementation of the provisions of the Act, which is in progress. After the Act comes into force, it would be permissible for credit information companies to collect credit information from banks/FIs and to disseminate same in accordance with the Act.

I.1.57 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.1.58 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. The Bill includes provisions for (i) removing the restriction on voting rights and introducing the requirement of prior approval of the Reserve Bank for acquisition of shares or voting rights above the specified limit (empowering the Reserve Bank to satisfy itself that the applicant is a ‘fit and proper person’ to acquire shares or voting rights and to impose such further conditions that the Reserve Bank may deem fit to impose); (ii) removing the lower limit (floor) of statutory liquidity ratio (SLR) and empowering the Reserve Bank to specify the SLR subject to a maximum of forty per cent of the total demand and time liabilities; (iii) amending the definition of approved securities in Section 5(a) of the Act to empower the Reserve Bank to specify from time to time any security, in addition to securities issued by the Central or State Government, as ‘approved securities’; (iv) amendment of Section 12 of the Act to enable banking companies to issue preference shares subject to regulatory guidelines framed by the Reserve Bank; (v) empowering the Reserve Bank to direct a banking company to disclose in its financial statement or furnish to the Reserve Bank separately such statements and information relating to the business of any associate enterprise as the Reserve Bank considers necessary and also to cause an inspection to be made of any associate enterprise; (vi) empowering the Reserve Bank to supersede the board of directors of a banking company and appoint an administrator; (vii) amendment of Section 56 of the Act to remove the provision facilitating primary credit societies to carry on the business of banking without obtaining a licence from the Reserve Bank; and, (viii) empowering the Reserve Bank to order special audit of a cooperative bank in public interest or in the interest of the cooperative bank or its depositors.

I.1.59 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. The Bill, *inter alia*, contains provisions to: (a) elect one to three shareholder directors to the board of the nationalised banks on the basis of issued capital of the bank instead of one to six directors under the existing provisions; (b) omit the provisions relating to mandatory nomination of directors by the Reserve Bank and financial institutions on the board of nationalised banks; (c) confer power upon the Reserve Bank to appoint one or more additional directors; (d) empower the shareholders of nationalised banks to discuss, adopt and approve the Directors’ report, the profit and loss accounts and balance sheet of the bank at the annual general meeting; (e) enable the banks to transfer the unclaimed dividends for more than seven years to Investor Education and Protection Fund established under section 205 C of the Companies Act, 1956; and (f) empower the Central Government to supersede, on the recommendation of the Reserve Bank, the board of directors of any nationalised bank. Subsequently, the Reserve Bank had suggested the following modifications to the Amendment Bill: (a) enabling nationalised banks to issue preference

shares in accordance with guidelines framed by the Reserve Bank and to raise capital by preferential allotment or private placement or public issue with the approval of the Reserve Bank and Central Government; (b) restricting the voting rights of preference shareholders to resolutions directly affecting their rights and up to a maximum of one per cent of the total voting rights of all the shareholders holding preference share capital only; (c) providing that the elected directors should be persons of 'fit and proper' status; and, (d) supersession of board by Central Government on the recommendation of the Reserve Bank and appointment of Administrator and a Committee to assist the Administrator. These suggestions of the Reserve Bank are under consideration of the Central Government.

I.1.60 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. The Bill proposes, *inter alia*, (a) to include securitisation certificate or instrument under the definition of 'securities' and to insert for the said purpose a new sub-clause (ie) in clause (h) of Section 2 of the SCR Act, 1956; and (b) to provide for obtaining approval from the SEBI for issue of securitisation certificate or instrument and procedure thereof and insert for the purpose a new Section 17 A in the SCR Act, 1956.

I.1.61 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. The Bill provides for (i) empowering the Reserve Bank to prescribe the form for transferring Government securities; (ii) holding of Government promissory notes by Trusts; (iii) simple procedure for recognising title to Government securities up to Rs. one lakh with enabling power to the Central Government to enhance the said limit up to Rs. one crore; (iv) micro films, facsimile copies of documents, magnetic tapes and computer printouts to be admissible as evidence; and (v) suspension of the holders of subsidiary general ledger account from trading with the facility of that account in the event of misuse. Other salient features of the Bill include enabling creation of pledge, hypothecation or lien in respect of Government securities; and, empowering the Reserve Bank to call for information, cause inspection and issue directions as well as make regulations with the previous approval of the Central Government for carrying out the purposes of the Bill.

I.1.62 The Central Government has introduced the State Bank of India (Subsidiary Banks Laws) Amendment Bill, 2006 in the *Lok Sabha* to amend the laws governing subsidiary banks to enhance the capital of the subsidiary banks, to enable them to raise resources from the market and to provide flexibility in the management of these banks.

I.1.63 The Payments and Settlements Bill, 2006 has been introduced in the *Lok Sabha* on July 25, 2006. The Bill seeks to designate the Reserve Bank as the authority to regulate Payment and Settlement Systems. The Bill contains provisions for (i) compulsory requirement of an authorisation by the Reserve Bank to operate payment systems; (ii) empowering the Reserve Bank to regulate and supervise the payment systems by determining standards, and calling for information, returns, documents, *etc.*; (iii) empowering the Reserve Bank to audit and inspect by entering the premises where payment systems are being operated; (iv) empowering the Reserve Bank to issue directions; and, (v) providing for settlement and netting to be final and irrevocable at the determination of the amount of money, securities or foreign exchange payable by participants.

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 (Table 1.1 and Appendix Table 4). 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 (Box I.3). 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 (Table 1.1 and Appendix Table 4). 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 During the year 2005, although the onset of South-West monsoon was delayed by a week, it covered the entire country almost two weeks ahead of its normal schedule. The cumulative area-weighted rainfall during the 2005 South-West monsoon (June 1 to September 30) turned out to be 99 per cent of the Long Period Average (LPA), closer to the prediction of a near normal monsoon (98 per cent) by the India Meteorological Department (IMD). The performance of South-West monsoon in 2005 was better compared to the previous year when the country had recorded 13 per cent below normal rainfall. Although the progress of the monsoon was not well-distributed in time with deficiency during the first three weeks of June, whole of August and the first week of September, it was offset by a perceptible improvement in the last week of June, most of July and in the second and third weeks of September 2005. The cumulative rainfall was evenly distributed with 32 out of 36 meteorological sub-divisions recording excess/normal rainfall and only 4 receiving deficient/scanty rainfall (Chart I.1). Only one sub-division, *viz.*, Jharkhand recorded moderate drought conditions. Among the four homogeneous regions, Central India, North-West India and South Peninsula received 110 per cent, 90 per cent and 112 per cent of normal rainfall, respectively; the rainfall was deficient by 20 per cent over North-East India. Out of the 525 meteorological districts, only 17 districts

Table 1.1: Growth Rates of Real GDP (at 1999-2000 prices)

(per cent)

Sector	2000-01 to 2002-03 (Average)	2003-04@	2004-05 *	2005-06 #	2005-06			
					Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9
1. Agriculture and Allied Activities	**-0.2**	**10.0**	**0.7**	**3.9**	**3.4**	**4.0**	**2.9**	**5.5**
	(23.5)	**(22.2)**	**(20.8)**	**(19.9)**				
1.1 Agriculture	-0.5	10.7	0.7	n.a.				
2. Industry	**5.2**	**6.6**	**7.4**	**7.6**	**9.5**	**6.3**	**7.0**	**7.9**
	(19.7)	**(19.5)**	**(19.5)**	**(19.3)**				
2.1 Mining and Quarrying	4.4	5.3	5.8	0.9	3.1	-2.6	0.0	3.0
2.2 Manufacturing	5.7	7.1	8.1	9.0	10.7	8.1	8.3	8.9
2.3 Electricity, Gas and Water Supply	2.8	4.8	4.3	5.3	7.4	2.6	5.0	6.1
3. Services	**6.6**	**8.5**	**10.2**	**10.3**	**10.1**	**10.3**	**9.7**	**11.0**
	(56.8)	**(58.3)**	**(59.7)**	**(60.7)**				
3.1 Trade, Hotels, Transport, Storage and Communication	8.5	12.0	10.6	11.5	11.7	11.0	10.2	12.9
3.2 Financing, Insurance, Real Estate and Business Services	6.5	4.5	9.2	9.7	8.8	10.5	8.9	10.5
3.3 Community, Social and Personal Services	4.1	5.4	9.2	7.8	7.3	8.0	8.4	7.6
3.4 Construction	5.9	10.9	12.5	12.1	12.4	12.3	11.5	12.0
4. Real GDP at Factor Cost	**4.6**	**8.5**	**7.5**	**8.4**	**8.5**	**8.4**	**7.5**	**9.3**

@ : Provisional Estimates. * : Quick Estimates. # : Revised Estimates. n.a. : Not Available.

Note : 1. Figures in parentheses denote percentage shares in real GDP.
2. Q1: First Quarter (April-June); Q2: Second Quarter (July-September); Q3: Third Quarter (October-December); and Q4: Fourth Quarter (January-March).

Source : Central Statistical Organisation.

Box I.3
Potential Output

Achievement of growth of above eight per cent per annum during the past three years (*i.e.*, 2003-04 to 2005-06) has raised optimism about future growth prospects of the economy. In the context of this acceleration in real GDP growth, an issue of debate is: whether the current acceleration in real GDP growth reflects a cyclical upturn after the slowdown of the late 1990s or is it a manifestation of an increase in the potential growth rate? For instance, according to Acharya (2006), an average real GDP growth of eight per cent for the next five years may not be sustainable in view of infirmities of economic policies emanating from infrastructure constraints, rising real interest rates, underutilisation of manpower resources due to labour laws, deceleration in agricultural growth, and inadequate policy response to rising oil prices; on the basis of this assessment, he suggests an average growth of 6.5 per cent is more likely for 2006-2011. Against this backdrop, estimates of India's potential output growth assume importance.

Potential output is an estimate of the level of real GDP attainable when the economy is making full use of its resources. It is, however, not a technical ceiling on output. Rather, it is a measure of maximum sustainable output, consistent with a low and stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures can start building; on the other hand, if output falls below potential, then resources may be lying idle.

While conceptually it is easy to define potential output, its measurement raises a number of issues. The methods available for estimating potential output can be grouped into two approaches: the "production function" approach and the "statistical" approach. The first approach relates output to the level of technology and factor inputs, usually labour and capital. Potential output would be the output if both labour and capital are fully utilised in an efficient manner. The approach requires the need to measure quantity and, especially quality, of inputs since the physical quantity of inputs does not fully capture the dynamics of output. Reliable data on the inputs – labour and capital – are not relatively easily available, especially for emerging economies. The approach also requires assumption about the mathematical form of the production function. For simplicity, typically, constant returns to scale production function (Cobb-Douglas specification) is assumed, but this specification need not be appropriate. Thus, the practical implementation of the production function approach involves a number of complex issues. In view of these problems, statistical approaches have become quite popular. A widely used approach in this context is the 'Hodrick-Prescott' filter which decomposes the actual real GDP into two components – a trend and a cyclical component – and potential output is proxied by the trend component. While being simple, this approach also has a number of drawbacks such as sensitivity to the sample period and the choice of the smoothing parameter. As this approach essentially smoothens the actual output series, it may not be able to capture any incipient trends in the growth process. Estimates of potential output are, thus, subject to a considerable degree of uncertainty and researchers, therefore, use a variety of techniques to estimate potential output.

As regards India, existing studies place estimates of potential output growth in a wide range of 6-9 per cent, reflecting differing time periods of study and different approaches. Donde and Saggar (1999) estimated the potential output growth to be 6.3 per cent using univariate approach. Dhal (1999) using dynamic input-output framework placed the potential growth at 6.5 per cent while a potential growth rate of 8-10 per cent was estimated based on the production function approach. Rodrik and Subramanian (2004) used growth accounting framework and placed India's potential output growth over the next two decades at close to seven per cent, with more upside potential.

The domestic savings rate has improved from 23.6 per cent in 2001-02 to 29.1 per cent in 2004-05. Concomitantly, with modest recourse to foreign savings, the domestic investment rate has increased from 23.0 per cent to 30.1 per cent over the same period. The improvement in domestic savings and investment rates in recent years augurs well for future growth prospects. Three issues, namely, the physical infrastructure, fiscal deficit, and agriculture are critical for maintaining the momentum of growth with stability (Reddy, 2006). In this context, as the draft approach document to the 11th Plan observes, the baseline growth rate, *i.e.*, the growth likely to be achieved without significant new policy initiatives, is around seven per cent per annum. With additional policy initiatives, as the draft approach document adds, it is possible to increase the average growth rate to somewhere between eight and nine per cent per annum.

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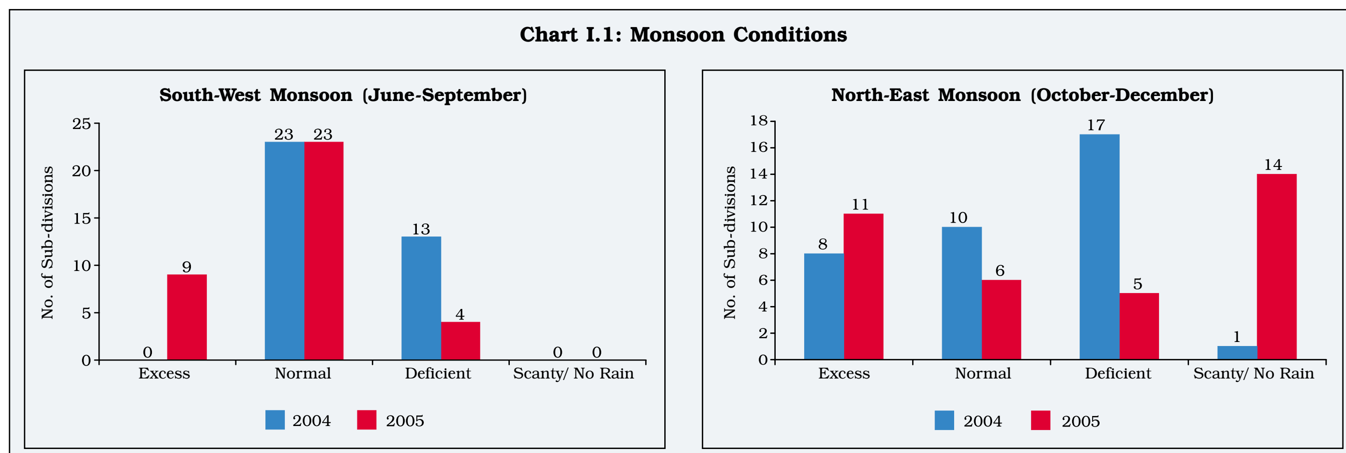

(3 per cent) experienced severe drought conditions at the end of the season. Out of the 168 meteorological districts, which faced drought conditions in 2004, as many as 113 districts received normal/excess rainfall in the 2005 monsoon season, while drought continued in 55 districts.

I.2.4 Following a near normal South-West monsoon during 2005, the overall performance of North-East monsoon also turned out to be better. The cumulative area weighted rainfall during the 2005 North-East monsoon season (October 1 to December 31) was 10 per cent above normal as against 11 per cent below normal during the previous year. However, the spatial distribution was uneven with 17 out of 36 meteorological sub-divisions receiving excess/normal rainfall and 19 sub-divisions receiving deficient/ scanty/no rain.

I.2.5 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. (Table 1.2 and Appendix Table 6).

I.2.6 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 (Box I.4).

Table 1.2: Agricultural Production

	Crop	2002-03	2003-04	2004-05	2005-06#
1		2	3	4	5
1	**Growth Rate (Per cent) $**				
	All Crops	**-13.2**	**16.1**	**-2.7**	**7.9**
	a. Foodgrains	-14.9	16.4	-7.2	4.4
	b. Non-foodgrains	-11.1	15.6	2.6	11.8
2	**Production (Million Tonnes)**				
	a. Foodgrains	**174.8**	**213.2**	**198.4**	**208.3**
	i. Rice	71.8	88.5	83.1	91.0
	ii. Wheat	65.8	72.2	68.6	69.5
	iii. Coarse Cereals	26.1	37.6	33.5	34.7
	iv. Pulses	11.1	14.9	13.1	13.1
	b. Non-foodgrains				
	i. Oilseeds++	14.8	25.2	24.4	27.7
	ii. Sugarcane	287.4	233.9	237.1	278.4
	iii. Cotton@	8.6	13.7	16.4	19.6
	iv. Jute and Mesta+	11.3	11.2	10.3	10.7
	v. Tea*	838.5	878.1	982.9	928.0
	vi. Coffee*	275.3	270.5	n.a.	n.a.

: Production based on Fourth Advance Estimates.
$: Growth rates are based on Index of Agricultural Production with base triennium ending 1993-94=100.
+ : Million bales of 180 kg. each
++ : For nine oilseeds out of eleven in all.
@ : Million bales of 170 kg. each.
* : Million kilograms; data for tea are on calendar year basis.
n.a. : Not Available.
Source : Ministry of Agriculture, Government of India.

Box I.4
Investment Trend in Agriculture

The Tenth Five Year Plan targeted real GDP growth in agricultural sector at four per cent per annum so as to reverse the deceleration in agricultural growth. The actual growth during the first four years of the Plan, however, averaged only two per cent per annum, reflecting, *inter alia*, decline in investment and the concomitant widening gaps in rural infrastructure. Investment in agriculture has declined from 2.2 per cent of GDP in 1999-00 to 1.7 per cent in 2004-05. Expenditure on various subsidies, namely, food, fertilisers, power and irrigation, is widely believed to have crowded out the resources for public investment in agriculture-related infrastructure. Inordinate delays in completing the projects on hand, relatively lower allocation for irrigation, and poor rural infrastructure and research, have held down agricultural investment in the economy. However, there is an indication of a reversal of the declining trend in public sector investment in agriculture in recent years. Private investment in agriculture, on the other hand, has continued to decline (Table).

Step-up in investment in agriculture is critical for higher as well as stable growth of the sector. As a response to inadequate private investment for agriculture, the Government, *inter alia*, established the Rural Infrastructure Development Fund (RIDF). Banks that fail to meet the required target of lending to priority sector/agriculture finance the Fund. With a view to addressing various issues and to suggest a road-map for banks to increase investment in agriculture, the Reserve Bank constituted an Expert Group on Investment Credit to Agriculture in 2005 (Chairman: Shri Y.S.P. Thorat). The Group's major recommendations included: i) State Governments to make legal provision/computerisation of land records, provide legal support for recovery, and introduce reforms in agricultural marketing; ii) improve credit absorption capacity by strengthening infrastructure and extension network and developing marketing links; iii) NABARD to design appropriate products for financing rural infrastructure; iv) banks to make efforts to reach the 'unreached' areas, and integrate short-term with term credit; and v) promote supplementary credit delivery channels, outsource monitoring services and provide loan support for diversified agriculture. The Government also launched an ambitious programme of doubling of credit flow to agriculture during the period 2004-05 to 2006-07. The improved availability of credit for agriculture and liberalised trade for agricultural products should enhance private investment in agriculture.

The Union Budget 2005-06 also stepped up public investment significantly for rural infrastructure development. The Union Budget 2006-07 identified assured irrigation, access to credit, diversification and creation of market for agricultural products as thrust areas and several initiatives were announced. Furthermore, following measures have been taken for agriculture development through enhanced capital formation such as: i) preparation of a road-map for agriculture diversification with a focus on horticulture, floriculture, animal husbandry and fisheries; ii) strengthening of agriculture marketing infrastructure; iii) national scheme for the repair, renovation and restoration of water bodies; iv) focus on micro irrigation, micro-insurance and rural credit; and v) setting up a national fund for strategic agriculture research. The recent improvement in State finances also augurs well for enhanced public investment in agriculture. While the increase in investment is important to improve production, the efficiency in the use of investment is also critical. The composition of investments and the quality of facilities created by them and the efficacy with which they are managed will also have an impact on agricultural production and incomes. Thus, apart from irrigation, investments in areas such as watershed development, rural road connectivity and rural electrification need to be stepped up. In this context, there is a need to revisit the issue of power subsidies to agriculture, since they are believed to be leading to overdrawal of ground water and lowering of water table in many areas.

Table: Gross Capital Formation in Agriculture

Year	Investment in Agriculture (Rupees crore)			Share in Agricultural Gross Investment (per cent)		Investment in Agriculture (per cent of GDP at constant prices)
	Total	Public	Private	Public	Private	
1	2	3	4	5	6	7
Old Series (at 1993-94 prices)						
1990-91	14,836	4,395	10,441	29.6	70.4	1.9
1995-96	15,690	4,849	10,841	30.9	69.1	1.6
1996-97	16,176	4,668	11,508	28.9	71.1	1.5
1997-98	15,942	3,979	11,963	25.0	75.0	1.4
1998-99	14,895	3,870	11,025	26.0	74.0	1.3
1999-00	17,304	4,221	13,083	24.4	75.6	1.4
New series (at 1999-00 prices)						
1999-00	43,473	7,754	35,719	17.8	82.2	2.2
2000-01	38,176	7,018	31,158	18.4	81.6	1.9
2001-02	46,744	8,529	38,215	18.2	81.8	2.2
2002-03	45,867	7,849	38,018	17.1	82.9	2.1
2003-04	47,833	12,809	35,024	26.8	73.2	2.0
2004-05 *	43,123	12,591	30,532	29.2	70.8	1.7

* : Quick Estimates
Source : Central Statistical Organisation.

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1. Government of India (2005), Economic Survey 2004-05.
2. Government of India (2003), Report of the Committee on Capital Formation in Agriculture.
3. Reserve Bank of India (2005), Report of the Expert Group on Investment Credit.
4. Government of India (2005), Mid-Term Appraisal of the Tenth Five Year Plan.

Allied Activities

I.2.7 India is endowed with diverse agro-ecological features that enable it to grow a variety of horticultural crops, rear different species of livestock and harvest wide range of fish species from various sources. From just about 10 per cent of the gross cropped area, the Indian horticulture sector contributed about 28 per cent to agricultural GDP during 2004-05. India was the second largest producer of fruits and vegetables in the world, with an estimated production of around 58 million tonnes and 99 million tonnes, respectively, during 2005-06. The share of fruits and vegetables output in GDP originating from agriculture and allied activities has increased sharply from 17.8 per cent during 1993-94 to 26.0 per cent during 2003-04.

I.2.8 Livestock sector plays an important role in value addition, providing employment and augmenting incomes, besides enhancing nutritional security of the people. With a production of 91 million tonnes during 2004-05, India was the world's largest producer of milk. During 2003-04, the output of milk was almost 22 per cent of GDP originating from agricultural and allied activities, exceeding that of output of paddy and wheat (15.4 per cent and 9.5 per cent, respectively). The share of livestock sector output in GDP originating from agriculture and allied activities increased from 30.9 per cent during 1993-94 to 32.4 per cent during 2003-04.

Food Management

I.2.9 The total stock of foodgrains with the Food Corporation of India (FCI) and the State agencies was 22.3 million tonnes as on June 1, 2006 (Table 1.3 and Appendix Table 7). The stocks were higher than the buffer stock norms (16.2 million tonnes as on April 1, 2006). The procurement of foodgrains (rice and wheat) at 15.0 million tonnes was lower by 21 per cent during 2006-07 (up to August 1, 2006). This was on account of procurement of wheat falling from 14.8 million tonnes to 9.2 million tonnes. During 2006-07, total off-take of rice and wheat (up to May 31, 2006) at 5.8 million tonnes was lower by 14.6 per cent than that a year ago (6.8 million tonnes).

Table 1.3: Management of Food Stocks

(Million tonnes)

	Opening Stock of Foodgrains			Procurement of Foodgrains			Foodgrains off-take				Closing Stock	Norms
	Rice	Wheat	Total	Rice	Wheat	Total	PDS	OWS	OMS - Domestic	Exports		
1	2	3	4	5	6	7	8	9	10	11	12	13
2005												
January	12.8	8.9	21.7	3.3	0.0	3.3	2.7	0.8	0.0	0.0	21.6	16.8
February	14.2	7.3	21.6	2.2	0.0	2.3	2.7	0.9	0.0	0.0	20.0	
March	13.7	5.8	20.0	1.7	0.0	1.7	2.7	1.7	0.0	0.0	18.0	
April	13.3	4.1	18.0	1.4	12.8	14.2	2.4	1.0	0.0	0.0	28.5	16.2
May	13.0	15.1	28.5	1.0	1.9	3.0	2.5	0.8	0.0	0.0	27.9	
June	11.6	15.7	27.9	0.8	0.1	0.9	2.5	1.7	0.0	0.0	25.1	
July	10.1	14.5	25.1	0.8	0.0	0.8	2.8	0.8	0.1	0.0	21.4	26.9
August	8.0	13.0	21.4	0.4	0.0	0.4	2.6	0.8	0.1	0.0	18.4	
September	6.4	11.6	18.4	0.4	0.0	0.4	2.7	0.7	0.1	0.0	15.5	
October	4.8	10.3	15.5	7.6	0.0	7.6	2.7	0.5	0.0	0.0	19.8	16.2
November	10.3	9.1	19.8	2.7	0.0	2.7	2.3	0.5	0.1	0.0	19.0	
December	11.1	7.6	19.0	3.4	0.0	3.4	2.7	0.7	0.2	0.0	19.3	
2006												
January	12.6	6.2	19.3	3.8	0.0	3.8	2.7	0.8	0.1	0.0	19.5	20.0
February	14.0	4.9	19.5	2.5	0.0	2.5	2.7	0.6	0.3	0.0	18.3	
March	14.1	3.5	18.3	1.9	0.0	1.9	2.6	0.9	0.2	0.0	16.6	
April	13.7	2.0	16.6	1.7	8.7	10.3	2.5	0.3	0.0	0.0	22.8	16.2
May	12.8	9.0	22.8	1.6	0.6	2.2	2.5	0.4	0.0	0.0	22.3	
June	12.0	9.3	22.3	1.5	0.0	1.5	n.a.	n.a.	n.a.	n.a.	n.a.	
July	n.a.	n.a.	n.a.	0.9	0.0	0.9	n.a.	n.a.	n.a.	n.a.	n.a.	26.9

PDS : Public Distribution System. OWS: Other Welfare Schemes. OMS: Open Market Sales. n.a. : Not Available.

Note : Closing stock figures may differ from those arrived at by adding the opening stocks and procurement and deducting offtake, as stocks include coarse grains.

Source : Ministry of Consumer Affairs, Food and Public Distribution, Government of India.

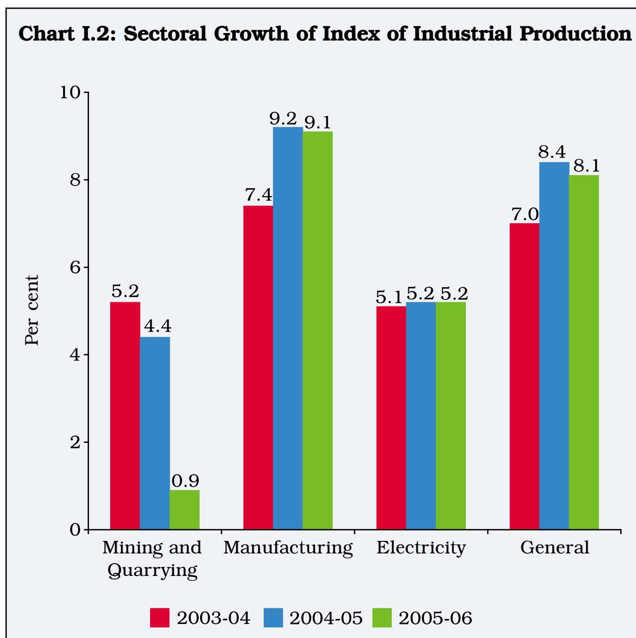
Industrial Performance

I.2.10 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 (see Table 1.1 and Appendix Table 4). 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.2.11 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 (Chart I.2 and Appendix Table 8). 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.2.12 At the two-digit manufacturing classification level, 13 out of 17 industry groups logged positive growth during the year. Industry-wise, manufacturing growth was led mainly by basic chemicals and chemical products, basic metal and alloy industries, machinery and transport equipment industries. Certain discernible changes can be observed in the sources of growth of the manufacturing sector during 2005-06 *vis-à-vis* the previous year. In 2004-05, nearly 60 per cent of the manufacturing sector growth was contributed by 'chemicals and chemical products' and 'machinery and equipments'. In 2005-06, the contribution of both these groups went down, while the contribution of 'basic metal and alloy' and 'transport equipments' increased (Appendix Tables 9 and 10). Turnaround in the growth of 'food products' was facilitated by high growth of sugar, tea, chocolate and sugar confectionery. Growth in respect of 'metal products and parts' and 'leather and leather products', however, turned negative while 'wood and wood products' witnessed negative growth for the second successive year.

Chart I.2: Sectoral Growth of Index of Industrial Production



I.2.13 In terms of use-based classification, acceleration in growth was observed in respect of all sectors except intermediate goods sector (Table 1.4).

Table 1.4: Index of Industrial Production (IIP) – Use-based Classification

(Per cent)

Sector	Weight	Growth Rate		Contribution to IIP Growth	
		2004-05	2005-06	2004-05	2005-06
1	2	3	4	5	6
Overall IIP	**100.0**	**8.4**	**8.1**	**100.0**	**100.0**
Basic Goods	35.6	5.5	6.6	20.9	25.3
Capital Goods	9.3	13.9	15.7	16.5	20.1
Intermediate Goods	26.5	6.1	2.4	20.3	8.0
Consumer Goods	28.7	11.7	12.0	42.6	46.8
Consumer Durables	5.4	14.4	15.2	12.9	14.9
Consumer Non-durables	23.3	10.8	11.0	29.8	31.9

Source: Based on data from Central Statistical Organisation.

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 (Appendix Table 11). Impressive performance of both the durable and non-durable segments aided the strong growth of consumer goods sector. Durable goods demand benefited from growing income levels, easier availability of credit and improved accessibility, particularly in rural areas. Growth in consumer non-durables was largely driven by items such as sugar, cigarettes, chocolate, sugar confectionary, sulpha drugs, sunflower oil and rectified sprit. Growth of the basic goods sector was facilitated by expansion in production of cement, salt, hard coke, carbon steel, structurals, ferro silicon, copper metal, and aluminium extrusion. The weak performance of the intermediate goods sector during 2005-06 could be attributed to a variety of factors such as subdued performance of the petroleum refinery products, increase in imports of goods such as yarn and polyester fibre, and continued negative growth of wood and wood products industries.

I.2.14 The current industrial upturn entered its fourth year of expansion during 2005-06. Based on the IIP, growth in industrial production reached a peak of 12.2 per cent in June 2005 – the highest growth after May 1996 – and the phase of expansion continued despite some signs of slowdown in the second and third quarters of 2005-06. The recent uptrend in the industrial production has been one of the longest in the past decade (Box I.5).

Capacity Utilisation

I.2.15 Reflecting the sustained growth in industrial activity, the overall capacity utilisation of the industrial sector is estimated to have increased from 82.2 per cent during 2004-05 to 82.7 per cent during 2005-06. Capacity utilisation is estimated to be above 90 per cent in the case of industries like cotton textiles, wool, silk and man-made fibres, and textile products. Capacity utilisation recorded an improvement, even as capacity additions took place across various industries during the year (Table 1.5).

Infrastructure Industries

I.2.16 The infrastructure sector recorded a subdued performance for the second successive year. Growth in infrastructure industries, which have a weight of 26.7 per cent in the IIP, decelerated from 5.8 per cent during 2004-05 to 5.3 per cent during 2005-06 (Appendix Table 12 and Chart I.3). The deceleration was mainly on account of decline, as noted earlier, in production of crude petroleum largely due to lower production in ONGC oil fields due to break-out of fire in Mumbai-High on July 27, 2005. Among various infrastructure industries, only cement exhibited robust growth (12.3 per cent in 2005-06 as compared with 6.6 per cent in 2004-05), reflecting increased demand from the housing and infrastructure sectors. Substantial increase in exports (48 per cent during 2005-06) also provided a boost to domestic production of cement.

I.2.17 As regards coal, its production was affected severely in the first half of 2005-06 owing to disruption in mining activities in various coal fields caused by heavy downpour in some regions during the monsoon. However, mining activities improved in the second half of the fiscal which facilitated a recovery in coal production. The finished steel sector witnessed some deceleration during the year, which could be partly attributed to higher imports and slowdown in exports. Growth in the production of petroleum refinery products recorded a slowdown due to unscheduled shutdown of certain refineries and some moderation in off-take of petroleum products. The subdued growth in electricity sector, as noted earlier, could be attributed to inadequate availability of coal and gas. Reflecting these trends, production of many infrastructure industries fell short of their targets for 2005-06 (Table 1.6). The fertiliser sector also remained below target due to lacklustre performance both by public and private sector plants on the back of shortage of raw materials and natural gas in a few plants and equipment problems. Natural gas production, however, exceeded the target, even as electricity generation was held down by inadequate supply of gas.

Performance of Central Sector Projects

I.2.18 The number of delayed Central sector projects increased during the year. The delays, largely on account of projects in railways and surface transport sectors, are mainly attributable to factors such as fund constraints, land problems, environmental clearance, and lack of supporting

Box I.5
Growth Cycles in Industrial Production

Macroeconomic variables tend to exhibit cyclical behaviour, displaying phases of expansion and contraction. An analysis of the cyclical fluctuations provides useful information in predicting the sustenance/subsidence of expansion or contraction. For India, several studies such as Chitre (1982), Dua and Banerji (1999), Mall (1999) and Gangopadhyay and Wadhwa (1997) have established synchronous movements in respect of a large number of key economic processes. Mohanty *et al.* (2000) using the composite leading indicator approach found that there have been 13 growth cycles in the Indian economy with varying durations between 1970-71 and 2001-02. According to Nilsson and Brunet (2006), industrial production in India registered seven growth cycles measured from trough to trough over the period 1978-2004 and the average duration of the cycle was 38 months – with the expansion and contraction phases lasting for 20 months and 18 months, respectively.

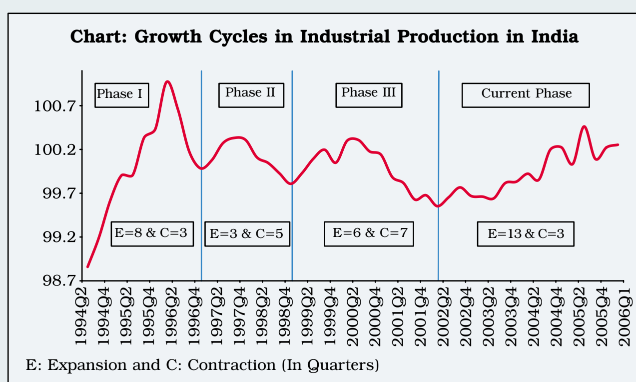
Empirical analysis based on the cyclicity[1] of the IIP growth behaviour since 1994 reveals that the industrial sector in India has seen several upswings and downswings. These can broadly be divided in to four phases (Chart).

Phase I marked eight quarters of expansion (1994Q2 to 1996Q1) which was supported by all round growth of the industrial sector. The cyclical downturn of the industrial sector in 1996Q2 was led by the slowdown in mining and electricity sectors on account of poor performance of crude oil and negative growth in hydro-electricity generation. Recovery in industrial growth in the second phase was supported by improved performance of all the three sub-groups, *viz.*, manufacturing, mining and electricity sectors. However, this recovery phase lasted only for a short while. The industrial sector once again entered recession in 1998 which can be attributed to poor performances by mining and manufacturing sectors in an environment of slowdown in global demand following the Asian crisis.

In the third phase starting from the first quarter of 1999, the industrial sector witnessed some turnaround. Various supportive policies of the Government such as rationalisation of excise duties on intermediate goods and customs duty on imported raw materials, reduction in interest rates and extension of infrastructure status to telecommunications, oil exploration and industrial parks, fiscal incentives, such as tax holidays and concessional duties as well as cut in corporate tax rates across-the-board helped in rejuvenating industrial growth. Subsequently, marked slowdown in manufacturing sector as well as electricity and mining sectors led to the downswing of the industrial sector during 2001-02.

The current phase of industrial resurgence, which started in 2002Q2, was buoyed by sharp rise in the production of capital goods, non-oil imports, higher level of manufacturing exports enabled by global recovery, and higher domestic demand for consumer durables in an environment of softer interest rate regime. Industrial recovery also benefited from growing efficiency and competitiveness of domestic production, emanating from various policy reforms and restructuring of the country's industrial sector since the early 1990s. The current cyclical upturn remains one of the longest in the last decade as it has continued for four years. The IIP growth reached a peak in 2005Q2. Although some signs of slowdown were visible in the third and fourth quarters of 2005, industrial activity recovered in 2006Q1. While contraction in industrial activity during 2005Q3 and 2005Q4 seemed to suggest that industrial growth might lose some of its momentum in the ensuing quarters, the phenomenal growth of capital goods sectors coupled with its imports and increased capacity additions across the industry suggest a buoyant investment climate.

Chart: Growth Cycles in Industrial Production in India



E: Expansion and C: Contraction (In Quarters)

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2. Mohanty, J., Bhupal Singh, and Rajeev Jain (2000), "Business Cycles and Leading Indicators of Industrial Activity in India", Reserve Bank of India Occasional Papers, Monsoon and Winter.
3. Reserve Bank of India (2002), Report of the Working Group on Economic Indicators, June.

[1] For obtaining the cyclical components, the IIP series is first adjusted for seasonality using the census X-11 method and the deseasonalised series is then detrended using the Hodrick-Prescott (HP) filter.

Table 1.5: Capacity Utilisation

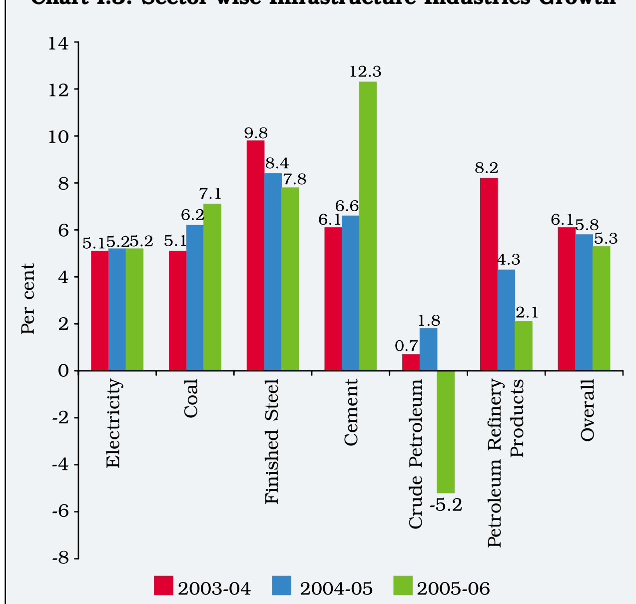
(Per cent)

Industry	Weight	Growth Rate		Capacity Utilisation	
		2004-05	2005-06	2004-05	2005-06
1	2	3	4	5	6
Food products	90.83	-0.9	2.1	66.2	66.0
Beverages, tobacco and products	23.82	10.8	15.9	77.0	84.9
Cotton textiles	55.18	7.4	8.5	91.4	97.4
Wool, silk and man-made fibre textiles	22.58	3.6	0.0	89.2	90.8
Jute and other vegetable fibre textiles	5.90	3.7	0.5	83.6	83.5
Textile products	25.37	19.2	16.3	81.5	92.7
Wood and wood products, furniture	27.01	-9.1	-6.8	81.6	81.0
Paper and products and printing	26.52	9.7	-1.0	82.5	88.7
Leather and leather and fur products	11.39	6.9	-5.6	84.5	79.9
Chemicals and chemical products	140.02	14.3	8.2	81.6	80.5
Rubber, plastic, petroleum and coal	57.28	2.4	4.3	86.5	86.1
Non-metallic mineral products	43.97	1.5	10.6	86.8	83.8
Basic metal and alloy industries	74.53	5.5	15.7	86.3	83.8
Metal products and parts	28.10	5.7	-1.1	71.1	68.8
Machinery and equipment	95.65	19.5	11.8	74.9	75.1
Transport equipment and parts	39.84	3.9	12.7	78.2	82.3
Other manufacturing industries	25.59	17.3	25.0	79.8	71.9
Manufacturing Industry	**793.58**	**9.2**	**9.1**	**80.4**	**80.8**
Mining and Quarrying	**104.73**	**4.4**	**0.9**	**86.1**	**85.9**
Electricity	**101.69**	**5.2**	**5.2**	**92.5**	**94.0**
All Industries	**1000**	**8.4**	**8.1**	**82.2**	**82.7**

Note : 1. Data are provisional.
2. Capacity utilisation has been calculated from the production data for 299 industries supplied by the Ministry of Statistics and Programme Implementation.
3. Capacity utilisation has been estimated using the peak-output approach.

Source : Based on data from Ministry of Statistics and Programme Implementation, Government of India.

Chart I.3: Sector-wise Infrastructure Industries Growth



infrastructure facilities. Although the number of delayed projects has increased, there has been a marked improvement in controlling the cost overrun in respect of ongoing projects. This is reflected in a significant decline in the cost overrun of delayed projects in terms of their original cost: the ratio has declined to 35.6 per cent at end-March 2006 from around 92 per cent in 2001 (Table 1.7). The decline in cost overrun during the recent years is attributable, *inter alia*, to increase in number of projects in surface transport sector with lower cost overrun, decline in anticipated cost over the originally envisaged cost in respect of coal and telecommunication sectors, improved implementation efficiency and, low and stable inflation.

Mergers and Acquisitions

I.2.19 During 2005-06, the process of mergers and acquisitions (M&A) activities gathered further momentum, reflecting efforts at consolidation to face

Table 1.6: Targets and Achievements of Infrastructure Industries

Sector	Unit	2004-05			2005-06		
		Target	Achievement	Gap (%)	Target	Achievement	Gap (%)
1	2	3	4	5	6	7	8
Power	Billion Units	586	587	0.3	620	616	-0.7
Coal	Million Tonnes	365	377	3.3	400	402	0.4
Finished Steel	Million Tonnes	44.1	40.7	-7.6	50.3	44.8	-11.0
Railways	Million Tonnes	600	602	0.3	668	667	-0.1
Shipping (Major Ports)	Million Tonnes	362	384	6.1	425	423	-0.4
Fertilisers	Million Tonnes	16.3	15.3	-6.0	16.2	15.5	-4.4
Cement	Million Tonnes	133	132	-1.1	142	148	4.1
Crude Petroleum	Million Tonnes	33	34	2.5	34	32	-6.6
Petroleum Refinery Products	Million Tonnes	122	127	4.2	129	130	0.8
Natural Gas Production	Million Cubic Meters	30,927	31,774	2.7	30,986	32,205	3.9

Source : Ministry of Statistics and Programme Implementation, Government of India.

enhanced competition. The value involved in acquisition deals increased by over 70 per cent during the year (Table 1.8). Significant activities were also observed in the overseas acquisitions of foreign companies by the Indian corporates. During 2005-06, maximum mergers were witnessed in the financial services, chemical industry, textiles, food and beverages, machinery and trading activities. As regards acquisitions, maximum activity was observed in respect of electronics, financial services, information technology, machinery and textiles. Financial services sector witnessed increased M&A activities in tune with the consolidation in the sector as well as the potential for high growth and steady revenue streams. The M&A activities in the Information Technology Enabled Services (ITES) sector were driven by the greater level of competition and need for economies of scale in order to compete with global IT majors as also by the influx of multinational IT companies for expanding their global reach. In the chemicals sector, drugs and pharmaceuticals segment recorded the highest M&A activities due to the tremendous export potential of the industry, potential for clinical R&D, lower cost production facilities as well as the vastness of the market. M&A activities are expected to remain strong in the coming years as the Indian corporate sector is likely to intensify efforts towards consolidation to reap efficiency gains and scale economies. Financial services, IT, pharmaceutical and manufacturing sectors such as auto components are amongst the sectors likely to see continued high levels of M&A activities in view of growing international interest in India as an outsourcing base.

Investment Climate

I.2.20 The investment intentions registered in Industrial Entrepreneurs Memoranda, after having increased substantially during 2004-05, recorded

Table 1.7: Performance of Central Sector Projects

	March			
	2001	2004	2005	2006
1	2	3	4	5
1. Number of Projects (a to d)	**187**	**286**	**327**	**396**
(a) Ahead	5	28	16	6
(b) On Schedule	58	73	65	113
(c) Delayed	65	112	125	149
(d) Without Date of Commissioning	59	73	121	128
2. Cost Overrun of Total Projects (Rupees crore)	40,303	40,411	39,585	47,337
3. Cost Overrun of Total Projects (% of original cost)	36.4	21.8	19.2	18.2
4. Cost Overrun of Delayed Projects (Rupees crore)	23,374	26,689	25,388	29,655
5. Cost Overrun of Delayed Projects (% of original cost)	91.6	51.8	45.2	35.6

Source : Ministry of Statistics and Programme Implementation, Government of India.

Table 1.8: Mergers and Acquisitions Announced

(Amount in Rupees crore)

Period	Acquisitions				Mergers	
	2004-05		2005-06		2004-05	2005-06
	Number	Amount	Number	Amount	Number	
1	2	3	4	5	6	7
Q1	184	10,980	212	17,014	39	72
Q2	177	5,809	190	26,465	53	102
Q3	231	17,619	201	32,994	79	107
Q4	205	25,874	264	23,804	101	89
Total	**797**	**60,282**	**867**	**1,00,277**	**272**	**370**

Note : Deals include preferential allotments, buy-back of shares and disinvestment proposals, amongst others.
Source : Centre for Monitoring Indian Economy.

further growth during 2005-06, indicative of the buoyancy in investment climate (Table 1.9). Industries such as metallurgical industries, chemicals, fuels, textiles, mechanical industries, electrical equipments and telecommunications which performed well during the year attracted more investment.

Small Scale Industries

I.2.21 Small scale industries (SSI) continued to record steady progress during 2005-06 (Table 1.10). The sector plays a vital role in the growth of the country as it contributes almost 40 per cent of the gross industrial value added in the Indian economy. Almost 44 per cent of the total manufactured exports of the country are directly accounted for by the SSI sector.

Table 1.9: Industrial Investment Proposals

Year	IEMs		LOI/DILs	
	No. of Proposals	Proposed Investment (Rupees crore)	No. of Proposals	Proposed Investment (Rupees crore)
1	2	3	4	5
2001-02	3,094	71,017	102	1,361
2002-03	3,178	80,824	60	332
2003-04	4,130	1,54,954	145	3,454
2004-05	5,548	2,89,782	101	4,309
2005-06	6,341	3,82,743	135	3,638
Cumulative*	**64,207**	**18,77,257**	**4,154**	**1,19,083**

* : August 1991 to March 2006.
IEM : Industrial Entrepreneurs Memoranda.
LOI : Letters of Intent.
DILs: Direct Industrial Licences, which are being issued since November 2003.
Source : Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India.

I.2.22 Industrial production has continued with its momentum during 2006-07 so far registering growth of 10.1 per cent during April-June 2006 (10.4 per cent in April-June 2005). The manufacturing sector with 11.2 per cent growth (the same as a year ago) continued to be the key driver of industrial activity, contributing almost 92.7 per cent of the growth in industry. Electricity and mining sectors continued to record subdued growth. In terms of the use-based classification, capital goods growth remained buoyant (22.9 per cent as compared with 13.8 per cent a year ago), reflecting the strength of investment activity. The production of basic goods rose by 8.8 per cent (7.8 per cent) and that of intermediate goods rose by 9.1 per cent (3.6 per cent). On the other hand, there was deceleration in the growth of consumer goods to 8.2 per cent (18.4 per cent), partly reflecting base effect. Growth in the six infrastructure industries decelerated to 6.3 per cent in April-June 2006 from 7.5 per cent in April-June 2005 on account of slowdown in all industries except petroleum refinery products and coal.

Services Sector

I.2.23 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 (Table 1.1 and Appendix Table 4). 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 (Table 1.11). 'Trade, hotels, transport and communication services' continued to grow at double-digit rates for the third successive year. Activity in the

Table 1.10: Performance of Small Scale Industries

Item	2001-02	2002-03	2003-04	2004-05	2005-06
1	2	3	4	5	6
Number of Units (Million)	10.5	11.0	11.4	11.9	12.3
Employment (Million)	24.9	26.0	27.1	28.3	29.5
Investment (Rupees crore)	1,54,349	1,62,317	1,70,219	1,78,699	1,88113
Value of Output (Rupees crore)	2,82,270	3,11,993	3,57,733	4,18,263	4,71,244 *
Exports (Rupees crore)	71,244	86,013	97,644	n.a.	n.a.

* : Based on April-September 2005 production estimates.
n.a.: Not Available.
Source : Ministry of Small Scale Industries, Government of India.

hotel industry improved significantly, aided by rise in domestic and international tourism, both business as well as leisure. The transport sector recorded a healthy growth during 2005-06 reflecting growth in the revenue earning freight traffic by the railways (10.7 per cent), cargo handled at major ports (10.3 per cent), cargo handled by civil aviation (10.6 per cent) and passengers handled at five major airports (21.6 per cent). Growth in the number of new cell phone connections (89.4 per cent) during 2005-06 also strengthened the services sector. 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.

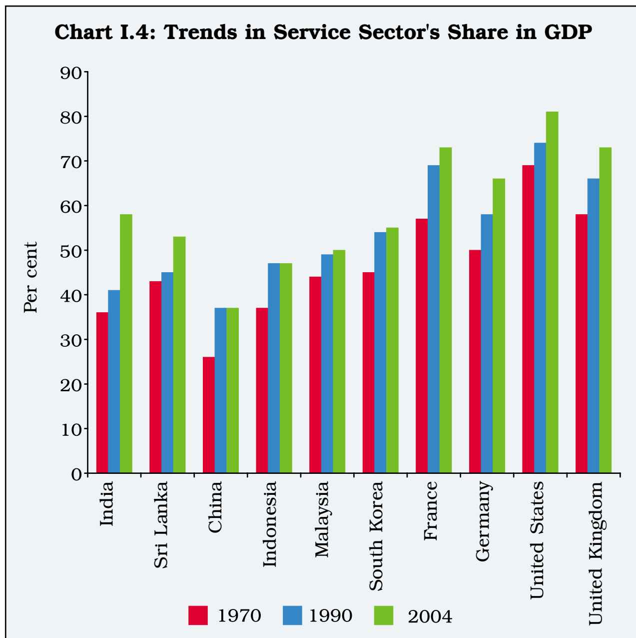
I.2.24 Reflecting the sustained growth, the share of the services sector (including construction) in the overall GDP of the economy has increased from 46 per cent in 1990-91 to over 60 per cent during 2005-06. The rising share of the services sector in the GDP corresponds to general pattern of growth observed in developed and in some of the emerging market economies (Chart I.4). 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. For example, in China, the decline in the share of agriculture from 27 per cent in 1990 to 15 per cent in 2004 was completely cornered by rise in the share of mining, manufacturing and utilities sector from 37 per cent to 46 per cent; the share of the services sector remained stagnant at 37 per cent during the period. Similarly, in the case of Malaysia, decline in agriculture's share from 15 per cent to 10

Table 1.11: Performance of the Services Sector

(Per cent)

Sub-sector	Growth Rate						Relative Contribution	
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2004-05	2005-06
1	2	3	4	5	6	7	8	9
Trade, Hotels, Transport and Communication	7.1	9.2	9.1	12.0	10.6	11.5	44.4	47.8
Financing, Insurance, Real Estate and Business Services	4.1	7.3	8.0	4.5	9.2	9.7	20.5	21.1
Community, Social and Personal Services	4.7	3.9	3.8	5.4	9.2	7.8	22.0	18.3
Construction	6.1	4.0	7.7	10.9	12.5	12.1	13.2	12.8
Services Sector	**5.7**	**6.8**	**7.3**	**8.5**	**10.2**	**10.3**	**100.0**	**100.0**
Memo:								
Shares of Services in GDP	55.8	56.3	58.3	58.3	59.7	60.7		

Source : Central Statistical Organisation.



per cent over the period 1990 to 2004 was absorbed by rise in manufacturing sector's share from 24 per cent to 31 per cent. This is in line with the general pattern of development wherein transformation from agriculture to modern economy is intercepted first by rise of industrial sector and subsequently dominance of services sector prevails with economic maturity. On the other hand, in India, the entire decline in the share of agricultural sector from 41 per cent in 1970-71 to 20 per cent in 2005-06 has been more than absorbed by the services sector, as its share rose from 36 per cent to 61 per cent. Manufacturing sector's share has recorded only a modest rise from around 13 per cent in 1970 to 15 per cent in 2005-06. 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 (Box I.6).

I.2.25 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 (Table 1.12). 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.

AGGREGATE DEMAND

I.2.26 Information on the constituents of aggregate demand, available upto 2004-05, indicates that growth remained domestic demand driven, led by consumption as well as investment. Real gross domestic capital formation continued to remain buoyant, recording an increase of over 15 per cent for the third consecutive year. Both private and public investment recorded an acceleration during the year and this was manifested in the rapid rate of growth of credit, improvement in production and import of capital goods, increase in number and value of primary issues and the stock price rally in secondary markets. Consumption expenditure continued to dominate the demand side of national income, although growth rate of total final consumption expenditure recorded some deceleration on account of slowdown in private final consumption expenditure in consonance with some deceleration in real GDP growth during 2004-05 (Table 1.13).

Saving and Capital Formation

I.2.27 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

Box I.6
Services Sector Growth

The conventional wisdom about the stages of development process suggests that an economy evolves from being agriculture-dominated to industry-dominated, and then to services-dominated. History suggests that the dominance of services sector is unlikely to be sustained without strong growth of industry and agriculture (Acharya, 2002).

The Indian growth experience, however, appears to negate the stylised Rostowian stages of growth hypothesis, since transition in India has been marked by the rapid movement from agriculture-dominated growth to services-dominated growth bypassing the stage of industry-dominated growth. In this context, it may be noted that the process of economic growth leads to the creation of new services (*e.g.*, software development), which provide inputs to other sectors. The high-income elasticity of services indicates that as real per capita income rises, the quantity demanded rises more than the quantity of commodities. Trade liberalisation and reforms also have had a positive impact on growth of services. In particular, revolution in information and communication technology (ICT) sectors has imparted tradability to services, which were hitherto considered untradable.

The synergy between services and industry is found to be significant for India[1]. Services can be classified as producer, consumer and Government services[2]. While the producer and consumer services have recorded higher growth rates and shares in the post-reform period, the share of Government services witnessed a decline mainly due to curtailment of revenue expenditure (Table).

The increasing share of producer services reflects the growing complementarity between services and manufacturing (Banga and Goldar, 2004; Hansda, 2001). Concomitantly, there also exists a positive relationship between use of services input and industrial productivity in the manufacturing sector (Banga and Goldar, 2004). In this context, as the cross-country experience suggests, investments in the ICT sectors contribute to productivity gains across other sectors of the economy such as manufacturing. Productivity gains in manufacturing, of course, also reflected benefits of increased competition following the reforms in the 1990s which, *inter alia*, led to declines in import tariffs and domestic barriers to entry.

Table: Growth of Gross Value Added in Services Sector

(Per cent)

Services	1981-82 to 1990-91	1992-93 to 2004-05	2001-02	2002-03	2003-04	2004-05
1	2	3	4	5	6	7
Producer Services	7.7 (67.5)	8.4 (70.0)	8.5 (68.7)	8.9 (69.6)	9.3 (70.4)	9.9 (70.4)
Consumer Services	6.2 (18.1)	8.6 (17.6)	5.5 (18.8)	5.7 (18.6)	6.2 (18.2)	10.7 (18.4)
Government Services	6.5 (14.4)	5.9 (12.4)	2.4 (12.5)	1.1 (11.8)	4.6 (11.4)	8.2 (11.2)

Note : Figures in brackets are shares of sub-sectors in gross value added of services excluding construction.

Source : Central Statistical Organisation.

In brief, evidence suggests that the services activity could be leading to higher growth in manufacturing sector by providing sustained demand for manufactured goods as well as by raising the productivity. Further research is, however, required to have a clearer understanding of the sources and significance of the role of service sectors in propelling India's recent growth and the marked differences in this respect from other countries. In this context, it also needs to be noted that the nature of services sector activity is evolving quite rapidly with the emergence of new services as well as innovations in the delivery of these services. Accordingly, issues of appropriate measurement of services activity in national accounts along with their productivity assume importance.

Services-led growth should, however, not assume a lopsided nature. Policies to accelerate the current pace of growth in manufacturing activity and raise agricultural growth would need to be pursued for a further step-up in the economy's overall growth rate. An economy of India's size and scope cannot ignore the manufacturing sector. A substantial manufacturing base is essential to absorb the workforce moving out of agriculture. Finally, the advanced skill-intensive part of the Indian economy may be bidding up scarce skills in such a way as to slow the growth of labour intensive manufacturing. Greater attention may need to be paid to improve the quality of education so as to enhance the supply of skilled labour.

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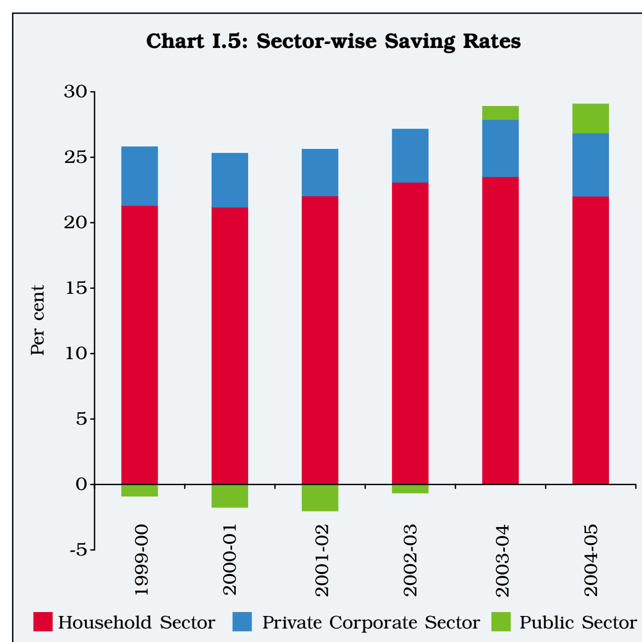
[1] LSERVICE = 2.02 + 0.68*LINDUSTRY + 0.67*LSEREXP - 0.97*LPD
[5.04] [7.69] [-2.81]
where LSERVICE = Log of Service Sector Output, LINDUSTRY= Log of Industrial Output, LSEREXP = Log of Service Exports, LPD = Log of Prices of Service. Figures in parentheses are t-statistics.

[2] Trade, transport and communication, financing, insurance, real estate and business services can be categorised as producer services with hotels and restaurants and other services as consumer services. Government services comprise public administration and defence services.

Table 1.12: Performance of Indian IT Sector

Year	Annual Revenue (US $ billion)	Per cent of GDP
1	2	3
1997-98	4.8	1.2
1998-99	6.0	1.5
1999-00	8.2	1.9
2000-01	12.1	2.7
2001-02	13.4	2.9
2002-03	16.1	3.2
2003-04	21.6	3.5
2004-05	28.4	4.1
2005-06	36.3	4.8

Note : IT includes hardware, software and related business service industry.
Source : NASSCOM.



(Appendix Table 13 and Chart I.5). 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 (Box I.7).

I.2.28 Savings of the household sector, on the other hand, recorded some decline although the sector continued to be the major contributor to total savings, with its share remaining at more than three-fourths in 2004-05 (Box I.8).

I.2.29 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. In the 1999-2000 series, a new item, 'valuables', which covers expenditures made on acquisition of precious metals and stones as a store of value has been included in the gross capital formation, in line with the recommendations of UNSNA, 1993. A pick up in 'valuables' also helped in acceleration in the investment rate during 2004-05 (Table 1.14).

I.2.30 Preliminary estimates based on the latest available information place financial saving (net) of the household sector in 2005-06 at 11.5 per cent of GDP at current market prices as compared with

Table 1.13: Growth in Select Sources of Real Effective Demand #

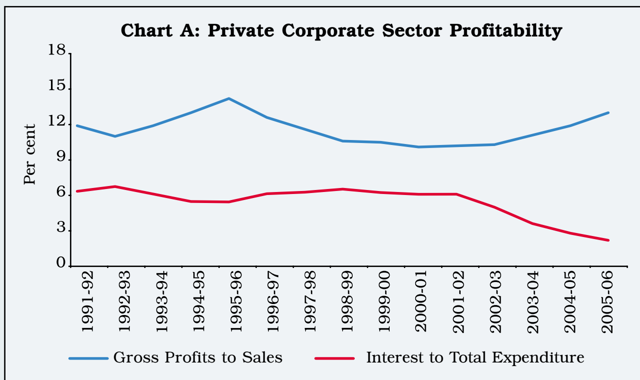
(Per cent)

Item	2000-01	2001-02	2002-03	2003-04@	2004-05*
1	2	3	4	5	6
1. Total Final Consumption Expenditure	1.9	5.2	1.2	7.0	6.7
of which:					
Private Final Consumption	2.3	5.9	1.6	7.9	6.3
Government Final Consumption	0.3	1.7	-0.6	2.4	9.2
2. Total Investment +	-4.5	-1.9	16.5	15.8	15.7
Private Investment ++	-4.6	3.8	16.9	10.3	10.4
Public Investment ++	-4.0	3.2	-6.0	11.8	16.7
Valuables $	-8.1	-5.4	-4.1	66.0	54.4
3. Total Fixed Investment	0.0	5.0	9.9	11.3	9.5
of which:					
Private Fixed	-0.6	5.5	13.0	10.5	9.8
Public Fixed	1.3	3.9	2.2	13.7	8.6

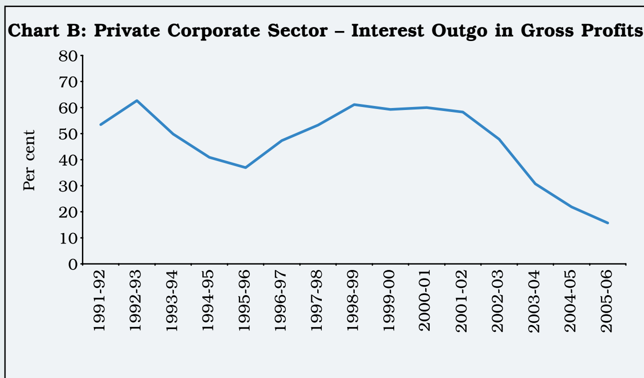
: Based on select disposition of real GDP at market prices.
@ : Provisional estimates. * : Quick estimates. + : Adjusted for errors and omissions. ++ : Unadjusted for errors and omissions.
$: 'Valuables' covers the expenditures made on acquisition of valuables, excluding works of art and antiques.
Source : Central Statistical Organisation.

Box I.7
Corporate Performance in Recent Years

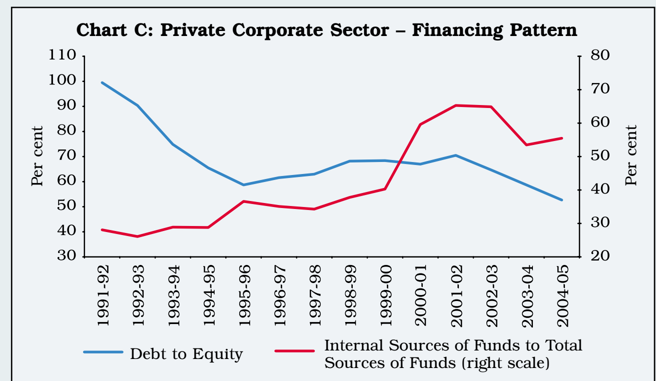
The Indian private corporate sector has witnessed a significant improvement in the financial performance during the period 2003-04 to 2005-06 in terms of key parameters. Growth in gross profits from 2001-02 to 2005-06 outpaced sales growth indicating improvement in profit margin of corporates[1] (Chart A). High level of corporate profitability resulted from two major factors – higher economic activity and declining debt servicing. Lower dependence on borrowed funds also helped in curtailing the interest outgo. The stability of sales growth *vis-à-vis* gross profit growth is also notable, indicating the ability of corporates to cut costs including the debt servicing costs and thereby enhance profit per unit of sales. Furthermore, a steep decline in inventory to sales ratio is observed, which suggests improved efficiency in inventory management thereby reducing working capital requirements.

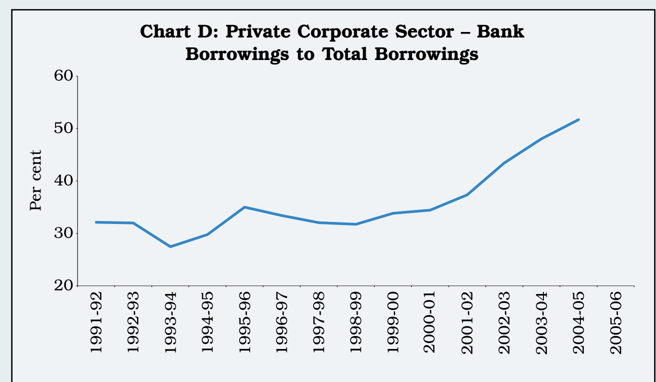


The share of interest outgo in gross profits, which averaged over 50 per cent during the 1990s has seen a steady decline since 2002-03 and was 15.7 per cent in 2005-06 (Chart B). Consequently, the share of pre-tax profits in sales steadily increased from below 7 per cent in 1990s to 11.0 per cent in 2005-06.



The decline in interest rates and high profitability in the recent years has led to significant changes in the pattern of funding of the corporate sector. Internal sources are now a major source of funds, thereby reducing the dependence on borrowed funds. Concomitantly, the debt-equity ratio of corporates, which averaged about 69 per cent during 1998-2002, has declined sharply to around 53 per cent in 2004-05 (Chart C). At the same time, the share of bank borrowings in total borrowings shows an increasing trend, suggesting that corporates have undertaken a major debt restructuring exercise, including retiring high cost debt contracted earlier (Chart D).



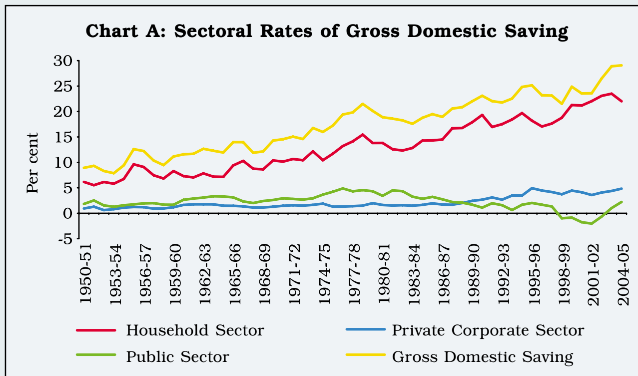


In brief, the strong economic activity as well as a reduction in debt servicing costs in the past few years enabled the corporates to register strong profitability and strengthen their balance sheets. Strong corporate balance sheets are expected to have a positive effect on private investment in the economy. At the same time, they will provide the Indian corporate sector greater flexibility in the years ahead to face enhanced competition as well as increase their capacity to acquire companies, both at home and abroad.

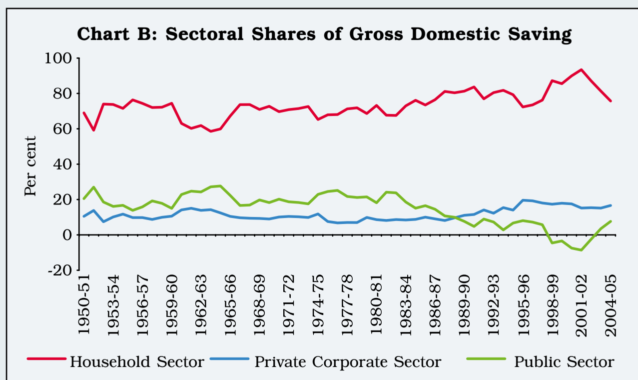
[1] The analysis in this Box is based on RBI studies on company finances using audited annual accounts of selected non-Government non-financial public limited companies.

Box I.8
Evolution of Savings in India

India is one of the high saving economies of the world. The rate of gross domestic savings (GDS) (*i.e.*, GDS as a percentage of GDP at current market prices) has recorded a steady increase since the 1950s. The savings rate has increased from an average of around 10 per cent in the 1950s to over 23 per cent in the 1990s. It crossed 25 per cent in the mid-1990s and reached its highest level of 29.1 per cent in 2004-05 (Chart A).



A large part of the overall improvement in domestic savings has emanated from higher household savings. The rate of household saving – comprising financial and physical savings – increased from around 7 per cent in the 1950s to over 18 per cent in the 1990s. In 2004-05, it stood at 22.0 per cent. Since the 1950s, the household sector has remained the predominant source of the GDS, and it contributed around 76 per cent of total domestic savings in 2004-05 (Chart B). Over time, although both financial and physical savings have recorded an increase, the composition of household savings has seen a shift in favour of financial savings reflecting the spread of banking and financial services across the country. The share of household savings in physical assets – comprising investment in 'construction', 'machinery and equipments' and 'change in stocks'– in the total household saving declined from more than 70 per cent in the 1950s to around 53 per cent in 2004-05. Concomitantly, the share of household financial savings – comprising currency, 'net deposits', 'shares and debentures', 'net claims on government', 'life insurance funds' and 'provident and pension funds' – in the total household savings increased from around 25 per cent in the 1950s to around 47 per cent in 2004-05. The rate of financial saving increased from less than 2 per cent in the 1950s to 10.3 per cent in 2004-05.



Since 2000-01, the household sector has shown some preference for saving in the form of physical assets, which could be attributed partly to the soft interest rate regime in recent years as well as investments in housing. Within financial assets, preference has shifted from savings in the form of shares and debentures and deposits to claims on government and contractual savings. Contractual savings – comprising saving in life insurance funds and provident and pension funds – amounted to 3.8 per cent of GDP during 2000-01 to 2004-05. Demographic variables like life expectancy, literacy rate and dependency ratios have emerged as key determinants of savings in addition to traditional variables like real interest rate, growth, per capita income, spread of banking facility and rate of inflation.

The rate of savings of the private corporate sector increased from around one per cent in 1950s to 1.8 per cent in 1980s and 3.7 per cent in 1990s. By 2004-05, it improved to 4.8 per cent.

The rate of savings of the public sector has witnessed mixed trends. It recorded an increasing trend till the 1970s, but started declining thereafter and turned negative between 1998-99 and 2002-03 owing to sharp deterioration in the savings of the Government administration. From 2003-04 onwards, public savings have turned positive again, mainly reflecting fiscal consolidation. In 2004-05, public savings rate was 2.2 per cent, still less than a half of the peak of almost five per cent touched in 1976-77. Nonetheless, the turnaround of 4.2 percentage points of GDP in public sector savings – from a negative 2.0 per cent of GDP in 2001-02 to a positive 2.2 per cent of GDP in 2004-05 – has been a key factor that has boosted domestic savings from 23.6 per cent to 29.1 per cent over the same period. In particular, the dissaving by Government administration has more than halved from 6.0 per cent of GDP in 2001-02 to 2.7 per cent in 2004-05. This augurs well for the Indian economy as it aims for a higher growth path.

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1. Athukorala, Prema-Chandra and Kunal Sen (2002), Saving, Investment and Growth in India, Oxford University Press, New Delhi.

2. Reserve Bank of India (2003), Report on Currency and Finance 2001-02.

Table 1.14: Gross Capital Formation

(Per cent of GDP at current market prices)

Item	1999-2000	2000-01	2001-02	2002-03	2003-04@	2004-05*
1	2	3	4	5	6	7
1. Household Sector	10.7	11.0	11.2	12.7	12.0	11.7
2. Public Sector	7.5	6.9	6.9	6.2	6.5	7.2
3. Private Corporate Sector	7.2	5.7	5.6	5.8	6.8	8.2
4. Valuables+	0.8	0.7	0.6	0.6	0.9	1.3
5. Gross Domestic Capital Formation (GDCF) #	26.0	24.2	23.0	25.3	27.2	30.1

@ : Provisional. * : Quick Estimates. + : 'Valuables' covers the expenditures made on acquisition of valuables, excluding works of art and antiques.
# : As GDCF is adjusted for errors and omissions, the sector-wise capital formation figures do not add up to the GDCF.
Source : Central Statistical Organisation.

the revised estimates of 10.1 per cent in 2004-05 (Table 1.15 and Appendix Table 14). Savings in the form of 'currency', 'deposits' and 'investment in shares and debentures', as per cent to GDP, increased in 2005-06. While the rate of 'contractual savings' was the same as in the previous year, that of 'claims on Government' (particularly small savings) decreased. Financial liabilities of the household sector registered a sharp increase due to higher loans and advances principally driven by personal loans to finance consumer durables and increased demand for housing loans. However, it needs to be noted that the fiscal year variations for banking and monetary data for 2005-06 had an additional fortnight (see para I.3.6). For comparability purposes, if the data on currency, bank deposits and credit are adjusted for the additional fortnight, financial savings (net) of the household sector for the year 2005-06 would be placed at 10.7 per cent of GDP at current market prices.

Table 1.15: Household Saving in Financial Assets

(Amount in Rupees crore)

Item	2003-04 P	2004-05 P	2005-06 #
1	2	3	4
A. Financial Assets (Gross)	**3,80,090**	**4,35,706**	**5,88,656**
	(13.8)	**(14.0)**	**(16.7)**
1. Currency	42,675	36,977	51,954
	(1.5)	(1.2)	(1.5)
	[11.2]	[8.5]	[8.8]
2. Deposits@	1,45,657	1,61,416	2,78,985
	(5.3)	(5.2)	(7.9)
	[38.3]	[37.0]	[47.4]
3. Claims on Government	87,372	1,06,420	86,755
	(3.2)	(3.4)	(2.5)
	[23.0]	[24.4]	[14.7]
4. Investment in Shares and Debentures +	492	4,967	29,008
	(0.0)	(0.2)	(0.8)
	[0.1]	[1.1]	[4.9]
5. Contractual Saving**	1,03,895	1,25,926	1,41,954
	(3.8)	(4.0)	(4.0)
	[27.3]	[28.9]	[24.1]
B. Financial Liabilities	**70,732**	**1,21,187**	**1,82,539**
	(2.6)	**(3.9)**	**(5.2)**
C. Saving in Financial Assets (Net) (A-B)	**3,09,358**	**3,14,519**	**4,06,117**
	(11.2)	**(10.1)**	**(11.5)**

P : Provisional. # : Preliminary Estimates.
@ : Comprise bank deposits, non-bank deposits and trade debt (net).
+ : Including units of Unit Trust of India and other mutual funds.
** : Comprise life insurance, provident and pension funds.
Note: 1. Components may not add up to the total due to rounding off.
2. Figures in ( ) indicate per cent of GDP at current market prices and [ ] indicate per cent of financial assets (gross).

I.2.31 To sum up, the Indian economy exhibited strong growth for the third successive year. Real GDP growth has averaged above eight per cent for the past three years. Agriculture sector recorded an improvement, partly reflecting the base effect. A noteworthy feature of 2005-06 was the sustained buoyancy in manufacturing activity, led by both investment and consumption demand. The infrastructure sector, however, continued to record subdued growth. Services activity continued with its double-digit growth, remaining the driver of economic activity. Another positive development was the step-up in investment rate in consonance with an increase in the savings rate, mainly led by higher public sector savings.

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 (Chart I.6).

I.3.3 Intra-year movements in reserve money reflected the Reserve Bank's liquidity management operations and accretions to foreign exchange reserves. Most of the increase in reserve money took place in the second half of the year, especially the last quarter, mirroring injection of liquidity by the Reserve Bank. Currency in circulation followed the usual seasonal pattern, contracting during the second quarter while expanding in the other quarters. The expansion of reserve money in the first quarter of 2005-06 was primarily due to an increase in net Reserve Bank credit to the Government on account of reversal of reverse repos and reduction in the Centre's surplus investment with the Reserve Bank, partly offset by absorption through the MSS. During the second quarter, the Reserve Bank's foreign currency assets witnessed large increase. Concomitantly, this led to an increase in absorption of liquidity through LAF reverse repos and hence, net Reserve Bank credit to the Centre declined during the quarter. The dynamics of reserve money during the third quarter were driven by net injection of liquidity – initially through reversal of reverse repos and subsequently through repos under the LAF operations as well as through unwinding of the balances under MSS. During the fourth quarter, liquidity conditions were relatively tighter following the IMD redemption and build-up of large Government surplus amidst continued high credit demand. Consequently, the Reserve Bank injected liquidity through LAF repo operations, continued unwinding of MSS, some private placement and purchases of foreign exchange (Table 1.16).

Chart I.6: Reserve Money

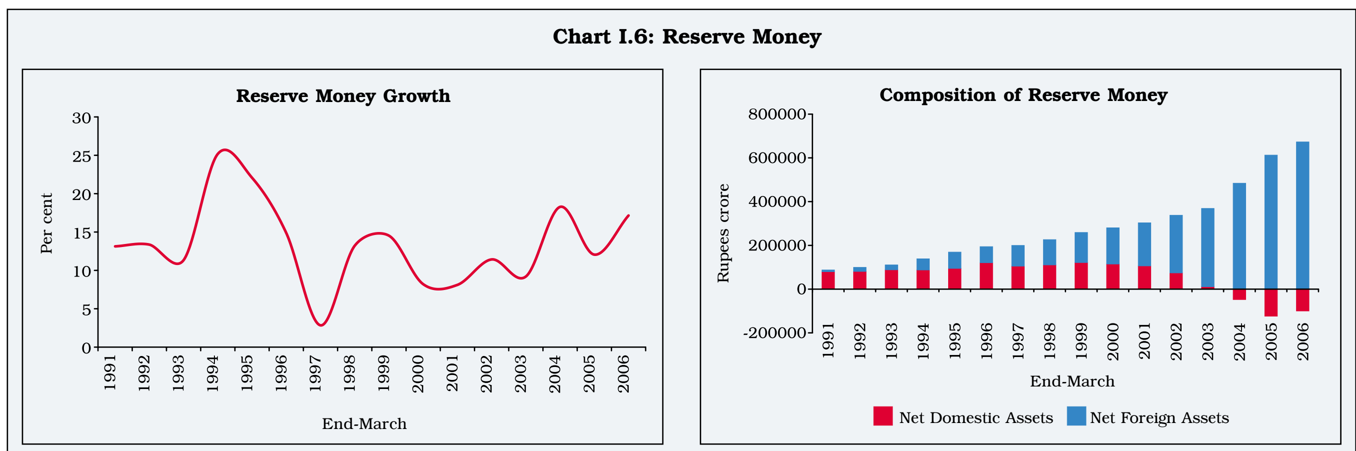


Table 1.16: Variation in Major Components and Sources of Reserve Money

(Rupees crore)

Item	2004-05	2005-06	2004-05				2005-06			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
Reserve Money	**52,623 (12.1)**	**83,930 (17.2)**	**-6,812**	**-6,285**	**31,546**	**34,174**	**7,177**	**1,062**	**25,440**	**50,251**
Components										
1. Currency in Circulation	41,633	62,015	14,317	-4,166	16,467	15,015	19,877	-9,479	29,154	22,462
2. Bankers' Deposits with RBI	9,631	21,515	-19,665	-2,874	14,769	17,401	-10680	9,780	-2,967	25,382
3. 'Other' Deposits with the RBI	1,359	401	-1,463	755	310	1,757	-2,021	761	-747	2,408
Sources										
1. RBI's net Credit to Government	-62,882	26,111	-34,143	-6,179	184	-22,744	9,275	-25,251	19,879	22,208
of which: to Central Government	-60,177	28,417	-30,029	-4,499	203	-25,852	14,600	-25,251	19,812	19,256
2. RBI's credit to banks and commercial sector	-833	535	-2,985	-740	3,726	-835	1,155	-1,869	101	1,148
3. NFEA of RBI	1,28,377	60,193	57,525	-5,260	31,462	44,651	-14,595	24,823	23,741	26,224
4. Government's Currency Liabilities to the Public	152	1,306	37	9	89	17	384	910	-100	112
5. Net Non-Monetary Liabilities of RBI	12,191	4,215	27,245	-5,885	3,916	-13,085	-10,957	-2,450	18,180	-559
Memo:										
1. Net Domestic Assets	-75,754	23,737	-64,336	-1,025	84	-10,477	21,771	-23,761	1,700	24,027
2. FCA, adjusted for revaluation	1,15,044	68,834	33,160	-3,413	29,858	55,440	5,034	23,665	11,998	28,137
3. NFEA/Reserve Money (per cent) (end-period)	125.3	117.4	126.1	126.7	124.9	125.3	120.5	125.3	123.7	117.4
4. NFEA/Currency (per cent) (end-period)	166.2	156.3	158.8	159.2	160.7	166.2	154.0	164.4	158.4	156.3

NFEA : Net Foreign Exchange Assets. FCA: Foreign Currency Assets.

Note : 1. Data are based on March 31 for Q4 and last reporting Friday for all other quarters.
2. Figures in parentheses are growth rates over the previous year.

I.3.4 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 (Table 1.17). 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.

Developments during 2006-07

I.3.5 The year-on-year (y-o-y) reserve money expansion was 17.5 per cent as on August 11, 2006, higher than that of 15.3 per cent recorded a year ago. The Reserve Bank's foreign currency assets (adjusted for revaluation), on a y-o-y basis, increased by Rs.75,825 crore as on August 11, 2006 as compared with Rs.1,12,281 crore a year ago. The Reserve Bank's net credit to the Centre increased, y-o-y, by Rs.26,629 crore as against a decline of Rs.43,430 crore in the preceding year.

MONETARY SURVEY

I.3.6 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 (Chart I.7). In this context, it

Table 1.17: Net Reserve Bank Credit to the Centre – Variations

(Rupees crore)

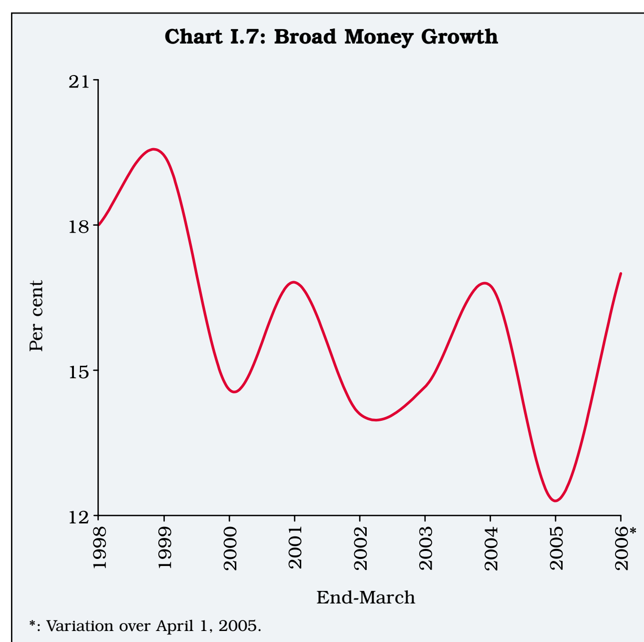
Item	2004-05	2005-06	2004-05				2005-06			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
Net Reserve Bank Credit to the Centre (1+2+3+4-5)	**-60,177**	**28,417**	**-30,029**	**-4,499**	**203**	**-25,852**	**14,600**	**-25,251**	**19,812**	**19,256**
1. Loans and Advances	0	0	3,222	-3,222	0	0	0	0	0	0
2. Treasury Bills held by the Reserve Bank	0	0	0	0	0	0	0	0	0	0
3. Reserve Bank's holdings of Dated Securities	12,323	13,869	-2,900	22,176	14,095	-21,048	8,221	-17,243	19,378	3,513
4. Reserve Bank's holdings of Rupee Coins	57	7	175	-10	-94	-14	-40	-33	157	-77
5. Central Government Deposits	72,558	-14,541	30,525	23,443	13,799	4,791	-6,419	7,974	-277	-15,820
Memo *										
6. Market Borrowings of Dated Securities by the Centre #	80,350	1,31,000	28,000	26,000	14,000	12,350	42,000	39,000	24,000	26,000
7. Reserve Bank's Primary Subscription to Dated Securities	1,197	10,000	0	847	0	350	0	0	0	10,000
8. Repos (+) / Reverse Repos (-) (LAF), net position	15,315	12,080	-26,720	34,205	27,600	-19,770	9,660	-14,835	18,635	-1,380
9. Net Open Market Operations {Purchase (+)/ Sales (-)} @	-2,899	-3,913	-429	-427	-871	-1,171	-1,543	-941	-261	-1,168
10. Injection (+)/ Absorption (-) through MSS	-64,211	35,149	-37,812	-14,444	-353	-11,602	-7,470	4,353	19,713	18,552
11. Primary Operations $	-6,625	-33,328	37,353	-30,484	-36,984	23,490	18,205	-24,689	-38,715	11,871

* : At face value. # : Excluding Treasury Bills. $: Adjusted for MSS and Centre's surplus investment.

@ : Excluding Treasury Bills but including Consolidated Sinking Funds (CSF) and other investments.

Note : 1. Quarterly variations are based on March 31 for Q4 and last reporting Fridays for other quarters.

2. In case of rows 8 to 11, (+) sign indicates injection of liquidity to the banking system while (-) sign indicates absorption of liquidity.



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 (Table 1.18).

Table 1.18: Monetary Indicators

(Amount in Rupees crore)

	Outstanding as on March 31, 2006	Variation			
		2004-05		2005-06	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
I. Reserve Money	5,73,066	52,623	12.1	83,930 *	17.2 *
II. Broad Money (M_3)	27,29,535	2,45,773 (2,42,260)	12.3 (12.1)	3,96,868	17.0
a) Currency with the Public	4,13,143	40,892	13.0	58,272	16.4
b) Aggregate Deposits	23,09,514	2,03,522 (2,00,009)	12.1 (11.9)	3,38,037	17.1
i) Demand Deposits	4,05,224	26,528	10.3	83,861	26.1
ii) Time Deposits	19,04,290	1,76,994 (1,73,481)	12.4 (12.2)	2,54,176	15.4
of which: Non-Resident Foreign Currency Deposits	59,275	802	1.1	-16,876	-22.2
III. NM_3	27,47,575	2,82,988 (2,44,300)	14.4 (12.5)	4,21,114	18.1
of which: Call/Term Funding from Financial Institutions	83,144	44,853 (9,678)	181.8 (39.2)	11,224	15.6
IV. a) L_1	28,51,364	3,00,247	14.8	5,19,543	22.3
of which: Postal Deposits	1,03,789	17,259	24.2	15,142	17.1
b) L_2	28,54,296	2,96,125	14.5	5,20,352	22.3
of which: FI Deposits	2.932	-4,122	-66.0	809	38.1
c) L_3	28,75,990	2,96,244	14.4	5,22,206	22.2
of which: NBFC Deposits	21,694	118	0.6	1,854	9.3
V. Major Sources of Broad Money					
a) Net Bank Credit to the Government	7,69,093	13,863 (1,670)	1.9 (0.2)	20,386	2.7
b) Bank Credit to Commercial Sector	16,90,961	2,64,098 (2,31,216)	26.0 (22.8)	3,59,703	27.0
c) Net Foreign Exchange Assets of Banking Sector	7,26,194	1,22,669	23.3	78,291	12.1
Memo :					
Scheduled Commercial Banks' Aggregate Deposits	21,09,049	1,95,782 (1,92,269)	13.0 (12.8)	3,23,913	18.1
Scheduled Commercial Banks' Non-food Credit	14,66,386	2,54,484 (2,21,602)	31.6 (27.5)	3,54,193	31.8

FIs : Financial Institutions. NBFCs : Non-Banking Financial Companies. * : Variation over March 31, 2005.

NM_3 is the residency-based broad money aggregate and L_1, L_2 and L_3 are liquidity aggregates compiled on the recommendations of the Working Group on Money Supply (Chairman: Dr. Y.V. Reddy, 1998). Liquidity aggregates are defined as follows:

L_1 = NM_3 + Select deposits with the post office saving banks.

L_2 = L_1 +Term deposits with term lending institutions and refinancing institutions (FIs) + Term borrowing by FIs + Certificates of deposits issued by FIs.

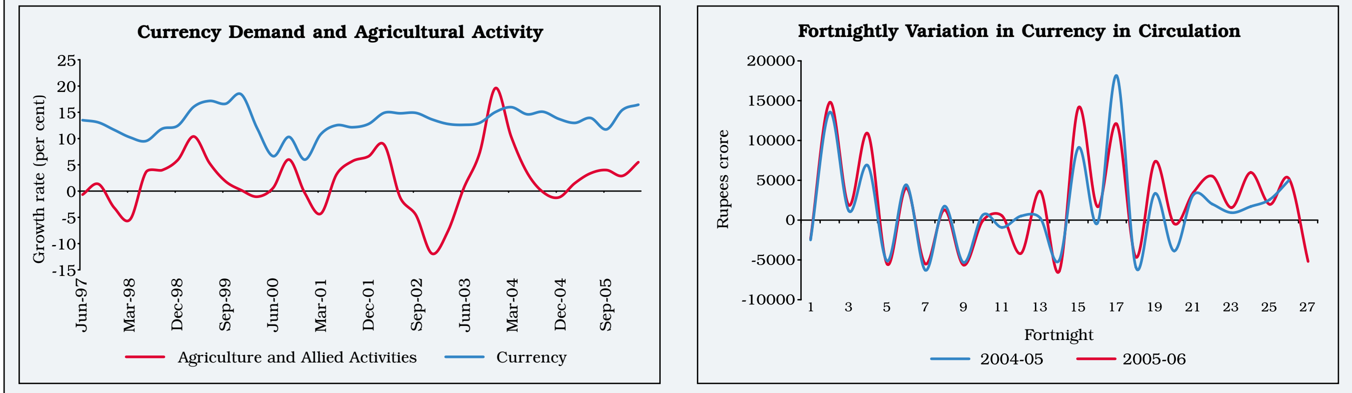
L_3 = L_2 + Public deposits of non-banking financial companies.

Note : 1. Data are provisional.

2. Figures in parentheses are adjusted for the effect of conversion of a non-banking entity into a banking entity on October 11, 2004.

3. Data on variation for 2005-06 are variations between April 1, 2005 and March 31, 2006 unless otherwise stated.

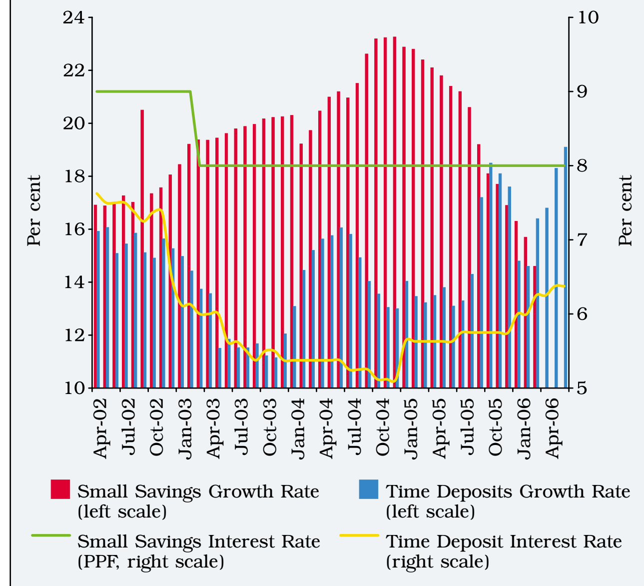
Chart I.8: Currency with the Public



I.3.7 Demand for currency accelerated during 2005-06 to 16.4 per cent from 13.0 per cent during the previous year, in consonance with higher economic activity, particularly recovery in agricultural activity. Currency demand broadly exhibited the usual intra-year seasonal pattern, increasing during festival seasons and initial part of the month (Chart I.8).

I.3.8 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 (Chart I.9). 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.

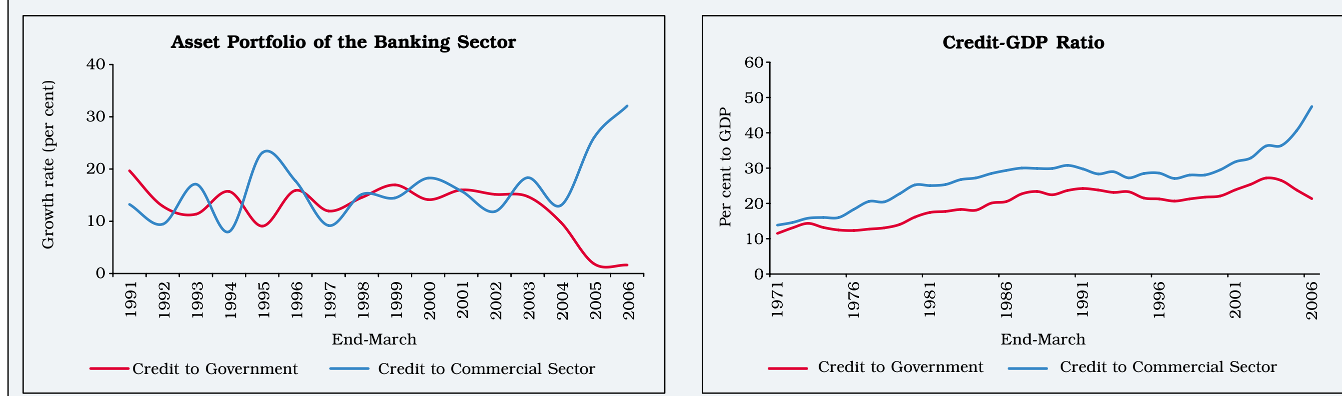
Chart I.9: Time Deposits and Small Savings



Sources of Money

I.3.9 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 (Chart I.10). 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

Chart I.10: Bank Credit to Commercial Sector



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 (see Box III.1). 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 (Table 1.19).

I.3.10 In view of the credit demand remaining high, banks liquidated part of their excess holdings of Government securities. The gilt portfolio of commercial banks declined by Rs.19,514 crore during 2005-06 in contrast to an increase of Rs.52,031 crore (net of conversion effect) during the previous year. Accordingly, commercial banks' holding of Government and other approved securities declined to around 31 per cent of their net demand and time liabilities (NDTL) as on March 31, 2006 from around 38 per cent a year ago, *albeit* still higher than

Table 1.19: Credit to Private Sector

(Per cent to GDP)

Country	1980	1990	1995	2000	2001	2002	2003	2004
1	2	3	4	5	6	7	8	9
Brazil	42	39	37	36	35	36	35	35
Chile	47	47	54	63	63	65	62	63
China	53	88	85	112	111	119	127	120
Hong Kong, China	..	164	153	156	155	151	152	150
India	25	30	29	32	33	37	37	41
Indonesia	9	47	54	20	18	19	21	24
Korea	51	63	61	91	95	101	103	98
Malaysia	49	69	124	140	149	146	141	130
Mexico	19	17	29	18	16	19	17	17
Philippines	42	22	45	44	40	37	36	35
Russian Federation	..	..	9	13	16	18	21	25
Singapore	81	97	106	111	130	114	115	107
Sri Lanka	17	20	31	29	28	29	30	32
Thailand	41	83	140	108	97	103	103	97
United Kingdom	28	116	115	133	138	142	148	156
United States	112	144	173	231	225	212	236	249
Region								
East Asia and Pacific	41	74	86	99	99	104	110	105
Europe and Central Asia	..	..	17	22	22	22	24	27
Latin America and Caribbean Islands	33	29	31	28	26	27	25	26
Middle East and North Africa	32	35	31	39	41	41	40	40
World	77	108	118	134	134	130	136	138

.. : Not available.
Source : World Development Indicators Database, World Bank; and Reserve Bank of India.

Table 1.20: Scheduled Commercial Banks' Non-SLR Investments

(Rupees crore)

Instrument	Outstanding as at end-March		
	2004	2005	2006
1	2	3	4
1. Commercial Paper	3,770	3,891	4,821
2. Units of UTI and other Mutual Funds	11,808	12,623	10,345
3. Shares issued by	9,696	13,427	15,044
3.1 Public Sector Undertakings	1,272	1,613	2,274
3.2 Private Corporate Sector	7,395	10,288	10,501
3.3 Public Financial Institutions	1,029	1,525	2,270
4. Bonds/debentures issued by	1,12,371	1,13,695	1,03,170
4.1 Public Sector Undertakings	48,646	45,937	32,345
4.2 Private Corporate Sector	27,903	31,934	29,523
4.3 Public Financial Institutions	30,704	29,190	26,402
4.4 Others	5,118	6,633	14,899
Total (1+2+3+4)	1,37,644	1,43,636	1,33,380
Memo :			
Bank Credit	8,40,785	11,00,428	15,07,077

Note : Excluding Regional Rural Banks.

the statutory requirement of 25 per cent. On the other hand, the Reserve Bank's net credit to the Government, as noted earlier, increased during 2005-06 reflecting the liquidity injection operations. As a result, the overall net bank credit to Government (*i.e.*, including the Reserve Bank and commercial and co-operative banks) increased by Rs.20,386 crore during 2005-06 as compared with Rs.1,670 crore in 2004-05.

I.3.11 In addition to liquidating a part of their gilt portfolio, banks also reduced their non-SLR investments (especially, investments in the bonds/ debentures issued by various corporate entities) by Rs.10,256 crore during 2005-06 (Table 1.20). Non-food credit extended by scheduled commercial banks, including their non-SLR investments, increased by 27.3 per cent during 2005-06 as compared with 24.1 per cent, net of conversion, during 2004-05.

I.3.12 Apart from higher deposit mobilisation and liquidating their gilt as well as non-SLR investments, banks were able to finance higher demand for bank credit by raising funds from the primary market and internal accruals. Continued recourse to call/term funding as well as issuances of subordinate Tier II bonds also provided funds to banks to finance higher credit demand (Table 1.21).

Table 1.21: Scheduled Commercial Banks Survey

(Amount in Rupees crore)

Item	Variation			
	2004-05		2005-06*	
	Amount	Per cent	Amount	Per cent
1	2	3	4	5
Sources of Funds				
I. Aggregate Deposits	1,92,269	12.8	3,23,913	18.1
II. Call/Term Funding from Financial Institutions	9,678	39.2	11,224	15.6
III. Overseas Foreign Currency Borrowings	8,529	49.8	1,295	4.5
IV. Capital and Reserves	29,135	27.9	40,320	29.3
Uses of Funds				
I. Bank Credit	2,26,761	27.0	3,54,868	30.8
II. Investments in Government Securities	52,031	7.9	-19,514	-2.7
III. Investments in Other Approved Securities	-2,658	-11.6	-3,295	-16.5
IV. Foreign Currency Assets	-8,295	-24.1	14,059	47.8
V. Balances with Reserve Bank	19,108	27.7	34,077	36.6

* : Variation over April 1, 2005.

Note : 1. Data are provisional.

2. Variations of select aggregates are adjusted for the effect of conversion of a non-banking entity into a banking entity on October 11, 2004.

I.3.13 On a quarterly basis, operations of scheduled commercial banks display certain important features. As the reporting Fridays for end-September and end-March during 2005-06 fell on September 30, 2005 and March 31, 2006 (coinciding with half yearly and yearly closing, respectively), the second and the fourth quarter data show sharp increases *vis-à-vis* the other quarters as well as the corresponding quarters of the previous year (Table 1.22).

I.3.14 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 (Chart I.11).

Table 1.22: Operations of Scheduled Commercial Banks

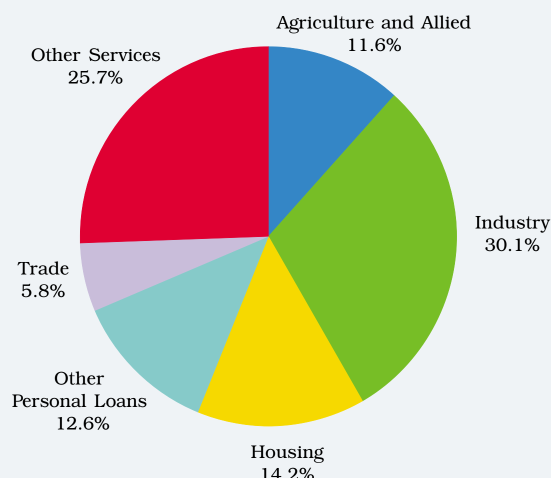
(Rupees crore)

	Outstanding as on March 31, 2006	Variation							
		2004-05				2005-06			
		Q1	Q2	Q3	Q4	Q1*	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10
Components									
1. Aggregate Deposits of Residents (a+b)	20,49,773	57,050	21,232	38,447	78,251	7,145	1,29,596	13,065	1,90,983
a) Demand Deposits	3,64,640	-12,155	2,277	15,280	17,604	-22,249	41,167	-3,430	63,135
b) Time Deposits of Residents	16,85,133	69,206	18,955	23,167 (19,654)	60,647	29,394	88,430	16,495	1,27,848
2. Call/Term Funding from Financial Institutions	83,144	5,409	530	35,464 (289)	3,451	-1,002	7,359	1,836	3,031
Sources									
1. Credit to the Government	7,00,742	40,056	-9,546	-5,918 (-18,111)	39,632	-1,457	18,324	-25,068	-11,314
2. Credit to the Commercial Sector (a to d)	16,63,499	32,884	40,538	1,08,835 (75,953)	79,929	12,862	1,04,416	53,032	1,72,011
a. Bank Credit	15,07,077	38,085	41,605	1,07,402	72,551	8,994	1,15,035	62,858	1,67,981
Food Credit	40,691	7,100	-4,872	5,590	-2,659	4,788	-5,255	1,464	-322
Non-food Credit	14,66,386	30,985	46,477	1,01,812	75,210	4,206	1,20,290	61,394	1,68,303
b. Net Credit to Primary Dealers	4,369	-678	977	-923	125	7,130	-2,759	1,128	-2,913
c. Investments in Other Approved Securities	16,712	-184	-561	-1,232	-680	-532	-10	-736	-2,017
d. Other Investments (in non-SLR Securities)	1,35,340	-4,339	-1,482	3,587	7,933	-2,730	-7,851	-10,218	8,961
3. Net Foreign Currency Assets of Commercial Banks (a-b-c)	-45,616	-6,706	904	-3,172	-8,652	-2,057	-4,850	9,935	26,612
a. Foreign Currency Assets	43,494	-2,741	56	2,441	-8,051	-2,179	-1044	11,169	6,114
b. Non-resident Foreign Currency Repatriable Fixed Deposits	59,275	953	-189	-654	692	804	187	1,856	-19,723
c. Overseas Foreign Currency Borrowings	29,834	3,012	-658	6,267	-90	-925	3,618	-622	-775
4. Net Bank Reserves	1,38,619	10,392	-3,644	14,151	-1,267	3,060	9,679	-2,886	25,729
5. Capital Account	1,77,727	14,884	1,393	9,435	3,423	20,359	2,530	9,342	8,090

* : Variation over April 1, 2005.

Note : 1. Data relate to last reporting Friday of each quarter.
2. Figures in parentheses are adjusted for the effect of conversion of a non-banking entity into a banking entity on October 11, 2004.

Chart I.11: Incremental Bank Credit during 2005-06



I.3.15 Growth in credit to industry was mainly accounted for by infrastructure (transport, power, roads, port, telecommunication, *etc.*), construction, textiles, iron and steel, chemicals, petroleum, vehicles, gems and jewellery, engineering and food-processing industries (Table 1.23 and Appendix Table I.22). Infrastructure sector alone absorbed around one-fourth of incremental credit to the industry, while textiles and iron and steel together bagged another one-fourth of the incremental credit. Credit to agriculture sector also accelerated reflecting the various initiatives to increase the flow of credit to the sector. Housing sector continued to be a key driver of bank credit – recording a growth of 44.8 per cent during 2005-06 and absorbing around 14 per cent of the incremental bank credit (Box I.9). Rising disposable incomes, low interest rates and tax incentives have sustained demand for housing in the recent years. Credit to commercial real estate continued to grow at a fast pace.

Table 1.23: Sectoral Deployment of Non-food Gross Bank Credit

(Amount in Rupees crore)

Sector/Industry	Outstanding as on March 31, 2006	Variation			
		2004-05 (March 18, 2005 over March 19, 2004)		2005-06 (March 31, 2006 over March 18, 2005)	
		Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6
Non-food Gross Bank Credit (1 to 6)	**14,05,146**	**1,88,069**	**25.8**	**4,05,358**	**40.5**
1. Agriculture and Allied Activities	**1,72,292**	**31,774**	**35.1**	**47,042**	**37.6**
2. Industry (Small, Medium and Large)	**5,49,057**	**62,014**	**19.8**	**1,22,165**	**28.6**
Small Scale Industries	90,239	8,051	12.2	15,651	21.0
3. Services	**48,137**	n.a.	n.a.	**17,553**	**57.4**
Transport Operators	16,101	n.a.	n.a.	6,502	67.7
Professional & Others	16,070	n.a.	n.a.	2,809	21.2
4. Personal Loans	**3,53,777**	n.a.	n.a.	**1,08,697**	**44.4**
Consumer Durable	8,783	108	1.3	-300	-3.3
Housing	1,86,429	n.a. (23,192)	n.a. (44.6)	57,701	44.8
Advances against Fixed Deposits	34,897	3,259	12.4	5,047	16.9
Advances to Individuals against share, bonds, *etc.*	5089	366	18.1	972	23.6
Credit Cards Outstanding	9,177	n.a.	n.a.	3,417	59.3
Education	10,057	n.a.	n.a.	4,938	96.5
5. Trade	**81,402**	**31,262**	**125.7**	**23,454**	**40.5**
6. Others	**2,00,481**	n.a.	n.a.	**86,447**	**75.8**
Real Estate Loans	26,682	7,622	136.7	13,380	100.6
Non-Banking Financial Companies	30,942	2,501	14.9	8,458	37.6
Memo :					
Priority Sector	**5,09,910**	**1,06,235**	**40.3**	**1,28,434**	**33.7**
Industry (Small, Medium and Large)	**5,49,057**	**62,014**	**19.8**	**1,22,165**	**28.6**
Food Processing	30,843	1,109	5.4	6,410	26.2
Textiles	57,716	4,648	13.6	13,739	31.2
Petroleum, Coal Products & Nuclear Fuels	24,103	1,426	10.6	8,534	54.8
Chemical and Chemical Products	48,935	1,661	5.4	9,443	23.9
Iron and Steel	50,358	3,120	11.9	14,384	40.0
Other Metal and Metal Products	14,436	1,938	23.7	2,800	24.1
All Engineering	34,666	273	1.0	5,270	17.9
Vehicles, Vehicle Parts and Transport Equipments	18,667	2,990	54.7	6,805	57.4
Gems and Jewellery	19,866	3,013	32.8	5,560	38.9
Construction	13,867	1,708	28.6	5,745	70.7
Infrastructure	1,08,787	21,829	42.5	29,778	37.7

n.a. : Not Available.

Note : 1. Data are provisional and relate to select scheduled commercial banks which account for over 90 per cent of bank credit of all scheduled commercial banks.

2. Owing to change in classification of sectors/industries and coverage of banks, data for 2005-06 are not comparable with earlier data. Figures in parentheses for 2004-05 pertain only to housing loans of above Rs.15 lakh. Data on housing loans for 2005-06, on the other hand, are also inclusive of loans less than 15 lakhs.

I.3.16 In addition to increased recourse to bank credit, the corporate sector also resorted to other sources of funding – both domestic and foreign – to meet their financing needs. Amongst domestic sources, buoyant domestic capital markets provided corporates an opportunity to raise funds through primary capital market issuances. Funds raised through issuances of commercial paper, however, turned negative in view of some tightness in domestic markets. Amongst foreign sources, funds mobilised through ADR/GDR issues more than doubled. Funds raised through external commercial borrowings also

Box I.9
Drivers of Credit Growth

Sustained demand for bank credit has characterised the Indian banking system in the past four years in consonance with the upturn in economic activity. Non-food credit extended by scheduled commercial banks (SCBs) recorded an average annual growth of 26.1 per cent between 2002-03 and 2005-06, notably higher than that of 14.5 per cent recorded during the preceding four-year period (1998-99 to 2001-02) as well as the long-run average of 17.8 per cent (1970-2006). The recent acceleration in credit growth could be partly attributed to the step-up in real GDP growth from 5.7 per cent between 1998-99 and 2001-02 to 7.1 per cent between 2002-03 and 2005-06. Empirical evidence indicates that credit demand is strongly influenced by economic activity. For the period since mid-1970s, income elasticity of (real) credit demand is estimated to be 1.6[1]. In recent years, growth in credit demand has outpaced the growth that would have emanated from the historical relationship between credit and economic activity. Decline in interest rates in the recent years could have also boosted demand for credit. The stagnation in credit flow observed during the late 1990s, in retrospect, was partly caused by reduction in demand on account of increase in real interest rates, turn down in the business cycle, and the significant business restructuring that occurred during that period (Mohan, 2006).

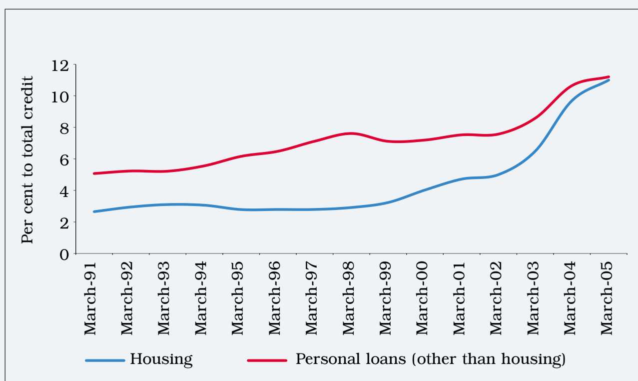
The sharp expansion in credit in recent years also reflects, in part, policy initiatives to improve flow of credit to sectors like agriculture. Thus, growth of credit to agriculture accelerated from 10.7 per cent during 1990s to 24.9 per cent between 2002-03 and 2004-05[2]. Similarly, demand for credit by industry has shown a recovery in the current cyclical upturn. Growth of credit to the industrial sector accelerated from 15.6 per cent during 1990s to 18.5 per cent between 2002-03 and 2004-05. Increasingly, retail credit led by demand for housing loans has emerged as a driver of growth in bank credit. Credit to housing sector recorded an increase of 57.3 per cent during 2002-05, well-above the growth recorded in the overall non-food credit over the same period. As a result, the share of housing credit in overall credit extended by SCBs has increased from 2.4 per cent at end-March 1990 to 11.0 per cent at end-March 2005. Retail credit growth has also emanated from increased use of credit cards, loans for consumer durables and demand for education loans (Chart). The share of non-housing retail credit has increased from four per cent at end-March 1990 to around 11 per cent at end-March 2005. Thus, the share of total retail credit in bank credit has increased from 6.4 per cent to over 22 per cent in the past 15 years. The share of agriculture in total credit, which had declined from 15.9 per cent at end-March 1990 to 9.6 per cent at end-March 2001 has since recovered to 10.8 per cent by end-March 2005. The share of industry in total credit has continued to decline, falling to 38.8 per cent by March 2005 from its recent peak of 49.1 per cent in March 1999.

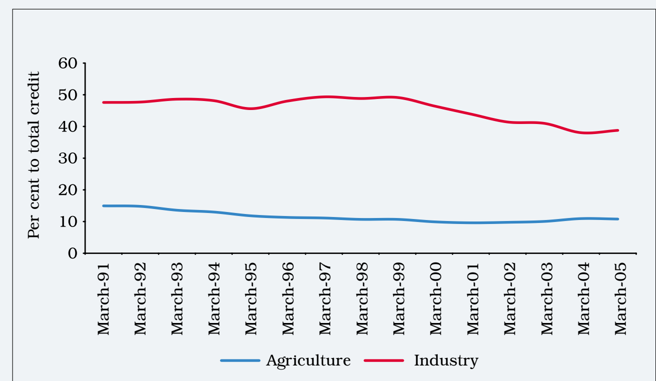
Demand for bank credit is expected to remain buoyant. With their investments in SLR securities fast approaching the statutory requirement, banks will need to intensify efforts to mobilise higher deposits through stable sources in order to be able to finance higher credit requirements. At the same time, in the light of high credit growth, a need is recognised to ensure that asset quality is maintained.

Reference

Mohan, Rakesh (2006), "Financial Sector Reforms and Monetary Policy: The Indian Experience", Reserve Bank of India Bulletin, July.

Chart : Bank Credit by SCBs – Sectoral Shares





[1] Using annual data from 1975-76 to 2004-05, the estimated long-run relationship in an autoregressive distributed lag (ARDL) model of order (1,0,0) is as follows: LRNFC = -12.6 + 1.65 LGDPR – 0.12 AVGRATE,
(10.6) (16.9) (2.3)
where, LRNFC, LGDPR and AVGRATE denote (log of) real non-food credit, (log of) real GDP and weighted average lending rate of scheduled commercial banks, respectively. Figures in parentheses are t-statistics.

[2] Data on sectoral deployment of credit in this Box are based on Basic Statistical Returns of Scheduled Commercial Banks in India.

Table 1.24: Key Sources of Funds to Corporates

(Rupees crore)

Item	Variation during	
	2004-05	2005-06
1	2	3
A. Bank Credit to Industry #	62,014	1,22,165
B. Flow from Non-banks to Corporates		
1. Capital Issues (i+ii)	10,456	13,781
i) Non-Government Public Ltd. Companies (a+b)	7,772	13,408
a) Bonds/Debentures	0	245
b) Shares	7,772	13,163
ii) PSUs and Government Companies	2,684	373
2. ADR/GDR Issues	2,960	7,262
3. External Commercial Borrowings (ECBs)	39,517	40,496
4. Issue of CPs	4,734	-1,517
C. Depreciation Provision +	22,697	28,883
D. Profit after Tax +	39,599	67,506

: Data pertain to select banks which account for over 90 per cent of bank credit of all scheduled commercial banks.

+ : Data are based on audited/unaudited abridged results of select non-financial non-Government companies.

Note : 1. Data are provisional.

2. Data on capital issues pertain to gross issuances excluding issues by banks and financial institutions. Figures are not adjusted for banks' investments in capital issues, which are not expected to be significant.

3. Data on ADR/GDR issues exclude issuances by banks and financial institutions.

4. Data on external commercial borrowings include short-term credit. Data for 2005-06 are exclusive of the IMD redemption.

remained steady, reflecting investment demand in the economy even as interest rates in international financial markets edged up over the course of the year. Internal accruals in view of robust profitability continued to remain an important source of funds to corporates (Table 1.24).

Developments during 2006-07

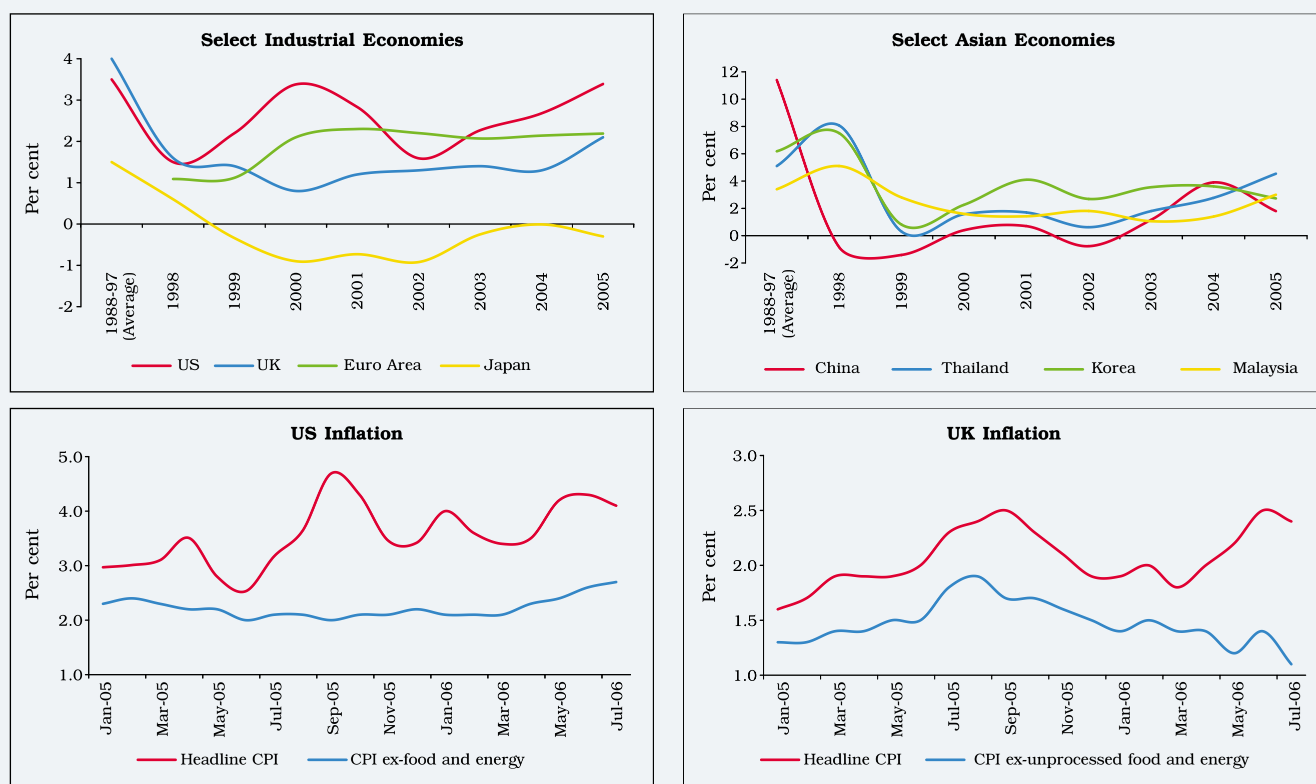
I.3.17 On a y-o-y basis, growth in broad money (M_3) accelerated to 19.1 per cent on August 4, 2006 from 14.4 per cent a year earlier reflecting the impact of sustained credit demand. Scheduled commercial banks' non-food credit registered a growth of 32.2 per cent as on August 4, 2006 on top of 31.2 per cent a year back while growth in aggregate deposits accelerated to 20.9 per cent from 15.8 per cent a year ago.

PRICE SITUATION

I.3.18 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.3.19 Global headline inflation firmed up during the second half of 2005 in response to pressures from international crude oil prices reaching record highs (Chart I.12 and Table 1.25). 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 (Box I.10). 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.



Source : World Economic Outlook, April 2006, IMF; US Bureau of Labour Statistics; and National Statistics, UK.

I.3.20 Many central banks tightened monetary policy during 2005 and 2006 in order to contain inflation and inflationary expectations, especially in view of continued strong output growth and the fact that a significant part of the increase in international crude oil prices is increasingly viewed by policy authorities as somewhat permanent. In the US, with rising resource utilisation and elevated prices of energy and other commodities viewed as having the potential to add to inflationary pressures, the US Federal Reserve raised its target Federal Funds rate to 5.25 per cent – an increase of 425 basis points between June 2004 and June 2006 (25 basis points hike at each of its 17 meetings till June 2006) (Table 1.26). In its latest

Table 1.25: Retail Petroleum Products Prices – Select Countries

(Per cent increase between March 2004 and June 2006)

Sr. No.	Country	Petrol			Diesel		
		Including Tax	Excluding Tax	Share of Taxes in Total Price (June 2006)	Including Tax	Excluding Tax	Share of Taxes in Total Price (June 2006)
1	2	3	4	5	6	7	8
1.	France	30.1	87.8	62.1	38.2	90.7	45.3
2.	Germany	26.5	79.0	63.0	32.8	81.0	48.8
3.	Italy	28.2	66.5	58.9	40.3	80.9	41.4
4.	Spain	34.9	73.8	50.6	44.7	84.4	35.1
5.	UK	28.3	88.1	64.3	28.7	85.3	56.7
6.	Japan	23.5	56.2	44.3	26.7	47.1	33.2
7.	Canada	66.9	92.9	30.3	71.4	90.6	23.9
8.	USA	66.7	85.6	13.8	78.1	107.7	15.9

Source : International Energy Agency.

Box I.10

Oil Price Pass-through: A Cross-country Analysis

International crude oil prices have more than doubled in the past two years. In view of the fact that a large component of this increase is viewed as permanent, keeping domestic prices unchanged not only leads to inefficiency in the use of petroleum products but also poses increasing risks to the health of public finances and overall macroeconomic stability. In most industrial economies, end-user prices, which are market-determined, have increased in consonance with higher crude oil costs. Developing countries, where fuel prices are typically administered, have also been passing on the impact to domestic petroleum products prices, although the pass-through remains incomplete.

The increase in end-user prices of petroleum products varies across countries depending upon the share of taxes in retail prices as well as the extent of pass-through. Amongst the sample countries, retail prices of petrol (including tax) have increased ranging from 24 per cent (Japan) to 67 per cent (USA and Canada) between March 2004 and June 2006 (see Table 1.25). As regards diesel, the increase in prices (including tax) ranged between 27 per cent (Japan) and 78 per cent (USA). In comparison, India's domestic retail prices of petrol and diesel increased by about 40 per cent and 50 per cent, respectively, over the same period. Amongst Asian economies, in Thailand, petrol and diesel prices have been increased by about 75 per cent and 88 per cent, respectively, between March 2004 and June 2006. In Indonesia, which used to cover only crude costs, petrol prices have been increased by almost 150 per cent since February 2005. Similarly, in Malaysia, petrol prices were raised by 19 per cent in February 2006.

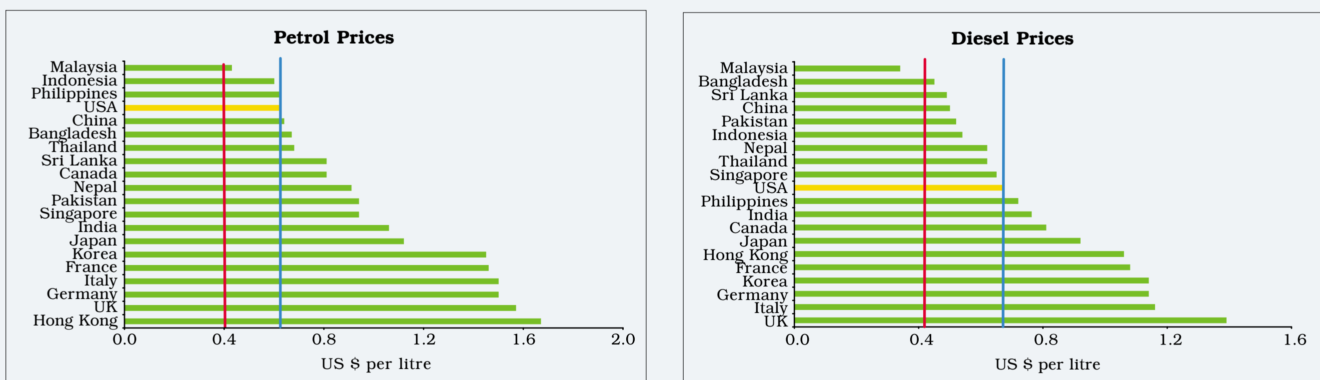
However, cross-country analysis of end-user prices does not present a proper picture of the pass-through in view of the wedge created by the tax component. The tax component varies across countries and is as high as 40-60 per cent of retail prices of petrol and diesel in European countries such as the UK, France, Italy and Germany. On the other hand, taxes at 14-16 per cent are fairly low for the US. In India, the tax component is estimated to be around 55 per cent of the retail price of petrol and 34 per cent in the case of diesel. Analysis of the pass-through by excluding the tax component shows that petrol prices (excluding taxes) have increased in a range of 56-93 per cent while diesel prices (excluding taxes) have recorded an increase in the range of 47-108 per cent. For countries with high tax components such as the European countries, the price increase (excluding tax component) is much higher than that obtained from variation in end-user prices (inclusive of taxes); on the other hand, for countries with low tax component such as the US, the increase in prices (excluding the tax component) is much closer to prices inclusive of the tax component. Illustratively, for the UK, petrol prices (excluding tax) have increased by about 88 per cent between March 2004 and June 2006 in contrast to an increase of about 28 per cent (including tax component). On the other hand, in the USA, the increase in petrol prices (excluding tax) at 86 per cent was much more comparable to that of 67 per cent in prices inclusive of the tax component over the same period.

Since the tax component is fairly small in the US, the retail US prices - determined in a competitive market with an efficient refining industry - can be considered as an approximate benchmark for the full pass-through retail price particularly for countries with low tax components (ADB, 2006). In a number of developing countries, retail prices, especially diesel, remain below this benchmark suggesting that domestic prices need to increase further in those economies (Chart).

References

1. Asian Development Bank (2006), Asian Development Outlook 2006.
2. International Monetary Fund (2006), World Economic Outlook, April.
3. Reserve Bank of India (2006), 'Oil Price Hike: The Implications for SAARC Countries', May.

Chart : International Oil Prices



Note : 1. Data for China, Hong Kong, Korea, Thailand, Malaysia, Indonesia, Philippines, Bangladesh, Pakistan and Sri Lanka pertain to February 2006 as per the Asian Development Outlook 2006, ADB and data for other countries are for March 2006 from IEA.

2. Blue line indicates the retail petroleum product prices in the US market, while red line indicates the price of crude oil.

meeting held on August 8, 2006, the US Federal Reserve kept the Fed Funds target rate unchanged at 5.25 per cent. With inflation remaining above the target, the European Central Bank (ECB) - after maintaining rates at historically low levels for two and a half years – has raised the key policy rate by 100 basis points since December 2005 to keep inflation expectations anchored to levels consistent with price stability. In the UK, the Bank of England raised its policy rate by 25 basis points on August 3, 2006 after having kept it unchanged for almost a year. In Japan, year-on-year consumer price inflation has turned positive since January 2006 and unit labour costs have picked up suggesting easing of underlying deflationary pressures. The Bank of Japan (BoJ), therefore, decided in March 2006 to end the quantitative easing policy by changing the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralised overnight call rate. In July 2006, the BoJ decided to raise the uncollateralised overnight call rate by 25 basis points on expectations that the economy would expand for a sustained period and CPI inflation would follow a positive trend. The Reserve Bank of Australia also raised its policy rate by 25 basis points each in May and August 2006 to 6.0 per cent in response to strong economic activity and underlying inflationary pressures.

I.3.21 Many central banks in emerging Asia also tightened their monetary policies during 2005 and 2006 in view of inflationary pressures. The Bank Indonesia raised policy rates by 425 basis points between July-December 2005; the policy rate has been cut by 100 basis points since May 2006. The Bank of Thailand has raised rates by 275 basis points since June 2005 while the Bank of Philippines has raised rates by 75 basis points since March 2005. In Korea, inflationary pressures seen from strong economic recovery and high oil prices have prompted the Bank of Korea to raise the policy rate by 125 basis points since the tightening began in October 2005. On the other hand, despite strong growth, consumer price inflation in China fell to 1.8 per cent in 2005 from 3.9 per cent a year ago, mainly due to incomplete pass-through of higher oil prices, lower food prices and downward pressures on prices in some sectors

Table 1.26: Global Inflation Indicators

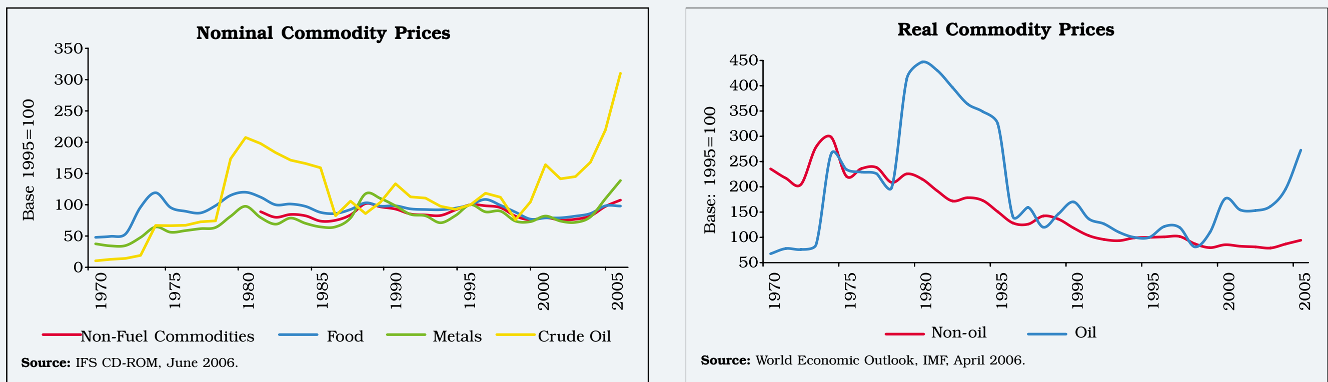
(Per cent)

Country/ Region	Key Policy Rate	Policy Rates (August 17, 2006)	Changes in Policy Rates (basis points)		Inflation (y-o-y)		Growth (y-o-y)	
			Since end-March 2005	Since end-March 2006	2004	2005	2004	2005
1	2	3	4	5	6	7	8	9
Developed Economies								
Australia	Cash Rate	6.00	50	50	2.3	2.7	3.6	2.5
Canada	Overnight Rate	4.25	175	50	1.8	2.2	2.9	2.9
Euro area	Interest Rate on Main Refinancing Operations	3.00	100	50	2.1	2.2	2.1	1.3
Japan	Uncollateralised Overnight Call Rate**	0.25	25	25	0.0	-0.3	2.3	2.7
UK	Official Bank Rate	4.75	0	25	1.3	2.1	3.1	1.8
US	Federal Funds Rate	5.25	250	50	2.7	3.4	4.2	3.5
Developing Economies								
Brazil	Selic Rate	14.75	(-) 450	(-) 175	6.6	6.9	4.9	2.3
India	Reverse Repo Rate	6.00	125	50	3.8	4.2	7.5	8.4*
Indonesia	BI Rate	11.75	325^	(-)100	6.1	10.5	5.1	5.6
Israel	Key Rate	5.50	200	75	-0.4	1.3	4.4	5.2
Korea	Overnight Call Rate	4.50	125	50	3.6	2.7	4.6	4.0
Philippines	Reverse Repo Rate	7.50	75	0	6.0	7.6	6.0	5.1
South Africa	Repo Rate	8.00	50	100	1.4	3.4	4.5	4.9
Thailand	14-day Repo Rate	5.00	275	50	2.8	4.5	6.2	4.4

* : Financial year basis. **^ :** Change since July 2005.

** : The Bank of Japan decided on March 9, 2006 to change the operating target of money market operations from the outstanding balance of current accounts at the Bank to the uncollateralised overnight call rate.

Source : World Economic Outlook, April 2006, IMF and websites of respective central banks.

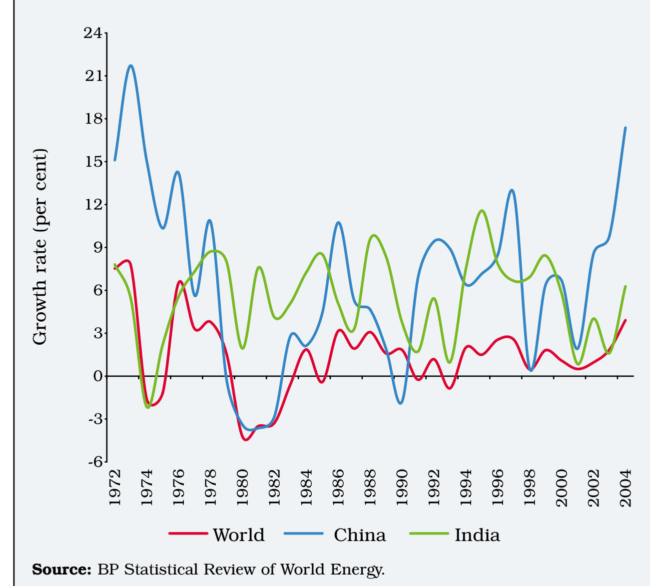


reflecting excess capacity. In view of stronger growth in money supply and credit, however, the People's Bank of China increased the benchmark 1-year lending rate by 27 basis points to 5.85 per cent effective April 28, 2006 and raised the cash reserve ratio by 50 basis points each effective July 5, 2006 and August 15, 2006. Amongst other emerging economies, South Africa raised the policy rates by 50 basis points each in June and August 2006 to 8.0 per cent. Turkey also raised the policy rate by 425 basis points during June - July 2006. On the other hand in view of weak economic activity, Brazil has reduced policy rates on nine occasions since September 2005 to 14.75 per cent on July 19, 2006.

Global Commodity Prices

I.3.22 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 (Charts I.13 and I.14). 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.

I.3.23 International crude oil prices which rose to record highs during 2005-06 firmed up further during the first four months of 2006-07. Although growth in global demand for oil decelerated during 2005, oil prices have firmed up reflecting limited spare capacity. Notwithstanding periodic increases in supply by the Organisation of the Petroleum Exporting Countries (OPEC), tight supply conditions were further exacerbated by hurricane-related supply disruptions in the US and concerns over stability of supplies from the Middle East due to geo-political uncertainties. Speculative purchases by hedge funds further added to nervousness in the world oil market, imparting a great deal of volatility to oil prices. Reflecting these factors, international crude oil prices have reached successive record highs - the US West Texas Intermediate (WTI) crude prices rose to US $ 70.8 a barrel on August 30, 2005 in the immediate aftermath of Hurricane Katrina. Prices in the subsequent months moderated to below US $ 60 a barrel during November-December 2005 reflecting supply augmenting efforts by the International Energy Agency (IEA) and the OPEC amidst signs of slowing global oil demand growth



and a relatively warmer weather in the US. But, prices again edged up to US $ 67-68 a barrel in January 2006 on disruption of Russian natural gas deliveries to Ukraine threatening supplies to Western Europe, unrest in Nigeria and tensions over Iran's nuclear programme. Average international crude oil prices increased by 38.3 per cent from US $ 41.3 a barrel in 2004-05 to US $ 57.1 a barrel in 2005-06 (Table 1.27). Renewed concerns over Iran's nuclear programme, unrest in Nigeria and heightened geo-political uncertainties in the Middle East have led to further increases since March 2006, with prices reaching a new record high of US $ 78.4 a barrel on July 14, 2006.

I.3.24 Non-fuel commodity prices were led by higher metals and sugar prices. Metal prices firmed up sharply during 2005, and gathered pace during the first quarter of 2006 with prices reaching record highs/ multi-year highs on the back of robust construction and manufacturing demand from China and the US on the one hand and supply constraints on the other hand. The rally in metal prices was led by copper, zinc, iron ore and aluminium whose prices increased by 37 per cent, 45 per cent, 52 per cent and 14 per cent, respectively, during 2005-06 reflecting declining inventories to historical lows as well as a series of supply disturbances, including the labour strikes in the US and Chile in the copper industry. As a result, the IMF's metals price index rose by 29 per cent in 2005-06. However, following the release of higher than anticipated US inflation data for April 2006, global metals prices witnessed correction during May-June 2006 on fears that further monetary tightening by the US might slow down demand for metals. International steel prices stabilised in the second half of 2005 on the back of supply management efforts by major steel producers in the face of strong increase in Chinese production, higher inventories in the US and sluggish demand in Japan. Prices have, however, again edged higher in recent months.

Table 1.27: International Crude Oil Prices

(US dollars per barrel)

Year/ Month	Dubai Crude	UK Brent	US WTI	Average Crude Price	Indian Basket Price
1	2	3	4	5	6
2001-02	21.8	23.2	24.1	23.0	22.4
2002-03	25.9	27.6	29.2	27.6	26.6
2003-04	26.9	29.0	31.4	29.1	27.8
2004-05	36.4	42.2	45.0	41.3	38.9
2005-06	53.4	58.0	59.9	57.1	55.4
March 2004	30.5	33.8	36.7	33.7	31.9
March 2005	45.6	53.1	54.2	50.9	48.8
March 2006	57.7	62.3	62.9	60.9	59.6
April 2006	64.1	70.4	69.4	68.0	66.8
May 2006	64.9	70.2	70.9	68.7	67.2
June 2006	65.1	68.9	70.9	68.3	66.7
July 2006	69.1	73.9	74.4	72.5	71.1

Source : International Monetary Fund and the World Bank.

I.3.25 After remaining broadly stable during April-June 2005, sugar prices firmed up sharply from September 2005 reflecting declining global inventories and higher global sugar consumption, especially from the developing countries of the Far East and Latin America. Global sugar prices during April-June 2006 were almost double of their levels a year ago.

I.3.26 Prices of agricultural commodities exhibited mixed trends during 2005-06. Wheat prices firmed up from the second half of 2005 due to lower production. Rice prices eased in the second half of 2005 on the back of record output, but again hardened in the first half of 2006 reflecting higher demand from many countries in Asia and a tightening of export availabilities in major exporting countries. Prices of oilseeds eased during the second half of 2005-06 with the waning of weather concerns and record carryover stocks at the close of the marketing season (October-September). On the other hand, prices of edible oils and fats which eased during the second half of 2005, have strengthened in recent months due to strong consumption demand from China and India and demand for non-food uses such as biodiesel from the EU and the US. Global cotton prices increased between October 2005 and March 2006 on the back of strong demand, especially from China and estimated lower global production during 2005-06 season.

I.3.27 International gold prices increased sharply during 2005 as investors switched to gold, partly on concerns over higher US inflation and expected depreciation of the US dollar. According to the estimates of the World Gold Council (WGC), global demand for gold rose by 7 per cent to 3574 tonnes in 2005. Global supply of gold rose by 15 per cent to 3859 tonnes in 2005 partly reflecting higher official sector sales – net central bank selling reached a record level of 663 tonnes. In India, overall demand in 2005 was estimated to have increased by 17 per cent to 724 tonnes. India's share was, thus, more than a fifth of total global demand in 2005. Available information indicates that only a small proportion (less than 10 per cent) of the gold imported into India is used for jewellery exports.

INFLATION CONDITIONS IN INDIA

Wholesale Price Inflation

I.3.28 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 (Table 1.28). 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 (Appendix Tables 25 and 26).

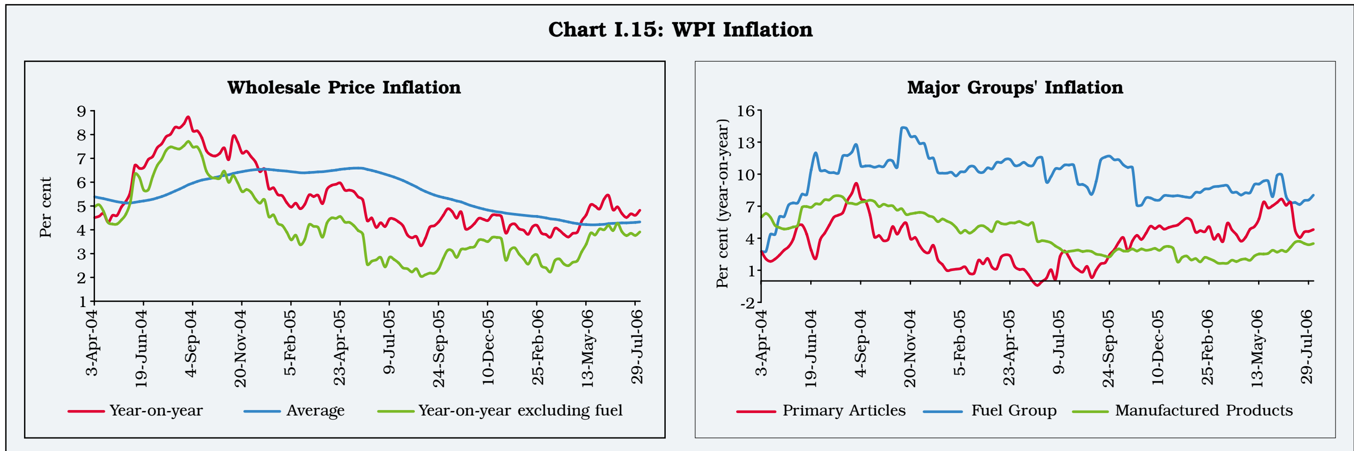
Table 1.28: Annual WPI Inflation by Component

(Base: 1993-94=100)

(Per cent)

Major Group / Item		Inflation Rate (year-on-year)		Weighted Contribution to Inflation	
	Weight	2004-05	2005-06	2004-05	2005-06
1	2	3	4	5	6
All Commodities	**100.0**	**5.1**	**4.1**	**100.0**	**100.0**
1. Primary Articles	**22.0**	**1.3**	**5.4**	**5.5**	**28.3**
Food Articles	15.4	3.0	6.6	8.9	24.2
i. Rice	2.4	2.9	2.7	1.3	1.4
ii. Wheat	1.4	-1.1	12.9	-0.3	4.3
iii. Pulses	0.6	-2.6	33.2	-0.3	4.4
iv. Vegetables	1.5	11.9	8.1	2.3	2.1
v. Fruits	1.5	11.5	-1.0	4.1	-0.5
vi. Milk	4.4	-1.7	1.9	-1.5	1.9
vii. Eggs, Fish and Meat	2.2	7.3	14.3	3.1	7.9
Non-Food Articles	6.1	-6.9	-1.9	-8.8	-2.7
i. Raw Cotton	1.4	-23.8	-1.4	-6.5	-0.4
ii. Oil Seeds	2.7	-6.5	-7.8	-3.4	-4.5
iii. Sugarcane	1.3	-0.7	0.7	-0.2	0.3
Minerals	0.5	68.0	43.6	5.3	6.8
i. Iron Ore	0.2	119.1	60.0	5.2	6.9
2. Fuel, Power, Light and Lubricants	**14.2**	**10.5**	**8.9**	**42.7**	**47.9**
i. Mineral Oils	7.0	16.0	13.2	34.9	39.8
ii. Electricity	5.5	0.8	4.5	1.2	8.2
iii. Coal Mining	1.8	17.1	0.0	6.4	0.0
3. Manufactured Products	**63.8**	**4.6**	**1.7**	**52.0**	**23.2**
i. Food Products	11.5	0.4	0.9	0.9	2.2
of which: Sugar	3.6	19.7	6.6	10.3	4.9
ii. Cotton Textiles	4.2	-12.7	1.1	-10.4	1.0
iii. Man Made Fibre	4.4	0.6	-4.6	0.3	-2.5
iv. Chemicals and Chemical Products	11.9	3.9	3.6	9.1	10.2
of which : Fertilisers	3.7	3.3	0.3	2.2	0.2
v. Basic Metals, Alloys and Metal Products	8.3	17.1	-2.9	28.4	-6.7
of which: Iron and Steel	3.6	21.3	-7.5	17.0	-8.7
vi. Non-Metallic Mineral Products	2.5	11.4	8.6	4.7	4.7
of which: Cement	1.7	10.2	13.0	2.9	4.8
vii. Machinery and Machine Tools	8.4	7.1	3.9	8.6	6.1
viii. Transport Equipment and Parts	4.3	6.2	1.2	4.3	1.1
Food Items (Composite)	**26.9**	**1.9**	**4.2**	**9.8**	**26.5**
WPI Excluding Food	**73.1**	**6.3**	**4.0**	**90.2**	**73.5**
WPI Excluding Fuel	**85.8**	**3.7**	**2.7**	**57.3**	**52.1**
Memo:					
GDP Deflator (as per the Base: 1999-2000=100)		4.0	4.1		
Average WPI Inflation		6.4	4.4		
Average CPI Inflation:					
Industrial Workers		3.8	4.4		
Urban Non-Manual Employees		3.6	4.7		
Agricultural Labourers		2.6	3.9		
Rural Labourers		2.6	3.9		

Chart I.15: WPI Inflation

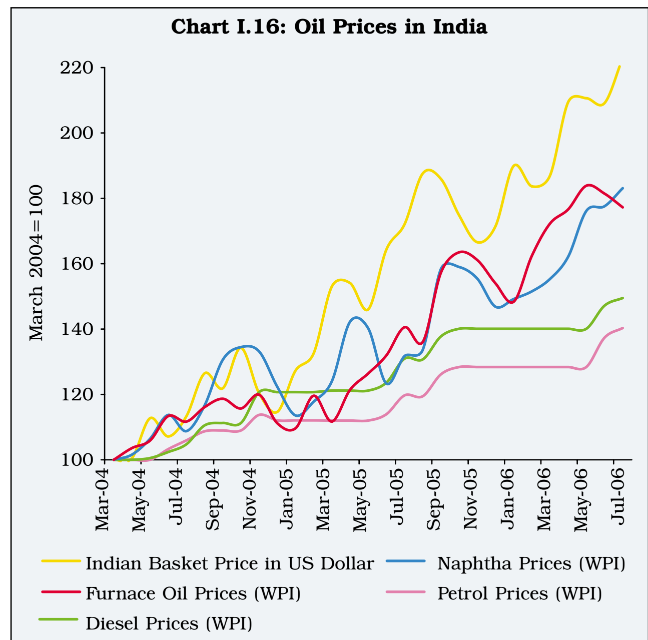


I.3.29 Inflation initially increased during 2005-06 to an intra-year high of 6.0 per cent on April 23, 2005 reflecting increase in prices of fruits and vegetables, iron and steel and select petroleum products such as furnace oil and naphtha. Subsequently, with the base effect coming into play and the revival of the monsoon, inflation began to ease reaching an intra-year low of 3.3 per cent on August 27, 2005. Inflation again edged up during the third quarter of 2005-06 – but remained below 5.0 per cent - under the impact of the hike in petrol and diesel prices in early September 2005 as also elevated vegetables prices. Headline inflation remained low during January-March 2006 on account of the seasonal easing of vegetables prices as well as reduction in domestic iron and steel prices, which offset upward pressures from non-ferrous metals and electricity prices. Consequently, inflation moderated to 4.1 per cent by end-March 2006.

I.3.30 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 (Chart I.15).

I.3.31 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 (Chart I.16). 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 (Box I.11).

Chart I.16: Oil Prices in India



I.3.32 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

Box I.11
Report of the Committee on Pricing and Taxation of Petroleum Products

In India, the pass-through of international crude oil prices to domestic prices has been partial as well as incomplete (restricted only to petrol and diesel), reflecting burden sharing between the Government and oil companies on the one hand and the consumers on the other hand. LPG and kerosene prices have been unchanged, but this has adverse implications for the oil marketing companies as well as the efficiency of resource use. The issues related to fuel subsidy were comprehensively addressed by the Committee on Pricing and Taxation of Petroleum Products (February 2006) (Chairman: Dr. C. Rangarajan). As international crude oil prices are unlikely to soften in the near to medium term, the Committee stressed on immediate adjustment of prices and subsidies with regard to petroleum products prices in India to promote efficiency in their use. Accordingly, the Committee recommended the following:

i) Trade parity principle should be followed for pricing petrol and diesel. Initially, the trade parity price could be a weighted average of the import parity and export parity prices in the ratio of 80:20;

ii) The Government should keep an arms length from the actual price setting by the oil marketing companies (OMCs) subject to the indicative ceiling;

iii) OMCs should disseminate the details of the pricing model adopted by them for promoting transparency;

iv) Termination of the principle of freight equalisation;

v) Customs duty on crude oil to be retained at 5 per cent, whereas that on petrol and diesel should be reduced from 10 per cent to 7.5 per cent.

vi) Excise duties should be restructured to protect the consumers from excessive volatility in prices by shifting to a system of pure specific excise duty (Rs.14.75 per litre for petrol and Rs.5 per litre for diesel) from the current position of a mix of *ad valorem* and specific excise duty (8 per cent + Rs.13 per litre for petrol and 8 per cent + Rs.3.25 per litre for diesel). The rate of specific duty may be reviewed every year as a part of the budgetary process.

vii) The Committee noted that if its recommendations were fully accepted, the domestic prices needed to increase by Rs.1.21/litre for petrol and Rs.1.96/litre for diesel;

viii) Subsidy for kerosene to be restricted to below poverty line (BPL) families;

ix) As regards LPG, given the large subsidy of Rs.171 per cylinder, domestic prices needed to be increased by Rs.75 per cylinder immediately followed by gradual increase of retail prices to eliminate subsidy over time;

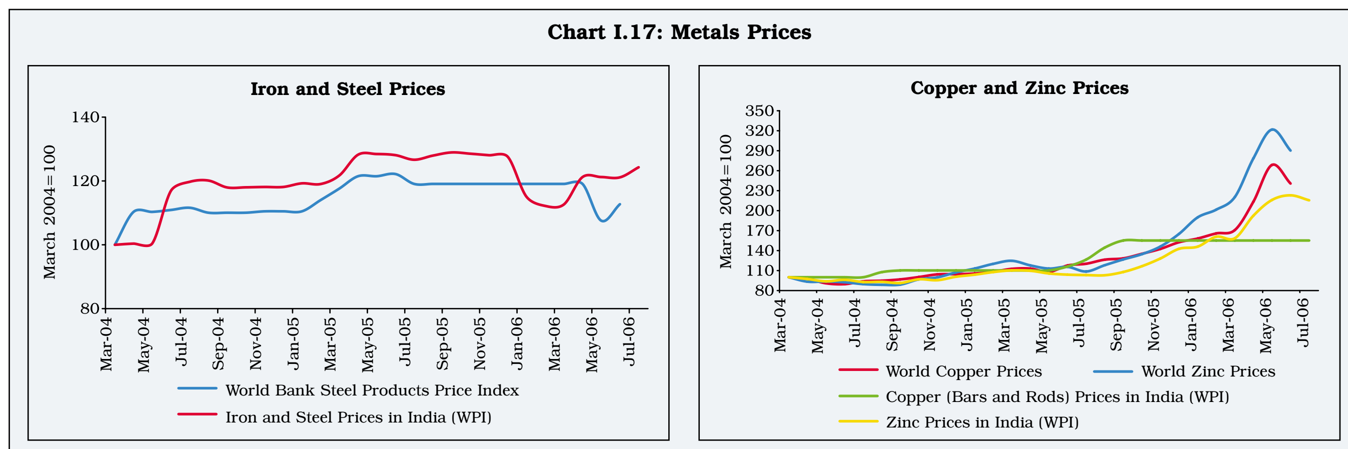
x) Cost of subsidy should be met through current provisioning without any recourse to oil bonds since it only postpones the resolution of the problem. The Committee estimated that gross annual subsidy burden on account of LPG and kerosene is Rs.26,604 crore (0.8 per cent of GDP). The Committee noted that if its recommendations of restricting subsidising kerosene only to BPL families and one time increase of Rs.75 per cylinder for LPG were accepted, then the subsidy burden would be Rs.15,875 crore (0.5 per cent of GDP). The Committee further recommended that the upstream subsidies being paid by Oil and Natural Gas Corporation (ONGC)/Oil India Limited (OIL) to OMCs be stopped and the cess being paid by ONGC/OIL be increased accordingly to increase transparency and fiscal integrity. Fiscal integrity demands that all the support required to be borne by ONGC/OIL should come as a cess, be accounted for in the consolidated fund and then allocated for funding the subsidy. The total subsidy amount (Rs.15,875 crore) be shown explicitly in the budget as such.

It needs to be noted that international crude oil prices which were around US $ 60 a barrel at the time of the Committee's recommendations are moving around US $ 75 a barrel. In this context, as the Reserve Bank's Annual Policy Statement for 2006-07 observed, the Indian economy needs to prepare for higher orders of pass-through into consumer prices, in respect of the overhang as well as the possibility of additional increases in crude prices in the future. While the recommendations of the Rangarajan Committee are being debated, it is increasingly becoming clear that there has to be a fuller pass-through of increases in international crude prices. In the event, inflation could turn out to be higher in 2006-07 than the current benign levels. Regardless of the manner in which the future scenario for crude oil prices unfolds, there is a need for continuous and close monitoring and appropriate policy responses to contain its inflationary impact.

Reference

Government of India (2006), Report of the Committee on Pricing and Taxation of Petroleum Products (Chairman: Dr. C. Rangarajan), February.

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.3.33 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 (Chart I.17). 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.

I.3.34 To summarise, despite dominance of supply-side pressures emanating from oil prices, headline inflation for 2005-06 turned out to be lower than anticipated. Pre-emptive monetary policy actions in the form of reverse repo rate hikes have helped in anchoring inflation expectations. The incomplete pass-through of international oil prices to domestic prices amidst the burden sharing strategy by oil companies as well as through customs/excise duty reductions also mitigated the immediate cost push impact of international crude oil prices. Furthermore, competitive pressures, improved corporate profitability and productivity gains in several sectors helped abate the second order effects of higher oil prices and contained manufactured products inflation.

Consumer Price Inflation

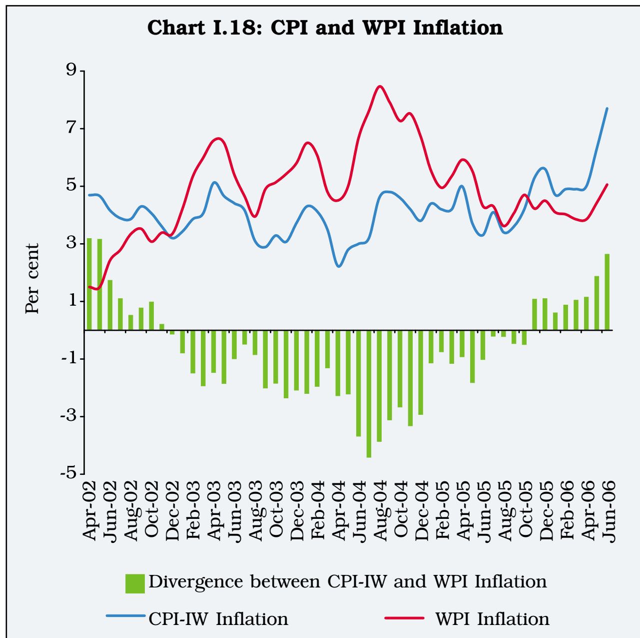
I.3.35 Consumer price inflation edged up during 2005-06 largely reflecting higher food and fuel prices (Table 1.29). While all measures of consumer price inflation recorded an increase, the CPI for Agricultural Labourers and Rural Labourers recorded relatively higher order of increases in 2005-06 as these indices have higher weights on food products. Food prices remained firm for greater part of the year initially on concerns about unsatisfactory progress of the South-West monsoon and subsequently due to damages to some crops on account of excessive rainfall and floods in parts of the country. Prices of services such as medical care, and transport and communication recorded higher increase during 2005-06. On the other hand, increase in the housing index - which includes rent paid for rented, self-owned and rent free houses - in the CPI-IW basket decelerated to 6.6 per cent (y-o-y) in March 2006 from 20.4 per cent in March 2005.

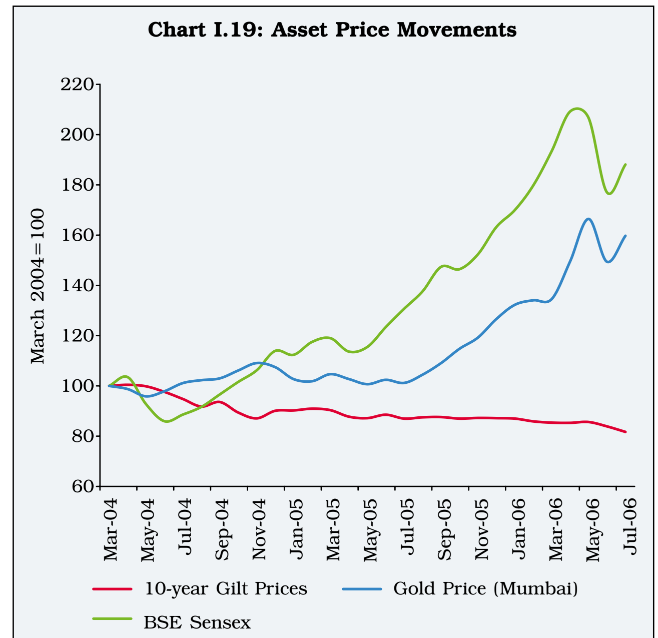
Table 1.29: Consumer Price Inflation (CPI) in India
(year-on-year)

(Per cent)

Inflation Measure	March 2003	March 2004	March 2005	March 2006	June 2006	July 2006
1	2	3	4	5	6	7
CPI-IW	4.1	3.5	4.2	4.9	7.7	-
CPI- UNME	3.8	3.4	4.0	5.0	6.5	-
CPI-AL	4.9	2.5	2.4	5.3	7.2	6.3
CPI-RL	4.8	2.5	2.4	5.3	7.2	5.9
Memo:						
WPI Inflation	6.5	4.6	5.1	4.1	4.8	4.6

IW : Industrial Workers   UNME : Urban Non-Manual Employees
AL : Agricultural Labourers   RL : Rural Labourers





I.3.36 WPI inflation exceeded CPI inflation during the first half of 2005-06 reflecting higher fuel and metals prices which have higher weights in the WPI *vis-à-vis* CPI. In contrast, CPI inflation exceeded WPI inflation in the second half of the year reflecting higher food prices, which have a higher weight in the CPI *vis-à-vis* WPI (Chart I.18 and Appendix Table 27).

Asset Prices and Inflation

I.3.37 While prices of goods and services remained relatively moderate, asset prices in India, as in other parts of the world, recorded sharp increase in 2005-06. Buoyancy in domestic equity markets continued on the back of strong support by FIIs as well as domestic mutual funds reflecting better prospects for economic activity and strong corporate performance (Chart I.19). Domestic gold prices firmed up in line with international trends. International gold prices, as noted earlier, have risen sharply since mid-2005 as investors preferred gold in an environment of higher inflation. During May-June 2006, domestic equity and gold prices witnessed some corrections in line with global trends. Gilt yields edged higher during 2005-06 and prices fell during the year, with intra-year movements influenced by trends in domestic inflation and liquidity conditions. Gilt yields edged up further during the first four months of 2006-07.

Developments during 2006-07

I.3.38 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.

I.3.39 In view of sustained rise in international crude oil prices, domestic petrol and diesel prices were raised by about Rs.4 (around nine per cent) and Rs.2 (around six per cent), respectively, effective June 6, 2006. LPG and kerosene prices were, however, left unchanged. The Government also announced the following measures: i) reduction in customs duty on petrol and diesel to 7.5 per cent from 10.0 per cent, ii) movement to trade parity pricing mechanism for petrol and diesel from the existing system of import parity pricing, and iii) issuance of oil bonds worth Rs.28,000 crore (over and above Rs.11,500 crore issued during 2005-06) to oil marketing companies to compensate for their under-recoveries in domestic operations.

I.3.40 In brief, monetary and liquidity conditions remained more or less comfortable during 2005-06 amidst a sharp and sustained pick-up in demand for bank credit. With credit growth outpacing deposit growth during 2005-06, banks scaled down their investments in Government securities as well as non-SLR securities. The Reserve Bank's liquidity injection operations also helped to finance enhanced demand for commercial credit. Reserve money growth during 2005-06 was higher than 2004-05 reflecting the Reserve Bank's injection of primary liquidity. Broad money growth was also higher than the previous year.

I.3.41 Despite continued pressures from record high international crude oil prices, inflation was contained during 2005-06. This could be attributed to pre-emptive monetary policy measures by the Reserve Bank which helped stabilise inflationary expectations. Fiscal measures such as rationalisation of the duty structure in regard to crude oil and petroleum products, productivity gains, increased competition and incomplete pass-through also helped to contain inflation. Although headline inflation was low, it needs to be noted that underlying inflationary pressures continue, especially in view of the incomplete pass-through of higher international crude oil prices. During 2006-07 so far, while headline inflation has remained contained within the indicative trajectory, upward pressures are seen from higher primary food articles prices as well as continued high and volatile international crude oil prices. Accordingly, in order to stabilise inflation expectations as also taking into account the global interest rate cycle, the Reserve Bank has increased the LAF reverse repo rate by 50 basis points during 2006-07 so far - 25 basis points each effective June 9, 2006 and July 25, 2006. In order to improve domestic supplies 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 imports of wheat and palm oils, and restriction on exports of pulses.

I.3.42 Cross-country analysis shows that while inflation in India is higher than developed economies, it is comparable to most of the emerging economies. In major advanced economies, for instance, consumer price inflation in March 2006 (year-on-year) was in the range of 2-3 per cent as compared with 4.9 per cent for India. In emerging economies, consumer price inflation displays a greater variability : 0.8 per cent in China, 2.0 per cent in Korea, 3.4 per cent in South Africa, 3.4 per cent in Mexico, 3.6 per cent in Israel, 4.7 per cent in Malaysia, 5.4 per cent in Brazil, 5.7 per cent in Thailand, 7.6 per cent in Philippines, 11.1 per cent in Argentina and 15.8 per cent in Indonesia.

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 (Table 1.30). 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.

Table 1.30: Indicators of Fiscal Policy: Combined Finances

(Per cent of GDP)

Item	1990-91	1995-96	2004-05	2005-06 RE
1	2	3	4	5
Gross Fiscal Deficit (GFD)	9.4	6.5	7.5	7.5
Revenue Deficit	4.2	3.2	3.7	3.1
Primary Deficit	5.0	1.6	1.4	1.6
Revenue Receipts	18.6	18.3	19.7	20.8
Tax Revenue	15.4	14.7	15.8	16.8
Direct Taxes	2.5	3.5	5.0	5.7
Indirect Taxes	12.9	11.2	10.8	11.1
Non-tax Revenue	3.2	3.6	3.9	4.0
Total Expenditure*	28.7	25.4	27.9	28.6
Developmental Expenditure	17.1	13.9	14.3	15.5
Non-developmental Expenditure*	11.6	11.5	13.6	12.8
Interest Payments	4.4	5.0	6.2	5.8
Debt@	64.9	61.3	82.5	79.5
				Per cent
Capital Outlay/ Total Expenditure	13.1	10.8	13.0	14.1
Interest Payments/ Revenue Receipts	23.6	27.2	31.2	28.1
Revenue Deficit/ Gross Fiscal Deficit	44.6	48.8	48.9	41.5

RE : Revised Estimates. * : Net of repayments.

@ : Includes 'reserve funds', 'deposits and advances' and 'contingency fund'.

Note : 1. All indicators are based on combined data of the Centre and States with inter-Governmental transactions netted out.

2. Data in respect of the State Governments are provisional for the years 2004-05 and 2005-06 and relate to budgets of 29 State Governments (including National Capital Territory of Delhi), of which four are *Vote-on-Accounts*.

Table 1.31: Major Fiscal Indicators of the Centre

(Rupees crore)

	Item	2005-06 (BE)	2005-06 (RE)	2006-07 (BE)	Variation (3 over 2)		Variation (4 over 3)	
					Amount	Per cent	Amount	Per cent
1		2	3	4	5	6	7	8
1.	Revenue Receipts	3,51,200	3,48,474	4,03,465	-2,726	-0.8	54,991	15.8
2.	Disinvestment	0	2,356	3,840	2,356	-	1,484	63.0
3.	Revenue Expenditure	4,46,512	4,40,295	4,88,192	-6,217	-1.4	47,897	10.9
4.	Capital Outlay	62,180	56,993	66,938	-5,187	-8.3	9,945	17.4
	of which: Defence	34,375	33,075	37,458	-1,300	-3.8	4,383	13.3
5.	Net Lending @	-6,348	-283	861	6,065	-95.5	1,144	-404.2
6.	**Revenue Deficit (3-1)**	**95,312 (2.7)**	**91,821 (2.6)**	**84,727 (2.1)**	**-3,491**	**-3.7**	**-7,094**	**-7.7**
7.	**Gross Fiscal Deficit (4+5+6-2)**	**1,51,144 (4.3)**	**1,46,175 (4.1)**	**1,48,686 (3.8)**	**-4,969**	**-3.3**	**2,511**	**1.7**
8.	Interest Payments	1,33,945	1,30,032	1,39,823	-3,913	-2.9	9,791	**7.5**
9.	**Primary Deficit (7-8)**	**17,199 (0.5)**	**16,143 (0.5)**	**8,863 (0.2)**	**-1,056**	**-6.1**	**-7,280**	**-45.1**

RE : Revised Estimates. BE : Budget Estimates.

@ : Net lending was negative in 2005-06 (BE) and 2005-06 (RE) on account of decrease in loans to States/UTs following the recommendations of Twelfth Finance Commission.

Note : Figures in parentheses are percentages to GDP.

Central Government Finances – 2005-06

Revised Estimates

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 (Table 1.31). 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 improvement in revenue account *vis-à-vis* the budget estimates was mainly due to curtailment of non-plan revenue expenditure in respect of interest payments, subsidies and grants to States. There was, however, a shortfall in revenue receipts on account of non-tax revenue due to lower interest receipts, reflecting the impact of rescheduling of loans of the Centre to the States under the TFC's award. Tax revenues, on the other hand, turned out to be marginally higher than the budget estimates, with the improved collections under customs duties and service tax benefiting from strong import growth and upbeat activity in the services sector. The new taxes introduced in the last two budgets also boosted the overall tax revenue. Corporation tax, personal income tax and excise duties in the revised estimates were, however, lower than the budgeted levels. The gross fiscal deficit was also placed lower in the revised estimates than the budgeted level. This reduction was contributed by improved performance in the revenue account, the availability of disinvestment proceeds and lower capital outlay. The curtailment of capital outlay by Rs.5,187 crore was mainly in respect of non-defence expenditure. Loans and advances, however, exceeded the budget estimates by Rs.5,765 crore on account of post-budget provision for pass-through of loan component of Externally Aided Projects under State and Union Territory Plans.

I.4.4 Reflecting the reduction in the fiscal deficit, net market borrowings were lower by 2.6 per cent than budgeted. Market borrowings (dated securities and 364-day Treasury Bills) financed 69.2 per cent of GFD as compared with 68.7 per cent in the BE. While draw down of cash balances financed 10.3 per cent of GFD as compared with 2.1 per cent in the BE, financing from external assistance in the RE was lower at 5.1 per cent of GFD than the budgeted level of 6.4 per cent.

Table 1.32: Key Deficit Indicators of the Centre for 2005-06: Provisional Accounts

(Rupees crore)

Indicator	Budget Estimates	Revised Estimates	Provisional Accounts	Variation (per cent)	
				Col. 4 over Col.3	Col.4 over Col.2
1	2	3	4	5	6
Revenue Deficit	95,312 (2.7)	91,821 (2.6)	94,644 (2.7)	3.1	-0.7
Gross Fiscal Deficit	1,51,144 (4.3)	1,46,175 (4.1)	1,46,348 (4.1)	0.1	-3.2
Primary Deficit	17,199 (0.5)	16,143 (0.5)	14,591 (0.4)	-9.6	-15.2

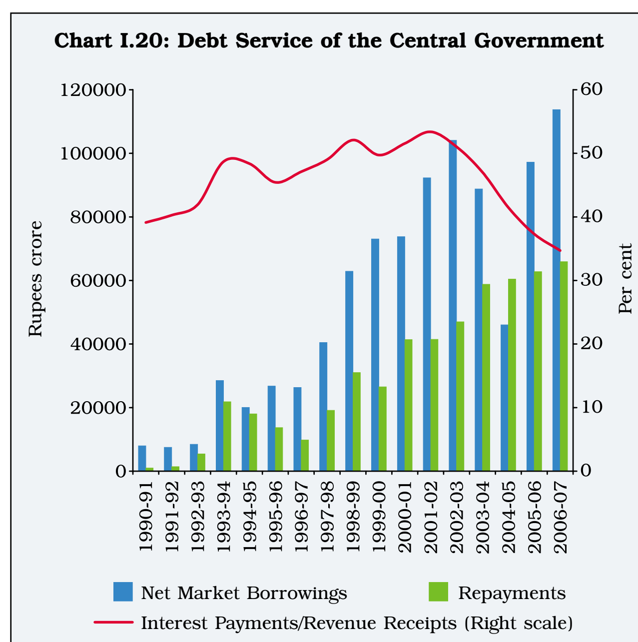
Note: Figures in parentheses are percentages to GDP.

I.4.5 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 (Table 1.32). 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.4.6 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 (Appendix Table 34). 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.

Chart I.20: Debt Service of the Central Government



I.4.7 The ratio of interest payments to revenue receipts continued its downward trajectory, falling from 53.4 per cent in 2001-02 to 37.3 per cent in 2005-06 (Chart I.20). This reflected the twin impact of a moderate growth in interest payments (21.0 per cent between 2001-02 and 2005-06) and an impressive growth in revenue receipts (73.1 per cent over the same period). The average interest rate on outstanding market loans declined by 111 basis points during 2005-06 to 8.76 per cent, although weighted average yield on incremental Government market borrowings firmed up during 2005-06. On account of the States Debt Swap Scheme, the average interest cost of borrowing from National Small Savings Fund (NSSF) has also shown a marked decline in the last three years. On the other hand, the average interest rate on State Provident Funds continued to increase in 2005-06 (Table 1.33).

State Government Finances - 2005-06[2]

I.4.8 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

[1] As per Reserve Bank records, net and gross market borrowings in 2005-06 were Rs.98,237 crore and Rs.1,60,018 crore, respectively.

[2] The analysis of State Finances and combined finances for 2005-06 (Revised Estimates) is based on the budgets of 29 State Governments (including National Capital Territory (NCT) of Delhi), of which 4 are *Vote-on-Accounts*. All data are provisional.

Table 1.33: Average Interest Rate on Outstanding Domestic Liabilities of the Centre

(Per cent)

Year	Market Loans	Small Savings/ NSSF	State Provident Funds	Special Deposits
1	2	3	4	5
1990-91 to 1994-95	10.86	10.85	11.63	11.53
1995-96 to 1999-2000	12.39	11.62	11.62	10.93
2000-01	12.99	11.60	10.54	9.87
2001-02	12.83	11.61	9.09	10.50
2002-03	12.11	11.56	8.53	8.82
2003-04	11.11	10.88	7.39	7.94
2004-05	9.87	9.37	7.99	7.65
2005-06 (RE)	8.76	8.91	8.15	7.49

RE: Revised Estimates.

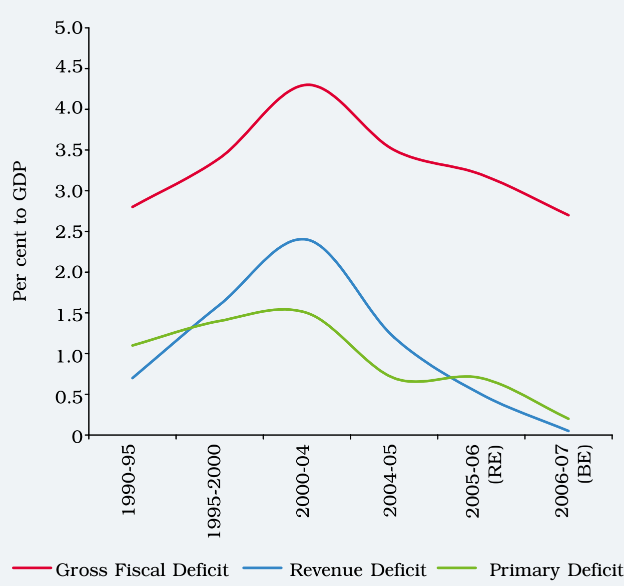
Note: 1. Market loans represent dated securities.

2. Small savings represent small saving deposits, certificates and public provident fund. Since 1999-2000, interest on small savings represents interest on Central Government Special Securities issued to the National Small Savings Fund (NSSF).
3. The Government notified the freezing of the corpus of the Special Deposit Scheme as on June 30, 2003.
4. The interest rate for each component is computed by dividing the interest payments in a year by the outstanding liabilities at the end of the preceding year.

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 (Box I.12 and Chart I.21).

I.4.9 As regards financing of GFD, flows from the NSSF continued to retain their dominant position, accounting for about 65 per cent of GFD in 2005-06 (RE) followed by market borrowings (15.7 per cent) and State Provident Funds (7.9 per cent). The decline in the share of market borrowings during 2005-06 reflected completion of debt swap scheme (DSS) in 2004-05. The reduction in the share of loans from the Centre could be attributed to discontinuance of loans from the Centre following the recommendations of the TFC.

Chart I.21: Major Deficit Indicators of State Governments



COMBINED BUDGETARY POSITION OF THE CENTRE AND THE STATES – 2005-06

I.4.10 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 (Table 1.34). 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.

Combined Debt

I.4.11 The combined outstanding liabilities, as a proportion to GDP, declined by 3.0 percentage points during 2005-06 to 79.5 per cent, reflecting the improvement in the fiscal position as well as the buoyant economic growth (Table 1.35).

Contingent Liabilities/Guarantees of the Government

I.4.12 The combined outstanding guarantees given by the Central and State Governments continued to decline during the year ended March 2005 on account of a sharp decline in the guarantees given by State Governments. The Central Government guarantees, however, increased during 2004-05 mainly on account of guarantees given in favour of Food Corporation of

Box I.12
Evolution of State Finances in India

In recent years, State finances have witnessed a significant improvement after recording progressive deterioration during the second half of the 1990s. Factors like growing revenue expenditure (particularly wages, salaries and pensions), losses of the State public sector enterprises (particularly power utilities), declining Central transfers (as per cent to GDP) and inadequate user charges contributed in large measure to the fiscal deterioration. One major reason for the sharp deterioration in the finances of the State Governments in the late 1990s was the implementation of the Fifth Pay Commission award. The slower growth in revenues in relation to expenditure and ambitious plan outlays of the States compounded the problem. With the widening gaps in the revenue account, States resorted to higher borrowings resulting in rising debt servicing costs. The States also became increasingly dependent on 'Small Savings' loans (securities issued to NSSF). The deterioration in fiscal imbalances during the late 1990s had an adverse impact on the quality of expenditure of the State Governments (Table).

The fiscal deterioration and the erosion in the quality of expenditure led to growing recognition of an urgent need to improve State finances. Based on recommendations of the Eleventh Finance Commission, the Union Government created a Fiscal Reform Facility (2000-01 to 2004-05) to provide incentives to the States to undertake Medium Term Fiscal Reforms (MTFR). The Union Government also introduced a debt swap scheme (2002-03 to 2004-05) to swap high cost debt of the State Governments with low cost debt. The State Governments also adopted specific expenditure and revenue reform measures along with undertaking institutional measures such as setting up of consolidated sinking funds and guarantee redemption funds. These steps are being backed by putting an institutional mechanism for rule-based fiscal policy through the enactment of fiscal responsibility legislations for durable fiscal adjustment plans. Efforts are underway by States to control the rising pension liabilities. The Twelfth Finance Commission (TFC) has also prescribed a path of financial restructuring for the State Governments (see Box I.14).

The reform measures appear to be having a favourable impact on the fiscal situation. As a ratio to GDP, revenue receipts have increased and revenue expenditure has declined in the recent years. Revenue receipts showed acceleration due to increase in own tax revenue, and shareable Central taxes and grants, despite the secular decline in States' own non-tax revenue. Reduction in revenue deficit/GDP ratio has also enabled an improvement in the quality of expenditure. Capital outlay-GDP ratio has seen a notable increase. While the decline in the developmental expenditure has been contained in recent years, the rise in non-developmental expenditure continues. Factors like inappropriate user charges and large accumulation of debt continue to affect State finances. Appropriate user charges along with improvement in the provision of public services will help in further consolidation of State finances. This will, in turn, allow States to provide higher outlays for infrastructure spending and thus contribute to the economy's growth prospects.

Table: Major Indicators of State Finances

(Per cent of GDP)

Sr. No.	Indicator	1990-91 to 1994-95	1995-96 to 1997-98	1998-99 to 2003-04	2004-05 to 2006-07
	1	2	3	4	5
1.	Gross Fiscal Deficit (GFD)	2.8	2.8	4.3	3.1
2.	Revenue Deficit (RD)	0.7	1.0	2.5	0.6
3.	Capital Outlay (CO)	1.6	1.4	1.5	2.3
4.	Revenue Receipts	12.1	11.3	11.0	12.6
5.	Own Tax Revenue	5.4	5.3	5.5	6.3
6.	Own Non-Tax Revenue	1.8	1.8	1.4	1.4
7.	Current Transfers	4.9	4.2	4.0	4.9
8.	Shareable Taxes	2.6	2.6	2.3	2.6
9.	Grants	2.3	1.7	1.7	2.3
10.	Revenue Expenditure	12.8	12.3	13.5	13.1
11.	Development Expenditure	10.8	9.6	9.7	9.8
12.	Non Development Expenditure	4.3	4.6	5.8	5.9
13.	Debt	22.2	21.4	29.1	32.7
	Memo				(Per cent)
1.	Interest Payments/Revenue Receipts	14.4	16.8	23.2	20.9
2.	RD/GFD	24.7	35.4	57.1	16.7
3.	CO/GFD	55.3	52.5	34.3	73.7

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Table 1.34: Indicators of Combined Finances of the Centre and States

(Amount in Rupees crore)

Item	1990-91	1995-96	2000-01	2004-05	2005-06 BE	2005-06 RE	Variation (RE over BE)	
							Amount	Per cent
1	2	3	4	5	6	7	8	9
Gross Fiscal Deficit [II - IA - IB(a)]	53,580	77,671	1,99,852	2,34,719	2,70,901	2,63,195	-7,706	-2.8
	(9.4)	(6.5)	(9.5)	(7.5)	(7.8)	(7.5)		
Revenue Deficit [II1 - IA]	23,871	37,932	1,38,803	1,14,761	1,20,082	1,09,105	-10,977	-9.1
	(4.2)	(3.2)	(6.6)	(3.7)	(3.4)	(3.1)		
Primary Deficit	28,585	18,598	75,035	42,407	61,807	57,233	-4,574	-7.4
	(5.0)	(1.6)	(3.6)	(1.4)	(1.8)	(1.6)		
I. Total Receipts (A+B)	1,51,593	2,96,628	5,94,804	8,78,536	9,78,565	9,94,959	16,394	1.7
A. Revenue Receipts (1+2)	1,05,757	2,17,526	3,78,817	6,15,643	7,01,296	7,32,848	31,552	4.5
1. Tax Receipts (a+b)	87,564	1,74,851	3,05,374	4,92,481	5,78,711	5,91,641	12,930	2.2
a) Direct Taxes	14,267	41,603	80,215	1,56,804	1,98,593	1,99,984	1,390	0.7
b) Indirect Taxes	73,297	1,33,248	2,25,159	3,35,677	3,80,118	3,91,657	11,539	3.0
2. Non-Tax Receipts	18,193	42,675	73,443	1,23,162	1,22,584	1,41,207	18,622	15.2
B. Capital Receipts (a+b)	45,836	79,102	2,15,987	2,62,893	2,77,270	2,62,111	-15,158	-5.5
a) Non Debt Capital Receipts	3,531	6,968	12,591	19,393	7,639	13,621	5,982	78.3
b) Debt Capital Receipts	42,305	72,134	2,03,396	2,43,500	2,69,631	2,48,490	-21,141	-7.8
II. Aggregate Expenditure (1+2+3=4+5)	1,62,868	3,02,166	5,91,258	8,69,755	9,79,836	10,09,665	29,829	3.0
1. Revenue Expenditure	1,29,628	2,55,457	5,17,618	7,30,404	8,21,377	8,41,953	20,576	2.5
2. Capital Outlay	21,353	32,594	55,875	1,13,304	1,38,944	1,42,324	3,380	2.4
3. Loans and Advances	11,887	14,115	17,766	26,048	19,514	25,387	5,873	30.1
4. Development Expenditure	97,149	1,65,361	3,08,546	4,45,352	5,06,551	5,46,795	40,244	7.9
5. Non- Development Expenditure @	65,719	1,36,805	2,82,712	4,24,403	4,73,285	4,62,870	-10,415	-2.2

RE : Revised Estimates. BE: Budget Estimates.
@ : Excludes repayments.
Note : 1. Inter-Governmental transactions have been netted out.
2. Figures in parentheses are percentages to GDP.

India for procurement operations to ensure food security (Table 1.36). The net accretion to guarantee stock of the Central Government during 2004-05 was 0.57 per cent of GDP as against 0.50 per cent stipulated under FRBM Rules, 2004.

Table 1.35: Combined Liabilities of the Centre and States

(Rupees crore)

end-March	Outstanding Liabilities			Debt-GDP Ratio (per cent)		
	Centre	States	Combined	Centre	States	Combined
1	2	3	4	5	6	7
1990-91	3,14,558	1,28,155	3,68,824	55.3	22.5	64.9
1995-96	6,06,232	2,50,889	7,28,208	51.0	21.1	61.3
2000-01	11,68,541	6,02,073	14,92,032	55.4	28.6	70.8
2001-02	13,66,408	7,00,524	17,42,810	59.9	30.7	76.4
2002-03	15,59,201	7,98,921	19,83,298	63.6	32.6	81.0
2003-04	17,36,678	9,24,422	22,52,996	62.9	33.5	81.6
2004-05	19,94,422	10,43,809	25,76,650	63.9	33.4	82.5
2005-06 RE	21,95,387	11,57,476	28,05,874	62.2	32.8	79.5
2006-07 BE	24,73,562	12,61,461	31,07,051	62.6	31.9	78.6

RE: Revised Estimates. BE : Budget Estimates.
Note : 1. Under 'combined liabilities', inter-Governmental transactions are netted out.
2. Data include 'reserve funds', 'deposits and advances' and 'contingency fund'.

Table 1.36: Outstanding Government Guarantees

(Amount in Rupees crore)

end-March	Centre		States		Total	
	Amount	Per cent of GDP	Amount	Per cent of GDP	Amount	Per cent of GDP
1	2	3	4	5	6	7
1993	58,088	7.8	42,515	5.7	1,00,603	13.4
1994	62,834	7.3	48,865	5.7	1,11,700	13.0
1995	62,468	6.2	48,479	4.8	1,10,947	11.0
1996	65,573	5.5	52,631	4.4	1,18,204	9.9
1997	69,748	5.1	63,409	4.6	1,33,157	9.7
1998	73,877	4.9	73,751	4.8	1,47,628	9.7
1999	74,606	4.3	97,454	5.6	1,72,060	9.9
2000	83,954	4.3	1,32,029	6.7	2,15,983	11.0
2001	86,862	4.1	1,68,719	8.0	2,55,581	12.1
2002	95,859	4.2	1,65,386	7.2	2,61,245	11.5
2003	90,617	3.7	1,84,294	7.5	2,74,911	11.2
2004	87,780	3.2	2,17,091 (P)	7.8	3,04,871	11.0
2005	1,07,957	3.5	2,00,602 (P)	6.4	3,08,559	9.9

P: Provisional.
Note : Ratios to GDP may not add up to the total due to rounding off.
Source : 1. Data on Centre's guarantees are from budget documents of the Central Government.
2. Data on States' guarantees are based on the information received from State Governments and pertain to 17 major States.

FISCAL OUTLOOK FOR 2006-07

Central Government

I.4.13 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 (Box I.13). 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 (see Table 1.31 and Appendix Table 28). 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.

Box I.13
Recent Fiscal Consolidation: Role of Macroeconomic Performance

Fiscal policy plays a key role in determining an economy's growth path. Macroeconomic performance also has an impact on a country's fiscal position. For instance, high growth contributes to fiscal consolidation through improved tax collections and lower requirement for undertaking social sector expenditures such as unemployment benefits and social security. Similarly, reduction in fiscal deficit, particularly when the public debt is high and unsustainable, can accelerate economic growth through lower interest rates and increase in investment. Fiscal tightening achieved primarily through reductions in non-productive expenditure is found to have a more favourable impact on growth than that achieved through cutbacks in public investment or increases in taxes. Furthermore, fiscal consolidation that persists over time has the greatest positive effect on growth.

The impact of macroeconomic performance on fiscal operations is usually assessed through measurement of cyclical components of relevant budgetary variables. The functioning of automatic stabilisers is, however, weakened in the case of developing countries where expenditures such as unemployment benefits, which are responsive to business cycles, are less important while structural components of expenditure dominate. However, it needs to be stressed that while the effects of macroeconomic variables on the behaviour of public finances probably may prevail in the short run, the impact of autonomous fiscal policies on macroeconomic performance certainly becomes the more important linkage in the longer run.

Empirical evidence on the inverse relationship between the macroeconomic performance and cyclical fiscal position is, however, mixed. For instance, fiscal deficit in the EU countries did not fall during favourable cyclical periods as the effects of automatic stabilisers were offset by the countries' discretionary fiscal policies (European Commission, 2001). Analysing the experience of industrial countries (European countries and the US), McDermott and Wescott (1996) concluded that real economic growth did not seem to significantly affect the chances of successful action towards fiscal consolidation. The authors found that while favourable economic environment helps fiscal consolidation, the outcome is not guaranteed.

The Indian experience during the recent years shows that economic growth, through buoyant revenues, appears to have contributed to the fiscal consolidation process. For instance, during 1994-95 to 1996-97 (which experienced an average growth rate of 7.5 per cent) and the recent phase 2003-04 to 2005-06 (which experienced an average growth rate of 8.1 per cent), average annual reduction in GFD-GDP ratio of the Centre was 0.7 percentage point and 0.6 percentage point, respectively. On the other hand, during the period 1997-98 to 2002-03, which witnessed a modest growth of 5.2 per cent, the GFD-GDP ratio, on an average, increased by 0.2 percentage point annually. Since the late 1990s, the fiscal consolidation process has been primarily led by revenue augmentation which implies greater role to be played by economic growth in containment of fiscal gaps. The correlation between change in GFD-GDP ratio and real GDP growth for the period 1999-2000 to 2005-06 at (-)0.42 was substantially stronger than that of (-)0.02 for the period 1971-72 to 1989-90. The experience of the recent years suggests that prudent fiscal policy and high economic growth comprise a virtuous circle.

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Table 1.37: Decomposition of the GFD of the Centre

(Per cent)

Year	Revenue Deficit	Capital Outlay	Net Lending	Other Non-debt Receipts @
1	2	3	4	5
1990-91	41.6	27.2	31.2	0
1995-96	49.4	23.4	29.6	-2.3
2000-01	71.7	20.8	9.2	-1.8
2001-02	71.1	18.8	12.7	-2.6
2002-03	74.4	20.1	7.7*	-2.2
2003-04	79.7	27.8	6.3*	-13.8
2004-05	62.6	41.3	-0.4*	-3.5
2005-06(RE)	62.8	39.0	-0.2	-1.6
2006-07(BE)	57.0	45.0	0.6	-2.6

@ : Include disinvestment proceeds and value of bonus shares.
* : Adjusted for debt swap transactions.

I.4.14 During 2006-07, the GFD is budgeted to be lower than the gross budgetary support for the Plan. Thus, as was the case in 2004-05 (after a gap of 20 years), the financing for the Plan will not be entirely from borrowed resources. Another salient feature of the Central Government finances is the continuous decline in the revenue deficit to gross fiscal deficit ratio. This has enabled freeing of resources for undertaking capital outlays while maintaining the momentum of fiscal correction (Table 1.37).

Pattern of Receipts

I.4.15 Growth in revenue receipts in 2006-07 is budgeted to accelerate to 15.8 per cent, primarily due to higher tax collections. As a result, gross tax to GDP ratio, which has consistently increased in recent years, is budgeted to improve further to 11.2 per cent in 2006-07 (Table 1.38).

I.4.16 Among the direct taxes, corporation tax is budgeted to show a substantial growth on the back of expectations of strong economic activity as well as measures to neutralise the erosion of tax base. Personal income tax collections, on the other hand, are budgeted to decelerate in 2006-07. Under indirect taxes, the growth in collections under customs duty is budgeted to accelerate, notwithstanding the further reduction in tariffs. Service tax collections are budgeted to increase substantially, reflecting the continued policy to enhance service tax rates towards CENVAT rate level as well as the further widening of the service tax base. The growth rate in excise duty collections would, however, show a deceleration in 2006-07 (Table 1.39 and Appendix Table 30). The

Table 1.38: Gross Tax Revenues of the Centre

(Per cent to GDP)

Year	Direct Tax	Indirect Tax	Total
1	2	3	4
1990-91	1.9	8.2	10.1
1991-92	2.3	8.0	10.3
1992-93	2.4	7.5	10.0
1993-94	2.4	6.5	8.8
1994-95	2.7	6.5	9.1
1995-96	2.8	6.5	9.4
1996-97	2.8	6.6	9.4
1997-98	3.2	6.0	9.1
1998-99	2.7	5.6	8.3
1999-2000	3.0	5.8	8.8
2000-01	3.2	5.7	8.9
2001-02	3.0	5.2	8.2
2002-03	3.4	5.4	8.8
2003-04	3.8	5.4	9.2
2004-05	4.3	5.5	9.8
2005-06 (RE)	4.8	5.7	10.5
2006-07 (BE)	5.3	5.9	11.2

RE : Revised Estimates. BE : Budget Estimates.

Securities Transaction Tax and the Banking Cash Transactions Tax are budgeted to show substantial growth.

I.4.17 Non tax revenue in 2006-07 is budgeted to show a marginal increase of 2.6 per cent as higher receipts from dividends and profits are expected to offset lower interest receipts. Interest receipts are expected to maintain the declining trend on account of reduction in lending rates to State Governments and debt swap scheme which enabled them to prepay their high cost debt to the Centre.

Pattern of Expenditure

I.4.18 Aggregate expenditure, as per cent of GDP, is budgeted to decline marginally in 2006-07 on account of containment in non-Plan expenditure on subsidies and interest payments (Table 1.40 and Appendix Table 29). The share of interest payments, defence expenditure and subsidies in non-Plan revenue expenditure would decrease marginally from 69.2 per cent in 2005-06 (RE) to 69.0 per cent in 2006-07 (BE). Lower expenditure on subsidies is mainly on account of decline in interest subsidies and containment of fertilisers subsidies. The share of the Plan component in total revenue expenditure, on the other hand, would improve from 25.9 per cent in 2005-06 (RE) to 29.4 per cent in 2006-07 (BE) primarily on account of higher allocation to the Central Plan.

Table 1.39: Revenue Position of the Centre

(Rupees crore)

Item	2004-05 (Actuals)	2005-06 (RE)	2006-07 (BE)	Variation			
				2005-06		2006-07	
				Amount	Per cent	Amount	Per cent
1	2	3	4	5	6	7	8
Total Receipts (1+2)@	**4,73,137 (15.2)**	**4,93,668 (14.0)**	**5,63,991 (14.3)**	**20,531**	**4.3**	**70,323**	**14.2**
1. Revenue Receipts	3,06,013 (9.8)	3,48,474 (9.9)	4,03,465 (10.2)	42,461	13.9	54,991	15.8
Tax Revenue (Net)	2,24,798 (7.2)	2,74,139 (7.8)	3,27,205 (8.3)	49,341	21.9	53,066	19.4
Non-Tax Revenue	81,215 (2.6)	74,335 (2.1)	76,260 (1.9)	-6,880	-8.5	1,925	2.6
2. Capital Receipts	1,67,124* (5.4)	1,45,194 (4.1)	1,60,526 (4.1)	-21,930	-13.1	15,332	10.6
Non-Debt Capital Receipts	33,792* (1.1)	14,056 (0.4)	11,840 (0.3)	-19,736	-58.4	-2,216	-15.8
Debt Capital Receipts@	1,34,907 (4.3)	1,31,138 (3.7)	1,48,686 (3.8)	-3,769	-2.8	17,548	13.4
Memo:							
Gross Tax Revenue	**3,04,958 (9.8)**	**3,70,141 (10.5)**	**4,42,153 (11.2)**	**65,183**	**21.4**	**72,012**	**19.5**
Corporation Tax	82,680 (2.6)	1,03,573 (2.9)	1,33,010 (3.4)	20,893	25.3	29,437	28.4
Income Tax	49,259 (1.6)	63,500 (1.8)	73,409 (1.9)	14,241	28.9	9,909	15.6
Customs Duty	57,611 (1.8)	64,215 (1.8)	77,066 (1.9)	6,604	11.5	12,851	20.0
Union Excise Duty	99,125 (3.2)	1,12,000 (3.2)	1,19,000 (3.0)	12,875	13.0	7,000	6.3
Service Tax	14,200 (0.5)	23,000 (0.7)	34,500 (0.9)	8,800	62.0	11,500	50.0
Securities Transaction Tax	590	2,389	3,500	1,799	304.9	1,111	46.5
Banking Cash Transaction Tax	-	350	500	-	-	150	42.9

BE : Budget Estimates. RE: Revised Estimates.
@ : Excludes changes in cash balances.
* : Net of Rs.32,675 crore received under Debt Swap Scheme utilised for repayments to National Small Savings Fund (NSSF).
Note : Figures in parentheses are percentages to GDP.

I.4.19 Capital expenditure would remain unchanged at 1.9 per cent of GDP in 2006-07. Within capital expenditure, share of capital outlay is budgeted to increase from 83.3 per cent in 2005-06 to 88.3 per cent, mainly on account of higher non-defence outlay. While defence capital outlay would increase from 48.3 per cent of total capital expenditure to 49.4 per cent, non-defence capital outlay would improve from 35.0 per cent to 38.9 per cent.

I.4.20 The Budget continued with its thrust on education and health, with their shares in total expenditure budgeted to improve by 0.7 percentage point and 0.3 percentage point, respectively, in 2006-07 (Table 1.41). The Budget sought to improve

Table 1.40: Expenditure Pattern of the Centre

(Rupees crore)

Item	2004-05 (Actuals)	2005-06 (RE)	2006-07 (BE)	Variation			
				2005-06		2006-07	
				Amount	Per cent	Amount	Per cent
1	2	3	4	5	6	7	8
Total Expenditure	4,65,007 * (14.9)	5,08,705 (14.4)	5,63,991 (14.3)	43,698	9.4	55,286	10.9
1. Non-Plan Expenditure	3,32,731 * (10.7)	3,64,914 (10.3)	3,91,263 (9.9)	32,183	9.7	26,349	7.2
i) Interest Payments	1,26,934 (4.1)	1,30,032 (3.7)	1,39,823 (3.5)	3,098	2.4	9,791	7.5
ii) Defence	75,856 (2.4)	81,700 (2.3)	89,000 (2.3)	5,844	7.7	7,300	8.9
iii) Subsidies	43,653 (1.4)	46,874 (1.3)	46,213 (1.2)	3,221	7.4	-661	-1.4
iv) Grants to States	14,784 (0.5)	30,390 (0.9)	35,361 (0.9)	15,606	105.6	4,971	16.4
v) Other non-Plan Expenditure	71,504 * (3.3)	75,918 (2.2)	80,866 (2.0)	4,414	6.2	4,948	6.5
2. Plan Expenditure	1,32,276 (4.2)	1,43,791 (4.1)	1,72,728 (4.4)	11,515	8.7	28,937	20.1
i) Budgetary Support to Central Plan	80,120 (2.6)	1,07,253 (3.0)	1,31,285 (3.3)	27,133	33.9	24,032	22.4
ii) Central Assistance for State and UT Plans	52,156 (1.7)	36,538 (1.0)	41,444 (1.0)	-15,618	-29.9	4,906	13.4
Memo:							
Grants	55,321	73,927	86,273	18,606	33.6	12,346	16.7
Loans	37,910	11,417	8,861	-26,494	-69.9	-2,555	-22.4

BE : Budget Estimates. RE: Revised Estimates. * : Net of repayments to the NSSF.
Note : Figures in parentheses are percentages to GDP.

Table 1.41: Expenditure on Select Development Heads of the Centre

(Rupees crore)

Item	2005-06 (RE)	2006-07 (BE)
1	2	3
Agriculture	36,641 (7.2)	39,843 (7.1)
Education	15,792 (3.1)	21,670 (3.8)
Health	8,373 (1.6)	10,579 (1.9)
Rural Development	14,108 (2.8)	15,508 (2.7)
Irrigation	392 (0.1)	446 (0.1)
Total Expenditure	**5,08,705**	**5,63,991**

RE : Revised Estimates. BE : Budget Estimates.
Note : Figures in parentheses are percentages to total expenditure.

the health services by placing more emphasis on health care infrastructure and family welfare in rural areas.

Financing of Gross Fiscal Deficit

I.4.21 Net market borrowings (excluding allocations budgeted under the MSS) will continue to be the largest source of financing the GFD in 2006-07. The budget estimates have not made any provision for draw down of cash balances as compared with 10.3 per cent of GFD in the preceding year (Table 1.42 and Appendix Table 31).

Central Government Finances: April-June 2006

I.4.22 Revenue receipts of the Union Government, as a proportion to the budget estimates (BE), improved from 10.8 per cent in April-June 2005 to

Table 1.42: Financing Pattern of Gross Fiscal Deficit of the Centre

(Amount in Rupees crore)

Item	2005-06 (RE)	2006-07 (BE)
1	2	3
Gross Fiscal Deficit	1,46,175	1,48,686
Financed by		
Market Borrowings	1,01,082	1,13,778
	(69.2)	(76.5)
Securities against Small Savings	1,350	3,010
	(0.9)	(2.0)
External Assistance	7,515	8,324
	(5.1)	(5.6)
State Provident Funds	5,500	6,000
	(3.8)	(4.0)
NSSF	-7,332	648
	-(5.0)	(0.4)
Reserve Funds	3,526	1,725
	(2.4)	(1.2)
Deposit and Advances	4,654	11,013
	(3.2)	(7.4)
Postal Insurance and Life Annuity Funds	1,215	1,265
	(0.8)	(0.9)
Draw Down of Cash Balances	15,037	0
	(10.3)	(0.0)
Others #	13,627	2,923
	(9.3)	(2.0)

: Include savings (taxable) bonds 2003 and Deposits Scheme for Retiring Employees.

Note : Figures in parentheses are percentages to GFD.

13.0 per cent in April-June 2006 reflecting both higher tax and non-tax revenues. Total expenditure at 23.3 per cent of the BE was also higher than 18.2 per cent of the BE in April-June 2005. There was a substantial increase in Plan expenditure under economic and social services. There was also a sharp rise in non-Plan revenue expenditure under grants to States, food and fertiliser subsidies, and interest payments. Accordingly, as a proportion to the BE, the gross fiscal deficit and revenue deficit increased to 52.3 per cent and 83.4 per cent, respectively, during April-June 2006 from 36.1 per cent and 49.6 per cent in the corresponding period of 2005.

State Budgets 2006-07[1]

I.4.23 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 (Table 1.43 and Appendix Table 32). 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 (Box I.14).

I.4.24 The sharp correction in revenue deficit during 2006-07 is proposed to be brought mainly by higher transfers from the Centre, especially the shareable Central taxes (Table 1.44).

Table 1.43: Major Deficit Indicators of State Governments

(Rupees crore)

Item	1990-95 (Average)	1995-00 (Average)	2000-04 (Average)	2004-05	2005-06 BE	2005-06 RE	2006-07 BE	Percentage variations Col.7/5	Col.7/6	Col.8/7
1	2	3	4	5	6	7	8	9	10	11
Gross Fiscal Deficit				109,256	110,070	113,978	105,895	4.3	3.6	-7.1
	(2.8)	(3.4)	(4.3)	(3.5)	(3.1)	(3.2)	(2.7)			
Revenue Deficit				36,423	24,770	17,284	1,786	-52.5	-30.2	-89.7
	(0.7)	(1.6)	(2.4)	(1.2)	(0.7)	(0.5)	(0.05)			
Primary Deficit				21,267	16,772	24,984	6,449	17.5	49.0	-74.2
	(1.1)	(1.4)	(1.5)	(0.7)	(0.5)	(0.7)	(0.2)			

BE : Budget Estimates. RE : Revised Estimates.

Note : Figures in parentheses are percentages to GDP.

[1] The analysis of State Finances and combined finances for 2006-07 (Budget Estimates) is based on the budgets of 29 State Governments (including NCT Delhi), of which 4 are *Vote-on-Accounts*. All data are provisional.

Box I.14
Twelfth Finance Commission (TFC) and State Finances

The Report of the TFC, which covers the period from 2005-06 to 2009-10, is expected to have far reaching implications on State finances in the medium term. A unique feature of the TFC, unlike the earlier Finance Commissions, has been its emphasis on outlining a time bound restructuring path and setting fiscal targets for the States. Besides, the TFC has recommended incentive-linked debt relief scheme, contingent upon the enactment of fiscal responsibility legislations prescribing specific annual fiscal targets.

The revised estimates of 2005-06, the first year of the TFC award period, indicate the favourable impact of recommendations of the TFC on State finances (Table). Notably, the major deficit indicators, *i.e.*, revenue deficit and gross fiscal deficit witnessed substantial improvement in 2005-06 and are budgeted to attain the TFC's targets in 2006-07. However, the consolidated position masks variations across the States in respect of these indicators.

The recommendations like enhanced devolution and transfer to the States (through shareable taxes and grants) have enabled the States to progress towards the restructuring targets set by the TFC. Moreover, the debt relief scheme of the TFC has paved way for decline in debt levels as well as interest payments. The achievement of revenue balance (even surplus) would enable the States to deploy larger resources under capital outlay as well as reduce the reliance on debt. It is noteworthy that following recommendations of the TFC, the State Governments have been expediting enactment of fiscal responsibility legislations, and setting of sinking funds and guarantee redemption funds. The benefits to the States from the award of the TFC are likely to accrue till the year 2009-10. The States would have the challenge of sustaining the fiscal prudence that they achieve under an incentivised target oriented framework without compressing their development spending, particularly in respect of the social sectors.

Table: Restructuring Plan of TFC: State Finances

(Per cent of GDP)

Sr. No.	Item	2004-05	2005-06 (RE)	2006-07 (BE)	TFC target for 2009-10	Average Annual Adjustment based on 2005-06 (RE)
1	2	3	4	5	6	7
1.	Revenue Deficit	1.2	0.5	0.05	0.0 *	-0.17
2.	Fiscal Deficit	3.5	3.2	2.7	3.0	-0.05
3.	Primary Deficit	0.7	0.7	0.2	1.0	-
4.	States' Own Tax Revenues	6.1	6.4	6.4	6.8	0.10
5.	Own Non-Tax Revenue	1.5	1.3	1.3	1.4	0.03
6.	Revenue Receipts	11.9	12.9	13.0	13.2	0.07
7.	Interest Payments	2.8	2.5	2.5	2.0	-0.13
8.	Revenue Expenditure	13.1	13.3	13.0	13.2	-0.03
9.	Capital Expenditure (Capital Outlay)	2.0	2.4	2.4	3.1	0.18
10.	Total Expenditure	18.3	17.3	16.7	16.3	-0.25
11.	Interest Payments/Revenue Receipts	23.6	19.6	19.4	15.0	-1.15
12.	Debt (end-year Adjusted Liabilities)	33.4	32.8	31.9	30.8	-0.50

* : The target for achieving revenue deficit of zero is 2008-09.
Note : The Table is based on the Budget Documents of 29 States (of which four are *Vote-on-Accounts*).
Source : Report of the Twelfth Finance Commission and Budget Documents of State Governments.

I.4.25 Correction in revenue deficit during 2006-07 will also be facilitated by deceleration in revenue expenditure, partly on account of deceleration in expenditure on administrative services and pensions (Table 1.45). Capital outlay is budgeted to decelerate during 2006-07 though, as a ratio to GDP, it would be maintained at 2.4 per cent. Power is one of the sectors under which expenditure is expected to decline in 2006-07. Developmental expenditure will decelerate during 2006-07 after recording a sharp increase in the previous year.

I.4.26 Decomposition of GFD indicates that fiscal deficit during 2006-07 would be mainly on account of capital outlay reflecting the sharp decline in revenue deficit. Small savings (NSSF) remain the major source of financing the GFD followed by market borrowings (Table 1.46 and Appendix Table 36).

I.4.27 As regards resource transfer from the Centre to States, a perusal of Union Budget 2006-07 in conjunction with State Budgets reveals that, first, States have over-estimated grants from the Centre while shareable Central taxes have been under-estimated during 2006-07. Second, as regards the financing of GFD, the flows from NSSF have been under-estimated in State Budgets for 2006-07 compared to those announced in Union Budget 2006-07. Finally, there are some differences with regard to loans from the Centre. Taking into account the data on current devolution and transfers from the Centre as indicated in the Union Budget 2006-07, the States' revenue deficit and gross

Table 1.44: Aggregate Receipts of State Governments

(Amount in Rupees crore)

Item	1990-95	1995-00	2000-04	2004-05	2005-06 BE	2005-06 RE	2006-07 BE	Percentage variations		
	(Average)							Col.7/5	Col.7/6	Col.8/7
1	2	3	4	5	6	7	8	9	10	11
Aggregate Receipts (1+2)				15,50,787	11,55,807	14,99,747	13,99,224	-3.3	29.8	-6.7
				(49.7)	(33.2)	(42.5)	(35.4)			
	(16.1)	(15.2)	(17.4)	*18.6*	*16.6*	*17.4*	*16.8*			
1. Total Revenue Receipts (a+b)				3,72,075	4,30,270	4,54,152	5,13,166	22.1	5.6	13.0
	(12.1)	(10.9)	(11.4)	(11.9)	(12.4)	(12.9)	(13.0)			
(a) States Own Revenue				2,36,667	2,61,795	2,71,356	3,05,275	14.7	3.7	12.5
	(7.3)	(6.9)	(7.1)	(7.6)	(7.5)	(7.7)	(7.7)			
States Own Tax				1,89,132	2,15,243	2,24,780	2,52,573	18.8	4.4	12.4
	(5.4)	(5.3)	(5.7)	(6.1)	(6.2)	(6.4)	(6.4)			
States Own Non Tax				47,535	46,552	46,576	52,702	-2.0	0.1	13.2
	(1.8)	(1.6)	(1.4)	(1.5)	(1.3)	(1.3)	(1.3)			
(b) Central Transfers				1,35,408	1,68,475	1,82,796	2,07,891	35.0	8.5	13.7
	(4.9)	(4.0)	(4.2)	(4.3)	(4.8)	(5.2)	(5.3)			
Shareable Taxes				78,551	90,003	92,722	108,325	18.0	3.0	16.8
	(2.6)	(2.4)	(2.4)	(2.5)	(2.6)	(2.6)	(2.7)			
Central Grants				56,857	78,472	90,074	99,566	58.4	14.8	10.5
	(2.3)	(1.6)	(1.9)	(1.8)	(2.3)	(2.6)	(2.5)			
2. Capital Receipts (a+b)				1,178,712	7,25,537	10,45,595	8,86,058	-11.3	44.1	-15.3
				(37.8)	(20.8)	(29.6)	(22.4)			
	(4.0)	(4.2)	(6.0)	*6.7*	*4.3*	*4.6*	*3.8*			
(a) Loans from Centre@				26,991	31,216	11,561	13,855	-57.2	-63.0	19.8
	(1.2)	(1.0)	(1.0)	(0.9)	(0.9)	(0.3)	(0.4)			
(b) Others Capital Receipts				11,51,721	6,94,321	10,34,034	8,72,203	-10.2	48.9	-15.7
				(36.9)	(19.9)	(29.3)	(22.1)			
	(2.8)	(3.2)	(5.0)	*5.8*	*3.4*	*4.3*	*3.4*			

BE: Budget Estimates. RE: Revised Estimates.

@ : With the change in the system of accounting with effect from 1999-2000, States' share in small savings which was earlier included under loans from Centre is included under internal debt and shown as special securities issued to National Small Saving Fund (NSSF) of the Central Government. The data for the years prior to 1999-2000 as reported in this Table exclude loans against small savings, for the purpose of comparability.

Notes : 1. Figures in parentheses are percentages to GDP.

2. Since 2003-04, data on capital receipts are on a gross basis and therefore, not comparable with that of earlier years. Figures in *italics* are percentages to GDP and are on a net basis (for items of public account) and given for comparison with earlier years.

fiscal deficit will be somewhat higher than that emanating from their Budget documents. States, however, are not likely to have much difficulty in financing their budget deficits primarily due to higher accrual from NSSF. The dependence on market borrowings and loans from other sources by States is likely to be subdued during 2006-07.

Combined Budgets for 2006-07

I.4.28 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 (Table 1.47).

I.4.29 Revenue receipts are budgeted to increase mainly on account of increase in tax revenue (Table 1.48 and Appendix Table 33). The combined tax-GDP ratio is budgeted to improve from 16.8 per cent in 2005-06 to 17.4 per cent in 2006-07. On the expenditure side, the share of development expenditure in total expenditure is, however, budgeted to decline from 54.2 per cent in 2005-06 to 53.6 per cent during 2006-07.

I.4.30 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 (Table 1.49 and Appendix Table 36).

Social Sector Expenditure

I.4.31 The combined social sector expenditure, as a proportion of GDP, is budgeted to decline marginally during 2006-07. However, expenditure on education - which is a major component of social sector expenditure, with a share of almost 44 per cent - is

Table 1.45: Expenditure Pattern of State Governments

(Amount in Rupees crore)

Item	1990-95	1995-00	2000-04	2004-05	2005-06 BE	2005-06 RE	2006-07 BE	Percentage variations		
	(Average)							Col.7/5	Col.7/6	Col.8/7
1	2	3	4	5	6	7	8	9	10	11
Aggregate Expenditure 1+2 =3+4+5				15,50,136	11,53,938	14,99,416	13,95,333	-3.3	29.9	-6.9
				(49.7)	(33.1)	(42.5)	(35.3)			
	(16.0)	(15.3)	(17.4)	*18.3*	*16.6*	*17.3*	*16.7*			
1. Revenue Expenditure				4,08,497	4,55,040	4,71,437	5,14,952	15.4	3.6	9.2
of which	(12.8)	(12.6)	(13.8)	(13.1)	(13.1)	(13.3)	(13.0)			
Interest Payments				87,989	93,298	88,994	99,446	1.1	-4.6	11.7
	(1.7)	(2.0)	(2.8)	(2.8)	(2.7)	(2.5)	(2.5)			
2. Capital Expenditure				11,41,639	6,98,898	10,27,979	8,80,381	-10.0	47.1	-14.4
of which				(36.6)	(20.1)	(29.1)	(22.3)			
	(3.2)	(2.7)	(3.6)	*5.2*	*3.5*	*3.9*	*3.7*			
Capital Outlay				61,559	76,764	85,331	95,192	38.6	11.2	11.6
	(1.6)	(1.4)	(1.6)	(2.0)	(2.2)	(2.4)	(2.4)			
3. Dev. Expenditure				2,93,537	3,25,848	3,62,273	3,84,040	23.4	11.2	6.0
	(10.8)	(9.6)	(9.7)	(9.4)	(9.4)	(10.3)	(9.7)			
4. Non-Dev. Expenditure				1,88,299	2,11,192	2,03,212	2,28,036	7.9	-3.8	12.2
	(4.3)	(4.9)	(6.0)	(6.0)	(6.1)	(5.8)	(5.8)			
5. Others*				10,68,300	6,16,898	9,33,931	7,83,257	-12.6	51.4	-16.1
				(34.2)	(17.7)	(26.4)	(19.8)			
	(0.9)	(0.8)	(1.7)	*2.9*	*1.2*	*1.3*	*1.2*			

RE: Revised Estimates. BE: Budget Estimates.

* : Comprises Compensation and Assignments to local bodies, Grants-in-Aid and Contributions, Reserve with Finance Department, Discharge of Internal Debt, Repayment of Loans to the Centre till 2002-03. Since 2003-04, it also includes Inter-State Settlement, Contingency Fund, Small Savings, Provident Fund, Reserve Funds, Deposit & Advances, Suspense & Miscellaneous, Appropriation to Contingency Fund and Remittances.

Note : 1. Figures in parentheses are percentages to GDP.

2. Capital expenditure starting with 2003-04 includes corresponding heads of public account, which were hitherto included on a net basis under capital receipts. The figures, therefore, are not comparable with that of earlier years. Figures in *italics* are percentages to GDP with expenditure heads of public account being excluded from capital expenditure and are given for comparison with earlier years.

budgeted to increase by 0.5 percentage point of GDP, with both the Central and State Governments allocating significantly higher outlays in the revenue account (Table 1.50).

Table 1.46: Decomposition and Financing Pattern of Gross Fiscal Deficit of States

(Per cent)

	1990-95	1995-00	2000-04	2004-05	2005-06 BE	2005-06 RE	2006-07 BE
	(Average)						
1	2	3	4	5	6	7	8
Decomposition (1 to 4)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
1. Revenue Deficit	24.7	44.7	56.3	33.3	22.5	15.2	1.7
2. Capital Outlay	55.3	43.2	36.7	56.3	69.7	74.8	89.9
3. Net Lending	20.0	12.1	7.0	10.4	7.8	10.0	9.4
4. Disinvestments	..	..	..	..	..	..	-1.0
Financing (1 to 11)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
1. Market Borrowings	16.0	16.1	24.6	30.1	16.3	15.7	21.0
2. Loans from Centre	49.0	40.6	7.9	-15.1	15.8	2.3	4.8
3. Loans against Securities Issued to NSSF	-	28.9 *	35.4	66.5	50.3	65.0	53.5
4. Loans from LIC, NABARD, NCDC, SBI and Other Banks	1.8	2.8	5.0	0.1	7.7	4.8	6.7
5. State Provident Fund	14.3	13.4	8.3	7.4	7.7	7.9	7.8
6. Reserve Funds	6.8	5.5	4.5	6.5	3.8	2.9	4.1
7. Deposits & Advances	9.8	9.8	3.4	7.4	-2.5	-0.5	-0.7
8. Suspense & Miscellaneous	4.3	2.7	-0.8	-9.7	-1.3	-0.8	1.7
9. Remittances	-1.4	-3.6	0.6	1.1	1.5	0.8	1.9
10. Overall Surplus (+)/Deficit (-)	4.4	-2.6	0.7	0.6	1.7	0.3	3.7
11. Others	-5.0	9.5	10.4	5.2	-0.9	1.5	-4.5

BE : Budget Estimates. RE : Revised Estimates. .. : Nil. - : Not applicable.

* : Pertains to 1999-2000 as it was introduced from that year only. The sum of items for 1995-2000 (average) will not thus be equal to 100.

Notes : 1. Overall surplus/deficit would be matched by increase/decrease in cash balance since 2003-04. This is due to Cash Balance Investment Account now included under 'Suspense and Miscellaneous' while WMA/OD from RBI is included under 'Internal Debt'.

2. 'Others' (item no.11) includes miscellaneous capital receipts, Contingency Fund, Inter-State Settlement, *etc.*

Table 1.47: Measures of Deficit of the Central and State Governments

Year	Amount (Rupees crore)			Per cent to GDP		
	Gross Fiscal Deficit	Revenue Deficit	Primary Deficit	Gross Fiscal Deficit	Revenue Deficit	Primary Deficit
1	2	3	4	5	6	7
1990-91	53,580	23,871	28,585	9.4	4.2	5.0
1995-96	77,671	37,932	18,598	6.5	3.2	1.6
2000-01	1,99,852	1,38,803	75,035	9.5	6.6	3.6
2001-02	2,26,425	1,59,350	84,039	9.9	7.0	3.7
2002-03	2,34,987	1,62,990	75,927	9.6	6.7	3.1
2003-04	2,34,502	1,59,406	56,701	8.5	5.8	2.1
2004-05	2,34,719	1,14,761	42,407	7.5	3.7	1.4
2005-06 RE	2,63,195	1,09,105	57,233	7.5	3.1	1.6
2006-07 BE	2,57,088	86,512	30,488	6.5	2.2	0.8

BE : Budget Estimates. RE : Revised Estimates.

I.4.32 To conclude, the combined finances are budgeted to show improvement during 2006-07 with the fiscal consolidation process at both the Centre and the States gathering momentum. The fiscal consolidation strategy is based on revenue augmentation through buoyant tax collections in an environment of strong economic activity and a reasonably stable tax structure. On the expenditure front, the emphasis is on reprioritising expenditures towards development expenditure, especially education and containing non-development expenditures. Notwithstanding the fiscal consolidation in recent years, the combined fiscal deficit continues to be high by global standards. The persistence of large deficits over the past decades has resulted in high levels of public debt, currently around 80 per cent of GDP. Furthermore, revenue deficits continue to remain high. Determined measures for fiscal consolidation would be necessary to achieve the declared FRBM targets so that the current growth momentum of the Indian economy can be maintained.

Table 1.48: Combined Receipts and Disbursements of the Centre and States

(Amount in Rupees crore)

Item	2005-06 (RE)	2006-07 (BE)	Variation	
			Amount	Per cent
1	2	3	4	5
Total Receipts (A+B)	9,94,959	11,07,432	1,12,473	11.3
A. Revenue Receipts (1+2)	7,32,848	8,35,469	1,02,621	14.0
1 Tax Receipts (a+b)	5,91,641	6,88,103	96,462	16.3
a) Direct Taxes	1,99,984	2,40,728	40,744	20.4
b) Indirect Taxes	3,91,657	4,47,375	55,718	14.2
2 Non Tax Receipts	1,41,207	1,47,365	6,158	4.4
B. Capital Receipts	2,62,111	2,71,963	9,852	3.8
Total Disbursements (A+B)	10,09,665	11,03,534	93,869	9.3
A. Development Expenditure	5,46,795	5,91,683	44,888	8.2
B. Non-Development Expenditure@	4,62,869	5,11,852	48,983	10.6

RE: Revised Estimates. BE: Budget Estimates.
@: Exclude repayments.
Note : Figures in parentheses are percentages to GDP.

Table 1.49: Financing of Gross Fiscal Deficit of the Centre and States

(Rupees crore)

Year	Market Borrowings	State Provident Funds	Small Savings	External Borrowings	Others	Gross Fiscal Deficit
1	2	3	4	5	6	7
2004-05	83,849 (35.7)	13,344 (5.7)	87,690 (37.4)	14,753 (6.3)	35,083 (14.9)	2,34,719 (100.0)
2005-06 BE	1,19,899 (44.3)	12,925 (4.8)	90,000 (33.2)	9,656 (3.6)	38,421 (14.2)	2,70,901 (100.0)
2005-06 RE	1,18,993 (45.2)	13,733 (5.2)	89,800 (34.1)	7,515 (2.9)	33,153 (12.6)	2,63,195 (100.0)
2006-07 BE	1,36,013 (52.9)	14,190 (5.5)	86,500 (33.6)	8,324 (3.2)	12,061 (4.7)	2,57,088 (100.0)

BE: Budget Estimates. RE: Revised Estimates.
Note : Figures in parentheses are percentages to GFD.

Table 1.50: Combined Expenditure of the Centre and States on Social Sector

(Amount in Rupees crore)

Item	2004-05	2005-06 (BE)	2005-06 (RE)	2006-07 (BE)
1	2	3	4	5
Expenditure on Social Sector *	2,30,956	2,66,630	2,86,259	3,09,444
of which: Social Services	1,77,013	2,05,351	2,22,172	2,42,722
of which:				
i) Education	85,792	99,238	1,03,194	1,35,416
ii) Medical & Public Health	25,764	32,538	33,874	3,9251
Per cent to GDP				
Expenditure on Social Sector	7.4	7.7	8.1	7.8
of which: Social Services	5.7	5.9	6.3	6.1
of which:				
i) Education	2.7	2.9	2.9	3.4
ii) Medical & Public Health	0.8	0.9	1.0	1.0
Per cent to Total Expenditure				
Expenditure on Social Sector	26.6	27.2	28.4	28.0
of which: Social Services	20.4	21.0	22.0	22.0
of which:				
i) Education	9.9	10.1	10.2	12.3
ii) Medical & Public Health	3.0	3.3	3.4	3.6

* : Expenditure on social sector includes expenditure on social services, rural development and food subsidies.