II ASSESSMENT AND PROSPECTS

ASSESSMENT OF 2005-06

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

OUTLOOK FOR 2006-07

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

II.35 India's merchandise exports continued to post strong growth during April-July 2006 *albeit* with some deceleration (20.8 per cent as compared with 34.6 per cent a year ago). Non-oil imports recorded a much lower growth of 9.9 per cent (52.0 per cent a year ago). Commodity-wise data available for April-May 2006 indicate that imports of gold and silver declined by 33.7 per cent as against an increase of 55.6 per cent during April-May 2005. Imports of capital goods continued to record strong growth (37.2 per cent during April-May 2006, *albeit* lower than that of 55.9 per cent during April-May 2005). Oil imports posted acceleration in growth during April-July 2006 (43.2 per cent on top of 36.5 per cent a year ago) on the back of further hardening of international crude oil prices. The trade deficit widened from US $ 14.4 billion during April-July 2005 to US $ 16.7 billion during April-July 2006. The buoyancy witnessed in the capital inflows to India during the year 2005-06 appears to have continued in the current year as well. Inflows under FDI, NRI deposits and issuances under ADRs/GDRs during April-May 2006 were higher than that in the corresponding period of 2005. On the other hand, foreign institutional investors (FIIs) recorded net outflows during April-June 2006 (US $ 1.8 billion) as against net inflows of US $ 0.5 billion during the corresponding period of 2005. India's foreign exchange reserves have increased by US $ 13.7 billion in the current fiscal year so far to US $ 165.4 billion as on August 18, 2006. On the whole, despite the growing oil import bill, the anticipated current account deficit in 2006-07 is manageable, as in the past, due to the continuing underlying strength of merchandise exports, invisibles and capital flows. The balance of payments is, therefore, expected to remain comfortable during 2006-07. Assessed in terms of a medium-term perspective taking into account the possible levels of the current account deficits, the composition of capital flows, the level of international confidence in the ability of the country's payment position and pace and quality of growth, the current level of reserves continues to be comfortable. In this context, it is relevant to note that two major international rating agencies have upgraded India's foreign currency rating to investment grade. The continuous strength of the external sector and, in particular, the recent fiscal consolidation efforts are among the important factors that have led to upgrading of external ratings in the recent past.

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

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

REAL SECTOR

Agriculture

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

II.39 The slow growth in agriculture in recent years is characterised by the stagnation in domestic production in the case of commodities like wheat, sugar and pulses. Illustratively, the production of wheat after touching a peak of 76 million tonnes (mt) in 1999-2000 has since then been range-bound at around 70 mt. Similarly, the production of pulses has not been able to exceed the peak of 14.9 mt reached in 1998-99. The production of pulses at 13.1 mt in 2005-06 was even lower than the level achieved more than 15 years back (14.3 mt in 1990-91). As a result, the share of pulses in total foodgrains output has declined consistently from 8.1 per cent in 1990-91 to 6.3 per cent in 2005-06. At constant (1999-2000) prices, investment in agriculture has been stagnant in recent years: Rs.43,123 crore in 2004-05 as compared with Rs.43,473 crore in 1999-2000. As a result, the ratio of investment to GDP fell from 2.2 per cent in 1999-2000 to 1.7 per cent in 2004-05. The decline is mainly on account of private investment which has fallen from Rs.35,719 crore to Rs.30,532 crore over the same period. On the other hand, public sector investment in agriculture has shown signs of revival, increasing from Rs.7,018 crore in 2000-01 to Rs.12,591 crore in 2004-05. Revival of rural cooperative credit institutions through legal and institutional reforms will help in improving the flow of credit to the agricultural sector and this could, in turn, encourage investment in the sector. While increase in investment is essential for improving the prospects of the agricultural sector, the composition of investments, the quality of facilities created and the efficacy with which these facilities are used are also important.

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

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

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

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

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

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

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

II.47 The promotion of efficient use of resources and technology, private sector participation through contract farming and leasing arrangements, involving new location specific and improved varieties of farm crops, livestock species will help to improve the competitiveness of Indian agriculture. Apart from agronomic measures for raising productivity, interventions are required for educating farmers to enable them to upgrade their skills to improve the quality of products so that they conform to the strictest sanitary standards in the context of WTO.

II.48 In this context, the suspension of the Doha Round of multilateral trade negotiations over the issue of huge subsidies being paid by developed countries to their farmers is a matter of concern. Subsidised exports by developed countries not only pose a threat to food and livelihood security in developing countries, but also expose farmers of developing countries like India to unfair trade competition in their exports. These developments are of particular concern to India in view of the continued dependence of a majority of population on agriculture and a large number of rural poor.

II.49 The Government has introduced the National Rural Employment Guarantee Act in 2005. The basic objective of the Act is to enhance livelihood security in rural areas by providing at least 100 days of guaranteed wage employment in a financial year to every household whose adult members volunteer to do unskilled manual work. This work guarantee can serve other objectives: generating productive assets, protecting the environment, empowering rural women, reducing rural-urban migration and fostering social equity, among others. This is also expected to help in addressing the problems of rural unemployment and poverty as well as provide an impetus to demand in the economy.

Industry

II.50 The rebound in the industrial sector in conjunction with the services sector has powered India's GDP growth since 2003-04 and has led to build up of optimism of targeting still higher growth for the economy. The resilience shown by the industrial sector against the hardening of global oil prices is reflective of inherent strengths and capabilities that the industrial sector has built up over the years since the initiation of economic reforms in the country. Strong corporate profitability and balance sheets in the past three years have also provided the corporate sector necessary resilience to absorb various shocks. A distinctive feature of India's industrial sector is the growing competitiveness especially in respect of automobiles and pharmaceuticals, evidenced from their export performance. This has strengthened the manufacturing performance further, which holds potential for India to become more of a manufacturing base for global production in certain sectors. The recent performance of the capital goods sector and the business investment surveys suggest a further scope for capacity additions in the Indian industries. At the same time, corporates are likely to face challenges from factors such as infrastructural bottlenecks, rising input costs from higher oil and other commodity prices, and the possibility of emerging shortages of domestic skilled labour. Furthermore, the manufacturing sector, especially the small and medium enterprises (SMEs), will have to gear up to meet challenges that may emanate from imports from China; it may be recalled that China has already emerged as the largest source of India's non-oil imports. The domestic manufacturing sector will have, thus, to continuously improve its productivity and competitiveness in order to effectively face the likely challenges.

II.51 Improvements in infrastructure facilities will be critical to sustain and accelerate the current industrial growth. It is noteworthy that, in the recent years, improvements have taken place in infrastructure facilities in areas such as telecommunications, roads and, to some extent, ports and railways. These developments are having a positive impact on the productivity and competitiveness of Indian economy. At the same time, infrastructural constraints in most critical areas such as power supply and urban infrastructure continue to impinge on the competitiveness of manufacturing activity. Apart from higher levels of investment, issues of governance and management including policies relating to appropriate pricing and user charges would need to be addressed to achieve satisfactory results.

II.52 Electricity and mining sectors have continued to record subdued growth, remaining a cause of concern and this could hinder the sustainability of manufacturing activity. Electricity generation continues to be hampered by policy shortcomings, continued excessive transmission and distribution losses, and collection of dues along with emerging difficulties in the availability of coal and gas. Furthermore, apart from unreliable supply of power, the tariffs facing the domestic manufacturing sector are higher *vis-à-vis* other countries such as China with implications for domestic competitiveness. The higher tariffs for the manufacturing sector in India reflect cross-subsidisation of tariffs on the one hand and the recourse to captive generation on the other hand.

II.53 India remains dependent upon coal for its energy requirements. The share of coal in total commercial energy consumption in the country is 55 per cent while that of oil is one-third. Supply of coal, however, continues to lag the demand and this, in turn, is having an adverse impact on the power situation in the country. Illustratively, as against the requirement of 338 million tonnes of coal during 2005-06, domestic availability was only 317 million tonnes. Non-availability of the desired level of coal is estimated to have resulted in generation loss of 1512 million units during 2004-05.

II.54 Similarly, demand for natural gas is outstripping supply in India, resulting in a huge loss of power generation. For instance, the country's requirement of gas during 2004-05 at 90 per cent plant load factor (PLF) was 49.7 million cubic metres per day (mcmd). As against this, only 30.7 mcmd (*i.e.*, 62 per cent of the demand) was supplied. The shortage in the gas availability is estimated to have resulted in a generation loss of almost 35 billion units per annum, on average, during 2000-05. Inadequate power generation capacity, lack of optimum utilisation of the existing generation capacity, insufficient inter-regional transmission links, inadequate and ageing sub-transmission and distribution network, slow pace of rural electrification and inefficient use of electricity by the end use consumer have exacerbated the absolute shortages.

II.55 Given the rising international crude oil prices and stagnant domestic crude oil production, an integrated approach to efficient use of energy – both oil and non-oil energy resources – assumes importance. The intensity of oil and overall energy use per unit of GDP in India remains higher than in developed as well as many developing economies. Against this backdrop, measures such as better house keeping in industrial units, better maintenance and upkeep of transport vehicles and improved traffic management would help in energy security. It also becomes necessary to increase the domestic availability of coal and gas through measures such as private participation in non-captive mining through legislative amendments; revival of loss making companies and restructuring of the coal sector; permitting freer trade of coal; and, intensification of exploration and upgradation of coal reserves. Alternative avenues of energy such as coal bed methane, hydel and wind energy sources, ethanol and bio-diesel would also need to be explored. Finally, in view of the large increase in international crude oil prices, a higher degree of pass-through to domestic prices will encourage incentives to economise on the use of oil and thereby moderate the adverse consequences of high oil prices on the real economy.

II.56 Provision of urban infrastructure facilities also needs greater attention. Globally, cities have consistently provided the environment for institutional and technological innovation, and acted as engines of economic growth. Substantial improvement in the quality of urban infrastructure, governance and management is essential to maintain and accelerate the momentum of economic growth and productivity enhancement. The recently launched "National Urban Renewal Mission" with its focus on improving infrastructural facilities in urban areas is a welcome development.

II.57 After carving out its niche in the services sector, India has also the potential of emerging as a favoured manufacturing destination of the world especially in respect of certain manufacturing activities enjoined by entrepreneurial dynamism and cost competitiveness that the country enjoys. Indian manufacturing industries have certain inherent strengths such as relatively inexpensive, adequate and highly skilled labour force, large manufacturing base, vast domestic market and growing external market as well as proximity to some of the fast growing EMEs in the Asian region, which augur well for maintaining high growth in the manufacturing sector in the medium term. The process of dereservation of items reserved for exclusive production by SSIs could be expedited, especially since imports of such reserved items are in any case freely permitted. This would help the sector to reap the economies of scale and add to the manufacturing sector's competitiveness. A substantial manufacturing base is essential to absorb the workforce and ensure sustainable growth of the economy. An economy of India's size and scope cannot ignore the manufacturing sector. A modern manufacturing sector is essential for the development of scientific and technological base, growth of knowledge economy and national security.

II.58 For this potential of manufacturing to be achieved, productivity of Indian labour needs to be improved further. Apart from improvements in physical and social infrastructure, this would, *inter alia*, require imparting requisite skills to the labour through setting up of high quality industrial training institutes (ITIs). Furthermore, the Indian industry needs to step up research and development expenditure to improve its competitiveness in the global economy to move up the value chain and to strengthen its position in skill intensive industries.

Services

II.59 The services sector in the country has benefited from the availability of vast skilled labour and is expected to continue to lead the economy, drawing from its linkage with the well performing industrial sector and expanding international trade. The synergetic relationship between manufacturing and services needs to be sustained and accelerated further. Gains in the services sector activities such as telecommunications and software have not only provided a boost to the value added in the services sector but are also providing cost-efficiency gains and productivity benefits to manufacturing. The spread and the thrust of information and communication technology (ICT) have provided unprecedented scope for productivity gains the world over in a very short span of time. The ICT can have a positive impact on growth through a surge in ICT investment, strong productivity effects from the ICT-producing industries and a more productive use of the ICT in the rest of the economy. The ICT equipments enable new organisational models and other innovations in the production process as well as the production of new goods and services. Thus, even if the ICT investment goods are standard products, they enable firms to innovate and accumulate firm-specific capital with positive spillovers on production. For reaping full benefits of the ICT, complementary investments in human and knowledge capital as well as in organisational innovations become necessary. In this context, it is necessary for the Indian services sector to continuously scan the global markets, identify the evolving preferences of the international clients, diversify the range of services offered and achieve greater efficiency to face the emerging global competition.

II.60 Unlike other countries at this stage of development, India appears to have skipped directly to specialisation in skill intensive industries (within manufacturing) or to services where they appear to have a comparative advantage (at least *vis-à-vis* other poor countries). This advanced skill-intensive part of the Indian economy may be bidding up scarce skills. A renewed emphasis on quality higher education commensurate with the requirements of knowledge intensive industries is needed for the current growth momentum to be maintained and built upon.

II.61 In the coming years, India is expected to benefit further from the demographic dividend emanating from a higher proportion of younger population. For this demographic dividend to be reaped fully, improvements in education, skills, health and governance would be needed so that the Indian labour force is globally competitive. In particular, the provision of educational facilities requires greater attention than before to take advantage of the evolving demographics. There is need to improve the availability of educational facilities at all levels – primary, secondary and tertiary – to equip the labour with the necessary skills to maintain current competitive advantage. With the quality of manufactured goods improving all the time, the demand for high skilled labour is expected to accelerate. Furthermore, the growing knowledge-intensive services activities will require human resources equipped with appropriate skills. Hence, enhancement of skills of human resources at all levels, especially at higher levels of education, requires greater priority. In particular, demand for tertiary education is expected to increase significantly in the coming years. A renewed focus on developing high quality institutions of learning at all levels will be essential for India to benefit from its demographic advantage. Finally, it may be noted that growth of population is not evenly spread through out the country. There is, therefore, a greater need to improve employment skills rapidly in regions with higher population growth and higher unemployment.

FISCAL POLICY

II.62 While the front-loaded revenue augmenting fiscal policy for 2004-05 led to a reduction in revenue and fiscal deficits by more than twice the stipulated minimum thresholds under the FRBM Rules, the ‘pause’ in the FRBM path in 2005-06 has resulted in a slowdown in the progress towards fiscal consolidation. Both revenue deficit and gross fiscal deficit, relative to GDP, slipped in 2005-06 over their levels in 2004-05. With the resumption of progress in approaching FRBM targets in 2006-07, reductions in key deficits have been budgeted to fulfil only the minimum annual stipulations. Consequently, larger deficit reductions in 2007-08 and 2008-09 will be required to meet the FRBM targets. Given that revenue expenditure has remained broadly stable in the last decade and a half, and non-tax receipts continue to be sluggish, the scope for deepening fiscal empowerment lies in improving tax revenue. This would require concerted efforts in substantially improving the tax/GDP ratio through further widening of the tax base and severe curtailment in tax exemptions. In this regard, the Government has identified several exemptions, both in direct as well as indirect taxes, and the continuance of these exemptions is proposed to be reviewed after receiving public feedback and examining the rationale thereof. Broadly, such exemptions are end-use based or have outlived their utility or need certification or give rise to disputes. Removal/ reductions of tax exemptions would not only lead to higher tax/GDP ratio but would also enhance economic growth since tax exemptions and deductions distort allocative efficiency, undermine horizontal and vertical equity, increase compliance costs and impose administrative burdens. The Government’s strategy of augmenting tax collection through, *inter alia*, liquidation of tax arrears and improvement in tax administration needs to be continued with greater vigour in the wake of expected sluggishness in non-debt receipts. In addition, the tax regime could be revisited in a comprehensive fashion to minimise transaction costs and remove regressive elements, thus contributing to both growth and fairness in public policy.

II.63 On the expenditure front, with the scope for increasing outlays being constrained by compulsions to meet FRBM targets, reprioritisation needs to be continued so as to ensure adequate investment in the social sector. The shift in emphasis from outlays to outcomes of plan expenditure since 2005-06 with the objective of improving the efficiency of the delivery mechanism needs to be extended to non-plan expenditure as well. A beginning has been made in this regard with the Outcome Budget of Ministry of Finance for 2006-07 also covering select non-plan schemes apart from plan expenditure. The Government has proposed a thorough review of Plan schemes ahead of the Eleventh Plan so as to merge similar schemes, review schemes of sub-critical size and redesign schemes to improve asset creation role of plan expenditure. These measures along with containment and proper targeting of subsidies would enable effective expenditure management.

II.64 The persistence of large fiscal deficits in the past has resulted in accumulation of outstanding debt which is substantially high by international standards. The interest burden of the Government, therefore, continues to be high constraining the Government’s ability to increase social sector and other productive outlays. Budgetary implications of issuance of oil bonds, outlays on the National Rural Employment Guarantee scheme and revenue implications of special economic zones also need to be factored.

II.65 Adhering to the FRBM targets in respect of fiscal deficit and revenue deficit is, therefore, critical for macroeconomic, financial, external sector and budgetary sustainability. Furthermore, as use of borrowed resources for meeting the current expenditure requirements has resulted in widening of asset-liability mismatches over the years, it is essential to eliminate revenue deficit and generate sufficient revenue surplus which may be utilised for asset creation without creating liabilities. Any slippage in achieving the FRBM targets could erode the gains achieved in the initial year of the FRBM. It could also generate a chain effect at the State levels to relax targets set out in their fiscal responsibility legislations. Any deviation from the FRBM targets will have both national and international repercussions in terms of credibility.

II.66 As regards State finances, notwithstanding the progress in fiscal consolidation since 2004-05, structural rigidities persist as manifested in sluggish non-tax revenue, downwardly rigid non-development expenditure and low allocation in respect of social sectors such as health and education. The State Governments have a major responsibility in regard to provision of social and economic services such as education and health and economic infrastructure such as roads, waterworks and power. In order to make the process of fiscal consolidation durable and sustainable, adequate investment in economic infrastructure and spending on social services would be essential. Accordingly, the States would be required to incur higher outlays on the provision of these services. Against this backdrop, a desirable path to fiscal correction lies through fiscal empowerment, *i.e.*, by expanding the scope and size of revenue flows into budget, rather than fiscal enfeeblement. Augmenting resource mobilisation from non-tax revenue through appropriate user charges and restructuring of State public sector undertakings continues to be of critical importance. Higher user charges will, however, not be feasible unless there is a greater efficiency in the delivery of the services provided by the States. Therefore, improving delivery of public services should be a priority for the State Governments. The issues of power subsidies also need to be addressed.

II.67 Finally, while the fiscal responsibility legislations address the need to constrain deficits of the Central and State Governments, there are no such rules for containing the deficits of the public sector undertakings. As borrowing needs of different segments of the public sector increase and the need to monitor the market behaviour and responses increases, it would be desirable to assess the overall public sector borrowing requirements.

EXTERNAL SECTOR

II.68 Merchandise export growth of 24 per cent per annum, on average, in the past four years points to the growing competitiveness of the Indian manufacturing. In the current fiscal year, export growth has remained strong so far, *albeit* with some deceleration. India's export base (*i.e.*, the commodity and country composition) is far more diversified now than it used to be in the early 1990s. Improvements in infrastructure assume critical importance for maintaining and improving our competitiveness as also encouraging investment in export production and sustaining the pace of export growth in the longer term.

II.69 As the Asian region has developed, intra-Asian trade has gathered momentum leading to even higher economic integration within the region. In the recent years, the Asian economies have, therefore, emerged as major trading partners of India. Emerging Asian economies accounted for a significant share of 22.6 per cent in India's total exports in 2005-06 (15.6 per cent in 2000-01) and 29.0 per cent of India's total non-oil imports (22.1 per cent in 2000-01). China has emerged as the third major export destination for India after the US and the UAE; it has now become the largest source of non-oil imports for India, surpassing the US. India is also at various stages of negotiation for entering into various regional economic cooperation, free/preferential trade agreements and bilateral investment treaties with its Asian neighbours.

II.70 The engagement of Indian firms with the world has acquired new dimensions. Apart from its leading edge in the software services, India has also the potential for becoming a centre for manufacturing in certain sectors. The Indian information technology industry is becoming increasingly global through cross-border acquisitions, on-shore contract wins and organic growth in other low-cost locations. This has been complemented by global majors continuing to significantly improve their off-shore delivery capabilities in India. Indian firms are also acquiring manufacturing firms abroad to leverage comparative advantage of foreign locations, using synergies between the parent company and the company under acquisition and having production facilities near the major markets also. The acquisitions are also driven by the need to have a marketing and distribution base as well as the need to acquire appropriate technologies. The attainment of domain knowledge through such activities, along with best practice business knowledge, and economies of scale in marketing may enhance the productivity growth of Indian business. Reportedly, there is an increasing emphasis on service approach to manufacturing with adaptation of techniques such as lean production to keep quality high and boost efficiency. These tendencies are perhaps reflective of a penchant for innovation among growing entrepreneurial class in India, imbued with professionalism and seeking to be globally competitive.

II.71 The buoyancy observed in service exports in the recent years is likely to strengthen as exports of business and professional services gather further growth momentum. The remittances from overseas Indian workers are also likely to remain an important and stable source of financial inflows with a continuous transition to higher skill categories of the Indian migrant workers. For the full potential of earnings from exports of services to be realised, issues relating to skill enhancement and quality of education assume greater importance. Demand for education, especially higher education, is expected to grow immensely in the coming years in view of the demand emanating from knowledge intensive nature of the services sector as well as demands from the manufacturing sector. In view of reports of growing shortages of skilled human power, policies that hinder setting up of high quality educational institutions need to be ironed out. Public-private partnership in the field of education holds great promise for equipping the country with institutes of excellence.

II.72 The overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows and other requirements. India's foreign exchange reserves are comfortable in terms of various reserve adequacy indicators. The increase in the reserves in recent years has been mainly on account of higher capital flows rather than a surplus on the current account. The exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility, without a fixed target or a pre-announced target or a band, coupled with the ability to intervene if and when necessary. These policies have served the country well so far.

II.73 Persistent rise in international crude oil prices to record highs has led to hardening of consumer price inflation in a number of economies. Core inflation and inflation expectations have also indicated signs of edging higher in recent months. Higher oil prices coupled with ongoing monetary tightening globally are expected to lead to slowdown in aggregate demand and output.

II.74 Apart from higher oil prices, global economic prospects continue to be marked by the risk of a disorderly adjustment to the rising level of global imbalances and their changing distribution across nation states and country groups. International financial markets have witnessed large volatility since May 2006 after having remained benign during 2005 and early part of 2006. Risk premia on a wide variety of risky assets – equities, corporate bonds, emerging markets debt, housing and real estate property assets and government bonds – had declined during 2005, reflecting investors' appetite for risk despite the major macroeconomic risks. However, beginning mid-May 2006, concerns over higher US inflation and possibility of larger than anticipated monetary tightening seemed to have unnerved global financial markets. As a result, investors pulled out of risky assets, especially from those of emerging market economies. Stock markets in many emerging economies recorded large losses while exchange rates came under pressure. The flight to safety led to easing of the yields on gilts in the US and other major economies. Financial markets are currently re-pricing risks in an environment of uncertainty and, in particular, in emerging market economies. There is uncertainty as to whether the process of re-pricing of risks, in general, is complete; and whether corrections are incomplete in the economies which benefited from lower-priced risks in the past. These developments pose downside risks to the growth prospects of the Indian economy.

FINANCIAL SECTOR

II.75 The various reform measures in the financial sector since the early 1990s have had a positive impact on the overall efficiency, productivity and stability of the banking system in India. The measures have also enabled accelerated economic growth in an environment of macroeconomic stability. The financial system is now robust and resilient, contributing to public confidence and overall stability.

II.76 Consistent with the policy approach of conforming the financial sector in India to the best international standards with emphasis on gradual harmonisation with the international best practices, all commercial banks in India are required to start implementing Basel II with effect from March 31, 2007. Banks in India will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. After adequate skills are developed, both by the banks and also by the supervisors, some of the banks may be allowed to migrate to the Internal Rating Based (IRB) Approach. On current indications, implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently. The cushion available in the system, which at present has a Capital to Risk Assets Ratio (CRAR) of over 12 per cent, provides for some comfort but the banks are exploring various avenues for meeting the capital requirements under Basel II. In addition to the issue of a Guidance Note on Operational Risk Management and the issue of draft guidelines on implementation of the New Capital Adequacy Framework, the Reserve Bank has, for its part, issued policy guidelines enabling issuance of innovative perpetual debt instruments and debt capital instruments by banks so as to enhance their capital raising options. It has also been decided that banks may augment, their capital funds through issuance of perpetual non-cumulative preference shares and redeemable cumulative preference shares; guidelines in these cases will be issued separately in due course.

II.77 Taking into account the size, the complexity of operations, the relevance to the financial sector, the need to ensure greater financial inclusion and the need for having an efficient delivery mechanism, the capital adequacy norms applicable to the various entities in the financial sector have been maintained at varying levels of stringency. In the post-March 2007 scenario, thus, Basel II, Basel I and non-Basel entities will be operating simultaneously in the Indian banking system. The three-track approach would not only ensure greater outreach of banking business, but also, in the present scenario of high growth, enable the banks to usefully lend to the disadvantageous sections and successfully pierce the informal credit segment. The three-track approach to Basel II implementation can, in principle, give rise to scope for regulatory arbitrage within the banking system. This would, however, not be of much concern in the Indian context on account of the relatively insignificant size of the non Basel II entities and their relevance from the systemic perspective.

II.78 With gross domestic savings rate of nearly 30 per cent of GDP and the economy recording a growth rate of about 8 per cent annually, a continued increase in household financial savings can be expected. On the production side, there are vast demands for financing the infrastructure investment, the growing services sector, SMEs and rural enterprises. The emphasis on financial inclusion will also lead to enhanced need for financial intermediation. The banking system has to respond adequately to these new challenges, opportunities and risks. Innovative channels for credit delivery for serving these new rural credit needs, encompassing full supply chain financing, covering storage, warehousing, processing, and transportation from farm to market will have to be found.

II.79 While continuing with its efforts to strengthen the domestic financial sector, the Reserve Bank has been laying an increasing stress on financial inclusion with particular attention to issues relating to farmers. A beginning has already been made to ensure greater outreach of banking facilities in rural areas through appointment of reputed non-governmental organisations (NGOs)/post offices *etc.* as banking facilitators and banking correspondents. The Reserve Bank will pursue with its efforts to ensure greater outreach of banking facilities in rural areas and to ensure availability of bank finance at reasonable rates with focus on measures to assist distressed farmers, including provision of financial counselling services and introduction of a specific Credit Guarantee Scheme.

II.80 The Reserve Bank is also laying greater stress on customer services to improve basic banking services provided to the common persons. A Banking Ombudsman facility has been established covering all States and Union Territories for redressal of grievances against deficient banking services. The recently constituted Banking Codes and Standards Board of India is an important step in this regard which is expected to ensure that the banks formulate and adhere to their own comprehensive code of conduct for fair treatment of customers. To provide a framework for a minimum standard of banking services, which individual customers can legitimately expect, a “Code of Bank’s Commitment to Customers” has been released. A similar code for lending to SMEs, such as on the lines of the Business Banking Code in the UK, would be useful to nurture the SME sector given their importance in the Indian economy.

MONETARY POLICY

II.81 In the light of high credit growth, the need to ensure asset quality assumes importance. The Reserve Bank has accordingly drawn attention of the banking sector to maintain asset quality. Although the increase in bank credit has been quite broad-based, expansion in bank credit to some sensitive sectors such as commercial real estate was quite large. Appropriate measures such as higher risk weights in case of sectors that have witnessed very high growth and increased provisioning requirements have been put in place in order to ensure financial stability. Furthermore, banks have been advised to put in place stricter credit appraisals on a sectoral basis, monitor loan-to-value ratios and generally ensure the health of credit portfolios on an enduring basis.

II.82 Concomitantly, in view of the observed increased dependence of banks on short-term non-core bulk deposits raised from corporates, banks were advised to focus on mobilisation of retail deposits which have durability. Bulk deposits raised at relatively higher rates can not sustain a higher credit demand on an enduring basis and have a potential for adverse consequences for balance sheet management and profitability. Banks were advised to review their policies and make sustained efforts towards mobilising stable retail deposits by providing wider access to better quality of banking services. This would sustain prudent business expansion without facing undue asset-liability mismatches.

II.83 Consistent with the multiple indicator approach adopted by the Reserve Bank, monetary policy in India has emphasised the need to be watchful about indications of rising aggregate demand embedded in consumer and business confidence, asset prices, corporate performance, the sizeable growth of reserve money and money supply, the rising trade and current account deficits and, in particular, the quality of credit growth. In retrospect, this risk sensitive approach has served the country well in containing aggregate demand pressures and second round effects to an extent. It has also ensured that constant vigil is maintained on threats to financial stability through a period when inflation was on the upturn and asset prices, especially in housing and real estate, are emerging as a challenge to monetary authorities worldwide. Significantly, it has also reinforced the growth momentum in the economy. It is noteworthy that the cyclical expansion in bank credit has extended without encountering any destabilising volatility but this situation warrants enhanced vigilance. In this context, despite sustained pressures from record high international crude oil prices as well as pressures from prices of primary food articles, inflation has been contained while keeping inflation expectations low and stable. This has been facilitated by timely and appropriate monetary policy measures. In this context, it is also important to recognise the importance of inflation perceptions. If the prices of commodities, which are purchased frequently, rise, the perception of inflation would be different from say, a rise in the price of television set. While recognising the overlap, the distinction between inflationary expectations and inflation perceptions in the context of inflation policy is worth bearing in mind. Inflation perceptions tend to harden if prices of frequently purchased goods increase.

II.84 In the context of the recent firming up of headline inflation across the globe, primarily on account of higher oil and other commodity prices, issues of proper measurement of inflation and inflationary pressures have attracted renewed debate. In particular, the debate involves the relevance of core inflation as a guide for the conduct of monetary policy *vis-à-vis* the use of headline inflation. Use of core measures is debatable in the current context of record high crude oil prices. A core measure is useful if a shock is temporary. In the current scenario, a large part of increase in the oil price is widely believed to have a large permanent component. Therefore, the use of core inflation excluding oil prices could be somewhat misleading. Furthermore, the current high oil prices reflect in large part the increase in global demand for oil from countries such as China. At the same time, these emerging economies have added to global supply of manufactures and this has kept prices of tradables low. Thus, exclusion of high oil prices while including the benefits from low prices of tradables – both of which are a result of the phenomenon of increased globalisation – is conceptually debatable. In India, core inflation is not considered relevant for several reasons, especially because the two major sources of supply shock, food and fuel, account for a large share of the index. Moreover, pass through of higher oil prices has been halting and not full and the headline inflation in a way understates the problem. Thus, the Reserve Bank in its recent monetary policy communications has emphasised the fact that there is clear evidence of a permanent component in the oil price increase, and hence the headline inflation may be understated till that component is fully passed through. While the permanent component is judgmental, broad magnitudes could be perceived and articulated. Such an explanatory approach to headline and underlying inflation pressure in monetary policy has added credibility to the policy and influenced and guided the inflation expectations in India.

II.85 In this context, distinction between monitoring and influencing inflation expectations on the one hand and giving forward indication on the other has attracted growing interest in recent months. There are dangers of a central bank trying to give forward guidance in a highly uncertain world. The Reserve Bank of India provides detailed information and shares relevant analysis fully to influence expectations while being hesitant to give firm inferences from analysis or forward guidance. Guidance on future course becomes far more difficult when the policy rates of monetary authorities get closer to what appears to be the relevant range of neutral interest rates. This is because the trade offs get more acute, judgmental and contextual relative to a state when interest rates are clearly farther from the range of possible neutral rates and the direction of movement is fairly obvious to all. The challenge of communication gets more daunting, if simultaneously, the inflation expectations are also under stress.

II.86 To conclude, the Indian economy is exhibiting strong fundamentals and displaying considerable resilience. At the same time, there are continuing signs of demand pressures, especially high credit growth, that could exert upward pressure on prices when associated with supply shocks such as from oil. These pressures have the potential for impacting stability and inflation expectations. Against this background, judgments are necessary on a continuing basis as to the relative weights to be accorded to growth and price stability, recognising lags in monetary policy. While domestic developments continue to dominate the economy, global factors tend to gain more attention now than before. 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. Hence, it is necessary to strike a balance between reinforcing the resilience of the Indian economy against global risks and giving a boost to growth prospects over the medium-term, taking advantage of global expansion.