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

*For the Year July 1, 2006 to June 30, 2007**

PART ONE : THE ECONOMY : REVIEW AND PROSPECTS

I ECONOMIC REVIEW

I. MACROECONOMIC POLICY ENVIRONMENT

I.1.1 Global economic activity remained buoyant for the fourth successive year during 2006 and available information suggests that the growth momentum is likely to continue during 2007, *albeit* with some moderation. Global economic growth accelerated from 4.9 per cent during 2005 to 5.5 per cent during 2006, and has averaged 4.9 per cent per annum during the four-year period 2003-2006. A positive feature of the global economic activity during 2006 was the broadening of growth across major regions/countries. The moderation of economic activity in the US since the second half of 2006 has been largely offset by the acceleration of activity in the euro area and in Japan; emerging and developing countries, led by China and India, have provided stable support to the global economy with sustained high growth. The rising global activity is, however, leading to closing of output gaps in many countries; strong demand, in conjunction with strong gains recorded by global commodity prices, was reflected in inflationary pressures in major economies. With headline inflation crossing the targets/comfort zones in major countries, many central banks pursued monetary tightening to contain inflationary expectations.

I.1.2 In an environment of strong global growth, the Indian economy continued to exhibit robust growth during 2006-07. Real GDP growth accelerated to 9.4 per cent in 2006-07 from 9.0 per cent in 2005-06, boosted by the double-digit growth in the services and industrial sectors. Real GDP growth, thus, averaged 7.6 per cent per annum during the Tenth Five Year Plan period (2002-03 to 2006-07) – the fastest pace of expansion in any Plan period so far – significantly higher than that of 5.7 per cent per annum during the 1980s and the 1990s. Growth in per capita income (*i.e.*, per capita net national product at factor cost) accelerated from 7.4 per cent in 2005-06 to 8.4 per cent during 2006-07. Per capita income growth averaged 6.1 per cent per annum during the Tenth Plan period and 7.1 per cent per annum during the last four years (2003-04 to 2006-07), more than double of 3.4 per cent per annum recorded during the 1980s and the 1990s. The acceleration of economic activity is being supported by a significant rise in domestic savings and investment, and productivity gains. A notable feature of the economic growth during 2006-07 was the further strengthening of the manufacturing activity. Consequently, in view of the sustained high growth since 2003-04, capacity utilisation has risen in a number of industries which, along with supply shocks from primary articles, were reflected in a rise in the various measures of inflation during 2006-07. The Reserve Bank, accordingly, took a series of pre-emptive monetary measures to contain inflationary expectations. The monetary measures were also accompanied by fiscal and supply side measures.

I.1.3 The sustained strengthening of domestic economic activity over the past few years has been underpinned by proactive policy measures to improve the productivity and competitiveness of the Indian economy. A number of steps covering the various sectors of the economy – real, fiscal, external, monetary and financial sectors – were taken during the year to sustain the current growth momentum, and make it more inclusive in an environment of macroeconomic and financial stability. These policy measures are covered in the first part of this Chapter while the developments in the various sectors of the economy are covered in the subsequent parts of this Chapter.

* : While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated beyond March 2007. For the purpose of analysis and for providing proper perspective on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

REAL SECTOR POLICIES

Agriculture and Allied Activities

I.1.4 In view of the renewed focus on faster, more broad-based and inclusive growth, reversal of the deceleration and containment in volatility in agricultural growth remained the highest priority of the Government. A number of steps were taken to improve the availability of irrigation facilities, crop yields, flow of institutional credit and rural infrastructure while also providing some relief to debt stressed farmers.

I.1.5 A National Rainfed Area Authority was created in November 2006 to support upgradation and management of dryland and rainfed agriculture. The Authority would coordinate all schemes relating to watershed development and other aspects of land use. The Union Budget 2007-08 allocated Rs.100 crore for the new Rainfed Area Development Programme. It also proposed to revamp the Accelerated Irrigation Benefit Programme (AIBP) in order to complete more irrigation projects in the quickest possible time. The outlay under AIBP was budgeted to increase from Rs.7,121 crore in 2006-07 to Rs.11,000 crore in 2007-08 (inclusive of the grant component of Rs.3,580 crore to the State Governments). In line with the pilot project launched in March 2005, to repair, renovate and restore water bodies in 13 States, similar projects are planned for other States with assistance from the World Bank. The Union Budget 2007-08 urged the State Governments to come forward with proposals so that the whole country can be covered in the next two years. Depletion of ground water has assumed grave proportions, with the Central Ground Water Board identifying 1,065 assessment blocks in the country as ‘over-exploited’ or ‘critical’. The Union Budget 2007-08 provided for 100 per cent subsidy to small and marginal farmers and 50 per cent subsidy to other farmers to erect structures which would divert rain water into dug wells. Of the proposed seven million structures, about two million structures would be on land belonging to small and marginal farmers. In this regard, a sum of Rs.1,800 crore would be transferred to the National Bank for Agriculture and Rural Development (NABARD). The amount would be held in escrow account and would be disbursed through the lead bank of the district concerned to the beneficiaries.

I.1.6 The Ministry of Agriculture had formulated an Action Plan in October 2006 for increasing the production and productivity of wheat in the country. Under this plan, 50 per cent of the area under wheat is being targeted for enhancing productivity by identifying about 138 districts in the States of Bihar, Uttar Pradesh, Madhya Pradesh, Maharashtra, Rajasthan, Gujarat, Punjab, Haryana and West Bengal. The interventions proposed in the Action Plan include improved package of practices of wheat; increasing the seed replacement rate to 33 per cent from the present 13 per cent; promoting the application of macronutrient and gypsum; popularising zero till machines and sprinklers; and subsidising diesel used for irrigation. Stagnation in the production and productivity of pulses is a matter of concern. A critical issue is the availability and quality of certified seeds. In view of this, the Union Budget 2007-08 proposed to expand the Integrated Oilseeds, Oil palm, Pulses and Maize Development Programme.

I.1.7 The Green Revolution of the 1960s was brought about by thousands of agricultural extension workers who worked side by side with farmers under a Training and Visit (T&V) programme. In order to revive the extension system, the Union Budget 2007-08 proposed to draw up a new programme to replicate the T&V with suitable changes. Furthermore, the Union Budget proposed that the Indian Council of Agricultural Research (ICAR) would set up a teaching-cum-demonstration model of water harvesting in each of the 32 select State agricultural universities and ICAR institutes. In this regard, an interest free loan of Rs.3 crore to each institution to create a corpus fund has been provided for. The yield from the fund will be used for implementing the training programme.

I.1.8 The National Development Council (NDC) in its 53rd meeting held on May 29, 2007 adopted a resolution that agricultural development strategies must be reoriented to rejuvenate agriculture to meet the needs of farmers. The NDC resolved that the Central and State Governments needed to take a number of steps to achieve 4 per cent annual growth in the agricultural sector during the Eleventh Plan (Box I.1). Furthermore, the Central Government committed Rs.25,000 crore for public investment in agriculture in the next four years.

I.1.9 The credit flow to the agricultural sector exceeded the target for the third consecutive year during 2006-07. As against the target of Rs.1,75,000 crore, the actual disbursements of farm credit by the banking system in 2006-07 were Rs.2,03,296 crore. For 2007-08, the Union Budget has fixed a target of Rs.2,25,000 crore as farm credit with an addition of five million new farmers to the banking system. The Union Budget, 2006-07 provided for the continuance of the two per cent interest subvention scheme for

Box I.1
National Development Council: Resolution on Agriculture

Actions to be taken by the Central Government

(i) A Food Security Mission to be launched as a Central scheme with the objective of producing over the next four years an additional eight million tonnes of wheat, 10 million tonnes of rice and two million tonnes of pulses over the base year (triennium ending 2006-07).

(ii) A new Additional Central Assistance (ACA) to State Plans to be introduced to incentivise States to draw up plans for their agriculture sector taking into account agro-climatic conditions, natural resource issues and technology integrating livestock, poultry and fisheries.

(iii) Additional resources to be provided for irrigation *via* Accelerated Irrigation Benefit Programme (AIBP), including a component on modernisation, linked to adoption of improved participatory irrigation management and command area development. Schemes involving intra-State linking of rivers could also be considered for AIBP.

(iv) Additional resources to be provided for the National Strategic Research Fund. Initiatives to be taken to improve the skill development in the farming community for employing modern methods of agriculture.

(v) The pattern of Rural Infrastructure Development Fund (RIDF) allocation by NABARD to be restructured so as to build it properly into the State and District plans.

(vi) Steps to be initiated to restructure the fertiliser subsidy programme for proper delivery to the farmers as also for providing balanced plant nutrition without adverse effects on soils. The use of bio-fertilisers, organic manure and micro-nutrients to enhance soil health will be promoted.

Actions to be taken by the State Governments

(i) Plan for each district to be formulated utilising resources available from all existing schemes. State agricultural plans to be formulated based on district plans aimed at achieving the States' agricultural growth objective. Each State will ensure that the baseline share of agriculture in its total State Plan expenditure is maintained to enable it to access the new ACA.

(ii) Special efforts to be made to complete projects under the AIBP without time and cost overrun and prioritise irrigation projects according to their agriculture production targets. States to also endeavour for better water management and improved water use efficiency.

(iii) Highest priority to be accorded to ensure adequate supply of quality seeds of crops and fodder at reasonable prices and at the right time to help in reducing the existing yield gaps.

(iv) A major expansion and revamping of State agricultural extension systems to be undertaken involving the State Agricultural Universities and *Krishi Vigyan Kendras*, while using public private partnership (PPP), wherever possible.

(v) Signing of the Memorandum of Understanding (MoU) (if not done so far) to be expedited for early implementation of the Vaidyanathan Committee recommendations and monitorable deadlines to be set for revamping the co-operative credit structure.

(vi) Development of modern markets to be encouraged by amending the Agricultural Produce Marketing Committee (APMC) Act and notifying the rules thereunder. A variety of instruments including cooperatives of farmers and contract farming to be used for reforms in agricultural marketing. The process of notifying rules under the amended APMC legislation should be completed during 2007-08.

Concrete proposals to implement these steps will be spelt out in detail both by the Central Government and the State Governments at the earliest.

short-term crop loans up to Rs.1 lakh granted by banks in *kharif* and *rabi* of 2005-06. Furthermore, in accordance with the Union Budget announcement, crop loans up to a principal amount of Rs.3 lakh were provided at seven per cent rate of interest beginning *kharif* 2006-07 for which the Government provided interest rate subvention of two per cent. The Union Budget, 2007-08 announced the continuance of this scheme for 2007-08 also. A National Agricultural Innovation Project, launched in July 2006, was aimed at enhancing livelihood security by involving farmer groups, Panchayati Raj Institutions and private sector. In order to improve the flow of credit from the cooperatives, a package for revival of the short-term rural cooperative credit structure was announced in January 2006. The Union Budget 2007-08 asked the regional rural banks (RRBs) to undertake an aggressive branch expansion programme and open at least one branch in the 80 uncovered districts of the country in 2007-08.

I.1.10 In view of the growing volume of farm credit, the demand for refinance from NABARD is expected to increase. In order to augment the resources of NABARD, the Union Budget 2007-08 proposed to allow it to issue rural bonds to the extent of Rs.5,000 crore, guaranteed by the Government and eligible for suitable tax exemption.

I.1.11 The Government has decided to implement immediately two of the recommendations of the Interim Report of the Committee on Financial Inclusion (Chairman: Dr. C. Rangarajan). First, a Financial Inclusion Fund is being established with NABARD for meeting the cost of developmental and promotional interventions. Second, a Financial Inclusion Technology Fund will be established to meet the cost of technology adoption. Each fund will have an overall corpus of Rs.500 crore, with initial funding to be contributed by the Central Government, the Reserve Bank and the NABARD.

I.1.12 A special plan is being implemented over a period of three years in 31 distressed districts in four States involving a total amount of Rs.16,979 crore. Of this, Rs.12,400 crore is for water related schemes. In order to provide subsidiary income to the farmer, the special plan includes a scheme for induction of high yielding milch animals and related activities.

I.1.13 The National Agricultural Insurance Scheme (NAIS) is proposed to be continued in its present form for *kharif* and *rabi* 2007-08. The Union Budget made a provision of Rs.500 crore for the scheme. The NAIS, however, suffers from the lack of reliable methodology for estimating and reporting crop yields. Since yield assessment is made on the basis of crop cutting experiments by the State Agricultural Departments, there are problems of delay in the settlement of claims. In this context, rainfall-based insurance schemes are considered as more transparent and less cumbersome to administer, especially because most of the crop insurance claims in India are linked to rainfall variations. Events such as adverse rainfall can be independently verified and measured. The Agricultural Insurance Corporation (AIC) has been running a pilot weather insurance scheme since *kharif* 2004. Accordingly, the Government has advised the AIC to start a weather-based crop insurance scheme on a pilot basis in two or three States, in consultation with the concerned State Governments, as an alternative to the NAIS. The scheme would be operated on an actuarial basis with an element of subsidy. The Union Budget for 2007-08 allocated Rs.100 crore for this purpose.

I.1.14 In order to meet the funding requirement for rural infrastructure, the Union Budget 2007-08 raised the corpus of the Rural Infrastructure Development Fund (RIDF)-XIII to Rs.12,000 crore. A separate window for rural roads under RIDF which was opened in 2006-07 with a corpus of Rs.4,000 crore is proposed to be continued under RIDF-XIII in 2007-08.

I.1.15 The National Rural Employment Guarantee Scheme (NREGS), a demand-driven scheme carrying a legal guarantee for employment, was launched on February 2, 2006. The Union Budget 2007-08 made an initial allocation of Rs.12,000 crore (including the North Eastern Region component) for the NREGS. The Government intends to expand the coverage of the NREGS from the current level of 200 districts to 330 districts. In addition, Rs.2,800 crore has been provided for *Sampoorna Gramin Rozgar Yojana* (SGRY) for rural employment in the districts not covered by the NREGS. The Union Budget also increased allocation for *Swaranjayanti Gram Swarozgar Yojana* (SGSY), intended to promote self employment among the rural poor, from Rs.1,200 crore in 2006-07 to Rs.1,800 crore in 2007-08.

Manufacturing and Infrastructure

I.1.16 The acceleration of activity in the manufacturing sector since 2003-04 has been, *inter alia*, facilitated by improvement in investor friendly and sector specific policies. The policy framework was further rationalised and simplified during 2006-07 and 2007-08 so far to entrench the growth momentum, with a focus on upgrading the infrastructural facilities in the country. Initiatives to upgrade human skills to cope with the growing demand for the skilled labour were intensified during the year. Steps were also taken to strengthen the small and medium enterprises (SMEs) segment.

I.1.17 Work on the golden quadrilateral (GQ) is nearly complete while considerable progress has been made in the North-South, East-West corridor project, which is expected to be completed by 2009. The phases of the National Highway Development Programme (NHDP), *viz.,* NHDP-III, NHDP-V and NHDP-VI are in advanced stages of planning or implementation. Under the NHDP-III, the Government has approved upgradation and four-laning of 12,109 km of National Highways on build, operate and transfer (BOT) basis. Approval has also been granted for the six laning of 6,500 km of the National Highways (including 5,700 km of the GQ) under NHDP-V and for construction of 1,000 km of expressways under the NHDP-VI. So far, the National Highways Authority of India (NHAI) has given Rs.2,072 crore as viability gap funding but has also received Rs.1,900 crore[1]. The

[1] The concept of viability gap funding was included in the policy announced by the Government in 1997 for private sector participation to provide incentives for facilitating their participation. The NHAI started giving viability gap funding from the year 2001-02 for their BOT projects. A sum of Rs.1,900 crore has been given by the concessionaires (private participants) to the NHAI.

private sector investment leveraged under the NHDP was Rs.25,366 crore from the year 2001 to January 2007 with a corresponding public component of Rs.3,423 crore.The Union Budget 2007-08 proposed to increase the provision for the NHDP from Rs.9,945 crore in 2006-07 to Rs.10,667 crore in 2007-08.

I.1.18 Consistent with the notification of the Micro, Small and Medium Enterprises Development Act, 2006 in October 2006, the definition of the micro, small and medium enterprises has been modified. For enterprises engaged in the manufacture or production of goods, micro, small and medium enterprises have been defined as those in which investment in plant and machinery does not exceed Rs.25 lakh, Rs.5 crore and Rs.10 crore, respectively. For enterprises engaged in providing or rendering of services, micro, small and medium enterprises have been defined as those where the investment in equipment does not exceed Rs.10 lakh, Rs.2 crore and Rs.5 crore, respectively.

I.1.19 The list of items reserved for exclusive manufacturing by the SSI sector has been further pruned down. During 2006-07, 392 items were dereserved: 180 in May 2006, 87 in January 2007 and 125 in March 2007. As a result, the number of items reserved for exclusive manufacturing by the SSI sector has declined to 114 in March 2007 from 836 in 1990.

I.1.20 A new National Pharmaceutical Policy was announced in July 2006 to strengthen the drug regulatory system and the patent office. The draft Amendment Bill to the National Institute of Pharmaceutical Education and Research Act, 1998 has been approved by the Cabinet, which would empower the Central Government to set up similar institute or its centres in any part of the country. The Government has approved the setting up of three more extension centres of the Central Institute of Plastics Engineering & Technology (CIPET) at Jaipur, Panipat and Aurangabad.

I.1.21 The public private partnership (PPP) model has enabled greater private sector participation in the creation and maintenance of infrastructure. In order to quicken the project preparation under the scheme, the Union Budget 2007-08 proposed to set up a revolving fund with a corpus of Rs.100 crore. The fund will contribute up to 75 per cent of the preparatory expenditure in the form of interest free loan that will be eventually recovered from the successful bidder.

I.1.22 The Government formulated a policy to boost investment in natural gas pipelines and city gas distribution (CGD) projects in a transparent and fair manner. A number of gas projects for supply to vehicles and households are expected to come up, which would not only bring down pollution level but also improve the quality of life with smooth, efficient and economical supply of gas through pipelines.

I.1.23 The Government notified the Semiconductor Policy in March 2007, providing capital subsidy to the investors setting up chip manufacturing units in India. The Government expects to attract an investment of Rs.24,000 crore in the next three years. An appraisal committee will be formed to receive expression of interest from interested parties and submit its recommendations.

I.1.24 Amendments to the Special Economic Zone (SEZ) Rules were notified in August 2006 and March 2007. While the amendments made in August 2006 relate to the definition of trading activity and investment in plant and machinery, the amendment in March 2007 sought to simplify procedures to provide more amenities to SEZ developers and sub-contractors undertaking work within these zones.

I.1.25 In order to promote industrial activity and investment in the North Eastern region, the North East Industrial and Investment Promotion Policy (NEIIPP), which came into effect from April 1, 2007, envisages incentives for expansion of capacity/modernisation and diversification. It also provides for enhancement of capital investment subsidy from 15 per cent of the investment in plant and machinery to 30 per cent; the limit for automatic approval of subsidy at the enhanced rate will be Rs.1.5 crore per unit. Furthermore, it includes incentives for service industries, bio-technology industry and power generating industries.

I.1.26 The Union Budget 2007-08 extended the ongoing Technology Upgradation Fund Scheme for textile and jute industry up to the close of Eleventh Plan Period, *i.e.*, up to 2011-12. A cluster approach for the development of the handloom sector introduced in 2005-06 has been further strengthened to take up an additional 100-150 clusters in 2007-08.

I.1.27 The Information Technology (IT) Amendment Bill was introduced in the Parliament on December 15, 2006 to put in place technology applications, security practices and procedures relating to such applications. The Bill has also addressed the issue of technological neutrality in IT laws as recommended by UNCITRAL Model Law on Electronic Signature. In order to ensure penetration of the IT and IT-enabled services (ITES) in the rural areas, the Government has formulated a proposal to establish 100,000 Common Service Centres (CSCs) in rural areas, which will serve not only as the front-end for most government services but also as a means to connect the citizens of rural India to the world wide web. The scheme will be implemented through PPP. An outlay of Rs.5,742 crore has been approved; of this, the share of the Central Government and the State Governments would be Rs.856 crore and Rs.793 crore, respectively. The balance would be invested by the private sector.

I.1.28 In order to sustain the manufacturing growth as well as to make available more input materials at competitive rates to domestic manufacturers, the Government cut customs duties across various categories in January 2007. The Union Budget 2007-08 announced further reduction in peak customs duty to 10 per cent as well as rationalisation of other taxes. The customs duties on most chemicals and plastics were reduced from 12.5 per cent to 7.5 per cent, while those on seconds and defectives of steel were cut from 20 per cent to 10 per cent; duties on polyester fibres and yarns were cut from 10 per cent to 7.5 per cent. Full exemption from duty was granted for all coking coal, irrespective of the ash content, and for dredgers. With the aim of conserving natural resources as well as to raise revenue, customs duties were imposed on export of iron ores and chrome ores. Recognising the growth and employment potential of the gem and jewellery industry, cut and polished diamonds were fully exempted from customs duties.

FISCAL POLICY

I.1.29 Fiscal policy resumed the process of fiscal correction in 2006-07 as stipulated under the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004, while at the same time pursuing the objectives of economic growth, equity and macroeconomic stability. The revised estimates of the finances of the Central Government indicate reductions in all key deficit indicators, *viz*., revenue deficit, fiscal deficit and primary deficit by 0.1 percentage point of GDP from the corresponding budget estimates. The provisional accounts, released subsequently in May 2007, indicated a reduction of further 0.1-0.2 percentage point of GDP in the revenue and fiscal deficits over the revised estimates. Robust growth, increased tax revenues and prudent expenditure management policies contributed to the improvement in all key deficit indicators by more than the minimum stipulated reductions under the FRBM Rules, 2004, whereby the fiscal deficit is envisaged to decline by at least 0.3 percentage point of GDP and the revenue deficit by 0.5 percentage point every year till 2008-09. The gross tax/GDP ratio improved to 11.5 per cent in 2006-07 as per provisional accounts from 10.3 per cent in 2005-06. The expenditure management policy measures were aimed at stabilising expenditure pattern and curtailing of non-Plan revenue expenditure.

I.1.30 The tax policy for 2006-07 focused on a rational and stable tax rate regime, expansion in the tax payer base and improvement in the efficiency of tax administration. The income and corporation tax rates were kept unchanged and no new taxes were introduced.

I.1.31 As many cooperative banks function at par with commercial banks, the income tax exemption given to cooperative banks, excluding Primary Agricultural Credit Societies (PACS) and Primary Cooperative Agricultural and Rural Development Banks (PCARDB), was withdrawn. In a bid to narrow the differential of the minimum alternate tax (MAT) with corporate tax rate, the MAT rate was increased from 7.5 per cent of book profit to 10 per cent. The rate of the securities transaction tax (STT) was raised by 25 per cent across the board on account of the increase in implicit capital gains in securities transactions. The fringe benefit tax (FBT) was rationalised by exempting expenditures on free sample of medicines and medical equipment for doctors, expenses on brand ambassador and celebrity endorsement, free or subsidised transport and allowances for the employees to their place of work, and employer contributions, up to Rs.1 lakh per annum per employee, to an approved superannuation fund. Furthermore, valuation of benefits with respect to ‘tour and travel’ and ‘hospitality, hotel boarding and lodging’ provided by airline and shipping industry was reduced from 20 per cent to 5 per cent for application of the FBT. The ‘one-by-six’ scheme - which mandated the filing of income tax returns if the person falls under any one of the expenditure/asset criteria even if his/her total income was below the threshold limit - was abolished from April 2006.

I.1.32 In the case of indirect taxes, in line with the objective of bringing customs duty to the mean level of the East Asian countries, the peak rate on non-agricultural products was reduced from 15 per cent to 12.5 per cent. In order to make the input tariff rates lower than output tariff rates, customs duties on capital goods and raw materials were reduced to ensure availability of inputs at competitive rates to domestic manufacturers. Continuing with the Government’s objective of converging the excise duty rates to the Central Value Added Tax (CENVAT) rate, the excise duty on two items attracting a higher rate of 24 per cent, *viz.,* aerated drinks and small cars, was reduced to the CENVAT rate of 16 per cent. In order to widen the service tax base in line with the rising share of services in GDP, 15 new services were included under the tax net including certain financial services. In line with the objective of introducing the Goods and Services Tax (GST) with effect from April 1, 2010 and consequently with the aim of converging the service tax rate and the CENVAT rate, the service tax rate was raised from 10 per cent to 12 per cent.

I.1.33 In order to increase transparency and to augment the Centre's receipts by means of identifying and reducing the extent of tax and non-tax arrears, two statements *viz*., 'Tax Revenue Raised But Not Realised' and 'Arrears On Non-Tax Revenues' were introduced in the 2006-07 budget. In order to provide information on revenue forgone on account of various tax exemptions, details on tax expenditures under various taxes were also provided.

Union Budget 2007-08

I.1.34 The Union Budget 2007-08 noted that the Indian economy appeared to have entered a phase of high growth. The fiscal consolidation strategy for 2007-08 was based on the need to sustain the momentum of progress made under the FRBM roadmap with the aim of achieving the FRBM goals by 2008-09. In view of the growing necessity for expenditure on social sectors and physical infrastructure, the approach to fiscal consolidation continued to be essentially revenue-led, with a focus on outcomes and improvement of the allocative efficiencies of public expenditure.

I.1.35 The underlying focus of the tax proposals in the Union Budget 2007-08 was to sustain the growth in tax revenues by creating an increasingly efficient, liberal and equitable tax system through reasonable tax rates, fewer exemptions and wider tax base. Overall, the direct tax measures in the Union Budget 2007-08 are estimated to yield additional resources of Rs.3,000 crore whereas the indirect tax proposals are revenue neutral.

I.1.36 While leaving the overall rates of personal and corporate income taxes unchanged, the threshold limit of exemption from income tax in the case of all assessees was increased by Rs.10,000. The deduction in respect of medical insurance premium was increased to a maximum of Rs.15,000 (Rs.20,000 in the case of senior citizens). In order to encourage investments in small and medium enterprises, the surcharge on companies with a taxable income of Rs.1 crore or less was removed. The rate of dividend distribution tax (DDT) was raised from 12.5 per cent to 15 per cent on dividends distributed by companies and to 25 per cent on dividends paid by money market mutual funds and liquid mutual funds. With a view to expanding the existing tax base, it was decided to (a) bring the profits of Software Technology Parks of India (STPI) units and Export Oriented Units (EOUs) within the ambit of the MAT; (b) extend the provisions of tax deduction at source (TDS) to payments made to contractors by individuals and Hindu Undivided Families (HUF) engaged in business and having turnover above a specified limit; and (c) expand the scope of the FBT to include the benefits provided under the Employees' Stock Option Plan (ESOP). Amongst the major reliefs granted under the direct taxes, cash withdrawals by the Central and State Governments were exempted from the scope of the Banking Cash Transactions Tax (BCTT) while the BCTT exemption limits for individuals and HUFs were raised from Rs.25,000 to Rs.50,000. The 100 per cent deduction provided for 10 years in respect of profits and gains provided for infrastructure facilities was extended to cross-country natural gas distribution network. To facilitate the creation of urban infrastructure, the Budget proposed to sanction the issue of tax-free bonds through State Pooled Finance Entities formed for raising funds for a group of urban local bodies. The weighted deduction of 150 per cent given for expenditure relating to in-house research and development was extended for five more years up to March 31, 2012. The tax exemption given to venture capital funds was limited only to investments in venture capital undertakings in biotechnology, information technology relating to hardware and software development, nanotechnology, seed research and development, research and development of new chemical entities in the pharmaceutical sector, dairy industry, poultry industry and production of bio-fuels. The Finance Act, 2007, which was passed in May 2007, extended the benefit of tax exemption to hotel-cum-convention centres and to developing, operating and maintaining any infrastructural facilities.

I.1.37 In the case of indirect taxes, continuing with the policy of reducing the customs duty rates to ASEAN levels, the peak rate of customs duty for non-agricultural imports was reduced from 12.5 per cent to 10 per cent. The simple average tariff for non-agricultural goods would, thus, be reduced from 12.2 per cent to about 9.4 per cent. The concessional rate of 5 per cent duty available to the publicly funded research institutions was extended to all research institutions registered with the Directorate of Scientific and Industrial Research with the aim of advancing research and development in the country. The strategy with respect to excise duties is to continue the policy of expanding the tax base rather than rates and moving towards the CENVAT rate. In this direction, the Union Budget 2007-08 kept the general CENVAT rates unchanged. The *ad valorem* component of excise duty on petrol and diesel was reduced from 8 per cent to 6 per cent in order to share the burden of higher international crude prices.

I.1.38 While leaving the general service tax rate unchanged, the tax base was broadened by bringing several new services into the tax net. These included services outsourced for mining of mineral, oil or gas; renting of immovable property for use in commerce or business; development and supply of content for use in telecom and advertising purposes; asset management services provided by individuals; and design services. The value of services in the execution of a work contract would also attract the service tax. On the other hand, in the interest of small service providers and consumers, the exemption limit for small service providers was raised from Rs.4 lakh to Rs.8 lakh.

I.1.39 With the aim of increasing the investment by the Government in secondary and higher education, an additional surcharge of 1 per cent, over and above the existing 2 per cent, was imposed on all taxes.

I.1.40 The Union Budget noted that under the Fiscal Responsibility legislations, the progress of fiscal consolidation in respect of both the Centre and the State Governments has been satisfactory. The Value Added Tax (VAT) was considered to be 'an unqualified success' in view of the acceleration in the VAT revenues in the implementing States. The Union Budget proposed, based on the mutual agreement between the Centre and the States, to phase out the Central Sales Tax (CST), commencing with a reduction of the CST rate from 4 per cent to 3 per cent from April 1, 2007. The Union Budget provided an amount of Rs.5,495 crore for compensation of losses to the States, if any, on account of the VAT as well as the CST. In the spirit of ongoing cooperative fiscal federalism between the Centre and the States, the Union Budget announced that the Empowered Committee of State Finance Ministers would prepare a roadmap for introducing a national level Goods and Services Tax (GST) with effect from April 1, 2010 (Box I.2).

I.1.41 Reiterating the high priority to strengthen the tax administration, a series of administrative goals were set for the ensuing year. These include the expansion in the coverage of the Annual Information Returns; extension of the Refund Banker System to more areas; extension of the e-payment facility through more banks; making electronic filing of returns mandatory for more categories of assessees; creation of new Large Tax Payer Units; and making the permanent account number (PAN) the sole identification number for all participants in the securities market.

I.1.42 As regards the expenditure policy, the focus was on reduction of non-developmental expenditures and enhancement of expenditure on critical social sectors such as rural employment, education and health and increased outlays on physical infrastructure. Simultaneously, emphasis was also laid on improving the quality of implementation, and efficiency and accountability of the delivery mechanism. Emphasis has shifted from outlays to outcomes so as to ensure that the budgetary provisions are not only spent within the year but also that the intended outcomes are actually achieved. In this direction, a major initiative in recent years has been the preparation of the Performance Budget and the Outcome Budget by the various Ministries/ Departments which would be merged and presented as a single document, effective from 2007-08. The document would indicate goals of the Ministry/ Department, policy framework, budget estimates, scheme-wise analysis of physical performance and linkage between financial outlays and outcomes. Furthermore, to rationalise expenditure by the various Ministries/Departments, a set of austerity measures has been implemented such as a ban on creation of posts, pruning of foreign travel expenditure and strict monitoring of the implementation of schemes/ programmes to avoid cost and time overruns. Continuing with the initiatives taken for ensuring better cash management, the quarterly exchequer control based cash and expenditure management system has been extended to cover 23 Demands for Grants from the existing 14.

I.1.43 Social sector infrastructure is being developed through outlays for certain flagship programmes relating to rural employment, education, health, water supply and other welfare programmes, and pursuing as well as monitoring the achievement of physical targets set out in these programmes. The allocations for education, health and family welfare were increased significantly in 2007-08. The increased allocation for education is to be channelled into *Sarva Shiksha Abhiyan* and Mid-day Meal schemes. The Union Budget 2007-08

Box I.2
Goods and Services Tax

Goods and Services Tax (GST) is a comprehensive value added tax (VAT) on goods and services levied and collected on the value added at each stage of sale and purchase wherein the manufacturers and dealers claim credit for 'input tax' while the final consumer bears the incidence of the full tax. Introduction of the GST widens the tax base while reducing the compliance and administration costs. The seamless credit mechanism under the GST system not only 'builds-in' voluntary compliance but also improves international competitiveness by removing cascading effect of taxes. It enhances production and distributional efficiency, as it is neutral to business structures and processes, product substitutes and geographical locations.

The GST has been introduced in more than 140 countries. It has been in vogue in Europe for the past 50 years and is being increasingly preferred by countries in the Asia-Pacific region. In countries such as Singapore, Australia and New Zealand, almost all items are taxed at a single rate, whereas in countries such as Canada, multiple rates exist. In the case of China, the GST applies only to specific goods and services. While the standard GST rate ranges between 15-20 per cent, it ranges between 22-25 per cent in Scandinavian countries where social security coverage is higher.

In Australia, a national level GST model is implemented and the proceeds are collected by the Federal Government and are passed on to the States. The GST at 10 per cent is levied on most goods and services sold in the country. Items such as basic food for human consumption, some health services and education courses, some activities of charitable institutions, childcare, religious services, water and sewerage services are exempt from the GST. Input-taxed sales include financial supplies (*e.g.*, the loans by banks) and residential rent. Variations in the GST rate or base cannot be made without the unanimous agreement of the States, the Commonwealth Government and both the houses of the Commonwealth Parliament.

In Canada, a system of dual-VAT operates, with the GST being levied by the Federal Government and the Provincial Sales Tax (PST) by the provincial Governments. In general, there are various models of dual-VAT tax systems with differences in rates and in their administration. The province of Quebec administers its own PST or the Quebec Sales Tax (QST), levied at the rate of 7.5 per cent on the federal GST (6 per cent). In Ontario, the Retail Sales Tax (RST), at 8 per cent, is administered by the province, while the Federal Government collects the GST. There is also the instance of a Harmonised Sales Tax (HST) operating in the three maritime provinces (New Brunswick, Nova Scotia and Newfoundland). Under the HST, the GST is combined with the PST, and is administered federally and levied on a harmonised base in place of the earlier federal and provincial sales taxes at a federal-provincial rate of 14 per cent. Of this, the federal GST is 6 per cent and the PST is 8 per cent.

Country practices in the implementation of the GST, thus, differ, primarily with respect to whether the GST is a single rate (centrally levied and administered) or is in the form of 'dual-VAT' (levied, at single or multiple rates, at both the Centre and State/Provincial levels). In most of the 'dual-VAT' GST models, the stress is on harmonisation of tax base rather than tax rates across the sub-national levels.

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proposed to expand the coverage of the Mid-day Meal scheme to upper primary classes in 3,427 educationally backward districts. In order to contain the drop-out ratio and encourage students to continue their education beyond Class VIII, the Union Budget introduced a National Means-cum-Merit-Scholarship with a corpus fund of Rs.750 crore in 2007-08 (with similar amounts added every year for the next three years). The *National Rural Health Mission,* in the second year of its operation, is enabling institutional integration of all the health schemes at the district and lower levels. The *Integrated Child Development Services* (ICDS), in its second phase, was expanded by sanctioning 173 ICDS projects, 107,274 *Anganwadi* centres and 25,961 mini-*Anganwadi* centres. The Government is committed to cover all habitations and settlements during the Eleventh Plan Period and planned for a wider reach under the ICDS. Based on the recommendations of the Oversight Committee on implementation of the reservation for the OBC communities, a National Mission for Education through information and communication technology (ICT) is being launched for meeting the requirement for enhanced number of students.

State Governments

I.1.44 The States continued to pursue fiscal correction and consolidation programme during 2006-07 and made further progress in terms of the path of fiscal restructuring prescribed by the Twelfth Finance Commission (TFC). The improvement in the fiscal position of the States was facilitated by the larger grants and shareable Central taxes, as recommended by the TFC. Fiscal Responsibility Legislations (FRLs) have been enacted by 26 State Governments (as at end-July 2007). All States, excepting Uttar Pradesh, have implemented the Value Added Tax (VAT) in *lieu* of sales tax. The Medium Term Fiscal Plans (MTFP) of various States focus on removing tax distortions and prioritising expenditure.

I.1.45 The States, while presenting their budgets for 2007-08, have taken into account the priorities as laid down in the Eleventh Five Year Plan (2007-12). Allocations for the social and infrastructure sectors are proposed to be raised in 2007-08 by some of the States, *viz.,* Madhya Pradesh, Kerala, Maharashtra, Himachal Pradesh, Andhra Pradesh, Assam and West Bengal. Many States have proposed to implement the infrastructure projects through the framework of public private partnership. The States have also undertaken the development of urban infrastructure under the Jawaharlal Nehru National Urban Renewal Mission (JNNURM).

I.1.46 In order to augment their revenues, the States in their budgets for 2007-08 announced measures for mobilisation of additional resources through simplification/rationalisation of tax structure, better enforcement and tax compliance. Some States proposed to review user charges in sectors such as power, water and transport. By adopting an outcome-oriented budgetary framework, the States, including Himachal Pradesh, Jammu and Kashmir, Arunachal Pradesh and West Bengal, have emphasised the translation of outlays into defined outcomes through monitorable performance indicators. Several States made commitments to contain revenue expenditure through restrictions on fresh recruitment and on creation of new posts. A few more States announced the introduction of a contributory pension scheme for their newly recruited staff to contain rising pension obligations. A few States also proposed a comprehensive review of the functioning of the State PSUs and their restructuring. In order to restore financial viability of electricity boards, some States signed Memorandum of Understanding (MoU) with the Central Government for bringing reforms in the power sector. Some States, including Madhya Pradesh, have also proposed to introduce “Gender Budget” to ensure empowerment and active participation of women in various development schemes.

EXTERNAL SECTOR POLICIES

I.1.47 With the aim of providing further momentum to export growth and for creating employment, the Government of India announced (April 2007) the Annual Supplement 2007 to the Foreign Trade Policy (2004-09). While deepening the incentives provided under the focus products and the focus markets schemes, the Annual Supplement also sought to reduce the transaction costs in foreign trade. In order to support agriculture exports, the *Vishesh Krishi* and *Gram Udyog Yojana* schemes are being expanded to include more commodities such as coconut oil, soyabean oil, potato flakes, meals and flours, and cardamom. For handloom and handicraft industries, arrangements are being made to provide for tools, machinery and equipment within the present duty-free entitlement ceiling so as to enable these rural-based activities to modernise and scale up operations to meet the market challenges. Similarly, in order to promote exports of gems and jewellery, tools, machinery and equipment needed by this sector would be covered within the present duty-free entitlement limit. With a view to facilitating the export of services from India, all the services rendered abroad and charged on exports from India would be exempted from the payment of service tax. As regards steps for reducing transaction costs and delays, the Annual Supplement announced on-line verification of documents under the various export promotion schemes, discontinuation of the restrictive requirement of block-wise fulfilment of export obligations and reduction of the length of the existing *Aayat Niryat Form.*

Foreign Exchange Transactions[2]

I.1.48 During the year, a number of measures were initiated to further simplify and liberalise the external payments regime and deepen the foreign exchange market, drawing from the recommendations of the Committee on Fuller Capital Account Convertibility (FCAC) (Chairman: Shri S.S. Tarapore) (2006). The Internal Task Force, which was constituted on the basis of the recommendations of the FCAC, reviewed

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

and made recommendations on 169 issues encompassing all areas under the foreign exchange management. The policy initiatives undertaken to further liberalise cross-border capital flows, both inflows and outflows, included increase in the overseas investment limits for joint ventures/wholly owned subsidiaries abroad by the Indian companies; higher portfolio investment limits for Indian companies as well as for domestic mutual funds; higher ceilings for investments by foreign institutional investors in Government securities; and enhanced prepayment limits for the external commercial borrowings (ECB). With regard to current account transactions, measures taken included liberalisation of the remittance scheme for resident individuals; extension of time for realisation of export proceeds; rationalisation of write-off of unrealised export bills; and liberalisation of project and service exports. Domestic producers/ users of certain metals, and actual users of aviation turbine fuel were permitted to hedge in international commodity exchanges. Greater flexibility in terms of higher limits/cancellation and rebooking was provided to exporters/importers and corporates with regard to their forward contracts. Ceiling for remittances by resident individuals was increased from US $ 25,000 per calendar year to US $ 50,000 per financial year in December 2006 and further to US $ 1,00,000 per financial year in April 2007. Resident individuals were also permitted to book forward contracts up to an annual limit of US $ 1,00,000 which can be freely cancelled and rebooked to manage/hedge their foreign exchange exposures, including anticipated exposures. A review of the ECB guidelines was undertaken in August 2007, keeping in view the prevailing macroeconomic situation and experience gained in administering the ECB policy. Accordingly, ECB of more than US $ 20 million per borrower company per financial year, under automatic/ approval routes have been permitted only for foreign currency expenditures for permissible end-uses. These borrowers would be required to park the proceeds overseas for use as foreign currency expenditures. ECB of up to US $ 20 million per borrower company per financial year have been permitted for foreign currency expenditures for permissible end-uses under the automatic route and these funds are required to be parked overseas, not to be remitted to India. ECB of up to US $ 20 million for rupee expenditure for permissible end-uses shall require prior approval of the Reserve Bank under the approval route, and shall continue to be parked overseas until actual requirement in India.

MONETARY POLICY FRAMEWORK[3]

I.1.49 The conduct of monetary policy during 2006-07 was guided by the policy challenge to manage the transition to a higher growth path while containing inflationary pressures. The Reserve Bank emphasised the need to be watchful in view of the increased demand pressures in the form of an upturn in investment in infrastructure, shortening capital expenditure cycle, increasing consumption demand, high monetary growth, invigorated by the pick-up in activity in all constituent sectors of the economy. Although there was no conclusive evidence of overheating in the Indian economy, the Reserve Bank indicated the need to reckon with the dangers of possible overheating. It was emphasised that persistence of high inflation not only operates as a tax on the poor but also undermines economic growth and macroeconomic stability. In the prevailing conditions of growth, price and financial stability, unequivocal relative emphasis on stability was warranted and a determined and co-ordinated effort by all to contain inflation without unduly impacting the growth momentum was an economic necessity. The shifting stance of monetary policy to greater emphasis on price and financial stability over 2006/2007 is indicated by the following: “ensuring 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” (April 2006) to “reinforcing the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum” and “to respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations and the growth momentum” (January 2007).

I.1.50 The Annual Policy Statement for 2007-08 reiterated the stance set out in January 2007. In its First Quarter Review of the Annual Statement on Monetary Policy (July 2007), the Reserve Bank noted that while the stance of monetary policy would “continue to reinforce the emphasis on price stability

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

and well-anchored inflation expectations and thereby sustain the growth momentum, contextually, financial stability may assume greater importance in the months to come" as "recent developments in financial markets in India and potential uncertainties in global markets warrant a higher priority for managing appropriate liquidity conditions in the policy hierarchy at the current juncture."

I.1.51 In recognition of the cumulative and lagged effects of monetary policy, the pre-emptive monetary tightening measures, which were initiated in September 2004, continued during 2006-07 and 2007-08. Since September 2004, the repo rate and the reverse repo rate have been increased by 175 and 150 basis points, respectively, while the cash reserve ratio (CRR) has been raised by 250 basis points. In view of the need to maintain asset quality against the backdrop of strong and sustained growth in credit, monetary measures were reinforced by tightening of provisioning norms and risk weights. In the context of large capital inflows and implications for liquidity and monetary management, the interest rate ceilings on non-resident deposits have been reduced by 75-100 basis points since January 2007.

I.1.52 While persevering with the policy measures to contain inflation and inflation expectations, the Reserve Bank continued with its initiatives of greater credit penetration and financial inclusion. In order to channel greater flow of credit to the priority sector – which includes agriculture, small scale units, micro credit, education loans and housing loans up to specified limits – guidelines for the priority sector lending were revised.

FINANCIAL SECTOR POLICIES[4]

I.1.53 The financial sector plays an important role in the efficient allocation of resources and this aspect assumes all the more significance in the context of an economy such as India which is on a rising growth trajectory. In view of the critical role played by the financial sector in supporting the acceleration in growth, the Reserve Bank continued to take measures during 2006-07 to strengthen the financial sector. Provisioning norms and risk weights were tightened to ensure asset quality in the face of sustained high credit growth to certain sectors. The Reserve Bank also took measures to strengthen the accounting and disclosure norms in order to enforce greater market discipline. Final guidelines for the implementation of the New Capital Adequacy Framework (Basel II) were issued. In consonance with the stated policy of benchmarking the Indian financial sector to international best practices in a phased manner, commercial banks will start implementing Basel II norms from end-March 2008. The objective of strengthening the urban cooperative banks was persevered with during 2006-07 by encouraging Memorandum of Understanding with the State Governments, setting up of State level Task Forces, and merger of weak banks with stronger banks. With regard to non-banking financial companies (NBFCs), the regulatory framework was strengthened by placing prudential limits on banks' exposure to NBFCs while also specifying capital adequacy norms and exposure norms for Non-Deposit taking Systemically Important NBFCs (NBFC-ND-SI). Alongside its initiatives to strengthen the financial sector, the Reserve Bank continued to take measures for protecting customers' rights, and enhancing the quality of customer service. A separate Customer Service Department was set up in the Reserve Bank in July 2006 to promote the interests of the customers.

Policies for Financial Markets

I.1.54 During 2006-07, initiatives to further widen and deepen the various segments of the domestic financial markets were intensified. The implementation of the provision of Fiscal Responsibility and Budget Management (FRBM) Act, 2003, which prohibits the Reserve Bank from participating in the primary market from April 2006 onwards, necessitated several structural and developmental measures for the Government securities market. These included revamping the primary dealer (PD) system to ensure a more dynamic and active participation of PDs in the auctions; allowing banks to undertake PD business; allowing stand-alone PDs to diversify their activities; standardising settlement cycle; permitting short-selling of Government dated securities; and introduction of 'when issued' market.

I.1.55 In order to make the Indian capital markets more efficient, transparent, investor friendly and liberal, a number of steps were taken during 2006-07 by Securities and Exchange Board of India (SEBI). Grading of initial public offerings (IPOs) was made

[4] A detailed discussion of financial sector policies is presented in Chapter IV ("Development and Regulation of Financial Markets") and Chapter V ("Financial Regulation and Supervision") of the Report.

mandatory so as to check the quality of public offers in the primary market. Companies with a listing history of less than six months were permitted to raise money through preferential allotment. To enable quick information dissemination on trading in corporate bonds, SEBI allowed the Bombay Stock Exchange Limited (BSE) and the National Stock Exchange of India Limited (NSE) to set up and maintain bond reporting platforms. Furthermore, effective January 1, 2007, all transactions above Rs.1 lakh are required to be reported within 30 minutes of closing the deal and settlements have to be reported within one trading day from completion of trades on the BSE.

I.1.56 To encourage foreign institutional investment, SEBI widened the range of international entities that can invest in the stock markets in India by including an institution incorporated outside India as a pension fund, mutual fund, investment trust, insurance company and reinsurance company as a registered foreign institutional investor (FII). The list would also include international or multilateral agencies, foreign governmental agency or a foreign central bank. In order to improve the quality of FII investments into the capital market, SEBI raised the registration and renewal fee for FIIs and reduced the validity period of the registration certificate.

I.1.57 SEBI approved norms for divestment of brokers' stakes in stock exchanges. It was decided to cap institutional investment in stock exchanges at 5 per cent, either in consortium or as a single entity. SEBI permitted listed companies to send a statement containing the salient features of the balance sheet, profit and loss account and auditors report to each shareholder instead of the earlier requirement of sending a copy of the complete and full balance sheet, profit and loss account and Director's report.

I.1.58 The Union Budget 2007-08 continued to lay emphasis on the Indian capital market with a focus on investor protection norms. In order to strengthen the Know Your Customer (KYC) norms and to ensure a sound audit trail of all transactions, the PAN was made the sole identification number for all participants in the securities market. To channelise resources to the infrastructure sector, dedicated infrastructure mutual funds were proposed to be introduced. The Union Budget also proposed to allow short-selling settled by delivery, and securities lending and borrowing to facilitate delivery by institutions. It also proposed to put in place an enabling mechanism to permit Indian companies to unlock a part of their holdings in group companies for meeting their financing requirements by issue of exchangeable bonds. Individuals have been allowed to invest in overseas securities allowing portfolio risk diversification to domestic investors.

Legal Framework

I.1.59 During 2006-07, significant amendments to the major banking legislations, *viz.*, the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 were carried out, which would provide greater flexibility to the Reserve Bank in its conduct of monetary policy while also strengthening its regulatory powers (Box I.3).

Box I.3
Legislative Amendments for Conduct of Monetary Policy

The Reserve Bank of India (Amendment) Act, 2006 was passed in June 2006. The amendment to the Act, *inter alia*, removed the ceiling as well as the floor of the CRR prescribed for scheduled banks. The Reserve Bank has, thus, been provided with the discretion to decide the percentage of scheduled banks' demand and time liabilities to be maintained as CRR without any ceiling or floor. Furthermore, consequent to the amendment, no interest will be paid on the CRR balances so as to enhance the efficacy of the CRR, as payment of interest attenuates its effectiveness as an instrument of monetary policy (see Chapter III for details). The definition of "repo" and "reverse repo" provided under the amended Act would facilitate transactions of market participants/banks in these instruments. The amendment Act also provides the Reserve Bank with the statutory backing for regulating the money market and trading of over-the-counter derivatives.

The Banking Regulation (Amendment) Act, 2007 (replacing the Banking Regulation (Amendment) Ordinance, 2007 which came into effect on January 23, 2007) was notified in the gazette on March 28, 2007. Consequent upon the amendment to Section 24 of the Banking Regulation Act, 1949, the floor rate of 25 per cent for the statutory liquidity ratio (SLR) has been removed and the Reserve Bank has also been empowered to determine the SLR-eligible assets.

The amendments to the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 have provided the Reserve Bank greater manoeuvrability in monetary management as it now has the flexibility to change the reserve requirements for scheduled banks depending on the evolving macroeconomic and monetary conditions.

I.1.60 The Government Securities Act was passed by the Parliament in August 2006 (Box. I.4). Amongst other major legislative developments, the Credit Information Companies (Regulation) Act, 2005 came into force with effect from December 14, 2006. The Credit Information Companies Rules, 2006 framed by the Central Government and the Credit Information Companies Regulations, 2006 framed by the Reserve Bank under the said Act have been notified. The salient features of the Act, *inter alia*, include (a) prohibition to commence or carry on business of credit information without obtaining a certificate of registration (CoR) from the Reserve Bank; (b) laying down the procedure for making application for grant/cancellation of CoR and appeal against order of rejection of an application for grant of CoR; (c) requirement of minimum capital; (d) management of credit information companies; (e) conferring powers upon the Reserve Bank to determine policy in relation to functioning of credit information companies and giving directions to these companies and other players in the business of credit information; (f) functions of credit information by credit information companies; (g) collection and furnishing of credit information; (h) powers and duties of auditors; (i) obtaining of membership by credit institutions of credit information companies; (j) information privacy principles; (k) alterations of credit information files and credit reports; (l) regulation of unauthorised access to credit information; (m) offences and penalties; (n) obligations as to fidelity and secrecy; (o) resolution of disputes between credit institutions and credit information companies or between credit institutions and their borrowers; (p) exemption from any or all the provisions of the proposed legislation to any credit information company or credit institution; and (q) amendment of certain enactments specified in the Schedule to the Bill so as to permit disclosure of credit information under the proposed legislation.

I.1.61 The Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Act, 2006 came into force from October 16, 2006. The Act amended the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980. The amended Act, *inter alia*, provides for the following: (i) increase in the number of whole-time directors from two to four so as to have more functional directors in view of expansion of activities of the nationalised banks; (ii) the Central Government, on the recommendation of the Reserve Bank, to nominate a person possessing necessary experience and expertise in regulation or supervision of commercial banks as director instead of nominating an officer of the Reserve Bank; (iii) removal of the provision for nominee directors from amongst the officials of SEBI/NABARD/public financial institutions (PFIs) *etc.*; (iv) nomination of up to three shareholder

Box I.4
Government Securities Act, 2006

Management of Government debt involves issuance and servicing of Government securities. The servicing of Government debt requires timely payment of interest and principal to the holders of Government securities and settlement of claims in the event of death of the holder. The issue of Government securities and their servicing is attended to by the Reserve Bank through the Public Debt Offices, the branches of State Bank of India/associate banks and the district treasuries/sub-treasuries.

The legal framework relating to issuance and servicing of Government securities was provided by the Public Debt Act, 1944. In view of the sharp increase in the volume of the public debt and other changes in the external environment, some of the provisions of the Act and the Rules framed thereunder were found to be onerous, and, at times, impeded further development of the debt market. Accordingly, the Government Securities Act, 2006 was enacted, which seeks to replace the Public Debt Act, 1944 and repeal the Indian Securities Act, 1920.

The Act proposes to consolidate and amend the law relating to issue and management of Government securities by the Reserve Bank. The Act, *inter alia*, provides for (i) definition of terms such as 'bond ledger account', 'constituent subsidiary ledger account' and 'Government security'; (ii) recognition of title to Government security of deceased sole holder or joint holders; (iii) nomination by holders of Government securities; (iv) acceptance of micro films, facsimile copies of documents, magnetic tapes and computer printouts as documents of evidence; (v) suspension of the holders of subsidiary general ledger account from trading with the facility of that account in the event of misuse of the said facility; (vi) stripping of a Government security separately for interest and principal; (vii) creation of pledge, hypothecation or lien in respect of Government securities. The Act also empowers the Reserve Bank to call for information, cause inspection and issue directions as well as to make regulations with the prior approval of the Central Government for carrying out the purposes of the Act.

The Rules under the Act are yet to be notified.

directors on the board on the basis of percentage of shareholding instead of the existing provision of one to six directors, so as to provide for a more equitable representation on the basis of percentage of ownership; (v) elected directors to fulfil 'fit and proper' status as per the criteria notified by the Reserve Bank from time to time; (vi) the Reserve Bank empowered to appoint one or more additional directors if found necessary in the interest of banking policy/public interest/interest of the bank or the depositors; (vii) nationalised banks enabled to raise capital by preferential allotment or private placement or public issue in accordance with the procedure as may be specified by regulation with the previous approval of the Central Government and after consultation with the Reserve Bank; (viii) the Central Government to hold at all times not less than 51 per cent of the paid-up capital consisting of equity shares; (ix) the voting rights of preference shares of the nationalised banks to be restricted only to resolutions directly affecting their rights subject to a ceiling of one per cent of total voting rights of all the shareholders holding preference share capital only; (x) shareholders empowered to discuss, adopt and approve the Directors' report, the annual accounts and the balance sheet at the annual general meeting; and (xi) the Central Government empowered to supersede the boards of directors on the recommendation of the Reserve Bank in public interest, or for preventing the affairs of the bank being conducted in a manner detrimental to the depositor's or bank's interest, or for securing the proper management of the nationalised banks; the supersession will be for a period not exceeding 6 months which may be extended up to a maximum of one year.

I.1.62 The Securities Contracts (Regulation) Amendment Act, 2007, which had amended the Securities Contract (Regulation) Act, 1956 so as to provide a legal framework for trading in securitised debt including mortgage backed debt, was passed in May 2007. The Act, *inter alia*, provides for (a) including securitisation certificates or instruments under the definition of 'securities'; and (b) obtaining approval from the Securities and Exchange Board of India for issue of securitisation certificate or instrument and procedure thereof.

I.1.63 The State Bank of India (Subsidiary Banks Laws) Amendment Act, 2007 which had amended the State Bank of Saurashtra Act, 1950, the State Bank of Hyderabad Act, 1956 and the State Bank of India (Subsidiary Banks) Act, 1959, came into effect on July 9, 2007. The Act, *inter alia*, provides for enhancing the capital of the subsidiary banks, enabling them to raise resources from the market and flexibility in the management of these banks. The major provisions of the Act include (a) increasing the authorised capital of subsidiary banks of the State Bank of India (SBI) to Rs.500 crore; (b) fixing of their issued capital by SBI with the approval of the Reserve Bank; (c) raising of their issued capital through preferential allotment/ private placement/public issue in accordance with the specified procedure, with the approval of SBI and the Reserve Bank; (d) issuance of bonus shares to the equity shareholders with the approval of SBI and the Reserve Bank; (e) reduction of SBI's shareholding from 55 per cent to 51 per cent; (f) removal of the restriction on individual shareholdings in excess of 200 shares and an increase in the percentage of voting rights of shareholders (other than SBI) from one per cent to ten per cent of the issued capital of the subsidiary bank concerned; (g) restriction of the voting rights of preference shares of subsidiary bank only to resolutions directly affecting their rights; (h) nomination of an official of SBI or of the subsidiary bank as the Chairman of the Board of a subsidiary bank, with the approval of the Reserve Bank; (i) nomination by the Reserve Bank of one director, with necessary expertise and experience in the matters relating to regulation or supervision of commercial banks, and another additional director, as and when considered necessary, in the interest of banking policy and depositors' interest *etc.*; (j) increase in the number of elected directors representing shareholders of subsidiary bank to a maximum of three; (k) specifying of the eligibility criteria, including 'fit and proper' criteria, for elected directors of subsidiary bank with the Reserve Bank having the power to remove elected directors not found 'fit and proper'; (l) holding of board meetings through video conference or through other electronic means; (m) supersession of the board of directors of subsidiary bank by the Reserve Bank in the public/ depositor's interest or for securing proper management of the subsidiary banks on the recommendation of SBI; and (n) framing of the regulation by the board of a subsidiary bank after consultation with the SBI and with the previous approval of the Reserve Bank.

I.1.64 The Banking Regulation (Amendment) Bill, 2005, introduced in the *Lok Sabha* on May 13, 2005, seeks to amend some of the provisions of the Banking Regulation Act, 1949 with a view to strengthening the regulatory powers of the Reserve Bank. The Bill includes provisions for (i) removing the restriction on voting rights and introducing the requirement of prior approval of the Reserve Bank for acquisition of shares or voting rights above the specified limit (empowering the Reserve Bank to satisfy itself that the applicant is a 'fit and proper person' to acquire shares or voting rights and to impose such further conditions that the Bank may deem fit to impose); (ii) amending Section 12 of the Act to enable banking companies to issue preference shares subject to regulatory guidelines framed by the Reserve Bank; (iii) empowering the Reserve Bank to direct a banking company to disclose in its financial statement or furnish to the Reserve Bank separately, such statements and information relating to the business of any associate enterprise, as the Reserve Bank considers necessary and also to cause an inspection to be made of any associate enterprise; (iv) empowering the Reserve Bank to supersede the board of directors of a banking company and appoint an administrator; (v) amending Section 56 of the Act to remove the provision facilitating primary credit societies to carry on the business of banking without obtaining a license from the Reserve Bank; and (vi) empowering the Reserve Bank to order special audit of a co-operative bank in public interest or in the interest of the co-operative bank or its depositors. The Standing Committee on Finance of the Parliament has submitted its report on the Bill.

I.1.65 The State Bank of India (Amendment) Bill, 2006 introduced in Lok Sabha on December 18, 2006 seeks to amend the State Bank of India Act, 1955. The Bill, *inter alia*, provides for (i) raising the authorised capital of the State Bank of India (SBI) to Rs.5,000 crore; (ii) the issued capital of SBI to consist of equity shares or equity and preference shares; (iii) right of registered shareholders to nominate; (iv) qualifications for election as directors; (v) powers of the Reserve Bank to appoint additional directors; (vi) supersession of the Central Board in certain cases; and (vii) transfer of unpaid or unclaimed dividend. The State Bank of India Amendment Ordinance 2007 was promulgated on June 21, 2007 to amend the State Bank of India Act, 1955 to enable the transfer of the Reserve Bank's shareholding in the SBI to the Central Government. The transfer was aimed at allowing the Reserve Bank to focus on its regulatory and supervisory functions and removing the conflict of interest in due discharge of its duties as the banking regulator and also the owner.

I.1.66 The Payments and Settlements Bill, 2006 was introduced in the Lok Sabha on July 25, 2006. The Bill seeks to designate the Reserve Bank as the authority to regulate payment and settlement systems. The Bill contains provisions for (i) compulsory requirement of an authorisation by the Reserve Bank to operate payment systems; (ii) empowering the Reserve Bank to regulate and supervise the payment systems by determining standards, calling for information, returns, documents, *etc.*; (iii) empowering the Reserve Bank to audit and inspect by entering the premises where payment systems are being operated; (iv) empowering the Reserve Bank to issue directions; and, (v) overriding other laws and providing for settlement and netting to be final and irrevocable at the determination of the amount of money, securities or foreign exchange payable by participants. The Bill was referred to the Standing Committee on Finance for its consideration and the Report of the Committee was presented to the Lok Sabha in May 2007.

II. THE REAL ECONOMY

I.2.1 Continuing the high growth phase that started in 2003-04, the Indian economy exhibited robust growth during 2006-07. Real GDP growth accelerated to 9.4 per cent in 2006-07 from 9.0 per cent achieved in the previous year on the back of a further firming up of activity in the industrial and the services sectors. Both these sectors recorded double-digit growth, which more than offset the deceleration in the agricultural sector (Table 1.1 and Appendix Tables 2 and 3). The services sector continued to be the mainstay of the economy, contributing 71.5 per cent to overall growth. The sustained resurgence in industrial activity in the recent period has reinforced the growth process, and has imparted stability to the growth process.

I.2.2 Real GDP growth averaged 8.6 per cent during the four-year period 2003-04 to 2006-07 and 7.6 per cent during the 10th Plan period (2002-03 to 2006-07), significantly higher than that of 5.7 per cent during the 1980s and 1990s. The actual growth during the 10th Plan period was quite close to the target of 8.0 per cent. Amongst major sectors, growth of the industrial sector averaged 8.0 per cent during 2002-03 to 2006-07, higher than that of 5.7 per cent during the 1990s and 6.4 per cent during the 1980s. Growth of the services sector has exhibited a consistent uptrend from 6.3 per cent during the 1980s and 7.1 per cent during the 1990s to 9.5 per cent during the 10th Plan period. Growth in agriculture and allied activities averaged 2.3 per cent during the 10th Plan period, lower than that of 3.2 per cent during the 1990s and 4.4 per cent during

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

(per cent)

Sector	1990-91 to 1999-2000 (Average)	2000-01 to 2006-07 (Average)	2002-03 to 2006-07 (10th Plan)	2004-05@	2005-06*	2006-07#	2006-07 Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11
1. Agriculture and Allied Activities	**3.2**	**2.5**	**2.3**	**0.0 (20.2)**	**6.0 (19.7)**	**2.7 (18.5)**	**2.8**	**2.9**	**1.6**	**3.8**
1.1 Agriculture	3.3	2.5	2.3	- 0.2	6.3	n.a.	n.a.	n.a.	n.a.	n.a
2. Industry	**5.7**	**7.0**	**8.0**	**8.4 (19.6)**	**8.0 (19.4)**	**11.0 (19.7)**	**10.6**	**11.3**	**10.8**	**11.2**
2.1 Mining and Quarrying	4.8	4.6	5.6	7.5	3.6	5.1	3.7	3.9	5.5	7.1
2.2 Manufacturing	5.6	7.7	8.7	8.7	9.1	12.3	12.3	12.7	11.8	12.4
2.3 Electricity, Gas and Water Supply	7.3	4.8	5.9	7.5	5.3	7.4	5.8	8.1	9.1	6.9
3. Services	**7.1**	**8.6**	**9.5**	**10.0 (60.2)**	**10.3 (60.9)**	**11.0 (61.8)**	**11.6**	**11.7**	**10.9**	**10.0**
3.1 Trade, Hotels, Restaurants, Transport Storage and Communication	7.5	10.3	11.1	10.9	10.4	13.0	12.4	14.2	13.1	12.4
3.2 Financing, Insurance, Real Estate and Business Services	8.1	7.9	8.8	8.7	10.9	10.6	10.8	11.1	11.2	9.3
3.3 Community, Social and Personal Services	6.5	6.0	6.6	7.9	7.7	7.8	11.3	8.3	6.7	5.7
3.4 Construction	5.6	9.9	11.8	14.1	14.2	10.7	10.5	11.1	10.0	11.2
4. Real GDP at Factor Cost	**5.7**	**6.9**	**7.6**	**7.5 (100.0)**	**9.0 (100.0)**	**9.4 (100.0)**	**9.6**	**10.2**	**8.7**	**9.1**

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

Note : 1. Figures in parentheses denote percentage shares in real GDP.

2. Q1: First Quarter (April-June); Q2: Second Quarter (July-September); Q3: Third Quarter (October-December); and Q4: Fourth Quarter (January-March).

Source : National Accounts Statistics, Central Statistical Organisation.

the 1980s. The step up in the growth rate of the economy since 2003-04 onwards has been driven by a higher investment rate, supported by a sizeable increase in the rate of gross domestic saving. Moreover, there are indications of some improvement in capital use[5], a turnaround in total factor productivity in manufacturing since 2002-03, and a steady improvement in productivity growth in the services sector. At the same time, the rising capacity utilisation during the year in the context of strong domestic growth for the fourth successive year was associated with incipient inflationary pressures.

I.2.3 Reflecting the sustained high growth over the past four years, India's share in world GDP (measured in terms of purchasing power parity (PPP) rates) increased from 4.3 per cent in 1991 and 5.4 per cent in 2000 to 6.3 per cent in 2006. According to the IMF data, measured in PPP terms, India was the world's fourth largest economy after the US, China and Japan during 2006. At market exchange rates, India was the 13th largest economy during 2006; India's share in world GDP at market exchange rates initially fell from 1.7 per cent during 1982-1985 to 1.1 per cent in 1993 before rising to 1.8 per cent in 2006.

AGGREGATE SUPPLY

Agriculture

I.2.4 According to the CSO's revised estimates, real GDP growth originating from agricultural and allied activities decelerated from 6.0 per cent in 2005-06 to 2.7 per cent in 2006-07, partly attributable to the base effect of the preceding year and some setbacks to the production from an uneven monsoon (Table 1.1). Overall agricultural production, in terms of the Index of Agricultural Production, is likely to

[5] The incremental capital-output ratio, which is an indicator of efficiency of capital use, declined from an average of 5.3 during 2001-02 to 2002-03 to 3.8 during 2003-04 to 2005-06. Recent studies also indicate some evidence of improvement in productivity [see Barry Bosworth and Susan Collins (2006), "Accounting for Growth: Comparing China and India" and Goldman Sachs (2007), Global Economics Paper 152].

post an increase of around 5.2 per cent during 2006-07 (8.5 per cent a year ago) on account of lower growth in the total foodgrains production (3.6 per cent during 2006-07 as compared with 5.2 per cent during 2005-06) (Appendix Table 4).

I.2.5 During 2006, the rainfall under the South-West monsoon was close to normal; the distribution of the rainfall was, however, uneven, both temporally and spatially (Table 1.2). The monsoon arrived over Kerala on May 26, almost a week prior to the normal date. There was, however, a prolonged hiatus in the South-West monsoon during the middle of June and early-July, 2006. Consequently, monsoon could cover the entire country only by July 24, with a delay of 9 days. The initial deficiency in the rainfall was compensated by the excess rainfall during the first three weeks of August 2006. As a result, the cumulative rainfall for the South-West monsoon season was close to normal at 99 per cent of the Long-Period Average (LPA). Month-wise, the rainfall was below normal in June 2006 (13 per cent below LPA), near normal in July and September 2006 (2 per cent and 1 per cent below LPA, respectively), and excess in August 2006 (5 per cent above the LPA). Of the 36 meteorological sub-divisions, cumulative rainfall for the season, on the whole, was deficient/scanty/no rain in 10 sub-divisions (4 sub-divisions during last year). Among the four homogenous regions, the rainfall was deficient in North-East India, North-West India and South Peninsula (83 per cent, 94 per cent and 95 per cent of the LPA, respectively), largely offset by the excess rainfall over Central India (116 per cent of the LPA). Of the 533 meteorological districts, 130 districts (25 per cent) experienced a moderate drought, while 30 districts (6 per cent) experienced severe drought[6] conditions at the end of the season. In view of the near normal rainfall for the season, on the whole, the reservoir position at the end of the South-West monsoon season was comfortable, with the total live water storage at 91 per cent of the Full Reservoir Level (FRL) (higher than that of 81 per cent in 2005 and the average of 71 per cent in the last 10 years), which augured well for the ensuing *rabi* crops. As against a near normal South-West monsoon during 2006, the North-East monsoon 2006 (October 1 to December 31) turned out to be deficient (cumulative rainfall being 21 per cent below normal) and was unevenly distributed.

Table 1.2: Spatial Distribution of Rainfall

Year	South-West Monsoon (June-September)					North-East Monsoon (October-December)				
	Cumulative Rainfall: Above(+)/ Below (-) Normal (per cent)	Excess Rainfall	Normal Rainfall	Deficient Rainfall	Scanty/ No Rain	Cumulative Rainfall: Above(+)/ Below (-) Normal (per cent)	Excess Rainfall:	Normal Rainfall	Deficient Rainfall	Scanty/ No Rain
		Number of Sub-Divisions					Number of Sub-Divisions			
1	2	3	4	5	6	7	8	9	10	11
1998	6	12	21	3	0	47	28	6	1	1
1999	-4	3	26	7	0	19	20	7	6	3
2000	-8	5	23	8	0	-47	0	4	13	19
2001	-8	1	30	5	0	13	14	10	9	3
2002	-19	1	14	19	2	-33	3	7	12	14
2003	2	7	26	3	0	9	9	9	6	12
2004	-13	0	23	13	0	-11	8	10	17	1
2005	-1	9	23	4	0	10	11	6	5	14
2006	-1	6	20	10	0	-21	3	6	14	13
2007*	+7	14	18	4	0					

*: up to August 8, 2007.

Note : Excess : +20 per cent or more. Normal : +19 per cent to -19 per cent. Deficient : -20 per cent to -59 per cent.
Scanty : -60 per cent or less. No Rain : -100 per cent.
All distributions are with respect to the long period average.

Source : India Meteorological Department.

6 According to India Meteorological Department (IMD), the departure of aridity index from the normal value is expressed in percentage and accordingly drought is categorised as severe (more than 50 per cent), moderate (26-50 per cent) and mild (up to 25 per cent).

I.2.6 Uneven and delayed rainfall during the South-West monsoon season led to some reduction in the area coverage under *kharif* crops in 2006 season; this decline was largely offset by improved sowing under *rabi* crops on account, *inter alia*, of favourable soil moisture conditions and remunerative open market and support prices. Significant improvement in the area sown was observed in the case of *rabi* crops such as wheat, pulses, maize and barley, which more than offset the decline witnessed in oilseeds.

I.2.7 As per the Fourth Advance Estimates, the foodgrains production during 2006-07 was 216.1 million tonnes, an increase of 3.6 per cent over the previous year, led by higher production of wheat. The *rabi* foodgrains production was estimated at 105.6 million tonnes, the highest since 1999-2000. Among non-foodgrains, the production of sugarcane and cotton scaled new peaks during 2006-07; the production of oilseeds was, however, lower on account of decline in acreage (Table 1.3 and Appendix Table 4).

I.2.8 Notwithstanding some improvement in foodgrains production during 2006-07, the production of major crops has witnessed stagnation in recent years. For instance, the production of rice, wheat and pulses during 2006-07 was still below the previous peaks touched in 2001-02, 1999-2000 and 1998-99, respectively (Table 1.4). This stagnation in production was on account of plateauing of yields, which could be attributed to a variety of factors such as limited varietal breakthrough, almost non-existent extension services, low resilience to moisture stress and pest infestation, low water use efficiency, inequity in water use and irrigation development, and decline in agricultural investment. Furthermore, yields differ vastly across States and, in many States, yields are much below the realisable potential of existing varieties. For instance, the unutilised potential in the case of wheat is only 6 per cent in Punjab, while it is as high as 84 per cent in Madhya Pradesh. In the case of rice, the potential yield increase is over 100 per cent in Assam, Bihar, Chattisgarh and Uttar Pradesh.

1.2.9 The share of private investment in agricultural gross investment declined to below 76 per cent in 2005-06 from 83 per cent in 2002-03 (Table 1.5). Farmers are likely to increase their investment in agriculture when a higher percentage of the benefits of production is assured to them. The markets may often be constrained to respond fully to thousands of small producers who interact with them on a one-to-one basis, with small quantities of produce. Small and marginal farmers may be well served by cooperative laws that are user-sensitive, user-owned, user-controlled and which enable them to enter markets with adequate bargaining power.

Table 1.3: Agricultural Production

Crop	2003-04	2004-05	2005-06	2006-07 #
1	2	3	4	5
1. Growth Rate (Per cent) $				
All Crops	**16.1**	**-0.3**	**8.5**	**5.2**
a. Foodgrains	16.4	-3.5	4.7	4.2
b. Non-foodgrains	15.6	3.7	12.4	6.3
2. Production (Million Tonnes)				
a. Foodgrains	**213.2**	**198.4**	**208.6**	**216.1**
i. Rice	88.5	83.1	91.8	92.8
ii. Wheat	72.2	68.6	69.4	74.9
iii. Coarse Cereals	37.6	33.5	34.1	34.3
iv. Pulses	14.9	13.1	13.4	14.2
b. Non-foodgrains				
i. Oilseeds+	25.2	24.4	28.0	23.9
ii. Sugarcane	233.9	237.1	281.2	345.3
iii. Cotton@	13.7	16.4	18.5	22.7
iv. Jute and Mesta ±	11.2	10.3	10.8	11.3
v. Tea*	850.5	830.7	930.9	722.5 $$
vi. Coffee*	270.0	275.0	274.0	300.0 ##

\# : Production based on Fourth Advance Estimates released on July 19, 2007.
$: Growth rates are based on Index of Agricultural Production with base triennium ended 1993-94=100.
\+ : For nine oilseeds out of eleven in all.
@ : Million bales of 170 kg. each.
± : Million bales of 180 kg. each.
* : Million kilograms.
$$: Estimated production for April-October.
\## : Relates to April-October including re-exports.
Source : Ministry of Agriculture, Government of India.

Table 1.4: Production of Major Crops

(Million tonnes)

Year	Rice	Wheat	Pulses	Total Foodgrains	Oilseeds
1	2	3	4	5	6
1990-91	74.3	55.1	14.3	176.4	18.6
1995-96	77.0	62.1	12.3	180.4	22.1
1996-97	81.7	69.4	14.3	199.4	24.4
1997-98	82.5	66.4	13.0	192.3	21.3
1998-99	86.1	71.3	14.9	203.6	24.8
1999-2000	89.7	76.4	13.4	209.8	20.7
2000-01	85.0	69.7	11.1	196.8	18.4
2001-02	93.3	72.8	13.4	212.9	20.7
2002-03	71.8	65.8	11.1	174.8	14.8
2003-04	88.5	72.2	14.9	213.2	25.2
2004-05	83.1	68.6	13.1	198.4	24.4
2005-06	91.8	69.4	13.4	208.6	28.0
2006-07	92.8	74.9	14.2	216.1	23.9

Source : Ministry of Agriculture, Government of India.

Table 1.5: Gross Capital Formation in Agriculture

Year	Investment in Agriculture (Rupees crore)			Share in Agricultural Gross Investment (per cent)		Investment in Agriculture (per cent of GDP at constant prices)
	Total	Public	Private	Public	Private	
1	2	3	4	5	6	7
			Old series (at 1993-1994 prices)			
1990-91	14,836	4,395	10,441	29.6	70.4	1.9
1995-96	15,690	4,849	10,841	30.9	69.1	1.6
1996-97	16,176	4,668	11,508	28.9	71.1	1.5
1997-98	15,942	3,979	11,963	25.0	75.0	1.4
1998-99	14,895	3,870	11,025	26.0	74.0	1.3
1999-2000	17,304	4,221	13,083	24.4	75.6	1.4
			New series (at 1999-2000 prices)			
1999-2000	43,473	7,716	35,757	17.7	82.3	2.2
2000-01	38,735	7,155	31,580	18.5	81.5	1.9
2001-02	47,043	8,746	38,297	18.6	81.4	2.2
2002-03	46,823	7,962	38,861	17.0	83.0	2.1
2003-04	45,132	9,376	35,756	20.8	79.2	1.9
2004-05	48,576	10,267	38,309	21.1	78.9	1.9
2005-06*	54,539	13,219	41,320	24.2	75.8	1.9

* : Quick Estimates.
Source : Central Statistical Organisation.

I.2.10 As a result of rising consumption, poor storage, overexploitation and wastage, water is emerging as a critical constraint on agricultural development in India. Almost 60 per cent area under principal crops remains unirrigated at the national level. India receives about 350 million hectare meter rain water annually, but almost half of it finds its way back to the sea. The per capita water storage in India is only 210 cubic meter as against 1,110 cubic meter in China and 3,145 cubic meter in Brazil. There is huge gap of 14 million hectare between irrigation potential created and utilised, and the irrigation intensity is only 135 per cent. Subsidised/ free supply of power and water has resulted in overexploitation and inefficient use of water in agriculture, which has led to receding groundwater table as also water logging and salination.

I.2.11 The Green Revolution launched in the mid-1960s enabled the country to meet the objective of national food security as it ensured sufficient food production to meet the market demand. The increase in the production of foodgrains coupled with remunerative support prices offered by the Government led to unprecedented foodgrains stocks of 65 million tonnes as at end-June 2002. The subsequent depletion in the stocks of foodgrains coupled with the decline in production and productivity and its impact on the overall prices situation, as was evident during 2006-07, has once again highlighted the issue of food security. Enhanced and stable growth of the agriculture sector is important as it plays a vital role not only in generating purchasing power among the rural population by creating on-farm and off-farm employment opportunities but also through its contribution to price stability. The National Commission on Farmers (Chairman: Prof. M.S. Swaminathan) has recommended various measures to revive the agricultural sector in India (Box I.5). The National Development Council in its 53rd meeting held on May 29, 2007 adopted a resolution to reorient agricultural development strategies to meet the needs of the farmers and called upon the Central and the State Governments to evolve a strategy to rejuvenate agriculture (see Box I.1).

I.2.12 Amongst the major agricultural crops, the output of horticultural crops accounts for 23.5 per cent of the gross output of the agricultural sector. The country produced around 185 million tonnes of horticultural crops during 2005-06 (4.2 per cent higher than a year ago). The total production of fruits and vegetables was 54.4 million tonnes and 113.5 million tonnes, respectively, during 2005-06. India is the second largest producer of fruits and vegetables in the world, with shares of 15 per cent and 11 per cent of the world production, respectively. The National

Box I.5
National Commission on Farmers (Chairman: Prof. M.S. Swaminathan): Major Recommendations

The Government of India constituted a National Commission on Farmers (NCF) under the chairmanship of Shri Sompal on February 10, 2004 to examine various issues confronting the Indian farmers and to suggest appropriate interventions for improving the economic viability and sustainability of diversified agriculture, including horticulture, livestock, dairy and fisheries, and for doubling the farmers' income. The Commission was subsequently re-constituted under the chairmanship of Prof. M.S. Swaminathan on November 18, 2004. The NCF submitted five Reports between December 2004 and October 2006 to the Government of India. The major recommendations of the Commission are:

- Prime farm land must be conserved for agriculture and should not be diverted for non-agricultural purposes.
- Livestock Feed and Fodder Corporations, National Livestock Development Council and National Biotechnology Regulatory Authority may be established with farmers' representatives.
- User-friendly insurance instruments covering production, post-harvest operations and market risks be introduced.
- The policy and legal framework governing the cooperatives may be reviewed.
- The Minimum Support Price (MSP) of crops should be linked to the input costs. The Government should procure the staple grains needed for the Public Distribution System (PDS) at the prices that private traders are willing to pay to farmers. The MSP should be at least 50 per cent more than the weighted average cost of production and should be expanded to cover all crops of importance for ensuring food and income security to the small farmers. The Commission on Agricultural Costs and Prices (CACP) should be an autonomous statutory organisation. The PDS should be universal and should undertake the task of enlarging the food security basket.
- The Indian Trade Organisation (ITO) may be established to safeguard the interests of farmers.
- A few Centres of Excellence on the model of the Indian Institute of Technology (IITs)/Indian Institute of Management (IIMs) should be established to enhance competitiveness of the agriculture graduates.
- As price fluctuation/competition from products imported from abroad are among the major problems facing a large number of small farmers engaged in the cultivation of plantation crops, a Price Stabilisation Fund may be considered. Agriculture Risk Fund and Food Guarantee Act should be formulated.
- A multi-stakeholder National Food Security and Sovereignty Board chaired by the Prime Minister may be set up.
- There is a need for an Agriculture Credit Policy and both credit and insurance literacy in villages. Drought prone areas should have a 4-5 year repayment cycle for crop loans, taking into account the management of risk. NABARD should function like a National Bank for Farmers.
- The Ministry and Departments of Agriculture, both at the Centre and the States, may be restructured to become Ministry/Department of Agriculture and Farmers' Welfare in order to highlight their critical role in ensuring the income and work security of over 600 million members of India's population.

The key recommendations covering the entire farming spectrum have been incorporated in the Revised Draft National Policy for Farmers. The Ministry of Agriculture, Government of India, held a Conference of State Ministers on December 23, 2006 to discuss the recommendations of the NCF. The State Ministers of Agriculture and Allied Sectors have supported the recommendations made by the NCF and have also given a number of suggestions. The suggestions made by the NCF are under consideration of the Government of India.

Horticulture Mission launched during 2004-05 aims at doubling the horticulture production by 2011-12.

I.2.13 The livestock sector provides an important source of supplementary income to the small and marginal farmers and women in rural areas of the country, besides providing cheap nutritional food to millions in the country, especially in the arid and semi-arid regions of the country. The output of the livestock sector increased from 24.8 per cent of the GDP originating in the agriculture and allied activities during 1999-2000 to 27.0 per cent during 2005-06. The milk group accounted for about 68 per cent of the value of output in the livestock sector during 2005-06. With a production of 97 million tonnes in 2005-06, India was the largest global producer of milk (about 14.5 per cent of the world milk production).

Food Management

I.2.14 The procurement of foodgrains (rice and wheat) during 2006-07 at 35.9 million tonnes (mt) was 13.8 per cent lower than that in the preceding year, mainly on account of decline in procurement of wheat from 14.8 mt to 9.2 mt (Table 1.6 and Appendix Table 5). The offtake of rice and wheat during 2006-07 at 36.8 mt was lower by 12.9 per cent over the previous year, mainly due to the fall in the offtake of wheat under the Targeted Public Distribution System (TPDS) and Other Welfare Schemes (OWS). The total stock of foodgrains with the Food Corporation of India (FCI) and other Government agencies rose to 25.1 mt as on May 1, 2007 from 22.8 mt a year ago after touching an intra-year low of 12.6 mt on October 1, 2006. The stocks of rice as well as wheat at 13.5 mt and 11.6 mt were higher than the respective buffer stock norms of 12.2 mt and 4.0 mt.

Industrial Performance

I.2.15 According to the CSO's revised estimates, real GDP growth originating from the industrial sector increased from 8.0 per cent in 2005-06 to 11.0 per cent in 2006-07, driven by strong manufacturing activity (Table 1.1 and Appendix Table 2). The upsurge in the industrial growth entered the fifth year of expansion on the back of strong investment and consumption demand. The industrial growth, thus, averaged 9.1 per cent during the three-year period ended 2006-07 and 8.0 per cent during the five-year period 2002-03 to 2006-07.

I.2.16 Based on the movements in the Index of Industrial Production (IIP), industrial growth accelerated from 8.2 per cent during 2005-06 to 11.5 per cent during 2006-07, the highest growth achieved since 1995-96 (13.1 per cent) [Appendix Table 6 and Chart I.1]. Growth during the year was driven mainly by the manufacturing sector, which contributed 91.1 per cent to the industrial growth. The growth of the manufacturing sector at 12.5 per cent in 2006-07 was

Table 1.6: Management of Foodstocks

(Million tonnes)

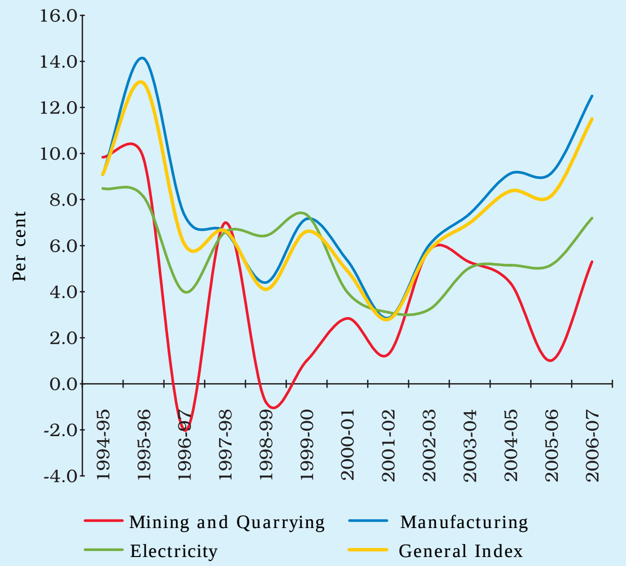
Year/Month	Opening Stock of Foodgrains			Procurement of Foodgrains			Foodgrains Off-take					Closing Stock	Norms
	Rice	Wheat	Total	Rice	Wheat	Total	PDS	OWS	OMS - Domestic	Exports	Total		
1	2	3	4	5	6	7	8	9	10	11	12	13	14
2004-05	13.1	6.9	20.7	24.0	16.8	40.8	29.7	10.6	0.2	1.0	41.5	18.0	
2005-06	13.3	4.1	18.0	26.9	14.8	41.7	31.4	9.8	1.1	0.0	42.2	16.6	
2006-07	13.7	2.0	16.6	26.7	9.2	35.9	31.6	5.1	0.0	0.0	36.8	17.8	
2006													
January	12.6	6.2	19.3	4.0	0.0	4.0	2.7	0.8	0.1	0.0	3.6	19.5	20.0
February	14.0	4.9	19.5	2.9	0.0	2.9	2.7	0.6	0.3	0.0	3.6	18.3	
March	14.1	3.5	18.3	1.9	0.0	1.9	2.8	0.9	0.2	0.0	3.6	16.6	
April	13.7	2.0	16.6	1.7	8.7	10.3	2.5	0.3	0.0	0.0	2.8	22.8	16.2
May	12.8	9.0	22.8	1.6	0.6	2.2	2.9	0.4	0.0	0.0	3.0	22.3	
June	12.0	9.3	22.3	1.5	0.0	1.5	2.6	0.6	0.0	0.0	3.1	20.5	
July	11.1	8.2	20.5	0.8	0.0	0.8	2.7	0.4	0.0	0.0	3.1	17.1	26.9
August	9.5	7.3	17.1	0.5	0.0	0.5	2.7	0.4	0.0	0.0	3.1	15.5	
September	7.8	6.7	15.5	0.2	0.0	0.2	2.6	0.5	0.0	0.0	2.8	12.6	
October	6.0	6.4	12.6	8.0	0.0	8.0	2.5	0.3	0.0	0.0	2.7	18.7	16.2
November	12.5	6.0	18.7	2.0	0.0	2.0	2.5	0.4	0.0	0.0	2.9	17.8	
December	12.1	5.6	17.8	2.6	0.0	2.6	2.6	0.3	0.0	0.0	3.0	17.5	
2007													
January	12.0	5.4	17.5	4.3	0.0	4.3	2.7	0.4	0.0	0.0	3.1	18.1	20.0
February	12.6	5.4	18.1	2.4	0.0	2.4	2.7	0.5	0.0	0.0	3.1	19.1	
March	14.0	5.1	19.1	1.2	0.0	1.2	2.7	0.5	0.0	0.0	3.2	17.8	
April	13.2	4.6	17.8	0.9	7.9	8.7	2.5	0.2	0.0	0.0	2.8	25.1	16.2
May	13.5	11.6	25.1	1.5	2.6	4.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
June	n.a.	n.a.	n.a.	1.3	0.7	2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	
July	n.a.	n.a.	n.a.	0.8	0.0	0.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	26.9

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

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

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

Chart I.1: Sectoral Growth of Index of Industrial Production



the highest since 1995-96 (14.1 per cent). The 'Machinery and equipments', 'basic metal and alloy industries' and 'chemicals and chemical products' groups remained the main drivers of growth, contributing almost 50 per cent to the manufacturing growth. At the two-digit level classification, 16 out of 17 manufacturing industry groups registered positive growth during the year (Appendix Tables 7 and 8).

I.2.17 The mining and electricity sectors also recorded higher growth during the year; however, their growth continued to lag behind the manufacturing growth (Table 1.7). The mining sector recorded a growth of 5.3 per cent in 2006-07, reversing the decelerating trend of the previous three years – from 5.3 per cent in 2003-04 to 1.0 per cent in 2005-06. Growth in the mining sector in 2006-07 benefited from the recovery in the crude oil production in Mumbai High (where the production was affected on account of fire in July 2005), as well as increased mining activity in respect of coal and other minerals. The growth of electricity generation edged higher in 2006-07 on the back of higher plant load factor (PLF) in thermal power plants as also double-digit growth in hydro-power generation. Notwithstanding the higher power generation, the country faces power shortage of about 10 per cent and a peaking shortage of over 13 per cent. In some States, the peaking shortage is as high as 25 per cent.

I.2.18 In terms of use-based classification, marked acceleration in growth was observed in respect of basic, capital and intermediate goods sectors. These three sectors more than offset the deceleration in the consumer goods sector (Table 1.7 and Appendix Table 9). The growth of the basic goods sector – the highest since 1995-96 – benefited from increased production of cement, high speed diesel, and various iron and steel products such as carbon steel, bars and rods, pipes and tubes. The intermediate goods sector, which had recorded subdued growth in 2005-06, bounced back and recorded a growth of 11.9 per cent in 2006-07, also the highest since 1995-96 (19.3 per cent). The growth was driven largely by yarn, polyester fibre, viscose staple fibre, PVC pipes and tubes and glazed tiles/ceramic tiles. The pickup in the intermediate goods sector has added strength to the already firmly entrenched industrial growth. The growth in the capital goods sector accelerated from 15.8 per cent in 2005-06 to 18.2 per cent in 2006-07, reflecting sustained investment demand in the country. The growth in the sector was largely on account of complete tractors, boilers, diesel engines, textile machinery, material handling equipment and process-control instruments. The continued robust expansion of the capital goods sector facilitated substantial capacity additions across a number of industries (Box I.6). The consumer goods sector, on the other hand, witnessed moderation in growth on account of decline in production of some non-durable goods such as food items, drugs, edible oils and durables.

I.2.19 The capacity utilisation of the industries is estimated at 81.8 per cent in 2006-07 as compared

Table 1.7: Index of Industrial Production: Sectoral and Use-Based Classification of Industries

(Per cent)

Sector	Weight in the IIP	Growth Rate		Weighted Contribution #	
		2005-06	2006-07P	2005-06	2006-07P
1	2	3	4	5	6
Sectoral Classification					
Mining	10.5	1.0	5.3	1.0	3.4
Manufacturing	79.4	9.1	12.5	93.2	91.1
Electricity	10.2	5.2	7.2	5.7	5.5
Use-Based Classification					
Basic Goods	35.6	6.7	10.3	25.4	27.2
Capital Goods	9.3	15.8	18.2	20.0	17.6
Intermediate Goods	26.5	2.5	11.9	8.4	27.0
Consumer Goods (a+b)	28.7	12.0	10.1	46.3	28.5
a) Consumer Durables	5.4	15.3	9.2	14.9	6.7
b) Consumer Non-durables	23.3	11.0	10.4	31.4	21.8
General	**100.0**	**8.2**	**11.5**	**100.0**	**100.0**

P : Provisional.
: Figures may not add up to 100 due to rounding off.
Source : Central Statistical Organisation.

Box I.6
Capacity Addition in Indian Industry: Role of the Capital Goods Sector

In view of strengthening of growth in the manufacturing sector since 2002-03, the capacity utilisation has remained high. This is being exhibited in the double-digit growth in the domestic production of capital goods and robust growth in the import of capital goods (Table A). Growth in imports of capital goods has also been boosted by the phased reduction/rationalisation of import tariffs.

Some of the capital goods such as metals, machine tools, and machinery, among others, have witnessed strong growth both in terms of domestic production and imports (Table B).

Capital goods are durables, which are used as accessories, equipments, plant and machinery in industrial sectors for production (directly or indirectly) as well as for rendering various services. Broadly, these comprise industrial machinery, electrical and non-electrical machinery, machine tools, automobiles, construction equipments and plant equipments, which have witnessed robust performance in recent years that supports the ongoing capacity expansions. Other indicators such as the cost of projects announced, number of proposed projects and the projects under implementation also point towards increased investment expenditure on adding new capacities. The capacity addition is well diversified across most sectors of the industry. In terms of cost of projects which are under implementation, the manufacturing sector constitutes a major component followed by electricity, services and construction sectors.

Table A: Select Indicators of Industrial Performance

(Growth rates in per cent)

Category	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
1	2	3	4	5	6	7
1. IIP	2.8	5.8	7.0	8.4	8.2	11.5
2. Capital goods production	-3.4	10.5	13.6	13.9	15.8	18.2
3. Machinery and Equipment	1.3	1.6	15.8	19.8	11.9	12.8
4. Capital goods imports	10.5	36.6	35.4	37.5	49.9	40.6
5. Project under implementation	10.6	-1.4	5.4	13.5	12.2	54.2
6. Project addition	7.6	-5.6	-0.8	29.2	44.2	51.0
7. IEM	-24.4	13.8	91.7	87.0	32.0	80.9

IEM : Industrial Entrepreneurs Memoranda.
Note : Growth rates of imports are based on data in US $ terms.
Source : CSO, DIPP, DGCI&S and CMIE.

Within the manufacturing sector, metal and metal products, machinery, and chemicals are amongst the major industries that have recorded robust growth in capital expenditure.

The robust performance of the capital goods sector in the current cycle is in contrast with the previous period of strong industrial growth witnessed during 1993-96 when this sector did not play a significant role. The ongoing trend in capital goods production, growing imports and increasing capital expenditure by corporates highlight the new capacity additions, which are expected to further strengthen the growth performance of the Indian manufacturing sector.

Table B: Capital Goods: Production and Imports of Major Items

(Growth rates in per cent)

	Imports			Production	
Item	2005-06	2006-07	Item	2005-06	2006-07
1	2	3	1	2	3
Machinery except Electrical & Electronics	46.8	38.4	Textile Machinery	50.3	35.8
Electrical Machinery except Electronics	25.9	30.0	Switchgear (circuit breakers)	13.5	8.1
Electronic Goods including Computer Software	32.7	19.4	Control panels/ boards/ disks	44.8	17.6
Transport Equipments	104.2	74.4	Computer system and its peripherals	10.7	11.5
Project Goods	48.0	98.7	Commercial vehicles	11.7	33.0
Machine Tools	79.4	39.3	Material handling equipment	90.0	115.5
			Cranes	36.6	66.5
			Boilers	60.2	48.5
			Furnaces	35.9	22.8
			Machine tools	10.5	0.2

Note : Growth rates of imports are based on data in US dollar terms.
Source : CSO and DGCI&S.

with 82.4 per cent estimated in 2005-06 (Table 1.8). Some of the industries like sugar, salt, some edible oils, penicillin, well/offshore platforms, ship building and repair, tape recorders, turbines, high explosive nitro glycerine base, among others, recorded moderation in the overall capacity utilisation. However, industries such as matches, textile machinery, electric fans, paints, enamels and varnishes, diesel engines, optical whitening agent, air and gas compressor, soaps, pipes and tubes, paper and paper board, zip fasteners, lighting, fitting and fixtures, electric motors, machine tools, *etc.*, which mainly belong to the Small and Medium Enterprises (SMEs) sector, recorded more than 95 per cent capacity utilisation during the year.

Table 1.8: Capacity Utilisation

(Per cent)

Industry	Weight	Capacity Utilisation		
		2004-05	2005-06	2006-07
1	2	3	4	5
Food products	90.83	66.2	66.1	67.8
Beverages, tobacco and products	23.82	77.0	84.2	84.3
Cotton textiles	55.18	91.4	97.4	94.6
Wool, silk and man-made fibre textiles	22.58	89.2	90.8	87.6
Jute and other vegetable fibre textiles (expcect cotton)	5.90	83.6	83.5	71.4
Textile products (including wearing apparel)	25.37	81.5	92.7	92.3
Wood and wood products, furniture & fixtures	27.01	81.6	81.4	69.6
Paper & products and printing & publishing	26.52	82.5	88.2	93.6
Leather and leather & fur products	11.39	84.5	77.5	80.9
Chemicals and chemical products except petroleum & coal	140.02	81.6	80.6	79.0
Rubber, plastic, petroleum and coal products	57.28	86.5	86.1	87.1
Non-metallic mineral products	43.97	86.8	82.5	85.8
Basic metal and alloy Industries	74.53	86.3	82.8	83.4
Metal products and parts (except machinery and equipment)	28.10	71.1	68.8	65.5
Machinery and equipment other than transport equipment	95.65	74.9	75.0	75.3
Transport equipment and parts	39.84	78.2	82.3	80.7
Other manufacturing industries	25.59	79.8	71.7	73.2
Manufacturing	**793.58**	**80.4**	**80.6**	**80.1**
Mining and Quarrying	**104.73**	**86.1**	**85.3**	**83.7**
Electricity	**101.69**	**92.5**	**94.0**	**93.4**
All Industries	**1000**	**82.2**	**82.4**	**81.8**

Note : 1. Data are provisional.

2. Capacity utilisation has been calculated from the production data for 297 industries supplied by the Ministry of Statistics and Programme Implementation.

3. Capacity utilisation has been estimated under the peak output approach. Under the peak output approach, the peak monthly output during the year for a particular industry is regarded as its installed productive capacity, while the average monthly output for the same year is regarded as its actual utilisation level for that year. Monthly capacity utilisation of a particular industry is the ratio of monthly production to the peak level of production during the financial year. The average of twelve months is considered as the annual capacity utilisation.

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

I.2.20 A substantial part of growth in the manufacturing sector has largely been concentrated in capital intensive sub-sectors. The traditionally labour-intensive manufacturing sub-sectors such as paper, food products and leather products have not kept pace with the strong overall performance of the manufacturing sector. Furthermore, inadequate employment generation in the organised manufacturing sector continues to be a cause of concern. However, there is some evidence of pick up in employment growth in the recent period. According to NSSO survey results (61st round), employment growth in India accelerated from 1.60 per cent per annum (1993-94 to 1999-2000) to 2.54 per cent per annum (1999-2000 to 2004-05) (Box I.7).

Infrastructure Industries

I.2.21 The infrastructure sector witnessed some improvement in performance during 2006-07, but its growth continued to lag behind the overall industrial growth. The growth of the infrastructure industries, with a weight of 26.7 per cent in the overall index of industrial production, rose from 6.2 per cent during 2005-06 to 8.6 per cent in 2006-07 (Chart I.2 and Appendix Table 10). The improvement during 2006-07 was mainly a reflection of the turnaround in growth of crude petroleum, and higher growth in electricity and petroleum refinery products sectors. The growth in crude oil production, as noted earlier, was partly a reflection of the recovery of production in Mumbai

Box I.7
Economic Growth and Employment Linkages in India

In the 1980s and the 1990s, the acceleration in the GDP growth did not lead to a commensurate pick up in employment growth. While real GDP growth accelerated from 5.4 per cent per annum between 1983 and 1993-94 to 6.5 per cent between 1993-94 and 1999-2000, the annual growth in employment decelerated from 2.06 per cent to 1.60 per cent over the same period.

The results of the 61st round of the NSSO survey conducted during July 2004-June 2005 show a reversal of the declining trend in employment growth. According to the survey results, total labour force increased from 367 million in 1999-2000 to 415 million in 2004-05. Employment growth[7] accelerated from 1.6 per cent per annum during the period 1993-94 to 1999-2000 to 2.5 per cent per annum during the period 1999-2000 to 2004-05. Almost 48 million people gained employment during 1999-2000 to 2004-05, significantly higher than 33 million during 1993-94 to 1999-2000. Net annual addition to employment at 9.6 million during 1999-2000 to 2004-05 was, thus, substantially higher than that of 5.5 million during the preceding six-year period. Cross-country data indicate that India added 11.3 million net new jobs per year[8] during 2000-05 as compared with 7.0 million in China, 2.7 million in Brazil, 0.7 million in Russia and 3.7 million in the OECD area.

Addition to employment of 48 million in India during 1999-2000 to 2004-05 was, however, marginally lower than the addition of 50.5 million to the labour force during the same period. As a result, the annual growth in employment (2.48 per cent) was slightly lower than that of the labour force (2.54 per cent). The unemployment rate, thus, rose from 2.78 per cent in 1999-2000 to 3.06 per cent in 2004-05,

Chart : Trends in GDP and Employment Growth in India

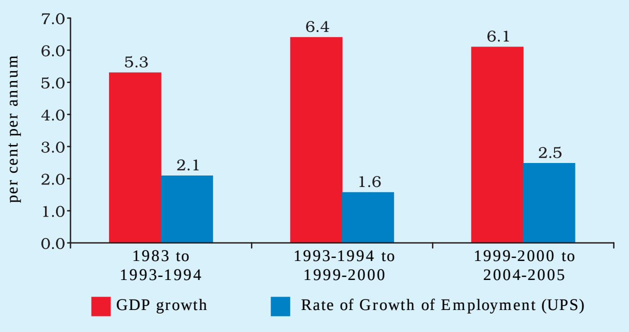


Table : Trends in Employment as per Usual Status@

(Number of persons employed per thousand persons)

Survey Round	Rural	Urban	All
1	2	3	4
32nd (1977-1978)	444	341	423
38th (1983)	445	340	420
43rd (1987-1988)	434	337	412
50th (1993-1994)	444	347	420
55th (1999-2000)	417	337	397
61st (2004-2005)	439	365	420

@: Principal status and subsidiary status taken together.
Source : NSSO.

primarily on account of higher unemployment amongst females, both in rural and urban areas. While the unemployment rate amongst males in the urban areas fell from 4.8 per cent in 1999-2000 to 4.4 per cent by 2004-05, that in rural areas remained unchanged at 2.1 per cent. As regards females, the unemployment rate rose from 1.5 per cent (1999-2000) to 3.1 per cent (2004-05) in rural areas and from 7.1 per cent to 9.1 per cent in urban areas. The unemployment rates based on 'current weekly status' and 'current daily status' remained much higher that that based on 'usual principal status'.

According to the Planning Commission, there is a need for at least 65 million additional non-agricultural opportunities in the 11th Plan to ensure that the unemployment rate falls to some extent. For this, the rate of growth of non-agricultural employment would need to accelerate to 5.8 per cent per annum from 4.7 per cent per annum in 1999-2005. Furthermore, in order to reduce the high unemployment among the educated youth and improve the quality of overall employment, a robust growth in organised sector employment would be necessary.

References

1. Government of India (2006), National Sample Survey Organisation, "Employment and Unemployment Situation in India 2004-05, Report No. 515".
2. _______ (2007), Economic Survey, 2006-07.
3. _______ (2007), Planning Commission, "Towards Faster and More Inclusive Growth: An Approach to the 11th Five Year Plan."
4. OECD (2007), Employment Outlook.

High. Larger exports, apart from the base effect, enabled the petroleum refinery products to register strong growth.

I.2.22 The cement and steel sectors continued to record robust growth during the year, though there was some deceleration due to capacity constraints. The

[7] Based on 'usual principal status', unless indicated otherwise.
[8] Including both 'usual principal status' and 'subsidiary status' workers.

Table 1.9: Target and Achievement of Infrastructure Industries

Sector	Unit	2005-06			2006-07		
		Target	Achievement	Gap (%)	Target	Achievement	Gap (%)
1	2	3	4	5	6	7	8
Power	Billion Units	620	616	-0.7	663	662	-0.1
Coal	Million Tonnes	400	401	0.4	425	425	0.0
Finished Steel	Million Tonnes	50.3	44.7	-11.0	52	50.6	-3.0
Railways	Million Tonnes	668	667	-0.1	726	728.4	0.3
Shipping (Major Ports)	Million Tonnes	425	423	-0.4	465.7	463.8	-0.4
Fertilisers	Million Tonnes	16.2	15.5	-4.4	16.3	16.1	-1.1
Cement	Million Tonnes	142	148	4.1	159.6	161.3	1.1
Crude Petroleum	Million Tonnes	34	32	-6.6	35.4	34.0	-4.1
Petroleum Refinery Products	Million Tonnes	129	130	0.8	135.3	146.5	8.3
Natural Gas Production	Million Cubic Meters	30,986	32,205	3.9	31,538	31,555	0.1

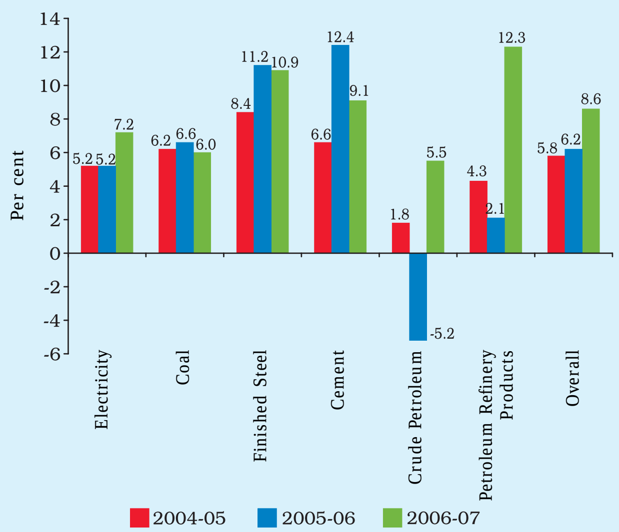
Source : Ministry of Statistics and Programme Implementation, Government of India.

slowdown in steel production could also be attributed partly to deceleration in exports. The production of power, cement, and petroleum refinery products exceeded the targets set for 2006-07 (Table 1.9). The production of crude oil, despite a recovery during the year, fell short of the target.

Performance of Central Sector Projects

I.2.23 The number of delayed central sector projects increased during the year. The delays, largely on account of projects in railways and surface transport sectors, could mainly be attributed to factors such as fund constraints, land problems, environmental clearance, and lack of supporting infrastructure facilities. Although the number of delayed projects increased, there was a marked improvement in containing the cost overrun in respect of ongoing projects in the country over the last decade. This was reflected in a significant decline in the cost overrun of delayed projects in terms of their original cost; the ratio declined to 19.8 per cent at end-March 2007 from around 92 per cent in 2001 (Table 1.10).

Chart 1.2: Sector-wise Infrastructure Industries Growth



Source : Office of the Economic Advisor, Ministry of Commerce and Industry, Government of India.

Investment Climate

I.2.24 The strong growth in investment activity witnessed during the past few years continued during 2006-07, buoyed up by rising production and capacity utilisation. The investment intentions, as reflected in

Table 1.10: Performance of Central Sector Projects

(end-March)

Item	2001	2004	2005	2006	2007
1	2	3	4	5	6
1. Number of Projects (a to d)	187	286	327	396	491
(a) Ahead	5	28	16	6	6
(b) On Schedule	58	73	65	113	179
(c) Delayed	65	112	125	149	171
(d) Without Date of Commissioning	59	73	121	128	135
2. Cost Overrun of Total Projects (Rupees crore)	40,303	40,411	39,585	47,337	39,741
3. Cost Overrun of Total Projects (% of original cost)	36.4	21.8	19.2	18.2	12.4
4. Cost Overrun of Delayed Projects (Rupees crore)	23,374	26,689	25,388	29,655	20,808
5. Cost Overrun of Delayed Projects (% of original cost)	91.6	51.8	45.2	35.6	19.8

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

Table 1.11: Industrial Investment Proposals

Year	IEMs		LOI/DILs	
	No. of Proposals	Proposed Investment (Rupees crore)	No. of Proposals (Rupees crore)	Proposed Investment
1	2	3	4	5
2001-02	3,094	70,994	102	1,361
2002-03	3,178	80,824	60	332
2003-04	4,130	1,54,954	145	3,454
2004-05	5,548	2,89,782	101	4,309
2005-06	6,341	3,82,743	135	3,638
2006-07	5,591	6,92,401	87	4,002
Cumulative*	**69,798**	**25,69,658**	**4,241**	**1,23,085**

* : August 1991 to March 2007.

Note : IEM : Industrial Entrepreneurs Memoranda.
LOI : Letters of Intent.
DILs : Direct Industrial Licences, which are being issued since November 2003.

Source : Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India.

the Industrial Entrepreneurs Memoranda, rose sharply by 81 per cent during 2006-07 and more than quadrupled from their levels during 2003-04 (Table 1.11). Impressive growth posted by gross capital formation in recent years suggests that the investment climate has been conducive.

I.2.25 Mergers and acquisitions (M&A) activities remained buoyant during 2006-07 on the back of strong growth prospects, healthy internal cash generation and the desire to obtain efficiency gains through economies of scale (Table 1.12). Indian corporates have also shown increasing interest in acquiring foreign companies to strengthen their position in overseas markets. Maximum mergers during 2006-07 were witnessed in the financial services (15 per cent of total), followed by chemicals (8 per cent), construction (5 per cent), and non-metallic mineral products and mining (3 per cent each). The acquisition activity was the largest in the communications sector (48 per cent of total), followed by chemicals (15 per cent), financial services (9 per cent), information technology (7 per cent) and mining (4 per cent).

Table 1.12: Mergers and Acquisitions Announced

Year	Total Acquisitions		Total Mergers
	Number	Amount (Rupees crore)	Number
1	2	3	4
2002-03	843	23,785	381
2003-04	830	35,073	291
2004-05	797	60,282	272
2005-06	874	1,00,612	394
2006-07	924	2,04,597	358

Note : Deals include preferential allotments, buy-back of shares and disinvestment proposals, amongst others.

Source : Centre for Monitoring Indian Economy.

Small Scale Industries

I.2.26 Small scale industries (SSIs) continued to record a steady progress during 2006-07 (Table 1.13). The sector plays a vital role in the growth of the country as it accounts for about 40 per cent of the industrial output in the Indian economy. About 47 per cent of total manufactured exports of the country are directly accounted for by the SSI sector.

Developments during 2007-08

I.2.27 During April-June 2007, industrial production registered growth of 11.0 per cent (10.5 per cent a year ago), led by the manufacturing sector (11.9 per cent growth as compared with 11.7 per cent a year ago). The electricity sector rose by 8.3 per cent (5.3 per cent) while the growth in the mining sector at 3.2 per cent was lower than a year ago (3.6 per cent). In terms of use-based classification, capital goods recorded growth of 22.3 per cent (21.0 per cent). The production of intermediate and basic goods expanded by 9.5 per cent (10.8 per cent) and 9.5 per cent (9.0

Table 1.13: Performance of Small Scale Industries

Item	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07 P
1	2	3	4	5	6	7
Number of Units (Million)	10.5	11.0	11.4	11.9	12.3	12.8
Employment (Million)	25.2	26.4	27.5	28.8	30.0	31.3
Investment (Rupees crore)	1,60,673	1,69,579	1,78,269	1,88,793	1,98,050	2,07,307
Value of Output (Rupees crore)	2,82,270	3,14,850	3,64,547	4,29,796	4,97,842	n.a.
Exports from SSI (Rupees crore)	71,244	86,013	97,644	1,24,417	1,50,242	n.a.

P: Provisional. n.a.: Not available.

Source : Ministry of Small Scale Industries, Government of India.

per cent), respectively. The consumer goods sector exhibited growth of 9.9 per cent (8.5 per cent). During April-June 2007, growth in six infrastructure industries was 6.9 per cent (7.4 per cent a year ago).

Services Sector

I.2.28 According to the CSO's revised estimates, real GDP growth originating from the services sector accelerated from 10.3 per cent in 2005-06 to 11.0 per cent in 2006-07 (Table 1.1 and Appendix Table 2). The growth in the services sector was led by acceleration in the sub-sectors 'trade, hotels and restaurants, transport, storage and communication' and 'financing, insurance, real estate and business services'. Buoyancy in foreign tourist arrivals, domestic travel, hotel occupancy, retail credit, commercial vehicles production, telecom use, revenue earning freight traffic of the railways, and passengers handled by civil aviation propped up the sub-sector 'trade, hotels and restaurants, transport, storage and communication' (Table 1.14). This sub-sector has emerged as the key driver of economic activity in the country, constituting almost one-half of the growth of the services sector and almost one-third of overall real GDP growth during 2006-07.

I.2.29 The construction sub-sector continued to exhibit high growth during 2006-07 (10.7 per cent), though there was some deceleration from the strong pace of over 14 per cent in the preceding two years. The sub-sector 'financing, insurance, real estate and business services' recorded double-digit growth for the second successive year, reflecting acceleration of growth in bank deposits, sustained growth in non-food credit, rapid growth of activity in the insurance sector and continued buoyancy in the information technology (IT) sector (Table 1.15). The IT sector was marked by sustained revenue growth, steady expansion of newer service-lines and increased geographic penetration. The sector attracted a substantial rise in investments from multinational corporations (MNCs).

Table 1.14: Indicators of Service Sector Activity

(Growth rates in per cent)

Item	2004-05	2005-06	2006-07
1	2	3	4
Tourist arrivals	22.8	12.1	14.4
Commercial vehicles production	28.6	10.6	33.0
Railway revenue earning freight traffic	8.1	10.7	9.2
New cell phone connections	10.4	89.4	85.4
Cargo handled at major ports	11.3	10.4	9.5
Civil aviation			
a) Export cargo handled	12.4	7.3	3.6
b) Import cargo handled	24.2	15.8	19.4
c) Passengers handled at international terminals	14.0	12.8	12.1
d) Passengers handled at domestic terminals	23.6	27.1	34.0
Cement	6.6	12.4	9.1
Steel	8.2	11.2	10.9
Aggregate deposits	11.9	18.1	23.0
Non-food credit	31.6	31.8	28.0
Central Government expenditure	9.5*	8.7	15.2

* : Net of repayments to NSSF.

Table 1.15: Indian IT Industry

(US $ billion)

Item	2003-04	2004-05	2005-06	2006-07E
1	2	3	4	5
1. Total Software and Services Revenues (i to iii)	16.7	22.6	30.3	39.7
Exports	12.9	17.7	23.6	31.3
Domestic	3.8	4.9	6.7	8.4
i) IT Services	10.4	13.5	17.8	23.7
Exports	7.3	10.0	13.3	18.1
Domestic	3.1	3.5	4.5	5.6
ii) ITES-BPO	3.4	5.2	7.2	9.5
Exports	3.1	4.6	6.3	8.3
Domestic	0.3	0.6	0.9	1.2
iii) Engineering Services and R&D, Software Products	2.9	3.9	5.3	6.5
Exports	2.5	3.1	4.0	4.9
Domestic	0.4	0.8	1.3	1.6
2. Hardware	5.0	5.9	7.0	8.2
3. Total IT Industry (including Hardware) (1+2)	21.6 (3.5)	28.4 (4.1)	37.4 (4.8)	47.8 (5.2)
Memo:				(in thousands)
4. Total Employment (a to c)*	830	1,058	1,293	1,630
a) IT Services	215	297	398	562
b) ITES-BPO	216	316	415	545
c) Engineering Services and R&D and Software Products	81	93	115	144
5. Domestic Market (including user organisation)	318	352	365	378

E : Estimates. * : Excluding hardware.

Note : Figures in parentheses are percentage to GDP.

Source : National Association of Software and Service Companies.

Performance of the Corporate Sector

I.2.30 The further strengthening of activity in the industrial and the services sectors was reflected in the performance of the corporate sector during 2006-07. Growth in sales of the select non-financial non-Government companies accelerated to 26.2 per cent in 2006-07 from an average of 19.0 per cent during the preceding three-year period (2003-04 to 2005-06). Growth in gross profits at 41.5 per cent during 2006-07 was also higher than the average of 26 per cent during 2003-04 to 2005-06, and outpaced the growth in sales by a large margin. Interest payments rose by 17.4 per cent in 2006-07, reversing the declining trend witnessed during 2001-02 to 2004-05. Nonetheless, the ratio of interest payments to gross profits declined further to 13.3 per cent during 2006-07 from 15.7 per cent during 2005-06. This ratio had varied between 36.9 per cent and 62.7 per cent in the 1990s. Profits after tax increased by 45.2 per cent during 2006-07 on top of 45.1 per cent average growth during the three-year period 2003-04 to 2005-06 and the average growth of 11.8 per cent during the 1990s. Concomitantly, profit margin - the ratio of profits after tax to sales - that fluctuated between 3.3 per cent and 7.8 per cent in the 1990s, improved from 5.9 per cent in 2003-04 to 10.7 per cent in 2006-07. Reflecting the sustained high profitability, internal sources now constitute a major source of funds. This has partly led to a reduced reliance on debt, and a decline in the debt-equity ratio to around 53 per cent by 2004-05 from more than 59 per cent during the 1990s. While the overall reliance on debt flows has declined in recent years, the share of bank borrowings in overall borrowings has risen (Table 1.16).

Table 1.16: Financial Performance of the Corporate Sector

(per cent)

Item	1990-91 to 1999-2000	2000-01 to 2006-07	2002-03	2003-04	2004-05	2005-06	2006-07	2006-07			
								Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8	9	10	11	12
Growth Rates	(Average)	(Average)									
Sales	14.0	14.6	8.5	16.0	24.1	16.9	26.2	25.6	29.2	30.3	22.5
Expenditure	14.0	13.9	10.2	14.9	23.6	16.4	23.5	24.6	26.6	26.9	19.5
Depreciation provision	17.3	9.4	4.9	6.0	11.2	10.2	15.4	14.9	16.4	16.8	18.1
Gross profits	12.5	20.0	9.8	25.0	32.5	20.3	41.5	33.9	45.9	51.8	39.2
Interest Payments	15.8	-0.6	-9.8	-11.9	-5.8	1.9	17.4	19.9	18.0	11.9	32.3
Profits after tax	11.8	35.6	76.2	59.8	51.2	24.2	45.2	34.7	49.4	59.5	39.6
Select Ratios	(Min.-Max.)	(Min.-Max.)									
Gross Profits to Sales	(10.5-14.2)	(10.1-15.6)	10.3	11.1	11.9	13.0	15.6	15.6	15.9	15.8	15.3
Profits After Tax to Sales	(3.3-7.8)	(2.6-10.7)	4.2	5.9	7.2	8.7	10.7	10.6	11.0	11.0	10.6
Interest Coverage Ratio (number)	(1.6-2.7)	(1.7-7.5)	2.1	3.3	4.6	6.4	7.5	7.2	7.8	8.0	7.7
Interest to Sales	(5.3-6.9)	(2.0-6.1)	4.9	3.4	2.6	2.0	2.1	2.2	2.0	2.0	2.0
Interest to Gross Profits	(36.9-62.7)	(13.3-60.0)	47.9	30.7	21.8	15.7	13.3	13.9	12.8	12.5	13.0
Interest to Total Expenditure	(5.4-6.8)	(2.3-6.1)	5.0	3.6	2.8	2.4	2.3	2.4	2.3	2.2	2.2
Debt to Equity	(58.7-99.5)	(52.7-70.5)	64.7	58.6	52.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Internal Sources of Funds to Total Sources of Funds	(26.1-40.3)	(53.5-65.3)	64.9	53.5	55.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Bank Borrowings to Total Borrowings	(27.5-35.0)	(34.4-51.7)	43.5	48.0	51.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Memo:											(Amount in Rupees crore)
Number of Companies			2,031	2,214	2,214	2,210	2,388	2,228	2,263	2,258	2,356
Sales			3,49,667	4,42,743	5,49,449	7,74,578	10,41,894	2,34,610	2,51,125	2,60,064	2,94,223
Expenditure			3,07,863	3,86,559	4,77,609	6,66,690	8,72,168	1,95,556	2,09,437	2,16,053	2,48,740
Depreciation provision			18,306	20,406	22,697	28,883	37,095	8,449	8,892	9,172	10,338
Gross profits			36,096	49,278	65,301	1,00,666	1,62,017	36,567	40,041	41,169	45,108
Interest Payments			17,276	15,143	14,268	15,789	21,500	5,083	5,121	5,162	5,862
Profits after tax			14,715	26,182	39,599	67,506	1,11,107	24,845	27,710	28,698	31,251

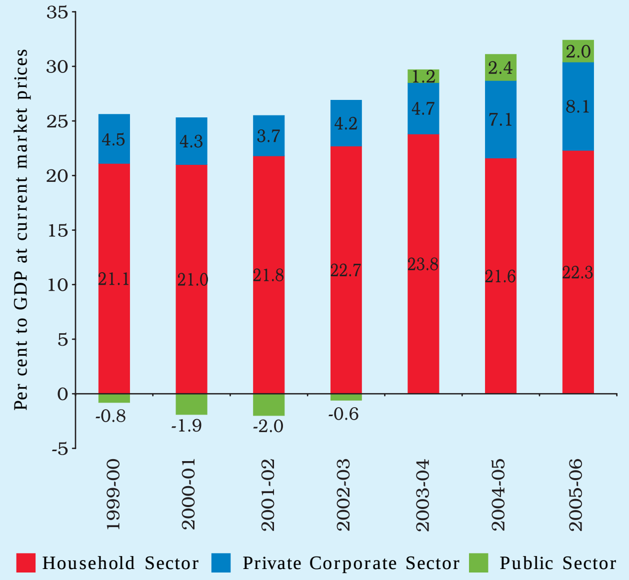
n.a.: Not available.

Note : 1. Total expenditure includes interest and depreciation provision.
2. Data upto 2004-05 are based on balance sheets of the select non-government non-financial public limited companies, while data from 2005-06 onwards are based on abridged unaudited results.
3. Growth rate are percentage changes in the level for the period under reference over the corresponding period of the previous year for common set of companies.

AGGREGATE DEMAND

I.2.31 Growth during 2006-07 was domestic demand driven, led by investment activity. Real gross domestic fixed capital formation, both private and public, continued to remain buoyant for the fifth consecutive year, recording an increase of 14.6 per cent during 2006-07 on top of 15.3 per cent during 2005-06; growth averaged 13.7 per cent per annum during 2003-04 to 2006-07. Investment in valuables rose by 38.0 per cent recovering from a negligible growth in 2005-06. Both private and government final consumption expenditure witnessed some deceleration during 2006-07 (Table 1.17). Almost 42 per cent of the incremental growth in real GDP during 2006-07 (the same as a year ago) was on account of gross fixed capital formation and 39 per cent on account of private consumption demand (44 per cent during 2005-06).

Chart I.3: Gross Domestic Saving



Saving and Capital Formation

I.2.32 Domestic savings and investment rates reached record highs during 2005-06. Gross domestic savings rose to 32.4 per cent of GDP in 2005-06 from 31.1 per cent in 2004-05 and 23.5 per cent in 2001-02. The increase during the year was driven by higher private corporate and household savings (Appendix Table 11). Reflecting the improvement in corporate profitability, as alluded to earlier, the private corporate saving rate doubled between 2002-03 and 2005-06. Savings of the household sector recovered in 2005-06 but remained below the level attained in 2003-04. Public sector saving witnessed some moderation in 2005-06, reversing the trend of improvement that started in 2003-04 (Chart 1.3). Reflecting the rise of 1.3 percentage points in the domestic savings rate as well as the higher recourse to foreign savings, the

Table 1.17: Growth in Select Sources of Real Effective Demand #
(Base Year: 1999-2000)

(Per cent)

Item	2000-01	2001-02	2002-03	2003-04	2004-05@	2005-06*	2006-07±
1	2	3	4	5	6	7	8
1. Total Final Consumption Expenditure	2.2	5.4	1.8	6.2	5.4	7.2	6.6
of which:							
Private Final Consumption Expenditure	2.6	6.0	2.2	6.9	5.4	6.7	6.2
Government Final Consumption Expenditure	0.5	2.0	-0.4	2.5	5.4	9.8	9.0
2. Total Investment +	-3.5	-2.8	16.6	19.1	19.0	16.5	n.a.
Private Investment ++	-5.4	2.1	19.0	14.0	16.8	19.9	n.a.
Public Investment ++	-3.0	2.9	-7.1	8.3	16.5	15.6	n.a.
Valuables ++	-8.1	-5.4	-4.1	66.6	57.2	0.4	38.0
3. Total Fixed Investment	0.3	4.5	8.7	13.1	11.8	15.3	14.6
of which:							
Private Fixed	-0.3	4.9	11.7	13.9	13.7	15.8	n.a.
Public Fixed	1.9	3.5	1.2	10.8	6.4	13.7	n.a.

\# : Based on select disposition of real GDP at market prices.
@ : Provisional estimates.
* : Quick estimates.
± : Revised Estimates.
\+ : Adjusted for errors and omissions.
++ : Unadjusted for errors and omissions.

Note : 'Valuables' covers the expenditures made on acquisition of valuables, excluding works of art and antiques.

Source : Central Statistical Organisation.

Table 1.18: Gross Capital Formation

(Per cent of GDP at current market prices)

Item	2000-01	2001-02	2002-03	2003-04	2004-05P	2005-06#
1	2	3	4	5	6	7
1. Household Sector	10.8	10.9	12.4	12.4	11.4	10.7
2. Public Sector	6.9	6.9	6.1	6.3	7.1	7.4
3. Private Corporate Sector	5.7	5.4	5.9	6.9	9.9	12.9
4. Valuables +	0.7	0.6	0.6	0.9	1.3	1.2
5. Gross Domestic Capital Formation (GDCF)*	24.3	22.9	25.2	28.0	31.5	33.8

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

domestic investment rate increased by 2.3 percentage points of GDP to 33.8 per cent of GDP in 2005-06, a substantial jump from 22.9 per cent recorded during 2001-02 (Table 1.18). The increase from the trough of 2001-02 has been led by the more than doubling in the private corporate sector investment to 12.9 per cent of GDP, offsetting some decline in household investment. The ratio of gross fixed capital formation to GDP at current market prices rose by a further 1.4 percentage points during 2006-07 to 29.5 per cent from 28.1 per cent in 2005-06.

I.2.33 Preliminary estimates, based on the latest available information, place financial savings (net) of the household sector for 2006-07 at 11.6 per cent of GDP at current market prices - the same as the revised estimate for 2005-06 (Table 1.19). The gross financial assets as well as financial liabilities of the household sector rose by 1.7 per cent of GDP each during 2006-07. Household financial savings underwent some changes in the preference pattern *vis-à-vis* 2005-06. Saving in the form of 'currency', 'deposits', 'investment in shares and debentures' and 'contractual savings' as per cent of GDP, increased in 2006-07, while savings in the form of 'claims on Government' decreased (Appendix Table 12). Financial liabilities registered an increase due to higher loans and advances.

I.2.34 To sum up, the Indian economy continued with its growth momentum during 2006-07 led by the services sector and the sustained pick-up in manufacturing activity. With real GDP growth accelerating to 9.4 per cent during 2006-07, the growth averaged 8.6 per cent per annum during the period 2003-04 to 2006-07. The higher growth trajectory has been facilitated by a substantial step up in domestic savings and investment rates and marked improvement in productivity and competitiveness of the economy. Agricultural growth, however, has remained modest.

Table 1.19: Household Saving in Financial Assets

(Amount in Rupees crore)

Item	2004-05P	2005-06P	2006-07#
1	2	3	4
A. Financial Assets (Gross)	**4,34,317 (13.9)**	**5,95,235 (16.7)**	**7,58,751 (18.4)**
1. Currency	36,977 (1.2) [8.5]	51,954 (1.5) [8.7]	65,427 (1.6) [8.6]
2. Deposits@	161,416 (5.2) [37.2]	2,80,602 (7.9) [47.1]	4,22,737 (10.2) [55.7]
3. Claims on Government	1,06,420 (3.4) [24.5]	87,168 (2.4) [14.6]	39,197 (1.0) [5.2]
4. Investment in Shares and Debentures+	4,967 (0.2) [1.1]	29,268 (0.8) [4.9]	47,918 (1.2) [6.3]
5. Contractual Savings*	1,24,538 (4.0) [28.7]	1,46,245 (4.1) [24.6]	1,83,471 (4.4) [24.2]
B. Financial Liabilities	**1,20,566 (3.9)**	**1,81,482 (5.1)**	**2,81,092 (6.8)**
C. Saving in Financial Assets (Net) (A-B)	**3,13,752 (10.0)**	**4,13,754 (11.6)**	**4,77,659 (11.6)**

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

III. MONEY, CREDIT AND PRICES

I.3.1 Growth in monetary and liquidity aggregates accelerated during 2006-07, with broad money growth remaining above the indicative trajectory projected by the Reserve Bank at the beginning of the financial year. Expansion in reserve money was led by a large accretion to the Reserve Bank's net foreign assets (NFA). Growth in bank deposits accelerated during the year, led by time deposits. Demand for bank credit remained robust for the third successive year, *albeit* with some moderation in growth. Banks' investments in SLR securities registered an increase during 2006-07 in contrast to a decline in the preceding year; nonetheless, banks' SLR investments, as a proportion of their net demand and time liabilities (NDTL), declined further during the year. The Reserve Bank continued to modulate market liquidity with the help of repo and reverse repo operations under the liquidity adjustment facility (LAF), issuance of securities, including dated securities, under the market stabilisation scheme (MSS) and the cash reserve ratio (CRR).

I.3.2 Inflation remained firm in many economies during 2006-07, reflecting high commodity prices and strong demand conditions. Although there was some easing of inflationary pressures in the second half of 2006-07 in tandem with the softening of international crude oil prices and favourable base effects, inflation remained above the inflation targets/comfort zones in many economies. Several central banks, both in developed economies and emerging markets, continued with pre-emptive monetary tightening to mitigate the second round effects, especially in the face of continuing strong demand. Some central banks in emerging market economies also took recourse to the use of cash reserve requirements in order to manage excess liquidity arising from large external capital flows. Some central banks changed direction during the course of the year – raising rates initially and then cutting them to support growth.

I.3.3 In India, headline inflation during 2006-07 firmed up reflecting the combination of supply and demand side factors. Wholesale price inflation rose to 5.9 per cent, year-on-year (y-o-y), on March 31, 2007; inflation remained above the upper end of the Reserve Bank's indicative projections of 5.0-5.5 per cent between mid-November 2006 and end-March 2007. Measures of consumer price inflation remained above the wholesale price inflation throughout 2006-07, mainly reflecting the impact of higher food prices. The Reserve Bank continued with the policy of gradual withdrawal of monetary accommodation, using various instruments at its disposal flexibly, to stabilise inflationary expectations. The Government also took various fiscal and supply-side measures to contain inflation.

RESERVE MONEY

I.3.4 Reserve money expanded by 23.7 per cent (18.9 per cent adjusted for the first round impact of the hike in the CRR[9]) during 2006-07 as compared with 17.2 per cent during 2005-06 (Table 1.20, Appendix Tables 13 and 14 and Chart I.4). The expansion in reserve money during 2006-07 was driven primarily by the accretion to the Reserve Bank's NFA. The Reserve Bank's foreign currency assets (net of revaluation) increased by Rs.1,64,601 crore during 2006-07 (Rs.68,834 crore during the previous year), reflecting large purchases of foreign exchange from authorised dealers. The bulk of market purchases – almost 65 per cent of the total purchases during the year – were in the fourth quarter (January-March) of the year.

I.3.5 During 2006-07, as in recent years, the movement in the net Reserve Bank credit to the Government was mainly on account of liquidity management by the Reserve Bank rather than passive financing of the fiscal gap of the Government. Reflecting the liquidity management operations, the Reserve Bank's net credit to the Centre declined by Rs.3,024 crore in 2006-07 as against an increase of Rs.28,417 crore in the previous year. During 2006-07, the decline in the Reserve Bank's net credit to the Centre was on account of an increase in deposits of the Centre (which, in turn, was on account of higher balances under the MSS) and open market sales, partly offset by increase in the net repo balances under the LAF. The issuances of Treasury Bills under the MSS, which were suspended during November 2005-April 2006, were re-introduced in May 2006. The balances under the MSS, accordingly, rose by Rs.33,912 crore during 2006-07. The LAF operations were primarily in an absorption mode during the first eight months of the year, but turned predominantly into injection mode from mid-December 2006. For the year as a whole, the LAF operations led to net injection of liquidity of Rs.36,435 crore (see Chapter III).

9 During 2006-07 (April-March), the CRR was raised by 100 basis points in various stages, impounding around Rs.27,500 crore (the first round impact) of banks resources (see Chapter III for details).

Table 1.20: Reserve Money

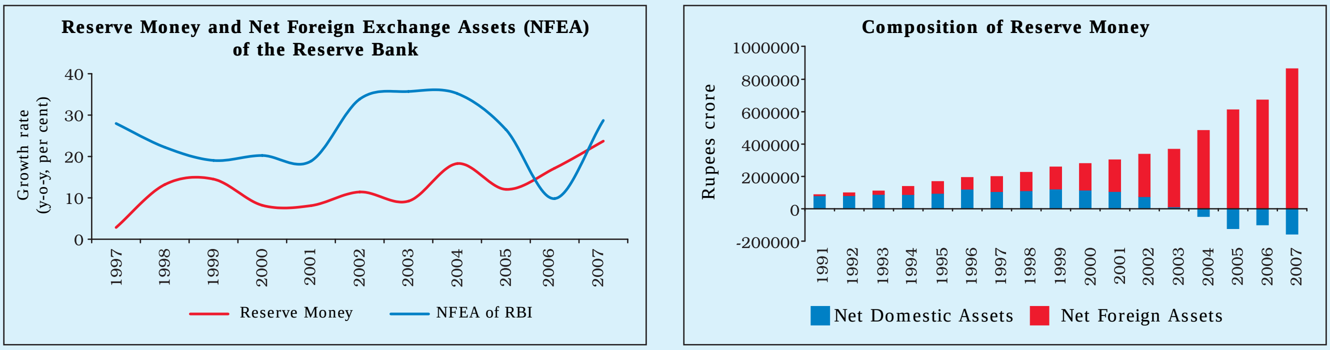
(Rupees crore)

Item	Outstanding as on March 31, 2007	Variation during 2005-06	Variation during 2006-07	2006-07 Q1	2006-07 Q2	2006-07 Q3	2006-07 Q4
1	2	3	4	5	6	7	8
Reserve Money	7,09,016	83,920	1,35,961	13,466	18,665	14,204	89,626
		(17.2)	(23.7)				
Components (1+2+3)							
1. Currency in Circulation	5,04,225	62,015	73,549	22,283	-2,011	26,871	26,405
		(16.8)	(17.1)				
2. Bankers' Deposits with the RBI	1,97,295	21,515	61,784	-7,204	20,224	-12,165	60,929
		(18.9)	(45.6)				
3. 'Other' Deposits with the RBI	7,496	390	628	-1,613	452	-502	2,291
		(6.0)	(9.1)				
Sources (1+2+3+4-5)							
1. RBI's net credit to Government	5,752	26,111	-2,384	53	2,826	-12,754	7,490
of which: to Centre (i+ii+iii+iv-v)	2,136	28,417	-3,024	3,071	2,584	-12,568	3,889
i. Loans and Advances	0	0	0	0	0	0	0
ii. Treasury Bills held by the RBI	0	0	0	0	0	0	0
iii. RBI's Holdings of Dated Securities	97,172	13,869	26,763	-27,610	24,944	22,733	6,696
iv. RBI's Holdings of Rupee coins	12	7	-143	9	-107	97	-142
v. Central Government Deposits	95,048	-14,541	29,644	-30,672	22,253	35,398	2,665
2. RBI's Credit to Banks and Commercial Sector	9,173	535	1990	-3,135	3,107	2,065	-47
3. NFEA of RBI	8,66,153	60,193	1,93,170	71,845	11,392	27,250	82,682
		(9.8)	(28.7)				
of which: FCA, adjusted for revaluation	–	68,834	1,64,601	28,107	10,948	31,634	93,913
4. Governments' Currency Liabilities to the Public	8,286	1,306	-467	-920	155	166	132
5. Net Non-Monetary Liabilities of RBI	1,80,348	4,225	56,347	54,376	-1,184	2,524	632
Memo:							
Net Domestic Assets	-1,57,137	23,727	-57,209	-58,379	7,272	-13,046	6,944
Reserve Bank's Primary Subscription to Dated Securities	–	10,000	0	0	0	0	0
LAF, Repos (+) / Reverse Repos (-)	29,185	12,080	36,435	-23,060	28,395	22,195	8,905
Net Open Market Sales # *	–	3,913	5,125	1,536	1,176	389	2,024
Mobilisation under MSS *	62,974	-35,149	33,912	4,062	8,940	-3,315	24,225
Net Purchases(+)/Sales(-) from Authorised Dealers	–	32,884	1,18,994	21,545	0	19,776	77,673
NFEA/Reserve Money £	122.2	117.4	122.2	127.0	125.0	126.5	122.2
NFEA/Currency £	171.8	156.3	171.8	164.4	167.7	164.0	171.8

NFEA: Net Foreign Exchange Assets. FCA: Foreign Currency Assets. LAF: Liquidity Adjustment Facility.
*: At face value. # : Excluding Treasury Bills. £ : Per cent, end of period.
Note: 1. Data are based on March 31 for Q4 and last reporting Friday for all other quarters.
2. Figures in parentheses are percentage variations during the fiscal year.

I.3.6 Currency in circulation, which rose by 17.1 per cent during 2006-07, followed the usual seasonal pattern, contracting during the second quarter and expanding during the other quarters. Growth in banks'

Chart I.4: Reserve Money



deposits with the Reserve Bank accelerated from 18.9 per cent during 2005-06 to 45.6 per cent during 2006-07, reflecting the impact of higher deposits as well as the hikes in the CRR during the year.

Developments during 2007-08

I.3.7 The year-on-year (y-o-y) reserve money expansion was 26.9 per cent (19.6 per cent adjusted for the first round impact of the increase in the CRR) on August 10, 2007 as compared with 17.2 per cent recorded a year ago. The Reserve Bank's foreign currency assets (adjusted for revaluation), on a y-o-y basis, increased by Rs.2,40,320 crore as compared with an increase of Rs.75,825 crore a year ago. The Reserve Bank's net credit to the Centre declined, y-o-y, by Rs.62,624 crore as compared with an increase of Rs.26,629 crore a year ago.

MONETARY SURVEY

I.3.8 Broad money (M_3) growth, y-o-y, accelerated to 21.3 per cent at end-March 2007 from 17.0 per cent a year ago and remained above the growth rate of 15.0 per cent projected in the Annual Policy Statement in April 2006 (Table 1.21, Appendix Table 15 and Chart I.5).

I.3.9 On a monthly average basis, broad money growth was 19.8 per cent during 2006-07 as compared with 15.7 per cent during 2005-06. Expansion in the residency-based new monetary

Table 1.21: Monetary Indicators

(Amount in Rupees crore)

Item	Outstanding as on March 31, 2007	Variation			
		2005-06		2006-07	
		Amount	Per cent	Amount	Per cent
1	2	3	4	5	6
I. Reserve Money	7,09,016	83,920	17.2	1,35,961	23.7
II. Narrow Money (M_1)	9,65,195	1,43,822	21.1	1,38,820	16.8
III. Broad Money (M_3)	33,10,278	3,96,878	17.0	5,80,733	21.3
a) Currency with the Public	4,83,471	58,248	16.4	70,352	17.0
b) Aggregate Deposits	28,19,311	3,38,081	17.1	5,09,754	22.1
i) Demand Deposits	4,74,228	85,025	26.5	67,841	16.7
ii) Time Deposits	23,45,083	2,53,056	15.3	4,41,913	23.2
of which: Non-Resident Foreign Currency Deposits	67,108	-16,876	-22.2	7,833	13.2
IV. NM_3	33,19,135	4,21,124	18.1	5,71,550	20.8
of which: Call Term Funding from Financial Institutions	85,836	11,224	15.6	2,692	3.2
V. a) L_1	34,34,684	4,36,395	18.1	5,83,181	20.5
of which: Postal Deposits	1,15,549	15,271	17.2	11,631	11.2
b) L_2	34,37,616	4,37,204	18.1	5,83,181	20.4
c) L_3	34,63,680	4,41,205	18.1	5,85,404	20.3
VI. Sources of Broad Money					
a) Net Bank Credit to the Government (i+ii)	8,38,177	17,888	2.4	71,582	9.3
i) Net Reserve Bank Credit to Government	5,752	35,799		-2,384	
of which: to the Centre	2,136	33,374		-3,024	
ii) Other Banks' Credit to Government	8,32,425	-17,910	-2.3	73,967	9.8
b) Bank Credit to the Commercial Sector	21,23,362	3,61,746	27.2	4,30,358	25.4
c) Net Foreign Exchange Assets of the Banking Sector	9,13,179	78,291	12.1	1,86,985	25.7
d) Government's Currency Liabilities to the Public	8,286	1,306	17.5	-467	-5.3
e) Net Non-monetary Liabilities of the Banking Sector	5,72,727	62,353	15.5	1,07,725	23.2
Memo:					
Aggregate Deposits of SCBs	26,08,309	3,23,913	18.1	4,99,260	23.7
Non-food Credit of SCBs	18,82,392	3,54,193	31.8	4,16,006	28.4

SCBs: Scheduled Commercial Banks. FIs: Financial Institutions. NBFCs: Non-Banking Financial Companies.

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

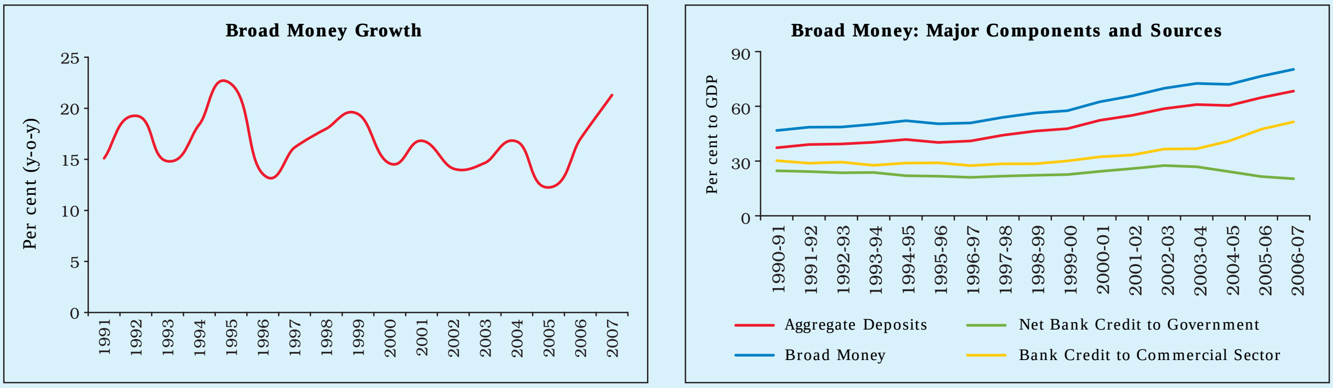
L_1 = NM_3 + Select deposits with the post office saving banks.

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

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

Note : 1. Data are provisional.
2. Data reflect the impact of redemption of India Millennium Deposits (IMDs) on December 29, 2005.
3. Variation during 2006-07 is worked out from March 31, 2006 whereas variation during 2005-06 is worked out from April 1, 2005.

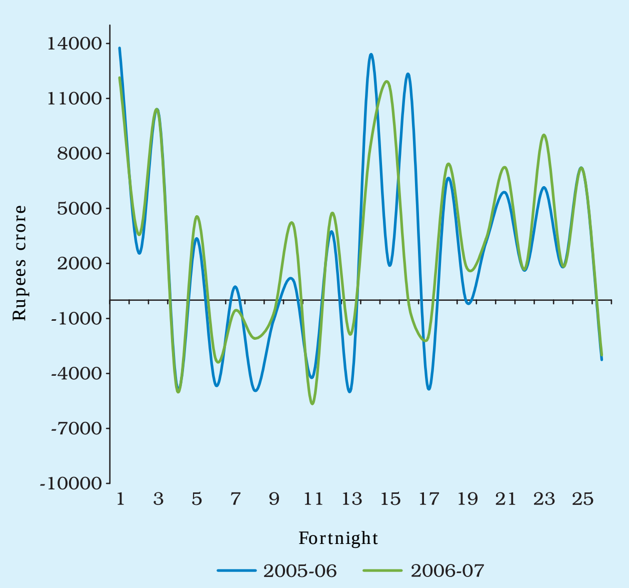
Chart I.5: Monetary Aggregates



aggregate (NM_3) as well as liquidity aggregates was also sharper during 2006-07 (Appendix Tables 16 and 17). Year-on-year growth in L_1 during 2006-07 was marginally lower than that in NM_3 which, in turn, was marginally lower than that in M_3. The lower order of growth in L_1 as compared with monetary aggregates could be attributed to the deceleration in postal deposits *vis-à-vis* bank deposits.

I.3.10 Amongst the major components of broad money, currency with the public accelerated during 2006-07 to 17.0 per cent from 16.4 per cent during the previous year, in consonance with higher economic activity. Currency in circulation broadly exhibited the usual intra-year seasonal pattern, increasing during festive seasons and initial part of the month (Chart I.6).

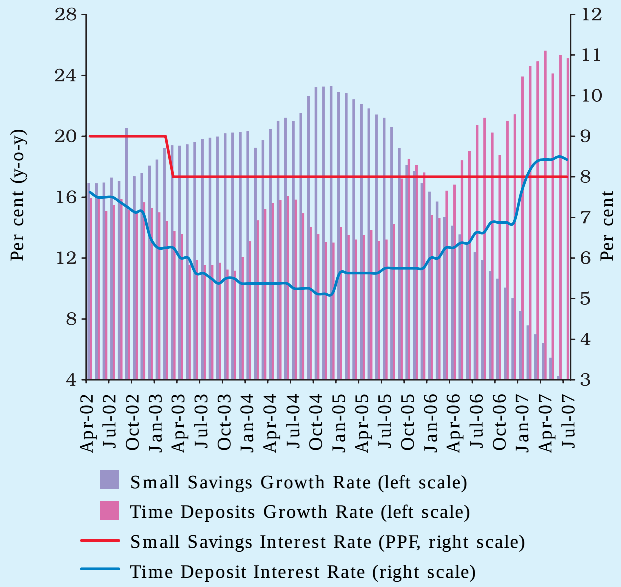
Chart I.6: Fortnightly Variation in Currency in Circulation



I.3.11 Aggregate deposits, the predominant component of broad money, also recorded an acceleration during 2006-07 on account of a sharp pick-up in time deposits (Appendix Tables 18 and 19). On a y-o-y basis, growth in demand deposits at end-March 2007 (16.7 per cent) was of a lower order than in the previous year (26.5 per cent). Accordingly, growth in narrow money, M_1, decelerated to 16.8 per cent at end-March 2007 from 21.1 per cent in the previous year. Time deposits, on the other hand, registered strong growth during 2006-07. Growth in scheduled commercial banks' (SCBs') time deposits accelerated to 24.9 per cent, y-o-y, at end-March 2007 from 16.4 per cent a year earlier which could be attributed to, *inter alia*, stronger economic activity, higher interest rates on bank deposits and extension of tax benefits under Section 80C for deposits with maturity of five years and above. In contrast to the sharp acceleration in time deposits, postal deposits witnessed a deceleration to 11.2 per cent in March 2007 from a growth of 17.2 per cent a year ago, partly attributable to rising interest rate differential in favour of bank deposits against the backdrop of unchanged interest rates on postal deposits (Chart I.7). Banks' non-resident repatriable foreign currency deposits increased by Rs.7,833 crore during 2006-07 as against a decline of Rs.16,876 crore during 2005-06; the decline during 2005-06 could be attributed to the IMD redemption (US $ 7.1 billion or Rs.31,959 crore) in December 2005.

I.3.12 Demand for commercial credit remained strong during 2006-07 for the third successive year, *albeit* with some moderation. Bank credit to the commercial sector registered a growth of 25.4 per cent, y-o-y, on March 31, 2007 on top of 27.2 per cent a year ago. Within the overall bank credit, SCBs' non-food credit rose by 28.4 per cent, y-o-y, on

Chart I.7: Time Deposits and Small Savings



March 31, 2007 as compared with 31.8 per cent a year ago (Table 1.22 and Chart I.8). Reflecting the slowdown in credit growth and the acceleration in deposits, the incremental credit-deposit ratio moderated towards the second half of 2006-07 after remaining above/around 100 per cent for the most part since October 2004. As at end-March 2007, the incremental credit-deposit ratio was around 84 per cent (y-o-y) as compared with 110 per cent a year ago (Chart I.9). Growth in non-food credit, however, averaged 29.2 per cent during the three-year period 2004-05 to 2006-07 as compared with an average growth of 16.4 per cent during the period 2000-2004 and 15.4 per cent during the 1990s.

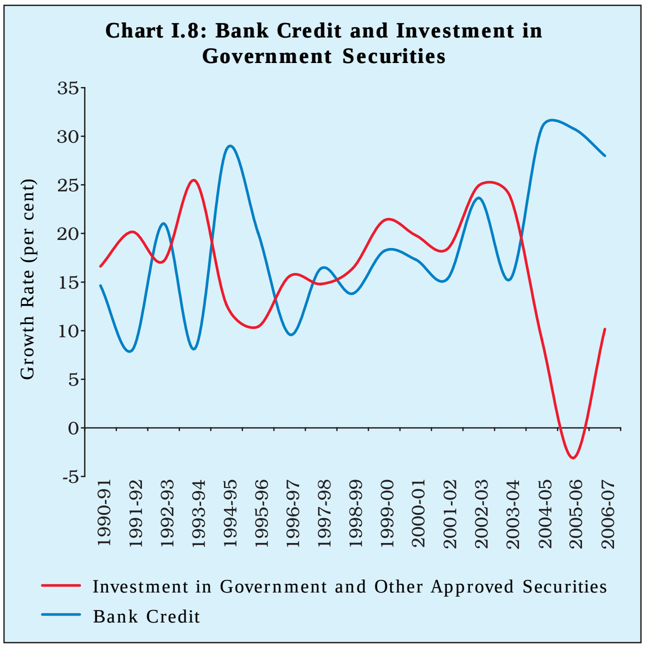
I.3.13 With credit growth continuing to outpace nominal GDP growth by a large margin, the credit-GDP ratio rose further during the year. The credit-GDP ratio increased from 30 per cent at end-March 2000 to 47 per cent at end-March 2006 to 51 per cent at end-March 2007. The credit-GDP ratio in India,

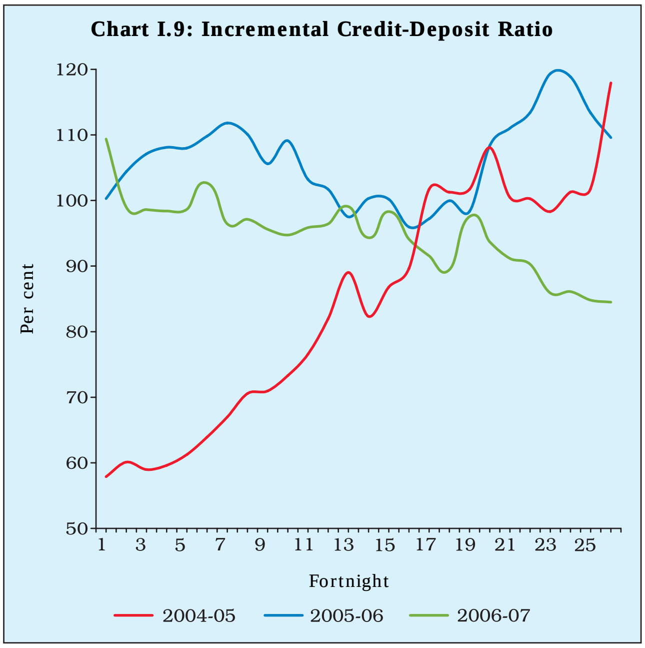
Table 1.22: Operations of Scheduled Commercial Banks

(Amount in Rupees crore)

Item	Outstanding as on March 30, 2007	Variation					
		2005-06	2006-07	2006-07			
				Q1	Q2	Q3	Q4
1	2	3	4	5	6	7	8
C.I. Aggregate Deposits of Residents (C.I.1+C.I.2)	25,41,201	3,40,789	4,91,427	30,677	1,66,396	31,469	2,62,886
C.I.1 Demand Deposits	4,29,137	78,623	64,497	-41,272	43,300	-8,905	71,374
C.I.2 Time Deposits of Residents (C.I.2.1+C.I.2.2)	21,12,063	2,62,167	4,26,930	71,949	1,23,096	40,374	1,91,511
C.I.2.1 Short-term Time Deposits	9,50,429	1,17,975	1,92,119	32,377	55,393	18,168	86,180
C.I.2.1.1 Certificates of Deposits	97,354	28,972	52,855	15,100	6,187	2,521	29,047
C.I.2.2 Long-term Time Deposits	11,61,635	1,44,192	2,34,812	39,572	67,703	22,206	1,05,331
C.II Call/Term Funding from Financial Institutions	85,836	11,224	2,692	3,118	-1,576	-4,468	5,618
S.I. Domestic Credit (S.I.1+S.I.2)	28,62,491	3,22,807	4,98,250	45,844	1,52,188	65,379	2,34,839
S.I.1 Credit to the Government	7,74,980	-19,514	74,238	23,238	10,723	602	39,675
S.I.2 Credit to the Commercial Sector (S.I.2.1+S.I.2.2+S.I.2.3+S.I.2.4)	20,87,511	3,42,321	4,24,012	22,606	1,41,465	64,777	1,95,164
S.I.2.1 Bank Credit	19,28,913	3,54,868	4,21,836	14,050	1,40,364	74,213	1,93,208
S.I.2.1.1 Non-food Credit	18,82,392	3,54,193	4,16,006	13,443	1,48,204	66,042	1,88,317
S.I.2.2 Net Credit to Primary Dealers	2,799	2,586	-1,570	-1,963	3,988	-2,783	-812
S.I.2.3 Investments in Other Approved Securities	15,451	-3,295	-1,262	526	-1,132	-352	-304
S.I.2.4 Other Investments (in non-SLR Securities)	1,40,347	-11,838	5,007	9,993	-1,756	-6,301	3,071
S.II. Net Foreign Currency Assets of Commercial Banks (S.II.1-S.II.2-S.II.3)	-40,259	29,640	5,356	-21,137	10,844	13,322	2,327
S.II.1 Foreign Currency Assets	58,754	14,059	15,260	-13,919	8,830	11,781	8,567
S.II.2 Non-resident Foreign Currency Repatriable Fixed Deposits	67,108	-16,876	7,833	3,917	1,671	1,233	1,011
S.II.3 Overseas Foreign Currency Borrowings	31,905	1,295	2,071	3,301	-3,685	-2,774	5,229
S.III. Net Bank Reserves (S.III.1+S.III.2-S.III.3)	1,90,086	35,581	51,467	-6,090	20,381	-15,423	52,599
S.III.1 Balances with the RBI	1,80,222	34,077	53,161	-6,738	20,025	-12,386	52,261
S.III.2 Cash in Hand	16,108	2,897	3,063	-837	1,784	-946	3,062
S.III.3 Loans and Advances from the RBI	6,245	1,393	4,757	-1,486	1,428	2,092	2,723
S.IV. Capital Account	2,02,618	40,320	24,891	12,025	6,168	2,250	4,447
S.V. Other items (net) (S.I+S.II+S.III-S.IV-C.I-C.II)	1,82,663	-4,304	36,063	-27,203	12,425	34,027	16,814

Note : Data relate to last reporting Friday of each quarter.





however, still remains lower than major advanced economies as well as most East Asian economies (Table 1.23).

I.3.14 Disaggregated data show that credit growth during 2006-07 was broad-based (Table 1.24 and Appendix Tables 20 and 21). While 36 per cent of the

Table 1.23: Domestic Credit provided by the Banking Sector

(Per cent to GDP)

Country	1990	1995	2000	2001	2002	2003	2004	2005
1	2	3	4	5	6	7	8	9
Brazil	92	50	78	79	82	81	80	83
Canada	104	115	115	207	201	195	197	206
Chile	84	77	100	87	89	88	87	86
China	90	88	120	123	143	152	140	136
Czech Republic	..	71	49	46	42	49	45	44
France	102	101	103	106	103	105	106	110
Germany	102	124	145	144	142	141	137	136
Indonesia	47	52	61	53	51	49	50	47
Japan	263	288	310	296	297	305	306	319
Malaysia	73	173	186	199	196	192	157	144
Mexico	37	50	34	33	36	36	35	35
New Zealand	80	92	112	110	113	117	121	133
Philippines	27	64	67	63	61	60	58	51
Poland	19	29	33	35	35	36	33	33
Russian Federation	..	25	25	26	27	28	26	21
Singapore	75	76	89	102	83	87	80	71
South Africa	98	140	152	184	160	165	173	185
Sri Lanka	38	41	44	44	44	42	45	44
Thailand	94	141	138	129	128	123	116	111
Turkey	20	28	55	74	58	54	55	57
United Kingdom	121	122	133	139	145	149	158	168
United States	151	173	201	208	200	214	220	224

.. : Not Available.

Source : World Development Indicators Online Database, World Bank.

Table 1.24: Deployment of Non-food Bank Credit

(Amount in Rupees crore)

Sector/Industry	Outstanding as on March 30, 2007	Year-on-Year Variations			
		March 31, 2006 over March 18, 2005		March 30, 2007 over March 31, 2006	
		Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6
Non-food Gross Bank Credit (1 to 4)	**17,95,357**	**3,98,396**	**39.6**	**3,92,128**	**27.9**
1. Agriculture and Allied Activities	**2,30,180**	**49,606**	**39.9**	**56,305**	**32.4**
2. Industry (Small, Medium and Large)	**6,91,483**	**1,26,804**	**30.0**	**1,41,543**	**25.7**
Small Scale Industries	1,16,908	16,831	22.7	25,888	28.4
3. Personal Loans	**4,55,503**	**1,03,733**	**40.5**	**95,422**	**26.5**
Housing	2,30,689	51,273	38.3	45,508	24.6
Advances against Fixed Deposits	40,455	4,509	15.1	6,172	18.0
Credit Cards	13,316	2,654	41.3	4,230	46.6
Education	15,020	4,282	75.4	5,058	50.8
Consumer Durables	9,151	-1,875	-20.9	2,050	28.9
4. Services	**4,18,191**	**1,18,254**	**58.8**	**98,857**	**31.0**
Transport Operators	26,416	8,945	106.5	9,075	52.3
Professional and other Services	23,782	5,627	58.3	8,499	55.6
Trade	1,08,041	25,233	43.4	24,613	29.5
Real Estate Loans	45,328	13,147	97.1	18,635	69.8
Non-Banking Financial Companies	48,496	11,463	50.3	14,226	41.5

Note : 1. Data are provisional and relate to select scheduled commercial banks.
2. Owing to change in classification of sectors/industries and coverage of banks, data for 2006 onwards are not comparable with the earlier periods.
3. Figures for 2005-06 relating to 27 fortnights are not comparable with those of 2006-07 relating to 26 fortnights.

incremental non-food credit was absorbed by industry and another 14 per cent by agriculture, personal loans absorbed 24 per cent of the incremental non-food credit during the year. The share of housing loans in personal loans on an incremental basis (y-o-y) declined to 47.7 per cent at end-March 2007 from 49.4 per cent a year earlier. Loans to commercial real estate continued to record high growth, though with some moderation. The Reserve Bank further tightened the provisioning requirement and risk weights in respect of those categories, which witnessed relatively higher credit growth (see Chapter V).

I.3.15 Based on the trends emerging from the Basic Statistical Returns data, the share of personal loans in total bank credit extended by SCBs increased from 6.4 per cent at end-March 1990 to 23.3 per cent at end-March 2006, driven by housing as well as non-housing loans. While the share of housing credit in overall credit rose from 2.4 per cent to 12.0 per cent, that of non-housing retail credit rose from 4.0 per cent to 11.3 per cent. The share of agriculture in total credit, which had declined from 15.9 per cent at end-March 1990 to 9.6 per cent at end-March 2001, recovered to 11.4 per cent by end-March 2006. The share of industry in total credit declined from 48.7 per cent in March 1990 to 37.4 per cent by March 2006 after touching 49.1 per cent in March 1999. The share of agricultural credit to agricultural GDP was around 29 per cent at end-March 2006 as compared with around 23 per cent at end-March 2005 and around 13 per cent at end-March 1990. The share of industrial credit to industrial GDP was around 84 per cent at end-March 2006 as compared with around 75 per cent at end-March 2005 and around 53 per cent at end-March 1990.

I.3.16 In recent years, the corporate sector has increasingly relied on non-bank sources to fund their financing requirements. This trend continued during 2006-07 with the corporate sector raising large resources from the capital markets and by way of external commercial borrowings (ECBs), besides relying increasingly on internal funds. Resources raised through domestic equity issuances more than doubled during 2006-07. Mobilisation through issuances of commercial paper staged a turnaround. Resources raised through markets abroad – equity issuances (ADRs/GDRs) and ECBs – also increased

Table 1.25: Select Sources of Funds to Industry

(Rupees crore)

Item	2005-06	2006-07
1	2	3
A. Bank Credit to Industry #	1,26,804	1,41,543
B. Flow from Non-banks to Corporates		
1. Capital Issues (i+ii)	13,781	29,180
i) Non-Government Public Ltd. Companies (a+b)	13,408	29,180
a) Bonds/Debentures	245	585
b) Shares	13,163	28,595
ii) PSUs and Government Companies	373	0
2. ADR/GDR Issues	7,257	16,184
3. External Commercial Borrowings (ECBs)	45,078	88,472
4. Issue of CPs	-1,517	4,970
C. Depreciation Provision +	32,156	37,095
D. Profit after Tax +	76,516	1,11,107

\# : Data pertain to select scheduled commercial banks. Figures for 2005-06 relating to 27 fortnights are not comparable with those of 2006-07 relating to 26 fortnights.

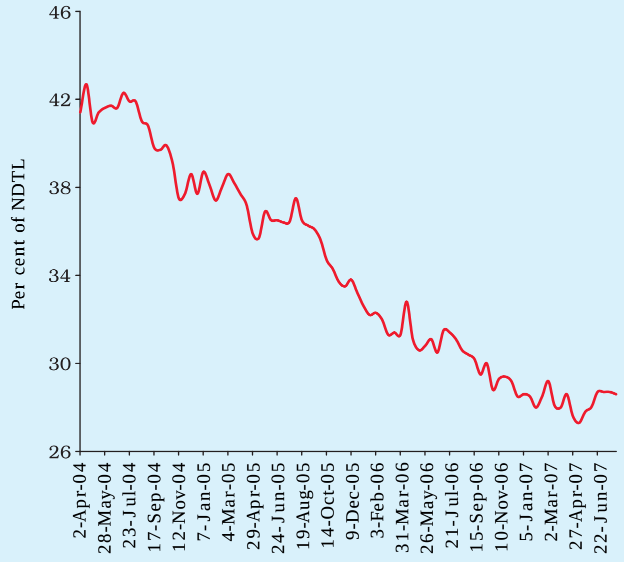
\+ : Data are based on audited/ unaudited abridged results of select 2,388 non-financial non-Government companies.

Note :
1. Data are provisional.
2. Data on capital issues pertain to gross issuances excluding issues by banks and financial institutions. Figures are not adjusted for banks' investments in capital issues, which are not expected to be significant.
3. Data on ADR/GDR issues exclude issuances by banks and financial institutions.
4. Data on external commercial borrowings include short-term credit. Data for 2005-06 are exclusive of the IMD redemption.

sharply during 2006-07. Finally, internal sources of funds continued to provide large financing support to the domestic corporate sector during 2006-07. Profits after tax of select non-financial non-government companies during 2006-07 were around 45 per cent higher than those during 2005-06 (Table 1.25).

I.3.17 Commercial banks' investments in gilts increased by 10.6 per cent, y-o-y, at end-March 2007 as against a decline of 2.7 per cent a year ago. Growth in SCBs' investments in gilts was, however, substantially below the growth of 23.5 per cent in their net demand and time liabilities (NDTL). As a result, commercial banks' holdings of SLR securities, as a proportion to their NDTL, declined to 28.0 per cent at end-March 2007 from 31.3 per cent at end-March 2006 and 42.7 per cent in April 2004 (Chart I.10). Excess SLR investments of SCBs fell to

Chart I.10: SLR Investments of Scheduled Commercial Banks



Rs.84,223 crore at end-March 2007 from Rs.1,45,297 crore at end-March 2006.

I.3.18 Commercial banks' non-SLR investments (*i.e.*, investments in commercial paper, shares, and bonds) recovered during 2006-07, after witnessing a decline in the preceding year. Their non-SLR investments were 7.2 per cent of their credit at end-March 2007. Non-food credit extended by scheduled commercial banks, including their non-SLR investments, increased by 27.2 per cent during 2006-07 as compared with 28.3 per cent during 2005-06 (Table 1.26).

Table 1.26: Scheduled Commercial Banks' Non-SLR Investments

(Rupees crore)

Item	Mar, 2005	Mar, 2006	Mar, 2007
1	2	3	4
Commercial Paper	3,891	4,821	8,977
Units of Mutual Funds	12,623	10,345	11,659
Shares issued by	13,427	15,044	20,171
Public Sector Undertakings	1,613	2,274	2,126
Private Corporate Sector	10,288	10,501	16,218
Public Financial Institutions	1,525	2,270	1,826
Bonds/debentures issued by	1,13,695	1,03,170	98,057
Public Sector Undertakings	45,937	32,345	28,472
Private Corporate Sector	31,934	29,523	27,600
Public Financial Institutions	29,190	26,402	24,362
Others	6,633	14,899	17,623
Total	**1,43,636**	**1,33,380**	**1,38,865**

Note : Data are provisional and exclude regional rural banks.

Table 1.27: Deposit and Credit – Bank Group-wise and Population Group-wise

(Per cent)

	Growth in Deposits		Share in Total Deposits (March 2007)	Growth in Credit		Share in Total Credit (March 2007)
	March 2006	March 2007		March 2006	March 2007	
1	2	3	4	5	6	7
All India	**19.4**	**24.2**	**100.0**	**30.6**	**28.5**	**100.0**
Population Group-wise						
Rural	12.8	13.9	9.9	25.5	21.5	7.9
Semi-Urban	15.2	18.1	13.7	27.5	25.6	9.7
Urban	18.7	23.1	20.4	31.7	27.4	16.2
Metropolitan	22.3	28.2	55.9	31.6	30.1	66.1
Bank Group-wise						
State Bank and Associates	15.5	17.9	22.3	31.1	28.9	23.2
Nationalised Banks	16.2	24.1	48.4	30.6	28.3	47.5
Foreign Banks	44.9	30.5	5.6	28.2	29.2	6.6
Regional Rural Banks	15.0	16.2	3.2	21.2	22.1	2.5
Private Sector Banks	28.1	31.5	20.6	32.3	29.0	20.3

Note : Data in this Table are as on March 31 and may differ from those in other Tables which are based on last reporting Friday of March.
Source : Basic Statistical Return (BSR)-7.

I.3.19 Commercial banks' recourse to foreign borrowings during 2006-07 was marginally higher than a year ago. Accretion to banks' capital and reserves was lower than a year ago (see Table 1.22).

Population Group and Bank Group Trends

I.3.20 Acceleration in deposit growth was witnessed across all population groups during 2006-07; the growth rate in metropolitan areas, however, remained the highest while that in rural areas was the lowest. Bank group-wise, except foreign banks, deposit growth accelerated across all other bank groups. Deposits with private sector banks recorded the highest growth, while those with regional rural banks registered the lowest increase amongst the bank groups. As regards credit growth, the deceleration observed at all-India level was seen in the case of all population groups. Bank-group wise, growth decelerated in the case of the State Bank group, nationalised banks and private sector banks. In contrast, foreign banks and regional rural banks, each recorded an increase of about 1 percentage point. Growth was the highest in the case of foreign banks, followed closely by the private sector banks, the State Bank group and the nationalised banks (Table 1.27).

Developments during 2007-08

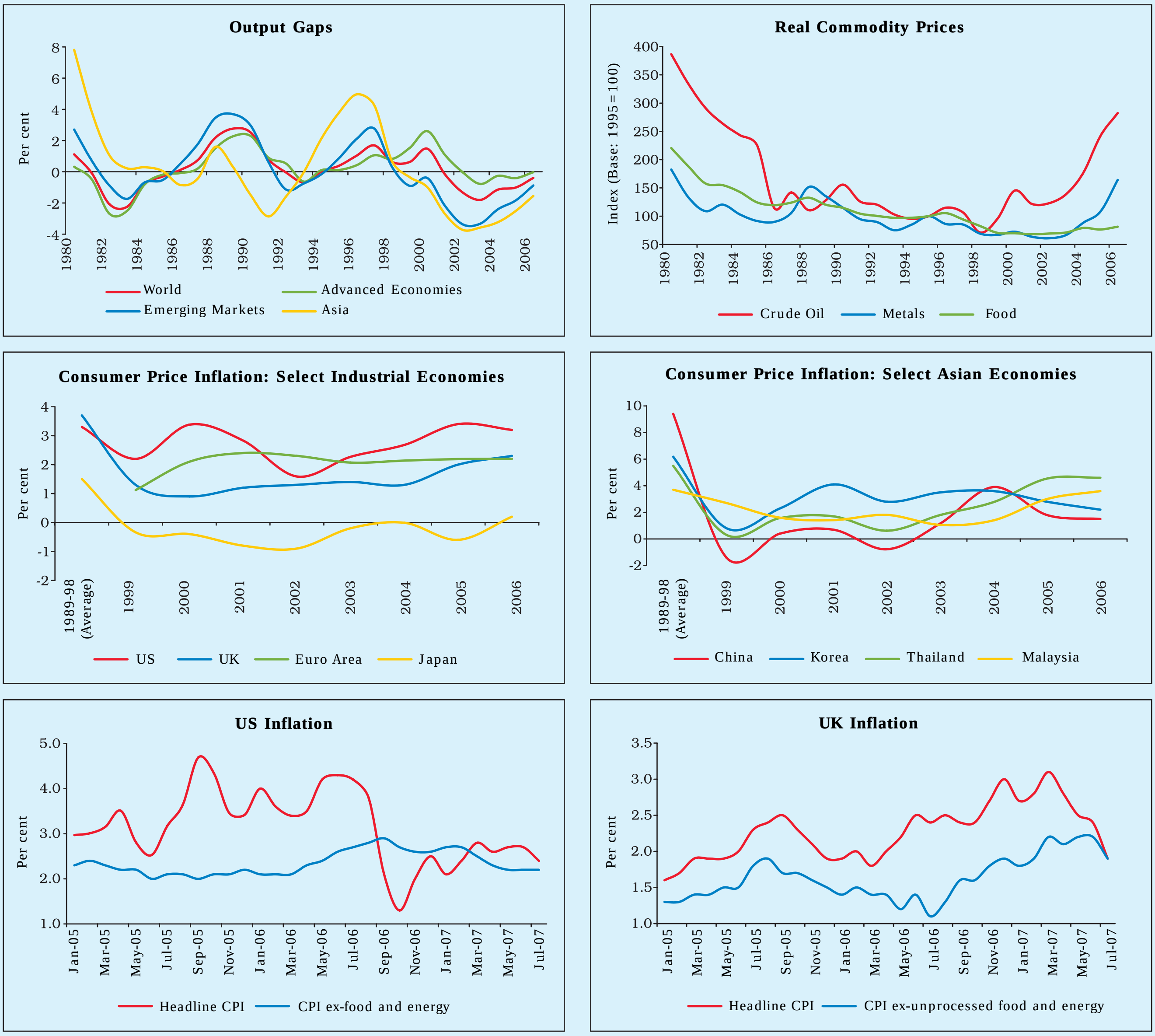
I.3.21 On a y-o-y basis, growth in broad money (M_3) was 21.7 per cent as on August 3, 2007 as compared with 21.3 per cent at end-March 2007 and 19.3 per cent a year ago. Amongst the major components, growth in aggregate deposits accelerated to 22.9 per cent from 19.7 per cent a year ago. On the sources side, scheduled commercial banks' non-food credit registered a growth of 23.6 per cent as on August 3, 2007 as compared with 32.5 per cent a year back, while their investments in Government securities expanded by 12.1 per cent (0.5 per cent a year ago).

PRICE SITUATION

Global Inflation

I.3.22 Global headline inflation remained firm during 2006-07 reflecting the combined impact of higher international crude oil prices in an environment of strong demand and closing of output gaps (Chart I.11). Although inflation moderated somewhat with the easing of crude oil prices from August 2006, inflationary pressures continued from other commodity prices and increased capacity utilisation rates. As a result, headline inflation remained above the inflation targets/ comfort zones in major economies. In OECD countries, headline inflation rose from 2.5 per cent in March 2006 to an intra-year peak of 3.1 per cent in June 2006 before moderating to 2.4 per cent in March 2007; core inflation (*i.e.*, excluding food and energy) rose from 1.6 per cent in March 2006 to 2.1 per cent in March 2007. The consumer price inflation in advanced economies was 2.3 per cent in the calendar year 2006, the same as a year ago, but higher than

Chart I.11: Global Inflation



Source : World Economic Outlook, April 2007, IMF; US Bureau of Labour Statistics; and National Statistics, UK.

that of 1.9 per cent during the preceding 5-year period (2000-04). Inflation in Developing Asia rose from 2.6 per cent during 2000-04 and 3.6 per cent in 2005 to 4.0 per cent in 2006. Although inflation has firmed up in many economies in the past couple of years, it still remains relatively contained despite sustained increase in commodity prices and buoyant demand (Box I.8).

I.3.23 Against the backdrop of inflationary pressures, many central banks, therefore, tightened monetary policies during 2006-07 in order to contain inflation and inflationary expectations. Amongst the major advanced economies, the US Federal Reserve Board (US Fed), the ECB, the Bank of England, the Sveriges Riksbank (Sweden), the Reserve Bank of New Zealand, the Reserve Bank of Australia, and the Bank of Japan tightened their policies during the year. In the US, core inflation remains at elevated level; however, in view of moderation in growth on the back of a cooling of the housing market, the US Fed has paused at each of the meetings held since end-June 2006. The Fed had earlier raised its target federal funds rate by 425 basis points since the tightening

Box I.8
Globalisation and Inflation

There has been a sustained and large increase in commodity prices since early 2004. Concomitantly, inflation has firmed up in many economies even as it remains relatively contained compared to the earlier episodes of sharp increases in commodity prices. A number of factors such as deregulation, increased competition, improvements in the conduct of monetary policies and globalisation have been offered as the major explanations for the relatively benign outturn. The recent period has, however, triggered some debate on the role of globalisation in containing domestic inflation.

In one view, the large level of imports at relatively cheaper prices from emerging economies like China and India has helped in lowering domestic inflation in advanced economies. Furthermore, globalisation reduces unwarranted price mark-ups. Competition among countries to attract and retain mobile production factors forces the governments to reduce inefficiencies, ensure fiscal discipline and macroeconomic stability. The focus on macroeconomic stability is one of the factors that has led to greater central bank independence and, in turn, lower inflation. Greater competition in the economy makes prices more flexible which reduces the impact of unanticipated inflation on output. This lowers the incentive for the monetary authority to systematically raise output above the potential. At the same time, while some resources are becoming less scarce on a global scale (notably skilled labour), other resources have become scarcer relative to world demand (for instance, basic raw materials, most notably oil and other sources of energy). Thus, the manufacturing-price and the wage-containing effects on inflation of globalisation seem to have been partly counterbalanced by inflationary pressures arising from the substantial increases in commodity prices. According to the IMF estimates, globalisation, through its direct effects on non-oil import prices, has reduced inflation by a quarter of a percentage point per year on average in the advanced economies. Recent studies also suggest that domestic inflation is being increasingly influenced by global output gap (*i.e.*, global demand-supply mismatches) rather domestic output gap (*i.e.*, domestic demand-supply mismatches). This underlines the need for a more intensive monitoring of external developments and prompt policy responses to the developing trends; otherwise, the central bank runs the risk of falling behind the curve.

The alternative view stresses that the globalisation process affects only the relative prices of goods and services and not the overall inflation rate. By permitting cheaper imports, it is true that imported inflation might be lower than before. However, if the long-run inflation objective of the central bank is unchanged, then the ultimate effect of the lower import prices on domestic inflation will be nil as higher prices of other items will offset the effect of lower import prices. Moreover, according to Kohn (2006), much of the decline in import prices in the US since the mid-1990s has been probably driven by movements in exchange rates and the effects of technological change on goods prices rather than by the growing integration of world markets. Thus, in this view, globalisation has no impact on the overall domestic inflation. In the long-run, domestic inflation is ultimately determined solely by monetary policy. However, in the short-run, central banks cannot offset completely the effects of shocks to supply or prices through monetary actions. Thus, in the short-run, forces of globalisation can influence inflation dynamics but in the long-run, inflation is ultimately determined by monetary policy.

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began in June 2004 (Table 1.28). According to the Federal Open Market Committee (FOMC), the risk that inflation will fail to moderate as expected remains the predominant policy concern and future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information. The FOMC in its statement released on August 17, 2007 observed that the downside risks to growth have increased appreciably due to uncertainty in view of deterioration in financial market conditions, and tighter credit conditions. On the same day, the US Fed announced a 50 basis point

Table 1.28: Global Inflation Indicators

(Per cent)

Country/ Region	Key Policy Rate	Policy Rate (As on August 17, 2007)	Changes in Policy Rates (basis points)			CPI Inflation (y-o-y)			Real GDP Growth (y-o-y)		
			2005-06 (April-March)	2006-07 (April-March)	Since end-March 2007	2006	July 2006	July 2007	2006	2006 (Q1)	2007 (Q1)
1	2	3	4	5	6	7	8	9	10	11	12
Developed Economies											
Australia	Cash Rate	6.50 (Aug. 8, 2007)	0	75	25	3.5	4.0	2.1 #	2.7	3.1	3.8
Canada	Overnight Rate	4.50 (Jul. 10 , 2007)	125	50	25	2.0	2.4	2.2 *	2.8	3.2	2.0
Euro area	Interest Rate on Main Refinancing Operations	4.00 (Jun. 6, 2007)	50	125	25	2.2	2.4	1.8	2.8	2.7	2.5 #
Japan	Uncollateralised Overnight Call Rate	0.50 (Feb. 21, 2007)	0**	50	0	0.2	-0.2	0.5 *	2.2	2.5	2.3 #
UK	Official Bank Rate	5.75 (Jul. 5, 2007)	(-)25	75	50	2.3	2.4	1.9	2.8	2.6	3.0 #
US	Federal Funds Rate	5.25 (Jun. 29, 2006)	200	50	0	3.2	4.1	2.4	3.3	3.2	1.8 #
Developing Economies											
Brazil	Selic Rate	11.50 (Jul. 18, 2007)	(-)275	(-)375	(-) 125	4.2	4.0	3.7	3.7	3.9	4.3
India	Reverse Repo Rate	6.00 (Jul. 25, 2006)	75	50	0	6.1	7.7	5.7 *	9.4	10.0	9.1
	Repo Rate	7.75 (Mar. 30, 2007)	50 (0)	125 (100)	0 (50)						
China	Benchmark 1-year Lending Rate	6.84 (Jul. 21, 2007)		81 (250)	45 (150)	1.5	1.0	5.6	11.1	10.9	11.9 #
Indonesia	BI Rate	8.25 (Jul. 5, 2007)	425@	(-)375	(-)75	13.1	15.2	6.1	5.5	5.2	6.3 #
Israel	Key Rate	3.75 (Jul. 23, 2007)	125	(-)75	(-) 25	2.1	2.4	0.3	5.1	5.2	5.4
Korea	Overnight Call Rate	5.00 (Aug. 9, 2007)	75	50 (80)	50	2.2	2.4	2.5	5.0	5.1	4.9 #
Russia	Refinancing Rate	10.00 (Jun. 19, 2007)	(-)100	(-)150 (150)	(-)50 (100)	9.7	9.6	8.8	6.7	5.5	7.9
South Africa	Repo Rate	10.00 (Aug. 17, 2007)	(-)50	200	100	4.7	4.9	7.0 *	5.0	4.0	5.4
Thailand	14-day Repurchase Rate	5.00 (Jun. 7, 2006)	225	50							
	1-day Repurchase Rate	3.25 (Jul. 18, 2007)		(-)44 ^	(-)125	4.6	4.4	1.7	5.0	6.1	4.3

@ : Bank Indonesia adopted BI rate as the reference rate with the formal adoption of inflation targeting in July 2005.

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

^ : Change over January 16, 2007. Effective January 17, 2007, the 1-day repurchase rate replaced the 14-day repurchase rate as the policy rate.

: Q2 of 2007. * : July 2007.

Note : 1. For India, data on inflation pertain to CPI for Industrial Workers. Data on GDP growth for 2006 pertain to fiscal year 2006-07.
2. Figures in parentheses in column (3) indicate the date when the policy rates were last revised.
3. Figures in parentheses in columns (5) and (6) indicate the variation in cash reserve ratios during the period.

Source : International Monetary Fund, websites of respective central banks and The Economist.

reduction in the primary credit rate to 5.75 per cent to promote the restoration of orderly conditions in financial markets; the target federal funds rate was, however, kept unchanged at 5.25 per cent. In the euro area, notwithstanding some easing in inflation since August 2006, risks to the price outlook are seen on the upside over the medium-term. The European Central Bank (ECB) has, therefore, raised the key policy rate by 200 basis points since the tightening began in December 2005. The ECB is of the view that monetary policy still continues to be on the accommodative side. The Bank of England has raised its policy rate by 125 basis points – 25 basis points each in August 2006, November 2006, January 2007, May 2007 and July 2007 – in view of strong economic activity, limited spare capacity, rapid growth of broad money and credit and risks to the outlook for inflation in the medium-term tilted to the upside. The Bank of Japan (BoJ), after maintaining zero interest rates for an extended period, raised the uncollateralised overnight call rate (the operating target of monetary policy since March 2006) by 25 basis points each on two occasions – July 2006 and February 2007 – during the year to 0.50 per cent. It has kept its policy rate unchanged since then.

I.3.24 As regards Developing Asia, consumer price inflation in China increased to 5.6 per cent in July 2007 from 3.3 per cent in March 2007 and 1.0 per cent a year ago. In view of strong growth in money supply and credit, the People's Bank of China (PBC) has increased the benchmark 1-year lending rate by 126 basis points since April 2006 in five steps to 6.84 per cent on July 21, 2007 and the cash reserve ratio by 450 basis points since July 2006 in nine steps of 50 basis points to 12.00 per cent. The monetary measures were supported by a series of industrial structure adjustments and trade policies.

I.3.25 Inflation remained relatively modest in several other Asian economies reflecting pre-emptive monetary tightening as well as appreciation of exchange rates. The Bank of Korea raised its policy rate by 25 basis points each on July 12, 2007 and August 9, 2007 to 5.0 per cent, after keeping it unchanged between August 2006 and June 2007; the rate has been increased by 175 basis points since the tightening began in October 2005. In view of sharp growth in monetary and credit aggregates, and financial institutions' liquidity led by inflows of foreign funds, the Bank of Korea increased the cash reserve ratio on demand deposits and money market deposit accounts from 5.0 per cent to 7.0 per cent, effective December 23, 2006. Beginning January 17, 2007, the Bank of Thailand has lowered the 1-day repurchase rate (which replaced the 14-day repurchase rate as the policy rate) by 169 basis points to 3.25 per cent by July 18, 2007 to support growth without exerting pressure on inflation. The Bank of Thailand had earlier raised the policy rate by 275 basis points between June 2005 and June 2006. In Indonesia, inflation, which had reached 18.4 per cent in November 2005, eased to 6.5 per cent in March 2007 and further to 6.1 per cent in July 2007 reflecting monetary policy actions as well as the easing of oil prices and the base effect. The Bank Indonesia has, therefore, cut its policy rate by 450 basis points since May 2006 (to 8.25 per cent in July 2007) to support growth, more than offsetting the increase of 425 basis points during July-December 2005 to contain inflation.

I.3.26 Amongst other emerging economies, the South African Reserve Bank raised the policy rate by 300 basis points since the tightening began in June 2006 to 10.0 per cent (effective August 17, 2007) to contain inflation pressures. Turkey has kept rates unchanged since August 2006 due to slowdown in domestic demand and moderation in inflation expectations (it had earlier increased its policy rate by 425 basis points during June-July 2006). On the other hand, in view of weak economic activity, Brazil has reduced policy rates by 825 basis points since September 2005 to 11.50 per cent on July 18, 2007. The Bank of Israel cut its policy rate by 200 basis points during October 2006-June 2007, reversing the increase of 200 basis points during October 2005-August 2006; it, however, increased the policy rate by 25 basis points on July 23, 2007 to 3.75 per cent. The Bank of Russia has raised the required reserve ratio on credit institutions' liabilities to non-resident banks in rubles and foreign currency from 2.0 per cent to 3.5 per cent effective October 1, 2006 and by another 100 basis points to 4.5 per cent effective July 1, 2007. It has, however, reduced the refinancing rate by 200 basis points from June 2006 to 10.0 per cent by June 2007.

I.3.27 In August 2007, real policy rates[10] were higher compared to March 2007 in a number of advanced economies but were lower in several developing economies (Table 1.29). In most countries, real rates ranged between 2 and 4 per cent in August 2007. In India, real policy rates increased in August 2007 as compared with March 2007. Of the select emerging economies, real policy rates were the highest in Brazil and the lowest in Russia.

I.3.28 In view of higher oil and food prices, core inflation remained generally below headline inflation during 2006-07 (Table 1.30). Although many central banks use core inflation for assessing inflation conditions, headline inflation remains the preferred

[10] Nominal policy rates less consumer price inflation.

Table 1.29: Nominal and Real Policy Rates – Select Countries

(Per cent)

Country	Nominal Policy Rate			Real Policy Rate		
	March 2006	March 2007	August 2007#	March 2006	March 2007	August 2007#
1	2	3	4	5	6	7
Developed Economies						
US	4.75	5.25	5.25	1.35	2.45	2.85
UK	4.50	5.25	5.75	2.70	2.15	3.85
Euro area	2.50	3.75	4.00	0.30	1.85	2.20
Developing Economies						
Brazil	16.50	12.75	11.50	11.20	9.75	7.80
China	5.58	6.39	6.84	4.78	3.09	1.24
India	6.50	7.75	7.75	1.60	1.05	2.05
				(2.40)	(1.85)	(3.70)
Indonesia	12.75	9.00	8.25	-3.05	2.50	2.15
Israel	4.75	4.00	3.75	1.15	4.90	3.45
Korea	4.00	4.50	5.00	2.10	2.30	2.50
Russia	12.00	10.50	10.00	1.40	3.10	1.20
South Africa	7.00	9.00	10.00	3.60	2.90	3.00
Thailand	4.50	4.50	3.25	-1.20	2.50	1.55

: As on August 17, 2007. Real policy rates for August 2007 are based on latest available inflation rates.

Note : 1. Real policy rate is the policy rate less year-on-year consumer price inflation. For India, repo rate is taken as the policy rate, while inflation refers to that for CPI-Industrial Workers.

2. Figures in parentheses for India are based on wholesale price inflation.

Source : International Monetary Fund, The Economist and official websites of respective central banks.

policy target in view of its simplicity and transparency. In the context of the recent firming up of headline inflation across the globe, primarily on account of higher oil and other commodity prices, the use of core measures has become debatable. 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. Even the recent rise in food prices is viewed as having a permanent component. Headline inflation is more sensitive to prices of items such as food. Accordingly, persisting supply shocks to prices of these commodities can impart a lasting impact on inflation expectations. Therefore, the use of core inflation, excluding oil and food prices, could be somewhat misleading. In emerging economies, core inflation is, therefore, 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 price index. Moreover, the pass-through of higher oil prices has been halting and not full and headline inflation in a way understates the problem. Monetary policy has to focus on the permanent component of supply shocks to the inflation process. The use of core inflation, therefore, may not be a proper guide of inflationary expectations and future inflation.

Table 1.30: Headline and Core Inflation (year-on-year)

(Per cent)

Country	March 2005		March 2006		March 2007		June 2007	
	Core	Headline	Core	Headline	Core	Headline	Core	Headline
1	2	3	4	5	6	7	8	9
US	2.3	3.2	2.1	3.4	2.5	2.8	2.2	2.7
UK	1.4	1.9	1.4	1.8	2.2	3.1	2.2	2.4
EU	1.6	2.1	1.4	2.2	1.9	1.9	1.9	1.9
Japan	-0.3	0.0	0.1	-0.2	-0.3	-0.1	-0.1	-0.2

I.3.29 It is increasingly accepted that inflation expectations play a key role in driving inflation. In this context, transparency in the conduct of monetary policy contributes towards anchoring of inflation expectations. Improvements in the institutional arrangements, clarity in the specification of the inflation target and effectiveness in the central bank's policy communications are amongst the major steps to improve transparency in the conduct of monetary policy (Box I.9). Accordingly, some of the practices followed in the inflation targeting (IT) countries for improving transparency can be of relevance to even non-IT countries.

Global Commodity Prices

I.3.30 International non-fuel commodity prices firmed up during 2006-07 led by metals and food prices. Metal prices recorded gains on the back of robust demand in emerging economies, especially China and increased investors' interest. Amongst food items, prices of wheat and edible oils rose reflecting a shortfall in global production. Crude oil prices exhibited large volatility, initially rising sharply to reach a record high in July 2006 followed by a sharp correction in the subsequent months. Overall, non-fuel commodity prices (as measured by the World Bank's index of non-energy commodities) were 19 per cent higher in March 2007 (year-on-year).

I.3.31 International crude oil prices (WTI) in March 2007 were broadly unchanged from a year ago level. Prices initially firmed up to a record high in July 2006 - US $ 78.4 a barrel on July 14, 2006 - on concerns over geopolitical tensions (Iran's nuclear programme and unrest in Nigeria) amidst limited spare capacity and speculative investors' interest. Subsequently, prices eased to around US $ 51 a barrel by mid-January 2007 on the back of

Box I.9
Inflation Targeting Framework: Institutional Arrangements

A cross-country survey of the institutional arrangements on the conduct of monetary policy in the inflation targeting central banks reveals the following features:

(i) It is important for the public at large to perceive that the central bank is insulated from political pressures to pursue inflation containment policy. A high degree of central bank autonomy in policy formulation (from political and fiscal policy pressures) coupled with effective accountability for the conduct of monetary policy is essential for the credibility of inflation targeting (IT). If fiscal policy is on an unsustainable path, or based on assumptions or objectives inconsistent with the inflation objectives, then the credibility or feasibility of inflation targeting may be compromised. A high degree of central bank autonomy in the setting of its policy instruments requires strict limits, or a total prohibition, on central bank financing of the government.

(ii) Goal autonomy is less important than goal prioritisation. Specifics of inflation targets are, in a majority of cases, set jointly by the government and the central bank. An important consideration in involving the government in deciding on the target is to ensure that the fiscal authorities take the inflation target seriously in their planning and decisions.

(iii) Regular reviews of inflation target specifications should be considered**.** In practice, reviews have tended to follow changes in governments.

(iv) A weak central bank financial position might be inconsistent with achieving or maintaining price stability. Consequently, strengthening the capitalisation of the central bank might be appropriate, together with measures to ensure the central bank's profitability on an ongoing basis.

(v) Central bank's management structure should be designed to minimise potential conflicts among different functions of management. This could involve establishing a formal, two-tier management structure involving a supervisory board (charged with responsibility for monitoring and evaluating the central bank's performance in relation to its assigned objectives), and a separate monetary policy committee (MPC) responsible for the formulation and implementation of monetary policy.

(vi) As regards MPCs, cross-country experience indicates a preference for a small size committee (generally between 5 and 10 persons) with members drawn from professional field relevant to monetary policy decision making but with majority representations from the central bank. Government officials should be either excluded from MPC or have only a non-voting presence.

(vii) Regarding the frequency of policy decision making, the MPC in a majority of inflation targeting central banks meets once every month (15 out of 24 countries covered in the survey), while 7 meet every six weeks; the remaining 2 meet every two months.

(viii) Although many countries routinely calculate, report and use measures of core inflation in policy formulation and communications, an overwhelming majority of countries prefer 'headline' consumer price inflation as the policy target in view of its simplicity and transparency.

(ix) Public communication activities are a key component of the IT frameworks, with focus on explaining policy issues and decisions, and, in general, more openness about central bank operations. The most common approach for the IT central banks is to provide a statement of 1–2 pages, describing the policy decision simply and precisely. Once per quarter, the policy statement is usually supplemented by the publication of an inflation report like document, providing a comprehensive review of economic and financial developments and the implications for inflation pressures and monetary policy.

(x) Finally, the accountability of the central bank is also important in an IT framework. The main accountability mechanisms include publication of regular inflation or monetary policy reports, special reports or open letters in the event of significant misses of the target, publishing minutes of policy meetings within a reasonable timeframe, and monitoring by the executive or legislature. In many countries, the central bank's reporting to the public on its policy decisions and actions goes far beyond what is formally required under the law or an inflation targeting agreement, aimed at the public at large.

Reference

Heenan, G., M. Peter and S. Roger (2006), "Implementing Inflation Targeting: Institutional Arrangements, Target Design and Communications", IMF Working Paper No.278.

improvement in inventory levels, increased perceptions of a possible fall in global oil demand led by the slowdown of the US economy, easing of tension over Iran's nuclear programme and warm winter weather. Prices, however, rebounded in the last week of January 2007 on the back of renewed winter demand and production cuts by the Organisation of Petroleum Exporting Countries (OPEC). The OPEC reduced crude oil production by 1.2 million barrels per day (mb/d) effective

Box I.10
Petroleum Product Prices and Subsidies : Cross-country Experience

Following the sharp increase in international crude oil prices, many countries have raised domestic prices of various fuel products; however, the increase in domestic fuel prices has been less than the rise in crude oil prices. According to a recent IMF study, which examined the pass-through in a sample covering 51 developing and emerging market economies (EMEs), the pass-though was found to be complete in only half of the surveyed countries. The survey examined pass-through in respect of three major products, *viz*., gasoline, diesel and kerosene over the period December 2003 to the second quarter of 2006.

In the case of gasoline, 26 countries (out of 44 countries surveyed), fully or more than fully passed on the increase in import prices, with the average pass-through ratio for the sample being 0.96. In some cases such as Turkey, the increase in domestic prices was higher than the increase in crude oil prices, reflecting the increase in excise taxes. In general, the pass-through was lower in net oil exporting countries (averaging 0.46) than in net oil importing countries (averaging 1.09); the smallest pass-through took place in Lebanon, Bangladesh, Argentina, Egypt and Azerbaijan, where retail fuel prices were either reduced or only slightly increased from 2003. Similarly, for diesel and kerosene, about half of the countries surveyed (39 countries in the case of diesel and 29 countries for kerosene) fully passed on the increase. The pass-through was found to be the lowest in the case of kerosene, averaging 0.83, largely reflecting the relative importance in the consumption basket of poor households. In two countries in the sample (India and Congo), kerosene prices were unchanged over the sample period.

Domestic fuel prices were found to have been liberalised in 15 countries. In some countries, while there are no direct price controls, fuel prices remained broadly unchanged over the study period, reflecting informal price agreements with private companies, backed by taxes on fuel exports to divert supply to the domestic market. In some cases, the pass-through has also been limited due to lowering of fuel taxes or cutting refinery margins. In the face of large increase in international prices, automatic adjustment mechanisms in domestic prices were suspended in seven countries. In contrast, Ghana moved from *ad hoc* price adjustments to an automatic mechanism and Turkey adopted a fully liberalised pricing regime.

The fiscal support can be both explicit and implicit. Explicit subsidies - the compensation provided to the national energy companies for difference between the wholesale domestic price and the world price of fuels - ranged from 0.1 per cent of GDP (Lebanon) to 8.5 per cent of GDP (Yemen) in 2006; such subsidies averaged 1.5 per cent of GDP for 16 countries. Implicit subsidies - costs borne by oil producing companies (when domestic prices are not raised) and revenues forgone from the tax exemptions provided to oil products - ranged from 0.3 per cent (the Dominican Republic) to 10.4 per cent of GDP (Azerbaijan), averaging 3.9 per cent of GDP in six countries. Some countries provide both explicit and implicit fuel subsidies. The combined subsidy was estimated to be 12.3 per cent of GDP in Azerbaijan and 7.9 per cent of GDP in Bolivia.

The benefits of subsidies, however, generally accrue more to the richer people in view of their significantly higher consumption. Illustratively, in Venezuela, the richest 20 per cent of the population is estimated to have received six times more in fuel subsidy per person than the poorest third of the population. Furthermore, subsidies can lead to continued inefficiency in the use of fuel. Thus, a phased increase in domestic prices to bring them at par with international prices, making subsidies explicit, and combining reductions in subsidies with measures to protect the poorest could be helpful.

Reference

Baig T., A. Mati, D. Coady, and J. Ntamatungiro (2007), “Domestic Petroleum Product Prices and Subsidies: Recent Developments and Reform Strategies”, IMF Working Paper No.71.

November 1, 2006 and by a further 0.5 mb/d effective February 1, 2007 to balance supply and demand to support prices. Prices increased to around US $ 65 a barrel in April-May 2007 following tensions over Iran’s detention of British naval personnel and unrest in Nigeria. Prices increased further to touch US $ 78 a barrel at end-July 2007 and eased somewhat thereafter. The increase in domestic prices of petroleum products in many developing and emerging market economies has been lower than the increase in international crude oil prices (Box I.10).

I.3.32 Metal prices rose further during 2006-07 on the back of robust demand and supply constraints amidst speculative investor interest. Although metals witnessed some correction during June-July 2006, metal prices (as measured by the World Bank’s index of metals and minerals prices) were 35 per cent higher in March 2007 (year-on-year) led by lead, nickel and tin. International steel prices, on the other hand, declined during the year (Table 1.31).

I.3.33 Food prices firmed up led by wheat and edible oils on reports of shortfalls in production,

Table 1.31: International Commodity Prices

Commodity	Unit	2004	2005	2006	2007 March	Variation (Per cent) (March 2007 over March 2006)
1	2	3	4	5	6	7
Energy						
Coal	$/mt	53.0	47.6	49.1	55.4	11.4
Crude oil (Average)	$/bbl	37.7	53.4	64.3	60.6	-0.5
Non-Energy Commodities						
Palm oil	$/mt	471.3	422.1	478.4	622.0	41.4
Soybean oil	$/mt	616.0	544.9	598.6	718.0	33.2
Soybeans	$/mt	306.5	274.7	268.6	322.0	25.8
Rice	$/mt	237.7	286.3	304.9	318.7	5.0
Wheat	$/mt	156.9	152.4	192.0	199.1	14.2
Sugar	c/kg	15.8	21.8	32.6	23.0	-39.5
Cotton A Index	c/kg	136.6	121.7	126.7	128.7	-0.5
Aluminium	$/mt	1716.0	1898.0	2570.0	2762.0	13.7
Copper	$/mt	2866.0	3679.0	6722.0	6452.0	26.4
Gold	$/toz	409.2	444.8	604.3	654.9	17.6
Silver	c/toz	669.0	734.0	1157.0	1316.0	26.8
Steel cold-rolled coil/sheet	$/mt	607.1	733.3	693.8	650.0	-13.3
Steel hot-rolled coil/sheet	$/mt	502.5	633.3	600.0	550.0	-15.4
Tin	c/kg	851.3	738.0	878.0	1389.0	74.9
Zinc	c/kg	104.8	138.1	327.5	327.1	35.3
Memo:						
Non-fuel Commodities Index	1990=100	107.4	121.9	151.9	166.9	18.9
Food Index	1990=100	110.0	109.9	120.6	130.7	9.3
Metals and Minerals Index	1990=100	112.4	142.5	215.0	244.8	35.5

$: US dollar. c: US cent. bbl: barrel. mt: metric tonne. kg: Kilogram. toz: toy oz.
Source : The World Bank.

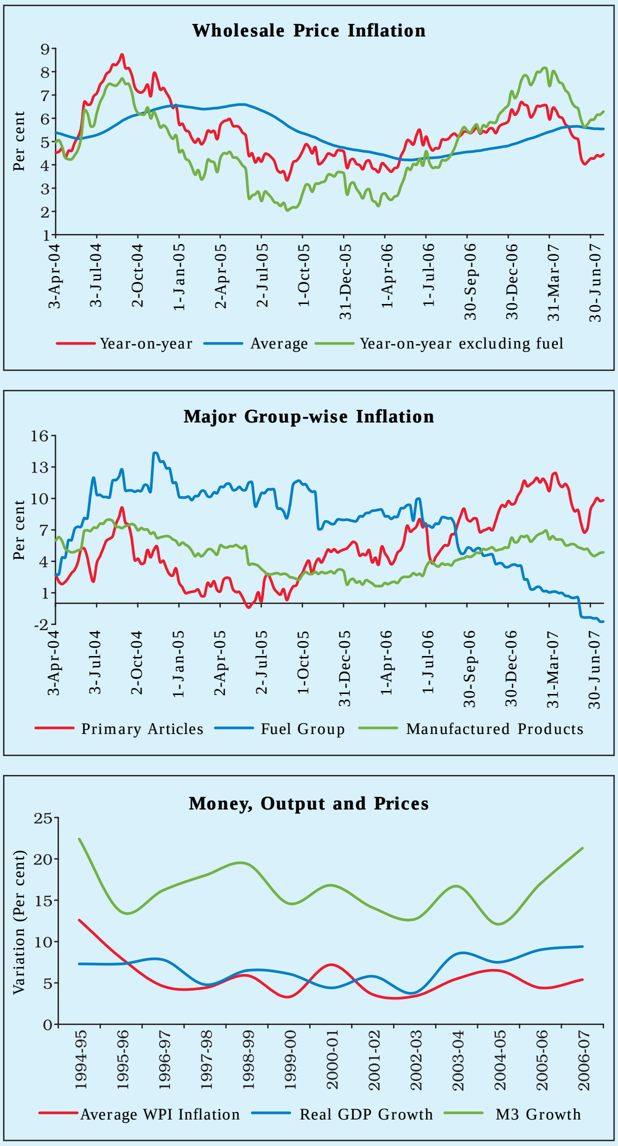
decline in stocks and increased demand for non-food uses. Global wheat prices reached an intra-year high of US $ 212 a tonne in October 2006 in view of depletion in stocks (estimated to fall by about 16 per cent to 125 million tonnes by the end of 2006-07 season, the lowest since 1981-82). Global wheat prices moderated to US $ 199 a tonne by March 2007 but were still higher by about 14 per cent on a year-on-year basis. Prices of oilseeds and edible oils edged up sharply in the second half of 2006-07, *inter alia*, due to lower production coupled with strong demand for non-food uses such as fuels and as feedstock for bio-diesel production. On a year-on-year basis, soybeans, soybean oil and palm oil prices in March 2007 were higher by 26 per cent, 33 per cent and 41 per cent, respectively. On the other hand, international sugar prices eased significantly from August 2006 on forecasts of higher global production during 2006-07. Sugar prices in March 2007 were 39.5 per cent lower than a year ago. Global cotton prices were largely range-bound during 2006-07. Overall, food prices (as measured by the World Bank's index of food prices) were 9 per cent higher in March 2007 (year-on-year).

INFLATION CONDITIONS IN INDIA

Wholesale Price Inflation

I.3.34 Headline inflation in India, based on movement in the wholesale price index (WPI), rose to 5.9 per cent as on March 31, 2007, year-on-year, from 4.0 per cent a year ago (Chart I.12). The increase in inflation reflected supply pressures emanating from higher primary articles prices as well as demand pressures amidst strong growth. Headline inflation moved in a range of 3.7-6.7 per cent during 2006-07. Inflation generally remained within the Reserve Bank's indicative projection of 5.0-5.5 per cent up to November 11, 2006 but exceeded the upper band during the remaining part of the year. Inflation remained above 6.0 per cent during the period January 6, 2007 and March 24, 2007. Reflecting the intra-year movement of inflation, the average WPI inflation rate (average of the 52 weeks) increased to 5.4 per cent

Chart I.12: Inflation Movements



from 4.4 per cent a year ago (Appendix Table 23). The y-o-y inflation, excluding the fuel group, at 7.4 per cent was above the headline inflation rate of 5.9 per cent as on March 31, 2007. In order to anchor inflation expectations to sustain the growth momentum, the Reserve Bank continued with pre-emptive monetary measures during 2006-07 including increase in the repo and the reverse repo rates as well as the cash reserve ratio (see Chapter III for details).

I.3.35 Among the major groups, prices of primary articles exerted upward pressure on inflation during 2006-07, reflecting shortfalls in domestic supply of major agricultural crops (see Table 1.3) amidst elevated international prices. Wheat, pulses, milk, oilseeds and raw cotton were the major drivers of primary articles inflation. While prices of wheat rose, year-on-year, by 7.3 per cent as on March 31, 2007, those of pulses edged higher by 12.5 per cent (on top of 33.3 per cent increase a year ago). Prices of oilseeds witnessed a sharp turnaround - an increase of 31.6 per cent, y-o-y, as against a decline of 9.2 per cent a year ago. Raw cotton prices increased by 21.9 per cent, y-o-y, as on March 31, 2007 in contrast to a marginal decline in global prices. Overall, prices of primary articles, on a y-o-y basis, increased by 10.7 per cent (4.8 per cent a year ago), the highest rate of increase in the past decade (Tables 1.32 and 1.33).

I.3.36 In order to contain the price rise in primary commodities, the Government undertook a number of fiscal and supply side measures such as (i) allowing the State Trading Corporation (STC) to tender overseas for 5.5 million tonnes of wheat to supplement domestic availability; (ii) permitting private traders to import wheat initially at 5 per cent duty from June 27, 2006 and subsequently at zero duty from September 9, 2006; (iii) allowing import of pulses at zero duty from June 8, 2006 and a ban on their exports from June 27, 2006; (iv) exempting sugar from customs duty from June 22, 2006 and a ban on its exports; (v) allowing imports of maize at zero duty in February 2007; (vi) reducing the customs duty on palm oils by 10 percentage points each in August 2006 and April 2007, and by another 5 percentage points in July 2007, and on crude palm oil, sunflower oil and refined sunflower oil by 10 percentage points each in January 2007.

I.3.37 Fuel group inflation, which had dominated the inflation outcome during the preceding two years, eased significantly during the second half of the year to reach its lowest rate in over a decade. Fuel group inflation initially rose from 8.3 per cent as on April 1, 2006 to an intra-year peak of 9.9 per cent on June 17, 2006 but moderated to 1.0 per cent by March 31, 2007 reflecting the base effect as well as cuts in prices of petrol, diesel and other fuel products. Domestic prices of petrol and diesel were initially raised by Rs.4 and Rs.2 per litre, respectively, in June 2006; subsequently, these were reduced by Rs.2 per litre (around 4 per cent) and Re. 1 per litre (around 3 per cent), respectively, on November 29, 2006 and, by a similar order again, effective February 15, 2007. However, the pass-through remains incomplete, especially in the case of kerosene oil and LPG whose prices have remained unchanged since April 2002 and November 2004, respectively. Apart from reduction in customs duty on petrol and diesel to 7.5 per cent from 10.0 per cent in June 2006, the Government also