II ASSESSMENT AND PROSPECTS

ASSESSMENT OF 2006-07

II.1 During 2006-07, the Indian economy exhibited acceleration in growth, led by manufacturing and services sector activities. The sustained high growth since 2003-04 has been supported by increase in domestic savings and investment. Robust growth during 2006-07, however, was accompanied by inflationary pressures on account of capacity constraints in certain sectors, strong growth in monetary and credit aggregates, demand-supply gaps in domestic production of foodgrains and oilseeds, and firm global commodity prices. A series of timely and appropriate measures undertaken by the Reserve Bank, and other supply side responses to rising prices made by the Government helped to contain headline inflation. More importantly, the measures facilitated the anchoring of inflationary expectations to a certain extent. Strong growth in general and of the industrial sector in particular enabled the corporate sector to maintain high profitability. This, in turn, resulted in buoyant tax collections and played a major role in improving public finances. The growth process was facilitated by financial market conditions, which remained orderly, barring a few episodes of volatility. However, interest rates in various segments of the financial market hardened to some extent. Strong growth led to a widening of the trade deficit. Nonetheless, the current account deficit, as per cent of GDP, remained unchanged from the previous year since the widening of the merchandise trade deficit was offset to a large extent by the continuing buoyancy in net invisibles surplus. Large capital flows led by external commercial borrowings and net foreign direct investment (FDI) inflows resulted in large accretion to foreign exchange reserves.

II.2 The Indian economy recorded robust growth for the fourth successive year during 2006-07. Real GDP growth accelerated from 9.0 per cent during 2005-06 to 9.4 per cent during 2006-07. The growth, thus, averaged 8.6 per cent per annum during the four-year period ended 2006-07. Real GDP growth during the Tenth Five Year Plan period averaged 7.6 per cent per annum, the highest in any Plan period. Acceleration in the growth rate during 2006-07 was attributable to buoyancy in the industrial and services sectors, which exhibited double-digit growth (11.0 per cent each), since higher growth in the industrial and services sectors more than offset the deceleration in the agricultural sector.

II.3 Growth in the agricultural sector decelerated from 6.0 per cent in 2005-06 to 2.7 per cent in 2006-07, partly on account of uneven rainfall during the South-West monsoon and also the base effect reflecting high growth in 2005-06. Although the overall foodgrains production rose by 3.6 per cent in 2006-07, the production of major crops still did not reach the previous peak touched in 2001-02. Amongst the major crops, the production of rice, wheat and pulses during 2006-07 was below the peaks reached in 2001-02, 1999-2000 and 1998-99, respectively. The stagnation in the production of major foodgrains and decline in stocks amidst firming up of global prices led to a significant hardening of domestic food prices during 2006-07. Amongst the non-foodgrains, the production of sugarcane and cotton scaled new peaks during 2006-07, while that of oilseeds declined.

II.4 The industrial upturn that started in April 2002 maintained its momentum during 2006-07. Based on the index of industrial production, industrial growth accelerated from 8.2 per cent in 2005-06 to 11.5 per cent in 2006-07, the highest growth achieved over the past decade. The growth led by the manufacturing sector (12.5 per cent) was broad-based. In terms of use-based classification, all sectors, except consumer goods, exhibited acceleration in growth. The production of capital goods remained buoyant with growth of 18.2 per cent indicative of robust investment demand. The basic goods and intermediate goods sectors also recorded higher growth during 2006-07. The growth of core infrastructure industries at 8.6 per cent during 2006-07 has been the highest since 1999-2000 (9.1 per cent).

II.5 The services sector with double-digit growth for the third successive year consolidated its position as the key driver of economic activity in the country. The services sector accounted for 61.8 per cent of GDP in 2006-07 and contributed nearly three-fourths to the overall real GDP growth during the year. The services sector benefited from the robust growth in domestic tourism, foreign tourist arrivals, telecom sector, railways traffic, civil aviation, cargo handled, construction, business process outsourcing (BPO), information technology enabled services (ITES), and banking and insurance activity.

II.6 The strengthening of economic activity in recent years has been supported by a steady upward trend in domestic savings and investment rates coupled with an efficient use of capital. The savings rate continued its upward trend from 23.5 per cent of GDP in 2001-02 to 32.4 per cent in 2005-06, while the investment rate rose from 22.9 per cent to 33.8 per cent over the same period. Data for 2006-07 suggest continuation of these trends, with the rate of gross fixed capital formation increasing by 1.4 percentage points to 29.5 per cent of GDP from 28.1 per cent in 2005-06.

II.7 The sustained economic growth since the early 1990s has also been associated with a significant reduction in poverty. The proportion of people living below the poverty line (based on uniform recall period) declined from 36.0 per cent in 1993-94 to 27.8 per cent in 2004-05. There is also evidence of pick-up in employment growth (based on usual principal status) from 1.57 per cent per annum (1993-94 to 1999-2000) to 2.48 per cent (1999-2000 to 2004-05). The annual growth in employment (2.48 per cent) was, however, marginally lower than that of the labour force (2.54 per cent) during 1999-2000 to 2004-05. As a result, the unemployment rate rose from 2.78 per cent in 1999-2000 to 3.06 per cent in 2004-05.

II.8 Growth in money supply (M_3) accelerated from 17.0 per cent during 2005-06 to 21.3 per cent during 2006-07. Amongst the major components, time deposits exhibited a higher growth during 2006-07 which could be attributed to factors such as higher interest rates on bank deposits and availability of tax benefits under Section 80C for bank deposits of appropriate maturity. On the sources side, growth of bank credit remained high, although there was some moderation from the previous two years. Demand for bank credit was largely broad-based with agriculture, industry and personal loans sectors absorbing 14 per cent, 36 per cent and 24 per cent, respectively, of the incremental expansion in overall non-food credit during 2006-07. Growth of credit to sectors such as real estate remained high, *albeit* with some moderation. In order to maintain asset quality, the Reserve Bank further tightened the provisioning requirements and risk weight prescriptions in respect of sectors witnessing high growth in credit. Commercial banks' SLR investments, as a proportion of their net demand and time liabilities (NDTL), declined further to 28.0 per cent by end-March 2007 (close to the prescribed ratio of 25 per cent) as the expansion in investments did not keep pace with the expansion in the NDTL. Net foreign assets (NFA) remained the key driver of reserve money and the Reserve Bank continued to modulate market liquidity through operations under the liquidity adjustment facility (LAF), issuance of securities under the market stabilisation scheme (MSS) and use of the cash reserve ratio (CRR).

II.9 Headline inflation firmed up from 4.0 per cent, y-o-y, on April 1, 2006 to 5.9 per cent on March 31, 2007 with an intra-year high of 6.7 per cent on January 27, 2007 and a low of 3.7 per cent on April 15, 2006. Both demand and supply side factors added to inflationary pressures during 2006-07. Supply side pressures emerged from higher food prices due to demand-supply gaps in domestic foodgrains and oilseeds production amidst rising global prices. Consumer price inflation rose from 4.9-5.3 per cent in March 2006 to 6.7-9.5 per cent in March 2007, mainly reflecting the impact of higher food prices. In order to contain inflation and to stabilise inflationary expectations, the Reserve Bank persevered with the policy of pre-emptive actions and gradual withdrawal of monetary accommodation, using various instruments at its disposal flexibly. Since the second half of 2004, the repo and the reverse repo rates have been increased by 175 basis points and 150 basis points, respectively. In addition, the cash reserve ratio has been raised by 250 basis points. The Government also took various fiscal and supply-side measures to contain inflation during the latter part of 2006-07.

II.10 The Central Government's provisional accounts for 2006-07 reflected the Government's commitment of staying on course with the path of fiscal correction under the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004. Gross fiscal deficit (GFD) and revenue deficit (RD), as ratios to GDP, at 3.5 per cent and 1.9 per cent, respectively, in 2006-07 (provisional accounts) were lower by 0.6 percentage point and 0.7 percentage point in comparison with 2005-06. The fiscal corrections, thus, turned out to be higher than the respective minimum reductions of 0.3 percentage point and 0.5 percentage point stipulated per year under the FRBM Rules, 2004, thereby partly compensating for the pause taken in 2005-06. Furthermore, the provisional accounts showed a primary surplus during 2006-07, reflecting containment of non-interest expenditure below the non-debt receipts. For the first time since 1970-71 (the period for which such data are readily available), primary surpluses were recorded in 2004-05 and again in 2006-07. If this trend continues in the coming years, it will help in stabilising and then reducing the debt/GDP ratio. The reduction in deficit indicators was enabled by buoyant revenue growth, reflecting both cyclical and structural factors that have resulted in higher economic growth, and improved expenditure management. The gross tax/GDP ratio maintained its upward trend and reached 11.5 per cent in 2006-07 (provisional accounts). Expenditure management efforts focused on moderating non-plan expenditure, while increasing plan expenditure. However, capital outlay continued to be low at around 1.4 per cent of GDP.

II.11 The consolidated fiscal position of the State Governments during 2006-07 (revised estimates) reflected the progress made by the States towards fiscal correction and consolidation.The consolidated revenue deficit was placed at 0.03 per cent of GDP in 2006-07 (revised estimates). In all, 17 States (including NCT Delhi) reported revenue surplus during the year. The correction in the revenue account was facilitated by buoyant own tax revenues of the States, aided by implementation of Value Added Tax (VAT) and higher devolution and transfers from the Centre consequent to the implementation of the recommendations of the Twelfth Finance Commission (TFC). The increase in revenue receipts more than compensated for the increase in revenue expenditure. The sustainability of this positive trend will depend upon the continued growth in States' own tax efforts over a period of time. The State Governments stepped up capital outlays, especially for education, rural and infrastructure development, which translated into GFD exceeding the budget estimates. A number of State Governments managed to bring down the ratio of GFD to Gross State Domestic Product (GSDP) to less than 3 per cent, two years ahead of the targets of the TFC. The State Governments continued to draw comfort from the accruals under the National Small Savings Fund (NSSF), notwithstanding some moderation in the accruals during 2006-07. Most of the State Governments continued to maintain high level of surplus cash balances. Consequently, the recourse to Ways and Means Advances (WMA) was low.

II.12 Financial markets remained orderly during 2006-07, barring some episodes of volatility, especially during the second half of March 2007. Capital inflows and movements in Government cash balances continued to be the key drivers of liquidity conditions and overnight interest rates. Interest rates in the various market segments hardened during the year, broadly in tandem with the pre-emptive monetary tightening measures taken by the Reserve Bank. By and large, the exchange rate of the Indian rupee exhibited two-way movement with respect to the main reserve currencies during 2006-07. The stock markets remained buoyant, with the benchmark indices reaching record highs during 2006-07, amidst intermittent corrections. The primary segment of the capital market also exhibited buoyant conditions.

II.13 India's balance of payments in 2006-07 reflected a number of positive features. Merchandise trade continued to exhibit robust growth during 2006-07, although there was some loss of pace from the strong growth of 2005-06. Based on the DGCI&S data, merchandise exports and imports expanded by 22.5 per cent and 27.8 per cent, respectively, during 2006-07, building upon the high growth phase that began in 2002-03. Export and import growth averaged 23.6 per cent and 30.2 per cent, respectively, during the five-year period ended 2006-07. On the import side, oil imports remained the largest component of imports in 2006-07 (29.9 per cent of total imports). Growth in oil imports during 2006-07 was on account of both volume and price changes. Non-oil imports continued to record strong growth in tandem with economic activity. Reflecting the growing integration with the global economy, import intensity (imports-GDP ratio) increased to 20.9 per cent in 2006-07 from 18.5 per cent in 2005-06. The higher growth of imports *vis-a-vis* exports led to a persistent rise in the trade deficit, on a balance of payments basis, from US $ 10.7 billion in 2002-03 to US $ 64.9 billion in 2006-07. The trade deficit, as a percentage of GDP, widened from 2.1 per cent in 2002-03 to 7.1 per cent in 2006-07. However, the spill over of the widening trade deficit to the current account was contained by robust growth in exports of services, led by software and other business services, and remittances from overseas Indians. Gross invisible receipts are fast catching up with the level of merchandise exports. Net surplus under invisibles at 6.0 per cent of GDP during 2006-07 offset a substantial part of the trade deficit. The current account deficit at 1.1 per cent of GDP during 2006-07 was the same as in 2005-06.

II.14 Net capital flows to India remained buoyant at US $ 45 billion or 4.9 per cent of GDP, far exceeding the current account deficit. Higher capital flows could be attributed to the strengthening of macroeconomic fundamentals, greater investor confidence and ample global liquidity. Both debt and non-debt flows witnessed a large increase during 2006-07. Direct investment flows showed a strong bi-directional movement. Net FDI inflows to India increased sharply from US $ 7.7 billion during 2005-06 to US $ 19.4 billion during 2006-07, while net FDI outflows increased from US $ 2.9 billion to US $ 11.0 billion.

Hence, FDI flows (net) at US $ 8.4 billion exceeded FII inflows (net) of US $ 3.2 billion during 2006-07. The debt flows (net) at US $ 25.0 billion were led by external commercial borrowings reflecting strong demand for capacity expansion, greater risk appetite of global investors for emerging market bonds and further liberalisation of the policy framework. Net capital flows, after financing the current account deficit, led to accretion of US $ 36.6 billion, excluding valuation changes, to foreign exchange reserves during 2006-07. While the stock of external debt rose during 2006-07, net international liabilities of the country declined reflecting a large increase in foreign exchange reserves.

II.15 Although the current account deficit has remained modest, averaging one per cent of GDP since the early 1990s, the integration of the Indian economy with the global economy has increased significantly over the same period. This can be seen in the steady rise in the current receipts-GDP ratio from around 8 per cent in 1990-91 to 27 per cent in 2006-07. Over the same period, current receipts and current payments combined together increased from 19 per cent to 55 per cent. Gross capital inflows and outflows constituted 45 per cent of GDP in 2006-07 as compared with only 12 per cent in 1990-91.

II.16 To sum up, the Indian economy witnessed acceleration in growth during 2006-07 led by manufacturing and services sector activities, extending the current phase of high growth that began in 2003-04. Growth in agricultural production, however, decelerated with the agriculture sector characterised by stagnation in output of major foodgrains. Both structural and cyclical factors contributed to the acceleration in growth of the Indian economy during 2006-07. The step-up in investment and domestic savings rates, growing linkages with the global economy, both on the trade and capital accounts, and signs of some improvement in productivity growth are the key structural changes that have provided support to economic activity in recent years. Several cyclical factors have also boosted domestic growth. These include: (i) robust global GDP growth for the fourth successive year; (ii) the persistent high growth in bank credit and money supply; (iii) the pick-up in non-oil import growth and the widening of the trade deficit in recent years. Cyclical forces were also evident in the steady increase in prices of manufactures, resurgence of pricing power among corporates, indications of wage pressures in some sectors, high level of capacity utilisation and elevated asset prices.

OUTLOOK FOR 2007-08

II.17 According to the latest forecast by the India Meteorological Department, the rainfall during the South-West monsoon season (June-September) is likely to be 93 per cent of the normal rainfall, with a model error of +/- 4 per cent. The cumulative rainfall during the season so far (up to August 8, 2007) has been 7 per cent above normal, *albeit* uneven in terms of temporal and spatial distribution. As on August 2, 2007, the total live water storage in 78 major reservoirs was 59 per cent of the full reservoir level (FRL); this was higher than that of 47 per cent last year and the average of 36 per cent for the past ten years. Sowing under *kharif* crops is picking up and as of August 3, 2007, 78.6 per cent of normal area had been sown (about 4.2 per cent higher than a year ago).

II.18 Industrial production remained buoyant during April-June 2007, led by manufacturing activity. Industrial production expanded by 11.0 per cent during April-June 2007 (10.5 per cent a year ago) on the back of 11.9 per cent growth in the manufacturing sector. In terms of use-based classification, basic, capital and consumer goods sectors exhibited accelerated growth. Growth of intermediate goods sector, however, decelerated. The growth of infrastructure industries was 6.9 per cent during April-June 2007 as compared with 7.4 per cent during April-June 2006.

II.19 Available information on lead indicators of service sector performance presents a mixed picture. Growth in tourist arrivals, revenue earning freight traffic of the railways, new cell phone connections, export cargo handled by civil aviation, passengers handled by civil aviation, cement, steel and banking aggregates moderated during April-June 2007. On the other hand, cargo handled at major ports and import cargo handled by civil aviation accelerated *vis-à-vis* the previous year.

II.20 Global economic activity in 2007 so far has remained buoyant, notwithstanding continuing weakness in the US economy. Robust growth in advanced economies other than the US and major emerging economies provided support to global growth. According to the estimates by the International Monetary Fund (IMF) (released in July 2007), global growth is likely to moderate from 5.5 per cent in 2006 to 5.2 per cent each in 2007 and 2008. Growth in the world trade volume is also expected to decelerate from 9.4 per cent in 2006 to 7.1 per cent in 2007 and 7.4 per cent in 2008.

II.21 Strong global growth since 2003 onwards and the growing integration of the Indian economy with the global economy have provided a boost to export demand and domestic economic activity. The emergence of protectionist pressures, further rise in oil prices, persisting global imbalances, adjustment in the US on account of housing slowdown and potential shifts in financial market sentiment pose downward risks to global growth prospects. These risks, if materialise, could have some adverse impact on the domestic economy. In particular, global financial market could turn volatile with attendant implications for EMEs like India. Conditions in the sub-prime mortgage sector in the US have deteriorated significantly as reflected in the rise in delinquencies on adjustable-rate loans. Further deterioration in sub-prime delinquencies could lead to reassessment of risk by investors across products and markets and retrenchment of capital from the emerging market economies (EMEs), given the contagion and herd mentality. The volatility in capital flows could be exacerbated by the growing dominance of players such as hedge funds in the volume of cross-border flows. Furthermore, private equity funds have emerged as a key source of capital flows to the EMEs. Such flows are sensitive to interest rate changes. Therefore, any further monetary tightening in major economies and reassessment of risks by investors has the potential to accentuate volatility in global financial markets, and adversely impact growth and stability in the EMEs.

II.22 Expansion of money supply (y-o-y) as on August 3, 2007 (21.7 per cent) was higher than a year ago (19.3 per cent) and also higher than the indicative projection of 17.0-17.5 per cent set out in the Annual Policy Statement. Growth in aggregate deposits accelerated, led by time deposits. Bank credit witnessed some deceleration from the strong pace of the preceding three years. Growth of non-food credit of scheduled commercial banks was 23.6 per cent, y-o-y, as on August 3, 2007 as compared with 32.5 per cent a year ago. Commercial banks' investments in SLR securities, as per cent of their NDTL at 28.6 per cent were marginally higher than those at end-March 2007, but below those of 31.1 per cent a year ago. Growth of reserve money as on August 10, 2007 at 26.9 per cent (19.6 per cent adjusted for the first round impact of the increase in the CRR) was higher than a year ago (17.2 per cent) and much beyond the trend growth mainly on account of high increase in bankers' deposits with the Reserve Bank due to CRR increases during last one year which were backed by accretion to the Reserve Bank's NFA.

II.23 Headline inflation, based on movements in the wholesale price index (WPI), moderated to 4.1 per cent on August 4, 2007 from 5.9 per cent at end-March 2007 and 5.1 per cent a year ago. Inflation for all the three sub-groups of the WPI eased from their end-March levels. Fuel group inflation y-o-y turned negative (-2.1 per cent) reflecting cuts in domestic prices during November 2006 and February 2007. International crude oil (average) prices have, however, increased by around 28 per cent up to July 2007 from February 2007, when domestic prices were cut last. Non-oil global commodity prices also remain firm led by food items and metals. Various measures of consumer price inflation were placed lower in June 2007 (5.7-7.8 per cent) than those in March 2007 (6.7-9.5 per cent). However, consumer price inflation continued to exceed wholesale price inflation, mainly on account of higher food prices. Although inflation has eased since end-March 2007, inflationary pressures could potentially persist for several reasons. There are concerns regarding further hardening of international commodity prices, in particular, oil prices. Moreover, the possibility of inflationary pressures from domestic factors such as strong growth in monetary aggregates, elevated asset prices and large capital flows with implications for domestic liquidity conditions need to be recognised. Accordingly, a continuous vigil supported by appropriate policy actions by all concerned would be needed to maintain price stability so as to anchor inflationary expectations on a sustained basis.

II.24 For monetary policy purposes, the Reserve Bank, in its Annual Policy Statement (April 2007), placed real GDP growth for 2007-08 at around 8.5 per cent, assuming no further escalation in international crude oil prices and barring domestic or external shocks. In view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming that supply management would be conducive, capital flows would be managed actively and in the absence of shocks emanating in the domestic or global economy, the Statement noted that the policy endeavour would be to contain inflation close to 5.0 per cent in 2007-08. The Reserve Bank in its First Quarter Review of the Annual Statement of Monetary Policy in July 2007 retained its projection of real GDP growth at around 8.5 per cent, barring domestic and external shocks. Assuming that aggregate supply management will continue to receive public policy attention and that a more active management of the capital account will be demonstrated, the outlook for inflation in 2007-08 in the First Quarter Review remained unchanged.

Accordingly, it was indicated in the Review that holding headline inflation within 5.0 per cent in 2007-08 assumes priority in the policy hierarchy; while reinforcing the medium-term objective to condition policy and perceptions to reduce inflation to 4.0-4.5 per cent on a sustained basis.

II.25 The stance of monetary policy in 2007-08, as the Annual Policy Statement observed, would be conditioned by the patterns in which the global and, more particularly, the domestic environment unfold. The likely evolution of macroeconomic and financial conditions indicates an environment supportive of sustaining the current growth momentum in India. Monetary policy, while contributing to growth, has to ensure and maintain conditions of price and financial stability. Accordingly, the policy preference for the period ahead was articulated strongly in favour of reinforcing the emphasis on price stability and anchoring inflation expectations. The Reserve Bank in its First Quarter Review of the Annual Statement on Monetary Policy in July 2007 observed that monetary policy in India would continue to be vigilant and proactive in the context of any accentuation of global uncertainties that posed a threat to growth and stability in the domestic economy. The domestic outlook continues to be favourable and would dominate the dynamic setting of monetary policy in the period ahead. It is important to design monetary policy such that it protects growth by contributing to the maintenance of stability. Accordingly, while the stance of monetary policy would continue to reinforce the emphasis on price stability and well-anchored inflation expectations and thereby sustain growth momentum, contextually financial stability may assume greater importance in the months to come.

II.26 Both the Central and State Governments have proposed to further strengthen the fiscal consolidation process during 2007-08. The revenue deficit and the gross fiscal deficit of the Central Government are budgeted at 1.5 per cent of GDP and 3.3 per cent of GDP during 2007-08, 0.5 percentage point and 0.4 percentage point lower than 2006-07 (revised estimates). Available information for 2007-08 (April-June) indicates that revenue deficit declined by 2.9 per cent. The fiscal deficit [adjusted for the expenditure incurred on acquisition of the Reserve Bank's stake in State Bank of India (Rs.35,531 crore)] also declined by 1.1 per cent over the corresponding period of 2006. The reduction in deficit indicators was primarily on account of higher tax revenue and non-debt capital receipts. However, as per cent of full-year budget estimates (BE), the revenue deficit during April-June 2007 increased to 96.0 per cent from 83.4 per cent a year ago, while the adjusted fiscal deficit declined to 50.9 per cent from 52.3 per cent during the corresponding period of the previous year. During 2007-08 (up to August 10, 2007), gross and net market borrowings (including 364-day Treasury Bills) amounted to Rs.96,628 crore and Rs.56,047 crore, respectively. Gross and net borrowings amounted to 51.5 per cent and 50.6 per cent, respectively, of the full year estimates as compared with 47.2 per cent and 39.3 per cent a year ago. The weighted average maturity of dated securities issued during 2007-08 (up to August 10, 2007) at 14.32 years was higher than that of 13.21 years during the corresponding period of the previous year, while the weighted average yield increased to 8.23 per cent from 7.87 per cent.

II.27 The State Governments have budgeted a revenue surplus during 2007-08, which would facilitate a reduction in the GFD to 2.4 per cent of GDP from 2.8 per cent in 2006-07. The surplus in the revenue account would also enable enhancement in capital disbursements for the social and rural sectors in line with the priorities set out in the Eleventh Five Year Plan. Adoption of fiscal reform measures aimed at augmentation of revenue and containment of non-plan revenue expenditure has helped several State Governments to achieve the targets set by the TFC ahead of the recommended schedule. All States, except eight, have budgeted revenue surpluses during 2007-08, a year ahead of the TFC target. Furthermore, 12 States (five special category and seven non-special category) have budgeted for gross fiscal deficit at less than three per cent of their respective GSDP, two years ahead of the target. The State Governments have budgeted for a deceleration in both revenue receipts and expenditure during 2007-08, after a sharp increase in the previous year. The accruals to the NSSF would remain the major source of financing the GFD; their share would, however, come down on account of reduction in the obligatory share of the State Governments in the NSSF to 80 per cent as announced in the Union Budget 2007-08. The State Governments have continued to maintain high levels of cash surplus during 2007-08 so far, as reflected in their investments in Treasury Bills.

II.28 Financial markets have remained generally orderly during 2007-08 so far. Short-term interest rates have eased from end-March 2007 levels. The amount of liquidity absorbed through the reverse repo operations under the liquidity adjustment facility was limited to a maximum of Rs.3,000 crore each day in terms of the modified arrangements from March 5, 2007. Overnight interest rates continued to exhibit volatility reflecting the impact of movements in Government cash balances and capital flows on liquidity conditions. Subsequently, in view of the prevailing macroeconomic and overall monetary and liquidity conditions, the First Quarter Review of the Annual Statement on Monetary Policy for 2007-08 announced the withdrawal of the ceiling of Rs. 3,000 crore on daily reverse repo under the LAF and the withdrawal of the Second LAF with effect from August 6, 2007. Call rates reverted to within the reverse repo-repo corridor from the second week of August 2007. Long-term Government bond yields and banks' deposit and lending rates have hardened. The Indian rupee has appreciated *vis-à-vis* the US dollar and other major currencies from its end-March 2007 levels till May but depreciated thereafter. The stock markets have recorded gains during 2007-08 so far, even as they turned volatile in the second and third weeks of August 2007 mainly on account of problems in the US sub-prime mortgage market.

II.29 Growth in merchandise exports was lower during April-June 2007, while imports posted a higher growth during this period as compared with the corresponding period of the previous year. According to DGCI&S, merchandise exports increased by 17.9 per cent during April-June 2007 (23.5 per cent a year ago). Imports expanded by 34.2 per cent (18.9 per cent), led by non-oil imports (growth of 47.4 per cent as compared with 8.9 per cent). Growth in oil imports moderated, mainly reflecting the impact of international crude oil prices. The trade deficit widened to US $ 20.6 billion in April-June 2007 from US $ 11.8 billion in April-June 2006. The growth momentum in India's exports of software services and ITES-BPO, and other business services continues to be strong. The remittances from overseas Indian workers also remain an important stable source of financial inflows with a continuous transition to higher skill categories of Indian migrant workers.

II.30 Capital inflows during 2007-08 so far have been higher than those in the corresponding period of 2006-07, led by a significant turnaround in FII inflows (net) (an increase of US $ 10.1 billion) during 2007-08 (up to August 10, 2007) in contrast to outflows (of US $ 1.5 billion) a year ago. FDI flows were US $ 3.7 billion during April-May 2007 (US $ 1.2 billion during April-May 2006). There were, however, net outflows of US $ 0.6 billion during April-May 2007 under non-resident deposits as against net inflows of US $ 0.7 billion a year ago. Foreign exchange reserves rose by US $ 27.3 billion between end-March 2007 and August 17, 2007. The overall trade and current account deficits in 2007-08 are expected to be of the same order as in 2006-07. Net capital flows are also likely to adequately finance the expected current account deficit in 2007-08.

II.31 To sum up, available information so far indicates continuation of the growth momentum during 2007-08 so far at a strong pace with the impulses of growth getting more broad-based. Steady increases in the gross domestic saving and investment rates, consumption demand, addition of new capacity as well as more intensive and efficient utilisation/capitalisation of existing capacity are expected to provide support to growth during 2007-08. Despite some efforts to remove the supply constraints in infrastructure, the higher growth in demand is placing greater pressure for accelerated expansion of supply of infrastructure, resulting in the stretching of capacity utilisation in sectors such as electricity generation, roads, ports and major airports. Supply constraints emanating from shortfalls in agricultural performance, and physical and social infrastructure could constrain future growth while also exerting inflationary pressures. In this environment of demand-supply mismatches, inflation can emerge as the key downside risk to the evolving macroeconomic outlook. The recent gains in bringing down inflation and in stabilising inflation expectations should support the current expansionary phase of the growth cycle. It is, however, necessary to continuously assess the risks to the inflation outlook emanating from high and volatile international crude oil prices, the continuing firmness in key food prices and uncertainties surrounding the evolution of demand-supply gaps globally as well as in India.

II.32 Appropriate macroeconomic policies have to be in place to avoid risks of financial imbalances and recurrence of inflationary pressures while facilitating the growth momentum in an inclusive fashion. In this regard, policy priority needs to be accorded to: (a) removal of infrastructure constraints; (b) improving investment climate especially for domestic investors, in particular small and medium enterprises; (c) stepping up growth of agriculture, in particular, production of foodgrains to ensure food security; (d) strengthening of institutional and micro structural environment that enhances flexibilities, especially supply elasticities in the economy; and (e) fiscal empowerment, emphasising provision of education, health, water and sanitation along with an equitable tax structure. These are some of the critical elements that need attention to enable non-disruptive and optimal path of further liberalisation in the financial and external sectors. Indeed, the progress in these critical elements will help resolve the dilemmas that were faced in 2006-07 in terms of large rupee liquidity and excess capital flows in foreign currency.

REAL SECTOR

Agriculture

II.33 The recent upward trends in global prices of major food items have significant implications for the domestic agricultural sector and overall macroeconomic and financial stability. Global wheat prices in July 2007 were 52 per cent above the average prices prevailing during the calendar year 2004, while rice prices were 38 per cent higher. Prices of major edible oils increased by 44 to 71 per cent over the same period. In view of large dependency on edible oil imports (about 45 per cent of domestic consumption), the higher international prices coupled with diversion of acreage from oilseeds towards coarse cereals, especially maize as bio-fuel feed stock as alluded to earlier, could further exacerbate pressure on prices of edible oils. Sugar prices, notwithstanding substantial correction since the second half of 2006, were also higher by 42 per cent. Increases in global food prices reflected a shortfall in global production and the rising demand for non-food uses such as bio-fuels. According to the latest assessment by the US Department of Agriculture (USDA), world vegetable oils stocks were expected to fall by about 12 per cent during 2006-07 and by an additional 9 per cent during 2007-08. Although global wheat production is expected to increase by 2.9 per cent in 2007-08 (June-May), global wheat stocks are likely to decline further in 2007-08 to 114.8 million tonnes - the lowest levels since 1981-82. Furthermore, wheat, apart from oilseeds, is reportedly also being diverted for bio-fuels. Rice stocks are also expected to decline by about 5 per cent during 2007-08. Reflecting the sustained uptrend in major food prices, the food price index (compiled by the IMF) reached a 26-year high in June 2007 - the highest since the early 1981. Against the backdrop of these hardening trends in global food prices, there is an urgent need to take measures to accelerate the growth in Indian agriculture, especially food crops.

II.34 Although the share of agriculture in overall GDP has declined over the years from around 40 per cent in 1980-81 to less than a fifth in 2006-07, it continues to play an important role in the Indian economy. The proportion of the population dependent upon agriculture remains large (almost 60 per cent). Since the mid-1990s, however, the growth of the agricultural sector has been low as well as volatile; the growth decelerated from an annual average of 4.7 per cent per annum during the 1980s to 3.1 per cent during the 1990s and further to 2.2 per cent during the Tenth Plan period. Per capita annual production of cereals declined from 192 kilogram (kg) during 1991-95 to 174 kg during 2004-07 and that of pulses from 15 kg to 12 kg over the same period. Per capita availability of foodgrains has, thus, fallen close to the levels prevailing during the 1970s.

II.35 Volatility in agricultural production has not only implications for overall growth but also, as the experience of 2006-07 amply demonstrated, for maintaining low and stable inflation. Although domestic foodgrains production rose by 3.6 per cent in 2006-07, the production of major crops was still below the previous peaks. Demand-supply gaps were reflected in higher domestic food prices in 2006-07. The recent rise in international agriculture prices could potentially represent the beginning of a structural increase in prices, reflecting both demand and supply side factors. Demand pressures for food items could strengthen further in view of strong growth in emerging economies, particularly India and China, and the growing demand for animal proteins. The supply side pressures could emanate from diversion of corn and oilseeds to produce bio-fuel as energy substitute, exacerbated by tendencies towards global warming. The consequent impact of demand-supply mismatches on inflation perceptions and hence, on inflation expectations could be disproportionately large, perhaps even in the industrialised economies. Developments such as the increasing global financialisation of commodity markets pose additional challenges to public policy in managing food prices. According to a recent joint assessment by the OECD and the FAO, global prices of agricultural commodities are likely to rule higher than their historic equilibrium levels over the next ten years.

II.36 Thus, enhanced growth of the agricultural sector is vital for ensuring food security, poverty alleviation, price stability, overall inclusive growth and sustainability of growth of the overall economy. The Eleventh Plan envisages agricultural growth of 4 per cent per annum. In view of the Eleventh Plan's vision of faster, more broad-based and inclusive growth, reversing the deceleration in agricultural growth was placed on top of the agenda in the Union Budget 2007-08.

II.37 The reduction in agricultural growth since the mid-1990s could be attributed to stagnant/declining yields, which, in turn, reflect a variety of factors such as declining investment, lack of proper irrigation facilities, inadequate other infrastructural facilities, inadequate attention to R&D for developing high yielding varieties of seeds, absence of major technological breakthroughs, improper use of fertilisers/nutrients and institutional weaknesses. Public investment in agriculture declined from 3.4 per cent of agricultural GDP during 1976-80 to 2.6 per cent during 2005-06, while budgetary subsidies to agriculture increased from three per cent (1976-80) to seven per cent of GDP (2001-03). Given the budget constraint, higher subsidies come at the cost of higher investments. While subsidies may provide short-term benefits, they tend to hinder long-term investments which may yield more durable benefits to the agricultural and rural sectors. Subsidies also encourage inefficiency in the use of resources. For instance, the existing scheme of subsidy with regard to fertilisers encourages excessive use of nitrogen at the cost of other nutrients. Indian agriculture is becoming increasingly unsustainable both from the point view of overall economic progress and environmental balance. Intensive and concentrated input usage for some of the crops is causing salinity, water logging and ground water depletion with adverse implications of desertification of soil in the long-run. As noted by the Prime Minister[1], the weak performance of the agricultural sector can be attributed to four deficits, *viz.*, public investment and credit deficit, infrastructure deficit, market economy deficit and knowledge deficit. In this context, it is noteworthy that the National Development Council (NDC) in its 53rd meeting held on May 29, 2007 adopted a resolution to reorient agricultural development strategies to meet the needs of the farmers. The NDC called upon the Central and the State Governments to evolve a strategy to rejuvenate agriculture to achieve 4 per cent annual growth in the agricultural sector during the Eleventh Plan. Furthermore, the Central Government committed Rs. 25,000 crore for public investment in agriculture in the next four years.

II.38 In view of stagnation in the production of major foodgrains, there may be a need to refocus production efforts in alternative potential areas with suitable agro-climatic conditions, rather than the traditional areas, particularly in the case of rice and wheat. The closing of the substantial yield gaps that exist in the case of major crops amongst various States can increase the production of cereals and pulses. This would need intensive efforts to improve inputs such as timely availability of seeds and fertilisers, provision of irrigation facilities, and adequate availability of credit.

II.39 As Indian agriculture continues to be heavily dependent on the monsoon, the need for enhancing the irrigation potential to meet the growing water requirements of farmers and to impart stability to agricultural production and yield assumes greater emphasis. While there was an addition of 8.8 million hectares to the potential irrigated area during the Tenth Plan, it was only one half of the target. Nonetheless, there was no increase in irrigated area over the Plan period, partly because water use was more intense than planned and partly due to some existing irrigated area going out of the system due to poor maintenance/decay. In view of the diminishing scope for new large scale irrigation projects, greater focus may be needed on completing ongoing projects and on modernisation of the existing projects. The Government has revamped the Accelerated Irrigation Benefit Programme (AIBP) to complete more irrigation projects in the quickest possible time. A National Rainfed Area Authority has been established to coordinate all schemes relating to watershed development and other aspects of land use. As past efforts in terms of increased outlays have not yielded the expected/targeted results in terms of actual addition to the existing potential, greater emphasis needs to be placed on monitoring the ongoing projects and their timely completion to avoid time and cost overruns.

II.40 Greater focus needs to be placed on agricultural research in the coming years as the success so far has been restricted to select crops. Efforts to modernise and strengthen the agricultural research system, including the agricultural universities, need to be intensified. A growing disparity between the actual and the potential yields points to a crucial gap between research and extension. There is an urgent need to revive the extension system so that it is able to respond to the emerging demands of renewed agricultural growth. The public extension system needs to become more demand driven, with stronger synergies between public and private extension efforts. There is a need for a more regionally differentiated research strategy and greater co-ordination between the public and the private sectors. According to the estimates of the Planning

[1] Address by the Prime Minister at the 2nd Agricultural Summit (October 2006).

Commission, public expenditure on research would need to increase from the present 0.7 per cent of agricultural GDP to 1.0 per cent by the end of the Eleventh Plan.

II.41 In order to bring marketing reforms, there is a need to take forward the process of implementing Agricultural Produce Marketing Committee (APMC) Act in all the States. So far, 15 States and five Union Territories have amended their APMC Acts; rules in many States are yet to be notified. There is also a need to have an appropriate legislative framework that is conducive to participatory organisations. In view of significant weather and price risks, appropriate risk mitigation policies would need to be put in place to provide relief to the distressed farmers as well as enhance efficiency of production.

II.42 While agricultural growth is envisaged at four per cent per annum during the Eleventh Plan, the Planning Commission's projections suggest that the production of foodgrains needs to increase by 2.0-2.5 per cent per annum. The production of non-foodgrains will, thus, have to expand at a much higher rate to achieve the overall target of four per cent which will necessitate substantial development of activities such as horticulture, dairy, poultry and fishery. This would require a revolution on the lines of the green revolution of the 1970s. In view of relatively homogeneous nature of cereal production and of milk, it was possible to design national programmes that were broadly applicable country wide with relatively easy regional variations. However, in the case of new agricultural activities, products are very heterogeneous and they also exhibit great regional differences. Accordingly, there may be a need for decentralised and regionally disaggregated packages for many different activities. Finally, the financing requirements of the supply chain from farm to market – warehouses, cold storages, rural transportation, refrigerated trucks and other service intermediaries – will need to be in place while minimising the transaction costs.

II.43 Inclusive growth calls for greater financial inclusion with *inter alia* enhanced and easy access to institutional credit. The programme for financial inclusion initiated by the Reserve Bank in collaboration with banks and several State Governments by adopting modern technology needs to be intensified and expanded urgently. Farm credit continues to grow at a satisfactory pace. The goal of doubling farm credit in three years, initiated in June 2004, was achieved in two years. Reform of the cooperative sector on the lines of the recommendations of the Vaidyanathan Committee would further increase the flow of credit to the agricultural sector on a sustainable basis.

II.44 In view of small and fragmented farm holdings, the population dependent upon agricultural activity and incomes will have to increasingly rely on non-farm sources of income in future. Thus, diversification towards activities such as poultry, food processing and other rural industries will be critical for the betterment of living standards in rural areas. While there has been rapid integration of the Indian economy with the global economy since the early 1990s, the pace of progress on intra-regional integration within the country needs to be quickened to enable the rural areas to reap the benefits of higher growth. Inadequate intra-national integration prevents the rural population from accessing new economic opportunities arising from rapid economic growth elsewhere. Greater intra-regional integration is hampered by a variety of factors such as segmented markets for agricultural produce, virtual absence of markets in land (arising from lack of clear titles and land records) to facilitate consolidation of fragmented and unviable holdings, lack of reliable and stable power supply, absence of connectivity to outside markets through wired and wireless communication systems, lack of all-weather village roads, non-availability of rural infrastructure to support fruit and vegetable processing, preservation and transport to marketing centres, and poor service delivery in primary education and basic health services.

Industry and Infrastructure

II.45 The rebound in industrial production that started in 2002-03 continued during 2006-07 benefiting from increased domestic and external demand. The sustained growth has led to high capacity utilisation and is contributing to higher investment activity. Industry grew, on an average, at 8.1 per cent in the five-year period ended 2006-07, mainly on account of 8.8 per cent growth in manufacturing. Industrial growth during the Tenth Plan period (2002-2007), however, fell short of the targeted 10 per cent. The continued double-digit growth of the capital goods sector since 2002-03, along with robust growth in imports of capital goods, indicates that the industrial sector is responding to the buoyant demand conditions of the economy through new capacity additions. Modernisation of the capital stock, reduction/rationalisation of import tariffs and other taxes, increased openness of the economy, higher foreign direct investment inflows, greater competitive pressures, increased investment in information and communication technology, and greater financial deepening are contributing to productivity gains in the industry. As a result, the industry is increasingly becoming an important growth driver in conjunction with the services sector. Many of the services such as trade, transport, communication and construction are directly linked to the industry.

II.46 The buoyancy in industrial performance in recent years highlights the beneficial impact of economic reforms over the past 15 years, which have enhanced the competitiveness and productivity of industry in an increasingly open economy amidst significant reduction in tariffs. The manufacturing companies in India are fast emerging as internationally efficient and low-cost producers in some areas. Many companies have started acquiring foreign firms to increase their presence in the international market.

II.47 It is encouraging to note that employment generation in the economy accelerated during the period 1999-2000 to 2004-05 from the preceding period (1993-94 to 1999-2000). Growth in employment during the period 1999-2000 to 2004-05, however, still trailed the growth in labour force over the same period. Moreover, it is the unorganised manufacturing sector that has generated more employment in recent years. The sustained growth in industry is, therefore, vital to generate employment opportunities and to absorb the disguised labour force dependent upon the agricultural sector. The formation of appropriate skills through a wide variety of vocational training as well as greater flexibility in labour laws could lead to greater employment generation, especially in the organised sector.

II.48 The manufacturing sector has recorded robust growth, despite several infrastructure deficiencies. As the Approach Paper to the Eleventh Plan (2007-12) has noted, the absence of world class infrastructure and shortage of skilled manpower are the most critical short-term barriers to the growth of the manufacturing sector. It is imperative to augment the existing infrastructure facilities, particularly roads, ports and power, to provide the enabling environment for industry to prosper.

II.49 There has been mixed progress in the infrastructure sector so far. The telecom sector has witnessed high growth as reflected in the accelerated spread of mobile telephony in the country. Railways and ports have also witnessed some improvement. However, progress remains less than adequate in other sectors such as power, coal, water, urban infrastructure and rural infrastructure.

II.50 During 2006-07, the electricity sector performed well benefiting largely from improved plant load factor in thermal power plants and higher hydro power generation due to improved reservoir levels. However, the overall performance of the power sector was not very promising. The power shortage of around 10 per cent and a peak hour shortage of over 13 per cent is a deterrent to the sustained current high growth phase. In the Tenth Plan, capacity addition was around 50 per cent of the target. Expansion of private investment in the power sector has been constrained due to perceived lack of assurance of timely payment for power supplied or as contracted. Security in collection of tariffs along with appropriate tariffs and measures to reduce theft of power would also facilitate greater investment in the power sector. The gas-based power plants, which account for about 11 per cent of the installed generating capacity, are operating below their capacity in view of inadequate supply of gas and constraints in using alternate, high-cost fuels such as naphtha and high speed diesel. Transmission and distribution losses remain unacceptably high, ranging from 30-45 per cent in many States. Upgradation of the transmission and distribution system in a time-bound manner along with steps to reduce thefts could increase availability of power supply in the country, reduce the cost of power for the users and improve the financial position of the State Electricity Boards.

II.51 In this context, it is important to note that significant investment activity is taking place in the industry as indicated by trends in investment intentions. According to the National Accounts Statistics, real gross capital formation in industry (at 1999-2000 prices) increased by around 29 per cent, on an average, during 2003-04 to 2005-06. Such significant investment activity is expected to further increase the demand for electricity in the country. At the same time, it needs to be recognised that the higher electricity generation has emanated, in part, from the rise in the thermal plant load factor (PLF), which increased from 64.6 per cent during 1998-99 to 74.0 per cent during 2005-06 and further to 76.8 per cent during 2006-07. In view of the substantial rise in the PLF, the scope of a further increase in the PLF is limited. Thus, higher electricity generation in future will have to increasingly come from new capacity addition. Therefore, there is need for fresh investment in the power sector. Higher capacity addition in electricity will improve the competitiveness of the Indian industry and help sustain the current growth momentum.

II.52 Growth of the mining sector during the last five years (an average of 4.4 per cent per annum during 2002-03 to 2006-07) lagged significantly behind manufacturing growth over the same period (8.8 per cent). Despite having significant reserves of coal – the third largest in the world, after the United States and China – the country continues to suffer from inadequate domestic supplies and problems of coal shortages. Further reforms in the mining sector may be necessary to increase the mining growth and ease constraints on industrial growth. Higher electricity generation will need assured fuel supplies. The demand for coal, thus, is expected to be significantly higher than that in the recent past.

II.53 The progress in the road sector at national level has been satisfactory. While the Golden Quadrilateral project is nearing completion, the North-South and East-West corridor projects are expected to be completed by 2009. The various phases of the National Highway Development Programme (NHDP) for upgradation of the existing roads/construction of expressways are at advanced stages of planning or implementation. As noted earlier, the Government is also undertaking steps to improve rural roads under the *Bharat Nirman*. Progress on the roads and highways front will depend, *inter alia*, on the success in dealing with constraints such as delays in land acquisitions, removal of structures and shifting of utilities, law and order problem in some States, and poor performance of some contractors.

II.54 Urban infrastructure is a vital element in the growth process. Studies show that increase in the size of urban agglomerations is associated with large productivity gains. These gains emanate from the proximity to product as well as labour markets, which provide savings in trade and transport costs on the one hand, and the availability of skilled labour on the other. Strengthening the management of cities will enable improvement in urban infrastructure facilities across the country. Efficient functioning of cities of all sizes is essential for improving overall efficiency. Improvements in the provision of water, transport, sanitation, health and education facilities in urban areas are also essential for the welfare of the poor. The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) is a significant move to address the weaknesses in urban infrastructure, but comprehensive planning and effective monitoring are essential to take this scheme successfully to its logical conclusion.

II.55 Given the large infrastructure requirements of the country, the public sector will always have to play a large role in providing infrastructure funding. This will require greater focus on improvement in the delivery of public services. The High Level Committee on Infrastructure headed by the Prime Minister has estimated that an investment of Rs.14,50,000 crore during the Eleventh Plan would be required to develop world class infrastructure. This would require a substantial increase in spending on infrastructure by both the public and private sectors from the current levels of 4.6 per cent of GDP to almost 8 per cent of GDP every year. These investments are to be achieved through a combination of public investment, public private partnerships (PPPs) and exclusive private investments, wherever feasible. The Government is actively pursuing PPPs to bridge the infrastructure deficit in the country and several initiatives have been taken in the last couple of years to promote PPPs in the infrastructure development. The appraisal mechanism for the PPP projects has been streamlined to ensure speedy clearance of the projects, removal of red tape, adoption of international best practices and bringing uniformity in guidelines. The awareness of concerns and issues relating to PPPs, however, is still lacking and not evenly spread across different States.

II.56 Domestic savings rose sharply to 32.4 per cent of GDP in 2005-06 from 23.5 per cent in 2001-02. In view of the increasing domestic savings, higher investment in infrastructure, both in the public and private sectors, is clearly possible. However, commensurate progress on project design, project implementation, appropriate user charges and appropriate policies would be necessary for such investments to be profitable and self-financing.

Services

II.57 The services sector has grown at double-digit rates in the last three years and emerged as the key driver of economic activity in the country. The sustained strength of manufacturing activity, strong growth in tourism, improvements in the telecommunications, buoyancy in IT and BPO sectors, robust growth of the construction sector, acceleration in deposit and credit growth and opening up of the insurance sector have buoyed the services sector in recent years. The impressive performance of the services sector was attributable largely to the availability of skilled and cheap labour. However, the sustained acceleration in services and the manufacturing activities is leading to incipient pressures on the supply of good quality skilled labour. While its demographic profile places the country favourably in terms of manpower availability, there are reports of emerging talent supply shortages. Only 10 per cent of the relevant age group is getting enrolled into institutions of higher learning in the country as compared with 40-50 per cent in most developed countries. Less than a half of secondary school students only join college education. Moreover, the quality of education imparted in several colleges and universities in the country remains less than adequate to meet the emerging demands for skilled professionals.

II.58 In order to reap the benefits of the demographic dividend, substantial expansion and reforms in the education sector would be needed on an urgent basis. The Government is focusing on vocational education in order to equip the labour force with the requisite skills. With the implementation of the *Sarva Shiksha Abhiyan,* which aims to provide universal elementary education and bridge all social, gender and regional gaps with the active participation of the community in the management of schools, enrolment of students in the secondary schools is expected to increase. In view of this, there would be a need for major expansion of infrastructure at secondary school level as well in the near future. Given the focus on skills in the increasingly knowledge intensive economic activities, special emphasis would need to be placed on imparting tertiary education and developing institutes of higher learning also. Education facilities would, thus, need to be extended at all levels, *viz*., primary, secondary and at a tertiary level. In this context, the Central Government has decided to establish 30 new Central Universities in the country with the objective of expanding the access to high quality education. The setting up of the proposed universities would need to be supplemented with upgradation of facilities in nationally well spread out existing colleges/universities to bridge the emerging demand-supply mismatches in the availability of skilled manpower and to reap the demographic dividend. Concerted efforts in the direction of improving the physical, urban and social infrastructure in the country would further entrench the growth of the services sector.

FISCAL POLICY

II.59 The process of fiscal consolidation in Central Government finances under the rule-based framework of the FRBM has been characterised by front-loaded reduction in deficit indicators in 2004-05, pause in 2005-06 and resumption of the process in 2006-07. The fiscal correction process is budgeted to continue during 2007-08. With gross fiscal deficit budgeted at 3.3 per cent of GDP in 2007-08, the FRBM target of 3.0 per cent by 2008-09 appears feasible. The revenue deficit is budgeted at 1.5 per cent of GDP for 2007-08; the FRBM path envisages elimination of revenue deficit in 2008-09. It is, thus, useful to note that the adherence to the FRBM target would require a reduction of 1.5 per cent in the revenue deficit/GDP ratio during 2008-09.

II.60 The revenue augmentation of the Government has been supported by a steady increase in the tax-GDP ratio, led by direct tax revenues. The share of direct taxes in total tax revenues increased to about 49 per cent in 2006-07 (RE) from 36 per cent in 2000-01. Within direct tax, the share of corporate income tax moved up significantly to about 64 per cent in 2006-07 from 52 per cent in 2000-01, with the corresponding decline in the share of individual income tax. As a proportion to GDP, both corporate and individual income taxes have exhibited an increase since 2000-01. While the ratio of corporate income tax increased from 1.7 per cent during 2000-01 to 3.6 per cent during 2006-07 (RE), that of individual income tax increased from 1.5 per cent to 1.8 per cent. Maintaining the current buoyancy in tax revenues over a higher base needs to be continued with sustained effort in the light of high income growth. The scope for deepening fiscal empowerment further through improved tax revenues lies in maintaining a moderate structure of tax rates and broadening the base without affecting the growth momentum of the economy. In order to broaden the tax base, it is imperative to rationalise/eliminate major tax concessions and bring the key segments of the services sector within the ambit of tax net in tandem with the growing share of this sector in GDP. The service tax constituted eight per cent of gross tax revenues and about 16 per cent of indirect taxes of the Central Government in 2006-07. With the successful implementation of value added tax (VAT) system by the State Governments and the move towards phasing out of central sales tax (CST), appropriate conditions are in place for the introduction of goods and services tax (GST) with effect from April 1, 2010. This is expected to have a positive impact on the efficiency of the indirect tax system. Furthermore, improvement in the efficiency and effectiveness of tax administration would enable reduction of tax arrears. The stock of tax revenues raised but not realised declined by about 19 per cent during 2005-06 to Rs.90,256 crore at end-March 2006.

II.61 Expenditure management of the Central Government in recent years has focused increasingly on improving the quality of implementation and on enhancing the efficiency and accountability of the delivery mechanism for translating budgetary outlays into the intended outcomes. The Government's policy of reprioritising expenditure has led to higher outlays for the social sector. The shares of public expenditure on education and health in India are, however, still low by international standards. In 2004, the share of public expenditure on health in India at 0.9 per cent of GDP was lower than Brazil (4.8 per cent), China (1.8 per cent) and least developed countries (1.8 per cent). Reprioritisation of expenditures towards social sectors along with higher capital outlays would promote fiscal discipline without restricting operational efficiency of the Government. Higher public spending on social services would improve the social infrastructure and provide productivity gains.

II.62 The finances of the State Governments have also exhibited significant improvement since 2003-04 guided by the Fiscal Responsibility Legislations (FRLs). As the State Governments come closer to meeting the objective of reduction in deficit indicators, they would have the challenge of containing non-developmental expenditures, while undertaking higher developmental expenditures in line with the priorities laid down in the Eleventh Five Year Plan. The improved macroeconomic performance is expected to have positive impact on tax mobilisation of the State Governments (both own tax revenue and shareable Central taxes). At the same time, it needs to be noted that it is the States who are primarily responsible for the provision of health and education. Apart from higher allocations towards social and economic services, the States would also need to focus on improving the quality of delivery of services, which would, in turn, enable them to adequately price these services. The States would also need to undertake enabling reforms to reap the full benefits of centrally sponsored schemes such as Jawaharlal Nehru National Urban Renewal Mission.

II.63 A salient feature of the fiscal consolidation process in recent years has been significant reduction in the key deficit indicators. However, deficit indicators as well as public debt in India still remain higher than many emerging and developed countries. Furthermore, there are certain risks to the fiscal consolidation process such as expected increase in expenditure from the revision of pay scales on implementation of the Sixth Pay Commission's recommendations, subsidies and the rising average cost of borrowings.

II.64 Adhering to the FRBM/FRL targets by the Centre as well as States would enable a further rise in public savings and overall domestic savings, apart from moderating the public debt burden. The reduction in the debt burden would contribute to overall macroeconomic stability and also ensure the sustenance of the growth momentum. For the current growth momentum to be entrenched on a durable basis, there is a need for a significant enhancement in capacity building and in the availability of public services that cannot be adequately provided by the private sector. Fiscal empowerment would allow higher capital outlays and boost infrastructure and social sector spending with beneficial impact on domestic productivity, growth and employment. It is, thus, necessary to emphasise the criticality of quality of fiscal adjustment.

EXTERNAL SECTOR

II.65 The external sector has imparted significant resilience to the Indian economy in the post-reform period. India's linkages with the global economy are getting stronger, underpinned by the growing openness of the economy and the two-way movement in financial flows. The ratio of merchandise exports to GDP has been rising since the early 1990s, reflecting growing international competitiveness. During 2002-2006, export growth of India was much higher than its key competitors in the Asian region, except China. At the same time, import intensity has been rising steadily as domestic entities have expanded access to internationally available raw materials and intermediate goods as well as quality inputs for providing the cutting edge to domestic production and export capabilities. Structural shifts in services exports, led by software and other business services, and remittances have imparted stability and strength to India's balance of payments. The net invisibles surplus has offset a significant part of the expanding trade deficit and helped in containing the current account deficit to an average of one per cent of GDP since the early 1990s. Gross current receipts (merchandise exports and invisible receipts) and gross current payments (merchandise imports and invisible payments) taken together, at present, constitute more than one half of GDP, highlighting the significant degree of integration of the Indian economy with the global economy.

II.66 The liberalised external payments regime is facilitating the process of acquisition of foreign companies by Indian corporates, both in the manufacturing and services sectors, with the objectives of reaping economies of scale and capturing of offshore markets to better face the global competition. Notwithstanding higher outflows, there has been a significant increase in capital flows (net) to almost five per cent of GDP in 2006-07 from an average of two per cent during 2000-01 to 2002-03. Capital flows (net) have remained substantially above the current account deficit and have implications for the conduct of monetary policy and macroeconomic and financial stability.

II.67 The overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows and other requirements. The objectives of reserve management in India are preservation of the long-term value of the reserves in terms of purchasing power and the need to minimise risk and volatility in returns. In India, foreign exchange reserves have been accumulated on account of capital inflows unlike other Asian economies which have built up a significant part of the reserves through current account surpluses. Nevertheless, these countries continue to intervene in the foreign exchange market as reflected in the high level of foreign exchange reserves in countries across Asia. Furthermore, ample global liquidity, relatively low interest rates in major advanced economies and the search for yield have led to large capital inflows into emerging market economies.

II.68 In India, interventions have been by and large successful in reducing volatility in the foreign exchange market, and have contributed to the overall financial stability. This, among other factors, makes India a preferred investment destination by overseas investors. While large corporates may be in a position to manage increased volatility, a large section of the population in countries like India does not have the wherewithal to withstand volatility in the financial markets. Interests of such sections of the population against volatility also need to be considered. Excessive volatility can also threaten financial stability and impinge on the real sector. The extent of volatility, thus, has to be consistent with the objectives of growth, and price and financial stability. As the Asian crisis demonstrated, even large corporates may not be in a position to withstand sudden volatility in exchange rates and interest rates as weaknesses in corporate balance sheets can spread to other participants in the economy, including the banking sector.

II.69 Like India, several other countries are facing a similar situation of excess foreign exchange inflows, which is affecting monetary management in these countries as well. However, monetary management at the current juncture in India is more complex than in other EMEs for several reasons. First, domestic interest rates are higher than the return on foreign exchange reserves, which leads to quasi-fiscal costs. Second, although the fiscal deficit and public debt have declined in recent years in India, by international standards, they still remain high. This restricts the flexibility available to fiscal policy to keep inflation relatively low. Third, in India, the real sector has been liberalised over the years which constrains the ability to take administrative measures with regard to supply management. At the same time, several policy rigidities persist, inhibiting the rapid and flexible adjustments that are needed by the demands of a well-functioning market economy. Further, in India, the banking system has been gradually deregulated and the conduct of monetary policy is largely through the use of market-based instruments. This restricts the ability to use administrative instruments such as prescribing deposit and lending rates, which some other countries may be able to use. Moreover, some countries are managing capital account more actively than before. Finally, it is also necessary to recognise that India is one of the few emerging market economies (EMEs) to record current account deficits, along with a significantly high trade deficit.

II.70 Though there has been a significant liberalisation of the policy framework with regard to capital outflows over the past few years, further possible liberalisation measures in this regard will continue to receive attention. However, each country has to design its policy regime for capital outflows keeping in view specific country context especially the characteristics of the real sector, and not merely the contextual level of inflows and extant absorptive capacity of the economy. First, the current regime of outflows in India is characterised by liberal but not incentivised framework for corporates to invest in the real economy outside India, including through the acquisition route. The regime has served the country well since Indian corporates are increasingly able to establish synergies with overseas units, to make up for lack of scale that has been a legacy problem in India, and to quickly acquire domain knowledge through acquisition. Second, significant liberalisation of outflows by individual households has been implemented following recommendations of the Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore, 2006). Further liberalisation here would be done in the light of some international experience which shows that resident individuals often precede overseas investors in initiating outflows when the perceptions in regard to domestic economy's performance or stability appear to turn adverse. Third, as regards the regime for outflows through financial intermediaries, the approach is characterised by caution and quantitative stipulations whereby both prudential considerations and compulsions of management of capital account are relevant.

II.71 Trade integration is undeniably beneficial but financial integration has both, benefits and risks, at the current stage of India's development. It is useful to narrate some noteworthy features of capital inflows to India. Foreign Direct Investment (FDI) is generally perceived to be an investment that creates physical assets and is associated with a degree of stability, in particular due to managerial skills. However, new types of FDI flows through private equity funds and venture capital funds may not necessarily have a direct link with investment in physical assets and could contain a volatile component at the margin. Similarly, inflows to acquire existing stakes or expanding foreign stakes in Indian companies are classified as FDI, but they do not contribute to the further creation of physical assets. However, these inflows do add to the foreign resources available for investment in the economy, which would be most productive when there is corresponding absorptive capacity at the macro level. Similarly, FIIs in their own account are generally long term investors with little or no interest in managerial control. However, investments under the category of FIIs in India have a significant part of portfolio flows through participatory notes and sub-accounts. Capital flows, particularly the portfolio flows, being volatile can easily reverse their direction and it is difficult to invoke the "rules of origin" with regard to such capital flows. Against this backdrop, the gradual process of fuller capital account liberalisation will be pursued over the medium-term, while recognising the growing ineffectiveness of micro controls in a world of growing trade and financial integration. Thus, in India, the trade, financial and capital account liberalisation do go together, but in a harmonious and well-sequenced manner, while closely aligning with the progress in the real sector, fiscal sector and institutional developments, including governance.

II.72 Given the flux associated with both financial markets and monetary policy settings, India cannot be immune to these developments. Accordingly, banks, financial institutions and corporates need to be vigilant and well-prepared with appropriate risk mitigation strategies to deal with significantly higher volatility than before. It is in this context that they are urged to monitor various types of exposures and hedge them to protect their balance sheets. The Reserve Bank has expanded the range of hedging tools available to market participants over the years and facilitated dynamic hedging.

FINANCIAL SECTOR

II.73 A strong and robust financial sector plays a critical role in the efficient allocation of resources among savers and investors, thereby contributing to the growth process. It also facilitates the transmission of monetary policy impulses to the rest of the economy. Accordingly, the various policy initiatives by the Reserve Bank since the early 1990s have aimed at developing a robust, efficient and diversified financial system[2]. During 2006-07, the Reserve Bank continued to fine tune the regulatory and supervisory initiatives. In order to ensure asset quality, prudential measures were further tightened through increases in the provisioning requirements and risk weights in respect of specific sectors. The focus of the various prudential and supervisory measures was on anchoring financial stability while providing flexibility to the financial system. In order to further strengthen the domestic banking sector and to conform the banking sector with international best practices, commercial banks will migrate to Basel II norms in a phased manner beginning March 2008. Although implementation of Basel II poses significant challenge to both banks and the regulators, it also offers two major opportunities to banks, *viz*., refinement of risk management systems and improvement in capital efficiency.

II.74 The Reserve Bank will persevere with its efforts towards deepening the financial system and widening its reach, given the present stage of development of the country. The burst of entrepreneurship across the country has to be nurtured and financed. Interest rates charged by banks in India on various types of loans and advances vary significantly. Banks need to tone up their risk assessment and risk management capacities to

[2] On the role of financial markets in economic development, see the *Report on Currency and Finance, 2005-06* of the Reserve Bank of India. The Report with the theme "Development of Financial Markets and Role of the Central Bank" considered approaches for making financial markets in India more developed, efficient and integrated in the light of India's own experience gained so far and keeping in view the international best practices, while recognising that India is an emerging market economy. The pace of financial market development will necessarily have to be guided by the predominant imperative of maintaining macroeconomic and financial stability, while enabling growth inclusive.

appropriately price their loans. In this context, the setting up of credit information bureaus should help in reducing the transaction and information costs for banks by making available the credit histories of both individuals and small businesses. Although banks' investments in SLR securities registered an increase during 2006-07 in contrast to a decline in the preceding year, such investments, as a proportion of NDTL, declined further during 2006-07. As a result, banks' portfolio of Government securities is now very close to the prescribed norm. To meet the growing credit demand, therefore, banks need to widen their deposit base. In particular, banks need to bring more and more financially excluded people within their fold. Apart from helping the low income households, this would help strengthen the financial deepening and provide necessary resources to the banks to expand credit and sustain high economic growth.

MONETARY POLICY

II.75 The conduct of monetary policy in India has been guided by the objectives of maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy for sustaining overall economic growth. The relative emphasis between price stability and growth, however, depends on the underlying macroeconomic conditions. In view of incipient inflationary pressures, the stance of monetary policy progressively shifted from an equal emphasis on price stability along with growth (October 2004/April 2005) to one of reinforcing price stability with immediate monetary measures and to take recourse to all possible measures promptly in response to evolving circumstances (January 2007). Concomitantly, the Reserve Bank has taken pre-emptive monetary measures beginning mid-2004 to contain inflation and inflationary expectations. The major policy challenge for monetary policy during the recent period has been to manage the transition to a higher growth path while containing inflationary pressures so that potential output and productivity are firmly entrenched to sustain growth. Monetary measures, supported by supply side and fiscal measures, have helped in containing inflation and anchoring inflation expectations while supporting the growth momentum.

II.76 The Reserve Bank's self-imposed medium-term ceiling on inflation at 5.0 per cent has had a salutary effect on inflation expectations and the socially tolerable rate of inflation has come down. In recognition of India's evolving integration with the global economy and societal preferences in this regard, the resolve, going forward, would be to condition policy and expectations for inflation in the range of 4.0-4.5 per cent. This would help in maintaining self-accelerating growth over the medium-term, keeping in view the desirability of inflation at around 3 per cent to ensure India's smooth global integration.

II.77 The conduct of monetary policy has become more challenging in recent years for a variety of reasons. Globalisation has brought in its train considerable fuzziness in reading underlying macroeconomic and financial developments, obscuring signals from financial prices and clouding the monetary authority's gauge of the performance of the real economy. Consequently, dealing with the impossible trinity of fixed exchange rates, open capital accounts and discretion in monetary policy has become more complex than before. Moreover, there is considerable difficulty faced by monetary authorities across the world in detecting and measuring inflation, especially inflation expectations. The operation of monetary policy in India is also constrained by some uncertainties in the transmission of policy signals to the economy. First, some categories of interest rates continue to be administered, thereby muting the impact of monetary policy on the structure of interest rates. Second, external sector management is complicated by the incentives for some elements of capital flows provided by the public policy setting. Thus, the magnitudes and direction of capital flows to select sectors in the domestic economy are beset with uncertainties with regard to the global and domestic environment not necessarily related to economic fundamentals or the monetary policy setting. Third, the operation of monetary policy has to be oriented around the predominantly public sector ownership of the banking system which plays a critical role not only in the transmission of monetary policy signals but also in other public policy considerations.

II.78 Monetary policy in India has also to contend with the burden of challenges emanating from other sectors. First, fiscal imbalances remain large by international standards and have to be managed in a non-disruptive manner. However, the recent salutary improvement in the fiscal position of States and significant consolidation in the finances of the Centre have alleviated the extent of the burden that monetary policy has to bear on this account. Second, the enduring strength of foreign exchange inflows complicates the conduct of monetary policy. In the event of demand pressures building up, increases in interest rates may be advocated to preserve and sustain growth in a non-inflationary manner. Higher interest rates, however, increase the possibility of further capital inflows and potentially reduce the efficacy of monetary policy tightening. Third, in India, levels of livelihood of a large section of the population are inadequate to withstand sharp financial fluctuations which impact real activity. Accordingly, monetary policy has also to take into account the effect on these segments of the economy from volatility in financial markets, often related to sudden shifts in capital flows.

II.79 Fourth, limitations on the elasticity of aggregate supply domestically impose an additional burden on monetary policy, particularly in the short term. While open trade has expanded the supply potential of several economies, it does not seem to have had any significant short-term salutary effect on supply elasticities. Persisting supply shocks to prices of commodities and services to which headline inflation is sensitive can exert a lasting impact on inflation expectations. Faced with longer term structural bottlenecks also in supply, with less than adequate assurance of timely, convincing and demonstrated resolution, monetary policy has to respond appropriately. The burden and the dilemmas, in fact, are greater in the event of a structural supply problem on account of its persistent effects on inflation. Managing structural change while keeping inflation low and stable without dampening the growth momentum is the quintessential challenge to monetary policy in the period ahead.

II.80 To sum up, there is evidence of some cyclical elements in the current growth process, although significant structural changes have also taken place in the Indian economy. There is a growing evidence that the economy is possibly poised on the threshold of a step-up in the growth trajectory, provided the vigil on price stability, including financial stability is intensified in a convincing manner.