REVIEW OF THE ECONOMY
2008/09

ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER
New Delhi

January 2009

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TO THE PRIME MINISTER

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CONTENTS

REVIEW OF THE ECONOMY 2008/09

EXECUTIVE SUMMARY

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REVIEW OF THE ECONOMY 2008/09

Executive Summary

i. The past year has been a turbulent one in the international economy. The tumultuous developments have had a negative impact on the pace of economic activity the world over, and India has been no exception. The sequence of crises began with the mounting losses on sub-prime mortgage derivatives which led to serious difficulties in a host of large financial institutions. There was a boom in commodity prices with crude oil rising to nearly $150 per barrel, as also soaring food prices and galloping inflation which confronted policy makers in the summer of 2008. The decision to let Lehman Brothers fail on 15 September 2008 pulled the plug on an already embattled and weakened financial system. Inter-bank accommodation and all classes of private credit literally dried up and brought down day-to-day economic activities almost to a halt. All classes of assets tumbled, the only exception being government bonds. As the contagion spread and job losses rose in the advanced industrial economies, confidence was eroded further and general consumer demand in both the US and other developed nations dropped. In consequence, emerging economies saw export markets contract. Both debt and equity markets received serious setbacks compromising their ability to function as platforms for raising capital.

ii. In the Economic Outlook issued in July 2008, the Council was of the view that the Indian economy would be able to grow by 7.7 per cent in 2008/09. At that time, the Council had opined that while a large part of the sub-prime losses had been accounted for, further setbacks were possible in the months to come and conditions were unlikely to stabilize before early 2009. The outcome in the first half of 2008/09 was broadly along the lines expected by the Council in July. Economic growth in the first half of the year averaged 7.8 per cent, down from the 9.3 per cent in the comparable period of last year. However, conditions became much worse from the middle of September 2008. Inflationary pressures which had been rising steeply till mid-September, began to fall off equally rapidly as commodities led by crude oil collapsed in the face of the financial meltdown and greater than anticipated intensity of recession in the advanced economies. The adjustment to these rapid changes is a major challenge before the Indian economy in the second half of

2008-09 and beyond. The revised estimates of growth in 2008/09 are at *Table-A*. We expect a slower overall growth of 7.1% than forecast in July 2008, the sectoral impact being dependent on the linkages with the international economy.

Table A : Estimated Growth of the Indian Economy in 2008/09
Sectoral Composition and Investment and Savings Rates

Unit: Percentage

	2004/05	2005/06	2006/07	2007/08	2008/09	
					July 08	Jan 09
Agriculture & Allied Activities	–0.2	5.9	3.8	4.5	2.0	3.0
Mining & quarrying	8.2	4.9	5.7	4.7	7.5	4.7
Manufacturing	8.7	9.0	12.1	8.8	7.2	4.0
Electricity, gas & water supply	7.5	4.7	6.0	6.3	6.5	3.1
Construction	16.1	16.5	12.0	9.8	8.5	8.0
Trade, hotels, transport, communications	10.9	11.5	11.8	12.0	9.8	9.3
Finance, insurance, real estate & business services	8.7	11.4	13.9	11.8	10.0	9.1
Community, social & personal services	6.8	7.2	6.9	7.3	8.4	9.6
GDP at factor cost	**7.5**	**9.4**	**9.6**	**9.0**	**7.7**	**7.1**
Industrial sector	10.3	10.1	11.0	8.5	7.5	5.1
Services sector	9.2	10.3	11.1	10.8	9.6	9.3
Non-Farm GDP	9.6	10.3	11.0	10.0	8.9	7.9
Per Capita GDP	5.8	7.8	8.1	7.5	6.2	5.6
Memo Items						
Investment Rate	32.2	35.5	35.9	37.4	37.5	35.0
Savings Rate	31.8	34.3	34.8	36.0†	34.5	33.1
Average* WPI Inflation	6.5	4.4	5.4	4.7	10.5	8.7
Current Account Balance as ratio to GDP**	(–) 0.4	(–) 1.1	(–) 1.1	(–) 1.5	(–) 3.2	(–) 1.9

Note: * Average of weeks
** (+) sign indicates a current account surplus, while (–) indicates a deficit
† Estimated from the investment rate and the provisional current account deficit for the year

iii. The investment rate was estimated to have been higher in the first half of 2008/09 as compared to the first half of last year. The Council is of the view that for the completed year 2008/09, the investment rate will be somewhat lower than that registered in the previous year, due to a combination of financing constraints facing Indian enterprises, a sharp downturn in investor confidence and general business conditions. The savings rate is also likely to be lower mainly on account of larger negative savings of the government administration. Both average inflation and the current account deficit are likely to be lower than was previously assessed.

iv. What is of great importance is to secure conditions for growth in fiscal 2009/10. This will be a function of the recovery in global economic and financial conditions and the offsetting measures that are taken in India through a combination of monetary, fiscal and other measures.

v. A significant part of the funding for new asset creation by Indian companies had come from External Commercial Borrowings (ECB). An equally important part had come from fresh issuance of equity with the balance obtained from the reinvestment of profits. The direct impact of funding constraints on the investment plans of Indian corporates and hence on growth and job creation, together with the second order effects of this development, coupled with the compression in export markets and the second order effects on this count, are the two principal channels through which the impact of the global financial and economic crisis are being felt in India. In addition there is of course the intangible, but not insubstantial, impact of weaker investor and business confidence due to the bad news and uncertainty flowing out of the advanced economies.

vi. The assessment of the IMF and the European Commission is that in the US, the EU and Japan, there will be a prevalence of recessionary conditions for at least the first half of 2009, with the possibility that this may extend into the third quarter, with some recovery in the fourth quarter of 2009. Furthermore, although the IMF has not yet put out estimates of growth for 2010, the feeling seems to be that when the advanced economies do return to recovery, it may not be very vigorous.

vii. It would appear that economic recovery in the principal advanced economies could, in the absence of concerted efforts by their respective governments and monetary authorities, be a long drawn out process, perhaps extending across 2009 and even into part of 2010. However, the fact is that fiscal and monetary instruments are being arrayed in great strength to bolster the financial system and keep demand from flagging. Keeping in balance all of these factors, the Council is of the view that economic conditions in the advanced economies may continue to be recessionary in the first half of 2009, but growth would re-surface in the third quarter of the year. Emerging economies, such as India and perhaps China, would have a difficult time in the first part of the year, but should be able to show a pick-up in growth in the last quarter of 2009, if not earlier.

viii. Keeping in mind all these factors, the Council expects that in 2009/10, the Indian economy is likely to remain relatively weak in the first quarter (April–June) and slowly pick up thereafter; that the economy would show fairly strong recovery in growth in the second half of the fiscal (Oct 2009 to Mar 2010) assuming some improvement in international economic and financial conditions. Overall, the Council assesses that growth in 2009/10 would be between 7.0 and 7.5 per cent or somewhat above that, with the first half of the year averaging growth close to 7.0 per cent and the second half an average growth of close to 7.5 per cent or higher.

ix. Unlike in the past, the present crisis has come upon the Indian economy at a point in time where several of its components are in relatively strong shape. Most of the bad years in the past had come when the agrarian economy was in crisis. This is not so currently. The Indian enterprise has undergone a fundamental process of modernisation since 1991 in both its business model and the manner of its organisation. Indian enterprises have learnt the hard lessons of the importance of managing business and financial risks, and are thus to that extent in a better position to ride out the storm of this crisis. Indian banks have also gone through a transformational process. Whatever deterioration in asset quality the present crisis brings in its wake, Indian banks today are better prepared to deal with it than at any time in their history. Total consumption expenditure – private & government – has over the past 15 years contributed 4 percentage points on an average to GDP growth. Indian households consume mostly out of current income: the proportion of leveraged consumption is low. There is, therefore, every reason to believe that domestic consumption expenditure will contribute somewhere around 4 percentage points to GDP growth. Domestic savings rate, notwithstanding high government revenue deficits, will be close to 31 per cent of GDP, which together with net savings from abroad (current account deficit) would translate to potential investment of about 32 per cent of GDP. Even with growth below the potential rate, and in the absence of other severe constraints, the economy should be able to generate growth in the region of 7.0 to 7.5 per cent in 2009/10.

x. The current external payment situation is also reasonably comfortable. On the basis of the available trade data and the balance of payments statements up to September 2008, the Council has prepared an estimate of the Balance of Payments for the second half and for the full year 2008/09. The method adopted and other details are in the text of the report. A summary is presented here at *Table B*. Despite the decline in oil prices the merchandise trade deficit is likely to touch historic highs, which is likely to be offset to a large extent by higher net invisible earnings. The projected current account deficit of $22.9 billion translates to 1.9 per cent of GDP – an average of very high first half and low second half numbers.

Table B: Projected Balance of Payments for 2008/09

Unit: US$ billion

	2004/05 R	2005/06 PR	2006/07 (P)	2007/08 (P)	2008/09		
					H1	H2	Year
Merchandise Exports	85.2	105.2	127.1	158.5	96.7	86.1	182.9
Merchandise Imports	118.9	157.0	192.0	248.5	165.9	137.7	303.6
Merchandise Trade Balance	–33.7	–51.8	–64.9	–90.1	–69.2	–51.6	–120.7
	–4.8%	–6.4%	–7.1%	–7.7%	–11.5%	–8.6%	–10.1%
Net Invisibles	31.2	42.7	55.3	72.7	46.9	51.1	97.9
o/w Software & BPO	14.7	24.6	31.2	37.0	22.2	25.0	47.2
Private Remittances	20.5	24.1	27.9	40.8	25.8	29.5	55.3
Investment Income	–4.1	–4.9	–6.0	–5.2	–1.6	–4.5	–6.1
Current Account Balance	**–2.5**	**–9.2**	**–9.6**	**–17.40**	**–22.3**	**–0.5**	**–22.9**
	–0.4%	***–1.1%***	***–1.0%***	***–1.5%***	***–3.7%***	***–0.1%***	***–1.9%***
Foreign Investment	13.0	17.2	15.5	44.8	9.0	2.7	11.8
o/w FDI (net)	3.7	4.7	8.5	15.5	14.6	3.0	17.6
Portfolio capital	9.3	12.5	7.1	29.3	–5.5	–0.3	–5.8
Loans	10.9	6.1	24.5	42.0	7.3	–14.3	–6.9
Banking capital	3.9	1.4	1.9	11.8	4.8	–0.4	4.4
Capital Account Balance	**28**	**23.4**	**45.8**	**108.0**	**19.9**	**–9.9**	**10.0**
	4.0%	***2.9%***	***5.0%***	***9.2%***	***–3.3%***	***–1.7%***	***0.7%***
Errors & Omissions	0.6	0.8	0.6	1.5	–0.1	0.0	–0.1
Accretion to Reserves	**26.2**	**15.1**	**36.6**	**92.2**	**–2.5**	**–10.5**	**–13.0**
	3.7%	***1.9%***	***4.0%***	***7.9%***	***–0.4%***	***–1.7%***	***–1.1%***

Note: * Business process outsourcing
Figures in parentheses denote proportion to GDP at current and market prices
Figures may not add up due to rounding off

xi. On the capital account side the first half had seen a net positive flow of nearly $20 billion. In the second half, this is expected to turn into a negative flow of about $10 billion, composed of larger negative flows in the third quarter (ending December 2008) and some positive flows in the final quarter. Overall net capital inflows for the year are projected at $10 billion. The foreign currency reserves are thus likely to be drawn down by a net amount of $13 billion in 2008/09. The next fiscal should start with a foreign exchange reserve with RBI of some $250 billion which is a comfortable level.

xii. WPI inflation peaked at close to 13 per cent in August 2008. Consumer price inflation continued to rise to 11 per cent in October and November due to price increase in primary foodstuff. The Council expects that the WPI inflation rate for manufactured goods is likely to fall to 4 per cent in February and fall further by the end of March 2009, a trend that may continue for a few months into the next fiscal year due to the base effect, given that a large part of the price surge happened between March and June of 2008. However, inflation in primary foods is likely to remain elevated at close to 8 per cent. Inflation in energy prices will be negative, as will be that in some non-food primary articles like iron ore. Overall the headline WPI inflation rate is likely to be close to 4 per cent by end-February/ early-March, with potential for more declines after that. CPI inflation will also fall, but the extent of the fall is unlikely to match that for WPI, considering the expected higher rate of food inflation and its larger weight in the consumer price indices.

xiii. The RBI has taken a series of measures to deal with the problems of liquidity, interest rates and other policies, bearing upon the challenges that the recent developments have thrust upon us. The aggregate of measures taken since October through early January has resulted in a reduction of the CRR to 5.0 from 9.0 per cent; of the repo rate to 5.5 from 9.0 per cent; and of the reverse repo rate to 4.0 from 6.0 per cent. Under the present conditions, banks may be expected to be shy in advancing credit, even as Indian banks themselves start out with strengths, rather than weaknesses, in their balance sheet. Thus, policy has to try and also use other channels for making sure that funds flow to meet the needs of commerce and business.

xiv. On the fiscal front, the events after the presentation of the Union Budget in February 2008 have led to three important developments. First, provisioning for pay revision, loan waiver, National Rural Employment Guarantee Act (NREGA) and various subsidies has significantly added to the Central Government expenditures and liabilities. This has significantly altered the deficit position. Second, the global financial crisis has shifted the focus of fiscal policy from fiscal stabilisation to providing growth stimulus. Finally, the pre-existing high levels of debt and fiscal stress, also limit the available headroom for a counter-cyclical thrust to fiscal policy. In the prevailing situation, repriortisation of government expenditure and speedy implementation of already funded projects at the Central and State levels are critical for the fast revival of the economy.

xv. The Rs.148,094 crore “cash outgo” in the Supplementary Demand for Grants comes to 2.8 per cent of GDP. The total of this together with Oil and Fertiliser Bonds of Rs 85,942 crore, is Rs. 234,036 crore, i.e. 4.4 per cent of GDP. To this may be added the slippage in tax collections from the budgeted estimate, amounting to 1 per cent of GDP, due to the reduction in excise duty and lower buoyancy because of difficult economic conditions. The fiscal deficit in the Union Budget was placed at 2.5 per cent of GDP to which the addition of 4.4 and 1.0 per cent of GDP brings up the total to about 8.0 per cent of GDP, including off-Budget items. The deficit of the States is also likely to be about 3.5 per cent of GDP. The combined deficit may thus be expected to be about or in excess of 10 per cent of GDP in 2008/09.

xvi. It must be recognised that there is compelling need to adjust the fiscal stance to the exceptional circumstances through which the economy has been passing. There is an equally urgent need to bring government finances back on the track of fiscal consolidation once there is an improvement in economic conditions and before the exceptional ways in present times start to grow into a habit and create a fiscal crisis in the medium term.

ECONOMIC OUTLOOK FOR 2008/09

FULL REPORT

Economic Advisory Council to the Prime Minister
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I ECONOMIC GROWTH IN 2008/09 – A REVIEW

2008 – A Year of Crises

1. With nine months of the fiscal year behind us, it is possible to gain greater clarity for the outlook in the balance part of the year. Calendar year 2008 has been a very tumultuous one and has had a negative impact on the pace of economic activity the world over, and India has been no exception. Internationally, there were several crises in 2008 – beginning with questions about the value of sub-prime mortgage derivatives in the face of rising delinquencies and home foreclosures that transformed into the consequential difficulties in a number of large financial institutions. The deep cuts in policy interest rates in the US seem to have aided in the process of building up of a perfect storm in commodity prices with crude oil rising to nearly \$150 per barrel, gold to nearly \$1,000 per troy ounce, rice and wheat to \$1,000 and \$600 per tonne and steel to \$1,200 per tonne. Galloping inflation raged through the summer of 2008, with monetary authorities in the OECD nations hampered in dealing with it – flowing from their commitment to keep the financial system afloat. Banks were already under severe pressure, having had to take huge losses on account of "mark-to-market" hits on their investment portfolios and many banks sought to raise capital to replenish their core capital.

2. In this climate the decision to let Lehman Brothers fail on 15 September 2008, pulled the plug from an already embattled and weakened financial system. Inter-bank accommodation and all classes of private credit literally dried up across the financial capitals of the world and brought down with it the entire gamut of economic activities that today inter-link the different economies of the world. The only assets that rallied were government bonds that in some cases went to zero yield in the months that followed. Over the course of the first nine months of 2008, the financial crisis in the US metamorphosed from a problem with sub-prime mortgages to a generalised financial panic impacting all classes of assets and pulling into the vortex of the storm every kind of economic activity: from the more proximate, such as commercial mortgages and prime home loans, to the

more distant. As credit began to dry up, leveraged sale became hard to transact, and the automobile industry was amongst the hardest hit.

3. As the contagion spread, job losses rose, confidence was eroded further and general consumer demand in both the US and other developed nations dropped. In consequence, emerging economies saw export markets contract as opposed to the expansion that they had come to be used to. Emerging market companies found conditions in the soured capital markets increasingly hostile to their offerings of debt securities, even as the risk spreads moved north. The equity market took such a severe beating worldwide through 2008 and particularly after mid-September 2008, that its capacity as an institution to raise risk capital to finance corporate investment has temporarily turned dysfunctional.

Revised Projections for 2008/09

4. In the Economic Outlook issued in July 2008, the Council was of the view that the Indian economy would be able to grow by 7.7 per cent in 2008/09. At that time, the Council had opined that while a large part of the sub-prime losses had been accounted for, further setbacks were possible in the months to come and conditions were unlikely to stabilize before early 2009. The domestic factors underlying the marked lowering of the growth outcome from the 9.0 per cent registered in the previous year was on account of the combined impact of very high rates of inflation, sharp deterioration in asset markets leading to higher cost of raising both debt and equity and weakening demand in the face of erosion in consumer and investor confidence.

5. The outcome in the first half of 2008/09 was broadly along the lines that were expected by the Council in July. Economic growth in the first half of the year averaged 7.8 per cent, down from the 9.3 per cent in the comparable period of last year. However, conditions became much worse from the middle of September on account of the fallout in the interbank credit market following on the failure of Lehman. On the other hand, inflationary pressures began to fall off rapidly as commodities led by crude oil declined rapidly. It was thus easier for the Reserve Bank of India (RBI) in October 2008 to sharply ease its monetary stance by cutting both reserve requirements and policy rates, as well as make other accommodation contingent upon the sudden and unexpected developments in the second half of September onwards.

Table 1: Estimated Growth of the Indian Economy in 2008/09
Sectoral Composition and Investment and Savings Rates

Unit: Percentage

	2004/05	2005/06	2006/07	2007/08	2008/09	
					July 08	Jan 09
Agriculture & Allied Activities	–0.2	5.9	3.8	4.5	*2.0*	3.0
Mining & quarrying	8.2	4.9	5.7	4.7	*7.5*	4.7
Manufacturing	8.7	9.0	12.1	8.8	*7.2*	4.0
Electricity, gas & water supply	7.5	4.7	6.0	6.3	*6.5*	3.1
Construction	16.1	16.5	12.0	9.8	*8.5*	8.0
Trade, hotels, transport, communications	10.9	11.5	11.8	12.0	*9.8*	9.3
Finance, insurance, real estate & business services	8.7	11.4	13.9	11.8	*10.0*	9.1
Community, social & personal services	6.8	7.2	6.9	7.3	*8.4*	9.6
GDP at factor cost	**7.5**	**9.4**	**9.6**	**9.0**	*7.7*	**7.1**
Industrial sector	10.3	10.1	11.0	8.5	*7.5*	5.1
Services sector	9.2	10.3	11.1	10.8	*9.6*	9.3
Non-Farm GDP	9.6	10.3	11.0	10.0	*8.9*	7.9
Per Capita GDP	5.8	7.8	8.1	7.5	*6.2*	5.6
Memo Items						
Investment Rate	32.2	35.5	35.9	37.4	*37.5*	35.0
Savings Rate	31.8	34.3	34.8	36.0†	*34.5*	33.1
Average* WPI Inflation	6.5	4.4	5.4	4.7	*10.5*	8.7
Current Account Balance as ratio to GDP**	(–) 0.4	(–) 1.1	(–) 1.1	(–) 1.5	*(–) 3.2*	(–) 1.9

Note: * Average of weeks
** (+) sign indicates a current account surplus, while (–) indicates a deficit
† Estimated from the investment rate and the provisional current account deficit for the year

6. At Table-1, the projections made in the July 2008 report may be compared with those being made in this review in January 2009. It may be observed that the principal departure is in the estimates of growth in the industrial sector (mining, manufacturing, electricity and construction), where the current estimate

is significantly lower than that made last July. This is also true for each of the components of the industrial sector as well.

7. We have earlier remarked that the pace of economic activity in the first half of 2008/09 was close to the expectation for the entire year as estimated in the July 08 outlook. However, while the difference between overall growth estimated in July 2008 (7.7 per cent) and January 2009 (7.1 per cent) is perhaps not very large, there is, however, a significant difference in the assessment of the second half of the year that is implicit in our two estimates. Basically, the revised estimated growth of 7.1 per cent for the full year implies that growth in the second half of the fiscal year will be as low as 6.5 per cent. This in turn is likely to comprise of a very weak third quarter (Oct to Dec) where growth may drop below 6 per cent and a better fourth quarter (Jan to March) where growth is likely to recover to 7 per cent.

8. While investment rates were estimated to have been higher in the first half of 2008/09 as compared to the first half of last year, the Council is of the view that for the completed year 2008/09, the investment rate will be somewhat lower than that registered in the previous year. This is seen to be a consequence of a combination of financing constraints facing Indian enterprises and a sharp downturn in investor confidence and general business conditions. The aggregate savings rate is likely to be lower than previously estimated on account of lower corporate savings and larger government negative savings, that is, the combined revenue deficits of the central and state governments (including off-Budget items). Both the average rate of inflation and the current account deficit in relation to GDP are likely to be lower than were previously assessed. In regard to inflation it needs to be pointed out that the bulk of the decline in the average inflation rate is on account of a completely transformed inflation environment in the last four months of 2008/09. Likewise, the lowering of the current account deficit (and its attendant implications on the currency market) will only be manifested in the second half of the year and that too largely in the last three months of 2008/09.

9. What is perhaps of greater importance at this point in time is to secure the conditions for growth in fiscal 2009/10. This is, to an extent, a function of the recovery in global economic and financial conditions and the offsetting measures that are taken in India through a combination of monetary, fiscal and other measures.

II. INTERNATIONAL ECONOMIC CONDITIONS

Impact of Global Financial Crisis on the Indian Economy

10. The world's advanced economies – the US, the EU, Japan and others – entered a phase of negative growth in the second and third quarters of calendar 2008. Most people estimate that this will continue into the first half of 2009; the more pessimistic guess is that negative growth will blight the third quarter and even the entirety of the second half of the year. The trouble, we may recollect, began in late summer 2007, when the problem with sub-prime mortgage assets first surfaced in the public domain and the entire market based on such underlying assets, very rapidly turned from being as liquid as treasuries to rapidly becoming illiquid.

11. In retrospect, other parts of the international capital market did not seem to view the problem with sub-prime assets as being intractable. Either the markets did not appreciate the magnitude of the problem or they reposed excessive faith in the ability of the regulatory authorities to "cure" it or more likely it was a combination of both factors. Immediately after the sub-prime problem broke into the media space in early August, the world's stock markets lost ground. However, by late September 2007, confidence returned and most stock indices hit all time highs by the end of October or early November; a few did so in December and some others in January 2008 – including that of India. Brazil and Russia, both commodity exporters, benefited from the spurt in the prices of their exports and their equity markets hit highs in May and June 2008 respectively. Most other equity markets, including that of India, weakened considerably through the first and second quarters of 2008.

12. The flush of liquidity and change in investing styles had led to a generalised decline in risk premium since 2002. Thus the *Emerging Bond Market Index* (EMBI), a proprietary index of JP Morgan, reported that credit premium (for a basket of emerging economies) had fallen from over 700 basis point (bps) in January 2003 to below 180 bps at the end of December 2006. The progressive discounting of risk was also evident in cross-country comparison of equity valuation, which

showed a decline in the spread between conventional metrics of equity valuation in advanced and emerging economies. A similar narrowing of the credit spread was also evident within markets as between government treasuries and corporate bonds. The outing of the sub-prime mortgage issue (which essentially was about the egregious mispricing of risk) in 2007, saw a sharp reversal in the declining trend in credit risk premium.

13. The risk spread on the leading public sector bank in India rose from a little over 50 bps to 100 bps in August 2007, but did not rise much further, with the year ending at a spread of less than 120 bps. More serious problems began to emerge in January 2008 in both the US and European financial sectors, leading to the arranged takeover of Bear Stearns by JP Morgan Chase in March 2008. By that time the credit spread for the leading public sector Indian bank had risen to 230 bps. This was part of a generalised increase in risk premium. The credit spread for the leading US and European banks roughly doubled between January and March 2008.

14. The absence of a further calamity in the subsequent months saw equity markets regain some ground and the credit spreads falling a bit. However, as crude oil soared and approached $150 per barrel, and inflation across countries reached unacceptable levels, the economic and financial outlook worsened and spreads rose. By this time, large international commercial banks, brokerages and other financial institutions had already posted over $500 billion in losses and the appetite for emerging market and corporate debt had diminished. However, Indian companies were able to raise $6.8 billion in *External Commercial Borrowings* (ECB) in the July to September quarter of 2008. This was indicative of the fact that raising debt was still possible, but at a significantly higher price and effort than it had been before.

15. A significant part of the funding for new asset creation by Indian companies had come from ECB. An equally important part had come from fresh issuance of equity with the balance obtained from the reinvestment of profits. Roughly, on an aggregate basis, about 35 to 40 per cent of the funding needs were met from reinvested profits, with the balance being split between domestic debt, ECB and fresh equity infusion. Conditions in the equity market were not conducive after February 2008 for the raising of fresh equity. This was perhaps initially due to the unwillingness of companies to seek lower listing prices, but as the markets

weakened thereafter, appetite for fresh issuance also declined. Hence, in the first six months (Apr–Sept) of 2008/09, the total of share issuance (domestic and overseas) by Indian companies was, according to *Securities and Exchange Board of India* (SEBI), down to Rs. 12,484 crore from Rs. 42,724 crore in the same period of last year - a decline of 71 per cent.

16. Equity and debt are not good substitutes. In the difficult situation where equity and ECB debt had become hard to come by, Indian companies have sought loans from the domestic banking system, presumably as a *temporary* measure. As a result, in the first quarter (April–June) of 2008/09, bank credit to the commercial sector increased by Rs. 68,000 crore more than it had in the corresponding period of 2007/08. In the second quarter (Jul–Sep), the increase in credit off-take was more by about Rs. 13,000 crore again compared to the same period of last year.

17. In other words, Indian companies had borrowed over Rs. 80,000 crore more in the first half of 2008/09 than they had in the first half of last year. While part of it was to meet the needs of higher levels of economic activity, another part was due to the financing of large working capital needs of public sector oil marketing companies and outstanding subsidies due to fertiliser companies; a very large part of it also flowed from the need to find alternate financing in lieu of what may have been planned to be raised through equity and overseas debt offerings.

The Crisis Post Lehman

18. After the mid-September decision to let Lehman Brothers file for bankruptcy, international financial conditions changed radically. Equity markets tumbled, credit spreads shot up and the inter-bank market virtually froze.

19. *Equity Markets:* To illustrate, till September 12, 2008, the *Bombay Sensitive 30 Stock Index* (BSE 30) had lost 33 per cent of its peak January 2008 value. After Lehman it lost more, going down another 40 per cent by 20 Nov 2008, though it has recovered somewhat since. The *Dow Jones Industrial Average* (DJIA) had till 12 September 2008, lost 19 per cent from its Oct 2007 peak value. Post-Lehman it went on to lose 34 per cent more in November, though it too has recovered some ground since.

20. *International Loan Markets:* Credit spreads (risk premium) shot up. The spread for the leading Indian public sector bank which was around 240 bps in

the week ending September 12, 2008 rose to over 850 bps towards the end of October. It has come down since, but in early January 2009, it is still 45 per cent higher than the pre-Lehman level. Credit spreads for leading US and European banks shot up by 40 to 100 per cent and more between the end of August and late September and early October 2008. They have since come down from their highs, but continue to remain elevated.

21. The 3-month *London Interbank Offer Rate* (3m-LIBOR) is the commonly used indicator of the willingness and cost of inter-bank lending – an integral component of the capacity of the banking system to intermediate payment and settlement functions. This parameter shot up from 2.82 per cent on September 12, 2008 to 4.82 per cent on October 10, 2008. It took a month for it to come down to a meaningful level of 2.20 per cent. This parameter has improved further to 1.35 per cent (January 8, 2009). The unwillingness to take any kind of risk is reflected in the plummeting yields on government securities that have fallen in the US to nearly zero for 1 to 6 month treasury bills. In the Euro-zone, a similar flight to government paper has transpired, but is a little less pronounced. Thus 2-year German gilts are now yielding 1.64 per cent, much lower than the main policy rate of the ECB, which is presently at 2.5 per cent and far lower than what the yield had been on 2 year notes in August 2008 (over 4 per cent).

22. *Trade Credit:* A particular victim of the freezing of inter-bank markets was trade credit. The inability of this mundane inter-bank accommodation to be renewed, wreaked havoc with importers as also exporters across the world. In India, as at the end of June 2008, there was a total of $45 billion of trade credit outstanding, of which $21 billion was of less than 180 days duration, the balance being above 180 days but less than one year duration. It is possible that a part of it was extinguished by September, but the situation in that month is likely to have been broadly similar to what it had been in June 2008. These trade credits tend to be rolled over and the extinction of this possibility after the failure of Lehman created an enormous problem, not just in India but across the world, especially in emerging economies. Eventually the credits were substituted by domestic lines of credit and the purchase of foreign currency in the market, but the sudden and massive nature of the adjustments caused considerable turmoil in both credit and foreign currency markets and also dislocated normal economic activities, causing enormous disruption to domestic sale and production. Output and other losses incurred in October and November were largely a result of this dislocation. The

steps taken by the RBI and commercial banks have restored to a large extent the normal working of the system but it takes time for things to normalize after such a severe and unexpected dislocation.

23. The acute problem with banks and the credit market in the US and Europe, has gravely accentuated the cyclical downturn in these economies. The US, the Euro-zone and Japan have all entered recession (technically defined as two successive quarters of negative growth). The EU and Japan did so in the second quarter of calendar 2008 and the US in the third quarter. It is a near certainty that the last quarter of 2008 would also show negative growth in all of these economies, thus putting all three into a technical recession. It is likely that the first quarter of 2009 will also be one with negative growth.

24. Unemployment, which had reached historically low levels in the US and Europe in early 2007, has risen significantly in the second half of 2008. The crisis has caused consumer and investment demand to be depressed and as a result has curtailed the export demand for emerging economies like India and China. This is particularly true for manufactured consumer goods and as a result both India and China are experiencing negative growth in merchandise exports. Indian merchandise exports fell by 12 and 10 per cent year-on-year in October and November respectively. Preliminary reports suggest that export growth was also negative in December 2008. Growth in China's merchandise export was positive in October, but it turned negative in November 2008 at (–) 2.2 per cent year-on-year.

25. It is not clear how severe the demand compression will be in the IT enabled export of services. Leading IT firms have suggested that export growth will come off from the 30+ per cent levels registered till last year to perhaps 15–20 per cent. Corporate results, as also the Balance of Payments statement, for the second quarter of 2008/09 show strong revenue growth, but it is the developments in the post-Lehman period that would be more indicative of what may happen in the second half of 2008/09 and perhaps the first part of 2009/10 as well.

26. The direct impact of funding constraints on the investment plans of Indian corporates and hence on growth and job creation, together with the second order effects of this development, coupled with the compression in export markets and the second order effects on this count, are the two principal channels through which the impact of the global financial and economic crisis are being felt in India. In

addition, there is of course the intangible, but not insubstantial, impact of weaker investor and business confidence due to the bad news and uncertainty flowing out of the advanced economies and the lack of clarity regarding how long it would take for the resolution of the underlying problems.

Assessment of Global Financial & Economic Conditions

27. The *International Monetary Fund* (IMF) in the 6 November *Update* to its October 2008 *World Economic Outlook* (WEO), drastically reduced its growth projection for the world in general and for the advanced economies in particular, both for the second half of 2008 and all of 2009. The estimate for world output growth in 2008 (estimated at Purchasing Power Parity, not market exchange rates) was reduced from the previous figure of 3.9 to 3.7 per cent. More pertinently, the growth estimate for 2009 was reduced from 3.0 to 2.2 per cent. Estimates of growth in the advanced economies in 2009 were reduced to (–) 0.3 per cent from 0.5 per cent presented in the October WEO. For the record, the corresponding estimate had been 1.3 per cent in the April 2008 WEO and 1.4 per cent in the July 2008 WEO Update.

28. In the November 2008 release, the IMF made the case, that conditions "have deteriorated over the past month, as financial sector deleveraging has continued and producer and consumer confidence have fallen……Activity in the advanced economies is now expected to contract by ¼ percent on an annual basis in 2009, down ¾ percentage points from the October 2008 WEO projections. This would be the first annual contraction during the post-war period, although the downturn is broadly comparable in magnitude to those that occurred in 1975 and 1982…. A recovery is projected to begin late in 2009." In emerging economies, the IMF concluded that growth would slow "appreciably but still reach 5 percent in 2009". Projected growth for 2009 in India and China were reduced from the October forecast by 0.8 and 0.6 percentage points respectively. For India, the revised IMF estimates were 7.8 and 6.3 per cent for 2008 and 2009 respectively. The IMF seems to have made these estimates in the context of an *absence* of fresh fiscal and monetary intervention as is evident from their statement that "… these forecasts are based on current policies. Global action to support financial markets and provide further fiscal stimulus and monetary easing can help limit the decline in world growth". However, it is expected that the IMF will bring out a review in the latter part of January 2009 where it is likely to take a somewhat more downbeat

reading of the outlook for growth in both the advanced and developing economies for the year.

29. The *European Commission* in early November released its Autumn Forecast 2008, where it stated that the Euro-zone had entered recession in the second half of 2008 and said that GDP growth "is expected to come to a stand-still in 2009 in both the EU and the euro area" and put their estimate of growth for the Euro-zone at 0.2 per cent in 2009. It went on to observe that for 2010 it expected "a slow recovery" in "most, but not all" EU member countries, with growth recovering to a modest 1.1 per cent in that year.

30. Since the collapse of Lehman in mid-September and the attendant escalation of the previously existing financial stress into an outright panic, governments across the world have intervened. First, to shore up their financial system where it was felt necessary; second, to ease the monetary stance, thus bringing down the cost of debt and helping firms and individual borrowers to benefit; third, fiscal measures have been taken in most countries to encourage demand, the design of the packages varying according to the needs of the individual countries. The *Global Finance Summit* of the heads of states/governments of G-20 countries, held in Washington on 15 November 2008, expressed the common resolve to co-ordinate economic policies so as to reduce the impact of the financial crisis on the growth process. The combination of the widespread monetary easing and fiscal stimulus will to some extent offset the effects of the global contraction of economic activity brought about by the combination of a cyclical downturn which was already due, with a virulent global financial crisis. The sharp decline in fuel and other prices since October 2008 in turn increasing disposable income in the hands of consumers, are also providing a significant stimulus.

31. Other important commentators including the *International Institute of Finance* (IIF) and leading private sector banking institutions take a view broadly similar to that of the IMF, but are more distinctly bearish about the growth outlook. Thus, for 2009, economic growth in the US is placed at (–)1.3 to (–)1.6 per cent, while some put prospects for the Euro-zone as low as (–)1.5 per cent. Prospects for Japan are placed at (–)0.6 to (–)1.2 per cent. Likewise the growth prospects for emerging economies are assessed at levels which are weaker than in the IMF's November update. The estimates made by the IIF and private banks suggest that in their view the emerging economies would grow by 3.1 to 4.8 per cent in 2009, with China expected to grow by 6.5 to 8.2 per cent and India by 5.0 to 5.8 per cent.

32. To summarise, the assessment of the IMF and the European Commission is that in the US, the EU and Japan, there will be a prevalence of recessionary conditions for at least the first half of 2009, with the possibility that this may extend into the third quarter, with some recovery in the fourth quarter of 2009. Furthermore, although the IMF has not yet put out estimates of growth for 2010, the feeling seems to be that when the advanced economies do return to recovery it may not be very vigorous, as some of the financial workout will remain to be completed. This is captured by the European Commission when it sees the EU growing at 1.1 per cent in 2010, with another major institution placing EU prospects below 1 per cent and that of the US at the long-term trend rate of growth of 2.8 per cent.

III. Assessment of Global Economic Conditions in 2009 and Growth Prospects for India in 2009/10

International Economic Environment

33. The past year has been full of surprises, mostly negative. Most institutions underestimated the damage that the evolving financial crisis of 2008 could cause to the process of global economic growth. The understandable fallout of this seems to have encouraged, in the post-Lehman period, the adoption of a position of greater pessimism, perhaps as a precautionary measure. While it is entirely possible that things may turn out to be worse than expected, it is also necessary to factor in both the facts on the ground as well as the magnitude of the monetary and fiscal stimulus that has been brought to bear on the economic problem, for an informed assessment.

34. The comparison of the present recession in the US is being commonly made not with the downturn in the early nineties or the more recent one after the dotcom bubble burst, but with the more long-lasting and severe ones of the early 1970s overlapping the first oil shock and the early eighties, attendant upon the second oil shock.

35. The US downturn of the mid-seventies began in the third quarter of 1973 (before the oil embargo) and continued for 21 months up to the end of the first quarter of 1975, with five of the seven quarters reporting negative growth of GDP. If we look at private domestic demand (which abstracts from the effects of external or export demand and that caused by government expenditure) we find that in this period, negative growth in private domestic demand also lasted for five of seven quarters – the only difference being that it started off earlier in the second quarter of 1973 and ended earlier with the last quarter of 1974.

36. The downturn in the US in the early eighties lasted much longer. GDP growth turned negative in the second quarter of 1980 and over the next nine quarters, that is, up to the third quarter of 1982, there were another five negative quarters – that is, a total of six negative quarters out of a total of ten. If we turn to private domestic demand, the downturn is seen starting out earlier in the second

quarter of 1979. Between then and the first quarter of 1982, an aggregate of 36 months, there were a total of eight negative quarters out of the twelve, including the last point in the series that is, the first quarter of 1982. The maximum number of consecutive negative quarters was *four*, starting from the last quarter of 1979 to the third quarter of 1980.

37. For the current period, GDP growth in the US turned negative in the last quarter of 2007, but recorded positive growth in the first and second quarters of 2008, before returning to negative in the third quarter and almost certainly in the fourth as well. Private domestic demand has, however, been continuously negative since the last quarter of 2007. That is, there have already been *four* negative quarters for this parameter, to which one can possibly add the fourth quarter of 2008 and the first of 2009, making for a total of *six* consecutive negative quarters, which will be a new record in the post-World War period. If the US recession were to continue into the second and third quarters of 2009, we would be looking at *further* successive negative quarters.

38. Given the surprises that surfaced in 2008, more negative developments are possible than are perhaps conceivable. However, it is worthwhile to recollect that in the downturn of the late seventies and early eighties, inflation was rampant and monetary policy was the reverse of being accommodative. In the period Apr 1979–Dec 1981, headline and core inflation rates were mostly into double digits, with inflation rates falling off in the latter part of 1982. Policy interest rates ranged between 9 and 19 per cent – averaging 13.5 per cent between April 1979 and December 1982. In so far as fiscal intervention was concerned, there was none in this period, till the passage of the *Economic Recovery* Tax Act in August 1981, which initiated a broad based reduction in income tax rates, incentives for business and exemption on specified savings.

39. This time around, however, monetary accommodation has been enormous – both in terms of the extent to which interest rates have been slashed, as also the extent of liquidity support extended by central banks in the US, Euro-zone, the UK and Japan. Governments in both the advanced and emerging economies have also extended very large doses of fiscal support to keep demand from completely flagging – and more of this is likely to be in evidence in 2009. A summary of major monetary and fiscal measures worldwide is presented in Box-I.

Box-1

Monetary Easing in Select Countries / Currency Areas

Central Bank	Area	Description of Intervention
US Federal Reserve	Interest Rates	Reduced 75 bps on each occasion in Jan & Mar 2008 to 2.25%; further 25 bps in June; On 8 Oct as part of the "coordinated" policy move by monetary authorities cut 50 bps, followed later in the month by a second50 bps rate cut reducing the target rate to 1.0%. In Dec reduced to a range between 0 and 0.25%
	Liquidity Support	A large number of new windows introduced and amounts offered increased and scope of collateral enlarged. Support to Commercial Paper and Money Market Mutual Funds introduced in Oct and Nov. The total monetary base has doubled to $1,660 billion from $830 billion one year ago. For comparison in the years 2001–03 when monetary policy was being eased the average increase was 7 per cent.
	Other Support	US Treasury Department support to the Government Sponsored Mortgage Enterprises (GSE), to JP Morgan for Bear Stearns, AIG and Citigroup. Permission to a range of entities to become bank holding companies and avail repo facilities. Swap lines with other central banks.
European Central Bank	Interest Rates	Cut by 50 bps on 8 Oct and then again in early Nov 2008 and Jan 15, 2009, each time by 50 bps. Main refinancing rate now stands at 2.0 per cent.
	Liquidity Support	Extensive liquidity support extended since late 2007. Main refinancing operation stands at nearly €220 billion and longer-term refinancing at €369 billion.
	Other Support	In Oct 2008, the Bundesbank along with the German government provided most of a €50 billion bailout to Hypo Real Estate, the largest German mortgage lender. In the same period, several European governments bailed out Fortis and Dexia banks.
Bank of England	Interest Rates	Cut by 50 bps on 8 Oct to 4 per cent the rate paid to commercial banks on their reserves. Cut on 6 Nov by 100 bps to 3.0 per cent and then again on 4 Dec by 100 bps to 2.0 per cent. On Jan 8, 2009 cut by 50 bps to 1.5 per cent.
	Liquidity Support	Special Liquidity Scheme (SLS) I March 2008 to allow banks to refinance high-quality mortgage-backed and other securities for UK Treasury bills as a follow up to previously launched special refinance schemes for mortgage backed paper the tenor of which was subsequently extended.
	Other Support	In Sep 2007 the UK Government guarantee deposits of the mortgage lender Northern Rock. In Oct 2008 it launched a re-capitalization and credit guarantee scheme through which it has already injected £65 billion into leading British banks, besides providing credit guarantee and other forms of liquidity support.
Bank of Japan	Interest Rates	On Oct 8,2008 the Bank of Japan reduced its policy rate by 20 bps to 0.3 per cent, but since then has left it untouched
	Liquidity Support	The BoJ has provided refinancing and other forms of exceptional liquidity support in the course of the past year and a half

Source: Compiled from respective Central Bank/Government press releases and other documents

Major Fiscal Stimulus in Select Countries / Economic Regions			
Country	**Description of Intervention**	**Total**	**% GDP**
Japan	1st Package (Aug 2008) - Easing Public Anxiety ¥2 trillion	¥10+ trillion (USD 105+ billion)	2.0
	2nd Package (Oct 2008) - Measures to Support Daily Public Life ¥5 trillion		
	3rd Package (Dec 2008) - ¥5 trillion		
EU	European Union €30 billion (0.3% GDP) including €6.3 billion: Structural + Social Funds; €7.2 billion: "Smart Investments"; €6.3 billion Jobs Protection	€200 billion (USD 254 billion)	1.5
	Expected from Member States: €170 billion (1.2% GDP)		
Australia	Including Payments to Pensioners (A$4.8 billion) and Low/ Middle Income Families (A$3.9 billion)	A$10.4 billion (USD 7.4 billion)	1.0
China	Infrastructure: Transportation (RMB 1,800 billion) and Rural (RMB 370 billion)	RMB ~ 4,000billion (USD ~ 586 billion)	8.9
	Post Disaster Reconstruction Projects: RMB 1,000 billion		
	Biological Conservation & Environmental Protection: RMB 350 billion		
	Low Income Earners Housing Projects : RMB 280 billion		
	Technical Innovation & Industrial Restructuring: RMB 160 billion		
	Healthcare, Education & Culture: RMB 40 billion		
Korea	Tax cuts: KRW 3 trillion	Korean Won 14 trillion (USD 11.3 billion)	1.1
	Fiscal Spending: KRW 11 trillion		
Chile	First Plan: Help to exporters $0.85 billion	Ps. 1,323 billion (USD 2 billion)	1.5
	Credits from Banco Estado to Businesses and Subsidies for Home purchases by Middle/Low Income Families		
Mexico	Fiscal Responsibility Law Changed to Allow Ps. 78.3 Billion additional spending	Ps 78.3 billion (USD 5.8 billion)	0.8
	First Stimulus: Ps 53 billion (Infrastructure: Ps 26 billion, Energy Projects: Ps 10 billion)		
	Support to Agriculture (end-Oct): Ps. 9 billion		
USA	Troubled Asset Relief Program (TARP) used to inject capital into banks; about half of it used so far.	USD 700 Billion	13.0
	Relief provided from TARP to General Motors & Chrysler	USD 17.4 Billion	
	Spring 2008 tax cuts, GSE bailout, capital infusion by FIDIC etc. not including loan guarantees	~USD 1,200 Bn	

Source: Global Economic Monitor, International Institute of Finance, December 2008 and media sources

40. The Euro-zone entered recession in the second quarter of 2008 and this is certain to hold through the last quarter of 2008 and perhaps the first quarter of 2009 as well, which would mean a total of *four* successive negative quarters. This will be without doubt the most severe recession since the formation of the monetary union. While the Euro-zone did not have a home-grown problem of sub-prime mortgage based collateralised debt obligations, the exposure of European banks to American products was of a magnitude that proved sufficient to create a financial crisis in the region, leading to credit flow problems, the transference of negative expectations and a metamorphosis of home-grown mortgage and other loan problems into a full-fledged financial crisis with great economic ramifications. Offsetting this to an extent is the improvement in fiscal conditions within the EU over the past several years which should prove quite helpful to the governments of the region to cushion the effects of the downturn.

41. In Japan, revisions to the data released in early December 2008, have enlarged the negative growth in the second quarter of 2008 initially estimated at 2.4 to 3.7 per cent (both annualised). Preliminary data for the third quarter also shows negative growth at 1.8 per cent (annualised), thus placing the economy in a sizeable technical recession. In the fourth quarter of 2008, growth is almost certain to have been negative and there is a possibility that recessionary conditions will persist in the first quarter of 2009. Private consumption expenditure has so far held up with the third quarter reporting positive growth. Private business investment and net exports were both in the red in the second and third quarters and the principal causal factors for the overall contraction. The steady reduction in fiscal expenditure over the past many years affords some elbow room to reverse the contribution to domestic expenditure by stepping up fiscal support temporarily – a course of action that the government has already announced.

42. For Japan, in 2009, the hardening of the currency and the weakness of export markets in the US and Europe (including the export of components that are shipped out as finished products from China) have strong negative implications for the revival of economic growth. There is no home-grown problem in Japan and its banks have had little exposure to problem US assets. It is possible that action by the Japanese authorities can prevent the economic problem in that country to take deep and independent roots. However, the strong nexus between Japanese business investment with the export business, either directly or through supplies to export-oriented Chinese enterprises are likely to

prevent the economy from fully recovering till better conditions return in the US and European economies.

43. On balance it would appear that economic recovery in the principal advanced economies could, in the absence of concerted efforts by their respective governments and monetary authorities, be a long drawn out process, perhaps extending across 2009 and even into part of 2010. However, the fact is that fiscal and monetary instruments are being arrayed with great vigour to strengthen the financial system and keep demand from flagging. The fact that the slowdown is global has totally altered the inflationary situation, making a co-ordinated monetary and fiscal response across developed and emerging nations more possible and by virtue of that, more powerful.

Prospects for 2009/10 in India

44. Keeping in view all of these factors, the Council is of the view that economic conditions in the advanced economies may continue to be recessionary in the first half of 2009, but growth would re-surface in the third quarter of the year. Emerging economies, such as India and perhaps China, would have a difficult time in the first part of the year, but should be able to show a pick-up in growth in the last quarter of 2009, if not earlier.

45. Recollecting the transmission channels that was discussed at the outset, the expected economic recovery in the second half of 2009, is likely to ease the capital market constraints, earlier than it may ease the export market constraints. The widely held view is that the recovery in the advanced economies when it comes in 2009, is unlikely to be robust and thus the limitations on the recovery of the export market may continue into 2010. However, capital market conditions are expected to recover earlier – given the greater extent of weakening that they have undergone. By recovery is meant that the markets become functional once again in terms of being able to allocate capital. That is, companies should be able to place debt and equity – *albeit* neither as easily nor at such attractive prices as were prevalent in 2006 and 2007. It is likely that loan market conditions will improve before the summer of 2009, although equity market conditions may not do so till the third or even fourth quarters of 2009.

46. As earlier stated, in its forthcoming Update likely to be released late in January 2009, the IMF may further reduce the growth outlook for advanced economies and also for most emerging economies as well. In the case of India this is likely to see a reduction from the November 2008 estimate of 6.3 per cent to somewhere below 6 per cent. International banks and other private agencies, as mentioned earlier, are placing growth in the Indian economy in 2009/10 in the region of 5.0 to 5.8 per cent.

47. The Council is of a different view. It expects that in 2009/10, the Indian economy is likely to remain relatively weak in the first quarter (April–June) and slowly pick up thereafter; that the economy would show fairly strong recovery in growth in the second half of the fiscal (Oct 2009 to Mar 2010) assuming an improvement in international economic and financial conditions in the second half of 2009. Overall, the Council assesses that growth in 2009/10 would be between 7.0 and 7.5 per cent or somewhat above that, with the first half of the year averaging growth close to 7.0 per cent and the second half with average growth of close to 7.5 per cent or higher. This outcome factors in the impact of monetary easing, fiscal stimulus and other administrative measures to keep the growth engine running in the economy.

Farm Sector & the Rural Economy

48. The present crisis has come upon the Indian economy at a point in time where several of its components are in relatively strong shape. Most bad years in the past arose when the agrarian economy was in crisis. This is not so currently. The farm sector has been fortunate in having had five successive good monsoons and good harvests, due in considerable measure to better seeds, improved market access, remunerative prices, availability of cheap fertiliser, and in the current year, the farm loan waiver.

49. Some of the earlier episodes of crisis – 1965/67, 1971/73 and 1979/80 derived principally from bad harvests. In the years running up to the BoP crisis of 1991/92, between 1985/86 and 1991/92, three out of seven years were poor for agriculture, two indifferent and two good. Likewise in the slowing down of the economy in the late 1990s and early 2000, of the six years between 1997/98 and 2002/03, three were bad (one disastrous), one indifferent and two good. While the farm sector did not lie at the heart of either of these two later

slowdowns, the pressures on the economy could not have been but enhanced because of the relatively stressed condition of the farm economy. In sharp contrast, of the six years leading up to 2008/09, all have been good, some excellent. The strength of the farm sector extends to the larger rural regions as well as industry catering to consumer goods and other manufactures absorbed by the rural economy.

Other Sources of Strength

50. The Indian enterprise has undergone a fundamental process of modernisation in both its business model and the manner of its organisation. The decades of import and industrial licensing and centralised licence-linked financing from state owned banks and institutions, had created a kind of lethargy because of non-competitive market conditions. The reforms of 1991 changed the conditions that Indian enterprises did business in, but many failed to understand the major change in the competitive environment. As a result many companies faced distress in the late nineties and an unprecedented wave of consolidation swept across Indian business. Exposed to competition, therefore exposed to business risk and also financial risk, Indian companies went through a hard school of learning survival. The survivors have learnt the hard lessons of the importance of managing business and financial risks, and are thus to that extent in a better position to ride out the storm of this crisis.

51. Indian banks have also gone through a transformational process. Adapting from a closed economy to an open one with more opportunities, but also uncertainties, has been a challenge for the lending institutions too. In the mid-nineties the non-performing loans (NPL) of our banks was on an average close to 18 per cent as a proportion of advances. In March 2008 this was down to 2.3 per cent, even as the stock of credit grew manifold. Over the years, the RBI has progressively tightened prudential norms, and whatever deterioration in asset quality the present crisis brings in its wake, Indian banks are today better prepared to deal with it than at any time in their history.

52. Total consumption expenditure – private & government – has over the past 15 years contributed to real GDP growth of over 4 percentage points on an average. The median value was 4.6, and that of the first quartile 3.6 percentage points. The years with lower consumption growth were ones with terrible or bad

harvests: 2002/03, 2000/01 (two successive bad years) and 1997/98. As discussed in the July 2008 Outlook, employment growth has been strong in past years, the farm sector is looking good and the government is planning to spend more. Indian households consume mostly out of current income: the proportion of leveraged consumption is low. There is, therefore, little reason to believe that domestic consumption expenditure will not contribute somewhere between its first quartile (3.6) and median (4.6) values towards aggregate GDP growth.

53. Domestic savings was reported at 34.8 per cent in 2006/07 and that in 2007/08 was possibly a little more. In 2008/09, the combination of an increase in government's negative savings (revenue deficits) due to lower than budgeted tax growth and higher revenue expenditure outgoes and pressure on corporate profitability will cause domestic savings to fall. This will be partly offset by lower losses of departmental enterprises (oil companies) and the secular increase in household savings. In 2009/10 there is likely to be further pressure on corporate earnings and tax growth may not recover easily, leading to the persistence of enlarged negative savings of government. It is, however, unlikely that the aggregate of domestic savings will fall by more than 3 to 4 percentage points in 2009/10 as compared to 2007/08. That is, domestic savings rate will in the adverse scenario, be close to or in excess of 31 per cent of GDP, which together with net savings from abroad (current account deficit) would translate to potential investment of about 32 per cent of GDP. Even with growth below the potential rate, and in the absence of other severe constraints, the economy should be able to generate growth in the region of 7.0 to 7.5 per cent in 2009/10.

IV. SECTORAL DEVELOPMENTS

Farm Sector

54. GDP arising in the farm sector has averaged growth of about 3.5 per cent over the past four years and recorded expansion of 4.5 per cent last year. In July 2008, the Council had made a conservative projection for 2008/09 that farm sector GDP would increase by 2.0 per cent, given the strong growth in previous years and the yet incomplete South West (SW) monsoon. The precipitation during the Monsoon months was quite good, as had been that in the pre-Monsoon season. The *First Advance Estimates* released by the Agriculture Ministry at the end of September 2008 suggest that the initial estimates of crop output in *kharif* 2008/09 were lower by 5.1 per cent for foodgrain and 9.6 per cent for the principal nine oilseeds than in the previous year.

55. However, the first advance estimates do get revised, often upwards. A more meaningful comparison may be between the *First Advance Estimate* of 2008/09 with the First *Advance Estimate* for 2007/08, in which case the picture is better. Paddy output is higher in the current year by 3.9 per cent, while total foodgrain output is higher by 2.8 per cent. Output of the nine main oilseeds is higher by 11.3 per cent, with groundnut up by 17.7 per cent and soybean is higher by 9.9 per cent. Cotton production is 4.2 per cent higher, though sugarcane output is 15 per cent lower than in the previous year. However, it is entirely possible that the extent of upward revision made last fiscal between the *First* and *Fourth Advance Estimates* may not be matched in this fiscal.

56. The precipitation in the SW monsoon has been particularly good in the northern parts of the country where the *rabi* crop is very important; it has also been strong in the eastern region. We would thus expect harvests of wheat, *rabi* oilseed and other winter crops to show significant expansion. The available data on *rabi* sowing up to 1 January 2009, suggest that the acreage under wheat is marginally higher this year by 0.2 per cent, while that for coarse cereals is up by 10.2 per cent; acreage under winter pulses is higher by 6.7 per cent and that for winter oilseeds is up 11.5 per cent. Overall the acreage under foodgrain (cereals and pulses) is higher by 3.4 per cent. The indications, therefore, are that the *rabi* harvest should result in a significant output gain in foodgrain and oilseeds compared to last year.

Horticultural and animal husbandry products are expected to show output gains, as they consistently have over the past few years.

57. It is on this basis, and on the assumption of normal weather conditions during the *rabi* season, that we are projecting 3.0 per cent growth in the farm sector GDP in 2008/09, with a strong possibility that this may be higher at about 3.5 per cent, depending upon weather and other conditions in the harvesting months.

58. The stock of foodgrain with government is at comfortable levels. The procurement of rice has gone well with 2007/08 (Oct–Sep) recording an increase of 14 per cent. In the fresh 2008/09 season (Oct–Sep) procurement has been higher by 20 per cent up to the end of December 2008. Official stock of rice at the beginning of January 2009 is estimated at 9.2 million tonnes, more than twice that of the buffer norm. Wheat stock at the beginning of November 2008 stood at 21 million tonnes, which was 32 per cent higher than in the same period last year.

Industry

59. In fiscal 2007/08, GDP arising in the industrial sector rose by 8.5 per cent, a marked decline from the 11.0 per cent growth recorded in 2006/07. In the July 2008 Outlook, the Council had projected a lower growth of 7.5 per cent in the industrial sector. In the first half of this year, GDP arising in the industrial sector registered an average growth of 6.5 per cent, a considerable decline from 9.3 per cent in the same period of last year. The fall in the rate of growth in industrial output in recent months has been more severe, with the *Index of Industrial Production* (IIP) registering a small negative growth in October 2008 and a small positive one in November. While the Council is of the view that industrial activity will show a recovery in the final quarter of 2008/09, average growth for the year is now projected conservatively at 5.1 per cent for the whole of 2008/09.

60. *Mining:* GDP arising in mining rose by 4.4 per cent in the first half of 2008/09. Production of crude petroleum, which accounts for 40 per cent of this sector, showed a *decline* of 0.8 per cent in the first half, compared to a growth of 0.6 per cent last year. In the second half of 2008/09, it is not clear whether the declining trend in crude petroleum output will continue. However, there may be some offsetting improvement from the expected initiation of the supply of Krishna Godavari (KG) Basin (Reliance Industries) natural gas in the last quarter of the year. Coal output has risen fast, growing by 8.3 per cent in the first seven months

of the year. For the year as whole, the Council has projected growth of 4.7 per cent, significantly lower than its forecast of 7.5 per cent made in July 2008.

61. *Manufacturing*: GDP arising in the manufacturing sector is reported to have expanded by 5.3 per cent in the first half of 2008/09 compared to 10.1 per cent for the same period of last year. The IIP output growth in October was reported to be (–)1.2 per cent, from which it recovered slightly to a positive 2.4 per cent in November 2008. Problems with the IIP data have been widely voiced by many commentators. On *prima facie* basis there seems to be weaknesses in respect of base year (1993/94), response rates and scope or coverage of industrial units. It would seem that revisions to the IIP index, in the form of a new base year, a wider scope of coverage and improved system of response rates is called for. It is also desirable that the *Central Statistical Organisation* (CSO) independently develop turnover indices for important sectors – industrial, services and farming – that will enrich the database of the economy and serve to help in the validation of statistical information. Keeping in mind the dislocation caused to the sale and manufacturing of a wide array of products after September 2008, the Council assesses that manufacturing activity will grow by an average of 2.5 per cent in the second half of 2008/09, yielding an annual average of 4 per cent growth for the full year. This estimate has an element of upside built into it, if the improvement is somewhat stronger in the closing months of 2008/09.

62. *Electricity, Gas & Water Supply*: Notwithstanding the largest-ever addition of 9,263 MW of generating capacity in 2007/08, actual generation has fallen significantly behind the programme (planned) generation. For the period April to December 2008, generation was only 93.1 per cent of programme levels. Generation in December 2008 was a mere 0.7 per cent more than in the same month of last year. For the first nine months of 2008/09 as against a planned increase in generation of 10.2 per cent, what the economy actually got was 2.6 per cent. This generation shortfall has added to the difficulties facing all sections of the economy, in particular the manufacturing sector, which has had to use expensive petroleum-based fuels to generate captive power, compounding all the other difficulties that it has had to face this year. It is hard to see a significant improvement in the balance three months of the year, though given the widespread power shortages, it is to be hoped that there will be some improvement. In the first half of 2008/09, GDP arising in this sector was estimated to have grown by 3.1 per cent. The Council

expects that with some improvement in the last quarter, overall expansion in the second half will remain at this level, making for an average of 3.1 per cent for the full year.

63. Construction: Construction activity encompasses public works (road, ports etc), erection of new plant & equipment and housing & commercial real estate. The latter has been negatively impacted by the loss of appetite for exposure to this sector by both equity and debt investors. This factor is unlikely to change significantly in the coming months. Fiscal and monetary measures to help build up affordability and interest in home loans will help avert some of the difficulties that the sector is facing, but overall conditions may be expected to be depressed for some time. Infrastructure and new plant erection is likely to be carried forward in the remaining part of the year at a pace similar to that in the more recent past, with the infrastructure sector possibly facing some boost from recently announced fiscal and other measures – but perhaps more so in the first part of the next fiscal, than in the balance part of the current one. In the first half of 2008/09, GDP arising in the construction sector was estimated to have grown by 10.5 per cent. This is expected to experience a significant decline in the first half and the revised projection for the full year is 8.0 per cent.

Services

64. The service sector encompasses trade, hotels, financial, real estate and business services, public and personal services, as well as transportation and communications. The general slowdown in the economy is bound to impact the expansion of the service sector. Growth was still brisk in the first half of the year, but indications are that there may be significantly slower growth in the hospitality and transportation sectors. The export of services has grown very rapidly in past years. However, the difficult economic and financial conditions in overseas markets hold out the possibility of some slowing down in the pace of growth in this sector.

65. Offsetting these will be the faster growth in public services on account of higher public sector pay, much larger transfer payments (subsidies) and the release of arrears. Overall the service sector is expected to show output growth of 9.3 per cent, comprising a reported 9.8 per cent growth in the first half of the year and a forecast of 8.9 per cent growth in the second half of 2008/09.

V. TRADE AND BALANCE OF PAYMENTS

Merchandise Export and Import

66. The trade deficit increased in the first half of 2008/09 on account of soaring crude oil prices. The value of crude oil and other petroleum product imports increased (in US dollar terms) by 80 per cent in the first six months (Apr–Sept) of 2008/09, compared to the same period of last year. In fact the increase in the oil import bill amounted to $27.6 billion, which was significantly *larger* than the total increase in the merchandise trade deficit of $25.4 billion in the course of the first half of 2008/09, relative to the comparable period of last year.

67. Merchandise exports rose by 42 per cent in the first quarter of 2008/09, but slowed down to 24.3 per cent in the second. Export growth was negative (in US dollar terms) in October, November and December 2008. Even while it is likely to turn positive from January 2009 onwards, overall export growth will be much weaker in the second half of 2008/09, as compared to the first half.

68. Disaggregated data show that for the first four months (Apr–July) of 2008/09, cotton textiles and apparel grew by 10 per cent, while manmade textiles improved by 38 per cent. However, the anecdotal evidence is that the pace of textile exports has fallen off very sharply after September. Likewise in the case of ores, where up to the end of July export growth was still strong at 37 per cent, export has fallen sharply in the subsequent months. Gems & jewellery exports have weakened after July 2008, and turned negative in October and November 2008. The value of refined petroleum product exports has increased this year, but the quantity of exports has lagged that of domestic consumption. As a result the increase in the value of petroleum exports has progressively fallen behind that of imports. Export of automobile products grew very strongly in the first quarter of 2008/09 but has been slowing down since and particularly so after September 2008, as world wide automobile sales slumped.

69. Overall imports increased sharply by 37 and 51 per cent in the first two quarters, mostly because of the soaring oil import bill, but also because of a sharp

increase in non-oil imports which rose by 21 and 35 per cent respectively in the first two quarters. Bullion (gold and silver) imports contracted in the first half of 2008/09 and given that most of the non-oil, non-bullion imports are intermediates and capital goods for industrial activity, the robust nature of this import growth is indicative of a continuing strong pace of economic activity during this period.

70. Besides petroleum products, fertiliser imports grew sharply in the first half of 2008/09, partly because of higher prices, but mostly due to larger volumes. The volume growth is likely to continue in the second half of the year, though value growth will be partially offset by lower prices. Intermediate imports also swelled partly because of higher prices, a situation that will change in the second half of the year. Import levels may also be negatively affected due to weaker economic conditions in the domestic economy.

Forecasts

71. Data on overall merchandise exports and imports are available up to November, though disaggregated data is available only up to the end of July 2008. Balance of payments data is available up to the end of the second quarter, that is, September 2008. These have been combined with projections for the balance part of the year. In estimating exports and imports, large value items namely, petroleum products, gold and silver and gems & jewellery have been treated separately and these have been forecast separately. The balance has then been independently estimated; the aggregate yields, the total of merchandise exports and imports.

72. *Imports*: The value of petroleum imports is known up to the end of November and the international price up to the end of December 2008. On this basis, the price and volume components can be separated and the same extended for the balance four months of the fiscal year. Benchmark (UK Brent) prices are assumed to average \$53 per barrel in the first quarter (Jan–Mar) of calendar year 2009 and a lag between import arrivals and prices of about one-and-a-half months is taken. This takes the total oil import bill for 2008/09 to \$98 billion, about 23 per cent higher than it was in the previous fiscal year.

73. The value of gold & silver imports declined by 42 per cent in the first four months (Apr–Jul) of 2008/09, a trend that is expected to persist for the rest of the year in light of other evidence. The bulk of bullion imports are absorbed as jewellery in the domestic market and this will be negatively impacted by weaker

domestic economic conditions. A part of bullion imports are used to make jewellery for export and this too is not expected to grow in the balance part of 2008/09. In the second half of 2008/09, bullion imports are expected to continue to decline but at a slower pace. Overall in 2008/09 the forecast is that the value of gold and silver imports will aggregate about $10 billion, some 47 per cent less than that recorded last year.

74. Diamonds (both rough & cut) as well as other precious stones add up to a sizeable import volume. The import of such items was valued at over $15 billion in 2007/08 according to the *Gems & Jewellery Export Promotion Council of India.* In 2008/09, import growth was 46 and 28 per cent in the first and second quarters. However, import growth was negative in October, though it recovered somewhat in November. However, bearing in mind the recession in the principal markets for gems & jewellery in North America and Europe, it has been assumed that import growth will be negative in the third and fourth quarters of the year, matching the assumed negative growth for gems & jewellery exports. The projected import value of precious stones in 2008/09 is $17 billion, 8 per cent larger than that of last year.

75. The increase in the value of items of export other than petroleum, bullion and precious stones, was 48 per cent in the first half of 2008/09, most of which was machinery, raw materials and intermediate products. It is expected that the pace of expansion in the second half will be slower at about 32 per cent, partly because of slower demand and partly due to price effects. Thus, the estimate for total merchandise imports in 2008/09 stands at $295 billion, about 23 per cent greater than in the previous year.

76. *Exports*: The value of refined petroleum product exports in the first half of 2008/09 showed an increase of 42 per cent, much smaller than the value of imports which was higher by nearly 80 per cent. The increase in domestic consumption combined with the sharp fall in the export price of refined products is expected to see second half exports fall by 57 per cent in US dollar terms. For the year as a whole, export of refined petroleum products is thus estimated to exceed $26 billion in 2008/09, which is 6 per cent less than that registered last year. This is inclusive of the expected single-quarter production in the newly commissioned refinery of Reliance Industries in Jamnagar.

77. The value of exports of gems & jewellery aggregated $14 billion in the first eight months (Apr–Nov) of 2008/09, which is about 3 per cent more than that recorded in the same period of last year. However, this was a combination of a small contraction [–6 per cent] in the first quarter and strong growth [+21 per cent] in the second quarter. Then, exports turned strongly negative in October and November [–48 and –34 per cent] and while the magnitude of contraction may soften in the balance period of this fiscal, export growth is expected to remain in the negative territory in both the third and fourth quarters. In the second half of 2008/09, the value of gems & jewellery export is expected to decline by 25 per cent. Overall exports in 2008/09 are thus expected to be a little below $18 billion, which is 10 per cent less than last year.

78. Non-oil, non-jewellery exports grew by nearly 36 per cent in the first half of 2008/09, much stronger in the first quarter than in the second, 54 and 21 per cent respectively. In the second half, the assumption is that this mixed bag of exports, which also includes inputs for exports, would grow at a slower pace of 12 per cent. The impact of the contraction in the value and volume of petroleum products and gems & jewellery export will be so pronounced that the value of total merchandise exports is likely to see a small contraction in US dollar terms in the second half of 2008/09. In the third quarter ending December 2008, overall export growth in US dollar terms may show a decline of up to 10 per cent, while growth in the last quarter of the fiscal year (Jan–Mar) may register positive single digit growth. Overall for the year, merchandise exports are expected to be $180 billion, leaving a trade deficit of $115 billion, sharply higher by 42 per cent over the $81 billion recorded last year. However, the present estimate of the trade deficit is lower than the trade deficit of $127 billion made in the July 2008 Outlook when crude petroleum prices were ruling high. These magnitudes correspond to the data reported by the *Directorate of Commercial Intelligence & Statistics* (DGI&S).

79. After adjustment for exports and imports that are included in the Balance of Payments (BoP) statistics but not in the DGCI&S data, the value of exports, imports and trade deficit come to $182.9, $303.6 and $120.7 billon respectively.

Table 2: Projected Balance of Payments for 2008/09

Unit: US$ billion

	2004/05 R	2005/06 PR	2006/07 (P)	2007/08 (P)	2008/09		
					H1	H2	Year
Merchandise Exports	85.2	105.2	127.1	158.5	96.7	86.1	182.9
Merchandise Imports	118.9	157.0	192.0	248.5	165.9	137.7	303.6
Merchandise Trade Balance	–33.7	–51.8	–64.9	–90.1	–69.2	–51.6	–120.7
	–4.8%	–6.4%	–7.1%	–7.7%	–11.5%	–8.6%	–10.1%
Net Invisibles	31.2	42.7	55.3	72.7	46.9	51.1	97.9
o/w Software & BPO	14.7	24.6	31.2	37.0	22.2	25.0	47.2
Private Remittances	20.5	24.1	27.9	40.8	25.8	29.5	55.3
Investment Income	–4.1	–4.9	–6.0	–5.2	–1.6	–4.5	–6.1
Current Account Balance	**–2.5**	**–9.2**	**–9.6**	**–17.40**	**–22.3**	**–0.5**	**–22.9**
	–0.4%	***–1.1%***	***–1.0%***	***–1.5%***	***–3.7%***	***–0.1%***	***–1.9%***
Foreign Investment	13.0	17.2	15.5	44.8	9.0	2.7	11.8
o/w FDI (net)	3.7	4.7	8.5	15.5	14.6	3.0	17.6
Inbound FDI	6.0	7.7	22.0	32.3	20.7	9.5	30.2
Outbound FDI	2.3	2.9	13.5	16.8	6.1	6.5	12.6
Portfolio capital	9.3	12.5	7.1	29.3	–5.5	–0.3	–5.8
Loans	10.9	6.1	24.5	42.0	7.3	–14.3	–6.9
Banking capital	3.9	1.4	1.9	11.8	4.8	–0.4	4.4
Other capital	0.7	–0.7	4.0	9.6	1.5	2.0	3.5
Capital Account Balance	**28**	**23.4**	**45.8**	**108.0**	**19.9**	**–9.9**	**10.0**
	4.0%	***2.9%***	***5.0%***	***9.2%***	***–3.3%***	***–1.7%***	***0.7%***
Errors & Omissions	0.6	0.8	0.6	1.5	–0.1	0.0	–0.1
Accretion to Reserves	**26.2**	**15.1**	**36.6**	**92.2**	**–2.5**	**–10.5**	**–13.0**
	3.7%	***1.9%***	***4.0%***	***7.9%***	***–0.4%***	***–1.7%***	***–1.1%***

Note: * Business process outsourcing
Figures in parentheses denote proportion to GDP at current and market prices
Figures may not add up due to rounding off

80. *Invisibles*: Export of services – software and other IT related activities – which may broadly be taken to be inclusive of private remittances (for the purpose of estimating future levels), grew by 43 per cent in the first half of 2008/09, with both first and second quarters showing strong growth of 34 and 53 per cent respectively, relative to comparable periods of the previous year. In 2007/08 this type of current receipts had aggregated $78 billion and had recorded annual growth of 31 per cent. In the second half of 2008/09, there is a case to expect slower growth in both service sector exports and remittances and growth in this item has been scaled down to 23 per cent. This results in the total value of export of services plus private remittances to total $103 billion. Net investment income, is a negative number, and is estimated at $6 billion for the year. The total of net invisible earnings is thus estimated at a total of $98 billion in 2008/09 (including other receipts such as net tourism earnings), up 35 per cent from the $73 billion recorded in the previous year.

81. Thus, the *Current Account Deficit* (CAD) in 2008/09 is likely to be $22.9 billion or 1.9 per cent of expected GDP, which is larger than the $17 billion (1.5 per cent of GDP) in 2007/08, but much smaller than the estimate of 3.2 per cent made by the Council in the July 2008 Outlook for the current fiscal year.

Capital Account

82. Projecting capital inflows is notoriously difficult and the developments this year have made this much more so. In 2007/08 total net inflows in the capital account was an unprecedented $108 billion. In the July 2008 Outlook, the Council was of the view that capital inflows will diminish due to the turbulence in the world financial markets and had estimated this to be $71 billion. In this scenario, the capital inflows were still more than adequate to finance the enlarged current account deficit (CAD) and a net increase in reserves was visualised by the end of the fiscal. Now, while the Council is projecting a much reduced CAD, the estimated capital balance is negative and a sizeable drawdown of reserves is visualised at year end. In fact, the draw down to date is larger. It is expected that an overall BoP surplus in the last quarter will help reduce the extent of the draw down.

83. The net inflows in 2008/09 on account of *Foreign Direct Investment* (FDI) were estimated in July 2008 at $19.7 billion, up from $15.5 billion in the

previous year. The Council is revising the estimate to $17.6 billion, based on the actual gross inflows up to November and the outflow data up to September 2008.

84. In July, the Council had estimated portfolio inflows – investments by *Foreign Institutional Investors* (FII) in equity and debt, subscription to American and Global Depository Receipts (ADR/GDR) and others – to be $4.1 billion, down from $29.3 billion in the previous year. The revised projection for this item is (–) $5.8 billion. The estimated net inflow in this fiscal year from FII till the end of December 2008 is about (–) $10 billion, with small positive inflows in November and December 2008. It is expected that modest positive inflows aggregating $3 billion will occur in the last quarter, given the expanded access to debt instruments. ADR/GDR issuance has been insignificant at $1 billion, mostly completed in the first quarter, and none is expected during the balance part of this fiscal year.

85. The biggest surprise has been with loan inflows and that too with short-term inflows. The accumulated trade credit at the end of June 2008 stood at $45 billion, of which $24 billion was over 180 days but less than 1 year, and the balance of 180 days or less. Most of these trade credits are provided by the banking system and largely entail accommodation between banks operating in the domestic economy and the international inter-bank market. Inter-bank accommodation is a routine matter based on relationships and reputation that go back decades. The net increase year-to-year is small and banks normally do not face problems in obtaining such accommodation. That continued to be the case till the failure of Lehman Brothers and the complete seizing up of the inter-bank market in the aftermath of the failure. It is not just that the benchmark LIBOR shot up, transactions between banks simply ceased. As both regulators and the media later put it, "banks ceased to have any trust in each other". The reason is obvious. Financial agents with claims on Lehman Brothers, suddenly found themselves left high and dry, and they did not want to extend this unexpected circumstance with respect to other banks that may go belly up.

86. The inability to generate trade credits after mid-September drove an enormous hole through world trade. With importers unable to arrange credit, and exporters unable to extend credit to their buyers, global commerce came close to a grinding halt. For individual companies the only solution was to obtain domestic credit lines and to purchase foreign currency in the market in order to pay

suppliers. Little wonder that there was a sudden surge of demand for credit and a sharp increase in hard currency in the markets of all emerging economies. Most economies had a tight monetary stance having had to fend off huge inflationary pressures from the $147/bbl oil and other levitating commodities. That made the difficulties more severe.

87. The running down of foreign currency assets in India began in the closing days of September and carried into October as some of the trade credits were substituted by domestic credit lines. Thus bank credit grew in an unprecedented fashion in October as was the draw down of foreign currency reserves. The sell-down of equities by foreign investors and possible outflows through the banking channel served to further compound the drawing down of foreign currency reserves and the corresponding reduction in available liquidity. The fall in the prices of crude oil, fertiliser and bulk commodities also reduced the value of these import transactions and resulted in a reduction in outstanding trade credit.

88. In the second quarter, short-term credit rose by $0.8 billion. It is assessed that in the third quarter ending December 2008, a substantial *reduction* of about $20 billion may have taken place, partly because of substitution with domestic credit and partly due to a fall in oil and fertiliser prices. In the second half of 2008/09 the Council assesses that a total reduction of about $22 billion will take place in the stock of short-term credit, making for a net reduction of a little over $19 billion in the full year 2008/09. This is, of course, vastly different from the expectation of a small reduction in the year-end position made in the July 2008 Outlook.

89. In the July 2008 Outlook, total net inflows through ECB/ Foreign Currency Convertible Bonds (FCCB) had been assessed at $16 billion. While gross raisings till November 2008 was $13.8 billion, on a net basis, the inflows till the end of September were much lower at $3.3 billion, partly due to repayments of older loans and in part due to lags in reporting and repatriation. Considering the difficult global loan market conditions, and the possibility of buy backs of maturing FCCB, the Council is of the view that notwithstanding the liberalised ECB guidelines, the total net inflows on account of this item may not exceed $10 billion in 2008/09.

90. Little change in development assistance is expected in the balance part of this year. Thus, the present assessment is that total net inflows of loan funds in 2008/09 will amount to (–)$14.3 billion in the second half of 2008/09, as against

the reported $7.4 billion in the first half. For the year as a whole, net inflow of loan funds is now placed at (–) $6.9 billion, a dramatically different situation from the expected inflow of $34 billion made in July 2008.

91. Banking channels had accounted for $11.8 billion of inflows in 2007/08, not on account of NRI deposits, but through other instruments. In July 2008, the Council had expected the trend to continue at a more subdued level at $8 billion. In the first and second quarters of this fiscal, these inflows were indeed positive at $2.7 and $2.1 billion respectively, of which a total of $1 billion was due to NRI deposits. The Council feels that while NRI deposits are likely to show positive inflows in the second half of 2008/09, net flows through conventional banking channels that may have turned negative in the Oct–Dec quarter will result in an overall negative inflow of (–)$0.4 billion in the second half of 2008/09.

92. Overall capital inflows in the first half of 2008/09 amounted to $19.9 billion. In the second half of the year, this is assessed to be a negative number, namely (–)$9.9 billion. For the year 2008/09 as a whole, the capital account balance is expected to be positive at $10.0 billion, while the overall Balance of Payments is expected to be in the negative at (–)$13 billion which will be equivalent to the draw down of foreign currency reserves. It should be stated at this point that the draw down of reserves in this fiscal up to the end of the third quarter (December 2008) has been much larger than this (double of the projected full year magnitude). However, the combination of an expected surplus in both the current and capital account in the last quarter of 2008/09 should replenish this erosion to some extent. The next fiscal should start with a foreign exchange reserve with RBI of some $250 billion, which is a comfortable level.

VI. PRICES

Elevated Level of Inflation in 2008

93. Inflation was rampant through the first half of 2008/09 as commodity prices that had begun to rise in the last couple of months of the previous year, gathered much greater momentum. Crude oil hit unprecedented highs and agricultural commodities such as soybean, corn, wheat, rice and edible oils followed suit, as there was a tendency to see the prices of these products in terms of their potential or actual use as bio-fuels and hence substitutes of diesel. Steel and ore prices also soared on the back of apparently insatiable demand and limits on production capacity. The anecdotal evidence suggests that the availability of ample liquidity and low dollar interest rates, prompted many investors to go "short dollar and long commodities", with the intervention being large enough to create a "commodity bubble" in the immediate wake of the "sub-prime housing bubble". The particular dynamics of the commodity mania that started out in the second half of 2007, that built on already elevated commodity price levels and collapsed a year later, will perhaps be fully understood only later. In any event, the surge in prices made for very difficult conditions in the first half of 2008, before collapsing into a recession in the advanced economies.

Wholesale and Consumer Price Indices

94. Inflation as reported by the *Wholesale Price Index* (WPI) began the year at 7.7 per cent in the first week of April, a level clearly above the comfort zone of policy making in India. WPI rose through the next several months, peaking just shy of 13 per cent in August. The *Consumer Price Index* (CPI) inflation broadly kept pace with the rising WPI rate and the three major indices (CPI-UNME, CPI-IW ad CPI-RL), peaked with a lag in October, when the inflation rate for CPI-UNME and CPI-IW hit 10.5 per cent in October. In November the CPI-IW continued to register 10.5 per cent inflation. The CPI-RL reported 11 per cent inflation in September, October and November 2008.

95. The Council in July 2008 had seen the task of managing inflation as being a challenging one and did not see the likelihood of the headline rate dropping to below 8 per cent by the end of March 2009. This was based on a presumption that

even as the global economy was showing some signs of slowing the easing of demand was unlikely to be sufficient to counteract the market dynamics that had taken commodity prices to stratospheric levels. In fact, through September 2008 the price of crude oil ranged between $85 and $100/bbl. In the days just after the collapse of Lehman, before the full implications sank in, oil recovered to over $100/bbl.

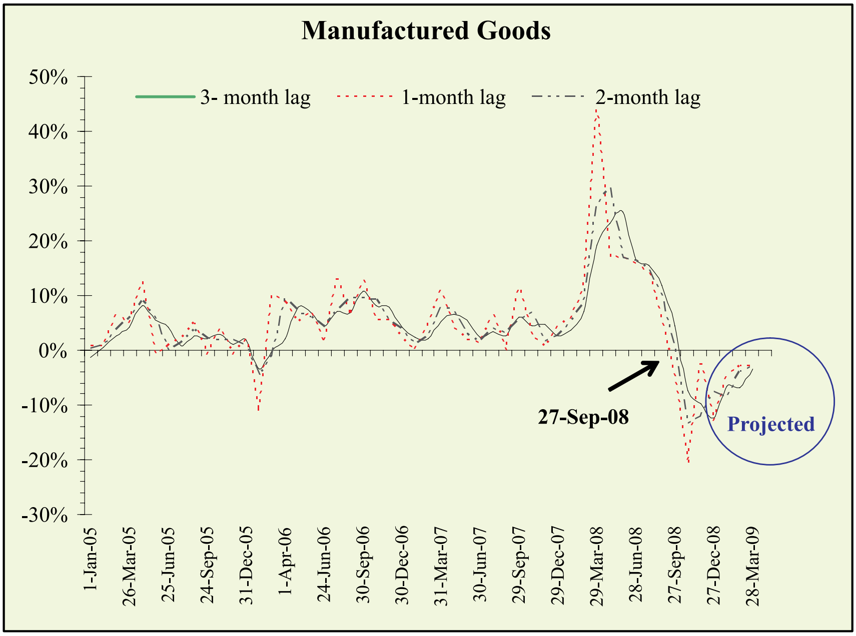
96. It was only when the inter-bank and other credit markets seized up, and the full magnitude of what the collapse of Lehman meant for the world's banks and other financial institutions began to dawn, and as economic conditions worldwide began to crumble, did oil begin its decline through the last quarter of 2008 to arrive at the prices that are ruling today. Other commodity prices followed in the wake of oil. In other words the turning point in commodity prices and inflationary pressure came after the collapse of Lehman and became apparent from the beginning of October. The transformation of a year-long commodity boom and raging inflation into a collapse of prices and global economic conditions was abrupt.

97. Headline WPI inflation slipped to 12 per cent in September and then to 10 per cent by the end of October, falling further to 8 per cent by end-November and below 7 per cent in December as gasoline and diesel prices were cut. Provisional numbers for the first week of January 2009 show WPI inflation having fallen to 5.3 per cent.

Annualised Short-Period Inflation

98. In July 2008 the Council had presented the behaviour of prices on a shorter-time frame – with 3 and less number of months lag, with the rates annualised. The computation was made for the manufacturing component of the WPI index, for these prices suffer less seasonal fluctuations. The same exercise has been brought up-to-date and is presented at *Chart-1*. It may be observed that short-period measures of annualised inflation (with 3–, 2– and 1– month lags) dropped sharply in late August and September and by the end of that month had turned negative. Since then, the direction has been sharply negative, though the magnitude should soon subside. However, the values will be negative for the balance of the fiscal while the trend will be a reversal towards positive. To the extent that the values of annualised rates of manufacturing inflation remain negative and/or below the current reported rates the headline point-to-point measure will continue to ease.

Chart 1Annualised Quarter-on-Quarter WPI Inflation Rates



Assessment

99. The Council expects that the WPI inflation rate for manufactured goods is likely to fall to 4 per cent in February and fall further by the end of March 2009, a trend that may continue for a few months into the next fiscal year due to the base effect, given that a large part in the price surge happened between March and June of 2008. However, inflation in primary foods is likely to remain elevated at close to 8 per cent. Inflation in energy prices will be negative, as will be that in some non-food primary articles like iron ore. Overall the headline WPI inflation rate is likely to be close to 4 per cent by end-February/early-March, with potential for more declines after that. CPI inflation will also fall, but the extent of the fall is unlikely to match that for WPI, considering the expected higher rate of food inflation and its larger weight in the consumer price indices.

VII. MONETARY CONDITIONS & THE FINANCIAL SECTOR

Views in the July 2008 Outlook

100. The Council in its July Outlook expected a continued expansion in credit, despite the monetary tightening, which was evidenced by the extent to which banks were borrowing from RBI at the repo window. The Council had noted that this arose from the needs of finance given the reduced access to *External Commercial Borrowings* (ECB), because of regulatory restrictions and the increase in credit premium (credit default spreads), the severe difficulties attendant in raising equity and the reduced volumes available with mutual funds.

101. The Council had advised that while maintaining monetary tightness, given the context of the then aggravated inflationary trends, the situation with respect to the balance of payments had altered this year. And in these "altered circumstances …… it may be time to review the temporary restrictions placed last year" on ECB.

Domestic developments since September 2008

102. The demand for credit, intensified through September and early October, with banks borrowing up to Rs. 90,000 crore from the RBI at the repo window. In part this was due to the reversal of trade credits and the concomitant issuance of domestic credit lines. Non-food credit increased by Rs. 51,234 and Rs. 61,217 crore respectively in the fortnights ended 26 September and 10 October 2008. Thereafter, credit growth slowed down. In the subsequent five fortnights ended 19 December 2008, non-food credit has risen by a further Rs. 33,909 crore.

103. The financial crisis that swept across the world since late September 2008 caused widespread disruption of normal commerce and dislocation in business. Severe difficulties for companies to access credit caused widespread cancellation of orders and defaults/delays on payments. The damage to business confidence was enormous with a not inconsiderable potential to be long-lasting.

104. The RBI has taken a series of measures to deal with the problems of liquidity, interest rates and other policies bearing upon the challenges that the recent

developments have thrust upon us. Beginning October, the RBI embarked on a programme to reduce the cash reserve ratio (CRR), policy interest rates, introduce new financing/re-financing windows and extend other measures supportive of business activity. A summary of some of the principal measures taken is at *Box-2.*

105. The aggregate of measures taken since September through early January has resulted in a reduction of the CRR to 5.0 from 9.0 per cent; of the repo rate to 5.5 from 9.0 per cent; and of the reverse repo rate to 4.0 from 6.0 per cent.

Box-2

Summary of Measures Taken by Government of India and RBI

Agency	Date	Description of Intervention
RBI	**Sept 2008 to Jan 2009**	**A. Rupee Liquidity** § Repo rate under LAF (liquidity adjustment facility) reduced from 9.0 per cent to 5.5 per cent § Reverse Repo rate under LAF reduced from 6.0 per cent to 4.0 per cent § Cash Reserve Ratio reduced from 9.0 per cent to 5.0 per cent § Statutory Liquidity Ratio reduced from 25 percent to 24 per cent, with exceptional reductions for specified conditions § Repo facility for Rs 60,000 crore under LAF to banks for lending to Mutual Funds and NBFC's § Scheme to advance Rs 25,000 crore to financial institutions under Agricultural Debt Waiver and Debt Relief Scheme
		B. Forex Liquidity § Interest rate ceiling on FCNR(B) and NR(E)RA term deposits increased § ECB up to $500 million permitted for rupee/foreign currency expenditure for permissible end use under automatic route § Systemically important non deposit taking NBFC's and Housing Finance Companies registered with NHB permitted to raise short term currency borrowing under the approval route § Buy back/Pre-payment of Foreign Currency Convertible Bonds permitted § Swap facility with Indian banks for foreign currency **C. Credit Delivery** § Extension of the period of pre shipment rupee export credit (at concessional rates)from 180 days to 270 days § Eligible limit of the ECR facility for banks enhanced to 50 per cent of the outstanding export credit eligible for refinance § Advance allocation of Rs 3,000 crores to SIDBI & NHB against estimated shortfall in priority sector lending by banks § Provisioning requirement for all type of standard assets reduced to 0.4 per cent § SPV for providing liquidity support to NBFC's to the tune of Rs 25,000 crore

Govern-ment	**7 Dec. 2008**	§ Government to seek authorization of additional plan expenditure up to Rs 20,000 crore in the current year. Total spending programme in the balance four months of 2008-09 expected to be Rs 300,000 crore § Across the board cut of 4 percentage points in the *ad valorem* cenvat rate (except for petroleum products) § Measures to support exports like interest subvention of 2 per cent for pre/post shipment export credit, additional allocation of Rs 350 crore for export incentive scheme, service tax refund on foreign agent commission and government back up guarantee to ECGC § Refinance facility of Rs 4,000 crore to National Housing Bank and of Rs 7,000 crore to SIDBI for lending to MSME sector. § Additional allocation of Rs 1,400 crore to clear the entire backlog under the TUF scheme (for textile sector) § Higher quantum of road projects announced § Authorize IIFCL to raise Rs 10,000 crore through tax free bonds by 31 March 2009 § Reprioritizing of budgeted expenditure by key government departments § Government departments allowed to replace vehicles § Export duty on iron ore fines eliminated and that on lumps reduced to 5 per cent
Govern-ment	**2 Jan 2009**	§ Guarantee cover under Credit Guarantee scheme increased from 50 percent to 85 per cent for credit up to Rs 5 lakh § State governments permitted to raise additional market borrowing of 0.5 per cent of their GSDP i.e. Rs 30,000 crore for capital expenditure § IFCL being enabled to access Rs 30,000 crore through tax free bonds (to fund highway and port projects) § To support exporters – DEPB rates restored to pre Nov 2008 levels § EXIM bank receives a Rs 500 crore line of credit from RBI for lending to exporters § Exemptions from CVD and basic customs duty being withdrawn § One time assistance under JNNURM, to states for purchase of buses for urban transport system

Banks, Credit Availability & Financial Conditions

106. As at the end of March 2008, the extent of non-performing loans (NPL) on the books of the banks was quite small. The RBI in its report *Trends & Progress in Banking* reports that Gross Non Performing Assets (NPA) as a proportion of Gross Advances for the banking system fell from 2.5 to 2.3 per cent between March 2007 and March 2008, while Net NPA to Net Advance remained unchanged at 1.0 per cent. Data available for larger banks suggests that there was no increase in NPA proportions up to September 2008 at which

point it remained at around 2.2 per cent. It is possible that the present spate of financial and commercial difficulties may see some companies in distress and that loan delinquencies may rise. Given the favourable starting point with NPL at historical lows, the Indian banking industry should be able to absorb the impact of some increase in delinquencies. It may also be noted that the RBI has been consistently tightening norms over the past several years. In order perhaps to offset the impact of some of this recent tightening in accounting standards in an environment of economic and financial stress, the RBI in August 2008 announced some guidelines to relax NPL recognition norms under specified conditions for assets that had been previously restructured. More recently it has extended the scope to cover commercial real estate, which includes hotels under construction, as also capital market and personal/consumer loans.

107. Under the present conditions, banks may be expected to be shy in advancing credit. Despite the massive amount of liquidity injection resorted to by the US Federal Reserve credit growth has barely responded. However, there is a world of difference between the financial conditions of banks in the US, many of which still face prospects of making further large provisions on their bad asset portfolio and the banks in India – and for that matter in many other parts of Asia. However, it is difficult for Indian banks to completely escape the environment and not to be influenced by fears of loan losses. Thus, policy has to try and also use other channels for making sure that funds flow to meet the needs of commerce and business. One method of doing so is to create adequate financing for non-bank channels that are of particular importance in the financing of commercial vehicles, two and three wheelers, construction equipment and passenger cars. Towards this end, government is proposing the use of a *Special Purpose Vehicle* (SPV) to provide refinance to NBFC that do make this kind of lending.

108. The decline of inflation and the changes in monetary policy have caused bond yields to fall sharply. With 10 year Government security yielding barely 5 per cent, there is considerable interest in notes issued by companies as well. Gains arising from the appreciation of bond prices can help create opportunities for Indian companies to raise finance from the capital market, which will help complement the credit off-take from commercial banks.

Table 3: Sovereign Credit Risk Premium or CDS Spreads over past two years					
Unit: Basis Points (bps), i.e. hundredths of percentage points					
	Jan-07	**Jan-08**	**Aug-08**	**Oct-08**	**Jan-09**
	Start of Month		***End of Month***	***Worst Point***	***Start of Month***
Advanced Economies					
Australia	9	14	20	100	115
Germany	3	7	8	38	45
Greece	7	22	51	139	230
Italy	9	20	40	132	168
Korea, South	19	47	116	700	301
Japan	11	9	16	63	43
Spain	3	18	38	109	101
Sweden	10	5	10	65	115
Temasek (Singapore)	4	70	118	577	280
UK	25	9	17	68	115
USA	9	8	16	40	67
Emerging Economies					
Brazil	99	103	130	584	290
Chile	17	30	62	315	201
China	11	29	65	297	176
Colombia	115	130	160	613	300
Czech Republic	6	16	44	228	165
Egypt	37	108	264	701	636
Hungary	21	55	124	605	406
Indonesia	116	154	261	1,245	624
Ireland	9	13	30	125	190
Israel	20	34	91	275	175
Kazakhstan	48	202	234	1,346	681
Malaysia	18	44	127	520	210
Peru	91	116	134	611	296
Philippines	123	153	242	775	370
Poland	13	26	68	270	242
Russia	44	88	132	1,117	728
South Africa	40	78	173	683	386
State Bank of India (India)	45	118	238	740	354
Thailand	35	55	135	524	226
Turkey	164	167	265	786	396

Global Loan Market Conditions

109. As a look at *Table 3* will show, a sea change has come about in the risk premium attaching to loans. At the beginning of January 2007, the

spreads for advanced economies were mostly in the single digits and that for emerging economies were at historical lows. Thereafter they moved north through the year and the next and by the end of August 2008 (before the Lehman failure) had increased to levels several times of where they were at the end of 2006 and the beginning of 2007. After the collapse of Lehman, spreads shot up to unprecedented high levels, not just for the emerging economies, but also for advanced ones, the worst point being the closing days of October 2008. Thereafter things have improved for most emerging economies and for Korea and Singapore. But spreads for many of the most advanced economies have actually risen to above 100 basis points (that is, above 1 per cent).

110. Notwithstanding the fact that sovereign credit spreads are higher than they were in August 2008 and certainly much higher than they were last January, a significant improvement is evident from the dire days of October and November. Some more improvement can be envisaged in the coming months and the ability of Indian companies to raise loan finance from international markets would become a little less difficult in the course of the next two quarters, that is, January through June 2009. Finally, it needs to be noted that with the base LIBOR rate around 1.1 per cent, the total cost of lending even with the sovereign and then company specific credit spreads is not excessively high.

Equity Market Conditions

111. Most of the world's equity markets peaked in late 2007, several months after the sub-prime mortgage crisis had hit the mass media. Some Asian markets, including that of India peaked in January 2008, while Russian and Brazilian markets rode on the rising prices of oil, iron ore and other commodities to peak out in May and June 2008. Equity markets in India and elsewhere began their downward slide in late January 2009, when a French bank which had a major losing position on equity derivatives started to unwind them. Thereafter, the bad news came in an unending tide and markets continued to lose ground. The raising of equity through initial and follow-on public issuance became increasingly difficult and then nearly impossible. By the end of the summer of 2008, markets had lost a fair amount of ground, but most of it had been lost in

the first three months of 2008. India was one of the few markets where levels recovered somewhat after March 2008. Broadly, equity markets in advanced economies dropped between 20 and 25 per cent of their value from their peaks up to September 12, 2008. Emerging markets lost more, between 30 and 35 per cent off their peaks.

112. After the collapse of Lehman Brothers, equity markets across the world took a nose dive. The plunge proceeded within a tight range, with little apparent discrimination between markets. In the North America, West Europe, Japan and Australia stock indices fell by 30–40 per cent. The median value was 33 per cent with standard deviation of 4 percentage points. Japan and Canada were the outliers. In major emerging markets the plunge ranged between 35 and 45 per cent, with a median value of 38 per cent and standard deviation of 4 percentage points. The difference between mature and emerging markets barely showed up much in the market collapse after the demise of Lehman. Russia and China (Shanghai) had a different experience. The former lost 57 per cent at its worst point after Lehman and Shanghai had lost 66 per cent prior to the bankruptcy of Lehman. As a look at *Table 4* shows, most markets have been able to claw back about 10–20 per cent from the worst point since the collapse of Lehman; in other words they have been able to regain about one-third in the case of emerging economies and in the case of advanced economies four-fifth of the erosion since the failure of Lehman.

113. After hitting bottom in late October and then further lows in late November 2008, equity markets seem to be trying to move towards a kind of stabilisation at lower levels. Most markets, including India's, have recovered between 10 and 20 per cent from their post-Lehman bottom with Latin American and some Asian markets making up more ground. The trend in the decline, plunge and the recovery seems to have had a generic character and was not closely related to the extent these markets had gained prior to 2008. However, the equity markets remain vulnerable and it will take some time before they may be regarded to have stabilised. It would appear that significant improvement will have to await some signs of economic recovery and improvement in corporate earnings which cannot be reasonably expected before the second half of 2009. Constraints in the raising of equity will thus continue to be operative for Indian companies for the better part of 2009.

Table 4: Changes in Major Stock Indices

Updated to week ended 9 Jan 2009

Unit: per cent

Index	Gain from trough after last boom at most recent peak	This peak vis-à-vis last peak	Maximum Loss from most recent peak	Current Loss vis-à-vis most recent peak	Current Loss since Lehman collapse	Gain since post Lehman collapse bottom	Current vis-à-vis trough after last boom
1	2	3	4	5	6	7	8
US Dow DJIA	89	21	–47	–39	–25	14	15
Swiss SMI	159	14	–46	–40	–21	11	55
US S&P 500	101	3	–52	–43	–29	18	15
Germany DAX	124	0	–49	–41	–23	16	33
UK FTSE 100	81	–3	–44	–34	–18	18	20
Italy Mibtel	112	–8	–55	–51	–28	8	4
France CAC 40	93	–12	–53	–46	–24	15	4
Australia All Ord.	150	98	–51	–46	–26	10	36
Canada S&P Tsx	165	97	–49	–40	–29	18	60
Russia RTS	1,445	789	–73	–67	–46	25	403
Brazil Bovespa	774	309	–60	–43	–21	41	397
Mexico IPC	482	295	–49	–34	–15	29	285
Argentina Merval	1,052	263	–64	–49	–28	42	487
Japan Nikkei 225	92	–15	–59	–49	–28	23	–3
South Korea Kospi	308	94	–54	–43	–20	26	134
Hong Kong HSI	244	73	–65	–55	–25	31	56
Singapore STI	207	47	–58	–53	–30	13	46
Taiwan Tsec	185	–4	–57	–54	–29	7	30
Indonesia Jakarta	706	302	–61	–50	–21	27	303
India BSE	703	255	–60	–55	–33	11	262
China SSEC	304	175	–72	–69	–8	12	26
Malaysia KLSE	174	50	–45	–39	–12	11	66

114. The recent fraud and possible embezzlement of funds on a large scale in Satyam Computers, a leading software developer and exporter, is a setback for Indian business and for the economy at large. It has undercut confidence amongst customers, investors and employees in the industry. However unfair it may seem, Indian businesses will now have to go the extra mile to counteract the negative effect of being tarred with the same brush. In an editorial, a leading international newspaper said the Satyam issue "raise disturbing questions about the risks of doing business in India – and even the sustainability of the country's much-vaunted growth miracle". It goes on to question whether the ambitions of Indian companies to make "western acquisitions", are "like India itself, whose economic success story is built on extremely rickety social and infrastructural foundations, such grand designs can also smack of hubris". It is imperative that the regulator and investigating agencies get to the bottom of this scandal and bring the guilty to book. Even with that the odour of this scandal will continue to be an obstacle and irritant for Indian businesses in their efforts to conduct business, acquire assets and secure finance in the global marketplace. It should also act as a reminder as to how much more careful an emerging economy needs to be in its efforts to maintain growth and secure a position in the world community.

VIII. GOVERNMENT FINANCES

Lower Tax Revenues, Higher Expenditures & Deficits

115. The events after the presentation of the Union Budget in February 2008 have led to three important developments. First, provisioning for pay revision, loan waiver, *National Rural Employment Guarantee Act* (NREGA) and various subsidies has significantly added to the Central government expenditures and liabilities. This has significantly altered the deficit position. Second, the global financial crisis and recessionary trends in OECD countries has shifted the focus of fiscal policy from stabilisation to providing growth stimulus to the economy by reinforcing aggregate demand and business confidence. In the immediate context, the FRBMA targets lose relevance. Finally, the pre-existing high levels of debt and fiscal stress, also limit the available headroom for additional counter-cyclical thrust to fiscal policy. In the prevailing situation speedy implementation of already funded projects at the Central and State levels is important for the fast revival of the economy.

116. There have been significant changes since the Council's July 2008 Economic Outlook. At that time, the Council while recognising the appreciable fiscal consolidation achieved in the last few years, had expressed concern that under-budgeted and off-budget liabilities could be sizeable. At the central level, besides not meeting the target of phasing out the revenue deficit, it was suggested that the under-budgeted and off-budget liabilities could add up to over 5 per cent of GDP. A significant part of off-budget liabilities was on account of the phenomenal increase in oil prices. Since then, although crude oil prices have sharply declined, the fiscal situation has been impacted by additional allocations that had to be made to meet various commitments and the economic slowdown which has caused a deceleration in revenue collections at both central and state levels.

117. Government of India placed two separate *Supplementary Demand for Grants* in October and December 2008 respectively before Parliament. These included payment under the revisions made pursuant to the *Sixth Central Pay Commission,* higher subsidies especially for petroleum products, fertilisers and food, additional expenditures under NREGA and others. The two supplementary demands asked for authorisation of expenditures involving "cash outgo", aggregating Rs. 105,614

crore and Rs. 42,480 crore respectively, that is a total of Rs. 148,094 crore. In addition they asked for authorisation of expenditures to be met out of "receipts/recoveries/savings" amounting to Rs. 131,673 in the first supplementary and Rs. 13,125 crore in the second supplementary, that is a total of Rs. 144,798 crore. A sizeable part of the expenditures to be met out of "receipts/recoveries/savings" involved the issuance of oil and fertiliser bonds. A summary of these two *Supplementary Demand for Grants is placed at Table 5.*

Table 5: Principal Components of Additional Expenditures Authorised By the Supplementary Demand for Grants

Unit: Rs in crore

		First Supplementary	Second Supplementary	Total
1	Total Net Cash Outgo	105,614	42,480	148,094
2	Expenditure matched by Savings/ Receipts etc	131,673	13,125	144,798
3	Grand Total	237,287	55,605	292,892
4	Cash Items of #2 above			
	a. Oil Bonds	65,942		65,942
	b. Fertilizer Bonds	14,000	6,000	20,000
	c. Sub-total	79,942	6,000	85,942
5	**Total Cash Outgo including Special Bonds**	**185,556**	**48,480**	**234,036**

Major Components of the two supplementary demand for grants (refer 5. above)

1. Pay & Pension Revision:	28,505	5. NREGA:	25,000
2. Oil Subsidy (Bonds):	65,942	6. Farmer's Debt Relief	15,000
3. Fertiliser Subsidy (incl. Bonds):	64,866	7. Transfer to States:	12,741
4. Food Subsidy:	11,471	Total of above 7 items	223,525

Likely Deficit in 2008/09

118. The Rs. 148,094 crore described in the *Supplementary Demand for Grants* comes to 2.8 per cent of GDP. The total of this item together with that of Oil and

Fertiliser Bonds of Rs 85,942 crore, which totals Rs. 234,036 crore, works out to 4.4 per cent of GDP. To this may be added the slippage in tax collections from the budgeted estimate, amounting to 1 per cent of GDP, due to the combination of reduction in excise duty and lower buoyancy in collections on account of difficult economic conditions. The fiscal deficit in the Union Budget had been placed at 2.5 per cent of GDP to which the addition of 4.4 and 1.0 per cent of GDP brings up a total of 7.9 say 8.0 per cent of GDP, including off-Budget items. The deficit of the States is also likely to exceed previously expected outcomes and is likely to be about 3.5 per cent of GDP. There are overlapping entries between the Central and State fiscal deficits and the combined deficit may thus be expected to be about or slightly in excess of 10 per cent of GDP in 2008/09.

The Medium Term

119. The fiscal stimulus package announced in early January 2009 is unlikely to add significantly to expenditures in the current fiscal year. Elevated level of deficits are needed in the present context where in its absence there is a danger of serious compression in domestic demand and in the capacity of the economy to bear the impact of the ongoing financial and economic crisis across the world. The incremental transfer payment of 5 per cent of GDP to the household and corporate sector through subsidies and tax reduction is large by any definition. It may be argued that much of it antedated the financial crisis, but the fact is that its disbursement overlapped the crisis and would have the same effect had the transfers been conceived at a later date. In addition to this, there has been a move to re-prioritise expenditures and to try and increase the roll-out of public-private infrastructure projects, especially in the road sector. In the prevailing situation of limited fiscal space, implementation of already funded projects at the Central and State levels are critical for the fast revival of the economy.

120. In the next fiscal year, that is, 2009/10, although the deficits are likely to remain at an elevated level, there should be a decline in its magnitude. Thus, the subsidies provided on petroleum products next year are likely to be a fraction of that incurred in the current year. Fertiliser subsidy, even if the present regime remains unchanged, will be much less next year than this year. This in itself should bring down the subsidy burden by 1.6 per cent of GDP. However, tax revenue growth is likely to remain subdued for the better part of the next fiscal and some of the other expenditure items will continue, even if there are no arrears needing to be paid

off. Thus, on balance the deficit numbers for 2009/10, though perhaps lower than that in 2008/09, are likely to remain elevated. It is therefore very important that there is abundant policy clarity as to the exceptional nature of circumstances in the current and next year and the urgent need to bring government finances back on the track of fiscal consolidation once there is an improvement in economic conditions and before the exceptional ways in present times grow into a habit and create a fiscal crisis in the medium run.