

REVIEW OF THE ECONOMY

2010/11

ECONOMIC ADVISORY COUNCIL TO THE PRIME MINISTER
NEW DELHI

February 2011

Economic Advisory Council to the Prime Minister
Hall-E
Vigyan Bhawan
Maulana Azad Road
New Delhi

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I. GROWTH PERFORMANCE AND OUTLOOK

1. The Council's July 2010 Economic Outlook had taken the view that the economy would grow by 8.5 per cent in 2010/11. The better than expected performance of the Indian economy in 2009/10 had been factored in to this projection. In the event, growth in the first half of 2010/11 has been higher at 8.9 per cent. The Council felt that, in the second half, the rate of growth will be somewhat moderated. The CSO Advance Estimates for 2010/11 show that this has indeed transpired. It has placed full year growth at 8.6 per cent. This is marginally higher than the estimate the Council had made in July 2010 (see Table 1).
2. The 2010 South West monsoon was a normal one, with average precipitation marginally higher than normal. However, eastern parts of the country received deficient rainfall. The recently released Second Advance Estimates for the year shows strong growth in *kharif* foodgrain and oilseed output compared to 2009/10. But the levels are lower than that achieved in the bumper year of 2007/08 and 2008/09. The estimates for the *rabi* season are also favourable. This is due both, to the good South West monsoon, as well as the comfortable status of our reservoir position. Rabi rice output is presently placed at 13.85 million tonnes, marginally lower than the record levels reached in 2007/08 and 2008/09. Overall rice output is now placed at 94 million tonnes, one of the largest ever harvests. It is likely that with favourable weather conditions continuing, we will have the largest ever wheat harvest, at 81.5 million tonnes. Kharif pulses output is a record 6.5 million tonnes and total output for the year at 16.5 million tonnes is an all-time record. Kharif oilseed output has been revised sharply upward to 182.2 lakh tonnes, the second largest on record. Cotton and sugarcane harvests have also been revised upward marginally. Overall, from the farm perspective, output conditions are likely to result in good economic growth in 2010/11, and has been assessed in the CSO's Advance Estimate to be 5.4 per cent.

Table 1 GDP Growth – Actual & Projected Unit: per cent								
		2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
						<i>QE</i>	<i>AE</i>	<i>f</i>
Year-on-year Growth Rates								
1	Agriculture & allied activities	5.1	4.2	5.8	-0.1	0.4	5.4	3.0
2	Mining & Quarrying	1.3	7.5	3.7	1.3	6.9	6.2	7.5
3	Manufacturing	10.1	14.3	10.3	4.2	8.8	8.8	9.0
4	Electricity, Gas & Water Supply	7.1	9.3	8.3	4.9	6.4	5.1	7.0
5	Construction	12.8	10.3	10.7	5.4	7.0	8.0	10.5
6	Trade, Hotels, Transport, Storage & Communication	12.2	11.6	11.0	7.5	9.7	11.0	11.0
7	Finance, insurance, real estate & business services	12.7	14.0	11.9	12.5	9.2	10.6	10.5
8	Community & personal services	7.0	2.9	6.9	12.7	11.8	5.7	8.8
9	Gross Domestic Product at factor cost	9.5	9.6	9.3	6.8	8.0	8.6	9.0
10	Industry (2 + 3 + 4 + 5)	9.7	12.2	9.7	4.4	8.0	8.1	9.2
11	Services (6 + 7 + 8)	11.0	10.1	10.3	10.1	10.1	9.6	10.3
12	Non-Farm Sector (9 - 1)	10.5	10.8	10.1	8.2	9.4	9.1	9.9
13	GDP (factor cost) per capita	7.8	8.0	7.8	5.3	6.5	7.1	7.5
Some Magnitudes								
14	GDP at factor cost - 2004/05 prices in Rs lakh crore (or Trillion)	32.5	35.7	39.0	41.6	44.9	48.8	53.2
15	GDP market & current prices in Rs lakh crore (or Trillion)	36.9	42.9	49.9	55.8	65.5	78.6	89.9
16	GDP market & current prices in US\$ Billion	834	949	1,241	1,223	1,385	1,724	1,999
17	Population in Million	1,106	1,122	1,138	1,154	1,170	1,186	1,203
19	GDP market prices per capita current prices	33,386	38,268	43,817	48,376	55,985	66,412	74,780
20	GDP market prices per capita in current US\$	754	846	1,090	1,060	1,184	1,453	1,662

Note: QE refers to the Quick Estimates for National Income released on 31 Jan 2011.

Est: Estimated for the year based on data released for Q1 and Q2 and other available data
f stands for forecasts made by the Council.

3. GDP arising from the industrial sector (mining & quarrying, manufacturing, electricity, gas & water supply and construction) showed very strong growth of 11.3 per cent in the first quarter of 2010/11. This was in line with the growth achieved in the last two quarters of 2009/10. In the second quarter of 2010/11, growth in GDP arising from industry declined to 8.9 per cent. The principal factor that governed this change was the sharp drop in manufacturing GDP growth from 13 per cent in the first quarter to 9.8 per cent in the second. We expect further moderation in manufacturing output growth in the second half of 2010/11, resulting in an average growth of 8.1 per cent in the industrial sector.
4. Growth of GDP in the services sector was 10.1 per cent in 2009/10 and 9.5 per cent in the first half of 2010/11. The Council expects service sector growth to show a slight pickup in the second half of the year, thus averaging 9.6 per cent growth for the year as a whole.
5. Both in the Economic Outlook released in July 2010, and in the earlier Review of the Economy released in February 2010, the Council had taken a view that economic growth in 2011/12 will be about 9 per cent. It had revisited the view on the components of GDP in July 2010, somewhat reducing the projected growth rate for industry and increasing it for services. The Council continues to be of the view that it is possible to achieve growth of 9 per cent in 2011/12, while slightly refashioning the GDP components. The farm sector is now expected to grow by 3 per cent, the industrial sector by 9.2 per cent and the services sector by 10.3 per cent. Per capita GDP at factor cost is projected to increase by 7.5 per cent in 2011/12, as against 7.1 per cent in 2010/11. These adjustments reflect ongoing changes observed in the industrial and services sector, both in respect of the domestic economy and global prospects.
6. The year 2010 has seen the advanced economies experiencing a gradual recovery. But it has also been witness to considerable volatility on account of diverse developments, prominent amongst them being the sovereign debt crisis in the euro zone, concerns about the fiscal trajectory in the US, the sharp increase in commodity prices – food and energy – and the rising tide of inflation in emerging countries. Volatility was experienced most clearly in

financial markets, but also in a less tangible fashion in other areas . Going into 2011, the widely shared expectation is that the economic recovery experienced in the US and EU during the second half of calendar 2010 will be reinforced. However, it is not clear how the extraordinarily easy monetary policy and unprecedented fiscal accommodation are going to be closed out as economic conditions improve. The sovereign debt problem in the euro zone has also not been convincingly resolved. Both, India and China as also many other emerging countries, are facing strong inflationary pressure. Food prices across the world have crossed the 2008 peak levels. Petroleum prices are at historical high levels (barring the few exceptional months of the summer of 2008) and political crisis overshadows the Middle East. In these circumstances, it can only be expected that the strong volatility of 2010 will continue into 2011 and make for some unexpected developments. This once again underscores the importance of pursuing domestic policies that factors in some adverse developments in the international sphere. On the domestic front, the principal challenge in the short to medium term is inflation management. Both monetary and fiscal policy are integral to this. It is critical that supply bottlenecks across the board, whether it be food, energy, other raw materials and intermediates be aggressively tackled, in order to permit the economy to grow at a pace consistent with strong underlying domestic demand, without putting excessive pressure on prices.

7. It is our expectation that wholesale price inflation which had reversed direction in December 2010 on account of an unexpected rise in vegetable prices, would begin to ease towards the end of January 2011. As this report goes to press indications are that vegetable prices have indeed begun to normalize from the last week of January onwards. The headline rate on this count is expected to come down further during February and March 2011 to about 7 per cent. Further declines can be expected during the first quarter of 2011/12 and a combination of appropriate policy management can create conditions conducive to returning the economy to the path of 5 per cent inflation .
8. On the Balance of Payments front, the Current Account Deficit (CAD) has been uncharacteristically high, especially in the second quarter of 2010/11. In the July 2010 Economic Outlook, the Council had expected that on account

of the poor recovery in export markets and strong domestic demand for imports, the Current Account Deficit would be much higher than what used to be considered the comfort-zone (namely 1.5 to 2.0 per cent of GDP). The Council had expected that the Current Account Deficit would be 2.7 per cent of GDP for 2010/11. In the first half of the year the Current Account Deficit was much higher at 3.7 per cent of GDP and as high as 4.1 per cent in the second quarter. However, on the evidence of the strong recovery in exports and lower-than-expected imports in November and December 2010 as also in January 2011, the Council feels that the Current Account Deficit will show considerable moderation in the quarter ended December 2010, as well as in the quarter ended March 2011. Accordingly in the second half of 2011, the Council places the Current Account Deficit at 2.4 per cent of GDP, thus making for a overall Current Account Deficit of about 3.0 per cent of GDP in 2010/11. While the reasons, why such a high level of CAD may be regarded as acceptable (due to the differential conditions obtaining in the domestic and external economic environment), remain valid, it must, however, be recognized that sustaining such high levels of Current Account Deficit on a regular basis is neither possible nor indeed desirable. Not only must it be clear that this is an exceptional development, but conditions must also be conducive for the adequate inflow of capital, preferably non-debt capital, to finance the deficit. This year it is likely that capital flows will be adequate to finance this order of Current Account Deficit and leave a small residual for absorption into the foreign exchange reserves. It is likely that in 2011/12 also the Current Account Deficit may be at an elevated level, projected at 2.8 per cent of GDP. However, it must be clear that even this is on the higher side and, ideally, in subsequent years, it should be possible to restrict the Current Account Deficit closer to 2 per cent of GDP. It is also equally important that investment conditions are conducive for the continued flow of foreign capital especially equity capital, in order to sustain even a 2.0 to 2.5 per cent level of Current Account Deficit.

II: INTERNATIONAL ECONOMIC CONDITIONS

9. The Council in its Economic Outlook (July 2010) had dealt at some length with the developments in the international arena, the likely course of development and the implications for emerging countries, such as India and the rest of developing Asia. It had also dwelt on the volatility in the financial conditions, flowing from the problems with sovereign debt in the euro zone and its impact on the currency markets.
10. In July 2010, the Council had noted that “continued disquiet in global financial conditions may result in further strengthening of the US currency, not only vis-à-vis Europe but perhaps against other emerging economies also”. It had also suggested that high domestic inflation may erode the financial and economic strength that developing Asia has come to acquire over the last decade and which has become a prominent feature since the recovery from the Crisis. Over the last several months we have been witness to repeated bouts of currency volatility involving first the strengthening of the euro and the corresponding dollar depreciation. The latter has come to be seen as an indicator of a decline in risk aversion. This phase has also come to be associated with strengthening asset prices and improved confidence. This has been rapidly followed by a strengthening of the US dollar, a corresponding decline in the euro and this has come to be seen as the obverse side of the medal, that is an increase in risk perception and equity and other asset prices have fallen in this phase. Several such cycles have happened in the last year, which has contributed to the inherent sense of a lack in stability in global financial conditions.
11. The IMF in its January 2011 Update to the World Economic Outlook has noted that while growth in emerging and developing countries remained robust in the third quarter of 2010, the outcome in the US and in Japan was better than previously forecast in October 2010. Thus, global economic activity had expanded at an annualized rate of just over 3.5 per cent in the third quarter of 2010. The Advance Estimate for the fourth quarter of 2010 shows that the US

economy grew by a very strong rate of 3.2 per cent (annualized basis) over the third quarter. This growth came from a big rise in private consumption expenditure and a major improvement in net exports. There is also reason to believe that the euro zone has also done better than expected in the closing months of 2010. The IMF has revised its growth estimates upwards for 2011 in the case of advanced economies, especially the USA, while more or less retaining its previous estimate for emerging economies.

12. The IMF has underlined the possibility of contagion effects that might result from adverse developments in the euro region. It has emphasized the need for policy makers to take into account the dangers that may develop from financial contagion, which may be more difficult to manage now because of balance sheet weakness in advanced countries.
13. While the January 2011 Update does mention the sharp increase in the inflation rate in many developing countries (especially food inflation) it takes comfort from the fact that inflationary conditions are subdued in advanced countries because of continued slack and well-anchored inflationary expectations. It sees a possible solution to the “overheating pressures” in emerging countries that run current account surpluses by (their) allowing real appreciation in the external value of their currencies.
14. The two largest emerging countries, namely India and China, which have both come out of the Crisis with a very strong rebound in growth, have been facing very high rates of inflation, particularly from food inflation. Many other emerging countries across the world are also facing pressures from food inflation, which in some cases has led to civil disturbances, some of them leading to change in government. It is not entirely without basis that many people argue that the sharp increase in commodity prices has been facilitated by the extraordinary accommodation in monetary policy by the reserve currency issuers, especially the US. It would not be unnatural to expect that the extraordinary and continued fiscal accommodation played out through equally

extraordinary monetary accommodation would lead to inflationary pressures, not only in that national economy, but also on a broader canvas wherever that currency is extensively used. It is a fact that in the US the inflation as measured by Consumer Price Index remains modest, especially if one were to look at “core” inflation (that is excluding food and energy). However, one ought also to take note of the fact that producer prices are showing a different trend, with annual inflation in the range of 4 to 6 per cent, depending on which aggregate one were to look at. In the euro area annual inflation hit a high of 2.2 per cent in December 2010 and Flash Estimates place it at 2.4 per cent in January 2011. This is well outside what the euro area monetary authorities regard to be the comfort zone. It may also be noted that the euro has borne the brunt of the currency adjustment involving the weakening of the US dollar and such an elevated level of inflation in the context of a 10 per cent unemployment rate is certainly a serious development.

15. The policy response by authorities in both India and China with regard to stabilizing prices through monetary and other policy measures have been interpreted by markets as a sign of enhanced risk, leading to weakness in asset prices. There also appears to be an assessment, that such measures would lead to a general slowing down of the economy and therefore lead to less favorable consequences for corporate performance. This has been on top of a steady upward reassessment of the prospects of the US and also European economies.
16. The underlying dynamics however still point towards sustained growth and improvement in general economic conditions in developing Asia. If the assessment about improved conditions in the West turns out to be accurate, that will be a positive development for everybody, including developing Asia. It would improve export markets and possibly inject greater discrimination in capital asset allocation and thereby lead to possibly greater global financial stability. However, rapid improvement in economic conditions in advanced economies, can under present conditions, also put additional pressure on commodity prices. That is, unless part of the price developments in the recent months has been on account of the activities of financial investors who may, with improved general conditions in western economies, return to other asset classes.

III: STRUCTURAL FACTORS

17. The Central Statistical Office (CSO) has recently released the Quarterly Estimates (QE) for 2009/10 and the revised data for previous years, alongwith the Advance Estimates for 2010/11. The revisions have resulted in an enlargement of the GDP at market prices, as well as at factor cost. However, the investment and savings ratios for previous years have all been revised slightly upwards, since the revisions have resulted in mostly increasing the investment and savings estimates. However, in the Crisis year of 2008/09, there was a marginal downward revision for investment, fixed capital and savings rates, while the Fixed Capital Formation rate underwent a larger change from 33 per cent to 32 per cent (see Table 2). The notable element for 2009/10 is that the investment rate now reported at 36.5 per cent is slightly higher than the estimate of 36.0 per cent published in the Economic Outlook (July 2010). However, Fixed Capital Formation at 30.8 per cent is much lower than our previous estimates of 33.0 per cent. The savings rate is now placed by CSO at 33.7 per cent which is slightly higher than our previous estimate of 33.4 per cent in the Economic Outlook (July 2010).
18. The CSO data clearly shows that the extent of decline in Fixed Capital Investment on account of the Crisis of 2008 and 2009 was stronger than had been previously assessed. This corresponds to the anecdotal evidence that many enterprises during the Crisis slowed down or deferred their capital expenditure plans and in some cases cancelled orders. It is reported that companies have again begun to place orders on equipment suppliers and investment in capital asset, especially equipment, is proceeding well. This is also borne out by the sharp rebound in Gross Domestic Capital Formation in the private corporate sector which grew (at constant prices) by 29.1 per cent in 2009/10, after suffering a severe decline of 28.9 per cent in 2008/09.
19. The Council expects that the overall investment rate in 2010/11 will be above the 36.5 per cent reported for 2009/10, at about 37 per cent propelled by real annual increases of about 12 per cent in private corporate capital formation and about 10 per cent for the economy as a whole. The domestic savings rate is expected to improve from 33.7 per cent in 2009/10 to 34.0 per cent in 2010/11.

Table 2 Values of Key Macro-economic Parameters

	Investment Rate	Gross Domestic Capital Formation	Gross Domestic Fixed Capital Formation	Domestic Savings Rate	Current Account Balance	Final Consumption Rate		Gross Domestic Capital Formation (GDCF)	GDCF in Fixed Capital only		Final Consumption Expenditure			
						Private	Govt.		Total	Pvt. Corp.	Total	Pvt. Corp.	Private	Govt. Total
Ratio to GDP at market prices														
2000/01 *	24.3	24.2	22.7	23.7	-0.6	64.0	12.6	-4.0	-28.3	-0.01	-11.0	3.6	0.9	3.2
2001/02 *	22.8	24.2	23.6	23.5	0.7	64.5	12.4	3.8	8.6	7.4	3.6	5.7	2.3	5.2
2002/03 *	25.2	25.2	23.8	26.3	1.2	63.3	11.9	10.9	17.1	6.8	3.5	2.8	-0.4	2.3
2003/04 *	27.6	26.8	25.0	29.8	2.3	61.8	11.3	12.9	24.6	13.6	23.2	6.0	2.6	5.5
2004/05	32.8	32.5	28.7	32.4	-0.3	59.4	10.9	22.3*	68.1*	18.9*	62.8*	5.5*	3.6*	5.2*
2005/06	34.7	34.3	30.3	33.5	-1.2	58.5	10.9	17.0	45.0	16.2	43.1	8.4	8.9	8.5
2006/07	35.7	35.9	31.3	34.6	-1.0	58.0	10.3	15.3	19.1	13.8	17.9	8.5	3.7	7.7
2007/08	38.1	38.0	32.9	36.9	-1.3	57.2	10.3	17.7	32.9	16.2	27.7	9.1	9.5	9.2
2008/09	34.5	35.4	32.0	32.2	-2.3	58.5	11.0	-3.9	-28.9	1.5	-22.0	7.4	10.7	7.9
2009/10 QE	36.5	35.8	30.8	33.7	-2.8	57.7	12.0	12.2	29.1	7.3	17.0	7.3	16.4	8.7
2010/11 est	37.0 [§]	35.9 [§]	30.8 [§]	34.0 [§]	-3.0 [§]	57.6 [§]	11.4 [§]	13.1 [§]	15.3 [§]	8.4	12.5	8.2	2.6	7.3
2011/12 proj.	37.5	37.0	32.0	34.7	-2.8	55.5	10.3	13.1	15.9	13.7	15.0	8.6	3.0	7.7

Note: * For these years the GDP and component figures are as per the old NAS series; [§] Estimates

20. In the coming year (2011/12), the Council expects further improvement in the investment rate, which may rise to 37.5 per cent, while the domestic savings rate would rise to 34.7 per cent, partly on account of further improvement in Government finances. It may be noted that according to the revised series, the highest previous investment rate was 38.1 per cent in 2007/08 (previously assessed at 37.7 per cent). The ratio of gross fixed investment to GDP is also likely to show a slight elevation from the 30.8 per cent reported in 2009/10 and the 29.6 per cent reported in the Advance Estimates for 2010/11. The latter is likely to be an underestimate and given changes in other parameters it is likely that on revision this ratio for 2010/11 will turn out to be close to value registered in 2009/10, namely 30.8 per cent. In 2011/12 it is expected that this ratio will improve to 32 per cent, while the real increase by the private sector in fixed capital will rise by 15 per cent.
21. Private Final Consumption Expenditure has shown steady growth of between 7 and 9 per cent per year, except for 2009/10, with average growth of 8 per cent and remained steady (7.4 per cent) even in the Crisis year of 2008/09. The Advance Estimates suggest that in 2010/11 private consumption expenditure in real terms grew by 8.2 per cent. The Council expects that in 2011/12 the rate of growth is likely to slightly higher. In consequence of the withdrawal of stimulus, the growth in Government consumption expenditure fell to a mere 2.6 per cent in 2010/11 from over 16 per cent in 2009/10. In 2011/12, the real growth in government consumption expenditure is expected to remain subdued at around 5 per cent.
22. The investment and savings rate for the years up to 2009/10 and available data for the first half of 2010/11 clearly suggests that, in terms of aggregate resources, the Indian economy is capable of growing at around 9 per cent. The principal challenge is to ease the various sectoral bottlenecks that continue to exist, whether it be in electricity and other infrastructure availability or slow-growing farm productivity and inadequate logistics for farm produce.

IV: SECTORAL: AGRICULTURE, INDUSTRY AND SERVICES

Agriculture

23. The Second Advance Estimate for 2010/11 shows that aggregate foodgrain output in 2010/11 is likely to be 232.1 million tonnes, which is slightly less than the record harvest of 234.5 million tonnes in 2008/09. The *kharif* foodgrain production at 117.2 million tonnes will be a million tonnes lower than in 2008/09, while the *rabi* output may be 1.4 million tonnes lower. The variation is because of lower rice output in both the *kharif* and *rabi* seasons. The forecast on the basis of acreage and assuming normal weather conditions is that this year the wheat harvest at 81.5 million tonnes will be the largest ever. An important development in 2010/11 will be the sharp increase in the production of pulses which is likely to touch a record level of 16.5 million tonnes. Strong improvement will be seen in both *kharif* (to 6.5 million tonnes) and *rabi* pulse production, which is an outcome of the combination of farmers positive response to high prices and a well thought out programme of the Central and State Governments to support higher pulse output, especially *kharif* pulse output, through increasing the availability of certified seeds, DAP fertilizer and other initiatives. While acreage under *kharif* and *rabi* pulses have shown improvement it is expected that we will find that the yield of *kharif* pulses and certain *rabi* pulses have shown a significant improvement. There is greater potential for improving productivity in pulses. The beneficial impact of higher pulse output may be seen in the sharp drop in wholesale prices of several pulses.
24. *Kharif* rice output at 80.2 million tonnes will be 4.75 million tonnes more than that achieved in 2008/09 (see [Table 3](#)), while the current estimate for *rabi* output is slightly lower. This is primarily on account of the fact that there was rainfall deficiency in parts of eastern India particularly in Gangetic West Bengal, Bihar, Jharkhand and some parts of eastern Uttar Pradesh. Rice output in the *rabi* season is presently placed at 13.85 million tonnes. The reservoir positions in almost every part of the country, particularly southern and central India,

Table 3 Farm Crop Output										
		2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11		
								1st AE	2nd AE	
Rice										
Wheat										
Coarse Cereals										
Pulses										
Foodgrains										
Oilseeds (nine major)										
Cotton										
Jute & Mesta										
Sugarcane										

showed a significantly better position at the end of January 2011 compared to either last year, or for that matter the average of the last 10 years. It is possible that the *rabi* rice harvest may eventually turn out to be larger than that projected in the Second Advance Estimate. Coarse cereal output in both *kharif* and the *rabi* seasons is expected to be almost as good as in the record years of 2007/08 and the aggregate output for the year is likely to be around 40 million tonnes, about the same as in 2008/09.

25. The Second Advance Estimate has revised upwards by over 5 per cent the *kharif* oilseeds output figure to 182 lakh tonnes, making this the largest summer oilseed crop after the record 207 lakh tonne harvest of 2007/08. The *rabi* is placed at 96.3 lakh tonnes, comparable to levels recorded in previous three years – the decline compared to 2005/06 and 2006/07 coming mostly from lower output of sunflower (with proportionate decline in acreage) and rape & mustard seed. Overall, for the year, oilseeds position is unlikely to exceed 280 lakh tonnes. Given the fact that we are large importers of crude edible oil and also that a linkage has developed over the years between international edible oil prices and that of crude petroleum, we need to strengthen our output levels of oilseeds and thus domestic edible oil production.
26. The Second Advance Estimate places cotton output at 339 lakh bales which is about the same level as last year's record crop. Sugarcane output is now projected at a level of 3,367 lakh tonnes which is slightly higher than in the First Advance Estimate.

Industry and Services

27. In July 2010, the Council had expected that the manufacturing sector will show a growth of around 10 per cent in both output and GDP. Manufacturing output growth for the period April to December 2010/11 is estimated to have been 9.1 per cent. The November and December 2010 output growth was very low at 3.2 and 1.0 percent respectively. While, in the case of November 2010, an explanation could be found in the larger number of closed days in November of 2010 on account of *Diwali* (the festival had occurred in 2009 in the month of October), this argument does not hold good for December.

28. A case can be made that if we were to look at the longer term trend – say with a lag of a year or more – in order to smoothen out the volatile effects of the slowdown in 2008/09 and the sharp recovery in 2009/10, the smoothened out growth numbers for the December 2010 ending quarter or for that matter for the month of December 2010 would be found to be in the range of 8 per cent annualized for both 2 and 3 year lags.
29. However, the fact is that the value of manufacturing index (provisional) in December 2010 was 385.0 and that in December 2009 was 381.1. Over this twelve month period, output levels barely changed, resulting in the year-on-year growth of 1.0 per cent. Looking at the components of the industrial production index it becomes clear that expansion in the following use-based categories were along expected lines, namely:
- Basic Goods (Nov: 6.4 per cent and Dec: 5.2 per cent)
 - Intermediate Goods (Nov: 2.3 per cent and Dec: 6.6 per cent)
 - Durable Consumer Goods (Nov: 4.4 per cent and Dec: 18.5 per cent)

But changes in two of the use-based categories have been unusual, namely:

- Capital Goods (Nov: 12.8 per cent and Dec: –13.7 per cent)
 - Non-durable Consumer Goods (Nov: –4.6 per cent and Dec: –1.1 per cent)
30. Now, capital goods output has shown considerable volatility in the past and revisions have affected this estimate significantly. However, the issue of non-durable consumer goods not showing growth is harder to understand. Ever since January 2010, this output index has been reporting very low rates of annual growth and in several months in addition to November and December 2010, it has been negative. The average cumulative growth for the period April–December 2010 is 0.7 per cent. In light of the IIP data for November and December 2010, the Council expects that manufacturing output growth is likely to be depressed through the last quarter of 2010/11. In consequence, the Council estimates that this overall manufacturing output growth may be in the range of 7.5 per cent. The Advance Estimate of GDP has estimated that

GDP arising in the manufactured sector will expand by 8.8 per cent and this may thus turn out to be lower, introducing a downward bias to the estimate of overall GDP growth of 8.6 per cent. However, this may be offset by higher output in the mining sector and better performance of the services sector.

31. In the mining sector, while the output of crude petroleum has been very favourable on account of the Rajasthan oil fields coming on line, with cumulative growth during April to December 2010/11 standing at 12 per cent, coal production has registered a very low rate of growth of only 1 per cent in the period of April–December 2010/11. It is unlikely that there will be a change in the last quarter of the current fiscal year. On account of more capacity coming on line, electricity generation, for the year is likely to be better than that registered in the first 9 months (4.5 per cent). The Advance Estimate places GDP arising in the mining sector at 6.2 per cent and that in the electricity, gas & water supply sector at 5.1 per cent. It is likely that the output/GDP growth in the mining sector may turn out to be higher, while that arising in the electricity, gas and water supply sector may not vary much from that estimated.
32. On the services side, the Advance Estimate places full year growth at 9.6 per cent. GDP arising in the services sector showed growth in the first quarters of the year at 9.5 per cent, with the second quarter registering growth of nearly 10 per cent. While bank deposit growth has shown slower expansion in the current year, other business services, particularly the IT sector, has reported a strong rebound. Transportation and other businesses have registered strong double-digit growth in the first two quarters of 2010/11. The available information on general trade, retail, transport and hospitality sectors support the assessment made in the Advance Estimate of GDP for 2010/11.
33. In light of the above discussion, the Council feels that while the second half growth for the current fiscal will be significantly slower than that recorded in the first half (8.9 per cent) it may still be adequate to result in overall growth of 8.6 per cent for 2010/11.

V: EXTERNAL SECTOR

34. Balance of payment estimates are available for the first half of the current fiscal. The second half of the last fiscal and the current year has been characterized by a strong recovery in exports, which had started becoming manifest from November 2009 onwards. During the first nine months of 2010/11, exports in US dollar terms have grown by 29.5 per cent. Imports which had begun to recover faster than exports, starting from December 2009, registered extraordinarily fast growth up to March 2010. Thereafter the value of merchandise exports appear to have stabilized at around \$17–18 billion per month, even as growth in imports soared towards \$30 billion per month in July and August 2010. There was some easing of export growth beginning July 2010, which seems to have turned around from November 2010 onwards, when export growth began to pick up. In consequence of the rapid build up of imports, the merchandise trade deficit soared from the last quarter of 2009/10 onwards.
35. The current account balance became a particular source of concern, because services export growth showed a greater lag in improvement from the Crisis. In the first quarter of 2010/11, the merchandise trade deficit stood at 8.3 per cent of GDP, which was not particularly high compared to the situation in the previous couple of years. In fact, the merchandise trade deficit in the first half of 2009/10 was as high as 9.4 per cent, while that for the year 2008/09 was 9.7 per cent. However, sluggish growth in net invisibles, on account of the deleterious consequences of the global Crisis on Information Technology Enabled Services (ITES) export markets resulted in a rapid expansion in the Current Account Deficit. In each of the last three quarters of 2009/10 the Current Account Deficit exceeded 3 per cent of GDP and averaged 3.4 per cent in the second half. For 2009/10 as a whole, the CAD was 2.8 per cent of GDP (the decline from the previously reported 2.9 per cent is due to higher GDP). In the first quarter of 2010/11 though some recovery had set in on the ITES export side, it was not sufficient to offset the larger merchandise trade deficit. Thus, the Current Account Deficit which stood at 3.2 per cent of GDP in the first quarter of 2010/11 soared to 4.1 per cent in the second quarter.

Table 4 Balance of Payments

Unit: US\$ billion

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11			2011/12
							H1	H2	Total	
Merchandise Exports	85.2	105.2	128.9	166.2	189.0	175.0	110.5	119.8	230.3	271.9
Merchandise Imports	118.9	157.1	190.7	257.6	308.5	295.5	177.5	184.9	362.3	423.4
Merchandise Trade Balance	-33.7	-51.9	-61.8	-91.5	-118.7	-120.5	-66.9	-65.1	-132.0	-151.5
	-4.7%	-6.2%	-6.5%	-7.4%	-9.7%	-8.5%	-8.8%	-6.9%	-7.7%	-7.7%
Net Invisibles	31.2	42.0	52.2	75.7	89.9	80.0	39.1	42.2	81.3	95.7
	4.3%	5.0%	5.5%	6.2%	7.4%	5.8%	5.1%	4.5%	4.8%	4.8%
o/w Software & BPO	14.7	23.8	27.7	37.2	47.0	41.0	22.2	26.0	48.2	56.6
Private Remittances	20.5	24.5	29.8	41.7	44.6	53.5	26.1	27.0	53.1	61.1
Investment Income	-4.1	-4.1	-6.8	-4.4	-6.6	-5.5	-6.1	-7.8	-13.9	-18.0
Current Account Balance	-2.5	-9.9	-9.6	-15.7	-27.9	-38.4	-27.9	-22.9	-50.8	-55.8
	-0.3%	-1.2%	-1.0%	-1.3%	-2.3%	-2.8%	-3.7%	-2.4%	-3.0%	-2.8%
Foreign Investment	13.0	15.5	14.8	45.0	3.5	51.8	29.1	19.0	48.1	45.0
o/w FDI (net)	3.7	3.0	7.7	15.4	19.8	19.5	5.3	4.0	9.3	20.0
Inbound FDI	6.0	8.9	22.7	34.2	37.7	35.6	12.6	15.0	27.6	40.0
Outbound FDI	2.3	5.9	15.0	18.8	17.9	16.0	7.2	11.0	18.2	20.0
Portfolio capital	9.3	12.5	7.1	29.6	-14.0	32.3	23.8	15.0	38.8	25.0
Loans	10.9	7.9	24.5	41.9	8.3	6.5	17.4	10.4	27.8	30.0
Banking capital	3.9	1.4	1.9	11.8	-3.2	0.4	0.8	1.1	1.9	6.0
Other capital	0.7	1.2	4.2	9.5	-4.0	-12.1	-9.0	-2.5	-11.5	-5.0
Capital Account Balance	28.0	25.5	45.2	108.0	6.8	47.8	36.7	27.9	64.6	76.0
	3.9%	3.0%	4.8%	8.8%	0.6%	3.6%	4.8%	3.0%	3.8%	3.8%
Errors & Omissions	0.6	-0.5	1.0	1.2	1.1	-1.6	-1.8			
Accretion to Reserves	26.2	15.1	36.6	92.2	-20.1	13.4	7.0	5.0	12.1	20.2
	3.6%	1.8%	3.9%	7.5%	-1.6%	1.0%	0.9%	0.5%	0.7%	1.0%

Note: Figures in parentheses are percentage of GDP

36. In the Economic Outlook of July 2010 the Council had opined that on account of the sharp rebound in domestic demand and the weakness in world export markets, the Current Account Deficit was likely to be at an elevated level for 2010/11 and also in 2011/12. However, the developments in the second quarter of 2010/11 began to suggest that the order of elevation of the Current Account Deficit would be larger than that which had been originally envisaged (2.7 per cent).
37. The sharp improvements in merchandise exports in the months of November–December 2010 as well as that assessed in January 2011 of about 32 per cent, have begun to cast a more favourable light on the current account. Not only has growth of merchandise exports recovered well, import growth has also begun to moderate. Undoubtedly the higher world prices for crude oil may have an impact on the import side, but this will, be offset to an extent by the increased availability of domestic crude from the Rajasthan oil fields.
38. The merchandise trade deficit in the second half of 2010/11 is now expected to be slightly lower at just below 7 per cent of GDP, compared to 8.8 per cent in the first half. The position of net invisibles is expected to weaken as a percentage of GDP between the first half and the second half of 2010/11, though in absolute terms net invisibles will be larger in the second half than in the first. In consequence, the Current Account Deficit is expected to decline to 2.4 per cent in the second half and the Current Account Deficit for 2010/11 as whole is now expected to be around 3 per cent of GDP.
39. On the capital account side, Foreign Direct Investment (FDI) on a net basis was only \$5.3 billion in the first half of 2010/11, which is significantly lower than the \$12.3 billion recorded in the first half of 2009/10. A similar trend of decline is expected to continue in the second half of 2010/11. This is in part on account of the slowing down of gross FDI inflows which has been separately reported in Government releases. However, the other component to the reduction in net FDI flows is the substantial quanta of FDI outflows as Indian businesses acquire overseas assets of various kinds, including manufacturing, services and oil/gas fields and coal mines.
40. Portfolio flows have been quite high in the first half of 2010/11 at \$23.8 billion, compared to about \$18.0 billion in the corresponding period of the previous

year. The driving force for this has been the quite large Foreign Institutional Investors (FII) inflows in the first eight months of this year. In the first half, FII inflows are estimated at \$22.3 billion compared to \$15.3 billion in the corresponding period of last year. However, from December 2010 onwards, FII inflows have been very subdued and negative on the equity side. The Council believes that this trend may correct in the last two months of the fiscal year and have accordingly projected a small growth in portfolio flows (including investment in debt instruments) for the last quarter of 2010/11.

41. Overseas loan growth has also been modest in the first half of 2010/11 and on the basis of available data, including ECB issuances up to December 2010, it seems that on a net basis after redemption of existing loans/bonds the total net loan flows in the second half are likely to be about 60 per cent of that recorded in the first half (\$17.4) of 2010/11.
42. Overall, the Council estimates that the capital account surplus will be \$27.9 billion in the second half of 2010/11 which will be one quarter less than the \$36.7 billion recorded in the first half of the fiscal. Overall, that would leave a very modest balance of payment surplus of about \$5 billion in the second half of 2010/11, which is 30 per cent less than the modest \$7 billion reported in the first half. Thus, total accretion to foreign exchange reserves will be about \$12 billion for the full year 2010/11, smaller than that recorded in 2009/10 (\$13.4 billion).
43. On the basis of the experience of the current year, the Council projects that the merchandise trade deficit will be of the same order in 2011/12 as that estimated for the current year (7.7 per cent of GDP). The position on net invisibles is also expected to remain at the same level (4.8 per cent of GDP). Improvement in service sector exports is likely to be offset to an expansion in the outflow of investment income. The Current Account Deficit for 2011/12 is accordingly projected at about \$56 billion or 2.8 per cent of GDP. On the capital side, flows of a similar magnitude amounting to \$76 billion (3.8 per cent of GDP) is projected for 2011/12, which will leave a modest sum of \$20 billion to be added in the foreign exchange reserves.
44. The large absolute values of current account deficits that have been in evidence from 2009/10 onwards, are likely to persist in 2011/12. Even in the subsequent

years, as the CAD is sought to be stabilized at a lower level of around 2.0–2.5 per cent of GDP, we would nevertheless require that capital inflows of sizeable magnitude also occur. The magnitude of the Current Account Deficits reflects the growth dynamics of the domestic economy. Undoubtedly, if export conditions improve, a moderation of Current Account Deficit will result. However, it is quite likely that the magnitude of the deficit will continue to be large and to that extent domestic conditions need to be favourable in order to attract foreign capital inflows, especially non-debt inflows. Investment conditions at home to a great extent determine its attraction to Foreign Direct Investment, as well as to investors in the equity of Indian companies. In order to be able to finance these large Current Account Deficits in a manner that does not stress the external payment account, and therefore the otherwise favourable macro economic growth conditions in the Indian economy, the focus must be on facilitating such capital inflows.

VI: PRICES

45. In July 2010, in the Economic Outlook, the EAC had dwelt at some length on the issue of managing inflation arising from foodgrain and also from cotton. Having factored in the expectation of a reasonably good harvest, the EAC had at that time expressed the view that the WPI headline inflation rate will remain high at 7–8 per cent till December 2010 and would subsequently drop to around 6.5 per cent by March 2011. In November 2010, the headline inflation rate fell to 7.5 per cent in line with this projection.
46. However thereafter, vegetables, which normally show a pronounced seasonal decline in prices as winter sets in and the supply expands sharply, began to show a contrary trend. Instead of falling, the normally seasonal decline through November, December 2010 and first half of January 2011 was reversed. Several key vegetable items experienced very sharp increases in price. As a category, vegetable prices rose by 48 per cent between the beginning of November 2010 and the third week of January 2011. This was in sharp contrast to the decline of 21 per cent that characterized the change in vegetable prices over the same period in the previous year (2009/10). Three items in particular drove this increase. The first was onion (94 per cent increase), the second was tomato (144 per cent) and the third brinjal (57 per cent).
47. In the absence of this anomalous and unexpected development, the overall headline inflation rate would have moved broadly along the directions indicated in the Council's July 2010 report. That is, the variation between an outcome of a March 2011 inflation rate of 6.5 per cent and our present assessment of about 7 per cent is entirely due to the aberrant behavior in the price of vegetables.
48. In recent days, the data has shown some degree of decline in the price of the above mentioned vegetable items. Provisional WPI for the week ending 29 January 2011 show that the price index for vegetables fell by 17 per cent compared to that in the previous week. Price indices for tomato were lower by 38 per cent, onion by 21 per cent, brinjal by 13 per cent and for cauliflower 12 per cent. However, the level of the indices for tomato and onion were both still above 50 per cent over the early November level and that for Brinjal 37 per

Prices

Table 5 Composition of Inflationary Pressure in 2010/11

Unit: per cent

	2009/10		2010/11		
	Sep	Mar	June	Sept	Dec
All Products	1.1	10.2	10.3	8.9	8.4
Primary Goods	10.6	22.2	20.1	18.2	16.5
Primary Food	13.9	20.6	21.0	16.3	13.5
Foodgrain	14.6	13.2	10.4	6.0	-2.6
Energy	-8.1	13.8	13.9	11.1	11.2
Manufactured Goods	0.2	5.2	5.6	4.8	4.5
Manufactured Food Products	12.1	15.1	4.6	3.6	0.4
Special combinations					
Manufactured Goods Excl Manufactured Foods	-2.0	3.3	5.6	5.1	5.3
All Products excluding Primary Food & Energy	0.5	7.1	6.9	6.6	6.4
Some key items					
Rice	16.1	8.1	8.2	5.5	1.2
Wheat	8.5	14.7	6.5	7.1	-5.0
Coarse cereals	15.2	9.6	6.5	7.6	6.2
Pulses	19.5	25.0	23.1	3.9	-11.7
Fruit & Vegetables	7.6	16.3	18.9	12.2	22.8
Milk	16.8	24.9	26.2	24.1	18.2
Eggs, Meat & Fish	19.9	35.5	39.0	29.5	19.2
Raw Cotton	-17.2	20.0	17.3	35.3	31.8
Sugar, <i>gur</i> & <i>khandsari</i>	53.9	41.7	10.9	-3.9	-9.4
Dairy products	9.8	13.1	12.8	12.1	12.5
Cotton Textiles	2.0	12.7	13.8	15.9	14.1
Manmade Textiles	-0.9	8.4	8.7	7.9	10.5

cent higher. Further correction is expected to happen in the subsequent weeks. However, like in many other things, prices tend to be downward sticky and in our assessment a complete normalization in the prices of vegetables may not reasonably be hoped for in the time horizon of next one to two months.

49. Accordingly, the Council now expects the headline inflation rate to be around 7 per cent with the risk of being marginally higher in March 2011. To the extent that there is some greater than expected easing of the downward stickiness in vegetable prices, the headline inflation rate may be marginally lower.
50. The inflation as measured by the Consumer Price Index has broadly tracked the WPI, particularly given that food has been accounting for such a large component of overall inflation.
51. We are almost at the end of 2010/11 and the pertinent issue is what might occur in the next fiscal year. The rice harvest and procurement, and the expected wheat harvest and procurement, are likely to be comfortable. Pulses output has increased dramatically this year and hopefully some further improvement will be manifest in the next year too. On the basis of this and assuming that the monsoon is moderately normal, we should be able to maintain stability in foodgrain prices even in a world where these price changes are quite adverse.
52. On the non-food primary products side, we should see some easing in further inflationary movement in raw cotton, although with international edible oil prices rising rapidly there may be some rise in the price of domestic oil seeds and edible oil. International crude oil prices are likely to go up further. We already have a backlog in the adjustment of prices of sensitive petroleum products, especially diesel. While some rationalization may help to make the enormous shortfalls in revenue for LPG and kerosene more manageable (as has been recommended by several high-powered Committees in the past) there is clearly an overdue need to make some adjustments in the price of diesel, even if this were to be done in a phased fashion. Thus, on the energy price front the only reasonable expectation is further upward price adjustments.

53. It would be reasonable to expect that further increase in the world prices of basic commodities is likely. The worldwide monetary and fiscal accommodation referred to in the first section continue to create conditions where inflationary pressures have considerable headroom. Although manufactured goods inflation has not been excessive in 2010/11, considerable care from the policy side has to be taken to ensure that it remains below 5 per cent in 2011/12.
54. There are some capacity constraints building up in the manufacturing sector on account of investments that were deferred during the Crisis. A combination of close observation of developments and imaginative measures involving trade and fiscal policy will have to supplement the overall monetary and fiscal stance in ensuring that conditions obtaining in 2011/12 are, while supportive of growth at 9 per cent, also produces a regime of acceptable price stability.

VII: MONETARY CONDITIONS AND THE FINANCIAL SECTOR

International Conditions

55. The July 2010 Economic Outlook had dwelt in some length on how despite the improvement in general economic conditions, globally financial markets had become vulnerable to a different kind of perceived risk – namely sovereign debt. The enormous fiscal accommodation that developed economies had extended to offset the impact of the Crisis of 2008–2009 was rapidly exposing the weakness and over-extended character of government finances in many of these countries. The Greek episode, followed by the Irish one and the acute concerns over Portugal and Spain, shook up confidence in the euro zone. While the continued support from major euro zone members, particularly Germany, has helped tide over the Crisis to date, deep uncertainties continue to trouble financial markets and investors, even as many of these economies appear to have embarked on seriously examining politically loaded issues pertaining to the sustainability of their social security systems. The developments in the euro zone have served to reinforce the perception of the US dollar as a safe haven, even as that country’s government deficits and debt continue to mount, with scant prospective relief either from a scaling down of expenditure or from new sources of revenue.
56. With both of the major reserve currency issuers in some sense suspect in the eyes of the financial markets, it is little surprise that the degree of volatility in all markets continues to rule very high, even as the worries that pervaded the Crisis have quite retreated and economic conditions have stabilized, pointing towards a gradual and broad based recovery, *albeit* one where the emerging economies have got off to an early start and the developed ones to a later one.
57. The path to an exit from the extraordinary monetary conditions in both the US and the euro zone remain unclear, more prominently in the first. Central banks in Australia and in most emerging economies – India, China, Brazil and many

others – have long back exited the easy money conditions specifically created during the Crisis and have tightened considerably to date. The rising tide of inflation in most emerging economies has caused acceleration in the process of re-normalization and subsequently the tightening of monetary policy in these economies. On balance, the monetary stance in most of these economies can be reasonably characterized as “tight” rather than “normal”. That this would come to pass in so short a span of time is testimony to the relatively low slack in the first place not only in these economies, but also globally – at least for the products that matter most in these economies – fuel, food and industrial commodities. Second, it also reflects the dynamics of global markets in key commodities such as crude oil, grain and major industrial commodities that seemingly tend to amplify price responses.

Domestic Conditions

58. The Reserve Bank of India has over the past one year increased the reverse repo by 225 basis point (bps), and the repo rate by 175 bps, to 5.5 and 6.5 per cent respectively. The Cash Reserve Ratio (CRR) has been raised by 100 bps to 6.0 per cent. The effective overnight interest rate has shifted from the reverse repo end of the corridor to repo end. Thus, as long as excess liquidity was being parked with the RBI till May 2010, the average overnight rate was around 3 per cent. Once conditions had tightened and banks were borrowing at the repo window the overnight rate climbed to well over 6 per cent and now over 6.5 per cent.
59. The tightness in the domestic market for liquidity that has seen banks borrowing large sums from the RBI at the repo window is in part an outcome of monetary policy that consciously tightened liquidity. However there were other factors at play as well to which a part of the outcome of tight liquidity may be ascribed. One is the large positive balances that the Central government maintained with the RBI, which itself was partly a consequence of the lumpy receipt of moneys from the 3G spectrum auction that basically saw a large amount of funds previously in circulation, getting overnight locked up in the treasury.
60. Then again the current account deficit was large and consumed most of the capital inflows, leaving little surplus to be injected as liquidity into the market.

Besides providing liquidity through the repo window and making adjustments to the effective Statutory Liquidity Ratio (SLR) in order to facilitate repo lending, the RBI also purchased government securities from the market. Keeping the market slightly short of liquidity where banks at the margin were constrained to borrow from the repo window and thus maintain the transmission of monetary policy taut and effective, was perhaps a part of the conscious design of the central bank. However the magnitude of the short liquidity was perhaps not – an unintended outcome which was the consequence of other factors that have been related above.

61. The domestic economic conditions tend to suffer from supply bottlenecks, as the robust character of demand growth tends to outstrip the pace of supply expansion. Thus, inflation on this count in this country always poses a proximate challenge and will continue to do so. In addition, the legacy of extraordinary monetary easing overseas by the issuers of reserve currency – a situation that continues to date with no clear exit path – creates a framework that is conducive to elevation of inflationary pressures. Widely traded global commodities from crude oil to liquefied natural gas (LNG), from wheat to sugar, from urea to cotton, from gold to copper to steel have seen their prices rise sharply, in many cases well past their 2008 peak levels. It is hard to escape the conclusion that these commodities, and the exchange traded funds that often represent them, have increasingly acquired a monetary character – the obverse side of the medal of a perceived debasement of the reserve currency. This makes the task of maintaining price stability at home much harder, but not impossible.
62. Inflation currently stands at an uncomfortably high level. Monetary and fiscal policies have to be appropriately tight to protect the economy from inflation. Monetary policy has an important role to play, even in situations where inflation is triggered by supply constraints.

VIII: GOVERNMENT FINANCES

63. After two years of very high fiscal deficits, the fiscal consolidation process was reinitiated in the last Union budget. In conforming to the targets set by the 13th Finance Commission, the Centre's fiscal deficit was planned to be reduced to 5.2 per cent in 2010-11 from 6.3 per cent in the previous year. Similarly, the revenue deficit of the Centre was budgeted at 4 per cent of GDP which, although was higher than the target set by the Finance Commission (3.2 per cent), was lower than the revised estimate of the previous year by 1.3 percentage points. In the case of the States, despite larger allowance for borrowing space given to them (4 per cent of GSDP) as a part of the fiscal stimulus package, their aggregate fiscal deficit for 2010-11 is budgeted at 3 per cent of GDP and revenue deficit is estimated at 0.5 per cent. With the recent upward revision of GDP estimates, the estimated revenue, fiscal and primary deficits as a ratio of GDP are marginally lower. Thus, the budget estimate of Central government's fiscal deficit relative to GDP is estimated at 5.2 per cent and the consolidated fiscal deficit of Central and State governments is estimated at 8 per cent. Similarly, the revenue deficit-GDP ratio of the centre for 2010-11 is budgeted at 5.2 per cent. Thus, both fiscal and revenue deficits in 2010-11 were lower than the previous year's revised estimates by 1.6 percentage points (Table 6).
64. During the first half of the year (April – September) there has been a spectacular increase in non-tax revenues mainly on account of realization from spectrum auction and this has resulted in the total Central revenues registering an increase of 62.9 per cent over the corresponding period last year. More importantly, the tax revenues too have shown very high buoyancy registering a growth of 25.3 per cent during the first half of the year and this was predominantly due to the very high buoyancy of customs duties (61.8%), excise duties (41.1%) and corporation tax (17.9%). As reported in the mid-year review of the Ministry of Finance, during the first half of the current year, the budget implementation shows a sharp increase in expenditures as well. Total expenditure of the Central government during April – September,

2010 has increased at 19.9 per cent. While the revenue expenditure grew at 15.6 per cent capital expenditures registered a sharp increase of 64.6 per cent. Furthermore, in the remaining months, revenue expenditure is likely to register a higher growth due to substantial outgo on account of food and fertilizer subsidies due to the prevailing high prices of food items and petroleum products.

65. The buoyant revenues could result in significant improvement in the revenue deficit situation at the Centre over the budget estimates. However, as capital expenditures too have shown a sharp increase in the first half of the year, the fiscal deficit outcome for 2010-11 could be only marginally better than the budget estimates. Thus, for the current year, the fiscal outcomes are expected to conform or even improve on the targets set in the medium term fiscal plan of the Central government.
66. In the case of the States, The revival of the economy has resulted in high buoyancy of states' own tax revenues and increases in the prices of motor spirit and high speed diesel has added to States' revenue from the sales tax on these items significantly. Many States have increased the VAT rate by one percentage point and this has also led to increase in buoyancy. The high buoyancy of Central taxes has also resulted in buoyant tax devolution. As the burden of pay revision has also been already over in most of the States, they should be able to limit their deficits at budgeted levels, if not improve upon them. Thus, on the whole, the consolidated fiscal deficit on the central and state governments in 2010-11 is likely to be about 7.5 to 8 per cent of GDP.
67. While the current year's fiscal adjustment may not be a problem, the government faces formidable challenge of conforming to the Finance Commission's targets in the medium term. According to the targets set by the Finance Commission, the Central government should compress its fiscal deficit to 3 per cent of GDP and increase capital expenditures to 4.5 per cent of GDP by 2014-15. About one per cent of GDP of capital expenditure is supposed to be financed from disinvestment proceeds and this means that in addition to the borrowings of 3 per cent of GDP, the Centre has to generate a

revenue surplus of 0.5 per cent by 2014-15. Thus, the Centre has to reduce the fiscal deficit to GDP ratio by 2.5 percentage points and revenue deficit to GDP ratio by over four percentage points over the budget estimates. In addition, there are pressures to increase expenditures on food security, right to education, universalising healthcare and increased wages in MGNREGA and these may require additional spending of about three per cent of GDP. On the whole, in the medium term, the central government may have to raise additional revenues or reallocate expenditures of about 5 percentage points to GDP and this is going to be a formidable challenge.

68. A significant proportion of this fiscal adjustment will have to come from additional tax revenues. The two major tax reforms planned to generate additional revenues are the implementation of the direct taxes code (DTC) and the introduction of goods and services tax (GST). The analysis of the revised paper on the DTC shows that while the reform may increase the revenue productivity of direct taxes in the medium term, there may not be significant expansion of the tax base and revenue gains in the short run. Indeed, increase in revenue productivity will have to come from continued attempts to reform tax administration, review the double taxation agreements and other measures to prevent the flight of incomes to tax havens.
69. Implementation of GST is another reform which can bring about significant improvement in revenue productivity. This is particularly important as DTC can only enhance revenue productivity in the medium term. The hope of meeting additional resource requirements for food security, increased allocation to education and healthcare will critically depend on the implementation of GST and therefore, is important for both Central and State governments.
70. Therefore, there is considerable urgency in restarting the GST reform. Both Central and State governments have agreed that there will be a dual GST one at the Centre and another at the State level and the tax will be destination based with inter-State transactions facilitated through the clearing house mechanism. It has also been agreed to choose NSDL as the technology

partner who will incubate the technology to administer GST which will be eventually taken out to constitute a special purpose vehicle with majority equity contributed by the Central and State governments. The important point in which the reform is stuck relates to the constitutional amendment and the contentious issue seems to be the constitution of the GST council with the Union Finance Minister as the Chairman. The Union Finance Ministry has revised the draft constitutional amendment thrice to take account of the States' concerns and hopefully, the bill will be placed in the Parliament in the forthcoming budget session.

71. A major motivating factor could be the centre starting the reform process unilaterally within the prevailing constitutional parameters. This requires the Centre to prune the exemption list to the minimum, rationalize the rates of excise duty by converting the specific duties into ad valorem and unifying them with the general rate and extend the tax to all services by converting the prevailing selective tax into a general tax. It is necessary to have a common threshold and rate for both goods and services. The threshold could be kept at Rs 50 lakh manufacturing turnover in the case of goods and sales turnover in the case of services, and the tax may be levied at a uniform rate of 10 per cent. A separate sumptuary tax can be levied on cigarettes. With the computerized information system linked to PAN put in place, and with exchange of information between excise and income tax departments, there could be significant revenue gains for both the taxes. The information on the size of the tax base on services could help the States in arriving at more reliable estimate of revenue neutral rates and design the GST structure as well.
72. There are a number of measures required at the state level before the tax is implemented and hopefully the States will initiate measures on them. Besides deciding on the list of exemptions and rate structure, the States have to decide on the ways to tax and appropriate revenue from inter-state services and hard to tax activities like real estate and financial services. Similarly, the States have to determine the administrative arrangements and institute a mechanism to deal with inter-state and centre-state disputes. Capacity building and administrative changes is another area requiring attention. A clear time table for these will

have to be worked out and this is possible only when the agreement between the Centre and States is arrived at without much loss of time.

73. It is important that the States should collectively finalize the design and operational details and set a clear time table for implementation. It seems, the States would prefer two rates than one and that may have to be accepted in the interest of carrying out reforms. Once the exemption list and the list of commodities for lower tax rate category is finalized (services will in any case be taxed at general rate), the progress in the collection of Central GST at the manufacturing stage should give a clearer idea about the revenue neutral rates. Available studies show that, when some important items of common consumption are taxed at a lower rate of 5 per cent, the States should be able to recover their revenues at a general tax rate of 10 per cent on regular items of consumption. On sumptuary items, tobacco products, motor spirit, high speed diesel and a few selected items of conspicuous consumption, in addition to the general rate, the States may be allowed to levy a special excise at the floor rates decided collectively. The Centre has already agreed to compensate the shortfall in revenue collections including the revenue from central sales tax for the first three years and this should provide adequate insurance to the States in implementing the reform. The reform could be implemented from April 2012. The progress in revenue collections should be monitored continuously and at the end of three years, the rate structure could be reviewed and if necessary, could be realigned.
74. As mentioned earlier, GST reform is imperative to achieve the fiscal consolidation goals in the medium term. It is important to implement the reform without much loss of time. This reform is necessary not only to enhance the revenue productivity of the tax system but also to minimize compliance cost and distortions in resource allocation. The reform undertaken when the economy is on the recovery path results in buoyant revenues and therefore, will be successful. Introduction of GST will be a win-win strategy for both the Centre and States and there is every reason to embrace it. Hopefully, Centre and States will agree on all important issues to introduce GST in April 2012.

Table 6 Fiscal Imbalance in India			
(Per Cent of GDP)			
	<i>Centre</i>	<i>States</i>	<i>Total</i>
Primary Deficit			
2008-09	2.6	0.6	3.4
2009-10 (RE)	3.0	1.5	4.7
2010-11 (BE)	1.8	1.0	3.0
Revenue Deficit			
2008-09	4.5	-0.2	4.4
2009-10 (RE)	5.0	0.7	5.9
2010-11 (BE)	3.8	0.4	4.3
Fiscal deficit			
2008-09	6.0	2.4	8.4
2009-10 (RE)	6.3	3.3	9.6
2010-11 (BE)	5.2	2.7	8.0

Note: 1. The deficits have been re-estimated using the revised GDP estimates for 2008-09 and 2009-10. For 2010-11, the estimates are derived by applying the implicit growth rate derived from the fiscal deficit percentage from “budget at a Glance”.

Source: Department of Economic Analysis and Policy, Reserve Bank of India.

Table 7 Budgetary Implementation: April – September 2010

No	Budget Item	2010-11 (BE) Rs. Crore	April – September Rs. Crore		2010-11 Actual as per cent of BE	Growth rate in 2010 over 2009 (Per cent)
			2010	2009		
1	Revenue Receipts (2+3)	682212	398234	244471	58.4	62.9
2	Tax Revenue	534094	233415	185669	43.7	25.7
	(i) Corporation Tax	301331	123161	104504	40.9	17.9
	(ii) Income Tax	120566	56480	49703	46.8	13.6
	(iii) Customs	115000	61051	37744	53.1	61.8
	(iv) Excise Duties	132000	52058	36893	39.4	41.1
	(v) Service Tax	68000	26936	23236	39.6	15.1
	(vi) Other Taxes	9754	4711	6800	48.3	-30.7
3	Non-tax Revenue	148118	164819	58802	111.3	180.3
4	Capital Receipts	426537	139743	204377	32.8	-31.6
5.	Borrowings and Other liabilities	381408	133252	197775	34.9	-32.6
6.	Total Receipts	1108749	537977	448848	48.5	19.9
7	Total revenue Expenditure	958724	473155	409454	49.4	15.6
8	Total Capital Expenditure	150025	64822	39394	43.2	64.6
9.	Total Expenditure	1108749	537977	448848	48.5	19.9
10	Revenue Deficit	276512	74921	164983	27.1	-54.6
11	Fiscal Deficit	381408	133252	197775	34.9	-32.6
12	Primary Deficit	132744	30473	111106	23.0	-73.6

Source: Mid Year Review Analysis 2010-11. Ministry of Finance, Government of India.

IX: CONCLUDING COMMENTS

Principal Constraints

75. The Council is of the view that the pace of formation of incremental domestic demand is autonomously quite strong and policy must be focused on resolving the elements that persistently result in serious supply bottlenecks across the economy from power to farm output to logistics. The operating target and expectation for economic growth in 2011/12 is 9 per cent – for which the demand conditions are deemed to be adequate. The supply side limitations that have the potential to create strains, the consequences of which are primarily inflation and also excessively large trade deficits, should be the primary policy focus. Monetary and fiscal policies must both be geared to induce price stability. To the extent that supply bottlenecks persist to a degree that is greater than expected, overall economic growth may be marginally lower than 9 per cent.

Agriculture

76. The Second Advance Estimates indicate that in the current year foodgrain production will be 232 million tonnes which is a considerable improvement over last year but still 2.5 million tonnes smaller than the record harvest of 2008/09 and only 0.6 per cent more than that registered in 2007/08. The average rate of GDP growth arising in the farm sector over the last three years is only 1.9 per cent, despite the strong showing in the current year. As against the target of average 4 per cent growth during the Eleventh Plan period, the actual average growth is likely to be slightly less than 3 per cent.

77. Foodgrain production has been in the region of 230–234 million tonnes in the good years after 2006/07, although it is higher than the effective range (210–215) in the first part of the present decade. There is a need to lift the range of foodgrain output to a significantly higher level. Somewhat in parallel, the per capita availability in grams per day has also not gone up in a context where per capita income has been rising quite strongly.

78. The international prices for grain have been very volatile and much elevated in recent times and therefore higher levels of domestic output is an even more important factor to consider in the context of domestic food security. Therefore, policy has to be on increasing productivity in foodgrain, as also in other food crops. Attention must be focused on building rural infrastructure, developing technologies that are appropriate to the region which have to be disseminated / delivered in an efficient fashion. The institutions that are enjoined with this task have to be activated in a more energetic fashion.
79. The liberalization of the economy has benefited the farm sector and as a result the terms of trade for agriculture are no longer adverse. Investment in the farm sector has also picked up substantially and capital formation as a percentage of agricultural GDP has more than doubled in the past decade. There seems to be evidence that better quality seeds and superior cultural practices are available, but the delivery system for translating these to the field are lagging.
80. Three areas need particular attention. The first is certified seeds of appropriate quality and quantity. The second is the management of water which includes both rainwater harvesting and impounding in surface reservoirs or through recharging ground water and better means of utilizing the groundwater through sprinkler and drip irrigation, as opposed to flood irrigation. The third challenge is managing soil fertility, where we have seen a decline in the organic content and natural fertility of soil, widespread prevalence of micro-nutrient deficiency and problems of salinity in certain areas. These are substantial challenges and we must be able to develop a time-bound programme of dealing with these challenges appropriately.
81. A major hurdle in agricultural development is the inefficiency of the delivery systems. There is a plethora of institutions in research, extension, credit and marketing. However, efficacy of these institutions to deliver goods and services to the country's vast small and marginal farms section is quite limited. This is a serious cause for concern. Nearly 50 per cent of land is now cultivated in small and marginal holdings. If the institutions and delivery systems by-pass these sections or deliver these at a very high cost, it amounts to discrimination against half of our agriculture. There is need therefore, to attune these various

institutions to the emerging agrarian structure, which is progressively identified with the small and marginal farmers

82. The farm sector also faces difficulties in accessing finance. This is particularly important since more than half of the cultivated land comprises of small and marginal holdings. A two-fold strategy is indicated for this purpose. One, to encourage farmer's collaborative efforts as in cooperatives, or more recently in producers companies, and vertical integration of production and marketing by suitable models of contract farming. Two, at the institutional level, the organizational changes to cut down the cost of transactions (e.g. through a flexible and inclusive business correspondent model) and the use of information technology for the same purpose needs to be encouraged. Such initiatives wherever taken seriously have made it possible for banking institutions to reach a large number of producers without increasing transactions cost. In addition both for purposes of ensuring remunerative prices for farmers as well as an anti-inflationary measure, the strengthening of organized retail, as well as use of these outlets for public distribution along with the strengthening of the existing public distribution networks, are measures that need to be tried out seriously.
83. The issue of procurement and distribution through the public distribution system (PDS) of coarse cereals has been often raised and correctly so in the past. It has been the experience, that where local procurement has supplemented the centralized procurement, the results have been good. Local procurement by State Government agencies provides an incentive for farmers to grow grain. Coarse cereals are a varied commodity and tastes differ across States. There is also a problem in handling coarse grains. If State Governments take greater initiative in local procurement they can readily purchase coarse cereals from farmers of the State and distribute it through their PDS system. This would be desirable both from the angle of providing an assured market for farmers and also in terms of the choice of cereals that are being offered through the PDS system.

External Payments

84. The Current Account Deficit (CAD) is forecast to be 3 per cent of GDP in 2010/11 and it is expected that the CAD will continue to remain elevated at around 2.8 per cent of GDP in 2011/12. The underlying reasons are the differentially more rapid recovery in the Indian economy, therefore resulting in domestic import demand recovering much faster than exports that reflect the lagging pace of recovery in the rest of the world, especially in the advanced economies. The higher levels of CAD for the current and next year must be viewed as a transitional situation. Efforts must be maintained to bring down the CAD to a more manageable level of between 2.0–2.5 per cent of GDP. This is desirable to impart much needed stability on the external payments front and to reduce the risk the domestic economy runs from volatility in international financial markets. However, in order to do this it is necessary, on the one hand, to make our exports more competitive and on the other, to moderate the dependence of the Indian economy on imported fuels to the extent that is possible.
85. India has been extremely well served by two-way flexibility in the exchange rate and has acquired both respect and experience in implementing a managed exchange rate regime. In the current year, intervention has been occasional and limited. The need for intervention has also been less, as the capital flows have been moderate. In this context, the management of the exchange rate must be seen primarily as an aspect of monetary policy.
86. While capital inflows have been adequate in the current year to finance the elevated CAD and it is expected this will be so true in the next year also, adequate attention must be paid to take the necessary steps so that the Indian economy is seen to be an attractive destination for foreign investors. This is a task with many facets. The decline in FDI in the current year is a matter of concern and it is important for policy makers to examine what concerns there may be amongst foreign investors, which has resulted in this outcome and take considered and appropriate steps. We need also to continue to encourage the flow of other kinds of equity investments and understand and meaningfully act on the concerns that this class of foreign investors may also have.

Physical Infrastructure

87. The pace of infrastructure creation has to be stepped up. The electricity sector is at the same time the single largest sub-sector in this field and is a good illustration. The Eleventh Five Year Plan had envisaged the creation of 78.4 GW of new capacity during the Plan period. At the end of January 2011, total addition to capacity in this Plan period was 32.5 GW. It now seems unlikely that the aggregate of capacity creation in the Plan period would approach the revised target 62.3 GW assessed in the Mid Term Appraisal barely a year ago, and may more likely be around 55 GW or even lower. The slippage has been of a large order (though admittedly less than in the Tenth Plan) and seemingly continues even as between March 2010 and today.
88. The slippage is palpably greater in the public sector, than in the private. As a proportion of total Eleventh Plan targets, the proportion that was commissioned by the end of January 2011 was 24 per cent (8.8 GW) in the Central sector, 48 per cent (12.9 GW) in the State sector and 73 per cent (11.0 GW) in the Private sector. This has important implications for how to adapt systems to get a better outcome from the public sector while at the same time improving the techno-economic conditions obtaining in the electricity business. The large commercial losses of State owned distribution companies is clearly an unacceptable state of affairs and has the potential of seriously undermining the expansion of electricity generation and consumption and therefore of the pace that the Indian economy can expand.

Inflation Management

89. The elevated levels of inflation over the past eighteen months have largely been the consequence of increase in primary food prices and some manufactured food products. They reflect the necessity of increasing farm productivity and perhaps even more the need to dramatically improve the logistics of reaching food from the farm to the kitchen table. The crisis with vegetable prices since November 2010 has underlined the consequences of antiquated logistics – collection, handling, storage and shipment – that continue to characterize many of the markets for our farm produce.

90. The sustained increase in food prices has as could have been expected spilled over into other areas leading to an increase in money wages on the one hand and perceptible increase in the prices of non-food products excluding energy. The international context for food, fuel and other commodities is hostile to price stability. The huge overhang of excess liquidity and low interest rates across the developed world is feeding, at least in part, inflationary fires in emerging economies which have recovered from the Crisis and has the potential of leading to inflationary pressures in the advanced economies as their recovery continues to gain momentum.
91. In this context maintaining price stability at home is harder, but far from being impossible. On the one hand, all measures that seek to relax supply constraints in specific areas must be energetically pursued. On the other, macro-economic policy – fiscal and monetary – and to some extent trade policy, must continue to be engineered to realize price stability and re-anchor inflationary expectations in the economy to the 4-5 per cent comfort zone.
