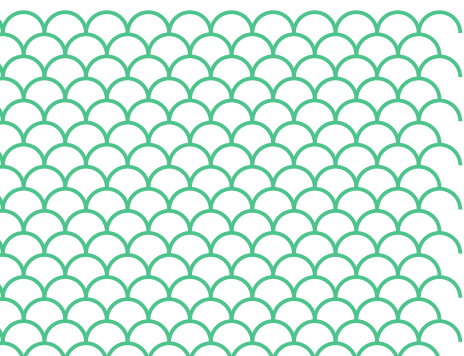


Mid-Year Review of the Indian Economy 2010-2011

Mythili Bhusnurmath



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of the Indian Economy 2010-11

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Preface

The Mid-Year Review of the Indian Economy is an annual seminar organized every November at the India International Centre. The event is made possible thanks to the generous endowment provided by the Elizabeth and Malcolm Adiseshiah Trust that also helps with the publication of the seminar as a book.

At this point, it would be appropriate to remember the man who made this seminar possible. Dr. Malcolm Adiseshiah (1910-1994) was a Life Trustee of the Centre and set up several of the Centre's financial procedures that are still in place. His special interest in economic welfare and deep involvement with the Economic Affairs Group is well known. After he retired from a distinguished public life, Dr. Adiseshiah devoted himself to the establishment and nurturing of research organizations, the establishment and promotion of good educational institutions, and devising programmes in the broad area of economics and education.

The Mid-Year Review is presented by an eminent economist and then debated among other experts and the audience. This year, an interesting feature was that for the first time the presenter was a lady: Ms. Mythili Bhusnurmath of *The Economic Times*. Moreover, as she herself reminded the audience, she is a journalist specializing in economic affairs rather than a professional economist. Given the importance of the press in highlighting issues of national importance, this was a fortuitous choice indeed.

After a brief introduction and homage to Dr. Adiseshiah, Ms. Bhusnurmath was invited to present her assessment. Among the issues raised by her, an important point was that

fiscal expansion and rise in deficit is not a consequence of the global economic crisis. She attributed the massive fiscal expansion in 2009-2010 to four reasons: loan waivers, pay revision, expansion in the scope of national rural employment guarantee act, and subsidies. This is perhaps what softened the blow of the global financial crisis in India. Ms. Bhusnurmath also discussed developments in agriculture, manufacturing and services, and external sectors, to identify future challenges.

She then turned her attention to some crucial sectors, the most important being the power sector. Unless reforms are enforced in the distribution system, she pointed out, we may be soon faced with bankrupt state electricity boards that will bog down state finances. In short, although she had a fairly optimistic outlook, Ms. Bhusnurmath warned that governance, infrastructure, fiscal adjustment and institutional reforms are going to be the major challenges that will have to be met in the medium term.

The IIC takes this opportunity to thank all the participants for this vigorous and stimulating seminar. Their cooperation and help in editing this volume has made it possible for us to bring out the proceedings in less than six weeks, a feat of which we are justifiably proud. We are certain that the material provided by the learned participants will be debated and discussed by all those who wish to understand where we stand today and who want see India's pride in its economic strength restored.

Ira Pande
Editor

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Introduction

In the euphoria surrounding the strong recovery of the Indian economy it might be tempting to say that the Indian economy has never had it as good. But that would not be correct. In the past, too, there have been years when our GDP grew by over 9 per cent (2005-06 and 2007-08). However, those were the boom years when the global economy was on a roll. In contrast, the global economy today is not out of the woods. In such a scenario our projected growth of 8.5 per cent for 2010-11 (even by the most conservative estimates) stands out as truly exceptional.

What explains this robust growth in the face of one of the worst economic slowdowns in the post-World War II period? There are as many theories as there are economists. Most centre round our relatively large domestic market and the fact that we are less globalized than many of our other emerging market peers. This ensured we were relatively less affected by the downturn when it came.

It also helped that the government embarked on a fiscal expansion spree well before the crisis, thanks to the fortuitous coincidence of general elections just a few months before the collapse of Lehman Brothers in September 2008. As a result, the fiscal stimulus was already in place in India by the time the crisis began to bite.

Consequently, the worst effects of the slowdown were largely mitigated. Economic recovery, which began by the middle of last year, has gathered pace and barring an unexpected reversal in the external environment, we are on target to achieve a growth rate of 8.5 per cent with an upward bias.

This holds good on the GDP front. Nevertheless, GDP numbers, as always, mask underlying problems in the Indian context. The most pressing of these is inflation. In a country where, by the Prime Minister's own admission, 37 per cent of the population is below the poverty line, any inflation in excess of, say, 4-5 per cent, hurts the *aam admi*. And when this inflation is more pronounced in food articles, as has been the case in India, it hurts him twice over.

Food constitutes a major chunk of the consumption basket of the poor, and sustained double-digit inflation of the kind we have witnessed in India for close to 2 years is ethically, socially and politically unacceptable.

Sustaining the growth process, even while withdrawing the stimulus, both fiscal and monetary, is another big challenge. Unlike many Latin American countries, one of our biggest strengths is that we have not experienced sharp ups and downs in our rate of growth (along with the social and political upheavals that such a growth process brings in its wake). It was easy to maintain a steady growth rate when our growth averaged 4-5 per cent; but it is going to be far more difficult when the trend rate has moved up to a higher trajectory of 8-9 per cent.

Likewise, managing capital flows is going to be another daunting task. With the U.S., in particular, determined to continue its easy money policy, cheap dollars are increasingly finding their way into emerging markets, including India. Foreign Institutional Investment (FII) flows into India have already (8 October 2000) crossed US\$20 billion. Surging capital flows in search of higher returns results in an artificial strengthening of the rupee, damages our export competitiveness and makes us much more vulnerable to the consequences of a reversal in hot money flows.

No review of the Indian economy is complete without detailing the infrastructure deficit. The good news is that the outlook here is much brighter than before. Both in the case of roads and the power sectors we seem to have reached an inflection point. Unfortunately, the same cannot be said about our social infrastructure, where we still lag behind many of our peers and even countries that are less advanced.

In keeping with the tradition of the Annual Mid-Year Review of the Indian Economy organized by the India International Centre, this Review examines the performance of the Indian economy in the first half of the year. But in a break from past reviews, it attempts some crystal-gazing. It identifies some of the more crucial challenges facing the economy and looks at how we can best address them.

Thus, there is a longish overview chapter that provides the macro-economic backdrop (sectoral) on the state of the economy followed by a chapter on the main challenges. As could be expected in a country as complex as India there are many challenges. It would be impossible to do justice to all of them in a Review such as this. Therefore, I have selected 5 of the more critical of these challenges and devoted a separate chapter to each in the hope that a more in-depth analysis of some challenges will make up for glossing over the others in what is, necessarily, a subjective process of selection.

Finally, although Alan Greenspan may have fallen from grace post the financial crisis, even he sometimes got it right! Asked to compare the rise of India and China, the former chairman of the U.S. Federal Reserve, reportedly retorted dourly, 'It's not what China is doing [that is remarkable] it's what India is not!' And that about sums up the India story!

We have great potential. The world view of India has changed. Indeed, there are times when it appears that the world view is running ahead of the real picture. It is for us to change the picture to suit the image.



Executive Summary

The performance of the Indian economy during the first half of 2010-11 has surpassed expectations. While official confirmation of this will come only when data for the period April-September is released by the Central Statistical Organization (CSO) on 30 November, there is enough evidence, both official (First Quarter GDP growth, Index of Industrial Production, export data, etc.) as also anecdotal, to lend credence to this view.

First-quarter gross domestic product (GDP) estimates released by the CSO show the economy grew at a robust 8.8 per cent during the April-June 2010 period compared to the corresponding period of the previous year. While some of the increase could be attributed to the base effect of a lower growth (6.0 per cent) in the corresponding period of the previous year, it must be noted that sequentially, too, the rate of growth is higher than the figure of 8.6 per cent recorded during the previous quarter, i.e. January-March 2010. It is also well above the 7.4 per cent growth recorded for 2009-10, suggesting that the recovery is now firmly rooted.

However as the chief economic adviser to the finance minister, Kaushik Basu, has warned, growth is likely to slow down during the second quarter, partly on account of the higher base (GDP growth during the second quarter of the last fiscal was 8.6 per cent as against 6.0 per cent in the first quarter).

The strong performance has resulted in various agencies upping their forecasts for the year. The most recent endorsement of the strength of the Indian economy's recovery has come from the IMF, which raised its forecast for the year to 9.7 per cent, up from the 9.4 per cent forecast in its July update.

Table 1.1: Agencies' Forecast for 2010-11

Agency	Latest Projection		Earlier Projection	
	Real GDP Growth (per cent)	Month	Real GDP Growth (per cent)	Month
Economic Advisory Council to the PM	8.5	July	8.2	Feb. 10
Ministry of Finance	8.75	Sept.	8.5	June 10
IMF (calendar year)*	9.7	Oct.	(+/-0.25)	July 10
ADB	8.5	Sep.	9.4	July 10
NCAER	8.1	April	8.2	July 10
OECD	8.3	May	8.4	Oct. 10
RBI	8.3	May	7.3	Nov. 09
	8.5	July	8.0	April 10

* Calendar year at market price

What is particularly heartening is that this growth has come despite renewed uncertainty about global economic recovery. Economic growth in the U.S.A., the world's largest economy with an annual GDP of US\$14,600 billion, slowed to 1.6 per cent in the second quarter, April-June (down from 2.4 per cent in the first estimate) as the economy struggled with high unemployment and the aftermath of the worst recession since the 1930s. This slower rate compares with a newly revised number of 3.7 per cent for Q1, and 5 per cent in Q4 of last year.

In Europe, the picture is more mixed, Germany showing strong recovery while the PIGS (Portugal, Ireland, Greece and Spain) continue to struggle. Germany's GDP rose by a headline-grabbing 2.2 per cent in the second quarter compared with the previous 3 months, taking projected annualized growth to 3 per cent overall in 2010, the fastest pace of expansion since 2006 and one of the best performances since reunification in 1990.

In September 2010, the European Commission expressed cautious optimism over the recovery, saying GDP in the 16-nation euro region is likely to increase by 1.7 per cent this year as against 0.9 per cent projected earlier at the peak of

the sovereign debt crisis in May 2010. However, it expects the growth rate to slow to 0.5 per cent in the third quarter and weaken further to 0.3 per cent in the fourth quarter.

Elsewhere, in Japan, second quarter GDP growth has been revised up to an annualized 1.5 per cent, up from the meagre 0.4 per cent initially reported in August 2010. But it is much too early to say whether this is a break from the past and if Japan will finally emerge from its lost two decades.

Thus, recovery continues to be uneven across countries, both in terms of pace as well as sustainability. Fiscal austerity measures being adopted in many advanced economies could potentially dampen the growth impulses in these economies.

In contrast, emerging market economies (EMEs) are expected to continue their stronger recovery. With the exception of China, India is likely to emerge as the second-fastest growing economy among the G-20 countries. Even here the good news is that the gap between the Indian and Chinese rate of growth has been narrowing over the years.

Table 1.2: The Chindia Story

(GDP growth per cent)

<i>Years*</i>	<i>China</i>	<i>India</i>
2002	9.1	4.0 (02-03)
2003	10.0	8.6 (03-04)
2004	10.1	7.3 (04-05)
2005	10.4	9.5 (05-06)
2006	10.7	9.7 (06-07)
2007	13.0	9.2 (07-08)
2008	9.0	6.7 (08-09)
2009	8.7	7.4 (09-10)

(Source: World Bank Tables and Economic Survey)
Calendar years for China and fiscal years for India

The RBI, in its mid-quarter Review of Monetary Policy in September, has expressed the view that, overall, even as the global environment continues to be a cause for caution, the big picture has not worsened significantly.

The October update of the International Monetary Fund's (IMF) World Economic Outlook has upped the forecast for India from 9.4 per cent in July 2010 to 9.7 per cent (calendar year

2010) though growth is expected to slow down to 8.4 per cent in 2011. 'Leading indicators – the production manufacturing index and measures of business and consumer confidence – continue to point up,' the IMF said in its report released in the first week of October 2010.

The Fund has also revised its estimate of world economic growth in 2010, from 'about 4.5 per cent' in July to 4.8 per cent in its October report, though growth is expected to slow down to 4.2 per cent in 2011. Emerging and developing economies are projected to grow at 7.1 and 6.4 per cent, respectively, in 2010 and 2011, while advanced economies are estimated to grow more slowly at only 2.7 and 2.2 per cent, respectively, implying high unemployment will remain a central issue for some time to come. Recovery in advanced economies is still fragile, says the Fund, and monetary policy, which is already very accommodative, can no longer be used to offset the adverse short run effects of fiscal consolidation.

Table 1.3: Economic Growth and Projections made by the IMF

<i>Zone/ Country</i>	<i>2008</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>
World Output (at market exchange rates)	2.8	-0.6	4.8	4.2
Advanced Economies	0.2	-3.2	2.7	2.2
Emerging and Developing Economies	6.0	2.5	7.1	6.4
U.S.A.	0.0	-2.6	2.6	2.3
Eurozone	0.5	-4.1	1.7	1.5
Germany	1.0	-4.7	3.3	2.0
France	0.1	-2.5	1.6	1.6
Italy	-1.3	-5.0	1.0	1.0
Spain	0.9	-3.7	-0.3	0.7
Japan	-1.2	-5.2	2.8	1.5
U.K.	-0.1	-4.9	1.7	2.0
Canada	0.5	-2.5	3.1	2.7
China	9.6	9.1	10.5	9.6
India	6.4	5.7	9.7	8.4
Asean 5	4.7	1.7	6.6	5.4
Brazil	5.1	-0.2	7.5	4.1
Russia	5.2	-7.9	4.0	4.1

Though anxieties over sovereign debt-related stress in the euro area might have abated, external conditions remain uncertain. The outlook in India, however, points to further

consolidation in growth during the course of the year, driven largely by pick-up in private consumption and investment demand.

The strong recovery in the agricultural growth rate is expected to give a fillip to the overall growth rate. All evidence points to the fact that a good agricultural year invariably lifts the overall GDP growth rate and there is no reason why this year should be any different. Reflecting this optimism, in September the finance minister upped the GDP growth estimate for the year to 8.75 per cent.

By all indications, therefore, the economy is poised to enter a new growth trajectory, far removed from the old Hindu rate of growth. However, whether we will be able to move from this new 'Sardar' rate of growth of 8-9 per cent to that elusive double-digit growth of 10 per cent plus depends on our overcoming a number of challenges.

In the short-term, reining in inflation, managing capital flows, and restoring fiscal health even while ensuring a calibrated exit from the stimulus package, must rank among the most pressing challenges.

In the medium-term, addressing the infrastructure deficit, both physical and social, and moving people from agriculture so that the share of the population dependant on a shrinking share of the pie comes down and improving our tax regime – both direct and indirect – must take priority.

As things stand, it does look as though the rollout of the Goods and Services Tax (GST) may be delayed beyond April 2011. Currently, the problems en route look intractable with the Centre insisting on veto power in the GST Council that will set the tax rate, and the states understandably reluctant to concede to that demand. There are related issues regarding the treatment of octroi and entry tax, apart of course from the entire issue of preparedness for the introduction of GST at the ground level.

However, to the extent that the introduction of VAT (value-added tax) was fraught with just as many problems, yet we did manage to usher in a VAT regime. So it is only a matter of time before we move to a GST. More so since, post-VAT, states also

realize the advantages of having a more efficient tax regime. GST will give us one unified market for goods and services in the country instead of fractured markets with a multitude of taxes as at present.

All this is in the realm of economics. What is not in the realm of economics and, therefore, should not by rights find place in a mid-year review of the economy such as this one are issues of governance – of delivery, of corruption, labour and legal reform. Over the longer term, some of these areas that are as yet untouched must be addressed. For too long have we occupied the bottom rung of league tables on Doing Business (World Bank) and Corruption (Transparency International); indeed, the most recent rankings show we have slipped further down in the corruption ranking.

Today we have a number of things going for us: a stable political environment; a young population; a large domestic market; a competitive manufacturing sector; and a skilled work force that can service the world. We are at the cusp of opportunity. What we make of it remains to be seen. If we overcome the challenges, none of which is insurmountable, there is no reason why India should not occupy her rightful place as an economic power to reckon with in the comity of nations.



Overview of the Indian Economy: Sectoral Trends

Economic recovery gained further momentum in the first quarter of the current fiscal with GDP recording a growth of 8.8 per cent in the period April-June 2010. Thanks to a good monsoon (rainfall is close to 5 per cent above the Long Period Average) agricultural output is expected to be better than last year.

Meanwhile, industrial production after recording double-digit growth since August 2009 has not shown any clear trend. The Index of Industrial Production has yo-yoed. After moderating to 5.8 per cent in June 2010 it recorded double-digit growth in July 2010 compared to July 2009, before dipping to 5.6 per cent in August. This takes cumulative growth for April-August 2010-11 to 10.6 per cent over the corresponding period of the previous year. What is encouraging is that this robust growth comes despite the waning of the favourable base effect of low growth in the previous year.

Lead indicators for services activities suggest a continuation of the momentum. Notwithstanding the ban on outsourcing by government agencies in some states in the U.S. and the hype by the Obama administration, IT majors seem unfazed. Other services, too, are expected to fare well.

Table 2.1 CSO GDP Growth: Growth Rates of Real GDP

Sector	2008-09				2009-10				2009-11				(per cent)				
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
1 Agriculture and Allied Activities	1.6	0.2	3.2	2	2	2	-1	3.3	1.9	0.9	0.9	0.7	2.8				
	(15.7)	(14.6)															
2 Industry	3.1	10.4	5.2	5	1.7	0.8	4.6	4.6	4.6	9	12	15	11.4				
	(20)	(20.5)															
2.1 Mining and Quarrying	1.6	10.6	2.6	1.6	2.7	-0	8.2	10	9.6	14	8.9						
2.2 Manufacturing	3.2	10.8	5.9	5.5	1.3	0.6	3.8	9.1	14	16	12.4						
2.3 Electricity, Gas and Water Supply	3.9	6.5	3.3	4.3	4	4.1	6.6	7.7	4.7	7.1	6.6						
3 Services	9.3	8.3	9.8	9	10	8	7.5	10	7.3	8.5	9.4						
	(64.4)	(64.9)															
3.1 Trade, Hotels, Restaurants, Transport, Storage and Communication	7.6	9.3	11	10	4.4	5.7	5.5	8.5	10	12	12.2						
3.2 Financing, Insurance, Real Estate and Business Services	10.1	9.7	9.1	8.5	10	12	12	12	12	12	7.9	7.9	8				
3.3 Community, Social and Personal Services	13.9	5.6	8.7	10	29	8.8	7.6	14	0.8	1.6	6.7						
3.4 Construction	5.9	6.5	9.8	7.2	1.1	5.7	4.6	4.7	8.1	8.7	7.5						
Real GDP at Factor Cost	6.7	7.4	7.8	8	6.1	5.8	6	8.6	6.5	8.6	8.8						

*Quick Estimates

#: Revised Estimates. Figures in parentheses indicate shares in real GDP

Memo:	(Amount in Rupees Crores)	
Real GDP at Factor Cost (2004-05)@	4154973	4464081
GDP at Current Market Prices	5574449	6231171

@: At 2004-05 Prices.

Hence, if present trends continue, GDP growth in 2010-11 can be expected to be between 8.5 per cent to 9.0 per cent.

Farm Sector

In a happy contrast to the previous year, when India had the weakest South-West monsoon since 1972 with a shortfall in precipitation of close to 25 per cent from the Long Period Average (LPA), the rain gods have been kind to us this year. Rainfall during the South-West monsoon season of 2010 (June to September) is likely to be 102 per cent of the LPA (with a model error of ± 4.0 per cent) according to the revised forecasts, dated 25 June 2010, by the Indian Meteorological Department.

According to the Indian Meteorological Department, cumulative rainfall during the South-West monsoon 2010 (1 June to 15 September 2010) was 2 per cent above the LPA (21 per cent below LPA last year). Of the 36 meteorological subdivisions, cumulative rainfall was excess/normal in 26 subdivisions (21 sub-divisions last year).

The spatial and temporal distribution of rainfall is no less important than overall precipitation. Here, the good news is that North-West India, which accounts for a disproportionate share, both of total food grain production and of marketable surplus, received abundant rainfall.

Over the four broad geographical regions in the country, rainfall for the 2010 South West monsoon season is expected to be 102 per cent of LPA over North West India, 103 per cent over North East India, and 102 per cent over South Peninsular India. Clearly, we could not have asked for more, at least as far as the monsoon is concerned.

Plentiful rains come with two other bonuses: plentiful supply of water for the dry months and reduced anxieties about hydropower. As on 22 July 2010, the total live water

storage in 81 major reservoirs of the country was 19 per cent of the Full Reservoir Level, but by late August had gone up to 60 per cent. With hydropower contributing almost 25 per cent of our generation capacity, full reservoirs are, therefore, good news for more reasons than one.

Table 2.2: Region-wise Long Period Average (LPA) and Coefficient of Variation of Rainfall

<i>Region</i>	<i>LPA (MM)</i>	<i>Coefficient of Variation per cent</i>
Season (June to September) Rainfall		
All India	890	10
North West India	612	19
Central India	994	14
North East India	1429	8
South Peninsula	725	15
Monthly Rainfall		
All India (July)	293	13
All India (August)	262	14

(based on 1941-1990 data)

Table 2.3: Agriculture Food Stocks

<i>Agriculture Food Stocks</i>	<i>2009 (March end)</i>	<i>2009 August</i>	<i>2010 March</i>	<i>August 2010</i>
Rice (Million Tonnes)	21.6	17.2	27.0	20.5
Wheat (Million Tonnes)	13.4	30.1	18.4	29.9

Source: Food Grains Bulletin, Ministry of Consumer Affairs, Government of India

Agricultural output during the quarter ended June 2010 grew by 2.8 per cent, up from 0.7 per cent for the comparable quarter of the previous year due to better *rabi* production. *Kharif* output, too, is expected to be good so that overall we should have one of the best agricultural years ever. This year's abundant rains are likely to lead to high soil moisture that will benefit the winter wheat crop. Wheat stocks are now close to 31 million tonnes, almost 8 times the target of 4 million tonnes.

Available data show the area sown during *kharif* 2010 (as on July 22) is higher than in the corresponding period of the previous year for all crop categories. The Fourth Advance Estimates for agricultural production in 2009-10 placed food

Table 2.4: Fourth Advance Estimates of Production of Food Grains for 2009-10

Crop	Season	2008-09			2009-10			
		2005-06	2006-07	2007-08	4th Advance Estimates	Final Estimates	Targets	4th Advance Estimates
Rice	Kharif	78.27	80.17	82.66	84.58	84.91	86.00	75.91
	Rabi	13.52	13.18	14.03	14.57	14.27	14.50	13.22
	Total	91.79	93.35	96.69	99.15	99.18	100.50	89.13
Wheat	Rabi	69.35	75.81	78.57	80.58	80.68	79.00	80.71
	Kharif	4.07	3.71	4.11	3.10	3.05	4.10	2.82
Jowar	Rabi	3.56	3.44	3.82	4.21	4.19	3.90	4.16
	Total	7.63	7.15	7.93	7.31	7.24	8.00	6.98
	Kharif	7.68	8.42	9.97	8.83	8.89	10.00	6.50
Bajra	Kharif	12.16	11.56	15.11	13.90	14.12	15.50	12.00
	Rabi	2.55	3.54	3.85	5.39	5.61	5.00	4.68
	Total	14.71	15.10	18.96	19.29	19.73	20.50	16.68
Ragi	Kharif	2.35	1.44	2.15	2.06	2.04	2.50	1.96
Small Millets	Kharif	0.47	0.48	0.55	0.45	0.44	0.55	0.35
	Rabi	1.22	1.33	1.20	1.54	1.69	1.55	1.30
Coarse Cereals	Kharif	26.73	25.61	31.89	28.34	28.54	32.65	23.63
	Rabi	7.33	8.31	8.87	11.14	11.49	10.45	10.14
	Total	34.06	33.92	40.76	39.48	40.03	43.10	33.77

Crop	Season	2007-08			2008-09		2009-10	
		2005-06	2006-07	2007-08	4th Advance Estimates	Final Estimates	Targets	4th Advance Estimates
Cereals	Kharif	105.00	105.78	114.55	112.92	113.45	118.65	99.54
	Rabi	90.20	97.30	101.47	106.29	106.45	103.95	104.07
	Total	195.20	203.08	216.02	219.21	219.90	222.60	203.61
Tur	Kharif	2.74	2.31	3.08	2.31	2.27	3.14	2.55
	Rabi	5.60	6.33	5.75	7.05	7.06	6.50	7.35
	Total	8.34	8.64	8.83	9.36	9.33	9.64	9.90
Gram	Kharif	0.90	0.94	1.12	0.83	0.84	-	0.85
	Rabi	0.35	0.50	0.34	0.28	0.33	-	0.40
	Total	1.25	1.44	1.46	1.11	1.17	-	1.25
Moong	Kharif	0.69	0.84	1.25	0.77	0.78	-	0.44
	Rabi	0.26	0.28	0.27	0.24	0.26	-	0.29
	Total	0.95	1.12	1.52	1.01	1.04	-	0.73
Other Pulses	Kharif	0.54	0.71	0.95	0.87	0.80	3.36	0.46
	Rabi	2.31	2.29	2.00	2.31	2.23	3.50	2.25
	Total	2.85	3.00	2.95	3.18	3.03	6.86	2.71
Total Pulses	Kharif	4.87	4.80	6.40	4.78	4.69	6.50	4.30
	Rabi	8.52	9.40	8.36	9.88	9.88	10.00	10.29
	Total	13.39	14.20	14.76	14.66	14.57	16.50	14.59
Total Food grain	Kharif	109.87	110.57	120.95	117.70	118.14	125.15	103.84
	Rabi	98.73	106.71	109.83	116.18	116.33	113.95	114.36
	Total	208.60	217.28	230.78	233.88	234.47	239.10	218.20

Table 2.5: Fourth Advance Estimates of Production of Oilseeds and Other Commercial Crops, 2009-10

Crop	Season	2008-09				2009-10			
		2005-06	2006-07	2007-08	4th Advance Estimates	Final Estimates	Targets	4th Advance Estimates	
Groundnut	Kharif	62.98	32.94	73.62	56.37	56.17	72.21	36.59	
	Rabi	16.95	15.69	18.20	17.01	15.51	24.59	18.51	
	Total	79.93	48.64	91.82	73.38	71.68	96.80	55.10	
Castorseed	Kharif	9.91	7.62	10.53	11.15	11.71	11.39	9.85	
	Kharif	6.41	6.18	7.57	7.33	6.40	7.50	6.57	
Nigerseed	Kharif	1.08	1.21	1.10	1.15	1.17	1.65	1.01	
	Rabi	81.31	74.38	58.34	73.68	72.01	82.54	64.13	
Rapeseed and Mustard	Rabi	1.73	1.68	1.63	1.55	1.69	2.76	1.46	
	Rabi	2.29	2.40	2.25	1.80	1.89	2.79	1.71	
Safflower	Kharif	4.56	3.66	4.63	3.81	3.57	4.92	2.16	
	Rabi	9.83	8.62	10.00	8.71	8.01	9.33	6.84	
Soybean	Total	14.39	12.28	14.63	12.52	11.58	14.25	9.00	
	Kharif	82.74	88.51	109.68	99.01	99.05	96.32	100.46	
	Kharif	167.68	140.12	207.13	178.82	178.08	194.00	156.63	
Total Nine Oil Seeds	Rabi	112.11	102.77	90.42	102.75	99.11	122.00	92.65	
	Total	279.79	242.89	297.55	281.57	277.19	316.00	249.28	
	Total	184.99	226.32	258.84	231.56	222.76	260.00	239.35	
Cotton #	Total	99.70	103.17	102.21	96.34	96.34	102.00	107.00	
	Total	8.70	9.56	9.90	7.73	7.31	10.00	5.91	
Mesta #	Total	108.40	112.73	112.11	104.07	103.65	112.00	112.91	
	Total	2811.72	3555.20	3481.88	2739.31	2850.29	3400.00	2777.50	

Lakh bales of 170 kgs. each

Lakh bales of 180 kgs. each

grains output at 218.2 million tonnes, a decline of 6.9 per cent over the preceding year. However, indications are food grains output in the current year will surpass the previous year.

This, together with the higher output of sugarcane and cotton and the good performance in horticulture, animal husbandry and fisheries, will enable the farm sector to turn in a healthier performance this year as compared to the 2 previous years when growth was a dismal 1.6 per cent (2008-09) and 0.2 per cent (2009-10).

In the case of commercial crops too, the outlook is satisfactory. While the output of cotton and jute is higher than in the previous year, the output of oilseeds may fall short of the previous year's figure.

In its July Outlook, the Prime Minister's Economic Advisory Council projected a farm GDP growth rate of around 4.5 per cent for the current fiscal year. More recently, the Planning Commission's Deputy Chairman,

Table 2.6: First Advance Estimates for 2010-11

<i>Crop</i>	<i>F2010 (4th Advance Estimates)</i>	<i>F2011 (1st Advance Estimates)</i>	<i>YoY per cent</i>
Rice	75.9	80.4	6 per cent
Jowar	2.8	3.2	14 per cent
Maize	12.0	14.1	17 per cent
Coarse cereals	23.6	28.2	20 per cent
Cereals	99.5	108.6	9 per cent
Tur	2.6	3.3	28 per cent
Urad	0.9	1.1	27 per cent
Moong	0.4	0.9	100 per cent
Total pulses	4.3	6	40 per cent
Sub Total:	103.8	114.6	10 per cent
Food Grains			
Groundnut	3.7	5.6	54 per cent
Castorseed	1.0	1	-4.0 per cent
Sesamum	0.7	0.6	-6.1 per cent
Soybean	10.1	9.8	-2.4 per cent
Sub Total: nine oilseeds	15.7	17.3	1030 per cent
Sugarcane	277.8	324.9	1700 per cent
Cotton	23.9	33.5	3990 per cent
Jute and Mesta	11.3	10.3	-8.9 per cent

Montek Singh Ahluwalia said agricultural output growth in the current financial year could be around 5-6 per cent, up from the earlier estimate of 4.8 per cent. Given the low base (0.2 per cent) and the good monsoon this year that seems a reasonable estimate.

The first advance estimates for the current year bear up to the hopes expressed earlier. With the exception of castorseed, sesame and soybean, output of all other crops is higher than the fourth advance estimates for 2009-10.

The Indian agricultural production basket comprises of: (a) food grains (wheat, rice, coarse cereals and pulses) and commercial or cash crops (cotton, sugarcane, oilseeds and other crops); and (b) high-value commodities such as fruits and vegetables, livestock (milk, meat, poultry and eggs) and marine products.

As compared with food grains, commercial crops – particularly cotton and sugarcane (more than 355 million tons of sugarcane as per the final estimates for 2006-07) – have performed well over time. For cotton, in particular, the technology breakthrough with Bt has worked wonders. In 2007-08, cotton exports reached an unprecedented level of 8.3 million bales.

Although the share of food grains in value of output of total agriculture is 24.9 per cent it comprises of nearly 64 per cent of the gross cropped area. This is in contrast to fruit and vegetables that comprise less than 6 per cent of the gross cropped area but constitute 16 per cent of the total agricultural output. The biggest success story in the farm sector is dairying, where India is now the highest producer of milk in the world (more than 100 million tonnes) despite the dependence on small producers and manual methods of milking. With the amendment of Milk and Milk Products Order (MMPO) in March 2002, private sector participation has increased in a significant way.

India is also a leading producer of fruit and vegetables, next only to China and Brazil. Despite the large volumes of horticulture production, we contribute very little to the global export market, primarily because we do not have the

infrastructure – essentially roads, cold storage vans – in place to get our produce (which is highly perishable) to the market. Estimates suggest close to 40 per cent of our output of fruits and vegetables is lost in the process. This is something we need to address, and speedily, since one way of augmenting fragile farm incomes is to supplement such income with production of fruits and vegetables that are, typically, higher earners for the farmer than cereals.

Industry and Services

After maintaining double-digit growth since August 2009 (though September 2009 was an exception) industrial production has fluctuated this fiscal. The scorching double-digit pace set by the Index of Industrial Production (IIP) in April 2010 (15.2 per cent) continued in May 2010 but fell rather sharply to 5.8 per cent in June 2010. It recovered to a healthy 15.2 per cent (revised upward from the earlier estimate of 13.8 per cent) in July 2010 only to go down again to a 15-month low of 5.6 per cent in August 2010 compared to the same month last year. Consequently, cumulative growth for the year to date is down from 11.4 per cent for the period April-July to 10.6 per cent for the period April-August 2010-11 compared to the corresponding period of the previous year.

However, recovery continues to be broad-based with 14 of the 17 industry groups (as per 2-digit NIC-1987) showing positive growth during August 2010 compared to the corresponding month of the previous year. With the exception of electricity, the other major groups – mining and manufacturing – turned in a strong performance, recording a growth of 7.0 per cent and 5.9 per cent, respectively, compared to August 2009.

The same revival trend is reflected in the cumulative performance during the April-August 2010 period. Cumulative industrial growth at 10.6 per cent is a vast improvement over the growth of 5.9 per cent recorded during April-August 2009. While manufacturing growth during this period is twice the

Table 2.7: Index of Industrial Production

Month	Mining (104.73)			Manufacturing (793.58)			Electricity (101.69)			General (1000)		
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
April	176.9	198.1		286.1	333		232.9	248.9		269.3	310.3	
May	183.4	201.6		298.5	334.8		237	252.2		280.3	312.5	
June	181.4	196.8		313.5	331.6		234.4	242.6		291.6	308.4	
July	175.5	192.8		313.1	365.4		235.4	244.1		290.8	335	
Aug.	178.1	190.6		314	332.6		245.1	247.6		292.8	309.1	
Sep.	174.9			327.2			235.8			302		
Oct.	191.1			309			240.4			289.7		
Nov.	194.2			323.9			220.4			299.8		
Dec.	209			363.5			235.2			334.3		
Jan.	216.9			357.9			240.6			331.2		
Feb.	203.3			344.1			228.3			317.6		
March	235.6			377			261.4			350.4		
Average												
Apr. -Dec.	179.1	196.0		305.0	339.5		237.0	247.1		285.0	315.1	
Growth over the corresponding period of previous year												
Aug.	11.0	7.0		10.6	5.9		10.6	1.0		10.6	5.6	
Apr. -Aug.	8.0	9.4		5.6	11.3		6.5	4.3		5.9	10.6	

* Indices for August 2010 are Quick Estimates.

Note: Indices for the months of May 2010 and July 2010 incorporate updated production data.

growth recorded during April-August 2009, growth in mining is also above that recorded in the comparable period last year. However, the increase in electricity generation at 4.3 per cent trails the growth recorded during the same period last year.

This healthy growth comes despite waning of the favourable base effect of low growth in the previous year. It also sets at rest fears that the withdrawal (albeit slow) of some of the stimulus measures will impede the recovery process.

The use-based classification also reflects the inconsistency seen in the IIP, capital goods recording a surprising minus 2.6 per cent growth in August after showing an incredible 72 per cent growth in July 2010, compared to the previous year. Consumer durables, however, continued to do well, growing 26.5 per cent in August 2010 vis-à-vis August 2009.

Despite the apparent recovery the August 2010 IIP numbers are disquieting. For one, they cast doubt on the sustainability of the recovery. More importantly, they make the IIP numbers look suspect. The apparent see-sawing of industrial production would seem to suggest industrial recovery is not on an even keel as yet. But is that the reality? There is no way of knowing. Frequent and fairly large corrections – the July number was revised upward from 13.8 per cent to 15.2 per cent, the April number was revised downward from 17.6 per cent to 15.2 per cent – as well as seemingly hard-to-comprehend fluctuations (growth in capital goods output is minus 2.6 per cent in August, down from an incredible 72 per cent in July 2010) make the data quality suspect. Even if the variation is on account of one or two suspect numbers, they take away from the robustness of the data. The Reserve Bank of India pointed this out as well earlier.

Any policy can only be as good as the data on which it is based as, for example, no physician can medicate if the thermometer used to measure the patient's temperature is faulty. Similarly, no central bank or government can frame appropriate policies if there is no way of knowing whether growth is faltering or surging. It would not be fair to blame our statisticians for this. They have no means of ensuring prompt and accurate submission of data as the rules under

Table 2.8: Trends in Industrial Output

	Sectoral Classification				Use-based Classification					
	General	Manufac- turing	Electri- city	Mining	Basic goods	Capital goods	Interme- diate goods	Total	Consumer Goods Durables	Non- durables
2007-08										
Q1	10.3	11.1	8.3	2.7	9.4	19.1	9.3	9	-0.7	12.4
Q2	8.7	8.9	7.1	7.4	9.3	21.3	10.5	2.2	-5.5	5.1
Q3	8.3	8.9	4.6	5.5	5	20.8	8.9	6.2	2.1	7.6
Q4	6.7	7.3	5.5	5.2	4.7	12.2	7.1	6.8	0.1	8.9
2008-09										
Q1	5.3	5.8	2	4	3.1	7.9	2.6	8.6	3.5	10.1
Q2	4.7	4.9	3.2	3.8	4.7	13.2	-1.7	6.6	10.8	5.1
Q3	0.8	0.5	2.9	2	2.4	3.8	-5.8	3.3	-1.8	4.9
Q4	0.8	0.3	3	0.9	0.4	5	-3.2	1.2	5.6	-0.1
2009-10										
Q1	3.8	3.4	6	6.8	6.3	2	7.4	-0.5	15.6	-5.3
Q2	9	9.2	7.4	9	5.9	8.6	11.7	10.1	23.7	5.1
Q3	13.4	14.6	3.8	10.3	6.1	21.6	19.3	12.5	33.7	6
Q4	15.1	16	6.7	12.7	10.1	41.1	17.1	7.5	31.5	0.2
2010-11										
Q1	11.6	12.2	5.4	10.4	6.9	34	9.8	9.2	27.9	2.4
2007-08	8.5	9	6.4	5.2	7	18	8.9	6.1	-1.0	8.5
2008-09	2.8	2.8	2.8	2.6	2.6	7.3	-2.1	4.7	4.5	4.8
2009-10	10.1	10.5	5.8	9.7	7.3	20	13.5	7.3	25.1	1.6
2010-11	9.8	10.1	7.5	8	5.7	28	6.3	8.5	16.5	5.3

Source: EAC Outlook 2010-11

the Collection of Statistics Act have not been notified to date. Agreed, the IIP is only one among many tools that policy makers use, but it is a vital tool.

Mirroring the fall in industrial production in August 2010 the Index of 6 core industries, having a combined weight of 26.7 per cent in the Index of Industrial Production (IIP), also grew by a much slower 3.7 per cent in August compared to 6.4 per cent in August 2009. The cumulative growth during April-August was 4.1 per cent (provisional) as against 4.8 per cent during the corresponding period of the previous year.

Overall, the pace of infrastructure growth has lagged behind the pace of industrial growth, raising fears that this will further widen the infrastructure gap.

Table 2.9: Performance of Six Core Industries, September 2010

Sector	Sector-wise Growth Rate (per cent) in Production				
	Sept. 09	Aug. 10	Sept. 10	Apr.- Sept. 09	Apr.- Sept. 10
Crude Oil	-0.5	15.2	12.5	-1.2	10.2
Petroleum Refinery Products	3.4	-2.3	-10.2	-3.6	2.6
Coal	6.5	1.0	-2.0	11.6	0.4
Electricity	7.4	1.4	1.3	6.4	4.0
Cement	6.5	1.6	5.2	12.3	4.7
Finished Steel	0.8	7.7	5.8	1.7	3.9
Overall	4.3	3.9	2.5	4.5	4.0

(Weight in IIP: 26.68 per cent)

Crude Oil

Crude Oil production (weight 4.17 per cent in the IIP) continued to record strong growth (12.5 per cent) in September 2010, up sharply from (-) 0.5 per cent in the same month last year and 15.2 per cent (provisional) in August 2010, taking cumulative growth during April-September 2010-11 to 10.2 per cent as against (-) 1.2 per cent during the same period of 2009-10.

Petroleum Refinery Products

Petroleum refinery production (weight 2.00 per cent in the IIP) fell (-) 10.2 per cent as against a growth of 3.4 per cent last

year, taking growth in the April-September 2010-11 period to 2.6 per cent (provisional) compared to (-) 3.6 per cent during the comparable period of 2009-10.

Coal

Coal production (weight 3.2 per cent in the IIP) registered a growth of (-) 2.0 per cent (provisional) in September 2010 compared to a growth rate of 6.5 per cent in September 2009, taking cumulative growth in coal production to an unsatisfactory 0.4 per cent (provisional) during April-September 2010-11, compared to 11.6 per cent during the same period last year.

Electricity

Electricity generation (weight 10.17 per cent in the IIP) registered a growth of 1.3 per cent (provisional) in September 2010, sharply lower than the 7.4 per cent recorded in September 2009, taking growth in the April-August period to 4.0 per cent (provisional), compared to 6.4 per cent during the same period of 2009-10.

Cement

Cement production (weight 1.99 per cent in the IIP) registered a growth of 5.2 per cent (provisional) in September 2010 compared to 6.5 per cent in September 2009, taking growth during April-September 2010-11 to 4.7 per cent provisional, compared to 12.3 per cent during the same period of 2009-10.

Finished (Carbon) Steel

Finished (Carbon) Steel production (weight 5.13 per cent in the IIP) registered a growth of 5.8 per cent (provisional) in September 2010 compared to 0.8 per cent (estimated) in September 2009, i.e. a 3.9 per cent (provisional) growth during April-September 2010-11 compared to 1.7 per cent during the same period of 2009-10.

Overall, the PM's EAC expects industrial GDP to expand by 9.7 per cent in 2010-11, though the fall in core sector growth in September 2010 makes that assessment appear slightly elevated.

Services

Growth in the services sector accelerated to 9.7 per cent in the quarter ended June 2010, compared with 8.4 per cent in the previous quarter and 7.5 per cent during the comparable quarter last fiscal. Within services, growth in the segments of trade, hotels, transport and communications decelerated slightly to 12.2 per cent compared to 12.4 per cent earlier. Growth in financing, insurance, real estate and business services picked up marginally to 8 per cent in the first quarter of 2010 compared to 7.9 per cent in the previous quarter. Growth in the segments of community, social and personal services accelerated to 6.7 per cent compared to 1.6 per cent in the quarter ended March 2010.

Some deceleration in services growth might be expected as the effect of the Sixth Pay Commission peters out, though this may be mitigated to the extent that state governments could be compelled to follow through with handouts to their employees.

Table 2.10: Table of Services

	2010-11 Apr.- June	2009-10 Jan.- Mar.	2009-10 Oct.- Dec.	2009-10 Jul.-Sep.	2009-10 Apr.- June
Services	9.4	8.5	7.3	10	7.5
Construction	7.5	8.7	8.1	4.7	4.6
Trade, Hotels, Transport and Communication	12.2	12.4	10.2	8.5	5.5
Financing, Insurance, Real Estate and Business Services	8	7.9	7.9	11.5	11.8
Community, Social and Personal Services	6.7	1.6	0.8	14	7.6

On the services front, community, social and personal services have shown a slightly slower growth in the first quarter as the effect of the Sixth Pay Commission has worn out. But the continued boom in the real estate sector (particularly residential real estate) is likely to see the construction sector continue to do well. If global recovery does not falter too much, the category of 'trade, hotels, transport and communication' is also likely to do well; though, here, too, some of the growth in the first quarter that was possibly driven by the Commonwealth Games might peter out.

Overall, the service is sector expected to expand by about 9.5 per cent in 2010-11.

External Sector

The global economy witnessed a robust recovery in the first quarter of 2010 before encountering heightened downside risks stemming from concerns relating to sovereign debt sustainability in several European countries. Fortunately, the sovereign debt crisis did not snowball into another crisis of confidence.

The staccato nature of the recovery has, however, resulted in much greater uncertainty, both about the pace as well as the strength of the recovery. So, while improving, demand conditions helped in the recovery of world trade, which grew by about 25 per cent in value terms on a year-on-year basis during the first quarter of 2010, it is still too early to say whether this trend will continue.

According to the IMF, exports of emerging and developing economies have witnessed higher growth than those of advanced economies in recent months. Despite high growth, the global export performance is yet to reach its pre-crisis level. In fact, world exports declined 3.0 per cent, on a quarter-on-quarter basis, during the first quarter of 2010. For the year as a whole, the IMF expects world trade (in goods and services) to grow by 9 per cent as against the 11.3 per cent decline in 2009.

The importance of trade and investment in firmly anchoring economic recovery is widely acknowledged. However, several

countries, notably the U.S., have failed to practise what they preach and have imposed new trade restrictions. According to the WTO, new import-restricting measures introduced during November 2009-May 2010 (along with new initiations of investigations into the imposition of trade remedy measures) cover close to 0.4 per cent of annual world imports compared with 1.0 per cent during October 2008-October 2009. There has also been an increase in export restrictions world wide in the form of introduction of new export duties, prohibitions and export quotas.

Economic conditions around the world, in particular the persistence of high levels of unemployment and mounting pressure on government finances, are likely to feed protectionist pressures further.

High levels of fiscal stress in advanced economies are also a potential risk to global recovery. Policy authorities are faced with a tough choice. If fiscal austerity is implemented to restore market normalcy, it could impede recovery. On the other hand, if the fiscal stress is allowed to continue to avoid weakening of recovery, markets could react adversely leading to further volatility.

India's exports, which contracted sharply in the wake of the crisis, have exhibited positive growth since October 2009. Imports, which were hit by the crisis, have recovered more rapidly with high positive growth since November 2009. Exports registered a growth of 22.5 per cent in August 2010, taking the April-August 2010-11 number to \$85.27 billion (growth of 28.6 per cent). Meanwhile, August imports at \$29.7 billion, up 32.6 per cent, took imports for the April-August period to \$141.89 billion (growth of 33.2 per cent) and saw the trade deficit widen to \$56.62 billion. The trend continued in September, with exports growing 23.2 per cent, while imports rose at a more moderate pace of 26.1 per cent.

Higher growth prospects, lower public debt and the continuance of loose monetary policies aimed at keeping interest rates low in many countries, especially in the U.S., could result in EMEs attracting much larger capital inflow in

search of yields in the coming months. This is likely to exert pressure on their exchange rates and asset prices.

India is no exception to this. Its improving growth prospects, combined with persistently high levels of global liquidity, have already seen overseas portfolio flows touch a record \$20 billion by the first week of October 2010, causing the rupee to appreciate more than 5 per cent since September. The RBI has largely desisted from intervening in this latest round of currency appreciation; but if the rupee continues to appreciate it may have no choice but to intervene – an unhappy choice given that any intervention would mean an increase in domestic liquidity at a time when inflation is already high.

Foreign exchange reserves, after falling in the first few months of the current fiscal, have risen to \$294 billion (up to 1 October 2010), following the sharp increase of overseas portfolio flows in September 2010.

Current Account

After the 1991 BoP crisis, policy makers have kept a wary eye on the current account deficit. This vigil has served the country well, ensuring that India escaped the worst of both the Asian crisis and the recent financial crisis. However, the asymmetry in the speed of the recovery in India vis-à-vis the rest of the developed world is likely to see imports grow faster than exports. As a result, the current account deficit is also likely to widen.

Beginning 2009-10, the current account deficit has begun to widen. In March 2010, current account deficits touched 2.9 per cent of GDP, even though oil prices were in the range of \$70-75 during the year. The relatively faster growth in imports, vis-à-vis exports, saw the current account more than treble to \$13.7 billion during the quarter ended June 2010, compared to the same period last year.

The trade deficit stood at \$34.2 billion at the end of June 2010, compared to \$25.6 billion in June 2009. However, recent numbers show that some of the concern on the trade front may be overdone. The trade deficit for September at \$9.12 billion, the

lowest since April 2010, is sharply lower than in the previous months of the current fiscal.

Though export growth continues to lag the growth in imports, as is inevitable in a fast-growing economy, shows that the gap has narrowed. Exports grew 23.2 per cent, while imports rose 26.1 per cent in September, setting at rest fears that a rising rupee would hit export growth and, in turn, employment. It would be hasty, of course, to conclude from this that the exchange rate has no impact on exports (the Chinese success story has been built almost entirely on an undervalued currency). But what it does suggest is that improving productivity has made the exchange rate less important than before. This is reassuring for two reasons. One, there will be less pressure on the Reserve Bank of India (RBI) to intervene in the forex market to arrest rupee appreciation (with all its attendant consequences on liquidity). Two, it will rein in the current account deficit (the trade deficit plus the balance on trade in services) presently hovering at close to 4 per cent on an annualized basis, well above what is regarded as the safe upper band of about 3 per cent of GDP.

There is just one flaw to this happy story. And this is: if capital inflows continue apace these could become a serious issue. To the extent that such flows were going to finance a

Table 2.11: Trade Performance

	<i>Exports (\$ billion)</i>			<i>Imports (\$ billion)</i>		
	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>
April	18.46	12.4	16.9	30.3	19.1	27.3
May	18.69	12	16.1	29.4	19.8	27.4
June	19.19	13.5	17.75	29	22.6	28.3
July	19.03	14.2	16.24	31.6	21.1	29.17
August	17.76	13.5	16.64	33.5	21.5	29.67
September	17.89	14.5	18.02	31.1	20.5	27.14
October	14.13	14.6		25.9	25.2	
November	11.16	14.5		23.5	24.1	
December	13.37	16.1		19.5	27.4	
January	12.9	15.3		18.2	24.6	
February	11.94	16.1		15.1	25.1	
March	12.9	19.9		16.6	19.9	
Total	187.42	176.6		185.3	270.9	

growing current account deficit there was reason to believe the absorptive capacity of the economy had increased. However, if the pace of capital inflows continues unabated and the current account deficit shrinks we could find ourselves in a situation like 2008 when the surplus on the capital account was grossly in excess of the deficit on the current account, resulting in further appreciation of the rupee to a point where it could hit exports. All of which only means it is too early to relax our guard; we can at best breathe easy for now.

A current account deficit of 3-4 per cent should normally not be a cause for concern. However, it does mean that we will require higher net inflows of foreign capital to finance the deficit. In a global market, where the risk appetite of investors may take some time to recover and capital flows could remain volatile for a while, any increased dependence on capital flows is bound to make the economy more vulnerable.

Most of the capital account surplus of \$17.5 billion at the end of the second quarter was accounted for by short-term credit, external commercial borrowings and banking capital.

Table 2.12: External Sector Indicators

	2006-07	2007-08	2008-09	2009-10
BoP (US\$ billion)				
Exports	128.9	166.2	189	182.2
Imports	190.7	257.6	307.7	299.5
Trade Balance	(-) 61.8	(-) 91.5	(-) 118.7	(-) 117.3
Invisibles Balance	52.2	75.7	89.9	78.9
Current Account Balance	(-) 9.6	(-) 15.7	(-) 28.7	(-) 38.4
Capital Account Balance	45.2	106.6	7.2	53.6
Overall Balance	36.6	92.2	(-) 20.1	13.4
Current Account Balance/GDP	(-) 1.0	(-) 1.3	(-) 2.4	(-) 2.9
Net Capital Flows /GDP	4.8	8.7	0.6	4.1
Debt Indicators				
Total Long-Term Debt	178.7	181.2	174.5	200.4
Short-Term Debt	45.7	43.4	50.6	42.4
External debt / GDP Ratio (per cent)	19	21.5	20.5	18.9
Debt Service Ratio (per cent)	4.7	4.4	3.7	5.2

Source: RBI

The higher capital account surplus, relative to the current account deficit, resulted in a net accretion to our forex reserves, taking total forex reserves to \$296 billion by late October 2010.

The globalization of capital markets and the steady rise in capital inflows makes it easier to fund a current account deficit than in the past. However, when most of the capital is of a short-term nature, i.e. FII (Foreign Institutional Investment) rather than FDI (Foreign Direct Investment), such flows are not an unmitigated blessing.

The United Nations Conference on Trade and Development's (UNCTAD) publication, *World Investment Prospects Survey 2010-2012*, projects India as the second-most popular destination for FDI globally over the next 2 years.

To the extent FDI is more sticky than portfolio investment and also brings with it positive externalities, such as greater employment and transfer of technology, it should fetch us rich dividends in terms of a higher rate of growth. In fact, many observers argue that much of the double-digit growth achieved by China post-reform is on account of the fact that our eastern neighbour liberalized FDI ahead of portfolio investment.



3

Challenges

By all indications, the economy is poised to enter a new growth trajectory, far removed from the old Hindu rate of growth. However, whether we will be able to move from this new 'Sardar' rate of growth of 8-9 per cent to that elusive double-digit growth of 10 per cent plus depends on our overcoming a number of challenges.

In the short-term, reining in inflation, managing capital flows, and restoring fiscal health even while ensuring a calibrated exit from the stimulus package, must rank among the most pressing challenges.

In the medium-term, addressing the infrastructure deficit, both physical and social, and moving people from agriculture so that the share of the population dependant on a shrinking share of the pie comes down, and improving our tax regime – both direct and indirect – must take priority.

As matters stand, it does look as though the rollout of the Goods and Services Tax (GST) may be delayed beyond April 2011. Today, the problems en route look intractable with the Centre insisting on veto power in the GST Council that will set the tax rate, with the states, understandably, reluctant to concede to that demand. There are related issues regarding the treatment of octroi and entry tax apart, of course, from the entire issue of preparedness for the introduction of GST at the ground level.

However, to the extent that the introduction of VAT was fraught with just as many problems, despite which we did manage to usher in a VAT regime, so too it is only a matter of time before we move to a GST. More so since, post-VAT, the states have also realized the advantages of having a more

efficient tax regime. GST will give us one unified market for goods and services in the country, instead of fractured markets with a multitude of taxes as at present. On the direct tax front, the new Direct Tax Code is in the works and should be in place before long.

All this is in the realm of economics. What is not in the realm of economics and, therefore, should not by rights find a place in a mid-year review of the economy such as this are issues of governance – of delivery, of corruption, labour and legal reform. Over the longer term, some of these areas that are as yet untouched must be addressed. For too long have we occupied the bottom rung of league tables on Doing Business (World Bank) and Corruption (Transparency International).

In what follows, some of the more crucial challenges have been discussed in detail.



Tackling Inflation

Inflation, as measured by the WPI for primary articles and fuel and power (base 2004-05) showed a welcome decline to 16.62 per cent during the week ended 16 October 2010, down from 18.05 per cent during the previous week. Food inflation also declined to 13.75 per cent, down from 15.53 per cent, due largely to a fall in the prices of vegetables. This is the second consecutive week when food inflation has declined.

Inflation in the fuel and power category was almost unchanged: 11.25 per cent for the week ended 16 October, compared to 11.4 per cent for the previous week.

In its mid-quarter Review on 16 September, the RBI expressed the view that the rate of inflation has reached a plateau, but is likely to remain at an unacceptably high level for some months. So far the Bank has maintained its position that inflation will ease to 6 per cent by March 2011.

According to the Bank, about two-thirds of the inflation in August can be attributed to items other than food articles and products, necessitating continued policy response to contain inflation and anchor inflationary expectations.

Table 4.1. Composition of Inflationary Pressure (Per cent)

	<i>Sep. 09</i>	<i>Mar. 10</i>	<i>April 10</i>	<i>May 10</i>	<i>June 10</i>
All Products	0.5	11	9.6	10.2	10.5
Primary Goods	8.4	18.3	13.9	16.6	16.3
Primary Food	14.2	17.4	16.9	16.5	14.6
Food Grains	16.1	13.7	11.9	9.6	9.1
Energy	-8.2	12.7	12.6	13	14.3
Manufactured Goods	0.5	7.4	6.7	6.4	6.6
Manufactured Foods	13.1	15.5	9.2	5.7	5.4

Special Combinations					
Manufactured Goods Excluding Manufactured Foods	-1.9	5.4	6.1	6.6	7
Manufactured Foods Excluding Sugar	6.8	4.2	0.2	-2.1	-1.0
Primary and Manufactured Food Items					
Wheat	6.5	13.4	6.5	3.4	4.5
Rice	20.9	9.1	8.3	7.1	6.4
Coarse Cereals	20.5	11.8	8.1	2.1	4.2
Pulses	20.8	32.6	30.6	31.9	32.6
Fruit and Vegetables	9.9	10	4.5	9.3	5
Eggs, Meat and Fish	21.4	31.5	32.7	37	30.7
Sugar, Gur and Khandsari	43.5	42.5	30.2	23.7	19
Dairy Products	9.8	13.1	12.8	12.1	12.5
Contribution to the Headline Rate (percentage points)					
Total	0.46	11.04	9.59	10.16	10.5
Primary Goods	1.93	4.37	3.36	4.01	3.91
Primary Food	2.2	2.86	2.81	2.74	2.57
Food Grains	0.77	0.75	0.65	0.52	0.51
Energy	-1.81	2.54	2.49	2.58	2.88
Manufactured Goods	0.29	4.13	3.75	3.59	3.74
Manufactured Foods	1.34	1.72	1.05	0.65	0.6
Special Combinations					
Manufactured Goods Excluding Foods	-1.05	2.42	2.7	2.94	3.14
Manufactured Foods Excluding Sugar	0.14	0.33	0.02	-0.17	-0.07

Note: *June 2010 numbers are projections except for primary goods and energy

Source: EAC, July 2010.

Table 4.2: Major Drivers of WPI Inflation, August 2010

	2010-11 (Y-on-Y)		2010-11		(Y-on-Y)		Monthly variation over previous month July 2010
	Weight	Inflation	WC	Inflation	WC	Inflation	
Commodities/Groups With Increase in Prices							
Sugarcane	0.6	0	0	53.3	3.1	0	0
Condiments and Spices	0.6	6.9	15.6	39.9	3.5	6.8	6.8
Eggs, Fish and Meat	2.4	18.7	142.4	27.1	8.9	1.2	1.2
Milk	3.2	14.3	140.9	26.5	10.9	0.9	0.9
Minerals	1.5	2.6	19.4	23.8	6.6	1	1
Commodities/Groups With Decrease in Prices							
Vegetables	1.7	27.2	170.9	(-) 6.6	(-) 1.9	0.6	0.6
Tea and Coffee	0.2	9.6	7.7	(-) 6.1	(-) 0.2	1.4	1.4
Oil cakes	0.5	11.6	21.6	(-) 2.9	(-) 0.2	1	1
Sugar	1.7	50.7	230.2	(-) 0.6	(-) 0.2	0.2	0.2
Electrical Machinery	2.3	(-) 0.9	(-) 6.4	(-) 0.3	(-) 0.1		

WC: Weighted Contribution

Source: RBI

The only silver lining is that the Consumer Price Index (CPI) for the industrial worker has declined from a peak of 15-16 per cent in the last fiscal to 9.88 per cent in August 2010. Meanwhile, the CPI for agricultural labour and rural labour for September 2010 has also fallen from 9.65 and 9.99 per cent in August 2010 to 9.13 and 9.34 per cent, respectively. The comparable rates for September 2009 were 13.19 and 12.97 per cent. However, this close-to-double-digit inflation, coming as it does on top of last year's high base, is a cause for serious concern in a country where close to 40 per cent of the population is below the poverty line.

Table 4.3 : CPI Inflation (Y-on-Y) (per cent)

<i>CPI for</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>Jul-09</i>	<i>Jun-10</i>	<i>Sep-10</i>
Industrial Workers (IW)	7.9	8	14.9	11.9	13.7	9.88**
IW-Food	9.3	10.6	16	12.2*	13.6#	13.9*
Agricultural Labourers	7.9	9.5	15.8	12.9	13	9.13
Rural Labourers	7.6	9.7	15.5	12.7	13	9.34

** : Value is for August * : Values pertain to June #: Values pertain to May

It may be mentioned here that we are likely to have a better sense of the extent of price rise with the new series of the Wholesale Price Index (WPI) launched by the government in early September. The new WPI has 676 items compared to the 435 commodities earlier listed. The number of quotations or sources for collating the price data is also higher – 5,482 as against 1,918, previously.

Thus, products such as television sets, canned meat, washing machines, computers, readymade and instant food products, mineral waters, dish antennae, gold, silver, telephone instruments, ice-cream, flowers and microwave ovens, among others, that did not figure in the earlier WPI now find a place in the new index. Using the same analogy, some 200 items, including products such as pan masala, beer, asbestos, baby food, hessian sacks and some kinds of chemicals have been dropped.

The weights of the main components have also been modified to reflect the changing structure of the economy. Thus, the primary articles category now has a weight of 20.11 per cent compared to 22.02 per cent in the new WPI, fuel and power, 14.91 per cent, up from 14.22 per cent, while the weight given to manufactured products is 64.97 per cent as against 63.74 per cent.

Though it is early days yet, it is hoped that the new series will capture the extent of the price rise more accurately. Also, that the divergence between the WPI and the Consumer Price Index (CPI) that has dogged our inflation data throughout the past many months of high inflation will be narrowed down as a consequence, resulting in more coherent policy formulation.

Nevertheless, the monthly average of WPI inflation for Q1 of 2010-11 under the new series at 10.6 per cent (about 50 basis points lower than 11.1 per cent under the old series) is significantly above the trend of 5.0-5.5 per cent in the 2000s.

The immediate effect of the change in the base year and composition of WPI has been a decline in the rate of inflation. Thus, inflation, as measured by the new WPI, stood at 8.51 per cent for August 2010 as compared to 9.5 per cent as per the old 1993-94 base. The latest number released for September 2010 shows inflation at 8.62 per cent, just a tad higher than that for August 2010 (the comparable number as per the old index has not been made public). However the year-on-year inflation in primary articles – food, non-food and minerals – at 17.45 per cent (on an annualized basis) in September continues to be a cause for concern.

The small decline in overall inflation combined with a persistence of food inflation has implications for the RBI's policy choices. Manufacturing inflation is considered to be largely a demand-driven phenomenon more amenable to respond to monetary policy signals than food inflation, bolstering the case for monetary policy tightening. However, to the extent the diffusion of food into generalized inflation (proxied by high inflation in products) may be less marked in the new data series, the RBI might be tempted to go slow on monetary tightening.

Table 4.4: Wholesale Price Index, September 2010

Commodities/Major Groups/ Groups/Sub-Groups	Weight	WPI Sept. 2010	Latest month over month				Build up from March				Month of September 2010 Year on Year	
			2009-10		2010-11		2009-10		2010-11		2009-10	2010-11
All Commodities	100.000	141.1	0.46	0.57	5.44	3.9	5.44	3.9	1.09	8.62		
Primary Articles	20.118	179.7	0.07	1.53	12.67	8.32	12.67	8.32	10.63	17.45		
Food Articles	14.337	179.0	0.65	1.59	14.09	9.41	14.09	9.41	13.92	15.71		
Cereals	3.373	168.6	2.06	-0.41	5.31	1.26	5.31	1.26	13.36	6.24		
Rice	1.793	164.8	2.94	-0.78	4.3	0.92	4.3	0.92	16.14	4.57		
Wheat	1.116	173.0	1.66	0.23	5.57	0.12	5.57	0.12	8.53	8.74		
Pulses	0.717	198.8	1.07	-2.79	18.92	-0.05	18.92	-0.05	19.52	5.07		
Vegetables	1.736	181.0	-7.48	5.05	46.9	37.12	46.9	37.12	11.93	6.03		
Potatoes	0.202	136.9	09.9	5.07	160.37	29.89	160.37	29.89	111.57	-49.05		
Onions	0.178	180.7	6.89	16.21	-14.07	5.49	-14.07	5.49	5.44	1.35		
Fruits	2.107	150.9	0.82	1.62	9.33	3.64	9.33	3.64	3.62	12.03		
Milk	3.238	176.9	2.59	0.51	6.57	05.8	6.57	05.8	16.78	23.97		
Non-Food Articles	4.258	157.2	0.15	2.01	6.57	4.59	6.57	4.59	-0.89	18.2		
Fibres	0.877	172.1	-0.81	9.83	7.58	13.9	7.58	13.9	-12.12	27.58		
Oil Seeds	1.781	140.4	-1.19	-0.43	4.46	3.08	4.46	3.08	0.3	5.25		
Minerals	1.524	248.6	-3.59	0.04	15.25	7.34	15.25	7.34	11.46	28.48		
Fuel and Power	14.910	147.6	1.06	-0.27	7.96	5.35	7.96	5.35	-8.09	11.06		
Liquefied Petroleum Gas	0.915	128.9	0	0	0.18	14.99	0.18	14.99	-7.45	15.3		
Petrol	1.090	139.9	0	0	9.97	8.62	9.97	8.62	-11.91	15.33		
High Speed Diesel Oil	4.670	153.5	0	0	6.52	6.15	6.52	6.15	-5.84	14.64		

Commodities/Major Groups/ Groups/Sub-Groups	WPI Sept. 2010	Weight	Latest month over month				Build up from March				Month of September 2010 Year on Year	
			2009-10		2010-11		2009-10		2010-11		2009-10	2010-11
			2009-10	2010-11	2009-10	2010-11	2009-10	2010-11	2009-10	2010-11		
Manufactured Products	64.972	127.6	0.49	0.31	2.18	1.59	0.16	4.59				
Food Products	9.974	139.3	1.8	0.72	10.07	-1.69	12.08	2.80				
Sugar	1.737	160.1	6.29	2.30	31.6	-12.8	55.14	-4.36				
Edible Oils	3.043	118.8	-0.79	0.76	-0.18	4.21	-8.56	4.85				
Beverages, Tobacco and Tobacco Products	1.762	143.8	0.52	0.14	3.43	1.27	6.85	5.89				
Cotton Textiles	2.605	121.7	-0.09	0.41	2.72	4.73	2.02	14.92				
Man Made Textiles	2.206	112.2	-0.1	2.56	2.6	3.51	-0.87	9.36				
Wood and Wood Products	0.587	149.7	2.54	0.40	5.6	2.25	9.51	3.17				
Paper and Paper Products	2.034	123.4	-0.17	1.23	2.32	3.26	2.05	3.44				
Leather and Leather Products	0.835	128.2	-0.31	-0.31	3.22	0.63	3.63	-0.08				
Rubber and Plastic Products	2.987	124.8	0.17	0.48	2.16	3.74	-1.74	5.32				
Chemicals and Chemical Products	12.018	122.5	-0.09	0.16	1.12	1.74	-2.17	4.34				
Non-Metallic Mineral Products	2.556	144.3	0.14	-0.21	1.95	0.91	8.37	2.20				
Cement and Lime	1.386	151.8	-0.2	-0.46	0.95	0.40	9.3	1.74				
Basic Metals Alloys and Metal Products	10.748	133.3	1.13	0.15	-1.02	3.41	-11.66	5.96				
Iron and Semis	1.563	123.7	1.72	0.24	-4.83	-0.08	-18.27	4.74				
Machinery and Machine Tools	8.931	120.5	-0.76	0.08	-0.51	0.84	-0.68	2.90				
Transport Equipment and Parts	5.213	120.8	0	0.33	-0.69	2.29	3.02	4.23				

This is more so since the government, confident in the knowledge that the next general elections are not due till May 2014, seems content to put inflation on the back burner when it comes to policy priorities.

This trend could be dangerous as one of the features of the present phase of inflation, as distinct from last year, is that asset prices that had gone down in the immediate aftermath of the meltdown have again started rising. The rise is most marked in real estate and the stock market as also in the price of precious metals such as gold and silver.

From its 9 March 2009 level of 8,160 the Sensex shot up to a record 20,688 points on 13 October 2010, not far short of the peak of 20,870 reached on 1 September 2008. Such a sharp rise is clearly not warranted by fundamentals; the price-earnings ratio of many Sensex companies now stands at levels that many would regard as unsustainable. The current bull-run can only be explained as a speculative surge from FIIs looking for yields in a world awash with liquidity.

Unfortunately, monetary policy is not the best tool to rein in inflation once inflationary expectations get entrenched (as seems to be the case in India today). It acts with a long lag; more so in India where the weakness in the transmission mechanism (thanks in part to a fragmented financial market where some interest rates are still administered) gives rise to more protracted lags. This seems to be borne out by the experience to date. Successive rate hikes since March 2010 have not borne fruit, the RBI is clearly behind the curve in reining in inflation.

The government must bear a great deal of the blame for the runaway inflation for close to 2 years now. Food inflation, in particular, could have been contained had the government been willing to offload from its over-flowing buffer stocks. However, for reasons that remain unexplained to date, the government dithered. While poor delivery mechanisms – the Public Distribution System (PDS) is in shambles in most parts of the country – limit the ability of the government to use buffer stocks as an effective antidote to food inflation, there is considerable evidence to suggest that mismanagement of the food economy was largely to blame.

Table 4.5: Changes in Policy Rates

<i>Date</i>	Per cent		
	<i>Reverse Repo Rate</i>	<i>Repo Rate</i>	<i>Bank Rate</i>
27 February 10	3.25	4.75	5.75
19 March 10	3.50 (+0.25)	5.00 (+0.25)	5.75
20 April 10	3.75 (+0.25)	5.25 (+0.25)	6.00 (+0.25)
24 April 10	3.75	5.25	6
2 July 10	4.00 (+0.25)	5.50 (+0.25)	6
27 July 10	4.50 (+0.50)	5.75 (+0.25)	6
16 September 10	5.00 (+0.50)	6.00 (+0.25)	6

In its July Outlook, the Prime Minister's Economic Advisory Council had suggested a phased release of stocks into the market at less than market prices, either by supplying more under the Targeted Public Distribution System (TPDS) or through Open Market Sales. More recently, the Supreme Court, in a sharp rebuke to the government in response to reports of food grains rotting in godowns, ordered the government to distribute it free to the poor. The government has not acted on either suggestion to date.



Managing Capital Flows

Capital flows are an important supplement to domestic savings in sustaining the high level of investment needed to drive growth. They help develop immature financial markets, promote financial discipline and reduce the borrowing costs for the government and corporates. However, there is a flip side. Capital flows are procyclical. They complicate macroeconomic management even in economies that do not have open capital accounts.

Large and persistent capital flows can potentially jeopardize financial stability.

Large speculative flows in 'search for yield' typically go into investment in assets, leading to a rapid and destabilizing build up in asset prices. Since speculative flows are volatile by nature, they can impair the orderly functioning of financial markets. When investors exit abruptly as a herd, stock and bond prices are affected. And when investors take the redemption proceeds out of the country, the exchange rate gets affected.

Like other emerging markets India has been the recipient of large FII flows. FII flows fell from \$27.4 billion in 2007-08 to a negative \$15 billion in 2008-09 only to bounce back to \$29 billion in 2009-10. In the year to date, FII flows have already crossed \$20 billion (by early October 2010). If present trends are any indication we may well match/exceed last year's record inflow.

Problems arise when, as in the Indian context, the inflows are in excess of the economy's absorptive capacity and when they are mostly speculative in nature. There are two policy options – intervention and non-intervention. Unfortunately, both have costs.

Table 5.1: Capital Flows

	(US\$ Billion)				
	2008-09	2009-10	Period	2009-10	2010-11
Capital Inflows to India					
FDI	35.0	31.7	(April-July)	10.4	7.6
FII (net)	(-) 15.0	29.0	(September 03)	12.1	12.1
NRI Deposits (net)	4.3	2.9	(April-August)	2.5	2.0
ECB (Approvals)	16.5	21.1	(April-August)	5.7	7.6
ADRs/GDRs	1.2	3.3	(April-August)	2.6	1.5
Short-term Trade Credits (net)	(-) 1.9	7.7			
Foreign Exchange Reserves (US\$ billion)					
Reserves Outstanding (end of period)	252.0	279.1	(On September 10)	281.0	284.5
Foreign Currency Assets (end of period)	241.4	254.7	(On September 10)	264.6	257.6
Reserves Changes (increase + / decrease -)	(-) 57.7	27.1	(Over end March)	29.0	5.4
Reserve Changes (net of valuation) (increase + / decrease -)	(-) 20.1	13.4			

Let us consider non-intervention first. The exchange rate is bound to appreciate as the supply of dollars exceeds the demand for them. However, when capital inflows are unduly large, this can lead to currency appreciation that is quite unrelated to fundamentals and trigger a 'Dutch Disease' syndrome.

The second option is to intervene in the foreign exchange market to dampen disorderly movements of the exchange rate. This will result in an accumulation of foreign exchange reserves and release of additional liquidity into the system. If left unsterilized, the additional liquidity so generated in the system will have potential inflationary implications.

The third option is to impose controls on capital flows. Prior to the recent financial crisis, received wisdom was against capital controls on the grounds that they are distortionary, difficult to implement, easy to evade, and that they become ineffective fairly quickly and entail negative externalities.

Post the crisis that view has undergone a change. Capital controls are now seen as a necessary 'evil' needed to ensure monetary policy autonomy, save sterilization costs, tilt the composition of foreign liabilities toward long-term maturities, and ensure macroeconomic and financial stability.

Typically, central banks have sterilized the flows, either partly or fully, using a variety of tools including open market operations, tightening the access of banks to the discount window, adjusting reserve requirements, using a foreign exchange swap facility, easing restrictions on capital outflows and prepayment of external debt.

But such intervention prevents domestic money market interest rates from falling and hence attracts more inflows, accentuating the pressure to appreciate. Intervention also entails large quasi-fiscal costs, as the domestic rate of interest is usually higher than the return on foreign exchange reserves.

The challenge for policy makers is to choose the best mix of these three options as to maximize the benefit and minimize the costs. For most of the past few years India has been struggling from a surfeit of plenty. The easy monetary stance of the U.S. Federal Reserve, dating from well before the latest crisis, had seen a strong inflow of portfolio investment in the period up to January 2008. The onset of the crisis saw overseas investors turn tail and exit in large numbers, only to return once the panic subsided.

The continuance of an easy monetary stance by the U.S. Federal Reserve and the consequent excess liquidity in the

system, together with the strong performance of the Indian economy in the first quarter of the current fiscal has seen a fresh bout of investment by overseas investors.

The exchange rate of the rupee has fluctuated in line with the ebb and flow of FII flows. Surging inflows in the past few weeks have caused the rupee to appreciate by more than 5 per cent in the year to date by early October. While part of the reason for the rupee's strength is the weakness of the dollar, there is no gain saying that strong dollar inflows have been a major contributory factor. For now, the appreciation may help contain the current account deficit and counter the inherent tendency of the currency to depreciate in the face of a widening deficit. But if inflows continue apace, we could see the rupee appreciate to a point where it begins to impact export performance adversely. This is bad news at a time when the trade deficit is already showing a worrisome increase.

Table 5.2: Exchange Rate Fluctuations

<i>Exchange Rate</i>	<i>2008-09</i>	<i>2009-10</i>	<i>Period</i>	<i>2009-10</i>	<i>2010-11</i>
Rupee per US\$ (end of period)	50.9	45.10	(On Sept. 17)	47.97	45.97
Appreciation (+)/ Depreciation (-) (per cent)	(-) 21.5	12.90	(Apr.-Sept. 17)	6.20	(-) 1.81
6-Currency REER (Base: 1993-94=100)	104.5	104.60	(On Sept. 17)	101.59	116.53
Appreciation (+)/ Depreciation (-) (per cent)	(-) 8.5	0.21	(Apr.-Sept. 17)	11.44	7.04

What makes matters worse is that a decline in exports hurts employment even more as an overwhelmingly large share of our exports is accounted for by small and medium enterprises that are, typically, labour-intensive. That is not all. Any reversal in inflows, (and this could be in response to factors entirely beyond our control) could see the exchange rate reverse direction and appreciate. The resultant volatility could do immeasurable harm.

The rise in the value of the rupee vis-à-vis the dollar, in tandem with the rise in the Sensex, demonstrates once again

that what is good for financial markets is not necessarily good for the real economy. As enthusiastic overseas investors pumped in money into the stock market, causing the Sensex to breach the 20,000 mark for the first time in 32 months, the rupee rose to a 4-month high of ₹ 45.58 against the dollar in intra-day trade by late September (20 September 2010), posing a serious threat to exports.

Managing capital flows (read volatile capital flows) is, therefore, one of the major challenges before the Reserve Bank of India. Intervening in the forex market to buy up surplus dollars and keep the exchange rate relatively stable is an option, but one that the RBI knows, from past experience, comes at a heavy cost. For one, it leads to an immediate increase in rupee liquidity at a time when the RBI is trying to tighten liquidity to rein in prices. For another, there is the cost of sterilization as the yield on the resultant increase in forex reserves is only a fraction of what the RBI has to pay in order to absorb the liquidity. In such a scenario, the government and the RBI may have no option but to seriously examine an option they have eschewed so far – controls on inflows.



Addressing the Infrastructure Deficit

'To say India's infrastructure is poor is an understatement.' That statement from Indra Nooyi, the India-born CEO of Pepsi, says it all. The poor state of our infrastructure remains our biggest Achilles' heel.

Much has been written about infrastructure bottlenecks and successive governments have tried to address the shortcomings, but with limited success. The telecom story, the sole instance of success in the infrastructure sector has, unfortunately, not been replicated elsewhere in the sector.

During the Tenth Five-Year-Plan (2002-07) less than 5 per cent of GDP was invested in agriculture compared to over 9 per cent in China and other East Asian economies. To bridge this gap, the Eleventh Five-Year-Plan (2007-12) has given a high priority to infrastructure development. The plan document envisages a total investment of about ₹ 20,562 billion, a more than 2-fold jump over the Tenth-Plan investment.

The challenges posed by such a quantum jump in investment (within this, private sector investment is expected to increase more than 3-fold) are enormous, more so since private investment on this scale in a country of our size has not been attempted anywhere else.

Needless to say, it has not been smooth sailing. With the exception of seaports and airports, where the public-private partnership model has enthused private investors (airports in most of the metros have been upgraded), sectors such as roads and power continue to disappoint.

Roads

Roads carry about 85 per cent of the passenger traffic and 65 per cent of the freight. The National Highways comprise only 2 per cent of the road network but carry about 40 per cent of total road traffic. Any effort to improve connectivity and, hence, competitiveness and efficiency must, therefore, focus on improving our highways.

The National Highways Development Project, which is being implemented in phases, envisages the improvement of more than 54,639 kms. of arterial routes of the National Highways network to international standards. The prime focus on developing roads of international standards is on creating facilities for uninterrupted flow of traffic with enhanced safety features.

However, progress in road construction, already slow following controversies over allotment of projects, suffered a further setback with the economic slowdown. As of February 2009, only 20 per cent of the total road length under NHDP had achieved completion. In the case of Phase II and Phase III, target completion dates have been postponed. The award of new projects was also slow on account of delays in the finalization of model-bid documents, regulatory and commercial reasons, as well as litigations.

In the last financial year, the National Highway Authority of India (NHAI) placed some 60 projects (entailing an investment of about ₹ 70,000 crore) for bidding under BOT Toll mode. However, it received only 22 responses, of which only 12 could be awarded, as 6 of the remaining 10 were single bids that are not allowed under the extant policy, and 4 were bids for NHDP Phase V packages, where the demand for grant was much higher than the 10 per cent permissible as VGF (viability gap funding).

In a bid to address the policy glitches holding up progress in this vital sector, the government appointed a committee under the chairmanship of Mr. B.K. Chaturvedi, Member, Planning Commission. The Committee recommended that while the BOT (Build, Operate and Transfer) (Toll) mode has to be the principal and preferred mode of delivery, considering the need

of balanced development of National Highways in the country, this couldn't be the only one.

While it may be necessary to resort to BOT (Annuity) or EPC (engineering performance contracts) (item rate contracts) in some selected low traffic density National Highway stretches, particularly in backward areas, for inclusive growth and balanced development of National Highway network, it must be ensured that the works on such highway sections are completed in the stipulated period (say 30 months). The NHAI Board may review the implementation of these National Highways sections at regular intervals.

If the NHAI is to meet the target of building 20 kms. per day, it will have to award at least 21,000 kms. over the next 3 years so as to achieve the objective of constructing 7,000 kms. per year (equal to 20 kms. per day). Given the pace of progress to date, that seems a Herculean task.

During the financial year 2010-11, about 7,305 kms. of the National Highways are to be improved along with construction/rehabilitation of 80 bridges and 19 bypasses at an estimated cost of ₹ 25,050.50 crores. In order to attract private investment in the road sector, the government has agreed to provide a capital grant of 40 per cent of the project cost to enhance viability and allow 100 per cent tax exemption in any consecutive 10 years out of 20 years.

To the extent that many of the grey areas have been addressed with the introduction of the Model Concession Agreement and the model RFQ (Request for Qualification) and RFP (Request for Proposal) it is hoped that the coming months will see some increase in activity. Especially, since banks now seem much more willing to fund infrastructure projects than in the past.

Highway project finance is dissimilar from other project finance, as the concessionaire has no ownership over assets created/upgraded through application of equity/debt by the concessionaire. The right of the concessionaire is to recoup his investment by toll receipts from the highway and this, in turn, is dependant on future traffic flows and government's noninterference in toll-setting.

Table 6.1: Power Scenario at a Glance: Installed Capacity and Actual Supply
 1. Installed Capacity as on 31.03.2010

Region	Thermal				Gas	Diesel	Nuclear		Total	MW
	Hydro	Coal	Coal	Gas			R.E.S.	(MNRE)		
Northern	13310.8	21275.0	3563.3	13.0	24851.3	1620.0	2407.3	42189.3		
Western	7447.5	28145.5	8143.8	17.5	36306.8	1840.0	4630.7	50225.0		
Southern	11107.0	17822.5	4392.8	939.3	23154.6	1100.0	7938.9	43300.5		
Eastern	3882.1	16895.4	190.0	17.2	17102.6	0.0	334.8	21319.5		
N.Eastern	1116.0	60.0	766.0	142.7	968.7	0.0	204.2	2288.9		
Islands	0.0	0.0	0.0	70.0	70.0	0.0	5.3	75.3		
All-India	36863.4	84198.4	17055.9	1199.8	102454.0	4560.0	15521.1	159398.5		

Note : I.C. does not include benefits from projects in Bhutan

2. Actual Power Supply Position

Period	Peak Demand (MW)	Peak Met (MW)	Peak Deficit Surplus (MW)	Peak Deficit Surplus (per cent)	Energy Requirement (MU)	Energy Availability (MU)	Energy Deficit Surplus (MU)	Energy Deficit Surplus (per cent)
Northern								
April, 09-March 10	37159	31439	-5720	-15.4	253803	224447	-29356	-11.6
March 10	31253	26843	-4410	-14.1	20956	18734	-2222	-10.6
Western								
April 09-March 10	39609	32586	-7024	-17.7	258551	223153	-35398	-13.7
March 10	39609	32586	-7024	-17.7	24589	20562	-4027	-16.4
Southern								
April, 09-March, 10	32082	29053	-3029	-9.4	220557	206525	-14032	-6.4
March, 10	32082	29053	-3029	-9.4	21945	19879	-2066	-9.4
Eastern								
April, 09-March,10	13963	12885	-1078	-7.7	88040	84054	-3986	-4.5
March, 10	13963	12885	-1078	-7.7	8254	7666	-588	-7.1
N-Eastern								
April 09-March 10	1760	1445	-315	-17.9	9349	8315	-1034	-11.1
March 10	1565	1358	-207	-13.2	749	672	-77	-10.3

The target for electricity generation for the year 2010-2011 was fixed as 830.757 Billion Unit (BU) comprising 690.857 BU, thermal; 111.352 BU, hydro; 22.000 BU, nuclear; and 6.548 BU, imported from Bhutan. This is a growth of around 7.67 per cent over actual generation of 771.551 for the previous year (2009-2010). The generation during April 2010 was 66.570 BU as compared to 62.780 BU generated during April 2009, representing a growth of about 6.04 per cent.

Table 6.2: Programme, Actual Achievement and Growth in Electricity Generation in the Country during 2007-08 to 2010-11

<i>Year</i>	<i>Target</i>	<i>Achievement</i>	<i>Per cent of Target</i>	<i>Per cent of Growth</i>
2007-08	710.00	704.50	99.20	6.30
2008-09	774.09	723.80	93.47	2.74
2009-10	789.511	771.551	97.73	6.60

Source: Power Ministry; Plant Load Factor (PLF):

Notwithstanding the fact that many of the Thermal Power Station (TPSs) in the country are very old, the plant load factor has shown improvement over the years 2007-08 to 2009-10.

Table 6.3: PLF during 2006-07 to 2009-10

<i>Year</i>	<i>Target</i>	<i>Actual</i>	<i>Sector-wise Actual</i>		
	<i>(Per cent)</i>	<i>(Per cent)</i>	<i>Central</i>	<i>State</i>	<i>Private</i>
2007-08	77.10	78.60	86.70	71.90	90.80
2008-09	79.17	77.19	84.30	71.17	91.01
2009-10	77.20	77.50	85.49	70.90	85.68

Source: Power Ministry

After a series of mistakes (of which Enron is the most visible) in the years immediately after we embarked on the reform process, we seem to have reached an inflection point in the power sector. Four ultra-mega power projects of 4,000 MW capacity each have been bid out so far and, with many of the early reforms now bearing fruit, the sector seems set to fare better in future. More so since the earlier focus only on generation, to the neglect of transmission and distribution, has been widened to encompass all 3 activities. We have also gone

Table 6.4: Power Supply Position: 2007-08 to 2009-10

Year	Energy			Peak			
	Requirement (MLU)	Availability (MLU)	Surplus/ Deficits (-) (MLU)	Surplus/ Deficits (-) (Per cent)	Peak Demand (MW)	Peak Met (MW)	Surplus/ Deficits (-) (Per cent)
2007-08	739345	666007	-73338	-9.9	108866	90793	-18073
2008-09	777039	691038	-86001	-11.1	109809	96785	-13024
2009-10	830594	746644	-83950	-10.1	119166	104009	-15157

Source: Power Ministry

through a certain learning process that should, hopefully, help us avoid a repeat of past mistakes.

Reforms in the power sector starting with the passage of the Electricity Act 2003 and the subsequent Electricity (Amendment) Act, 2007, which was brought into force with effect from June 2007, have prepared the ground for greater private sector participation and also helped contain T&D (transmission and distribution) losses. T&D losses, largely a euphemism for theft, have fallen from about 40 per cent just a few years ago to 30 per cent.

The 2007 Amendment mandates the central government, jointly with state governments, to endeavour to provide access to electricity to all areas, including villages and hamlets, through rural electricity infrastructure and electrification of households. It does away with licensing for sale of electricity from captive units. The definition of theft has been expanded to cover the use of tampered metres and use for unauthorized purposes. Theft has been made an explicitly cognizable and non-bailable offence. Open access has been permitted.

Two power exchanges have now been set up. Tariff-based bidding has become the norm and four Ultra-Mega Power Projects, each with a capacity of 4000 MW, are on the anvil. Many state governments had also embarked on reform of their electricity sectors, and 14 states have reorganized their SEBs.

The Accelerated Power Development Programme (APDRP) has been re-structured for the Eleventh Plan as a Central Sector Scheme. The focus of the programme is on actual, demonstrable performance in terms of AT&C loss reduction. Projects under the scheme would be taken up in two parts in urban areas – towns and cities with population of more than 30,000 (10,000 in case of special category states).

The most significant development in the power sector was the passage of the controversial Civil Nuclear Liability Bill. This paves the way for increasing our nuclear energy.

To sum up, we seem to be at a tipping point as far as the power sector is concerned. Increased certainty about payment (this is critical for private producers), shift to tariff-based bidding, freedom to sell power at market rates, the growing

volume of power trading coupled with much easier access to funding, have all combined to see a rush of interest from private producers. If, as it is hoped, the additional capacity of 78,000 MW for the current plan materializes as scheduled, a major bottleneck that dogs industry and reduces the competitiveness of Indian industry would be addressed.



Taking People off Agriculture

The Indian story has been an exception to the rule that, in the course of economic development, countries transit from primary to secondary to tertiary-led development, in that we seem to have leapfrogged over the intermediate stage of development. From being a pre-dominantly agrarian economy we are now a service-led economy, with services accounting for more than 60 per cent of our GDP.

Unfortunately, the change in the structure of the economy (agriculture now accounts for barely 20 per cent of GDP) has not been accompanied by a corresponding fall in the numbers dependent on agriculture for their livelihood.

The phenomenon of large numbers being dependant on a shrinking share of the pie poses a serious challenge to the sustainability of the growth process and has serious socio-political implications as well. The growing spread of Naxalism in large swathes of the country is often attributed to our inability to ensure that the fruits of growth filter down to the masses. Hence, we need to find ways of taking people off the farm sector and putting them to productive employment elsewhere.

The services sector, typically, employs only skilled labour, which means these people have to be able to find jobs in industry. But modern industry, too, demands a modicum of skills – at the very least it demands literacy – so the need of the hour is to equip those presently engaged in the farm sector with the skills needed to find alternative employment even while we improve productivity in agriculture so that it does not remain hostage to the monsoon and act as a drag on GDP growth.

For this, the government must focus on what noted agriculture economist Ashok Gulati calls the three I's (Investments, Incentives and Institutions) needed to bring about a quantum jump in agricultural growth.

Investments, Incentives, Institutions: The 3 I's of Agriculture

Investments

New investments are needed to lay the ground for higher productivity and prosperity. While India has a large production base, the lack of infrastructure and organized market structure stand in the way of successful diversification. Declining public investment has widely been held to be a cause for stagnation in agriculture. The reality, however, is that public investment accounts for only about 25 per cent of total investment in the sector, the balance being contributed by the private sector. Nonetheless, to the extent public sector investment in areas such as roads, irrigation canals and other basic amenities that the private sector, typically, shies away from, the declining public sector has a much more far-reaching impact.

At the same time, the government needs to re-prioritize the pattern of its expenditure in the farm sector. An IFPRI study on marginal returns in terms of agricultural GDP from a unit of public expenditure across various categories within agriculture reveals that the returns are the highest on public expenditures devoted to agriculture R&D, followed by rural roads, education, and irrigation, and lowest from fertilizer subsidies. Despite this, fertilizer subsidy continues at about ₹ 64,000 crore in 2009-10, indicating a huge inefficiency in the allocation of public expenditure.

Incentives

To reform incentives in agriculture, the first step is to dismantle the present system of MSP (minimum support price). While the reduction of tariffs on manufactured products, the

correction of exchange rate of the rupee and relaxation of export controls on several agricultural products since 1991 has helped reduce 'implicit taxes' on farm produce, interventions by the government (such as export bans on wheat and rice, or limits on the stocking of grains by private trade in 2008) dissuade private sector investment in the sector. It also results in short-changing the farmer by denying him the upside of international prices.

The main government intervention in agricultural markets currently comes through its policy of MSP for some 24-odd crops, although, in practice, this mainly works for rice, wheat, sugarcane and cotton, where there is a fair amount of procurement. Over time, the MSP has become a *de facto* procurement price and discourages farmers from diversifying into high-value crops that do not have such a support/procurement price. To make the system more market-oriented, it is critical to de-link the support price from the procurement price, where the latter can be moved up or down depending on market conditions.

This calls for abolition of all levies, freeing both input as well as output prices, allowing free movement of goods across the country, abolition of stocking limits, export bans, bans on future markets, etc., on private trade. Unfortunately, no government seems to have the courage to replicate in agriculture the kind of root-and-branch reform that was initiated in industry back in the 1990s, with the abolition of the industrial licensing system.

Institutions

While rationalizing subsidies and incentives can pave the way to more investments in the sector, both public and private, it is important to bring about certain institutional reforms to create an enabling environment for private sector participation with a view to promoting efficiency.

Reforms aimed at increasing and improving marketing and warehouse facilities and increasing transparency in land and credit markets could also go a long way in unleashing animal spirits in agriculture.

However, bureaucratic delays such as the delay in notification of the Warehousing (Development and Regulation) Act, 2007, passed in September 2007 do not help. The Act, which is aimed at ensuring that farmers are able to keep their goods in certified warehouses and use warehouses receipts as negotiable instruments to raise loans from banks rather than resort to distress sales, plugs a major institutional lacuna. The government needs to crack the whip on the concerned ministry to see the necessary paperwork is done expeditiously so that the Act becomes a reality.



Addressing Fiscal Weakness

The state of our public finances has steadily worsened. The deterioration in fiscal parameters witnessed in 2008-09 continued in 2009-10, with the ratios of gross fiscal deficit to GDP, revenue deficit to GDP and primary deficit to GDP, all showing deterioration over the previous year.

Table 8.1: Fiscal Indicators

<i>Fiscal Indicators of Central Govt.</i>	2007-08	2008-09	2009-10 (RE)	2010-11 (BE)
1. Gross Fiscal Deficit/ GDP	2.6	6.0	6.6	5.5
2. Revenue Deficit/ GDP	1.1	4.5	5.3	4.0
3. Primary Deficit/ GDP	(-) 0.9	2.6	3.1	1.9
4. Gross Tax Revenue/GDP	12.0	10.9	10.2	10.8
5. Debt/GDP	57.3	56.7	56.4	56.9
6. Gross Market Borrowings (₹ Crore)	200306	318550	492368	498635
7. Net Market Borrowings (₹ Crore)	130600	246975	394229	345010

Budget 2010-11

The Budget of 2010-11 was presented with the backdrop of some signs of revival in the Indian economy and the need to return to the path of fiscal consolidation without jeopardizing growth. Towards this end, the finance minister announced an

increase in disinvestment, reforms in fertilizer subsidy and pricing policy of petroleum and diesel, apart from reforms in both direct and indirect tax regimes, i.e. implementation of direct tax code and introduction of a goods and services tax in 2011-12.

As part of the effort to gradually withdraw the fiscal stimulus, a partial rollback of central excise duties on non-petroleum products and basic duties on petroleum products was also announced. At the same time, in order to ensure that the growth engine is not stalled as a consequence, a number of measures such as concessional customs duty, exemption of excise duty and service tax on a number of items such as select agricultural goods and related sectors, environment-friendly products, monorail projects for urban transport, domestic manufacture of mobile phones and medical equipment, was announced. Services tax was maintained at the existing level, but more services were brought within the ambit of service tax.

The Budget envisages a growth in gross tax revenue of 17.9 per cent, with all the major taxes, except personal income tax, expected to rebound with the partial roll back in indirect tax rates. Personal income tax receipts are, however, expected to decline following the broadening of tax slabs announced in the Budget. Non-tax revenues (NTR) are budgeted to increase substantially by 32.0 per cent on account of 3-G auction proceeds. Thus, revenue receipts during 2010-11 are budgeted to increase by 18.2 per cent over the revised estimates for 2009-10. Non-debt capital receipts are expected to increase 49.4 per cent, mainly due to a 54.1 per cent rise in disinvestment proceeds.

On the expenditure front, the Budget envisages a moderation in the rate of growth of aggregate expenditure to 8.5 per cent by reducing the growth in non-plan expenditure to 4.1 per cent from 26.0 per cent in the previous year. Plan expenditure, however, would be stepped up by 18.4 per cent as compared with 14.5 per cent in the previous year. Most of the increase in the plan expenditure would be in the central plan, while much of the curtailment in the growth of non-plan expenditure is to be achieved through a cut in subsidies.

This Budget projects an improvement in fiscal parameters, both in absolute terms and as per cent of GDP. The improvement is expected to come from a combination of improved indirect collections because of the partial rollback in tax rate cuts, higher non-tax revenue from 3-G auction proceeds and larger disinvestment proceeds reinforced by curtailing the growth of non-plan expenditure. Thus, RD, GFD and PD are budgeted at 4.0 per cent, 5.5 per cent and 1.9 per cent in 2010-11, lower than 5.3 per cent, 6.7 per cent and 3.2 per cent, respectively, during 2009-10.

Table 8.2: Budget Numbers

<i>Item</i>	<i>2009-10 (BE)</i>	<i>2009-10 (RE)</i>	<i>2010-11 (BE)</i>	<i>Variation (3-2)</i>	<i>Variation (4-3)</i>
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>
1. Revenue Deficit (3-2)	4.8	5.3	4	0.5	-1.3
2. Revenue Receipts	10.5	9.4	9.8	-1.1	0.4
3. Revenue Expenditure of which	15.3	14.7	13.8	-0.6	-0.9
Interest Payments	3.9	3.6	3.6	-0.3	0
4. Gross Fiscal Deficit {5-(2+6)}	6.8	6.7	5.5	-0.1	-1.2
5. Total Expenditure	17.4	16.6	16	-0.8	-0.6
6. Non-debt Capital Receipts	0.1	0.5	0.7	0.4	0.2
7. Capital Expenditure	2.1	1.9	2.2	-0.2	0.3
8. Gross Primary Deficit (4-3i)	3	3.2	1.9	0.2	-1.3

Prima facie, this would seem to suggest that the government is serious about returning to the path of fiscal rectitude. A closer scrutiny of the numbers, however, reveals that the fiscal consolidation envisaged in the Budget relies significantly on one-off items of expenditures and receipts. Excluding one-off items such as arrears payments and farm-debt waiver from

the expenditure, and disinvestment and 3-G proceeds from the receipts, RD will show a correction of 0.5 per cent of GDP, lower than the 1.3 percentage-point correction envisaged in the Budget.

Similarly, GFD will show a correction of 0.3 percentage points, much lower than the 1.2 percentage points correction envisaged in the Budget. However, to bring down the level of RD and GFD to zero per cent and 3.0 per cent of GDP, respectively, by 2013-14, as recommended by the Thirteenth Finance Commission (TFC), without relying on these one-items will be a difficult task. This is because, excluding these one-off items, the required reduction in RD in the next 3 years will be about 1.4 percentage points each, while that of GFD will be about 1.1 percentage points each.

Table 8.3: One-off Items in the Budget

Item	2009-10 (RE)		2010-11 (BE)	
	Amount (₹ Crore)	Per cent GDP	Amount (₹ Crore)	Per cent GDP
Debt Waiver (Revenue Expenditure)	15000	0.24	12000	0.17
Pay Arrears (Revenue Expenditure)	16643	0.27		
Disinvestment (Non-debt Capital Receipts)	25958	0.42	40000	0.58
3-G Auction (Non-tax Revenue)			35000	0.5
Revenue Deficit/GDP				
i) Budgeted		5.3		4
ii) Adjusted		4.8		4.3
Gross Fiscal Deficit/GDP				
i) Budget		6.7		5.5
ii) Adjusted		6.6		6.3

The Budget appears to recognize the difficulty of reducing the size of RD, given the projection of 2.7 per cent of GDP in 2012-13 in MTFPS. However, there are several items of expenditure, which are classified as revenue expenditure, though they are in the nature of creating durable assets such as the Rajiv Gandhi Grameen Vidyutikaran Yojana, the Jawaharlal Nehru National Urban Renewal Mission, the Pradhan Mantri Gram Sadak Yojana and the Accelerated Irrigation Benefit Programme. Recognizing this issue, the Fiscal Policy Strategy Statement emphasizes the need to re-classify expenditure in a more pragmatic way, with the focus on end outcome. However, it is important to note that reducing fiscal deficit, through reduction in revenue deficit, is the most desirable option.

The experience with the implementation of the Fiscal Responsibility and Budget Management Act (FRBM) has not been satisfactory. If creative accounting (read, resorting to off-budget treatment of items like food, fertilizer and oil subsidies) made a mockery of the intent behind the Act, the perfunctory regard shown by the government to targets laid down has rendered the Act largely ineffective. Though fiscal deficit estimates broadly followed the targets set by the task force for the first 3 years, they were missed by a wide margin in the last 2 years due to a mounting subsidy bill, pay revision to government employees following the acceptance of the Sixth Pay Commission Recommendations, loan waiver and the fiscal stimulus occasioned by the global crisis.

Even during the first 3 years, when there was some rough adherence to the targets, this was done, not by a reduction in the revenue expenditure and increase in capital expenditure relative to GDP, but by an increase in tax revenues, lower interest payments due to debt swap and compression of capital expenditure.

Fiscal Position to Date

To its credit, the government's finances are in relatively good shape in the year to date. The fiscal deficit in the first 5 months – April-August 2010 – was about 40 per cent of the Budget

Estimate as against 45.5 per cent in the corresponding period of the previous year, thanks to higher-than-expected receipts from auction of the 3-G spectrum (₹ 1.06 lakh crore as against the BE of ₹ 35,000 crore). Indeed, non-tax revenue receipts at ₹ 152,299 crore have already exceeded the full-year target of ₹ 1,48,118 crore.

In contrast, tax revenue during the same – April-August period – was just 26 per cent of the BE for the year, while total expenditure touched 40 per cent of the BE. Going forward, much will depend on how wisely the government manages its expenditure. To the extent the government has reduced its borrowing requirement for the second half of the fiscal by ₹ 10,000 crore from the earlier estimate of ₹ 1, 73,000, it would appear it is serious about fiscal discipline.

The Thirteenth Finance Commission, in its revised roadmap for fiscal consolidation, has recommended that the Centre's debt/GDP ratio should be reduced from 54.2 per cent in 2009-10 to 44.8 per cent in 2014-15. This translates into a reduction of the fiscal deficit from 6.8 per cent to 3 per cent and phasing out of the revenue deficit from the present 4.8 per cent.

The Commission has also suggested a number of reforms in the FRBM legislation to make the adjustment process more transparent and responsive to exogenous shocks and ensure better monitoring and compliance. Though the finance minister, in his Budget speech, announced the government's decision to accept the Commission's recommendations, it remains to be seen whether it will follow its advice on the FRBM legislation and bring about the necessary amendments.

For the first time, the Budget has targeted an explicit reduction in domestic public debt-GDP ratio and announced that a status paper giving a detailed analysis of the situation and a road map for curtailing the overall public debt will be brought out within 6 months. However, the targeted RD in the Budget is much higher than the TFC-recommended level of zero by 2013-14.

It is evident from the Budget that all the required adjustments in the next 3 to 4 years cannot be achieved through tax reforms envisaged under Direct Tax Code (DTC)

Table 8.4: Government Accounts End August

	Budget		Actuals@		Per cent of Actuals to Budget	
	Estimates		upto August		Estimates	
	2010-2011*	2010	₹	₹		
1	Revenue Receipts					COPPY**
2	Tax Revenue (Net)	682212	290799	42.6 per cent	(25.6 per cent)	
3	Non-Tax Revenue	534094	138500	25.9 per cent	(22.5 per cent)	
4	Non-Debt Capital Receipts	148118	152299	102.8 per cent	(35.9 per cent)	
5	Recovery of Loans	45129	5479	12.1 per cent	(71.7 per cent)	
		5129	3361	65.5 per cent	(43.1 per cent)	
6	Other Receipts	40000	2118	5.3 per cent	(179.7 per cent)	
7	Total Receipts (1+4)	727341	296278	40.7 per cent	(26.9 per cent)	
8	Non-Plan Expenditure	735657	311249	42.3 per cent	(35.3 per cent)	
9	On Revenue Account	643599	273620	42.5 per cent	(36.9 per cent)	
	(l) of which Interest	248664	85621	34.4 per cent	(32.0 per cent)	
10	On Capital Account	92058	37629	40.9 per cent	(22.2 per cent)	
	(l) of which Loans	1050	10735	1022.4 per cent	(23.7 per cent)	
	disbursed					
11	Plan Expenditure	373092	136454	36.6 per cent	(30.2 per cent)	
12	On Revenue Account	315125	117531	37.3 per cent	(30.2 per cent)	
13	On Capital Account	57967	18923	32.6 per cent	(29.8 per cent)	
	(l) of which Loans					
	disbursed	16760	6541	39.0 per cent	(34.0 per cent)	
14	Total Expenditure (8+11)	1108749	447703	40.4 per cent	(33.6 per cent)	
15	Fiscal Deficit (14-7)	381408	151425	39.7 per cent	(45.5 per cent)	
16	Revenue Deficit (9+12-1)	276512	100352	36.3 per cent	(54.9 per cent)	
17	Primary Deficit (15-9(l))	132744	65804	49.6 per cent	(62.8 per cent)	

** COPPY: Corresponding Period of the Previous Year

and GST. In the MTFPS, the incremental gross tax revenue to GDP ratio, after taking account of these tax reform measures, is estimated to be 0.7 percentage point during 2011-12 and 0.3 percentage points during 2012-13 only, while the minimum required corrections in revenue deficit would be much larger. Therefore, besides tax reforms, expenditure reforms in terms of prioritization and rationalization would be crucial.

The magnitude of the combined fiscal deficit of the Centre and the states is close to half of households' financial savings, which is the largest component of domestic savings. If 50 per cent of households' financial savings are taken away by the government sector, this has serious implications for the financial markets because the demand for funds from the non-government productive sectors of the economy also has to be met simultaneously.

However, elimination of the revenue deficit and bringing down the fiscal deficit in itself does not mean much. What is more important is the mode of financing the fiscal deficit and the use that the resources so raised are put to. Following the global financial crisis, dogmatic positions on fiscal deficit have undergone a change.

Few would argue that fiscal deficits are a complete no-no. Equally, few would argue that fiscal prudence has no place and governments can spend as though there is no tomorrow. Beyond a point, the rise in public debt/GDP ratio can have serious adverse implications. A recent study by Mehmet Caner and Thomas Grennes of North Carolina State University and Fritz Koehler-Geib of the World Bank identifies a threshold level of about 64 per cent of GDP (for developed countries it is 77 per cent) as the limit beyond which a rise in public debt/GDP is inadvisable for emerging markets. By this criterion, India's public debt/GDP at close to 60 per cent is not worrisome, except that our definition of public debt does not include the debt of quasi-government bodies such as public sector undertakings and, if we were to include that, the ratio could be much higher.

Conclusion

The Indian economy has staged a sharp recovery in the first half of the year. And, unlike in the past when growth in the agriculture sector used to trail far behind growth in industry and services, what is encouraging is that growth seems more evenly balanced in 2010. The gap between the sectoral growth rates, though wide, is less so than before.

Though the higher growth in agriculture is primarily because of the base effect (agriculture growth was just 0.2 per cent last year) and good monsoons, the net result is a narrowing of the gap between India and Bharat, i.e. between growth in urban and rural areas.

Barring a dramatic worsening of the external environment, the growth momentum is likely to continue in the second half of the year. Most estimates place GDP at anywhere between 8.5 per cent to 9.0 per cent.

However, there are risks on both the external and internal front. As far as external risks are concerned, there is very little we can do to make a difference. Despite the fact that India once again seems to be the flavour of the season (witness *The Economist's* recent cover story on India pulling ahead of China) and we now occupy a place at the G20 high table, we do not have a pivotal role. To use the former External Affairs Secretary, Shyam Saran's phrase, we are at best a 'premature power'. We can only tailor our domestic policies to maximize the positives and minimize the negatives of an increasingly open economy.

Thus, it is very clear that the focus must be on domestic policies. On the internal front, the risks to growth are synonymous with the challenges. The biggest risk, as also the biggest challenge, is inflation. Continued price rise could upset the growth apple-cart, compelling monetary authorities

to make up for lost time by coming down more harshly than otherwise. Headline WPI inflation has been in double digits since February 2010.

Worse, it has become increasingly generalized every successive month. Non-food manufacturing inflation accelerated from near zero in November 2009 to 7.3 per cent in June 2010, reflecting the impact of rising input costs, recovering private demand and associated return of pricing power to producers. In the last few months, price increases also reflected in upward revisions in several administered prices or delayed reporting of data.

Managing capital flows is going to call for much more dexterity than in the past, both because of the sheer volume of capital inflow and the increasingly belligerent posture being adopted by nations. In today's globalized world all countries sink or swim together. Beggar-my-neighbour policies, whether by way of unrestrained monetary easing (as in the U.S. and to a lesser extent, the U.K.) and non-tariff barriers (as with the Ohio, U.S., ban on outsourcing or the Bill passed by the U.S. House of Representatives to impose countervailing duties on Chinese imports) or currency intervention (by China and, to a lesser extent, other emerging markets, including India) will not lead anywhere.

Strauss-Kahn hit the nail on the head when he observed, 'Everybody has to keep in mind this mantra that there is no domestic solution to a global crisis.' Unfortunately, that does not quite gel with nation states. The only solution is global cooperation, not of the kind orchestrated by the IMF, but of a far more genuine kind represented by the G20. The occasion of the Fund-Bank meeting in early October should have led to some soul-searching by these two bodies, a recognition that they are no longer in a position to lead from the front. But, perhaps, it is unrealistic to expect them to sign their own epitaph! That will have to await the Seoul meeting of the G20 in November 2010.

Infrastructure is a perennial challenge. But here we seem to be on a stronger wicket than before. In two critical sectors – power and roads – we have made some headway. The bigger

worry is as far as social infrastructure is concerned. Here, too, there are signs of some forward movement in education with the enactment of the Right to Education Act, and faint signs of the government easing up on restrictions on foreign entry into education. The health sector, however, lags far behind. By almost any parametre – maternal and child mortality, malnutrition, among others – we are far behind both our peers as well as countries that rank below us in terms of GDP. Correcting the imbalance between the sectoral contribution to GDP and the proportion of the population dependant on the different sectors is another major challenge.

The biggest challenge, of course, is to manage all these other challenges without upsetting the fiscal applectart. According to the IMF, the current policy focus, worldwide, is to put in place fiscal consolidation plans. While fiscal stimulus was necessary to stem a potentially catastrophic collapse of output in 2008 and 2009, countries must return to a sustainable fiscal path. The question is when, and at what speed.

The Fund believes the first priority is to put in place a credible roadmap to stabilize the ratio of debt to GDP, particularly in advanced economies, where the debt/GDP ratio has shot up alarmingly during the past 2 years.

At the G20 Summit in Toronto, advanced economies have already committed to fiscal plans that will stabilize or reduce government debt to GDP ratios by 2016 in line with the Fund's recommendations. But too sharp a correction could prove counter-productive and affect global recovery adversely.

Meanwhile, as the pace of recovery slows there are signs that 'beggar-thy-neighbour' policies will again gain ground, as evidenced both by the U.S. President Barack Obama's threats to act against companies that engage in outsourcing as well as Japan's moves mid-September to intervene in the currency market in a bid to prevent the strengthening of the yen. Japan's intervention in the currency market, for the first time since 2004 that came after a surge in the yen to a 15-year high against the dollar, threatened the country's hesitant recovery. Japan is not the only country to go against the grain of the 'leave-it-to-the-markets' school. Either way, with more and more countries

looking to their own backyard, the outlook for the wider G20 process aimed at creating a strong, sustainable and balanced global recovery is not bright.

As Mervyn King, the Governor of the Bank of England, noted in a speech, Asian countries' focus on export-led growth 'allowed consumers in the West to enjoy rising living standards' but also created unsustainable flows of capital that contributed to the financial and economic crisis. The problem, it is widely acknowledged, can only be tackled by international cooperation. Unfortunately, that is sorely lacking in the world at the moment.

The good thing as far as India is concerned is that despite the greater openness of the economy today, there is still a great deal of growth that we can achieve on our own steam. This is provided we get our act together, undertake long-pending reforms in the labour market, judiciary, taxation (read: move faster on GST and the direct tax code) and above all, improve our quality of governance.



Discussions

Ajit Mozoomdar

The Mid-Year Review of the Indian Economy is now an annual event of some importance in the calendar of the India International Centre for the last several years. It owes its origin to the late Malcolm Adiseshiaiah, an economist and an international civil servant, who was a member of the Centre as well. At that time, and for many years afterwards, the Indian economy was not actually reviewed except at the end of the year with the Economic Survey of the Government of India. The situation has changed a great deal since then: there are certainly half-a-dozen important institutions, including the Reserve Bank, which make periodic surveys of the macro-economic conditions of India. In a way, one wonders whether there is still a place for this particular Review of the Economy. On reflection, indeed there is, for the reason that this Review is pitched to a non-expert audience and it goes beyond the simple macro-economic growth review. In fact, Malcolm Adiseshiaiah had turned it into something much like a Planning Review. This he did all single-handedly; there was no research body of any kind to help him. Today we are happy to continue with this, and I have particular pleasure in welcoming and thanking Mr. M.S.Verma for chairing this session.

Another first on this occasion – and at the risk of making a sexist remark – but, to my knowledge, this is the first time we have had a woman doing this Review, and not just a woman but, as she reminds me, a non-professional economist. Mythili Bhusnurmath has been an important figure for the last few years as a commentator and we are happy that she has undertaken this commission without a research institute to back her. Although the newspapers do help, to take on single-

handed, to contest the Reserve Bank, the Planning Commission, the Institute of Economic Growth, ICRIER, you name it – there are half a dozen of these – is very commendable.

M. Govinda Rao

I would like to thank the India International Centre as well as Mythili Bhusnurmath for giving me this opportunity to read the Mid-Year Review of Indian Economy, which Mythili has written this year. I must compliment the author for providing a comprehensive view and identifying very important challenges to the Indian economy, both in the short and medium-term. Unlike others, Mythili believes that she is crystal gazing, but before I do the same, let me also inform Dr. Mozoomdar that some of us who are heads of institutions do not necessarily depend upon institutional support to write mid-year reviews. We don't even involve research assistants, as this sort of work requires our own crystal gazing. In fact, we should ask Mythili to do more and more crystal gazing as she has been quite successful in doing that.

The entire issue of economists talking about growth rates reminds me of Albert Breton's statement, 'Political scientists who know better, have in their more generous moments treated economists as poor souls with a model in hand in need of an application.' In providing forecasts, economists possibly beat astrologers! But to return to the question: Mythili rightly recognizes the fact that fiscal expansion and rise in deficit is not a consequence of the global economic crisis. We have been stating all along that the sharp increase in fiscal deficit in 2008-09 was not due to the global economic crisis, which actually took place much later in the year, but by the expansion that was planned in the budget of 2008-09 itself. But she rightly attributes the massive fiscal expansion that took place due to the following four reasons: loan waivers, pay revision, expansion in the scope of national rural employment guarantee act, and subsidies. Whatever be the reason, the important point that she makes is that it helped the country to soft land in the period of crisis. For that matter, even election expenses did help in soft landing the economy.

After an interesting overview, Mythili discusses the developments in agriculture, manufacturing and services, and external sectors, and identifies challenges. Overall, I agree with much of her diagnosis and also the identification of challenges, but I would like to supplement her analysis. There are also some differences in the emphasis. This does not mean that we are in disagreement. She is of course overly optimistic, whereas I am not very certain whether there is quite so much room for optimism. On the issue of the sharp revival of the Indian economy, there cannot be any disagreement. It is also important that we immediately return to the path of fiscal consolidation.

Dr. Sudipto Mundle, Bhanumurty and I have recently written a paper at the request of the Ministry of Finance on the strategy for exiting from the stimulus in the context of G-20 countries. Obviously, those are countries that have revived faster, those that have an inflation threat hanging on the horizon, those with a large deficit and debt ratio to GDP, or those countries that have to immediately return to the fiscal consolidation path. India is the prime example of that. And, to be sure, we need to return to the fiscal consolidation path sooner than later. Appropriately, the budget for this year does signal a return to fiscal consolidation. The 13th Finance Commission has recommended the fiscal consolidation plan, and we will have to see how this can be done. It was easy in the first year but the future is much more difficult because there are no low-hanging fruits any more. A lot of adjustment will have to be done on the expenditure side.

Global economic recovery is still fragile. There are problems with reserve currency. Mythili has identified them, but then there are serious issues of global imbalances and they have not been addressed adequately. Two major issues continue to dominate. One is that China continues to follow the mercantilist policy and second, the U.S., apart from the recent quantitative easing amounting to \$ 600 billion, is also resorting to protectionist policies. In spite of G20 trying to guard against this, matters are not going to be easy. There are lots of protectionist noises that are being made and one has to take note of this. It is important

to realize that both of these issues will have implications for India in both short and medium term.

In some places Mythili is very optimistic. She states that the exchange rate does not impact export growth on the basis of the figures for September. I believe that is an optimistic assessment for we really do not have a counterfactual. Obviously, to make an observation on the basis of one month would be too sweeping. In my view, it is necessary to keep a close watch on the current account. I say this because policy prescriptions depend on this assessment. In particular, in my view, the RBI will have to take measures to sterilize the sharp increases in the inflow of foreign institutional investment to keep the exchange rates competitive.

Here, let me refer to the challenges that Mythili has identified. In the short term, she advocates reigning in inflation, managing capital flows and restoring fiscal health while making a calibrated exit from the expansionary fiscal stance. However, I believe that the entire exit strategy from expansionary fiscal stance is not just a short-term problem; in fact, it is much more a medium-term problem because in the short term and at least this year, thanks to the 3G auction proceeds, we will manage to contain the fiscal deficit at the budgeted level. With all one-time options exhausted, the low-hanging fruits have been reaped. As we go further, we will have problems in adhering to the fiscal targets set by the Finance Commission and we will identify some of them.

As regards, the medium-term deficit in physical and social infrastructure, it is much more in social sectors and it is not just the amount of spending but the need to liberalize the social sector from the licence-permit raj, particularly in the education sector that is important. And, of course, the movement of people from agriculture and improvement of the tax regime are important issues identified in the Mid-Year Review.

However, I believe that one of the most important issues we need to underline, whether we call that within the purview of economics or not, is governance. The governance deficit is the most challenging issue that needs to be overcome. Unless and until governance deficit through changes in both policies and

institutions is overcome, services cannot be delivered. How long can people suffer the frustration that takes place as they have to run from pillar to post get their services? So while we may not be able to say anything specifically in the review, it is important to identify the issue of governance reform. I would like to flag that because many other reforms will automatically follow if you have governance reforms in place.

Let me now come to some of the other challenges identified in the mid-year review. On infrastructure, the focus appears to be on Roads and Power. Nevertheless, there are equally serious infrastructure issues that merit attention such as urban infrastructure. If you really want the urban areas to be the growth centres for this country, as they are the ones that drive growth and generate employment, you need to address this. Water bodies are badly polluted because of untreated sewerage let out by urban agglomerations and we cannot afford to go on avoiding this issue.

Also, it is useful to talk about transport infrastructure rather than merely focussing on roads. Railways have been completely neglected and I think in a large country such as this they have to provide trunk transportation. I think railways have been so heavily politicized that perhaps the first step is to improve governance by corporatizing them. Unfortunately, successive railway ministers have mismanaged the sector, and immediate action to strengthen the sector is imperative if we have to sustain high growth rates.

As regards the power sector, Mythili has indicated some reforms, and Pronab Sen will perhaps speak more on this issue. However, I'm doubtful about how much can actually be achieved because this falls under the purview of the state sector and nothing of significance has happened in the distribution sector. Unless reforms are enforced in the distribution system, we are likely to be dealing with bankrupt state electricity boards, which will eventually burden the states' exchequer.

It is relatively easy to talk about Public Private Partnerships (PPP), which is still an unexplored area in many sectors. Regulatory systems will have to be in place and, here, let me stick my neck out by saying that, generally speaking, the

regulatory system in this country is extremely weak. Invariably, even when there are regulators in place, there is a bureaucratic capture of the regulatory system in every sphere and so long as this state of affairs continues, there is no hope of effectively dealing with the problem of asymmetric information, which the regulatory system is supposed to resolve. We need to have trained professionals as regulators, without which the regulatory system is not likely to be effective.

To return to fiscal consolidation, I would like to underline that there are no more low-hanging fruits as all one-off opportunities have been harvested. I would expect this year's consolidated deficit of Centre and states to be close to 8 per cent, slightly lower than the budgeted estimate of about 8.5 per cent, with the Centre's budgeted fiscal deficit at 5.5 per cent and the states' at 2.9 per cent. The better collection from telecom auctions is likely to lower the deficit over the budget estimate. If we wish to follow the fiscal adjustment path recommended by the Finance Commission, by 2014-15 the consolidated fiscal deficit aggregate will have to be reduced by about 2.6 percentage points to reach the target of 5.4 per cent. If we wish to add to that additional liability on account of food security, education and healthcare, we need an additional 3-4 per cent of GDP, which implies the adjustment required until 2014-15 is more than 6 per cent of GDP. The Finance Commission has recommended that one per cent more should be raised from disinvestment. Furthermore, as far as the Centre is concerned, capital expenditures will have to increase from 2.1 per cent this year to 5 per cent by the year of the recommendation, which implies that the Centre will have to generate a revenue surplus of 2 per cent of GDP from the prevailing revenue deficit of more than 4 per cent of GDP. With elections being held in some part of the country or other every year, I am doubtful about the actual extent of the adjustment that can be done.

Can the tax reforms generate increases in revenues to achieve the fiscal targets? In fact, in 2003, thanks to the tax information network and National Security Depository Ltd. (NSDL) doing a good job of setting up the tax information network (TIN), there was a 3 percentage point to GDP increase in tax revenue

between 2003-04 and 2007-08. This should be attributed to not merely the high growth rate of non-agricultural GDP, but also to better tax compliance. Tax compliance is a function of the rate of tax, the probability of detection and the penalty rate and, as the TIN increased the probability of detection significantly, tax compliance increased to enhance revenue productivity.

There is a minor error in the debt-GDP ratio reported in the mid-year review. India's debt-GDP ratio is close to 80 per cent, well above the World Bank's 64 per cent, to which Mythili refers. Of course, the finance ministry is reworking that and will publish a white paper on the debt according to which it will be around 72-73 per cent. Whatever be the numbers, the point is that the figures are not below but much higher than the safe limit and, therefore, it is a cause for concern.

Finally, there has been a lot of discussion on the goods and services tax (GST) reform as a game changer. I beg to disagree. While this is undoubtedly an important reform, it is not going to be a game changer. In fact, it was the introduction of Value Added Tax (VAT) in 2005 that was the most important reform. The NCAER has estimated that the introduction of GST will bring about significant productivity gains, but this is exaggerated. As they used the input-output table of 2003, the productivity gains estimated includes the gains from the introduction of VAT, which was imposed in 2005-06. There are other important reasons for productivity gains since 2003-04 and to take everything as owing to GST is clearly an exaggeration. This prediction doesn't capture whatever productivity changes have taken place. The point is while GST is an important reform, it is not going to solve all our fiscal problems.

I am writing a paper for the *Economic and Political Weekly* that will be published in December. A model GST essentially implies that there should be minimum exemptions, has to have only one rate, the rate has to be low and it has to be uniform across the states. A desirable tax reform should minimize 3 costs: the cost of collection, compliance cost, and cost in terms of the distortions it creates. When tax reform is calibrated in a federal system, it has to be a compromise between tax

uniformity and fiscal autonomy. To claim that the states would have expenditure autonomy even if they sacrifice tax autonomy as the Finance Commission has stated is to violate the principle of fiscal federalism. At the same time, tax reform is not an event – it is a process. Therefore, it is unreasonable for the Finance Commission to offer a budget of ₹ 50,000 crores as compensation with the rider that if the model GSD is not followed the funds will not be made available. There is no scope for a ‘grand bargain’ when such a corner solution is recommended. That is the Cornell solution. Does the Finance Commission imply that we can live without reform? If the Finance Commission believes that there is no scope for reform, that does not augur well for the future.

In any case, with the reform agenda pushed back, there is no likelihood of it being implemented from April 2011. The only silver lining in the reform process is that the Empowered Committee has chosen the technology partner. It has been decided by the Empowered Committee as well as the Union Finance Ministry that the technology will be incubated in the NSDL and when the technology is ready for use, a special purpose vehicle will be created with the central and state governments holding the majority stake and the technology partner being a minority shareholder. While this is an important development, it is necessary to note that the technology has to be absorbed by both the tax payer and the tax collector, which is not going to be easy. There will be hiccups, but that is going to be a major challenge.

In conclusion: governance, infrastructure, fiscal adjustment and institutional reforms are going to be the major challenges that will have to be met in the medium term.

Pronab Sen

Ladies and gentlemen, I am not sure I have fully recovered from the Diwali festivities and so if I sound a bit incoherent I am sure you will forgive me, or at least understand where it is coming from!

May I begin by complimenting Mythili for an incredibly well done job in what is a very difficult situation? I share Govind's view that she is an optimist and perhaps that is why they chose a journalist and not an economist. We, on the other hand, would have been pessimistic. Let me be very clear on this – it is a good choice. The mid-year review of the economy should uplift. It would be terrible if we came away depressed. But, then, as somebody who is required to comment on this, I think it is incumbent on me to throw a bit of cold water on the proceedings.

Let me begin by stating at the outset what my primary disappointment is with this paper. The disappointment is that it fails to bring out clearly the kind of extraordinary circumstances that the world and we have gone through, not just in the last year but in the previous year as well. All such reviews are necessarily based on comparisons of what has happened in the past. Moreover, that is the only way it can be assessed – and rightly so – but if the past is unusual, then I think it requires much more reflection. This is not only about last year, because the unique nature of the circumstances actually begins a year before that.

The high global inflation observed in the year previous to last year, and its consequent repercussions on a lot of the system, affects the pace of this whole exercise, which is the manner in which the first half of last year works. And I think, in a sense, the paper misses that. Mythili mentions 'base effects' several times, but it must be emphasized that the previous base also affects base effects, because it is being assessed in growth terms, thus causing innumerable problems.

The second serious criticism is that there were two major events that occurred last year, which have a bearing on how we assess what is happening this year. The first event, of course,

was the global crisis and that, as we well know, originated in the financial sector where it stayed and then spread to everything else. The second event was a drought. These two major events in the country were very disruptive. Mythili has covered more than adequately the impact of the drought, but I really failed to find any analysis of the financial sector at all. I don't believe it is possible to do a mid-year review of the economy for this particular year without an assessment of the financial sector, not just in India but elsewhere as well.

That forms the crux of my criticism. To give you an example of the kind of areas that I would have liked to see covered: we do know, for instance, that the year-before-last trade credit obtained from abroad totalled about US\$28 billion. Last year it fell sharply: in fact, it practically vanished and much of our export problems were related to that. But something happened fairly shortly after that, although, if you look at the trade credit figures today, external trade credit is still very small. There is something that the Indian banking sector has done which is quite remarkable – I would like to know what it is. Having had this function for the last year or so, will we return to what we did earlier, which is shift our trade credit demand to external sources, or would we have learnt a lesson? I believe it is critical for any prognosis of the future.

Let me now turn towards a few more technical subjects in the paper, as it were. You talked about the volatility in the index of industrial production, and that is perfectly true. There is high volatility, but this volatility has always existed. What has made an impact is the way the drivers of the economy have changed over this past year. Earlier it was consumption, which was a major driver. In this last year it has been investment, which has been a primary driver, followed by one component of consumption, which is in effect the durables. These two elements of the IIP have been always volatile. But they occupied less mind space and a lower amount of weight in what was happening in the IIP. However, this year it has changed.

Now, why do these two particular sectors cause us this kind of volatility? Capital goods are very understandable because the first thing we need to realize is that the index of

industrial production does not actually measure industrial production itself. What it does actually measure is industrial despatches. What we measure is what goes out of the factory gate, not what is produced. As the average production time of a capital good is usually 2-3 months, what usually happens is that there is a huge bunching that takes place. So for 3 months you will find there is zero production because there are zero despatches. They are all busy manufacturing the stuff that is going to go out 3 months later and it is shown as one shot. And that cycle repeats itself. So this volatility is natural.

The volatility in consumer durables is slightly different in nature. That depends on the spending habits of Indian households, which have, historically, shown very high volatility. But if we examine what has happened in first half of this year, consumer durables have actually shown steady high growth. On the other hand, the really stable component of the IIP, which is consumer non-durables, has shown very low growth. This is unusual and I am not sure I have the answer; but I do suspect that in finding that answer, and if we can find a good story to tell, it will have serious implications on the future trajectory of the Indian economy. What has happened over the last year, or perhaps 2 years, is that there has been a shake-up in the way Indian households think. This is something that we need to understand. Unfortunately, we do not have enough consumer research in this country to give us any decent feel for what is going on.

That brings me then to this whole issue of what is happening in rural areas. We do know that agriculture is important and with the poor rains last year there was a serious problem with agricultural incomes. But, again, that is an issue of data and the manner in which we interpret data. It is perfectly correct that if you go by the NSS, or even by the census kind of measurement of where people are employed, agriculture emerges with a very disproportionate share of employment in the country. But that really is a measure of how people see themselves in terms of their occupation. It is not, and I repeat it is not, a measure of where their livelihood is coming from. The evidence is that there has been a huge diversification in livelihoods in rural

areas. And for the average rural household, a much larger share of their income comes from agricultural occupations. So if we are to consider household behaviour, I believe agriculture now plays a much less significant role. It is still very important, but is diminishing year by year.

That being the case, why do people record themselves as working on farms? This may be attributed to reasons of status. In rural India, land is important. To be doing what is essentially manual services of all kinds – and this is where you are wrong, as there is a very large component of services in rural livelihoods – is seen to be socially demeaning. We have had this problem earlier, for instance, in the animal husbandry sector where, when we did the NSS exercise, we found to our surprise that whereas the average return to agriculture was ₹ 6000 a month, the average return to animal husbandry was ₹ 1,20,000. Nobody could believe these numbers and the reason was very simple – because those involved with animal husbandry, which in the Indian context was treated as a low-caste occupation, were not reported. Therefore, there was a serious problem with the denominator. The numerator was correct – you had measured the output very well – but the denominator was totally inaccurate. Now these kinds of problems do exist in the manner in which we classify matters, and we need to be cautious about what we say about them.

Let me now move to the issue of the external sector because that again is a key to what we have been saying. First of all, there was the question and the concern that was being expressed about the fact that there has been a huge surge in foreign portfolio investments into India. But it is a concern that is really contextual; it cannot be acontextual. At a time when there are a large number of primary issues coming up in the market, FII is good and it is no worse than FDI. The problem occurs when portfolio investments come in without the benefits of that being taken through primary issues. So it simply goes and creates a bubble in the secondary market. One of the problems that we have had is a lack of primary issues. So the question that we need to ask ourselves is: why is it that in the first half of this year in which (Mythili, as you have

rightly said) the Indian economy has done phenomenally well, that nobody has come up with a primary issue. Why are they sitting on their hands? That should give us a clue as to what is happening. The reason is because nobody is planning green field investments. Which means that, going forward, we will face serious problems because once the projects on hand are finished then the process of planning must begin. We could lose 6 months to a year in that process and that is what worries me. But that is the problem with economists – we worry! We find reasons to worry, and this is my principal reason: that the only primary issues that are coming to the market now are public sector. And this does not bode well for the future.

Having said that, let us now address the issue of rupee appreciation. I agree that there exists a genuine problem with the appreciation of the rupee and this FII inflow in the absence of adequate primary issues to take advantage does exacerbate the situation. However, I believe we also need to be very clear that there is a difference between rupee appreciation and dollar depreciation. And that again is reflected by what is happening to the real exchange rate vis-à-vis the bilateral exchange rate to the dollar. This difference is critical because it is essentially signalling the sort of causes that are causing financial flows to change. Second, it is also affected differently by the QE2 that is being proposed by the U.S. So the way it will actually work on us is going to be very different. Therefore, if we have the QE2 and the dollar depreciates vis-à-vis everybody else, that effect is completely different as compared to when the rupee actually appreciates in the classical sense.

Finally, one last word on this question of food – inflation, in general, and food inflation in particular. I think we need to move away from this mindset that agricultural inflation is supply- driven. Yes, there is a supply dimension; that is true in any form of commodity so that, ultimately, you have to ask the question as to what is leading what. The fact is food inflation in India today is primarily demand-driven. An examination of the food price data yields surprising results. Which is, prior to 2003-04, food inflation in India could be correlated one-on-one with rainfall patterns. Since 2003-04, there is no correlation

whatsoever of any kind. What it is correlated with is the fact that the Indian economy has suddenly gathered speed. We accelerated the 4.55 per cent that we had done for 5 years prior to 2003-04. Therefore, there was this huge change in consumption behaviour, particularly towards the kind of food products that you have shown, and this is a consequence – not a cause – but a consequence of high growth. And it is a situation that is likely to continue. So it is in fact demand-driven. The question is: do we want to do anything about that demand? The RBI can, to my mind, affect this food inflation through monetary policies. The point is: should it be done? And that is a question that needs to be answered through clear thinking. We haven't thought about it because we still continue to say that this is supply-driven. So let us change the way we view the economy because we are very different today compared to 20 years ago.



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