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General Review

Review of developments

(a) Macroeconomic overview

The economy appears to be in a resilient mode in terms of growth, inflation, and balance of payments, a combination that offers large scope for consolidation of the growth momentum with continued macroeconomic stability. Real Gross Domestic Product (GDP) is estimated to have grown by 8.1 per cent* in 2003-04, buoyed by a strong agricultural recovery of 9.1 per cent from the drought-affected previous year. A growth rate higher than 8 per cent has been achieved in the past in only three years: 1967-68 (8.1 per cent), 1975-76 (9.0 per cent) and 1988-89 (10.5 per cent). However, the higher than expected growth in 2003-04, like in the other three years referred to above, was on the back of a year of poor growth (4.0 per cent) due to an unfavourable monsoon and fall in agricultural production. The key macro aggregates are in Table 1.1 and Figure 1.1.

1.2 Apart from agriculture, the industry and services sectors also maintained the momentum with GDP growth from these two sectors accelerating from 6.4 per cent and 7.1 per cent, respectively, in 2002-03, to 6.5 per cent and 8.4 per cent, respectively, in 2003-04 (Table 1.2). A broad-based acceleration in growth from the second to the third quarter of 2003-04 was also observed in mining and quarrying; electricity, gas and water supply; trade, hotels, transportation and communication; and financing, insurance, real estate, and business services.

1.3 The quarterly GDP data released by the CSO indicate GDP growth rates at 5.7 per cent, 8.4 per cent, and 10.4 per cent respectively in the first three quarters of 2003-04. The GDP growth rate of 10.4 per cent in the 3rd quarter of 2003-04 was the highest in any quarter since at least 1997-98, when CSO started compiling quarterly estimates, and was supported by a growth of 16.9 per cent in agriculture, forestry and fishing, 6.5 per cent in industry and 9.0 per cent in the services sectors.

1.4 A benign world economic environment provided a conducive backdrop to the robust performance of the Indian economy in 2003-04. World output growth is estimated to have accelerated from 3.0 per cent in 2002 to 3.9 per cent in 2003. Strong performance by the US, China, and Russia, and a strong turnaround in Japan helped to brighten the world economic outlook in 2003. Volume of world trade in goods and services also grew rapidly by 4.5 per cent, compared to only 3.1 per cent in the previous year. The robust performance of India and the emerging market economies also contributed to the good performance of the world economy.

1.5 The Meteorological Department has predicted normal rainfall – 100 per cent of long period average – for the current year. The pre-monsoon rainfall (March 1 to end-May, 2004), which has been estimated at 25 per cent above normal, augurs well for the kharif sowing. Industry, which normally responds to a good agricultural year, is expected to do well, along with the services sector, which has been buoyant since 2001-02. Institutional projections of GDP growth for 2004-05 vary from 6.0 to 7.4 per cent.

* GDP for 2003-04 (Rs.27,55,034 crore at current market prices) as well as its growth rate of 8.1 per cent (at factor cost at constant prices) are based on the Advance Estimates released by the CSO on February 9, 2004. As the Survey was going to print, CSO released the Revised Estimates for 2003-04. According to the Revised Estimates, GDP at current market prices for 2003-04 is Rs.27,72,194 crore, and the growth of GDP at factor cost at constant prices is 8.2 per cent.

Table 1.1 : Key indicators

Items	2000-01	2001-02	2002-03	2003-04	2000-01	2001-02	2002-03	2003-04
	Absolute values				percentage change over previous period			
Gross national product (at factor cost) (Rs.thousand crore)								
At current prices	1885.7	2078.9	2230.3 Q	2497.7 A	8.0	10.2	7.3 Q	12.0 A
At 1993-94 prices	1187.0	1259.8	1306.8 Q	1413.0 A	4.4	6.1	3.7 Q	8.1 A
Gross domestic product (at factor cost) (Rs. thousand crore)								
At current prices	1903.0	2091.0	2249.5 Q	2516.9 A	8.0	9.9	7.6 Q	11.9 A
At 1993-94 prices	1198.6	1267.8	1318.3 Q	1424.5 A	4.4	5.8	4.0 Q	8.1 A
Agriculture and allied sectors (Rs. thousand crore) (at 1993-94 prices)	286.7	305.3	289.4 Q	315.8 A	-0.1	6.5	-5.2 Q	9.1 A
Index of agricultural production(1)	165.7	178.3	150.5 P	179.6 P	-6.3	7.6	-15.6 P	19.3 P
Foodgrains production (million tonnes)	196.8	212.9	174.2 P	210.8 P	-6.2	8.2	-18.2 P	21.0 P
Index of industrial production(2)	162.6	167.0	176.6	188.7	5.0	2.7	5.7	6.9
Electricity generated (in billion kwh)	498.5	515.3	534.0	558.1	3.9	3.1	3.6	4.5
Wholesale price index(3)	159.2	161.8	172.3	180.3	5.5	1.6	6.5	4.6
Consumer price index for industrial workers(4)	445	468	487	504	2.5	5.2	4.1	3.5
Money supply (M3)(5) (Rs. thousand crore)	1,313.2	1,498.4	1719. 2	2000.3	16.8	14.1	14.7	16.4
Imports at current prices								
(in Rs. crore)	2,30,873	2,45,200	2,97,206	3,46,474	7.3	6.2	21.2	16.6
(in US $ million)	50,536	51,413	61,412	75,400	1.7	1.7	19.4	22.8
Exports at current prices								
(in Rs. crore)	2,03,571	2,09,018	2,55,137	2,83,604	27.6	2.7	22.1	11.2
(in US $ million)	44,560	43,827	52,719	61,718	21.0	-1.6	20.3	17.1
Foreign currency assets (6)								
(in Rs. crore)	1,84,482	2,49,118	3,41,476	4,66,215	20.6	35.0	37.1	36.5
(in US $ million)	39,554	510,49	71,890	1,07,448	12.8	29.1	40.8	49.5
Exchange rate (Re./US $) (7)	45.68	47.69	48.40	45.95	-5.1	-4.2	-1.47	5.33

Note : Gross national product and Gross domestic product figures are at factor cost (new series base 1993-94).
Q-Quick estimates; A-Advance estimates; P-Provisional;

1. **Index of agricultural production (of 46 crops, including plantations) with base triennium ending 1981-82=100 (revised).**
2. **Index of industrial production; (base 1993-94=100).**
3. **Index (with base 1993-94=100) at the end of fiscal year.**
4. **Index (with base 1982=100) at the end of fiscal year.**
5. **Outstanding at the end of financial year.**
6. **Outstanding at the end of financial year.**
7. **Percent change indicates the rate of appreciation (+)/depreciation (-) of the Rupee vis-á-vis the US Dollar.**

Table 1.2 : Sectoral real growth rates in GDP (at factor cost)

Item	Percentage change over the previous year							
	1996-97	1997-98	1998-99	1999-2000	2000-2001	2001-2002 (P)	2002-2003 (Q)	2003-2004 (A)
I. Agriculture & allied	**9.6**	**-2.4**	**6.2**	**0.3**	**-0.1**	**6.5**	**-5.2**	**9.1**
II. Industry	**7.1**	**4.3**	**3.7**	**4.8**	**6.5**	**3.4**	**6.4**	**6.5**
1. Mining & quarrying	0.5	9.8	2.8	3.3	2.4	2.2	8.8	4.0
2 Manufacturing	9.7	1.5	2.7	4.0	7.4	3.6	6.2	7.1
3. Electricity, gas & water supply	5.4	7.9	7.0	5.2	4.3	3.6	3.8	5.4
4. Construction	2.1	10.2	6.2	8.0	6.7	3.1	7.3	6.0
III. Services	**7.2**	**9.8**	**8.4**	**10.1**	**5.5**	**6.8**	**7.1**	**8.4**
5. Trade, hotels, transport & communications	7.8	7.8	7.7	8.5	6.8	8.7	7.0	10.9
6. Financial services	7.0	11.6	7.4	10.6	3.5	4.5	8.8	6.4
7. Community, social & personal services	6.3	11.7	10.4	12.2	5.2	5.6	5.8	5.9
IV. Total GDP at factor cost	**7.8**	**4.8**	**6.5**	**6.1**	**4.4**	**5.8**	**4.0**	**8.1**

A : Advance estimates; Q : Quick estimates; P: Provisional estimates

Source : Central Statistical Organisation.

1.6 The growth recovery in 2003-04 was accompanied by continued maintenance of relative stability of prices. Inflation, as measured by the wholesale price index (WPI), was 4.6 per cent at end-March 2004 over end-March 2003, and 5.5 per cent on average. The manufacturing sector was the major contributor accounting for nearly 80 per cent of the inflation. Within the manufacturing sector, the prime movers were sugar, edible oils, textiles, leather and leather products, basic metal and alloys and iron and steel.

1.7 A firming of energy and primary product prices had resulted in the inflation rate crossing 6 per cent in January 2004. However, the inflation rate softened considerably during March 2004. The high point-to-point inflation through much of 2003-04 and its sharp deceleration in March 2004 were partly because of the carry over of the price increase that took place in the last quarter of 2002-03, especially in March 2003. Retail price inflation, as measured by the Consumer Price Index for Industrial Workers (CPI-IW), touched a peak of 5.1 per cent in April 2003 followed by a declining trend and reached 3.5 per cent in March 2004. CPI inflation declined further to 2.2 per cent in April 2004, compared to 5.1 per cent in April 2003, and abundant food grain stocks helped in maintaining stability in food prices.

1.8 The point-to-point inflation (WPI) was 5.5 per cent in the week ending June 5, 2004. The Reserve Bank of India (RBI), in its Annual Policy Statement for 2004-05, has placed the inflation rate, on a point to point basis, at around 5 per cent in 2004-05. After a long delay, prices of motor spirit, high speed diesel and LPG were revised upwards on June 15, 2004. The high international price of petroleum crude – for example, at around US$36 per barrel (Brent crude) on June 11, 2004 – and the necessary revision of prices of LPG and kerosene as well as motor spirit and high speed diesel in line with market developments would exert upward pressure.

1.9 The weakening of the US dollar, caused mainly by widening US deficits, has affected the rupee-dollar exchange rate. The Indian rupee, which started strengthening from June 2002 onwards, had appreciated, on a monthly average basis, by 8.8 per cent against the US dollar by March 2004. On annual average basis, the rupee, after depreciating by 1.5 per cent in 2002-03, appreciated by 5.3 per cent in 2003-04 vis-à-vis the US dollar. The movements in the rupee value were smooth and orderly, avoiding undue adjustment costs. Furthermore, while the rupee appreciated against the US dollar in 2003-04, it depreciated against the currencies of major non-dollar trading partners. Given the inflation differential, the appreciation has been less pronounced in trade weighted effective terms, with the Real Effective Exchange Rate (REER) of the rupee (5-country index with base 1993-94) appreciating by around 2 per cent on an annual basis in 2003-04.

1.10 A strong balance of payments (BOP) position in recent years has resulted in a steady accumulation of foreign exchange reserves. After a robust growth of US$21.3 billion in 2002-03, foreign exchange reserves (including gold, SDRs and Reserve position in IMF), increased by an unprecedented US$36.9 billion in 2003-04. The level of reserves crossed the US$100 billion mark on December 19, 2004 and stood at US$119.3 billion as of May 31, 2004. This accretion to reserves is attributed not only to capital inflows and current account surplus, but also to valuation gains arising from a steady appreciation of the major non-US dollar global currencies (the Euro and the Pound Sterling in particular) against the US dollar.

1.11 The focus of the monetary policy in 2003-04 was, thus, on dealing with this surge in reserves. The RBI had to moderate the impact of these inflows (Rs. 124,169 crore in domestic currency terms) through open market sale of Government securities and repo operations through the Liquidity Adjustment Facility. Moreover, outward foreign investment policies were liberalized and interest spreads over LIBOR on various non-resident deposit schemes were reduced.

1.12 The current account of BOP has been in surplus since 2001-02. Fuelled by strong growth in imports, reflecting an upsurge in economic activity, the current account balance – in surplus for previous six successive quarters – turned into deficit in the first quarter of 2003-04. But the trend was quickly reversed in the subsequent months, with the current account posting a surplus of US$3.2 billion in the first nine months of 2003-04. While the trade deficit increased from US$12.9 billion in the whole of 2002-03 to US$15.0 billion in April-December 2003, the deficit was neutralized by a higher surplus in the 'invisibles' in April-December 2003. Buoyant inflows of private transfers and higher inflows from software services exports, *inter alia*, contributed to this buoyancy in invisibles surplus. Growth momentum of merchandise exports was also broadly sustained with exports (in US dollar value, custom basis) growing by 17.1 per cent in 2003-04 on top of a rise of 20.3 per cent in 2002-03. The growth in merchandise imports was even faster, from 19.4 per cent in 2002-03 to 22.8 per cent in 2003-04.

1.13 The main contributors to capital account surplus, which increased from US$11.0 billion in 2001-02 to US$12.8 billion in 2002-03, were the banking capital inflows, foreign investment and 'other capital' inflows. Similarly, surplus in 2003-04 (April-December) was the result of the continuing steady growth in non-debt creating inflows, with external assistance recording net outflows due to prepayment of external debt. Outflows under external commercial borrowings were also higher because of redemption of India Resurgent Bonds in October 2003. The surge in foreign investment inflows (net), estimated at US$10.1 billion in April-December 2003, was mainly attributable to a sharp rise in foreign institutional investors' (FII) investment inflows. FII investment witnessed a sharp recovery from US$0.3 billion in 2002-03 to US$7.2 billion in April-December 2003. According to SEBI, FII investment in full year 2003-04 amounted to US$10 billion, two thirds of which occurred in the second half of the year. The inflows acquire significance in view of the cumulative FII investment in India since 1992, which stand at around US$27 billion.

1.14 Reserve money growth nearly doubled from 9.2 per cent in 2002-03 to 18.3 per cent in 2003-04, driven entirely by the increase in the net foreign exchange assets of the RBI. Reserve money growth in 2003-04 was the highest in recent years. Net RBI credit to the government continued to remain negative, owing to the open market sale of government securities to sterilise the foreign inflows. The declining stock of government securities held by the RBI somewhat constrained the scope of these operations. Broad money (M_3) grew by 16.4 per cent in 2003-04, higher than the targeted growth of 14.0 per cent mentioned in the annual monetary and credit policy, reflecting, primarily, the higher-than-anticipated GDP growth achieved during the year.

1.15 The money multiplier – the ratio of M_3 to reserve money – after increasing from 4.43 in 2001-02 to 4.66 in 2002-03, declined to 4.58 in 2003-04, suggesting some headroom for further expansion in M_3. The virtuous decline in income velocity of money – the ratio of gross domestic product at current market prices to the average money stock during the year – continued in 2003-04. Income velocity declined from 1.62 in 2001-02 to 1.50 in 2002-03 and further to 1.48 in 2003-04, indicating greater 'monetisation' of the Indian economy, with less of barter and more and more of M_3 being used for transactions in generating a unit of income.

1.16 Adequate liquidity in the banking system continued, and with a resurgence of growth, supported a credit pick up in 2003-04. Total bank credit (food and non-food) increased by 14.6 per cent in 2003-04 after an increase of 16.1 per cent in the previous year. Food credit, which after accelerating in 1999-2000 and 2000-01 had declined by 8.3 per cent in the 2002-03, fell by a steep 27.3 per cent in 2003-04 because of lower procurement and higher off-take of foodgrains. The flow of non-food credit, which remained subdued in the first two quarters, started picking up from the third quarter of 2003-04. Offtake of non-food credit in the last two quarters of 2003-04 amounted to Rs.1,01,407 crore, much higher than Rs.71,980 crore in the corresponding quarters of the previous year. For the year as a whole, non-food credit grew by 17.6 per cent, compared to a growth of 18.6 per cent (net of merger) in 2002-03.

1.17 In 2003-04, the total flow of agricultural credit from all lending institutions is estimated at around Rs.80,000 crore. The number of Kisan Credit Cards (KCC) increased from 6.1 lakh at the end of March 1999 to 413.79 lakh at the end of March 2004. To strengthen credit delivery to rural areas, a pilot project of linking self help groups (SHGs) of the rural poor with the banking system was launched in 1992. A unique feature of this programme is the absence of subsidies. By March 2004, 10.8 lakh SHGs were linked with banks, with 90 per cent of these formed exclusively by women. Cumulative assistance extended by over 30,000 branches of 504 banks that participated in the programme amounted to Rs.3,905 crore by March 31, 2004. In the year 2003-04, 3.62 lakh new SHGs were extended loans by banks as compared with 2.56 lakh new SHGs in 2002-03.

1.18 The downward trend in interest rates continued in 2003-04. RBI reduced the Bank Rate from 6.25 per cent to 6.00 per cent from the close of business on April 29, 2003. Also, the cash reserve ratio (CRR) was reduced by 25 basis points to 4.50 per cent in June, 2003. Lending rates have remained sticky and have not fallen by as much as the deposit rates. As a result, interest spread of commercial banks witnessed an increase in recent years. The RBI has advised scheduled commercial banks (SCBs) to announce benchmark prime lending rates based on their actual costs, and this has fortified the soft interest rate regime. A significant development in 2003-04 was the lower than budgeted market borrowings by the Central government, which was facilitated by an improvement in the cash position. During the year 2003-04, SCBs improved their profitability on account of higher income from treasury operations and higher spread.

1.19 Banks' recovery management improved considerably with corporate debt restructuring; recovery through Lok Adalats, Civil Courts, Debt Recovery Tribunals and compromise settlements; and the enactment of Securitisation and Reconstruction of Financial assets and Enforcement of Security Interest (SARFAESI) Act, 2002. Gross NPAs declined from Rs.70,861 crore in 2001-02 to Rs.68,715 crore in 2002-03, while net NPAs declined from Rs.35,554 crore to Rs.32,764 crore. The ratio of gross NPAs to gross advances for all SCBs declined from 12.7 per cent in 1999-00 to 8.8 per cent in 2002-03.

1.20 At the end of March 2003, capital to risk weighted assets ratio (CRAR) for public sector banks (PSBs) stood at 12.6 per cent, higher than the level of 11.8 per cent at the end of March, 2002. All the PSBs had CRAR above the stipulated minimum of 9 per cent in 2002-03. Of the 27 PSBs, as many as 26 banks had CRAR exceeding 10 per cent.

1.21 The spot yield curve on government securities steepened while yields declined at both ends. The short rate (91 days) dropped from 5.63 per cent in end-March 2003 to 4.72 per cent in end-March 2004. The long rate (10 years) dropped from 6.52 per cent to 5.44 per cent during the same period. Given 4.5 per cent inflation, this translates to a real rate of return of roughly 20 basis points at the short end and roughly 90 basis points at the long end.

1.22 Equity market return was 85 per cent in 2003-04, the second highest in Asia. With good corporate earnings in 2003-04, the Sensex crossed 6,194 on January 2004, after remaining low in the first half of 2003-04. There was a revival in primary market in 2003-04 with Rs. 23,271 crore raised as against Rs. 4,070 crore in the previous year. The secondary market rally and primary market revival were both helped by FII inflows. Market capitalisation of listed companies rose from Rs.7.2 trillion in 2002-03 to Rs.13.8 trillion in 2003-04 (49 per cent of GDP). Spot market trading volume rose sharply, from Rs.9.3 trillion in 2002-03 to Rs.16 trillion in 2003-04.

1.23 Stock market volatility in 2003-04 was already high compared to other Asian countries. After heavy net FII inflows of US$1.48 billion in April 2004, there was a net FII outflow of US$0.8 billion in May 2004. This reflected a broad-based outflow of FII money from emerging markets, spurred by hardening of interest rates in the US, a Chinese slowdown and further oil price increases. Moving beyond the recent elections to the Lok Sabha, on Friday, May 14, Nifty fell 7.8 per cent. On Monday, May 17, when the market reopened, the index fell 10 per cent, triggering a one-hour trading suspension. On resumption of trading, the index fell another 5 per cent, and triggered a two-hour suspension. At its lowest point, Nifty was 17.5 per cent down. Markets revived soon thereafter. The risk management system withstood the severe test imposed by highly volatile stock prices. The current index (June 17) is higher than in end-September 2003.

1.24 The combined fiscal deficit of the Centre and the States, which had been decreasing in the early nineties, worsened subsequently to reach a level of 10.1 per cent in the revised estimates (RE) for 2002-03, higher than the pre-reform level of 9.4 per cent. The revenue deficit followed a more disturbing trend, deteriorating more sharply than the fiscal deficit. The combined revenue deficit as a proportion of GDP, after declining from 4.2 in 1990-91 to 3.6 per cent in 1996-97, increased to 7.0 per cent in 2001-02, to decline again to 6.7 per cent in 2002-03 (RE) and further to a budget estimate (BE) of 5.8 per cent in 2003-04. For 2003-04, the combined fiscal deficit was budgeted at Rs.2,59,265 crore, constituting 9.4 per cent of GDP. Furthermore, a declining share of capital expenditure (excluding loans) in total expenditure, from 13.5 per cent in 1990-91 to 10.3 per cent in 2001-02, suggests a worsening quality of the deficit. With sustained efforts at stepping up capital expenditure, the share subsequently improved to 11.8 per cent in 2002-03. It was budgeted to go up to 14.5 per cent in 2003-04.

1.25 Fiscal deficit of the Central Government was budgeted at 5.6 per cent of GDP (Rs. 1,53,637 crore) in 2003-04, compared to Rs. 1,31,306 crore amounting to 5.3 per cent of GDP in 2002-03. Revenue deficit was budgeted at 4.1 per cent of GDP as compared with 4.4 per cent of GDP in the previous year. The reduction in revenue deficit was budgeted to be achieved from higher growth in revenue receipts and lower growth in revenue expenditure. In the event, according to unaudited figures, fiscal and revenue deficits, as a proportion of GDP, are estimated to have been 4.6 per cent and 3.6 per cent in 2003-04.

1.26 To enable the States to benefit from the soft interest rate regime, a debt-swap scheme mutually agreed between the States and the Centre is in operation since 2002-03. States are allowed to retire loans taken from the Central government bearing a coupon rate in excess of 13 per cent. The retirement of high cost loans is funded through additional market borrowings and a specified percentage of small saving collections. High cost Central loans to States amounting to Rs13,719 crore and Rs. 44,565 crore were retired in 2002-03 and 2003-04 respectively. Over the three-year period ending 2004-05, all the Central loans bearing coupon rate of 13 per cent and above are expected to be swapped, resulting in substantial saving in interest payments for the State Governments.

1.27 The Budget for 2003-04 undertook to provide a major thrust to infrastructure, principally to roads, railways, airports, and seaports, through innovative funding mechanisms. The total cost of these projects was estimated at about Rs. 60,000 crore. The scheme undertook to leverage public funds through private sector partnership through three critical components: release of public funds only when linked to specific and well-defined milestones in completion of the project, in physical terms; a sharing of the risks with the private promoters and financiers; and no open-ended Government guarantees at any stage. Implementation work on these projects has made substantial progress. NHAI has invited bids for 622 km. of highways and DPRs for 1510 km. are under preparation. The restructuring of the Mumbai and Delhi airports is under implementation. Bids have been invited for the modernisation of the Cochin port. Rail Vikas Nigam Ltd. (RVNL) is executing 61 projects.

1.28 As a ratio to total expenditure, the combined plan and non-plan expenditure of the Centre in social services (comprising education, health, family welfare, water supply, housing, social welfare, nutrition, and rural development) increased from 9.3 per cent in 1997-98 to 11.0 per cent in 2003-04. Expressed as a ratio of GDP at current market prices, the expenditure on social services increased from 1.4 per cent in 1997-98 to 1.9 per cent in 2003-04.

1.29 An Interim Budget for 2004-05 seeking a vote-on-account was presented on February 3, 2004, prior to the dissolution of the Thirteenth Lok Sabha and announcement of elections. While the Budget did not contain any fresh tax proposals, revenue and fiscal deficits – as proportions of GDP – were budgeted at 2.9 per cent and 4.4 per cent for 2004-05.

1.30 A significant reform initiative taken both by the Central government and some States has been the enactment of Fiscal Responsibility Acts. The enactment of the Fiscal Responsibility and Budget Management (FRBM) Act in 2003 marked an important landmark in this context. The FRBM Act mandates the Central Government to reduce the fiscal deficit and eliminate the revenue deficit by 2007-08, and thereafter build up adequate revenue surplus. The Act provides for greater transparency in budget formulation and execution, and a prudent fiscal policy stance is a natural concomitant of this legislation. A few States have put in place fiscal responsibility legislations to strengthen the institutional backing for fiscal reforms. These States include Karnataka, Kerala, Punjab, Tamil Nadu and Uttar Pradesh.

1.31 Among the major institutional and legislative reforms was a new pension system based on defined contribution basis operative from January 1, 2004. This new system is for new entrants to Central Government service, except to the Armed Forces, in the first stage. To tackle the problems of demand-supply imbalance in the recently deregulated sugar industry, the Essential Commodities Act, 1955, was amended to regulate free sale releases to ensure that sugar mills do not sell sugar in excess of their quota and Courts do not intervene in the release mechanism. Parliament also passed the Industrial Development Bank (Transfer of Undertaking and Repeal) Bill, 2003 and the Sick Industrial Companies (Repeal Provisions) Bill, 2001.

(b) **Consumption, savings and investment**

1.32 Private final consumption expenditure, at constant 1993-94 prices, increased by Rs.30,507 crore or 3.5 per cent in 2002-03 compared to an increase of Rs 47,099 crore (5.7 per cent) in 2001-02 (Table 1.3). This growth at a rate lower than that of GDP meant that private final consumption as a proportion of GDP at current market prices declined from

Table 1.3 : Disposition of gross domestic product (GDP)

Component	Percentage change over the previous year									
	(at current prices)					(at 1993-94 prices)				
	1998-99	1999-2000	2000-01	2001-02P	2002-03Q	1998-99	1999-2000	2000-01	2001-02P	2002-03Q
Total final consumption expenditure	**17.3**	**12.5**	**6.7**	**9.5**	**6.8**	**7.4**	**7.1**	**2.4**	**5.3**	3.4
Govt. final consumption expenditure	24.3	17.3	5.2	7.6	8.6	12.9	13.2	0.5	3.0	3.1
Pvt. final consumption expenditure	16.1	11.6	7.0	9.9	6.5	6.4	6.0	2.8	5.7	3.5
Gross domestic capital formation	5.0	24.8	3.7	3.8	8.9	0.7	20.8	0.7	-2.0	7.6
of which:										
Gross fixed capital formation	13.3	12.7	8.8	9.0	11.0	8.7	9.3	4.1	4.3	9.4
Exports of goods and services	**18.2**	**16.6**	**27.4**	**6.0**	22.2	—	—	—	—	—
Less imports of goods and services	**21.9**	**18.2**	**15.2**	**5.1**	19.7	—	—	—	—	—

P - Provisional Q-Quick estimates
Source : CSO.

65.5 per cent in 2001-02 to 64.4 per cent in 2002-03. The decline in private final consumption in 2002-03 was mainly on account of lower expenditure on cereals, which declined from Rs.1,58,621 crore in 2001-02 to Rs.1,24,560 crore in drought-affected 2002-03, and reduced the share of food, beverages and tobacco in total consumption by 2.6 percentage points to 44.8 per cent. Among other major categories of consumption, share of clothing and footwear, gross rent, fuel and power, medical care and health services, transport and communication and miscellaneous goods and services increased marginally, while the share of furniture, furnishings, appliances and services, and recreation, education and cultural services remained unchanged between 2001-02 and 2002-03.

1.33 In 2002-03, gross and net domestic savings at current prices grew by 11.7 per cent and 14.2 per cent respectively. Gross domestic savings as a proportion of GDP at current market prices increased from 23.5 per cent in 2001-02 to 24.2 per cent in 2002-03 (Table 1.4). Net domestic savings as a proportion of NDP also increased, from 15.4 per cent in 2001-02 to 16.2 per cent in 2002-03. In 2002-03, as a proportion of GDP, there was a marginal reduction in the gross savings of the household and the private corporate sectors, which are the mainstay of overall savings in the economy. The share of financial savings in total household savings declined from 49.0 per cent in the previous year to 45.5 per cent in 2002-03, while the share of savings in physical assets increased from 51.0 per cent to 54.5 per cent.

1.34 The increase in the overall saving rate in 2002-03 was on account of a decline in the dissavings of the public sector to 1.9 per cent of GDP in 2002-03 from 2.7 per cent in the previous year. Dissavings of the public sector declined from Rs.62,704 crore in 2001-02 to Rs.45,730 crore in 2002-03. Between 2001-02 and 2002-03, savings of departmental enterprises increased from Rs.1,023 crore to Rs.2,339 crore, and those of non-departmental undertakings from Rs.75,035 crore to Rs.91,909 crore.

1.35 Gross domestic capital formation (GDCF) at constant prices grew by 7.6 per cent in 2002-03. GDCF as a proportion of GDP at 1993-94 market prices was marginally higher at 25.8 per cent in 2002-03 compared with 25.1 per cent in 2001-02 (Table 1.5), with the improvement coming from capital formation in the private sector. Among the components of GDCF, gross fixed capital formation improved from 23.7 per cent of GDP in 2001-02 to 24.8 per cent of GDP in 2002-03, while the corresponding improvement in change in stocks was from 0.4 per cent of GDP to 0.5 per cent of GDP. Within gross fixed capital formation, there were variations across sectors, though in the aggregate, investment

Table 1.4 : Savings and investment

	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02 (P)	2002-03 (Q)
	(as per cent of GDP at current market prices)							
Gross Domestic Savings	**25.1**	**23.2**	**23.1**	**21.5**	**24.2**	**23.7**	**23.5**	**24.2**
a) Public	2.0	1.7	1.3	-1.0	-1.0	-2.3	-2.7	-1.9
b) Private	23.1	21.5	21.8	22.5	25.2	26.1	26.2	26.1
i) Household	18.2	17.0	17.6	18.8	20.9	21.9	22.7	22.6
Financial	8.9	10.4	9.6	10.4	10.6	10.7	11.1	10.3
Physical	9.3	6.7	8.0	8.4	10.3	11.3	11.6	12.3
ii) Private Corporate	4.9	4.5	4.2	3.7	4.4	4.1	3.5	3.4
Gross Domestic Investment*	**26.9**	**24.5**	**24.6**	**22.6**	**25.3**	**24.4**	**23.1**	**23.3**
Public	7.7	7.0	6.6	6.6	6.9	6.3	5.8	5.7
Private	18.9	14.7	16.0	14.8	16.7	16.3	16.5	17.1
GFCF	24.4	22.8	21.7	21.5	21.8	22.0	21.9	22.5
Change in stocks	2.2	-1.0	0.9	-0.1	1.9	0.6	0.4	0.3
Saving-Investment Gap@	**-1.7**	**-1.3**	**-1.5**	**-1.1**	**-1.1**	**-0.6**	**0.3**	**0.9**
Public	-5.6	-5.4	-5.3	-7.6	-8.0	-8.6	-8.6	-7.5
Private	4.2	6.8	5.8	7.7	8.5	9.7	9.7	8.9

Note : (i) Gross domestic investment denotes gross domestic capital formation (GDCF).
(ii) Figures may not add up due to rounding off.
*** : adjusted for errors and omissions;**
@ : refers to the difference between the rates of savings and investment.
GFCF : Gross fixed capital formation.
P : Provisional estimates; Q : Quick estimates;
Source : Central Statistical Organisation.

Table 1.5 : Real gross domestic capital formation

	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02 (P)	2002-03 (Q)
	(As percent of GDP at market prices, 1993-94 prices)						
GDCF*	**25.1**	**25.9**	**24.6**	**27.8**	**26.9**	**25.1**	**25.8**
Public	6.8	6.5	6.6	7.0	6.2	5.7	5.6
Private	15.5	17.3	16.7	19.0	18.8	18.5	19.7
Private corporate	8.7	9.0	7.6	7.7	6.4	5.8	6.0
Household Sector	6.9	8.3	9.1	11.3	12.4	12.6	13.7
GFCF	**23.4**	**22.8**	**23.4**	**23.9**	**24.0**	**23.7**	**24.8**
Public	6.7	6.2	6.4	6.2	6.0	5.4	5.7
Private	16.7	16.6	17.0	17.7	18.0	18.4	19.2
Change in stocks	**-1.0**	**0.9**	**-0.1**	**2.0**	**1.1**	**0.4**	**0.5**
Public	0.2	0.3	0.1	0.8	0.3	0.3	-0.1
Private	-1.2	0.7	-0.3	1.2	0.8	0.1	0.5
				Growth rate in per cent			
GDCF*	**-1.0**	**7.7**	**0.7**	**20.8**	**0.7**	**-2.0**	**7.6**
Public	-3.1	-0.8	7.3	13.3	-7.2	-3.5	2.5
Private	-13.7	16.4	2.6	21.5	3.0	3.3	11.6
GFCF	**1.5**	**2.1**	**8.7**	**9.3**	**4.1**	**4.3**	**9.4**
Public	-5.9	-2.8	9.4	2.7	0.4	-4.9	9.8
Private	4.8	4.1	8.4	11.8	5.4	7.3	9.2

Note : GDCF : Gross domestic capital formation; GFCF : Gross fixed capital formation;
Figures may not add up due to rounding off.
*** : adjusted for errors and omissions; P : Provisional estimates; Q : Quick estimates;**
Source : Central Statistical Organisation

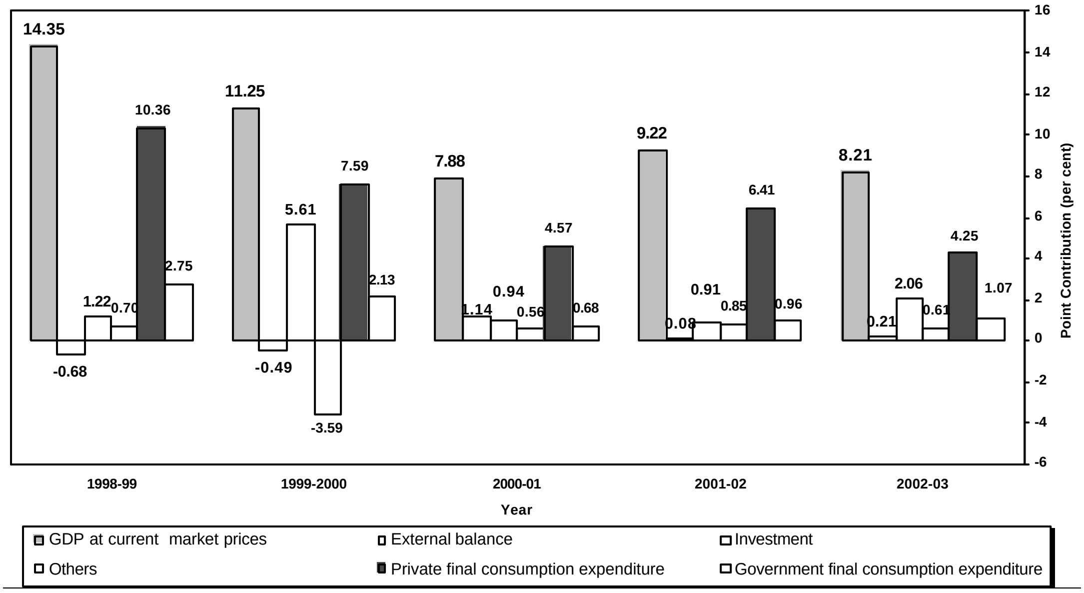
in machinery grew faster than investment in construction. In the public sector, fixed capital formation in construction grew by 16.7 per cent compared with a negative growth of 0.9 percent in machinery. In contrast, capital formation in machinery grew faster than that in construction in the household sector. In the private corporate sector, there was actually a decline in fixed capital formation in construction.

1.36 Domestic demand has been the main driver of growth in recent years (Figure 1.2). In 2002-03, among demand categories, private final consumption, by contributing 52.4 per cent of the GDP growth at current market prices, was the prime mover, followed by investment (25.6 per cent), government consumption (13.4 per cent) and external balance (2.4 per cent). The contribution of private final consumption to growth, however, was lower in 2002-03 compared to 69.6 per cent in the previous year. The contribution of investment to growth has not been following a consistent pattern; in recent years, it varied from 8.4 per cent (1998-99) to 50.0 per cent (1999-2000). During the period 1998-99 to 2002-03, on average, the contributions of private final consumption expenditure and investment to growth of GDP at current market prices were 64.2 per cent and 21.0 per cent respectively.

1.37 GDCF in the public sector as a proportion of GDP at current market prices witnessed a decline from 8.2 per cent in 1993-94 to 5.6 per cent in 2002-03, as the share of consumption expenditure in the total expenditure of the Central Government increased from 21.3 percent in 1990-91 to 23.6 percent in 1997-98. Public consumption expenditure of the Centre declined marginally to 21.2 per cent in 2002-03 (RE), and it was budgeted to increase to 22.3 per cent in 2003-04. Consumption expenditure of States increased from 38.1 per cent of total expenditure in 1996-97 to 38.8 per cent in 2000-01. The share of wages and salaries in the consumption expenditure of States witnessed an increase from 77.3 per cent in 1996-97 to 82.3 per cent in 2000-01.

1.38 The Government's current expenditure comprises consumption expenditure and current transfers. Apart from an increase in the consumption expenditure, there was also an increase in current transfers, squeezing public investment. The share of current transfers in the total expenditure of the Central Government increased from 43.0 per cent in

Fig. 1.2 **Point Contribution to GDP growth at current market prices**



1990-91 to 58.0 per cent in 2002-03 and was budgeted to decline marginally to 56.7 per cent in 2003-04. Among components of current transfers, the share of interest payments increased from 44.2 per cent in 1990-91 to 48.3 per cent in 2002-03 (RE), and was budgeted at 48.2 per cent in 2003-04. Grants to States, UTs and local bodies which constituted 24.6 per cent of current transfers in 1990-91 increased marginally to 25.0 per cent in 2002-03(RE), and was budgeted at 24.8 per cent in 2003-04. The share of subsidies in current transfers declined from 23.8 per cent in 1990-91 to 19.6 per cent in 2002-03, and was budgeted to go up to 21.1 per cent in 2003-04.

1.39 Because of the growth in consumption expenditure and transfer payments of the Central Government, the share of current expenditure in total expenditure increased from 64.3 per cent in 1990-91 to 79.2 per cent in 2002-03(RE), and was budgeted to marginally come down to 79.0 per cent in 2003-04. For the State Governments, the share of current expenditure in total expenditure was even higher, at 83.1 per cent in 1996-97 and 81.3 per cent in 2000-01. The share of current transfers in total State Governments expenditure declined from 45.0 per cent to 42.6 per cent between 1996-97 and 2000-01.

1.40 The softening of interest rates in recent years has provided a climate conducive to investment growth. Off-take of non-food credit has shown signs of revival. There are indications that the scope for producing more with the same capital stock through efficiency enhancement is getting increasingly limited which may lead to investment in fresh capacities. The improvement in stock-valuation and flurry of activity in primary markets in the latter half of 2003-04 reinforce the optimism about the investment outlook. A pick up in the momentum of industrial growth can boost private investment, which in turn will stimulate industrial growth, and thereby set off a virtuous cycle.

1.41 The surplus in the current account of India's BOP for three consecutive years ending in 2003-04 indicates that the rest of the world has contributed to sustaining aggregate demand. This surplus is likely to decline as investment picks up and the country transits to a sustained growth phase at a higher rate.

(c) **Production**

1.42 A good monsoon helped to increase the level of food grains production from 174.2 million tonnes in 2002-03 to 210.8 million tonnes in 2003-04, contributed by increase in the production of both cereals and pulses. The prospects for agricultural production in 2004-05 are considered bright with a normal monsoon forecast by the Meteorological Department.

1.43 As per the index of industrial production (IIP), overall growth in the industrial sector improved from 5.7 per cent in 2002-03 to 6.9 per cent in 2003-04, supported by growth rates of 5.1 per cent in mining, 5.0 per cent in electricity and 7.2 per cent in manufacturing. As per use-based classification, industrial growth was broad-based except for consumer non-durables. Capital goods took the lead with a growth of 12.7 per cent followed by consumer durables, which recorded a growth rate of 11.6 per cent. Enhanced availability of retail loans and lower interest rates contributed to the latter's growth. Intermediate goods and basic goods also performed better in 2003-04 than in 2002-03, with growth rates of 6.2 per cent and 5.4 per cent, respectively, while the growth of consumer non-durables decelerated substantially from 12.0 per cent in 2002-03 to 5.7 per cent in 2003-04.

1.44 As per the two-digit industrial classification, three out of 17 industry groups grew by over 15 per cent in 2003-04. These industries include transport equipment and parts (17.0 per cent), paper and paper products (15.9 per cent) and machinery and equipment other than transport equipment (15.2 per cent). Beverages and tobacco, and basic metals and alloys, also performed well in 2003-04, growing at 9.4 per cent and 9.1 per cent, respectively.

1.45 Fabric production, which peaked in 2001-02 at 42 billion square metres, declined marginally to 41.9 billion square metres in

2002-03. In 2003-04, despite an initial sharp decline attributed to strikes by power-loom units and truck operators, rise in cotton prices and poorer demand for textiles, it picked up again, touching 42.2 billion square metres by the close of the year. The share of the power-loom sector in the total production of fabrics increased to 82 per cent in 2003-04, compared to 80.6 per cent during the previous year.

1.46 Both production and exports of steel continued to rise, propelled by surging demand for steel in China and a strong domestic market. In 2003-04, total finished steel production rose by 7.5 per cent, reaching 36.2 million tonnes, while exports of finished steel grew by 17.6 per cent to 5.3 million tonnes.

1.47 During 2003-04, automobile production grew by 15.1 per cent, following up on strong growth of 18.6 per cent in the previous year. Commercial vehicles grew by 35.1 percent, while passenger cars grew by 38.3 per cent. A major development in Indian manufacturing has been the success in exports of automobile components and finished vehicles. With export of vehicles growing by 56 per cent in 2003-04, India appeared to be on its way to establishing itself as a new player in the international market for small passenger vehicles.

1.48 Six core and infrastructure industries (viz. electricity, coal, steel, cement, crude oil and petroleum products) having a total weight of 26.7 per cent in the Index of Industrial Production (IIP) registered a marginally lower average growth rate of 5.4 per cent in 2003-04 compared to 5.6 per cent in 2002-03. Among the other infrastructure sectors, new cell phone connections (with a growth of 159.2 per cent), goods traffic on railways (7.5 per cent), cargo handled at major sea ports (9.9 per cent) and air ports (5.3 per cent), and air passenger traffic at both domestic and international airports (10.3 per cent) performed well in 2003-04 due to sustained industrial growth and significant pick-up of service activities.

1.49 Major initiatives taken in 2003-04 for infrastructure development include: notification of the Electricity Act in June 2003; signing of the tripartite agreement by 28 States for one time settlement of the dues of State Electricity Boards to Central Public Sector Undertakings; launching of 50,000 MW hydro electric power initiative in May, 2003; unified access service license regime for telecommunication services; and the Bharat Jodo Project for development of 10,000 kms of roads connecting state capitals.

1.50 Many policies were announced in the Union Budget for 2003-04 to encourage industry. Major measures included: a special incentive package for textiles, garments and apparel, which have high exports and employment potential; income tax concessions to the sunrise sectors of biotechnology, pharmaceuticals and information technology; withdrawal of expenditure tax for tourism; and withdrawal of small-scale reservation from 75 items of chemicals, leather, plastics and paper products.

(d) Employment and poverty

1.51 It is well known that there was a significant decline in the poverty ratio from 36 per cent in 1993-94 to 26.1 per cent in 1999-2000. The Tenth Five Year Plan (2002-07) has set a target of reduction in poverty ratio by five percentage points by 2007 and by 15 percentage points by 2012.

1.52 Subsequently, 'thin' surveys for household consumer expenditure were conducted by the National Sample Survey Organisation (NSSO) for 2000-2001 (56th Round) and 2001-2002 (57th Round). As per the results of the 57th Round, the proportion of chronically hungry households (not getting enough to eat in any month of the year) declined to 0.5 per cent in rural areas and 0.1 per cent in urban areas. As for seasonal hunger, 16 per thousand households in rural areas and 3 per thousand households in urban areas reported getting enough food only in some months of the year.

1.53 Major initiatives taken for the social sectors during 2003-04 included: expansion of the Antyodaya Anna Yojana to cover an additional 50 lakh families; introduction of a community based Universal Health Insurance Scheme and a special pension policy called

Varishtha Pension Bima Yojana; launching a National Programme for Education of Girls at Elementary Level; launching a social security scheme for the unorganised workers in January 2004 on a pilot basis in 50 districts; and initiating the setting up of All-India Institute of Medical Sciences (AIIMS)-like institutions in six backward states (Bihar, Chattisgarh, Madhya Pradesh, Orissa, Rajasthan, and Uttaranchal).

1.54 The Economic Survey 2002-03 reported that the rate of growth of employment, on Current Daily Status (CDS) basis, declined from 2.7 per cent per annum in 1983-1994 to 1.07 per cent per annum in 1994-2000. The deceleration of the employment growth was mainly due to near stagnation of employment in agriculture, although employment growth in all the sub-sectors within services (except community, social and personal services) exceeded 5 per cent per annum.

1.55 Some estimates of employment are available for the period beyond 1999-2000. As per the Annual Rounds conducted in July-December 2002, employment growth in the country improved to 2.07 per cent per annum in 2000-2002 as compared to 1.07 per cent per annum in 1994-2000. In absolute terms, additional employment by 84 lakh per year on an average in 2000-2002 fell short of the target of additional employment of one crore per year. However, these estimates are based on thin samples which may contain large sampling errors.

Issues and priorities

1.56 The signs of improvement in the investment climate in recent months need to be nurtured for consolidating the growth process. Concerns about structural imbalances in the US economy, especially regarding the large current account and fiscal deficits and about the situation in Iraq remain. The global economic environment and outlook, however, continue to provide a benign backdrop for consolidating India's growth process.

1.57 The five major challenges facing the economy are: (i) Sustaining the growth momentum and achieving an annual average growth of 7-8 per cent in the next five years. (ii) Containing annual inflation rate to medium single-digit level. (iii) Boosting agricultural growth through diversification and development of agro-processing. (iv) Expanding industry fast, by at least 10 per cent per year to integrate not only the surplus labour in agriculture but also the unprecedented number of women and teenagers joining the labour force every year. (v) Effecting fiscal consolidation and eliminating the revenue deficit through revenue enhancement and expenditure management.

1.58 Growth in the Indian economy, which has steadily accelerated since 1979 (Figure 1.3), needs to be bolstered to 7-8 per cent per year by an appropriate mix of policies. Higher growth is essential for the rapid elimination of poverty. While India has an impressive 23-year record of growth averaging 5.7 per cent per year, the potential for even better performance is large. Many countries in East Asia have sustained higher rates of economic growth over periods longer than 23 years (Table 1.6). With the magic of compounding, even small differences in the annual growth rate, make over decades, a magnified difference in outcomes. For example, in 1963 Korea had initial conditions that were in many respects much worse than India, yet average annual growth of 7.96 per cent over 33 years transformed Korea into a developed country.

1.59 Sustainable growth hinges on the availability of efficient infrastructure. Although the demand-supply gaps in areas such as telecom, roads, and ports have been narrowed since the first half of the 1990s, the inadequate

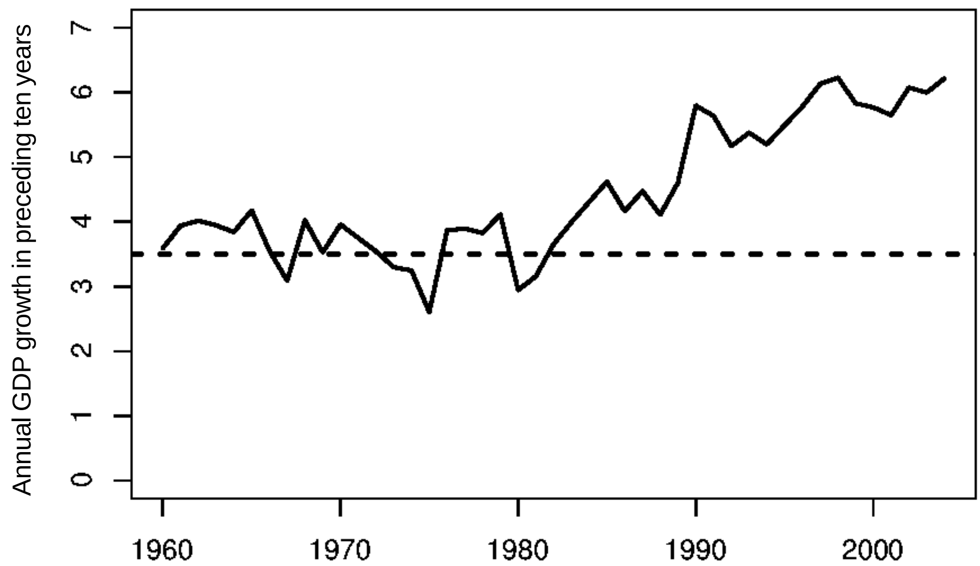
Table 1.6 : Some East Asian high-growth experiences : (1961–1996)

Country	GDP Growth
Hong Kong	7.97
Indonesia	6.39
Korea	7.96
Malaysia	7.22
Singapore	8.74
Thailand	7.71

Note: Compound rate of growth of GDP at 1995 US Dollar.

Fig. 1.3

India: Accelerating Growth



availability of these facilities, both in terms of quantity and quality, continues to hinder economic growth. Investment in infrastructure has been grossly inadequate, despite the establishment of specialized financial institutions. In the absence of a strongly enabling environment, the private sector has not been able to compensate for the decline in public spending in infrastructure.

1.60 Some improvement in infrastructure has underpinned and locked in the recent growth recovery. Legislative changes such as the Electricity Act 2003 and institutional changes such as the unified access service licensing regime have yielded rich dividends. Such changes must continue. Benefits have accrued from greater emphasis on collection of appropriate user charges, introduction of new technologies, private sector production, and regulatory frameworks that foster competition. The way forward lies in strengthening this emphasis. The potential of the new viability-gap funding mechanism announced in Budget 2003-04 for leveraging public money through public-private partnership, wherever possible, needs to be realised through the implementation of clearly defined and transparent guidelines.

1.61 Social infrastructure such as education and health, is as important as physical infrastructure, not only for sustaining high growth but also for enhancing welfare. The root of poverty often lies in illiteracy and lack of basic health. The National Common Minimum Programme (NCMP) announced an increase in public spending on education and health, to 6 per cent and 2-3 per cent of GDP from the 2003-04 (BE) levels of 3.1 per cent and 1.4 per cent of GDP respectively, in a phased manner. These measures will go a long way in addressing the social sector problems. What is important in this context is close monitoring of the outcome consistent with higher outlays. The quality of publicly-funded basic education and health facilities needs to be improved considerably. The sharply targeted family planning programme in approximately 150 high fertility districts announced in NCMP will also go a long way not only in helping population management but also in reducing the incidence of poverty in these districts.

1.62 The NCMP also rightly emphasizes the need for an accelerated AIDS control programme. Bold and appropriate steps, including improved surveillance through the setting up of more sentinel sites and the use of primary health centres to monitor HIV/AIDS, running public awareness campaigns, promoting safe sex through the use of condoms, and preventing drug abuse and distributing disposable syringes, need to be taken to achieve a zero-level growth of HIV/AIDS in the country. This is important not only for public health and welfare, but also because of the potential adverse impact of HIV/AIDS on the macroeconomics of the country.

1.63 The economy has enjoyed the benefits of relatively low inflation with comfortable stocks of foodgrains, enhanced competition in product markets and an appropriate mix of fiscal and monetary policies. The point-to-point inflation rate, after declining sharply in the first quarter of 2004 to 4.6 per cent at end-March 2004, inched up to 5.5 per cent on June 5, 2004. This was mainly because of the seasonal increase in prices of fruits and vegetables during this part of the year. The recent pick up in price increases probably does not represent the leading edge of steadily worsening inflation.

1.64 The surge in international oil prices is unlikely to stifle the growth recovery observed in the recent past. But, if maintained, it not only threatens to dampen some of the momentum from the process but also exert upward pressure on inflation. Furthermore, after the high growth in M_3 in 2003-04, the upswing in foreign exchange reserves, if it continues, will require a dexterous combination of policies. These may include measures such as external liberalization and sterilisation, to reconcile the multiple goals of limiting fiscal costs, maintaining orderly conditions in the foreign exchange markets and low inflation.

1.65 The full potential of agriculture as a profitable activity must be realized at the earliest not only to benefit farmers and a large section of the rural poor, but also to give a fillip to overall growth of the economy through the backward and forward linkages of agriculture with the rest of the economy. Higher yields and diversification away from cereals to high-value and labour-intensive agriculture and allied activities are critical for achieving sustained annual agricultural growth of over 4 per cent. Livestocks and fisheries, horticulture, organic farming, commercial crops and agro-processing are the potential areas of high growth. Rationalization of the minimum support price (MSP) regime and introduction of other risk-mitigation measures, improvements in rural infra-structure and post-harvest management technologies, legislative reform to unify the Indian common market in agricultural products, and strengthening research and development are essential for sustaining high agricultural growth.

1.66 Prices often run the risk of getting considerably distorted as a result of the MSP mechanism, which exist for 24 agricultural commodities. Cost-based calculations of MSPs can get out of line with demand conditions and result in excessive storage or export subsidies. With the transition from a net importer to a net exporter of agricultural products as well as the availability of futures prices in the commodity exchanges, cost-based MSPs require rethinking.

1.67 The decline in the capital formation in agriculture from 1.9 per cent of GDP in the early 1990s to 1.3 per cent of GDP after 2000-01 is a matter of concern. The declining trend is mainly due to a fall in public investment in agriculture since the mid-nineties. While there has been some reversal of this trend in recent years, public investment in agriculture needs to be augmented, especially in rural infrastructure, irrigation, and agricultural research and development.

1.68 Some of the measures for boosting agricultural growth require the development of a medium-term framework. It is imperative in the meantime to ensure that profitable opportunities in agriculture are not lost and that farmers do not suffer from a lack of adequate credit. Since the seventies, the decadal average growth rate of short-term institutional credit to agriculture has stagnated at around 15 per cent, while the growth rate of the volume of long-term credit has in fact declined, from 20.2 per cent in the 1970s to 11.9 per cent in the 1990s. Among the factors that will help in realizing the full potential in agriculture, better access to timely institutional credit for more farmers is of utmost importance.

1.69 On June 18, 2004, Government announced some immediate steps for doubling the flow of credit to agriculture in three years. The recommendations of the Vyas Committee on the flow of credit to agriculture are being examined by RBI for speedy implementation. Two considerations are relevant for resolution of the credit problem. First, despite 47,092 branches of SCBs including regional rural banks, and over one lakh outlets of cooperatives in rural and semi-urban areas, the problem of inadequate outreach through a low-cost network persists. Regulatory reforms to integrate micro-finance institutions, such as Non-bank Finance Companies (NBFCs), trusts and not-for-profit Section 25 companies with the formal financial architecture may help as would developing the concept of agent-banking. When a large section of the rural population meets its credit needs by borrowing at high rates from the informal markets, priority may be accorded to increasing coverage by the formal sector.

1.70 More than 58 per cent of the population depends on agriculture, a sector producing only 22 per cent of GDP. While an acceleration in agricultural growth to 4–4.5 per cent is imperative, even with such growth, the share of agriculture in GDP is likely to reduce further. Therefore, there is a need to absorb excess agricultural labour in other sectors, notably industry. Rapid development of agro-processing industry close to the agricultural production centres can bring about this shift without moving people from rural to urban areas.

1.71 Traditionally, in most parts of the developed world, the services sector's share of employment rose faster than its share of output. In India, the rise in labour productivity in services, mainly because of concentration in sub-sectors such as information technology, that are dependent on skilled labour, has resulted in relatively slow growth of jobs in the services sector. While growth in tourism and tourism-related services, such as hotels, holds a large potential for employment generation, the services sector alone is unlikely to provide a solution to the unemployment problem. IT-enabled services, such as business process outsourcing, have been growing rapidly in the recent past, and, given India's human resource endowment, have the potential for continued growth. However, the skill requirements for such services are of a specialised nature, and the emergence of somewhat inexplicable protectionist tendencies in some developed countries is a disturbing trend. Industry needs to grow rapidly not only to boost the overall growth rate in the economy but also to generate gainful employment for the existing unemployed, as well as the new entrants, who are projected to swell the ranks of the labour force by 1.9 per cent per annum, according to one estimate.

1.72 Annual industrial growth has been in disappointing single digits since 1995-96. One of the critical challenges facing Indian economic policy consists in devising strategies for sustained industrial growth in excess of 10 per cent per year. Some sub-sectors of industry, such as automobiles, have demonstrated the inherent strengths of Indian labour and capital. In a diverse range of industrial activities, several Indian firms have succeeded in getting integrated into global production chains and realized rapid growth of exports. This experience suggests that with appropriate scale, investment and technology, rapid industrial growth is indeed possible. The termination of the Agreement on Textiles and Clothing (ATC) on January 1, 2005 holds great potential for contributing to rapid growth of the textile industry, the largest industry in terms of employment.

1.73 Apart from infrastructure, particularly adequate and reliable power supply at reasonable cost and transportation facilities, there is need for stepped up investment in manufacturing. The pick up in both primary and secondary equity markets and in the off-take of non-food credit observed in the second half of 2003-04 indicates a possible revival of investment. Such revival needs to be nurtured. A better alignment of banks' lending rates with deposit rates through increased competition and better NPA resolution will strengthen the process.

1.74 Foreign investment is important not only for the funds they bring, but also for the technological knowhow, improved corporate governance practices and access to foreign markets that often come with it. A considerable part of the buoyancy of China's industrial growth observed over the last three decades came from considerable inflows of foreign investment. The slowdown in FDI observed in India since 2002-03 needs to be remedied. Suitable liberalization of both the FDI and FII regimes, including procedural issues, needs to be considered for enhancing foreign investment flows.

1.75 The strong interest displayed by FIIs in the Indian market in 2003-04 is encouraging and is likely to continue if there are no exogenous factors. Various supply and demand factors have made investing via institutions a rapidly growing sector in many developed countries. There is enhanced supply of funds from investors to institutions because ageing of populations, funded pension systems, and growing wealth in these countries. Institutions are also able to give better services and attractive returns because of ease of diversification, better corporate governance, liquidity, deregulation and fiscal incentives. Given this background, there is likely to be a large and growing demand for Indian securities by FIIs. This needs to be harnessed.

1.76 Among the other factors that can help in boosting industry is the removal of the remaining items from the list reserved for small-scale industry. Small and medium-scale enterprises are critical for industrial development, for they provide the cradle that nurtures the big businesses of tomorrow. They choose the appropriate product designs and techniques, be it labour or capital-intensive, and they have the flexible management capacities to respond to fast changing market conditions. The progress in gradually dismantling the reservation policy observed over recent years should continue and the policy of protection through reservation should be replaced by promotion as the cornerstone of future policy. Adequate supply of credit, services, technology assistance and infrastructure, and low transaction costs, are aspects upon which this promotion policy should focus.

1.77 The move towards gradually reducing customs duty rates and aligning them with that of ASEAN countries should continue as it will help Indian industry. The post-reform experience clearly demonstrates how a more open trading system leads to utilisation of the virtuous interaction among technology, competition and benchmarking to the best international standards. Furthermore, a popular consensus needs to be built up on the twin issues of more flexible labour laws and less friction in the creation and closure of firms in response to normal competitive market dynamics. Last, but not the least, for rapid industrial growth it is essential to adhere to the already announced deadline of April 1, 2005, for transiting to a State-level value added tax (VAT) system, with few rates and provision of credit for input taxes. The current regime of domestic trade taxes at the State level is characterised by distortions and inefficiencies arising from cascading and multiple rates.

1.78 The terms of reference of the Twelfth Finance Commission include examination of the issue of strengthening the finances of State and Central Governments. Recommendations of the Twelfth Finance Commission, which are expected in the later part of the year, as well as the introduction of the Value Added Tax from 2005-06, are going to be critical determinants of fiscal improvement at the state level.

1.79 To achieve the specified milestones in fiscal adjustment, there is a need for sustaining the reforms in tax and expenditure administration. Any misguided scepticism about the resolve behind the declared goals of fiscal consolidation should be scotched by bold actions. The rewards of fiscal consolidation will be the creation of more fiscal space for augmenting the expenditure on social and physical infrastructure, and the laying of a social foundation for macro-economic stability.