1

General Review

Review of developments

(a) Macroeconomic overview

The performance of the Indian economy in 2004-05 so far has exceeded expectations formed at the beginning of the year. Buoyed by a rebound in the agriculture and allied sector, and strongly helped by improved performance in industry and services, the economy had registered a growth rate of 8.5 per cent in 2003-04, the highest ever except in 1975-76 and 1988-89. Normally, strong growth is expected after anaemic growth, and vice versa. Following the 'bumper' growth in 2003-04, initial growth projections for 2004-05 were placed in the range of 6.2 per cent to 7.4 per cent. Modest expectations were further pared down to around 6.1 per cent when rainfall, after remaining normal in June, 2004, became deficient in the crucial sowing month of July and the shortfall in the south-west monsoon turned out to be 13 per cent. Deterioration in the benign world inflation environment, particularly of petroleum, coal and steel, led to further apprehensions about growth and inflation.

1.2 In the event, according to the advance estimate of the Central Statistical Organisation (CSO) released on February 7, 2005, the economy is likely to grow by 6.9 per cent in 2004-05. Year-on-year WPI-based inflation was 5 per cent on February 5, 2005 (Table 1.1). The economy has managed to maintain the growth momentum in spite of a deficient south-west monsoon, hardening international prices of oil and steel and, last but not the least, its first recorded experience of tsunami which caused extensive damage to life and property in Andaman & Nicobar islands, and 2,260 kms of coastline in Tamil Nadu, Kerala, Andhra Pradesh and Pondicherry.

1.3 After a drought-induced decline of 7.0 per cent in 2002-03, the growth rate in the agriculture and allied sector bounced back to 9.6 per cent in 2003-04. While industry maintained the higher growth of 6.6 per cent observed in 2002-03, the services sector improved its performance significantly from 7.9 per cent in 2002-03 to 9.1 per cent in 2003-04. Growth in the industry and services sectors in 2003-04 was broad-based with manufacturing, public utilities, the trade, hotels, transport and communication group, and community, social and personal services recording higher growth than that in the previous year.

1.4 The year 2004-05 began on a promising note with buoyant industrial growth, early onset of monsoon and forecast of a normal rainfall. But, in the event, the kharif (summer) crop suffered from a shortfall in the south-west monsoon, particularly in July. While the shortfall in kharif foodgrains output is likely to be partly offset by the prospects of a good rabi crop, overall foodgrains production in 2004-05 is estimated to decline by about 3 per cent (Figure 1.1). Yet, with a comfortable buffer of foodgrain stocks, pressure on food management is minimal. Furthermore, with buoyant performance of non-foodgrains agriculture (e.g. cotton, fruits and vegetables, and dairy), the agriculture and allied sector is expected to grow by 1.1 per cent in the current year (Table 1.2). Not only has the share of foodgrains in agriculture declined, but the share of agriculture in GDP has also gone down by as much as 3.5 percentage points since 2001-02.

Table 1.1 : Key indicators

Items	2001-02	2002-03	2003-04	2004-05	2001-02	2002-03	2003-04	2004-05
	Absolute values				percentage change over previous period			
Gross national product (at factor cost) (Rs.thousand crore)								
At current prices	2065.9	2241.7 P	2505.7 Q	2820.1 A	9.6	8.5 P	11.8 Q	12.5 A
At 1993-94 prices	1257.6	1310.5 P	1422.5 Q	1519.5 A	6.0	4.2 P	8.5 Q	6.8 A
Gross domestic product (at factor cost) (Rs. thousand crore)								
At current prices	2081.5	2254.9 P	2519.8 Q	2838.1 A	9.4	8.3 P	11.7 Q	12.6 A
At 1993-94 prices	1267.9	1318.4 P	1430.5 Q	1529.4 A	5.8	4.0 P	8.5 Q	6.9 A
Agriculture and allied sectors (Rs. thousand crore) (at 1993-94 prices)	304.7	283.4 P	310.6 Q	313.9 A	6.3	-7.0 P	9.6 Q	1.1 A
Index of agricultural production(1)	178.8	154.1	180.1 P	179.2 P	7.9	-13.8	16.9 P	-0.5 P
Foodgrains production (million tonnes)	212.9	179.4	212.4 P	206.4 P	8.1	-15.7	18.4 P	-2.8 P
Index of industrial production(2)	167.0	176.6	189.0	199.4 ^	2.7	5.8	7.0	8.4 ^
Electricity generated (in billion kwh)	515.3	531.6	558.3	437.9 ^	3.1	3.2	5.0	6.5 ^
Wholesale price index(3)	161.8	172.3	180.3	188.6 #	1.6	6.5	4.6	5.0 #
Consumer price index for industrial workers(4)	468	487	504	521 $	5.2	4.1	3.5	3.8 $
Money supply (M3)(5) (Rs. thousand crore)	1,498.4	1718.0	2003.1	2193.3(6)	14.1	14.7	16.6	13.9(6)
Imports at current prices								
(in Rs. crore)	2,45,200	2,97,206	3,59,108	3,76,815***	6.2	21.2	20.8	32.1***
(in US $ million)	51,413	61,412	78,149	83,442***	1.7	19.4	27.3	34.7***
Exports at current prices								
(in Rs. crore)	2,09,018	2,55,137	2,93,367	2,74,313***	2.7	22.1	15.0	23.1***
(in US $ million)	43,827	52,719	63,843	60,754***	-1.6	20.3	21.1	25.6***
Foreign currency assets (7)								
(in Rs. crore)	2,49,118	3,41,476	4,66,215	540246 *	35.0	37.1	36.5	18.3 *
(in US $ million)	510,49	71,890	1,07,448	123654 *	29.1	40.8	49.5	22.7 *
Exchange rate (Re./US $) (8)	47.69	48.40	45.95	45.18 @	-4.2	-1.5	5.3	2.1 @

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; @ Average exchange rate for April-January, 2004-05.
*** At the end of January, 2005 ** At the end of December, 2004 *** April-January, 2004-05**
 # As on February 5, 2005. $ As on December, 2004. + 2nd Advance estimates 2004-05
^ April-December, 2004

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. **As on Janauary 21, 2005, year-on-year growth (net of conversion of a non-banking entity into a banking entity from October 11, 2004).**
7. **Outstanding at the end of financial year.**
8. **Percent change indicates the rate of appreciation (+)/depreciation (-) of the Rupee vis-á-vis the US Dollar.**

Item	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003 (P)	2003-2004 (Q)	2004-2005 (A)
	Percentage change over the previous year							
I. Agriculture & allied	**-2.4**	**6.2**	**0.3**	**-0.1**	**6.3**	**-7.0**	**9.6**	**1.1**
II. Industry	**4.3**	**3.7**	**4.8**	**6.5**	**3.6**	**6.6**	**6.6**	**7.8**
Mining & quarrying	9.8	2.8	3.3	2.4	2.5	9.0	6.4	5.3
Manufacturing	1.5	2.7	4.0	7.4	3.6	6.5	6.9	8.9
Electricity, gas & water supply	7.9	7.0	5.2	4.3	3.7	3.1	3.7	6.3
Construction	10.2	6.2	8.0	6.7	4.0	7.3	7.0	5.7
III. Services	**9.8**	**8.4**	**10.1**	**5.5**	**6.8**	**7.9**	**9.1**	**8.9**
Trade, hotels, transport & communication	7.8	7.7	8.5	6.8	9.0	9.8	11.8	11.3
Financial services	11.6	7.4	10.6	3.5	4.5	8.7	7.1	7.1
Community, social & personal services	11.7	10.4	12.2	5.2	5.1	3.9	5.8	6.0
IV. Total GDP at factor cost	**4.8**	**6.5**	**6.1**	**4.4**	**5.8**	**4.0**	**8.5**	**6.9**

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

P: Provisional Q : Quick estimates; A : Advance estimates;
Source : Central Statistical Organisation.

1.5 Despite this setback in the kharif crop, the outlook for 2004-05 remains robust because of the persistence of the overall growth momentum observed in 2003-04 through the current year. With distinct signs of continuation of global recovery and world output growth estimated at 5.0 per cent in 2004, the highest in nearly three decades, the Indian economy is expected to do well in 2004-05.

1.6 GDP grew by 7.4 per cent in the first quarter and 6.6 per cent in the second quarter of the current year, compared with 5.3 per cent and 8.6 per cent in the corresponding quarters of the previous year. The deceleration of growth in the second quarter is on account of a negative growth of 0.8 per cent in agriculture and allied sector, a lower growth of 8.2 per cent in the services sector compared with 9.5 per cent in the first quarter, and a fall in the growth of community, social and personal services. The growth in industry accelerated from 6.9 per cent in the first quarter to 8.1 per cent in the second quarter. Within industry, growth in manufacturing accelerated from 8.0 per cent in the first quarter to 9.3 per cent in the second quarter, the highest in any quarter since 1997-98, when CSO started compiling quarterly estimates. Despite a lower growth in the second quarter, the overall growth in the first half of the current year at 7.0 per cent is marginally higher than the growth of 6.9 per cent achieved in the same period last year.

1.7 There was a sudden bout of inflation in the first half of 2004-05, caused by a combination of factors, some exogenous, like the sharp rise in global petroleum prices, deficient rainfall-induced inflationary expectations and monetary overhang from accretion of foreign exchange reserves. The year 2004-05, after starting with a point-to-point, annual inflation rate of 4.5 per cent on April 3, 2004 witnessed a peak level of inflation at 8.7 per cent on August 28, 2004, the highest in the last four years. However, as a result of the quick monetary and fiscal measures taken by the Reserve Bank of India (RBI) and Government, coupled with a slight easing of global petroleum prices, inflation has been on a declining trend and stood at 5 per cent on February 5, 2005 compared to 6.1 per cent a year ago.

1.8 The 52-week average inflation rate at 6.4 per cent on February 5, 2005 was, however, higher than the 5.5 per cent registered last year. In the current year up to February 5, 2005, both manufactured products and primary articles recorded lower year-on-year inflation rates at

4.5 per cent and 1.6 per cent, respectively, compared to 6.7 per cent and 3.4 per cent, respectively, last year. But there was acceleration in the inflation rate of the fuel, power, light and lubricant group from 7.6 per cent last year to 10.0 per cent this year due to a hardening of international prices of oil and minerals. The major groups witnessing high year-on-year inflation as on February 5, 2005 include minerals (135.5 per cent), coal (16.2 per cent), petroleum, oil and lubricants (POL) (14.6 per cent), sugar group (21.4 per cent), and basic metals and products (16.0 per cent). The contribution of these items with a combined weight of 21.5 per cent in the WPI was 88 per cent to the current inflation, compared to 52 per cent a year ago**.** The hardening of international prices of these commodities (except sugar) due to a surge in global demand shows that a major part of inflation is due to external factors.

1.9 Year-on-year inflation as measured by the Consumer Price Index (CPI) for industrial workers declined significantly from 5.1 per cent in April 2003 to 3.5 per cent in March 2004 and further to 2.2 per cent in April 2004. Thereafter, the CPI inflation rate started registering an increasing trend reaching 4.8 per cent in September 2004, as WPI inflation pushed up the consumer prices also. Partly in response to policy measures, and the subsequent easing of external pressure of oil imports, CPI declined to 4.6 per cent in October 2004 and further to 3.8 per cent in December 2004. The CPI inflation, which is considered a more appropriate indicator of general inflation, is also substantially lower than the average WPI inflation at 6.7 per cent in December 2004.

1.10 The lower inflation exhibited by the CPI than by the WPI was mainly because of the food group of commodities having lower than overall inflation and higher weight in CPI than in WPI. Thirty essential commodities for households, with a weight of 17.63 per cent in WPI, registered a 12-month point-to-point inflation of 4.5 per cent on February 5, 2005, compared to 4.9 per cent a year ago, and accounted for 15.6 per cent of the overall inflation compared to 14.0 per cent a year ago. Out of the 30 items, 11 items registered declines in absolute prices over last year, while year-on-year inflation was less than five per cent for 8 items as on February 5, 2005. There was double-digit inflation for potato, tea, sugar, salt, bajra, gur, and coking coal, partly because absolute prices of these items (except sugar, gur and coking coal) had witnessed a decline in the previous year. Furthermore, food group inflation is lower in CPI than in WPI, suggesting that food prices in the wholesale market increased faster than in the retail markets.

1.11 In the second quarter of 2004-05, Government stepped in to keep inflation under check by reducing excise and customs duties on selected petroleum products; reducing customs duties on non-alloy steel; exempting melting scrap of iron and steel from customs duty; and reducing tariff values of many vegetable oils. The RBI hiked the Cash Reserve Ratio (CRR) in two stages, effective from September 18, 2004, and October 2, 2004, respectively, and the reverse-repo rate was hiked effective from October 27, 2004, to check liquidity overhang in the system. These measures, coupled with the subsequent fall in international crude prices, helped to rein in inflation.

1.12 For the last two financial years, with widening fiscal and current account deficits in the United States (US), the rupee had been strengthening against the US dollar. This trend saw a brief spell of reversal during May–August 2004. With other major convertible currencies strengthening more than the rupee (vis-à-vis the US dollar), the rupee weakened against major non-dollar currencies. The rising expectations of higher US interest rates and buoyant growth contributed to moderate appreciation of the US dollar. This in turn led to the depreciation of the rupee against the dollar from May 2004. After April 2004, the rupee also depreciated against other major non-dollar global currencies (Euro, Pound Sterling and Yen) until August, 2004. May-July, 2004 also witnessed net portfolio outflows.

1.13 The exchange rate of the rupee has exhibited appropriate flexibility in response to market conditions in 2004-05. Furthermore, the international currency markets also saw

large changes in cross-currency rates. Thus, particularly with resumption of capital inflows, the depreciating trend of the rupee vis-à-vis the US dollar and other non-dollar major currencies was reversed from September and August, 2004, respectively. With the Euro strengthening sharply against the US dollar, the rupee began weakening again from October 2004 against the major non-dollar currencies. In January 2005, in nominal terms, the rupee appreciated against all major currencies.

1.14 In real effective terms, the rupee appreciated in June, August and September, 2004. Despite strengthening nominally against the US dollar from September 2004 due mainly to renewed foreign institutional investors' (FII) inflows and US dollar's weakness against global currencies, the rupee started depreciating in real effective terms due to a softening of domestic inflation and a sharp fall against non-dollar currencies. This trend continued until end-2004.

1.15 The rising trend in India's foreign exchange reserves continued with such reserves (including gold, SDRs and reserve position in IMF) reaching an estimated level of US$128.91 billion on February 4, 2005 in excess of India's total external debt of US$114 billion at end-September, 2004. However, the accretion to reserves so far in this year at just over US$15.9 billion is small compared to that of more than US$31 billion during the corresponding period of the previous year, and an unprecedented US$36.9 billion in the full year 2003-04. The slowdown in reserves growth – not entirely an unwelcome development – is due to three main reasons. First is the emergence of a current account deficit during the first half of the year compared to a surplus in the corresponding period last year. Second, with adjustment of interest rates on such deposits, non-resident Indians' (NRI) deposits went down. Third, relative to 2003-04, when there were large valuation gains with the weakening of the US dollar, such gains during the current year are difficult to predict.

1.16 The current account balance, after being in surplus for the three previous years in succession, turned into a deficit in the first half of the current year (April–September 2004-05). The surplus in the current account in the first quarter of the current year was not only reversed but more than offset by the deficit in the second quarter, resulting in an overall current account deficit of US$3.2 billion in the first half of 2004-05. The current account development can be attributed to two main reasons. First, there was a large merchandise trade deficit with a rise not only in the POL import bill because of high prices but also in non-bullion, non-POL imports, which overwhelmed the growth of exports in US dollar terms at over 23 per cent. Second, there was a relatively moderate growth of 23 per cent in net invisibles surplus in the first half of the current year as compared to 35 per cent in the corresponding previous period. While workers' remittances declined marginally, net non-factor services registered a robust year-on-year growth of 174 per cent, and software services exports remained buoyant with 28.7 per cent growth in the first half of 2004-05. Movements in the external merchandise trade account in the first ten months of the current year hold pointers to three emerging trends.

1.17 First, the buoyancy of merchandise export growth (25.6 per cent), in US dollar terms, after a continuous rise of more than 20 per cent in each of the previous two years, reflects a sustained rise in volume of exports with revival of growth in the manufacturing sector and increased export competitiveness. Commodity-wise export growth continued to be broad-based with the manufacturing sector in the lead. The main drivers of this high growth were the five major sectors of engineering goods, gems & jewellery, textiles, chemicals and related products, and petroleum products. However, despite the buoyancy of exports, among the top exporting countries of the world, India ranked 31st in 2003, down from 30th in the previous year. Government has fixed an ambitious target of US$150 billion for exports by the year 2008-09 to double India's share in world exports to 1.5 per cent.

1.18 Second, the estimated strong growth in non-POL, non-bullion merchandise imports by 33.7 per cent in April-January 2004-05 reflects buoyant domestic demand including for investment, a mildly strengthening rupee in real terms, and greater import liberalization.

1.19 Third, the emergence of the ASEAN + 3 (China, Japan and Korea) countries as India's dominant trading partners accounting for 19.9 per cent of India's total merchandise trade, followed by the EU and North America with shares of 19.0 per cent and 12.9 per cent in 2003-04, respectively, points to a broadening of the trade horizons and a 'look-east' emphasis. To broaden its trade horizons further, besides active participation in WTO negotiations, India also engaged itself in a number of bilateral trade agreements.

1.20 The capital account surplus in April-September 2004 was also down by around US$1.5 billion from April-September 2003. Buoyant foreign investment inflows along with robust inflows of commercial borrowings sustained the capital account. The balance of payments surplus was around US$7 billion in the first half of 2004-05, roughly half of what it was in April-September 2003.

1.21 In 2003-04, capital account surplus doubled to over US$20 billion. There was a rise of 255 per cent in net foreign investment flows, mainly of the portfolio variety driven by the heavily bullish sentiments in the Indian stock markets. NRI deposits increased by US$3.6 billion in 2003-04, compared to the previous year's increase of US$3.0 billion. The capital account remained in surplus during the first half of the current year, but at a reduced level compared to April-September 2003, reflecting a sharp fall in portfolio and banking capital inflows. Portfolio flows declined by about US$3 billion from the corresponding period of the previous year to US$512 million. With a decline in the premium on their interest rates, NRI deposits – the dominant component of banking capital — declined by US$1.2 billion in April-September 2004, compared to an increase of US$2.2 billion in the corresponding period of the previous year. With a more liberalized regime and an improvement in the country's foreign currency ratings, there was a large increase of about US$2 billion in external commercial borrowings (ECB) in the first half of 2004-05 over the corresponding period of the previous year; but this increase was not sufficient to offset the decline in portfolio flows and banking capital.

1.22 The decline in net portfolio flows in the first half of the current year was particularly pronounced in the first quarter with volatility in the Indian stock market in mid-2004, and reassessment of risk-return payoffs by FIIs in the wake of a rise in US interest rates. Recent data indicate that with resumption of bullish trends in the Indian stock market from July 2004, portfolio inflows have gathered momentum. Similarly, the upward revision of interest rate ceilings on NRI deposits from November 2004 appears to have contributed to a reversal of the declining trend in such deposits in the first half.

1.23 Improvement in India's external debt position continued in 2003-04. Apart from continuing with its extant prudent external debt policy, some initiatives such as prepayment of costly external debt and rationalization of interest rates as well as structure of NRI deposits contributed to an improvement in the debt-sustainability indicators during 2003-04. For example, external debt as a proportion of GDP went down from 20.2 per cent at end-March 2003 to 17.8 per cent at end-March 2004. Similarly, the share of short-term debt in total external debt declined from 4.8 per cent at end-March 2003 to 4.3 per cent at end-March 2004. In the first half of the current year, such indicators have shown a marginal deterioration, but within prudent limits, and for legitimate reasons such as an increase in short-term trade-credit reflecting larger import demand.

1.24 Compared to its stock at the beginning of the year, the growth in reserve money, which had accelerated from 9.2 per cent during 2002-03 to a high of 18.3 per cent during 2003-04, declined to 6.4 per cent in the current year up to January 28, 2005. The corresponding growth in reserve money a year ago was 7.8 per cent. The lower growth of reserve money in the current year was on account of lower growth of 15.9 per cent in net foreign exchange

assets (NFA) of the RBI compared with 32.8 per cent in the corresponding period last year. The sharp decline in net RBI credit to Government observed in 2003-04 (62.8 per cent in the full year) continued in the current year with a further fall of 69.9 per cent upto January 28, 2005, and resulted in NFA constituting 120.9 per cent of reserve money as of that date. Despite a lower growth of reserve money in the current year, liquidity management remained a major concern. This was because, after a sharp increase in reserve money in the previous year, there was a liquidity overhang of over Rs.81,000 crore in the form of outstanding reverse repos under the Liquidity Adjustment Facility (LAF), Government surplus balances and excess reserves of banks from the previous year. This overhang posed a nascent problem in liquidity management. The Government raised the limit under MSS from Rs.60,000 crore to Rs. 80,000 crore on August 26, 2004, after the threshold limit of Rs.50,000 crore was crossed. Measures taken by the RBI include discontinuation of the auction of 7-day and 14-day reverse repo and its substitution by an overnight fixed rate reverse repo, and raising the cash reserve ratio by 50 basis points to 5 per cent.

1.25 Compared to its stock at the beginning of the year, broad money (M_3) grew by 9.5 per cent (net of conversion) in the current year up to January 21, 2005, compared with the high of 16.6 per cent in the whole of the previous year, and 12.1 per cent in the same period last year. The money multiplier — the ratio of M_3 to reserve money — which increased from 4.43 at end-March 2002 to 4.65 at end-March 2003 declined to 4.59 at end-March 2004. As on January 21, 2005, this ratio stood at 4.72.

1.26 Despite lower growth of money supply in the current year, there was an impressive growth in gross bank credit by scheduled commercial banks (SCBs). Gross bank credit, net of conversion, increased by 19.9 per cent up to January 21, 2005 compared to 9.3 per cent in the corresponding previous period. Growth was observed in both food and non-food credit, more so in the case of the latter. Food credit grew by 15.2 per cent in the current year up to January 21, 2005 compared to a decline of 25.9 per cent last year, while non-food credit grew at an impressive 20.1 per cent compared to 11.9 per cent in the same period last year, the highest growth registered since 1996-97. Priority sector advances by public sector banks (PSBs) reached 44.0 per cent of net bank credit (NBC) in 2003-04, exceeding the target of 40 per cent. There were, however, shortfalls in meeting the sub-target under agriculture.

1.27 The Government announced a comprehensive policy envisaging a 30 per cent increase in agriculture credit in the current year and doubling the credit flow to the sector in three years.

1.28 There was an improvement in the performance of SCBs in 2003-04. While the ratio of net profits to total assets of SCBs improved marginally from 1.0 per cent in 2002-03 to 1.1 per cent in 2003-04, the ratio of operating profits to total assets improved from 2.4 per cent to 2.7 per cent in the same period. The profitability of SCBs showed a declining trend in the first half of the current year on account of a decline in treasury income. The annualized ratio of net profit to total assets was 1.1 per cent in the first half of 2004-05 compared to 1.3 per cent in the same period last year. There was a significant decline in the non-performing assets (NPAs) of SCBs. Gross NPAs of SCBs as a proportion of total assets declined from 4.0 per cent in 2002-03 to 3.3 per cent in 2003-04. The decline in the corresponding ratio of net NPAs was from 1.9 per cent to 1.2 per cent. The capital to risk weighted assets ratio (CRAR) of SCBs improved from 12.7 per cent in 2002-03 to 12.9 per cent in 2003-04.

1.29 In the current year, there was a marginal northward movement in deposit rates of five major banks by 25 basis points. Interest rates on housing loans witnessed a marginal firming up as well. Call money rates moved up in the second half of the year, reflecting higher growth of bank credit. Nevertheless, interest rates continue to be moderate. The benchmark prime lending rates of five major banks were lower by 25 to 50 basis points in December, 2004 compared to the rates prevailing a year ago.

1.30 Fiscal consolidation, after a promising beginning in the early 1990s, started faltering from 1997-98. Fiscal deficit of the Central Government as a proportion of GDP, after its decline from 6.6 per cent in 1990-91 to 4.1 per cent in 1996-97, rose every year to reach 6.2 per cent in 2001-02. Progress in fiscal consolidation resumed in 2002-03. According to provisional data, in 2003-04, the ratio at 4.6 per cent was lower than the budget estimate of 5.6 per cent. A further improvement in this ratio to 4.4 per cent was budgeted for 2004-05.

1.31 After witnessing a trend similar to that in fiscal deficit until 1996-97, the deterioration in revenue deficit was much sharper in subsequent years. The rise in revenue deficit continued till 2001-02, when it reached 4.4 per cent of GDP. Revenue deficit declined to 3.6 per cent of GDP in 2003-04 (Prov.), but even at this level, it was higher than the level of 3.3 per cent of GDP observed in the pre-reform year of 1990-91. The increasing share of revenue deficit in fiscal deficit distinctly reveals the deterioration in the composition of the fiscal deficit and in the quality of expenditure. The share of revenue deficit in fiscal deficit had risen from 49.4 per cent in 1990-91 to 78.0 per cent in 2003-04, which was sought to be reversed in 2004-05 by targeting a lower revenue deficit of 2.5 per cent of GDP in the budget estimates (BE).

1.32 The current year 2004-05 is the first year when the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 is in operation. With the notification of the Rules in July 2004, Central finances are subject to the discipline of the FRBM Act. Accordingly, the Government targeted a front-loaded fiscal adjustment in the Budget for 2004-05, going beyond the stipulated minimum reductions in the revenue and fiscal deficits. The budgeted reductions in fiscal and revenue deficits as proportions of GDP are 0.4 and 0.9 percentage points over revised estimates, respectively, as compared with the minimum reductions of 0.3 and 0.5 percentage points, respectively, mandated under the FRBM rules.

1.33 During the first nine months of the current year, the performance of Central finances was not very encouraging. As proportions of BE, fiscal and revenue deficits at 65.7 and 82.7 per cent, respectively, were higher than 60.2 and 65.0 per cent, respectively, observed in the corresponding previous period. A vigorous drive to collect tax arrears, mobilization of minimum dividend payment on Government equity, 10 per cent cut in the budgetary allocations under non-plan and non-salary expenditure, and restricting expenditure in the last quarter of the year to no more than 33 per cent of BE are expected to result in improved performance of Central finances in the last quarter of 2004-05.

1.34 Efforts at improving the fiscal health of the States are continuing. The consolidated fiscal deficit of the Centre and the States is budgeted to come down from 9.4 per cent of GDP in 2003-04 (RE) to 7.9 per cent of GDP in 2004-05. For the States, between 1990-91 and 2003-04(RE), as proportions of GDP, revenue and fiscal deficits had increased from 0.9 per cent and 3.3 per cent to 2.6 per cent and 5.1 per cent, respectively. In 2004-05, revenue and fiscal deficits are budgeted to be brought down to 1.4 per cent of GDP and 3.6 per cent of GDP, respectively. The Centre has been playing a proactive role in furthering the cause of fiscal reforms at the State level. Under the debt swap scheme, States swapped their high cost borrowings from the Centre amounting to Rs. 34,085 crore in the current year up to December, 2004, with additional market borrowings and loans from the National Small Savings Fund (NSSF). The cumulative high cost loans swapped by States amounted to Rs. 92,444 crore at end-December, 2004. The decision of States to introduce VAT from April 1, 2005 marks the culmination of efforts that began more than a decade ago at reforming domestic trade taxes.

1.35 State level reforms are likely to receive an impetus with the recommendations of the Twelfth Finance Commission (TFC) coming into force from 2005-06. The roadmap for reforms intended to put the State finances on a sustainable path unveiled by the TFC include: raising the share of States in the net proceeds of shareable Central taxes from 29.5 per cent to 30.5 per cent; and consolidation and

rescheduling of Central loans contracted till March, 2004 and outstanding on March 31, 2005 (Rs. 1,28,795 crore) for a fresh term of 20 years at a rate of interest of 7.5 per cent, subject to the enactment of fiscal responsibility legislation by the State. The fiscal responsibility legislation as recommended by the TFC should prescribe annual targets with a view to eliminating revenue deficit by 2008-09 and reducing fiscal deficit based on a path for reduction of borrowings and guarantees. The Commission also recommended a debt write-off scheme linked to reduction of revenue deficit of States.

1.36 The equity markets continued to boom in 2003-04 and in the current year so far. The top 50 stocks (Nifty) generated returns of 11 per cent in 2004, following returns of 72 per cent in 2003. The second rung of smaller stocks (Nifty Junior) generated returns of 31 per cent in 2004, following returns of 141 per cent in 2003. These strong returns largely reflected growth in profits of corporations, and not changes in expectations. Strong equity index returns in calendar 2003 led to a revival of the primary market in 2004. Overall public issues grew by roughly five times to Rs. 35,859 crore in 2004. The growth was concentrated in equity issues and particularly in equity initial public offerings (IPOs).

1.37 Securities markets in India grew strongly in terms of turnover. In 2004, the turnover on the equity spot and derivatives markets and on the spot market for government bonds was Rs.43 lakh crore and Rs.11 lakh crore, respectively. Turnover on commodity futures was Rs.1.7 lakh crore in the half year, April-September 2004. The equity spot and derivatives markets had experienced major reforms in recent years, and these reforms yielded results in terms of improved liquidity and robustness. Impact cost, by measuring the price impact of a large trade, reveals the liquidity and depth of the market. The impact cost of the top 50 stocks dropped in 2004 to a level which was one-third of that found as recently as in 2001.

1.38 Direct household participation in the securities markets, which had stagnated in 2002, grew strongly in 2003 and 2004 to a level of 6 million accounts at the National Securities Depository Limited (NSDL). Diverse participation is a major source of strength for equity markets. FIIs also showed greater interest in the equity market by increasing their share to 5.8 per cent of the total market turnover. In the latest two years, the top 50 stocks (Nifty) had a correlation of 0.33 against the U.S. S&P 500 index. The next 50 stocks (Nifty Junior) had a correlation of just 0.20. These low correlations imply that Indian equities continue to be highly attractive as a tool for diversification of global portfolios.

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

1.39 The significant improvement in the rates of savings and investment witnessed in 2002-03 continued through 2003-04. Savings rate, which is gross domestic savings as a proportion of GDP at current market prices, increased from 23.4 per cent in 2001-02 to 26.1 per cent in 2002-03. The corresponding increase in investment rate (gross domestic capital formation as a proportion of GDP) was from 22.6 per cent to 24.8 per cent. There were further improvements in savings and investment rates in 2003-04 to 28.1 per cent and 26.3 per cent, respectively. The savings rate in 2003-04 is the highest recorded so far and the investment rate in 2003-04 is the highest since 1996-97 (Table 1.3).

1.40 The years 2002-03 and 2003-04 marked a departure from the trend of declining savings and investment rates observed in recent years. The improvement in savings rate mainly came through a reduction in public dissavings and improvement in private savings, both household and private corporate. Within household savings, there was a significant improvement in savings in physical assets from 11.4 per cent of GDP in 2001-02 to 13.0 per cent of GDP in both 2002-03 and 2003-04. In contrast, household savings in financial assets (again as a proportion of GDP), after declining from 11.2 per cent in 2001-02 to 10.3 per cent in 2002-03, improved to 11.4 per cent in 2003-04. Thus, higher savings rate was on account of improved performance in all the three sectors. A noteworthy development was the reversal in

Table 1.3 : Savings and investment

	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03 (P)	2003-04 (Q)
	(as per cent of GDP at current market prices)							
Gross Domestic Savings	**23.2**	**23.1**	**21.5**	**24.2**	**23.5**	**23.4**	**26.1**	**28.1**
a) Public	1.7	1.3	-1.0	-1.0	-2.3	-2.7	-1.1	-0.3
b) Private	21.5	21.8	22.5	25.2	25.8	26.2	27.2	28.5
i) Household	17.0	17.6	18.8	20.9	21.6	22.6	23.3	24.3
Financial	10.4	9.6	10.4	10.6	10.4	11.2	10.3	11.4
Physical	6.7	8.0	8.4	10.3	11.3	11.4	13.0	13.0
ii) Private Corporate	4.5	4.2	3.7	4.4	4.1	3.6	3.8	4.1
Gross Domestic Investment*	**24.5**	**24.6**	**22.6**	**25.3**	**23.8**	**22.6**	**24.8**	**26.3**
Public	7.0	6.6	6.6	6.9	6.3	6.2	5.4	5.6
Private	14.7	16.0	14.8	16.7	16.3	16.0	17.3	17.4
GFCF	22.8	21.7	21.5	21.8	22.0	22.1	22.2	22.7
Change in stocks	-1.0	0.9	-0.1	1.9	0.6	0.1	0.4	0.3
Saving-Investment Gap@	**-1.3**	**-1.5**	**-1.1**	**-1.1**	**-0.4**	**0.8**	**1.3**	**1.8**
Public	-5.4	-5.3	-7.6	-8.0	-8.6	-8.9	-6.4	-5.9
Private	6.8	5.8	7.7	8.5	9.4	10.1	9.9	11.0

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; Q : Quick estimates;
Source : Central Statistical Organisation.

the trend of growing dissavings of the public sector, with dissavings declining from 2.7 per cent of GDP in 2001-02 to 1.1 per cent in 2002-03 and further to 0.3 per cent of GDP in 2003-04.

1.41 The improvement in the investment rate came mainly from private investment, which increased from 16.0 per cent in 2001-02 to 17.3 per cent in 2002-03 and further to 17.4 per cent in 2003-04. Public investment, after declining continuously since 2000-01, improved from 5.4 per cent in 2002-03 to 5.6 per cent in 2003-04. Gross capital formation in the public sector witnessed a significant improvement. It grew by 16.8 per cent in 2003-04 in contrast to a decline of 5.8 per cent in 2002-03. While private investment continued to dominate the change in overall investment rate, and public sector investment performance improved, there was a deceleration in the growth of gross capital formation in the private sector from 17.1 per cent in 2002-03 to 13.1 per cent in 2003-04.

1.42 Gross domestic capital formation (GDCF) at constant prices grew by 13.8 per cent in 2003-04, lower than the growth of 17.4 per cent in 2002-03. The growth in both years was higher than that in GDP, but with the difference between GDP growth and GDCF growth narrowing, the increase in GDCF as a proportion of GDP at 1993-94 market prices was only 1.3 percentage points in 2003-04 compared to 3.1 percentage points in 2002-03 (Table 1.4). This improvement came mainly from the private sector. The continuous decline in capital formation of the public sector observed from 2000-01 was reversed in 2003-04.

1.43 The increasing share of investment in GDP was reflected in a decline in the share of final consumption expenditure, consisting of Government final consumption expenditure (GFCE) and private final consumption expenditure (PFCE), from 76.2 per cent in 2002-03 to 75.3 per cent. This decline in the share of final consumption expenditure in GDP was driven by corresponding declines in both GFCE and PFCE. Within consumption

Table 1.4 : Real gross domestic capital formation							
	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03 (P)	2003-04 (Q)
	(As percent of GDP at market prices, 1993-94 prices)						
GDCF*	**25.9**	**24.6**	**27.8**	**26.3**	**24.3**	**27.4**	**28.7**
Public	6.5	6.6	7.0	6.2	6.0	5.2	5.3
Private	17.3	16.7	19.0	18.8	17.9	19.8	19.9
Private corporate	9.0	7.6	7.7	6.4	5.5	5.3	5.6
Household Sector	8.3	9.1	11.3	12.4	12.4	14.5	14.3
GFCF	**22.8**	**23.4**	**23.9**	**24.0**	**23.8**	**24.6**	**24.8**
Public	6.2	6.4	6.2	6.0	5.7	5.5	5.7
Private	16.6	17.0	17.7	18.0	18.1	19.1	19.1
Change in stocks	**0.9**	**-0.1**	**2.0**	**1.1**	**0.1**	**0.5**	**0.3**
Public	0.3	0.1	0.8	0.3	0.3	-0.2	-0.4
Private	0.7	-0.3	1.2	0.8	-0.2	0.7	0.7
	(Growth rate in per cent)						
GDCF*	**7.7**	**0.7**	**20.8**	**-1.4**	**-2.9**	**17.4**	**13.8**
Public	-0.8	7.3	13.3	-7.2	1.4	-8.9	10.0
Private	16.4	2.6	21.5	3.0	0.0	15.5	8.7
GFCF	**2.1**	**8.7**	**9.3**	**4.1**	**4.3**	**7.7**	**9.7**
Public	-2.8	9.4	2.7	0.4	0.3	0.4	13.1
Private	4.1	8.4	11.8	5.4	5.6	10.0	8.7

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; Q : Quick estimates;**
Source : Central Statistical Organisation

expenditure, with a marginal decline of 0.3 percentage points, the PFCE-GDP ratio came down to 64.0 per cent. Furthermore, within PFCE, while there was a decline in the share of food, beverages and tobacco, rent, fuel, and power, there was an improvement in the shares of transport and communication.

1.44 Consumption expenditure, particularly PFCE, has been a major contributor to GDP growth. The contribution of PFCE to GDP growth increased from 50.4 per cent in 2002-03 to 60.9 per cent in 2003-04. The contribution of GFCE also improved from 4.3 per cent to 6.9 per cent in the same period.

Table 1.5 : Disposition of gross domestic product (GDP)										
	Percentage change over the previous year									
	(at current prices)					(at 1993-94 prices)				
Component	1999-2000	2000-01	2001-02	2002-03P	2003-04Q	1999-2000	2000-01	2001-02	2002-03P	2003-04Q
Total final consumption expenditure	**12.5**	**6.7**	**9.1**	**5.9**	**10.7**	**7.1**	**2.4**	**5.3**	**2.0**	**7.5**
Govt. final consumption expenditure	17.3	5.2	7.2	2.9	7.1	13.2	0.5	3.1	-2.4	3.7
Pvt. final consumption expenditure	11.6	7.0	9.5	6.5	11.4	6.0	2.8	5.8	2.8	8.2
Gross domestic capital formation	24.8	1.5	3.1	18.8	19.1	20.8	-1.4	-2.9	17.4	13.8
of which:										
Gross fixed capital formation	12.7	8.8	9.2	9.3	14.5	9.3	4.1	4.3	7.7	9.7
Exports of goods and services	**16.6**	**22.1**	**4.5**	**22.3**	**14.7**	—	—	—	—	—
Less imports of goods and services	**18.2**	**12.0**	**4.5**	**22.2**	**16.7**	—	—	—	—	—
GDP at market prices	11.2	7.9	8.7	8.4	12.0	7.1	3.9	5.1	4.1	8.6

P - Provisional Q-Quick estimates
Source : Central Statistical Organisation.

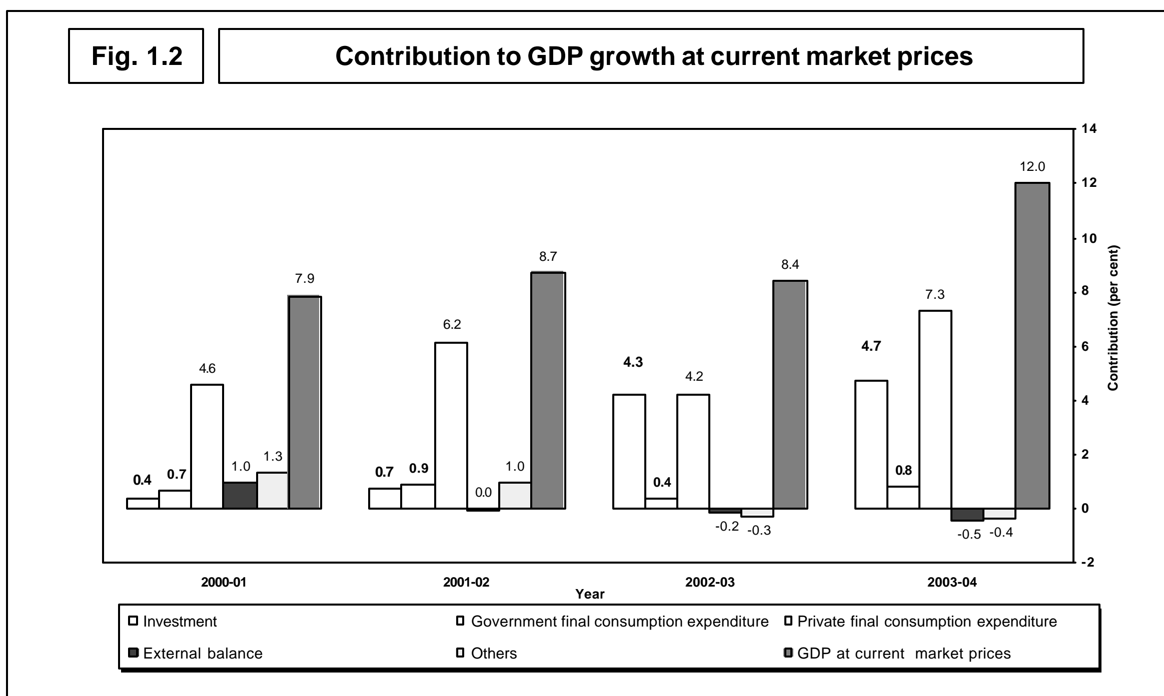


Fig. 1.2 **Contribution to GDP growth at current market prices**

The contribution of investment to growth has not been following any consistent pattern. Its contribution to growth varied from 8.4 per cent in 2001-02 to 50.6 per cent in 2002-03. In 2003-04, it contributed 39.3 per cent to GDP growth. Contribution of external sector remained negative at -2.2 per cent in 2002-03 and -3.8 per cent in 2003-04. For the period 1999-2000 to 2003-04, the average contribution of PFCE, GFCE, investment, and external sector to the GDP growth was 61.4 per cent, 9.8 per cent, 30.6 per cent and 0.3 per cent, respectively.

(c) **Production**

1.45 According to the second advance estimate of total foodgrains production, foodgrains output is expected to decline to 206.4 million tonnes in 2004-05 from 212 million tonnes in the previous year, with shortfalls in the output of coarse cereals and pulses. Output of rice and wheat is actually projected to be higher than last year’s. Horticulture, consisting of fruits and vegetables, spices, floriculture and coconuts, together with livestock, poultry and fisheries contribute more than 60 per cent of GDP from agriculture and allied sector, and these sub-sectors appear to be doing well in the current year. A bumper harvest of cotton in 2004-05, with output up almost 24 per cent from last year, augurs well for the cotton textile industry. With deficient rainfall in parts of Maharashtra in the current year, production of sugarcane is likely to continue its downward trend for the third consecutive year.

1.46 Industrial sector, as per the Index of Industrial Production (IIP), registered an impressive growth of 8.4 per cent in the first three quarters of 2004-05, the highest after 1995-96. Vis-à-vis the corresponding period of the previous year, there is improvement in all the broad groups by sources of production as well as by use-based classification. This improvement is particularly pronounced in manufacturing, and in capital goods and consumer durables. The broad-based improvement also implies an improvement in both investment and consumption demand.

1.47 The year started on a buoyant note with an annual growth of 8.9 per cent in the IIP in April 2004. The slowdown in annual growth in May 2004 to 6.8 per cent proved transient, and growth accelerated in each of the following months to peak at 9.8 per cent in October. The decline in IIP growth to 7.7 per cent in November 2004 again was reversed in December when growth rebounded to 7.9 per

cent. The positive development on the industrial front is most pronounced in manufacturing. During 2004, annual growth in manufacturing, after declining from 8.8 per cent in April to 7.5 per cent in May, consistently accelerated every month to reach double-digit levels in September and October. Within manufactured goods, capital goods and consumer durables continued to demonstrate vibrancy by registering double digit year-on-year growth rates in each of the first nine months of the current year except in May for consumer durables. In September 2004, growth in capital goods and consumer durables was satisfactorily high at 16.8 per cent, and 20.6 per cent, respectively.

1.48 Out of the seventeen industry groups at the two-digit level of classification, in April-December 2004, four registered double-digit growth; four grew between 5 and 10 per cent; and six grew between 0 and 5 per cent. Three key groups, namely, machinery and equipment other than transport equipment, other manufacturing industries not included elsewhere, and basic chemicals and chemical products (except products of petroleum and coal) with aggregate weight of about 32.9 per cent in the manufacturing sector and 26.1 per cent in the total IIP, recorded impressive growth rates of 21.9 per cent, 19.4 per cent and 15.7 per cent, respectively. Food products, jute and other non-cotton vegetable fibres, and wood and wood products, furniture and fixtures, with a total weight of 15.6 per cent in the manufacturing sector and 12.3 per cent in IIP, were the only sectors that registered negative growth in the first three quarters of the current year.

1.49 There are some encouraging signals in the first nine months of the current year from the Indian textiles industry regarding its preparedness to meet the challenges in a quota-free world trade regime in textiles from January 1, 2005. IIP for textile products (including wearing apparel) grew by 14.8 per cent in April-December 2004 compared to a decline of 2.8 per cent in the corresponding period of the previous year. Cotton textiles also improved its growth performance by an even bigger 14 percentage points to 8.3 per cent in the first nine months of the current year compared to a decline of 5.7 per cent a year ago. The investment intentions for the current year suggest a consolidation of the growth process in the textile sector.

1.50 The automobile and auto-component industry performed well in 2003-04. The increase in sales turnover of auto-components in 2003-04 was 20.0 per cent. The satisfactory trend appears to continue in the current year with, for example, the automobile industry increasing the production of total vehicles to 6.2 million in the first nine months of the current year from 5.2 million in the corresponding period of the previous year. Output of electronics and information technology (IT) industry is estimated to have grown by 18.2 per cent to Rs. 1,14,650 crore in 2003-04. During April-December 2004, production of steel increased to 28.3 million tonnes and recorded a growth of 4.0 per cent over the corresponding period of the previous year. During April-December 2004, production of cement at 96.3 million tonnes was 6.81 per cent higher than the production in the corresponding period of last year.

1.51 Six core industries (electricity, coal, finished steel, cement, crude oil and petroleum products), with important forward linkages with the rest of the economy, and having a weight of 26.68 per cent in the IIP, registered a lower average growth of 5.4 per cent during April–December 2004 compared to 5.8 per cent in the same period in 2003. The decline is on account of a sharp fall in the growth of finished steel. Among the other infrastructure sectors, goods traffic on railways (7.7 per cent), cargo handled at major sea ports (11.1 per cent) and airports (18.3 per cent), and air passenger traffic (21.8 per cent) experienced higher growth rates in April–December 2004 as compared to the same period in 2003.

(d) **Employment and poverty**

1.52 The Planning Commission estimates the incidence of poverty and unemployment on the basis of large-scale quinquennial sample surveys on household consumer expenditure, labour force and employment conducted by the National Sample Survey Organisation

(NSSO). With the last such survey conducted only in the 55th Round during 1999-2000, no official estimates of poverty and unemployment exist beyond 1999-2000. These last official estimates were reported in last year's Economic Survey. Although subsequent mini-annual rounds of survey suggest that poverty has come down and employment has increased, these are subject to large sampling and non-sampling errors.

1.53 The Human Development Index (HDI) encompasses the three important dimensions of income, education and health. Although there is no one-to-one inverse correspondence between the HDI and poverty, yet the HDI reported in the latest Human Development Report 2004 by the United Nations Development Programme (UNDP) provides some supporting evidence about a possible decline in poverty between 1995 and 2002. The HDI for India improved from 0.548 in 1995 to 0.579 in 2000 and further to 0.595 in 2002.

1.54 The National Common Minimum Programme (NCMP) of the Government attaches high priority to the development of social sectors to enable people to participate in and benefit fully from the development process. Major programmes initiated in this regard in 2004-05 include launching of the National Food for Work Programme in 150 most backward districts; introduction of the National Rural Employment Guarantee Bill, 2004 in Parliament on December 21, 2004 to provide for enhancement of livelihood security of the poor in rural areas; provision of additional Rs.12,000 crore of Gross Budgetary Support (GBS) for Plan programmes like Food for Work, Sarva Shiksha Abhiyan, mid-day cooked–meal scheme, basic healthcare, Accelerated Irrigation Benefit Programme, drinking water, and roads; increase in coverage of Antyodaya Anna Yojana from 1.5 crore to 2 crore families; improving facilities for universal education by imposition of a cess of 2 per cent on Union taxes and duties; upgrading Industrial Training Institutes (ITIs) over the next 5 years; and introduction of a new Universal Health Insurance Scheme for the poor and a special group insurance scheme.

Issues and priorities

1.55 The last Survey had pointed out the need for nurturing the investment climate to consolidate the growth process. There are some encouraging signs of positive developments on both fronts.

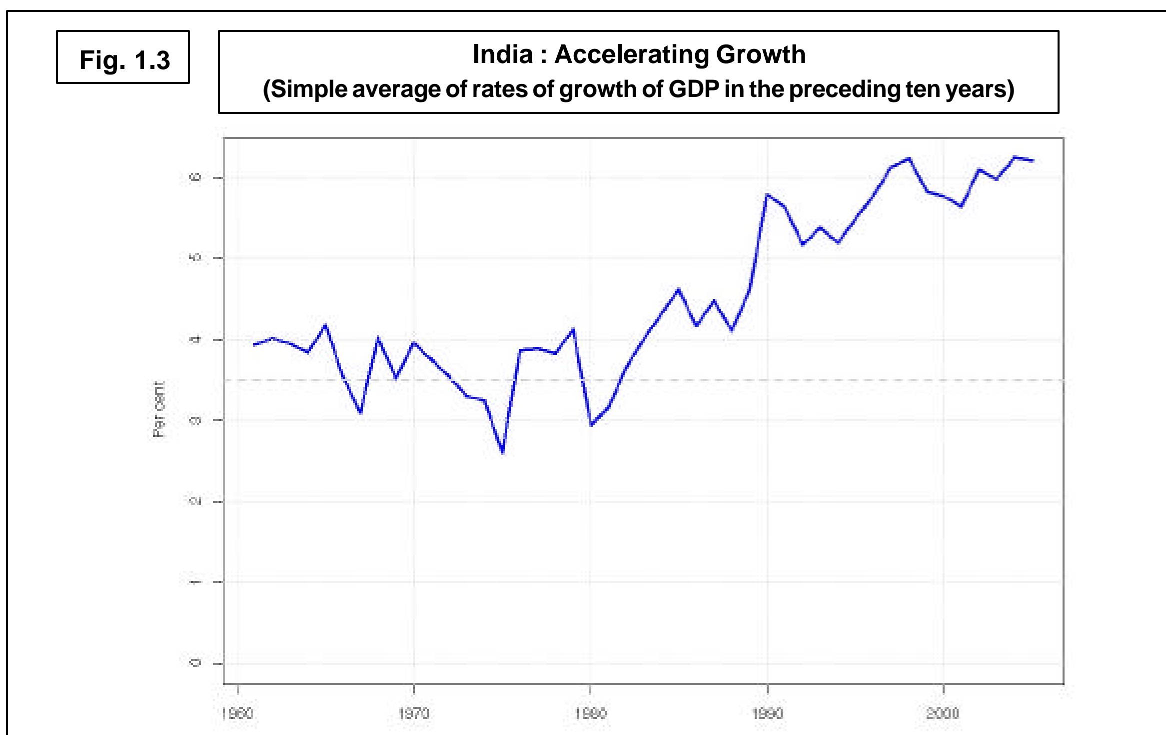
1.56 First, there is a pick up in investment. Gross domestic capital formation as a proportion of GDP, that is, the investment rate, has increased by 3.7 percentage points since 2001-02 to reach 26.3 per cent in 2003-04, the highest since 1996-97. There is increased activity in the primary market for securities, with the overall volume of issuance going up by more than five times in calendar 2004. The stock market indices peaked at an all-time high in mid-February 2005.

1.57 Second, the growth performance of the Indian economy during 2003-04 and 2004-05 indicates a possible ratcheting up of the trend rate of growth of the economy, from around 6 per cent, to about 7 per cent per year (Figure 1.3). Developments in the current year provide supportive evidence. The current account of the balance of payments has turned into a deficit showing an excess of investment over savings. Growth appears to have surpassed all projections made at the beginning and early part of the year. There was an initial spurt of inflation of the 'imported' variety, exacerbated by inflationary expectations induced by a deficient southwest monsoon. The deceleration of the inflation rate points to the strength of flexible supply response from a wide variety of the productive sectors. While a business-cycle type explanation of the performance of the economy in the two years 2003-04 and 2004-05 is also tenable, a trend acceleration may be underway with the recently observed sustained double-digit year-on-year growth rates of capital goods (except in October 2003 and in November 2004) and consumer durables (except in May 2004) since September 2003, as well as increase in the savings and investment rates.

1.58 Yet, vigorous efforts are needed to accelerate growth to achieve the NCMP mandate of ensuring "that the economy grows at least 7-8 per cent per year in a sustained

Fig. 1.3

India : Accelerating Growth
(Simple average of rates of growth of GDP in the preceding ten years)



manner over a decade and more and in a manner that generates employment so that each family is assured of a safe and viable livelihood." In its "Approach to the Mid-term Appraisal of the Tenth Plan", the Planning Commission has pointed out that a growth above 10 per cent in industry is essential to realize the NCMP growth objective. It is doubtful that the targeted high growth can be achieved with the current levels of investment simply by reducing the incremental-capital output ratio. Even after its increase in the last two years, the investment rate continues to be not only far below that in China and East Asia but also lower than that assumed in the Tenth Plan.

1.59 Demographic dynamics, with an increase in the share of working age population in total population and increasing incomes, have had a positive impact on the savings rate. This virtuous trend is likely to continue for some more years. Simultaneously, a part of the recent improvement in the savings rate has come from a decline in public dissaving. The FRBM Act has focused attention on improving public finances, and reducing not only the preemption of investible resources by the Government but also revenue expenditure to open up fiscal space for augmented capital expenditure. With the notification of the FRBM rules, the planned reduction in the revenue deficit of the Centre will help in directly augmenting saving and investment. Further enhanced credibility of the fiscal stance will yield upfront indirect benefits on the interest rate and hence investment front. The Twelfth Finance Commission has recommended that each State should enact a fiscal responsibility legislation providing for elimination of revenue deficit by 2008-09 and reducing fiscal deficit to 3 per cent of State Domestic Product. This recommendation, together with the Commission's linking of Central debt relief to States with fiscal reforms, should be effectively utilized by both the Centre and the States to pursue fiscal consolidation at the State level.

1.60 One of the challenges in fiscal reform will be reconciling the need for fiscal consolidation with appropriate tax reform. Indirect taxes not only affect efficiency of resource allocation but also the investment climate. Since a major share of tax revenue of the Central and State Governments comes from indirect taxes, reform of such taxes needs to be calibrated carefully to balance the conflicting objectives. The announced

introduction of VAT at the State level from April 1, 2005 will go a long way in removing the cascading effect of the extant sales tax regime. A phased rationalisation of the central sales tax to remove tax on inter-State sales and integrate the whole country into one common market, and consolidation of all indirect State level taxes into VAT along with a proper calibration of the VAT rates, can reconcile both the efficiency and revenue mobilization objectives. Progress towards aligning customs duties to ASEAN levels, which appears to have enhanced competitiveness of the economy and fuelled export growth, needs to continue. Simultaneously, the consequent loss in revenues of the Central Government, if any, needs to be made up in revenues from other sources and by a phased removal of exemptions. Both the Centre and the States need to improve their tax administrations to have an impersonal and hassle-free regime, with a low compliance cost for the honest tax payer and a high risk for the evader. This can be done through innovative approaches utilizing the power of information technology, not only for information collection, data mining and analysis, but also for automatic collection of tax revenues at source.

1.61 Looking beyond the question of fiscal consolidation through the vigorous implementation of the FRBM Act, there are five issues that need to be addressed to step up investment. First is the issue of investment in agriculture and allied activities, a sector that produces only 21 per cent of GDP, but supports nearly 57 per cent of the population. While there has been some diversification from foodgrains into areas such as fruits and vegetables, floriculture, dairy and poultry, much more needs to be done to encourage such diversification. There is a colossal loss of output due to inadequate storage and transport facilities and lack of sufficient food processing capacities. More public and private investment on these post-harvest facilities is required not only to increase value addition in agriculture but also to improve the link between agriculture and rural industrialisation. It is also likely to have an impact on unemployment and poverty in rural India, which is home to almost 75 per cent of the country's poor.

1.62 There is a paramount need to move Indian agriculture beyond its centuries' old dependency on the monsoon by bringing more area under irrigation and by better water management. This has rightly been identified in the NCMP as one of the areas with the highest investment priority. It is in this context that the appropriate design of the fiscal support to be given to agriculture becomes important. Given the compulsions of fiscal consolidation, the choice is between subsidy for price support to crops, fertilizer, irrigation and power, on the one hand, and higher public investment in supportive infrastructure for irrigation, roads, electrification, agricultural extension and research, on the other. With these investments, diversification of the rural economy beyond not only cereals but also agriculture appears feasible. The vibrancy of agricultural exports observed in recent years can get a fillip from such investments coupled with a stable policy towards agricultural trade.

1.63 Second is the issue of simplifying procedures and relaxing entry-exit barriers. The ease with which firms are able to enter into and exit from business activities is an important determinant of the investment climate. For business start ups, a large number of clearances have to be taken, both at the Central and State level. Such a system introduces delays and creates avenues for corruption. Studies show that with a heavy regulatory burden on business, India still ranks in the bottom quartile of comparable nations on the ease of doing business. In China, the average time taken to secure the necessary clearances for a start up, or to complete a bankruptcy procedure, is much shorter than in India. Indian labour laws, particularly Chapter VB of the Industrial Disputes Act, 1947, allow firms less latitude than the labour laws do in China, Brazil or Mexico. Small-scale reservation has not succeeded in producing the expected results, and has constrained investment in some critical sectors, such as knitwear, with large growth potential. There is little justification for continuance of such reservations since all

such items are now freely importable. Easing the entry-exit barriers will be critical in determining the success of the textiles sector to reap the enormous potential benefits of the post-quota regime. The recently constituted Investment Commission, with a mandate to interact with industry groups/houses and large companies abroad, secure investments, and also advise the Government on procedures and policies, should help. Similarly, the National Manufacturing Competitiveness Council will also help in focussing attention on the policies and procedures needed to tap the vast potential of manufacturing.

1.64 Third is the issue of finance. The incipient investment boom in infrastructure, industry (including housing), and services will yield best results only if the enormous resource flows are successfully intermediated at a low cost. It will depend on the ability of the financial sector to process information properly, and convert domestic and foreign savings into optimal investment by specific firms and sectors.

1.65 Farmers and enterprises should have access to finance at competitive rates and for all maturities for their credit-worthy projects. There has been some progress in improving the credit markets in recent years by, for example, establishing vibrant credit information flows through credit bureaus and improving enforcement of debt contracts. The dramatic reforms on the equity market since the early 1990s, with T+2 rolling settlement, screen-based anonymous order-matching, dematerialization, and competition among multiple exchanges, appear to have diversified the investor base. Yet, more needs to be done on both the debt and equity markets. There is need for greater competition and efficiency in banking to bring spreads down, reducing NPAs, improving credit culture, and better credit-appraisal skills to identify the future winners among start-ups and small-scale units. The vibrancy of equity markets needs to be extended to the debt market by moving to a screen-based anonymous order-matching and competition among alternate trading platforms. Subject to prudential norms, the participation of pension funds and contractual saving schemes in equity and long-term debt markets needs to be encouraged not only to benefit industry, agriculture and infrastructure, but also allow the small savers to cash in on the handsome returns that such markets are likely to yield in the medium term.

1.66 Fourth is infrastructure. Infrastructural inadequacy constrains economic growth, particularly in the backward States and in the agriculture sector. For example, fruits and vegetables will perish before reaching the household kitchen, if there are no good roads and no cold-chains. And cold-storages will not work if there is no reliable and adequate power supply. Similarly, even a wonder of the world tourist site will fail to attract a large number of international tourists if there are no means of rapid transportation and no urban infrastructure around it. Direct government production of infrastructure services introduces difficulties concerning technical efficiency, adequate scale of investment, proper enforcement of user charges, and competitive market structure. Such direct production, for example, runs the risk of infrastructure, like road construction and maintenance, being misaligned with user priorities and linked more to political interventions and budgetary compulsions. Private participation also mitigates the problem of risk for the public sector, starting from project formulation. At the same time, a complete reliance on private production in an unregulated market is not likely to produce sound results. The decline in public spending in the infrastructure sector has not been adequately compensated by the private sector mainly due to difficulties in the regulatory environment. Therefore, there is a need to find an appropriate policy framework enabling public–private participation in the infrastructure sector.

1.67 Under minimum subsidy bidding, the potential service provider quoting the lowest amount becomes eligible for subsidy payments. Eligibility is subject to fulfilling a specified level of performance or service provision obligation. This is a promising strategy for extending infrastructure services to poor consumers in commercially unviable,

sparsely populated rural areas, and also for facilities such as roads, sanitation, and waste management, for which complete cost recovery through user charges alone is not feasible. Many countries have deployed this approach in sectors as varied as telecom (Chile, Colombia, Peru and South Africa), electricity (Argentina and Chile), road reconstruction and maintenance (Argentina, Australia, Chile, and the UK), and civil aviation (Australia and the US).

1.68 Initiatives taken in a number of sectors like telecom, roads, ports and civil aviation have started yielding results. The National Electricity Policy announced recently envisages access to electricity for all households in the next five years and fully meeting power demand by 2012. The structure and composition of the telecom sector has undergone a substantial change with mobile telephones accounting for 50 per cent of the total phones and the private sector accounting for 44 per cent of the total phones. Expansion of the broadband telecom sector will also impact economic growth considerably. In the area of roads, there is a need to shift the focus from construction to corridor management and road safety. Ports need to have an adequate policy framework to promote inter-port and intra-port competition. Provision of port connectivity through rail and road, and international benchmarking of performance parameters and prices, are very important factors in determining the growth of the port sector. In the civil aviation sector, there is an immediate need to improve regulation and competition in the airline industry, and to build better airports. Given the volatility observed in recent years in international POL prices and the import dependency of the country for crude petroleum, efforts need to continue to enhance energy security by augmenting the infrastructure of trans-border gas pipelines.

1.69 Fifth is the need for higher foreign investment, in the form of foreign direct investment (FDI) and FII. Such investment triggers technology spillovers, assists human capital formation, contributes to international trade integration and particularly exports, helps create a more competitive business environment, enhances enterprise development, increases total factor productivity and, more generally, improves the efficiency of resource use. Progressive global integration of the Indian economy has resulted in successful assimilation of many domestic industries in global production chains. Automobiles, software and electronics are important examples. Entry of foreign investment has helped these industries in achieving technological upgradation and higher value addition.

1.70 While trade liberalisation, introduction of greater competition and liberal foreign investment policies have succeeded in transforming several segments of Indian manufacturing into globally competitive entities, there exists a strong case for revisiting the issue of caps in sectors such as coal mining, insurance, real estate and retail trade. Foreign direct investment in retail can not only organize a significant part of the largely unorganized domestic retailing, but can also invite established global retail brands into the Indian market, thereby creating greater outlets for sourcing and marketing Indian products. Organised retail formats will also help in upgrading the quality of products, establishing efficient supply chains from farm to market and generating greater employment.

1.71 Accelerating growth is necessary but not sufficient for reaching out to the poor in the economy. The NCMP emphasizes the need to empower the people through universal education and health care. The direct attack on unemployment envisaged in the NCMP has already been translated into the National Rural Employment Guarantee Bill, 2004, which was introduced in Parliament on December 21, 2004. The Bill promises to provide for enhancement of livelihood security of the poor in rural areas by ensuring at least 100 days of guaranteed wage employment in every financial year to every household whose adult members volunteer to do unskilled manual work. Employment Guarantee Councils are to be constituted to discharge various functions and duties at the Centre and the States. The success of these schemes will depend on the efficiency of the delivery

mechanism. There is need to suitably restructure the administrative machinery and put in place mechanisms for monitoring outcomes. This opportunity must be used actively to build robust rural infrastructure, particularly in backward districts. Furthermore, the additional outlays for these enhanced Government responsibilities need to be met from a rationalization of the subsidy regime, for which a discussion paper was placed in Parliament on December 23, 2004. A consolidation of the various poverty alleviation programmes can also increase the value for money from these programmes.

1.72 The macroeconomic stability observed in recent years needs to be sustained. The benefits of such stability for investment, protecting the poor and furthering growth are well-known. Growth in the post-reform period has avoided the pitfalls of earlier decades, when the economy suffered from balance of payments problems. There is a need to build on the growing external strength of the economy, and foster improvements in institutions and infrastructure, which will accelerate the current export momentum. Growth in India so far, from the demand side, has been mostly driven by private final consumption, with investment and exports playing a minor role, unlike in China and East Asia. The recent buoyancy of investment and exports needs to be enhanced to leverage growth in the Indian economy. Success in this regard will depend on how vigorously reforms are pursued to improve the investment climate and augment infrastructure.