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General Review

Review of developments

Macroeconomic overview

Vigorous growth with strong macroeconomic fundamentals has characterized developments in the Indian economy in 2006-07 so far. However, there are some genuine concerns on the inflation front. Growth of 9.0 per cent and 9.2 per cent in 2005-06 and 2006-07, respectively, by most accounts, surpassed expectations (Table 1.1). While the up-and-down pattern in agriculture continued with growth estimated at 6.0 per cent and 2.7 per cent in the two recent years, and services maintained its vigorous growth performance, there were distinct signs of sustained improvements on the industrial front (Table 1.2). Entrenchment of the higher growth trends, particularly in manufacturing, has boosted sentiments, both within the country and abroad. The overall macroeconomic fundamentals are robust, particularly with tangible progress towards fiscal consolidation and a strong balance of payments position. With an upsurge in investment, the outlook is distinctly upbeat.

1.2 The advance estimates (AE) of gross domestic product (GDP) for 2006-07, released by the Central Statistical Organisation (CSO) on February 7, 2007, places the growth of GDP at factor cost at constant (1999-2000) prices in the current year at 9.2 per cent. Growth in 2005-06, initially estimated by the CSO at the AE stage at 8.1 per cent in February 2006, was revised upwards to 8.4 per cent at the revised estimate stage in May 2006 and further to 9.0 per cent in the quick estimates released by the CSO on January 31, 2007.

1.3 The ratcheting up of growth observed in recent years is reflected in the Eleventh Five Year Plan target of an average annual growth of 9 per cent relative to 8 per cent targeted by the Tenth Plan (2002-03 to 2006-07). The shortfall in the annual average growth of 7.6 per cent from the target of 8 per cent in the five years of the Tenth Plan is attributable to the disappointing 3.8 per cent growth in the first year of the Plan and its subsequent surge to 8.6 per cent, on average, in the last four years.

1.4 Services contributed as much as 68.6 per cent of the overall average growth in GDP in the last five years between 2002-03 and 2006-07. Practically, the entire residual contribution came from industry. As a result, in 2006-07, while the share of agriculture in GDP declined to 18.5 per cent, the share of industry and services improved to 26.4 per cent and 55.1 per cent, respectively.

1.5 The lower contribution of industry to GDP growth relative to services in recent years is partly because of its lower share in GDP, and does not adequately capture the signs of industrial resurgence. First, growth of industrial sector, from a low of 2.7 per cent in 2001-02, revived to 7.1 per cent and 7.4 per cent in 2002-03 and 2003-04, respectively, and after accelerating to over 9.5 per cent in the next two years, touched 10.0 per cent in 2006-07. Second, growth of industry, as a proportion of the corresponding growth in services, which was 78.9 per cent on an average between 1991-92 and 1999-2000, improved to 88.7 per cent in the last seven years. Third, within industry, the growth impulses in the sector seem to have spread

Table 1.1 : Key indicators

Items	2003-04	2004-05	2005-06	2006-07	2003-04	2004-05	2005-06	2006-07
	Absolute values				percentage change over previous period			
Gross domestic product (at factor cost) (Rs. thousand crore)								
At current prices	2549.4	2855.9	3250.9 Q	3717.5 A	12.5	12.0	13.8 Q	14.4 A
At 1999-2000 prices	2222.6	2389.6	2604.5 Q	2844.0 A	8.5	7.5	9.0 Q	9.2 A
GDP–at market prices (Rs. thousand crore) (at current prices)	2765.5	3126.6	3567.2 Q	4100.6	12.5	13.1	14.1 Q	15.0 A
Gross national product (at factor cost) (Rs.thousand crore)								
At current prices	2531.2	2833.6	3225.9 Q	3693.4 A	12.6	11.9	13.8 Q	14.5 A
At 1999-2000 prices	2204.7	2367.7	2580.7 Q	2822.1 A	8.7	7.4	9.0 Q	9.4 A
Foodgrains production (million tonnes)	213.2	198.4	208.6	209.2 +	22.0	-6.9	5.1	0.3 +
Index of industrial production[1]	189.0	204.8	221.5	239.0 ^	7.0	8.4	8.2	10.8 ^
Electricity generated (in billion kwh)	558.3	587.4	617.5	493.1 ^	5.0	5.2	5.1	7.5 ^
Wholesale price index[2]	180.3	189.5	197.2	209.2 #	4.6	5.1	4.1	6.7 #
Consumer price index for industrial workers[3]	504	525	551	588 $	3.5	4.2	5.0	6.9 $
Money supply (M_3)[4] (Rs. thousand crore)	2005.7	2251.4 (2332.7)##	2729.5	3071.7[6]	16.8	12.3	17.0@@	21.1[5]
Imports at current prices								
(in Rs. crore)	3,59,108	5,01,065	6,60,409	5,98,287***	20.8	39.5	31.8	40.6 ^^
(in US $ million)	78,150	1,11,518	1,49,166	1,31,212***	27.3	42.7	33.8	36.3 ^^
Exports at current prices								
(in Rs. crore)	2,93,367	3,75,340	4,56,418	4,08,394***	15.0	27.9	21.6	40.6 ^^
(in US $ million)	63,843	83,536	1,03,091	89,489***	21.1	30.8	23.4	36.3 ^^
Foreign currency assets[6]								
(in Rs. crore)	4,66,215	5,93,121	6,47,327	7,64,501*	36.5	27.2	9.1	29.7 *
(in US $ million)	1,07,448	1,35,571	1,45,108	1,73,081*	49.5	26.2	7.0	29.4 *
Exchange rate (Re./US $)[7]	45.95	44.93	44.27	45.48 @	5.3	2.3	1.5	-2.7 @

Note: Gross domestic product and Gross national product figures are at factor cost (new series base 1999-2000).

Q-Quick estimates; A-Advance estimates; @ Average exchange rate for April-January, 2006-07.

@@ Computed over comparable data i.e. April 1, 2005 due to 27 fortnights during 2005-06.

*** At the end of January, 2007. ** At the end of December, 2004 *** April-December, 2006 (provisional).**

 # As on February 3, 2007. ## Outstanding balances as on April 1, 2005.

^ April-December, 2006 $ As on December, 2006.

^^ April-December, 2006 on provisional over provisional basis. + 2nd advance estimates 2006-07.

1. **Index of industrial production; (base 1993-94=100).**
2. **Index (with base 1993-94 = 100) at the end of fiscal year.**
3. **Index (with base 1982 =100) at the end of fiscal year.**
4. **Outstanding at the end of financial year.**
5. **As on Janauary 19, 2007, year-on-year growth.**
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 (at 1999-2000 prices)

Item	Percentage change over the previous year						
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 (Q)	2006-07 (A)
I. Agriculture & allied	**-0.2**	**6.3**	**-7.2**	**10.0**	**0.0**	**6.0**	**2.7**
II. Industry	**6.4**	**2.7**	**7.1**	**7.4**	**9.8**	**9.6**	**10.0**
Mining and quarrying	2.4	1.8	8.8	3.1	7.5	3.6	4.5
Manufacturing	7.7	2.5	6.8	6.6	8.7	9.1	11.3
Electricity, gas & water supply	2.1	1.7	4.7	4.8	7.5	5.3	7.7
Construction	6.2	4.0	7.9	12.0	14.1	14.2	9.4
III. Services	**5.7**	**7.2**	**7.4**	**8.5**	**9.6**	**9.8**	**11.2**
Trade, hotels, transport and communication	7.3	9.1	9.2	12.1	10.9	10.4	13.0
Financial, real estate & business services	4.1	7.3	8.0	5.6	8.7	10.9	11.1
Community, social and personal services	4.8	4.1	3.9	5.4	7.9	7.7	7.8
IV. Total GDP at factor cost	**4.4**	**5.8**	**3.8**	**8.5**	**7.5**	**9.0**	**9.2**

P : Provisional Q : Quick A : Advance estimates

Source : Central Statistical Organisation.

to manufacturing. Industrial growth would have been even higher, had it not been for a relatively disappointing performance of the other two sub-sectors, namely, mining and quarrying; and electricity, gas and water supply. Fourth, since 1951-52, industry has never consistently grown at over seven per cent per year for more than three years in a row before 2004-05. Fifth, year-on-year, manufacturing, according to the monthly Index of Industrial Production (IIP) available until December 2006, has been growing at double digit rates every month since March 2006, with the solitary exception of the festive month of October.

1.6 A notable feature of the current growth phase is the sharp rise in the rate of investment in the economy. Investment, in general being a forward looking variable, reflects a high degree of business optimism. The revival in gross domestic capital formation (GDCF) that commenced in 2002-03 has been followed by a sharp rise in the rate of investment in the economy for four consecutive years. The earlier estimates of GDCF for 2004-05 of 30.1 per cent, released by CSO in their advance estimates, now stand upgraded to 31.5 percent in the quick estimates. The rate of GDCF for 2005-06 as per the quick estimates released by CSO is 33.8 per cent. This sharp increase in the investment rate has sustained the industrial performance and reinforces the outlook for growth.

1.7 Services sector growth has continued to be broad-based. Among the three sub-sectors of services, 'trade, hotels, transport and communication services' has continued to boost the sector by growing at double-digit rates for the fourth successive year (Table 1.2). Impressive progress in information technology (IT) and IT-enabled services, both rail and road traffic, and fast addition to existing stock of telephone connections, particularly mobiles, played a key role in such growth. Growth in financial services (comprising banking, insurance, real estate and business services), after dipping to 5.6 percent in 2003-04 bounced back to 8.7 percent in 2004-05 and 10.9 per cent in 2005-06. The momentum has been maintained with a growth of 11.1 per cent in 2006-07.

1.8 After an annual average of 3.0 per cent in the first five years of the new millennium starting 2001-02, growth of agriculture at only 2.7 per cent in 2006-07, on a base of 6.0 per cent growth in the previous year, is a cause of concern. Low investment, imbalance in fertilizer use, low seeds replacement rate, a

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distorted incentive system and low post-harvest value addition continued to be a drag on the sector's performance. Given its low share, a mechanical calculation of the adverse impact of low growth in agriculture on overall GDP can be misleading. With more than half the population directly depending on this sector, low agricultural growth has serious implications for the 'inclusiveness' of growth. Furthermore, poor agricultural performance, as the current year has demonstrated, can complicate maintenance of price stability with supply-side problems in essential commodities of day-to-day consumption. The recent spurt of activity in food processing and integration of the supply chain from the farm gate to the consumer's plate has the potential of redressing some of the root causes such as low investment, poor quality seeds, and little post-harvest processing.

1.9 With a shortfall in domestic production vis-à-vis domestic demand and hardening of international prices, prices of primary commodities, mainly food, have been on the rise in 2006-07 so far. Wheat, pulses, edible oils, fruits and vegetables, and condiments and spices have been the major contributors to the higher inflation rate of primary articles. As much as 39.4 per cent of the overall inflation in WPI on February 3, 2007 came from the primary group of commodities. Within the primary group, the mineral subgroup recorded the highest year-on-year inflation at 18.2 per cent, followed by food articles at 12.2 per cent and non-food articles at 12.0 per cent. Food articles have a high weight of 15.4 per cent in the WPI basket. Including manufactured products such as sugar and edible oils, food articles contributed as much as 27.2 per cent to overall inflation of 6.7 per cent on February 3, 2007.

1.10 Starting with a rate of 3.98 per cent, the inflation rate in 2006-07 has been on a general upward trend with intermittent decreases. However, average inflation in the 52 weeks ending on February 3, 2007 remained at 5 per cent. A spurt in inflation like in the current year has been observed in the recent past in 1997-98, 2000-01, 2003-04 and 2004-05.

1.11 The international annual average price of the Indian basket of crude (about 60 per cent of Oman/Dubai and 40 per cent of Brent), after remaining more or less stable in 2002-04 at around US$27-28 per barrel, increased by over 40 per cent annually in the next two years to reach US$75.2 per barrel on August 8, 2006. To stop the hemorrhaging of public sector oil companies' finances, there was an unavoidable upward revision of retail selling prices of petro-products on June 6, 2006. The pass-through to consumers was restricted to just 12.5 per cent in a three-way burden sharing arrangement among consumers, Government and oil marketing companies. With the softening of international petroleum prices, domestic prices of petrol (motor spirit) and high-speed diesel were reduced by Rs. 2 and Re.1, respectively with effect from November 30, 2006, and again by the same amounts with effect from February 16, 2007.

1.12 Government closely monitored prices every week and initiated measures to enhance domestic availability of wheat, pulses, sugar and edible oils by a combination of enhanced imports, export restrictions and fiscal concessions. In wheat, State Trading Corporation, the parastatal, tendered overseas for 55 lakh tonnes of wheat; private trade was permitted to import wheat at zero duty from September 9, 2006; and exports were banned from February 9, 2007. The minimum support price (MSP) of wheat was raised by Rs. 50 per quintal and announced well in advance of the sowing season to bring additional acreage under wheat. In pulses, imports were allowed at zero duty from June 8, 2006; export was banned from June 22, 2006; and National Agricultural Cooperative Marketing Federation (NAFED) purchased urad and moong overseas. Regulation of commodity futures markets was strengthened for wheat, sugar and pulses; and as a matter of abundant precaution, futures trading was banned in urad and tur from January 24, 2007. Duty on palm group of oils, which meets more than a half of the domestic demand-supply shortfall in edible oils, was reduced by 20-22.5 percentage points in a phased sequence, first in August 2006 and later in January 2007.

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Further, tariff values of these oils for import duty assessment were frozen. On January 22, 2007, further duty cuts were announced for portland cement, various metals and machinery items. With a firming up of international prices, the impact of duty-free import of wheat and pulses in rolling the domestic prices back was limited. But such imports improved domestic market discipline.

1.13 Inflation, with its roots in supply-side factors, was accompanied by buoyant growth of money and credit in 2005-06 and 2006-07 so far. While GDP growth accelerated from 7.5 per cent to 9.0 per cent between 2004-05 and 2005-06, the corresponding acceleration in growth of broad money (M_3) was from 12.3 per cent to 17.0 per cent. Year-on-year, M_3 grew by 21.1 per cent on January 19, 2007. The industrial resurgence and upswing in investment was reflected in, and sustained by, growth of gross bank credit (as per data covering 90 per cent of credit by scheduled commercial banks), for example, to industry (medium and large) at 31.6 per cent and for housing loans at 38.0 per cent in 2005-06. It was also observed in year-on-year growth of gross bank credit at 32.0 per cent in September 2006, albeit marginally down from 37.1 per cent in 2005-06. Reconciling the twin needs of facilitating credit for growth on the one hand and containing liquidity to tame inflation on the other remained a challenge. RBI put a restraint on the rapid growth of personal loans, capital market exposures, residential housing beyond Rs. 20 lakh and commercial real estate loans by more than doubling the provisioning requirements for standard advances under these categories from 0.40 per cent to 1.0 per cent in April 2006. Simultaneously, it increased the risk weight on exposures to commercial real estate from 125 per cent to 150 per cent.

1.14 Liquidity conditions remained fairly comfortable up to early September 2006 with the unwinding of the Central Government surplus balances with the RBI and continued intervention in the foreign exchange market to maintain orderly conditions. During 2006-07, up to September 8, 2006, RBI had not received any bid for repo under Liquidity Adjustment Facility (LAF) and the continuous flow of funds under reverse-repo indicated a comfortable liquidity position. In 2005-06, the reverse repo rate had been raised by 25 basis points each time on April 29 and October 26, 2005, and on January 24, 2006 to reach 5.50 per cent. In 2006-07, it was raised again by 25 basis points each time on June 9 and July 25, 2006. There was some tightness with the onset of the festival season and due to high credit expansion and outflows on account of advance tax payment. From mid-September through October, 2006, while RBI had to provide accommodation to some banks through repo facility, with reverse repo operations simultaneously, in net terms, RBI absorbed liquidity from the system.

1.15 With year-on-year inflation stubbornly above 5 per cent from early-August 2006, on October 31, 2006, the RBI announced more measures to stem inflationary expectations and also to contain the credit off-take at the desired growth rate of 20.0 per cent. Unlike the previous four times, when both the repo and the reverse repo rates were raised by the same 25 basis points, thereby keeping their spread constant at 100 basis points, on October 31, 2006, only the repo rate was raised by 25 basis points. With a repeat of this policy move on January 31, 2007, the repo rate reached 7.50 per cent with a spread of 150 basis points over the reverse repo rate. Since deposits are growing at a lower rate than credit, the higher repo rate signaled to the banks the higher price of accommodation they would have to pay in case of credit overextension.

1.16 The cash reserve ratio (CRR) was hiked by 25 basis points each time on December 23, 2006 (5.25 per cent) and January 6, 2007 (5.50 per cent). While a further increase of CRR of 25 basis points was effected on February 17, another similar increase of 25 basis points will follow on March 3, 2007.

1.17 Sustained faster growth of M_3 relative to that of reserve money (M_0) observed in recent years continued in 2005-06 and

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2006-07 so far with the money multiplier ($\frac{M_3}{M_0}$) steadily increasing from 4.43 at end-March 2002 to 4.60 at end-March 2005, 4.76 at end-March 2006 and further to 4.79 on January 19, 2007. The increase in money-multiplier coincided with fast growth of M_0 at 17.2 per cent during 2005-06 and year-on-year at 20.0 per cent on January 19, 2007 and resulted in the rapid growth of M_3.

1.18 Driving the fast growth of reserve money was net foreign assets (NFA) of the RBI. Even with the redemption of the India Millennium Deposits, NFA of the RBI grew by Rs. 60,193 crore and contributed 12.3 percentage points to the 17.2 per cent growth in M_0 during 2005-06. The corresponding growth of NFA between end-March 2006 and January 19, 2007 was Rs. 114,338 crore. Liquidity in the system continued to be addressed by Market Stabilisation Scheme (MSS) operations. Outstanding balance under MSS, after increasing from Rs. 29,062 crore (1.0 per cent of M_3) on March 31, 2006 to a high of Rs. 42,364 crore (1.5 per cent of M_3) on August 25, 2006, started declining thereafter to reach Rs. 40,491 crore (1.3 per cent of M_3) on January 19, 2007.

1.19 The change in the liquidity and inflation environment is reflected in the continuous hardening of interest rates in 2005-06 and in 2006-07 so far. With the high demand for credit not adequately matched by deposit growth, there was steady increase in the credit-deposit ratio and hardening of interest rates. For example, the yield on 10-year residual maturity Government securities, which had gone up by 84 basis points during 2005-06 to 7.53 per cent at end-March 2006, hardened further to 8.08 per cent on February 14, 2007. Movements in the call money rates also reveal a similar picture. The hardening of rates was more pronounced at the shorter end of the yield curve, suggesting concerns about inflation only in the short run.

1.20 The rapid growth in NFA of the RBI was a reflection of the buoyant flows of foreign exchange reserves through the balance of payments. Reserve accretion through the balance of payments was US$15.1 billion in 2005-06 and US$8.6 billion in the first six months of 2006-07. While the appreciation of the US dollar vis-à-vis other major currencies resulted in a valuation loss of US$5.0 billion in 2005-06, in the first half of the current year, the weakening US dollar resulted in valuation gain of a similar amount. Inclusive of gold, IMF reserve tranche position and valuation changes, foreign exchange reserves grew from US$141.5 at end-March 2005 to US$151.6 billion at end-March 2006, and to US$165.3 at end-September, 2006. Such reserves were US$185.1 billion on February 9, 2007.

1.21 In the balance of payments, in 2005-06 and in the first half of 2006-07, capital flows more than made up for the current account deficits of US$9.2 billion and US$11.7 billion, respectively, and resulted in reserve accretion. The current account deficit reflected the large and growing trade deficit in the last two years. Exports grew fast, but imports grew even faster, reflecting in part the ongoing investment boom and the high international petroleum price. In 2005-06, imports (in US dollar terms and customs basis) had grown by 33.8 per cent. In the first nine months of the current year, imports grew by 36.3 per cent. While petroleum imports continued to grow rapidly, non-oil import growth decelerated to a moderate 18.7 per cent in the first nine months of the current year, primarily because of high bullion prices leading to a decline in import of gold and silver in the first few months of the year. The non-POL trade balance, after remaining in surplus till 2003-04, has turned negative since 2004-05.

1.22 India's exports (in US dollar terms and customs basis) have been growing at a high rate of more than 20 per cent since 2002-03. During 2005-06, with growth of 23.4 per cent, India's exports crossed the US$100 billion mark. During 2006-07, after a slow start, exports gained momentum to grow by an estimated 36.3 per cent in the first nine months to reach US$89.5 billion. Buoyancy of exports was driven by the resurgence in the manufacturing sector and sustained demand from major trading partners.

1.23 Overall, the external environment remained supportive with the invisible account remaining strong and stable capital flows seamlessly financing the moderate levels of current account deficit caused primarily by the rise in international oil prices. The trend in invisibles (net), comprising of non-factor services (like travel, transportation, software services and business services), investment income, and transfers, compensating to a large extent the trade deficit continued in 2005-06 and through the first half of 2006-07, and resulted in a moderate current account deficit of 1.1 per cent of GDP in 2005-06.

1.24 As a proportion of GDP, invisibles (receipts) at 11.5 per cent of GDP in 2005-06 exhibited steady growth from a modest level of 2.4 per cent of GDP in 1990-91. The most recent two years have shown acceleration, particularly in software and business services. Simultaneously, invisible payments at 6.2 per cent of GDP in 2005-06 have grown, albeit at lower levels and somewhat unevenly, again with acceleration being noticed in the last two years. Under receipts, tourism earnings are estimated to have crossed the US$6.6 billion in 2006. The UN World Tourism Organisation, in January 2007, has noted the 'emergence' of South Asia as a tourist destination, with remarkable growth of 10 per cent in tourist arrivals in 2006 which was more than double the global growth. Furthermore, it noted that growth of toursim in South Asia was 'boosted by India, the destination responsible for half the arrivals to the sub-region.'

1.25 Capital flows into India remained strong. The composition of flows, however, fluctuated from year to year. In the three-year period, 2002-05, there were large 'other flows' (delayed export receipts and others) accounting for a sizeable proportion of net capital flows. After being outflows in the previous two years, external assistance and external commercial borrowing (ECBs) — two major debt-creating flows — picked up in 2004-05. These debt flows, as a proportion of total capital flows, were 25 per cent in 2004-05 and 18 per cent in 2005-06. Foreign investment, as a proportion of capital flows, has remained in the range of 39.1 per cent to 79.3 per cent in the last four years ending in 2005-06. There was strong growth in foreign direct investment (FDI) flows (net), with three-quarters of such flows in the form of equity. The growth rate was 27.4 per cent in 2005-06 followed by 98.4 per cent in April-September 2006. This was even after gross outflows under FDI with domestic corporate entities seeking a global presence to harness scale, technology and market access advantages through acquisitions overseas. FII flows, the dominant variety of portfolio flows, after remaining buoyant until 2005-06, turned into net outflows in the first half of 2006-07. FII flows are reported to have turned positive again in the second half of the current year.

1.26 The buoyancy of foreign investment flows through the balance of payments, in part, reflected the bullish sentiments in the domestic capital markets. The BSE Sensex, the bell-weather stock-index of the Bombay Stock Exchange (BSE), rallied from a low of 8,929 on June 14, 2006 to an all-time intra-day high of 14,724 on February 9, 2007. The rally from the 13,000 mark to the 14,000 mark in only 26 trading sessions was the fastest ever climb of 1,000 points. India with a market capitalization of 91.5 per cent of GDP on January 12, 2007 compared favourably not only with emerging market economies but also with Japan (96 per cent) and South Korea (94.1 per cent). The strength of the market micro-structure from large retail participation continued.

1.27 The positive sentiments were manifest also in most indicators such as resource mobilized through the primary market. Aggregate mobilization, especially through private placements and Initial Public Offerings (IPOs), grew by 30.5 per cent to Rs. 161,769 crore in calendar year 2006, with about 6 IPOs every month, on average. Net mobilisation of resources by mutual funds increased by more than four-fold from Rs. 25,454 crore in 2005 to Rs. 1,04,950 crore in 2006. The sharp rise in mobilisation by mutual funds was due to buoyant inflows under both income/debt oriented schemes and growth/equity oriented schemes. The negative inflows in 2004 turned positive for the public sector mutual funds in

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2005 and accelerated in 2006. Other indicators of market sentiments, such as equity returns and price/earnings ratio also continued to be strong and supportive of growth.

1.28 The upbeat mood of the capital markets, reflecting the improved growth prospects of the economy, was partly also a result of steady progress made on the infrastructure front. Overall index of six core industries — electricity, coal, steel, crude oil, petroleum refinery products, and cement, with a weight of 27 per cent in IIP — registered a growth of 8.3 per cent in April-December 2006 compared to 5.5 per cent in April-December 2005. On the transport and communications front, railways maintained its nearly double-digit growth in the first nine months of the current year. There was, however, a growth deceleration in cargo handled at major maritime ports (both exports and imports) and airports (exports). The news of gas discoveries in the Krishna Godavari (KG) basin under New Exploration and Licensing Policy (NELP) in recent months was an encouraging development in the country's pursuit of reduced import-dependence in hydrocarbons.

1.29 Investment requirements for infrastructure during the Eleventh Five Year plan are estimated to be around US$ 320 billion. While nearly 60 per cent of these resources would come from the public sector, the balance would need to come either from the private sector and/or through public-private partnership (PPP). The potential benefits expected from PPP are: cost-effectiveness, higher productivity, accelerated delivery, clear customer focus, enhanced social service, and recovery of user charges. Further, the additionality of resources that PPP would bring, along with the 'value for money', continues to remain critical. Based on the number of projects that have been approved or are under consideration, it is estimated that a leveraging of nearly six times could be achieved through this route.

1.30 The ability of Government and the public sector to invest additional resources for developing the much-needed infrastructure critically depends on the creation of fiscal space. The notification of the Fiscal Responsibility and Budget Management Act (FRBMA) 2003, with effect from July 5, 2004, the culmination of the policy resolve to place the process of fiscal consolidation in an institutional framework, has yielded rich dividends in terms of creating such fiscal space. The fiscal deficit declined to 4.1 per cent of GDP in 2005-06 and was budgeted at 3.8 per cent of GDP in 2006-07. With the implementation of the award of the Twelfth Finance Commission (TFC), which was calibrated to restructure public finances of both the Centre and States, the process gained momentum. In the current year, as a proportion of GDP, the budgeted fiscal deficit of the States has declined to less than the mandated 3 per cent two years ahead of schedule, and only a marginal revenue deficit remains to be eliminated. The decline in the deficit indicators of the Centre has been relatively slower with demands on its resources, *inter alia*, on account of the implementation of the TFC award and a 'pause' in fiscal consolidation in 2005-06. The resumption of the fiscal consolidation process in 2006-07, without compromising the National Common Minimum Programme (NCMP) objectives, indicates the commitment towards meeting the FRBMA targets.

1.31 The fiscal consolidation process underway in India, unlike the expenditure compression strategy in most other countries, has been essentially revenue-led and has involved reprioritisation of expenditure with a focus on outcomes. The tax-GDP ratio of the Centre has steadily risen from 8.8 per cent in 2002-03 to 10.3 per cent in 2005-06 and was budgeted at 11.2 per cent in 2006-07. After growing by 20.3 per cent and 22.7 per cent, respectively in 2005-06, corporate income tax and personal income tax have grown by 55.2 per cent and 30.3 per cent, respectively in April-December 2006 over April-December 2005. Buoyant growth in direct taxes revenue has helped take its share in total revenue to 47.6 per cent in 2006-07 (BE). In the reduction of revenue and fiscal deficits, buoyant revenue growth has been complemented by a discernible shift in the composition of

expenditure. While as a proportion of GDP, total expenditure of the Centre declined from 16.8 per cent in 2002-03 to 14.1 per cent in 2005-06, gross budgetary support to the Plan increased on a like-to-like basis from Rs. 111,470 crore to (including disintermediated loans to States) to Rs.172,500 crore. The balance from current revenues, which had remained negative till 2003-04, turned positive in 2004-05 and has strengthened to Rs. 22,332 crore in 2005-06. With non-Plan expenditure as a proportion of total expenditure declining from 73.0 per cent in 2002-03 to 69.4 per cent in 2006-07 (BE), there have been distinct signs of reprioritisation of expenditure. With lower levels of borrowings of Government, the public sector draft on private savings has come down.

Consumption, saving and investment

1.32 The increasing trend in gross domestic savings as a proportion of GDP observed since 2001-02 has continued with the savings ratio rising from 26.4 per cent in 2002-03 to 29.7 per cent in 2003-04, 31.1 per cent in 2004-05 and 32.4 per cent in 2005-06 (Table 1.3). The rise in the savings rate in 2005-06 was contributed by two of its three components: private corporate and the household sector, which as proportion of GDP, increased by 1.0 percentage point and 0.7 percentage point, respectively. The third component, namely public savings, declined by 0.4 percentage points, and made a negative contribution to the overall savings rate. However, a redeeming feature of recent years is that the savings of the public sector, which had been negative until 2002-03, was positive for the third successive year in 2005-06. The positive saving of Rs. 71,262 crore in 2005-06 (QE) is largely attributable to the higher savings of non-departmental as well as departmental enterprises.

Table 1.3 : Savings and investment (Base: 1999-2000)

(New series base 1999-2000)

	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 (Q)
			(as per cent of GDP at current market prices)				
Gross Domestic Savings	**24.8**	**23.4**	**23.5**	**26.4**	**29.7**	**31.1**	**32.4**
a) Public	-0.8	-1.9	-2.0	-0.6	1.2	2.4	2.0
b) Private	25.6	25.3	25.5	27.0	28.5	28.7	30.4
i) Household	*21.1*	*21.0*	*21.8*	*22.7*	*23.8*	*21.6*	*22.3*
Financial	*10.6*	*10.2*	*10.8*	*10.3*	*11.3*	*10.2*	*11.7*
Physical	*10.5*	*10.8*	*10.9*	*12.4*	*12.4*	*11.4*	*10.7*
ii) Private Corporate	*4.5*	*4.3*	*3.7*	*4.2*	*4.7*	*7.1*	*8.1*
Gross Domestic Investment*	**25.9**	**24.0**	**22.9**	**25.2**	**28.0**	**31.5**	**33.8**
Public	7.4	6.9	6.9	6.1	6.3	7.1	7.4
Private	17.9	16.5	16.3	18.4	19.4	21.3	23.6
Valuables	0.8	0.7	0.6	0.6	0.9	1.3	1.2
Gross fixed capital formation	**23.4**	**22.8**	**23.0**	**23.8**	**24.8**	**26.3**	**28.1**
Change in stocks	1.9	0.6	0.2	0.7	0.8	2.0	2.9
Valuables	0.8	0.7	0.6	0.6	0.9	1.3	1.2
Saving - investment gap @	-1.1	-0.6	0.6	1.2	1.6	-0.4	-1.3
Public	-8.2	-8.8	-8.9	-6.6	-5.2	-4.7	-5.4
Private	7.7	8.8	9.2	8.6	9.2	7.4	6.9

Note : Gross domestic investment denotes gross domestic capital formation (GDCF) and is adjusted for errors and omissions
Figures may not add up due to rounding.
*** : Adjusted for errors and omissions;**
@ : Difference between the rate of savings and the rate of investment.
GFCF : Gross fixed capital formation.
Q : Quick
Source : Central Statistical Organisation.

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1.33 A dramatic element in the savings profile of the Indian economy has been the sharp rise in the savings rate of the private corporate sector for four years in a row. For 2004-05, the earlier quick estimate of private corporate savings of 4.8 per cent of GDP has been substantially scaled up to 7.1 per cent in the provisional estimates released by the CSO. The savings rate for 2005-06, as per the quick estimates, has been placed at 8.1 per cent. The private corporate sector has financed a large part of its investment in the on-going long capex cycle from such retained earnings or savings.

1.34 As much as 0.7 percentage point of the 1.3 percentage points increase in gross domestic savings rate between 2004-05 and 2005-06 has come from the household sector. Two forces have been acting simultaneously on the portfolio behaviour of Indian households: a construction boom with residential buildings financed from housing loans from banks and the progressive maturing of the domestic financial markets. While the former has tended to increase household savings in physical form and depress financial savings, the latter has provided incentives for higher financial savings. There was a perceptible shift in the household portfolio in the three years ending in 2005-06. Physical savings as a proportion of GDP has declined steadily from a high of 12.4 per cent in 2003-04 to 10.7 per cent in 2005-06. Financial savings, on the other hand, after declining from 11.3 per cent to 10.2 per cent between 2003-04 and 2004-05, more than recovered to 11.7 per cent in 2005-06.

1.35 The increase in savings rate is what is to be expected with higher growth rate of the economy and a declining dependency ratio. With the proportion of population in the working age group of 15-64 years increasing steadily from 62.9 per cent in 2006 to 68.4 per cent in 2026, the demographic dividend in the form of high savings rate is likely to continue. As the savings rate has gone up, private final consumption expenditure (PFCE), at current prices as a proportion of GDP, has shown a declining trend particularly from 2001-02. PFCE as a proportion of GDP declined from 63.1 per cent in 2002-03 to 62.1 per cent in 2003-04, 60.0 per cent in 2004-05, and further to 58.7 per cent in 2005-06. This decline has also been accompanied by substantial changes in the consumption basket in terms of the shares of different commodity groups. In PFCE, the share of food, beverages and tobacco came down from 43.3 per cent in 2002-03 to 39.4 per cent in 2005-06. The other major item of importance, namely, transport and communication, as a proportion of PFCE, rose from 15.8 per cent in 2002-03 to 19.1 per cent in 2004-05.

1.36 As a proportion of GDP at current prices, Government final consumption expenditure (GFCE), after declining from 11.9 per cent in 2002-03 to 11.0 per cent in 2004-05, increased to 11.5 per cent of GDP in 2005-06.

1.37 In tandem with the rise in the rate of gross domestic savings between 2003-04 and 2004-05, there was a step up in the rate of gross domestic capital formation (GDCF) or investment from 28 per cent of GDP to 31.5 per cent of GDP leading to a savings investment gap or a current account deficit of 0.4 percent of GDP in 2004-05 (Table 1.3). GDCF rose further to 33.8 per cent of GDP in 2005-06 as per the quick estimates, widening the saving–investment gap to 1.4 per cent of GDP, with its implications for the current account of the balance of payments.

1.38 GDCF at constant prices (base: 1999-2000) as a proportion of GDP (Table 1.4) is consistently lower than the corresponding proportion at current prices (Table 1.3). This differential may reflect the greater increase in the prices of capital goods relative to the general price level, with growing technological sophistication of the production processes in the economy in general and manufacturing in particular. But, irrespective of the choice of constant or current prices as the weights, the direction of change from year to year remains unaltered.

1.39 Of the two components of GDCF, namely gross fixed capital formation (GFCF) and changes in stocks, the contribution of GFCF (consisting of items such as plant and

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Table 1.4 : Real gross domestic capital formation (as percent of GDP at constant 1999-2000 market prices)							
	1999-00	2000-01	2001-02	2002-03	2003-0)4	2004-05	2005-06(Q)
GDCF*	**25.9**	**23.8**	**22.2**	**25.0**	**27.4**	**30.2**	**32.2**
Public	7.4	6.9	6.8	6.1	6.0	6.5	6.9
Private	17.9	16.3	15.8	18.1	19.1	20.6	22.6
Corporate sector	7.4	5.6	5.2	5.8	6.7	9.5	12.2
Household sector	10.5	10.6	10.6	12.3	12.4	11.1	10.3
Valuables	0.8	0.7	0.6	0.6	0.9	1.3	1.2
GFCF	***23.4***	***22.5***	***22.4***	***23.5***	***24.5***	***25.3***	***26.7***
Public	6.6	6.5	6.4	6.2	6.4	6.2	6.5
Private	16.8	16.1	16.0	17.2	18.1	19.0	20.2
Change in stocks	**1.9**	**0.6**	**0.1**	**0.7**	**0.6**	**1.8**	**2.8**
Public	0.8	0.4	0.4	-0.2	-0.3	0.3	0.4
Private	1.1	0.2	-0.2	0.9	0.9	1.5	2.4
Valuables	**0.8**	**0.7**	**0.6**	**0.6**	**0.9**	**1.3**	**1.2**

Note :
GDCF : Gross domestic capital formation
GFCF : Gross domestic fixed capital formation
Figures may not add up due to rounding
***Adjusted for errors and omissions**
Q : Quick
Source : Central Statistical Organisation

machinery) to growth of GDFC was lower than the corresponding contribution of changes in stocks between 2003-04 and 2004-05. While GFCF continued to lag behind changes in stocks in terms of contribution, the difference between the two contributions narrowed. This may indicate a recent pick up in fresh investment for creating additional capacity through fixed capital formation, particularly in the private sector.

1.40 From the demand-side perspective, unlike countries of East Asia during their high-growth phase or China in more recent times, GDP growth in India in the post-reform period was driven mostly by private final consumption expenditure or PFCE growth. PFCE contributed more than one half of the growth every year until 2001-02. After falling below one half in 2002-03, it had again dominated GDP growth in 2003-04. But this pattern appears to have undergone a virtuous transformation with investment rather than private consumption being the main source of GDP growth in the latest two years of 2004-05 and 2005-06 (Figure 1.2 and Table 1.5). Data on consumption and investment in the national accounts available until 2004-05 show that the 6.8 percentage point contribution of investment to 13.1 per cent growth in GDP at current market prices in 2004-05 exceeded the corresponding contribution of private final consumption expenditure at 6.1 percentage point for the first time in recent years. In terms of contribution to growth of GDP at current market prices, from the demand side, investment continued to provide the lead during 2004-05 and 2005-06. The percentage point contribution of investment in the growth of GDP at current market prices of 13.1 per cent and 14.1 per cent in 2004-05 and 2005-06, respectively, were 7.6 per cent and 7.0 per cent, respectively. With imports growing faster than exports, the external balance continued to have a negative contribution to GDP growth in recent years.

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

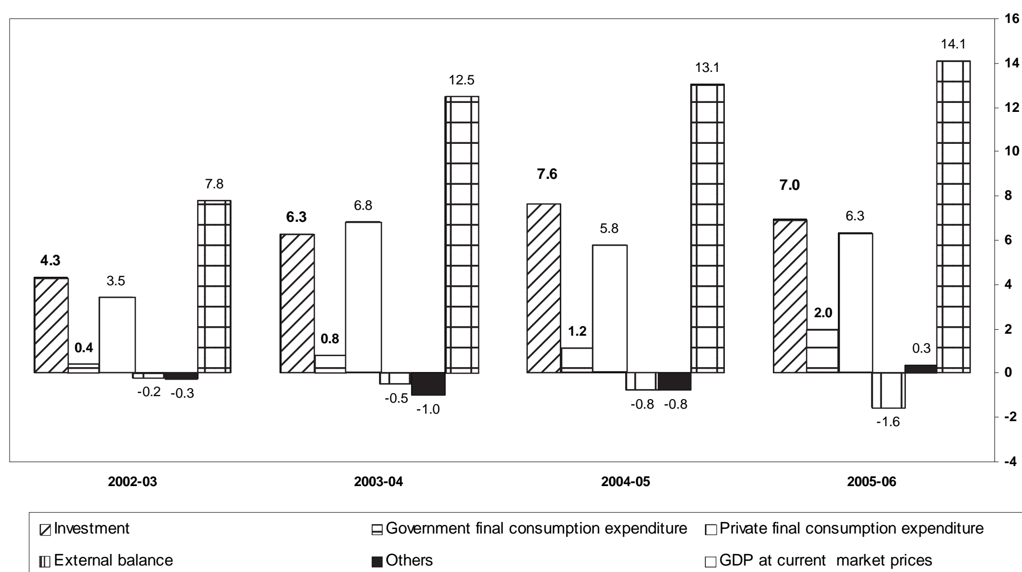

Table 1.5 : Disposition of gross domestic product (GDP)

	(percentage change over previous year)											
	at current prices						at 1999-2000 prices					
	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06(Q)
Total final consumption expenditure	**6.7**	**8.5**	**5.0**	**10.2**	**9.5**	**11.7**	**1.7**	**5.9**	**1.7**	**6.2**	**5.7**	**7.4**
Govt. final consumption expenditure	5.0	6.3	3.3	6.6	10.3	18.1	-3.6	6.3	-0.4	2.5	5.4	9.8
Private final consumption expenditure	7.1	8.9	5.4	10.9	9.4	10.6	2.8	5.8	2.1	6.9	5.7	7.0
Gross domestic capital formation	**-0.3**	**3.3**	**19.0**	**24.9**	**27.3**	**22.1**	**-4.5**	**-1.8**	**16.6**	**19.1**	**19.0**	**16.5**
Of which												
Gross fixed capital formation	4.8	9.9	11.2	17.6	19.7	21.6	0.3	4.5	8.7	13.1	11.8	15.3
Exports of goods and services	**22.1**	**4.5**	**22.3**	**14.7**	**39.5**	**27.4**	**18.2**	**5.7**	**21.8**	**5.8**	**28.1**	**22.0**
Less Imports of goods and services	**12.0**	**4.5**	**22.2**	**16.7**	**41.2**	**32.7**	**3.5**	**3.4**	**10.4**	**7.2**	**22.3**	**27.1**
GDP at market prices	7.7	8.5	7.8	12.5	13.1	14.1	4.0	5.2	3.7	8.4	8.3	9.2

Q : Quick
Source : Central Statistical Organisation

Production

1.41 The second advance estimates of crop production released by the Directorate of Economics and Statistics, Department of Agriculture and Cooperation on February 5, 2007 has placed total foodgrains production in 2006-07 at 209.2 million tonnes, which is marginally higher than the production of 208.6 million tonnes in 2005-06. Production of wheat and pulses is expected to increase by 4.5 per cent and 8.2 per cent, respectively. Production of commercial crops is expected to be significantly higher. Production of cotton expected at 21.0 million bales is not only up 13.5 per cent from 2005-06, but also an all-time record. Similarly, sugarcane production

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projected at 315.5 million tonnes is up 16.8 per cent from the output of 270.0 million tonnes in 2005-06. Output of coarse grains and oilseeds are likely to be lower than their levels in 2005-06 by 6.2 per cent and 15.7 per cent, respectively. Production is expected to improve in plantation crops (coffee, tea and rubber); livestock and poultry products; horticulture products; and dairy and fisheries.

1.42 Production of crops, particularly wheat and pulses, has plateaued for some time now. Wheat production reached its peak of 76.4 million tonnes in 1999-2000, which has not been achieved again. In case of pulses, production reached 14.9 million tonnes in 1998-99 and again in 2003-04, but has remained singificantly below that level in the last three years. There has not been any varietal breakthrough in pulses. Though pulses were brought within the ambit of Technology Mission on Oilseeds in 1990 and the centrally sponsored scheme of Integrated Scheme of Oilseeds, Pulses, Oilpalm and Maize (ISPPOM) is being implemented in major pulses-growing States with effect from April 2004, productivity of pulses has remained stagnant. Since pulses are genetically low-yielding; and are grown on marginal and sub-marginal lands under rain-fed conditions, focus needs to shift to micro-irrigation, micro-nutrients, improved production practices and development of improved/better yielding seeds. With overseas availability being limited, reduction in price volatility of pulses will depend on steady growth of domestic production. In case of wheat, there is need for the development of area-specific varieties, particularly to suit the water-abundant eastern region.

1.43 The year 2006-07 not only witnessed sustained growth in manufacturing, but also a distinct improvement in the growth of electricity. With a year-on-year growth of 11.4 per cent during April-December 2006 compared to a growth of 9.0 per cent in the corresponding period of 2005, manufacturing contributed over 91 per cent to the overall industrial growth measured in terms of IIP. Within manufacturing, chemicals, basic metals, machinery and equipments and transport equipments, with a weight of 35.0 per cent in IIP, contributed 55.2 per cent to its growth. All these industries are skill-intensive and produce relatively high value-added products. Growth in cotton textiles and textile products was also in double digits. Poor performance of the sub-sectors of food products and leather, however, continues to be a cause of concern. Both these industries are not only local resource based, but also employment-intensive. In terms of use-based classification, in the current year, higher growth rates were observed in basic goods, capital goods and intermediates. These sectors are expected to sustain these higher growth rates with nearly 85 per cent of the respondents of a Survey conducted by the Confederation of Indian Industry indicating their intentions of making additional investments. Notwithstanding a recovery in the growth in the mining sector to 4.0 per cent in April-December 2006 from 0.4 per cent in April-December 2005, performance of the sector continues to be below par.

Human development, poverty and unemployment

1.44 Efforts towards social sector development continued to focus on the key areas of human development and creation of social infrastructure. NCMP mandated flagship programmes of Government witnessed large increases in outlays. These programmes included the National Rural Employment Guarantee Scheme, Total Sanitation Campaign, National Rural Health Mission, Sarva Shiksha Abhiyan (SSA), Mid-day Meal, Integrated Child Development Services (ICDS), Jawaharlal Nehru National Urban Renewal Mission and the Rajiv Gandhi National Drinking Water Mission. Apart from extending their coverage, implementation continued to focus on the difficult task of improving their access, delivery and quality of the social services.

1.45 The importance of the recent efforts at improving social infrastructure assumes significance in view of India's relative rank of 126 (among 177) in 2004, only one position higher than in 2003, in the UNDP's global

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Human Development Report for 2006. National Family Health Survey III has pointed out widespread under-nutrition among women and children which needs to be addressed urgently by the National Rural Health Mission. Independent surveys on elementary education in the country have also pointed out the impossibility of achieving universal elementary education by the target date of 2007 and the low levels of achievement of the children passing out of the school system. SSA needs to garner greater efforts to focus attention on the achievement of quality education at the elementary level.

1.46 The results of the NSSO's 61st Round large-scale quinquennial survey on employment and unemployment conducted during 2004-05 throws a lot of light on the heated debate on jobless growth under reforms. The survey results show how the annual growth rate of employment, which had declined from 2.1 per cent during 1983-1994 to 1.6 per cent during 1993-2000, went up to 2.5 per cent during 1999-2005. While employment has grown faster than before, with the demographic dynamics and higher labour force participation, rate of unemployment (as measured by 'usual principal status') also went up marginally from 2.8 per cent to 3.1 per cent during 1999-2000 to 2004-05. While detailed analysis of the results of the survey is yet to be carried out, slowing down of the growth of agriculture could be one of the main reasons for the growth in the unemployment rate. Furthermore, the worrisome marginal decline in employment in the organised sector between 1994 and 2004, according to the Annual Survey of Industry data, has raised some disturbing issues about optimal regulation and incentives.

1.47 Based on the data on NSSO's 61st round large scale sample survey on household consumer expenditure for the year 2004-05, it may be concluded that the incidence of poverty came down to about 22 per cent in 2004-05 from a level of 26.1 per cent in 1999-2000 in terms of the mixed recall period (data for five non-food items, namely clothing, footwear, durable goods, education and institutional medical expenses are collected from a 365-day recall period and the consumption data for the remaining items are collected from a 30 day recall period). Meeting the Tenth Five Year Plan's targeted reduction of five percentage points in the poverty ratio requires about a 1 percentage point further decline in the ratio in 2005-07.

1.48 India will continue to benefit from the 'demographic dividend' until 2045. India is likely to achieve a Total Fertility Rate (which is the average number of children a woman produces during her life time) of 2.1, which is the replacement level of fertility, in the decade beginning 2010. With a high proportion of the population in the reproductive age group, the total population, however, will continue to grow for another 25-35 years before stabilizing around 2045. Experience of developed countries suggest that it takes around 35 years for population to stabilize after achieving the replacement rate; it is only after 35 years that one generation replaces another.

Issues and priorities

1.49 The economy appears to have decidedly 'taken off' and moved from a phase of moderate growth to a new phase of high growth. Achieving the necessary escape velocity to move from tepid growth into a sustained high-growth trajectory requires careful consideration of two issues and three priorities. The two issues are: the sustainability of high growth with moderate inflation; and the inclusive nature of such high growth. The three priorities are: rising to the challenge of maintaining and managing high growth; bolstering the twin pillars of growth, namely fiscal prudence and high investment; and improving the effectiveness of Government intervention in critical areas such as education, health and support for the needy.

1.50 On the first issue of *sustainability of high growth without running into high inflation,* various indicators suggest that the current growth phase is sustainable.

1.51 First, higher growth together with the demographic dividend (from a growing proportion of the population in the working age

group) is likely to lead to a rise in the savings rate to finance more and more investment. There is already evidence of this virtuous and mutually reinforcing growth-savings-growth cycle in the recently released savings and investment figures for 2005-06.

1.52 Second, efficiency improvements in the economy since 1999-2000 reinforce the confidence in the high-growth phase. The ratio of net capital stock to gross value added in the economy, according to the National Accounts Statistics, went down from 2.78 to 2.60 between 1999-2000 and 2004-05. While the ratio increased to 2.66 in 2004-05, the rise was primarily due to a corresponding rise in the ratio of net capital stock to value added in agriculture. There is an encouraging and almost steady decline in the ratio of net capital stock to value added in industry.

1.53 Third, it is not only the sustained increase in savings and investment, availability of labour at reasonable wage rates, and efficiency increases, but also the opening up of new avenues in services, beyond the already well-known IT and ITES, that bolster confidence in the new high-growth phase. For example, in a remarkable transition, the tourism industry has displayed buoyant double-digit annual growth rates in each of the last three years. Tourism contributes over 10 per cent of global GDP and its potential in India, given the country's enormous natural, human and technological resources, is well-recognised. The sector, through its backward and forward linkages, can stimulate many others, particularly hotels, restaurants, and handicrafts. While a recent study by National Council of Applied Economic Research estimates tourism's contribution towards GDP (both direct and indirect) in India at only 5.90 per cent, India has already emerged as among the fastest growing tourist destinations in the world. Given its bio-diversity, variety of unique destinations and natural locales, India can transform itself into a 365 days a year destination with increased emphasis on new products like medical tourism, rural tourism, and wellness tourism, and marketing India as a destination for Meetings/Incentives/ Conventions and Exhibitions (MICE).

1.54 Fourth, concerns have been expressed about whether the country is growing beyond its growth potential thereby straining its labour force and capital stock, and hence engendering inflationary instabilities. In India, with unemployment, both open and disguised, concerns about over-heating are connected more with capacity utilization and skill shortages. Rapid growth in capacity addition through investments can avert the problem of capacity constraints. Another indicator of over-heating namely, merchandise import growth, also appears to be within reasonable limits.

1.55 Fifth, infrastructure, that constrained for years the growth performance of the economy, appears to be improving. There are signs of tangible progress in areas such as power, roads, ports, and airports. Following the road shows abroad for attracting global financial capital, the setting up of a US $ 5 billion fund to finance Indian infrastructure on February 15, 2007 by four major financial institutions (Citigroup, Balckstone, Infrastructure Development and Finance Corporation and India Infrastructure Finance Company), is an encouraging development.

1.56 The second issue is about the *nature of this high growth in terms of inclusiveness*. Putting more people in productive and sustainable jobs lies at the heart of inclusive growth. But such success, primarily, will depend on the success in achieving and maintaining high growth. There cannot be inclusive growth without growth itself. The experience of East Asia clearly reveals how high growth can eliminate poverty and transform a developing country into a developed one.

1.57 The results of the latest NSSO's 61st Round clearly show how the annual growth rate of employment has not only accelerated from 1.6 per cent during 1993-2000 to 2.5 per cent during 1999-2005, but crossed the 2.1 per cent rate recorded during 1983-1994. Unemployment has gone up not because of high growth, but because growth was not high enough. It is important to avoid the misconception that inclusive growth, by necessity, will have to be low growth.

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1.58 The inclusive nature of the growth itself will be conditioned by the progress that is made in the areas of education, health and physical infrastructure. A young girl, when denied the benefit of education, often grows up to be excluded from participating in the growth process. Similarly, villagers are literally left behind in the growth process, when their village does not have the benefit of connectivity, be it roads, electricity, or communication.

1.59 Among the priorities, first is *rising to the challenge of maintaining and managing high growth*. Phase-transition invariably throws up new problems and challenges. It is necessary to make the required adjustments in mindsets, economic behaviour, and policy making. There is no scope for uneasiness or nervousness about high growth. In the latter half of the 20th century, the East Asian 'miracle' has been followed by even more rapid growth in China in more recent times. Fostering the momentum of growth in India continues to be a top priority.

1.60 Inflation in recent times has been triggered by the rapid rise in the prices of primary articles all over the world. In India, prices of essential food items have come under pressure. Why? Because of shortcomings on the supply side and poor and inefficient intermediation between the producer and the consumer. For managing inflation, supply side policies are critical, particularly in agriculture. Such policies will not only help in fighting inflation but also reinforce growth. What is important to note is that international experience shows that troublesome inflation need not be the price to be paid for favourable high growth. The fight against inflation has to be calibrated so that policies contain inflation without compromising growth. With appropriate policies, it should be possible to maintain and manage high growth without inflation.

1.61 Finding immediate answers to inflation induced by commodity-specific supply shortfalls is difficult. A durable solution to such inflation problem has to be found in increasing yields and domestic output for products such as pulses, edible oils, rice and wheat. There is tremendous scope for increasing yield levels through technology diffusion. Simultaneously, there is a need to recognize that there could be a potential contradiction between a 'remunerative' price for the farmer and a 'fair' price for the consumer in the short run. The same contradiction arises in the case of pricing of petroleum products. The reconcilitation of such a contradiction ought not to be in terms of an expensive compromise of fiscal rectitude.

1.62 The second priority is *bolstering the twin pillars of high growth, namely, fiscal prudence and high investment*. The growth resurgence observed in the economy is not an accident but the result of sound policies and several reform measures. The experience of the past few years has clearly demonstrated the benefits of fiscal prudence along the FRBMA lines. Reforms, along with the high growth, have brought about a surge in investment in the past few years. While accelerating growth and the demographic dividend will continue to boost savings and investment, simultaneously, policies have to be designed in a flexible manner to enhance investments in the economy to lay a robust foundation for growth. There is need for investment, both public and private, domestic and foreign. But it is important to resist the temptation of fiscal profligacy in the anxiety to enhance public investment. Adhering to fiscal rectitude has never been easy in any country at any time. Like going up a hill, the adjustments become harder as the destination gets closer. India's investment grade sovereign rating reflects not only the perceived strong economic prospects, strength of its balance of payments and the capital markets, but also its improving fiscal position.

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1.63 The third priority is *improving the effectiveness of Government intervention in critical areas especially in the social sector.* The goal of inclusive growth can be achieved only through effective government intervention in the areas of education, health and support to the needy. Value for every tax rupee spent has to be ensured by emphasizing the outcomes and avoiding any wastage or leakages in the delivery mechanism of public goods and services. Appropriate design of programmes and placing effective monitors over the programmes are critical in this regard.

1.64 A comparison of two alternative schemes to generate self-employment opportunities among the rural poor, namely the Prime Minister's Rozgar Yojana (PMRY) and SHG-Bank linkage, illustrates the importance of programme design. Recovery under PMRY has been around 35 per cent in the three years ending in 2005. The programme of linking self-help groups (SHG) of the rural poor with the banking system (SHG-Bank linkage), to strengthen the credit delivery in rural areas was launched in 1992 through NABARD as a pilot project and mainstreamed in 1996. The focus of SHG-Bank linkage is largely on small and marginal farmers, agricultural and non-agricultural labourers, artisans and craftsmen. The uniqueness of the programme is zero subsidy. It has been reported that the recovery rates under the SHG-Bank linkage programme are close to 90 per cent. The contrast leads to obvious conclusions. A loan programme with poor recovery cannot be sustained over a long period.

1.65 To make significant progress in social infrastructure, mere expansion of the coverage or the number of programmes is not enough. With the launch of the National Rural Employment Guarantee Scheme (NREGS), which provides the country with a potential social safety net, there is need to revisit the multiplicity of poverty alleviation schemes. The effective implementation of NREGS is critical for improving inclusiveness. It should reduce poverty and improve rural infrastructure; and any failure to do so will be an indicator of its ineffective implementation.

1.66 Improvement in the quality of social services is an urgent necessity for all social sector programmes. While a large number of school-age children still remain to be enrolled in primary schools, an independent survey has revealed that many students learn by Class 8 what they should have learnt by Class 2. However, there are success stories also in different parts of the country that wait to be replicated.

1.67 Subsidies are an important fiscal policy tool for correcting market failures, particularly under-consumption of basic essentials such as food. By the end of the Eleventh Five Year Plan, with the need to feed an estimated additional 150 million people, the system will confront new challenges. Such challenges will include changing dietary patterns with increasing income and changes in lifestyle. The NCMP mandate of targeting all subsidies sharply at the poor and the truly needy like small and marginal farmers, farm labour and urban poor remains to be implemented. The inconclusive debate on subsidies needs to be resumed, and tangible progress made for cost-effective income transfers to the truly needy. Alternative mechanisms for the delivery of subsidy are available. They must be tried atleast on a pilot basis, and the experience should lead to the invention of alternative and more effective mechanisms.

1.68 A sense of optimism characterizes the current economic conjuncture. Fostering the momentum of growth continues to be a top priority. Sustainability of such growth will depend on carefully calibrating policies to tame inflation without dampening growth; formulating appropriate supply-side measures, particularly in agriculture; better design and more effective delivery of social services, such as education, health and poverty-alleviation, to make growth more inclusive; and putting fresh impetus behind infrastructure. Downside risks from a rapid unravelling of global macroeconomic imbalances, volatile oil prices, and delays in the completion of the Doha Round remain, but, for the present, they appear to be limited.

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