Globalizaition of the Indian economy

1.30 The structure of the Indian economy has undergone considerable change in the last decade. These include increasing importance of external trade and of external capital flows. The services sector has become a major part of the economy with GDP share of over 50 per cent and the country becoming an important hub for exporting IT services. The share of merchandise trade to GDP increased to over 35 per cent in 2007-08 from 23.7 per cent in 2003-04. If the trade in services is included, the trade ratio is 47 per cent of GDP for 2007-08.

1.31 The rapid growth of the economy from 2003-04 to 2007-08 also made India an attractive destination for foreign capital inflows and net capital inflows that were 1.9 per cent of GDP in 2000-01 increased to 9.2 per cent in 2007-08. Foreign portfolio investment added buoyancy to the Indian capital markets and Indian corporates began aggressive acquisition spree overseas, which was reflected in the high volume of outbound direct investment flows.

1.32 Another important dimension has been the high degree of external dependence on imported energy sources, especially crude oil with the share of imported crude in domestic consumption exceeding 75 per cent. A major change in international crude prices is therefore bound to impact the Indian economy, as happened in early 2008-09.

Impact of global developments

1.33 The subprime crisis that surfaced around August 2007 had affected financial institutions in the United States and Europe including the shadow banking system comprising inter alia investment banks, hedge funds, private equity and structured investment vehicles. The collapse of the Lehman Brothers in mid-September 2008 further aggravated the situation leading to a crisis of confidence in the financial markets. The resulting heightened uncertainty cascaded into a full-blown financial crisis of global dimensions that stymied prospects of an early recovery.

1.34 India could not insulate itself from the adverse developments in the international financial markets, despite having a banking and financial system that had little to do with investments in structured financial instruments carved out of subprime mortgages, whose failure had set off the chain of events culminating in global crisis.

1.35 The effect on the Indian economy was not significant in the beginning. The initial effect of the subprime crisis was, in fact, positive, as the country received accelerated Foreign Institutional Investment (FII) flows during September 2007 to January 2008. This contributed to the debate on "decoupling," where it was believed that the emerging economies could remain largely insulated from the crisis and provide an alternative engine of growth to the world economy. The argument soon proved unfounded as the global crisis intensified and spread to the emerging economies through capital and current account of the balance of payments (BoP). The net portfolio flows to India soon turned negative as Foreign Institutional Investors (FIIs) rushed to sell equity stakes in a bid to replenish overseas cash balances. This had a knock-on effect on the stock market and the exchange rates through creating the supply-demand imbalance in the foreign exchange market. The current account was affected mainly after September 2008 through slowdown in exports. Despite setbacks, however, the BoP situation of the country continues to remain resilient.

1.36 The global crisis also meant that the economy experienced extreme volatility in terms of fluctuations

Figure 1.3(i) : Growth of M_3 and M_0 (Y-o-Y)

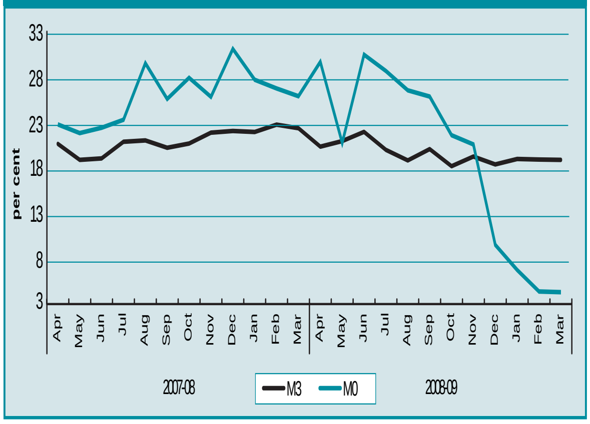
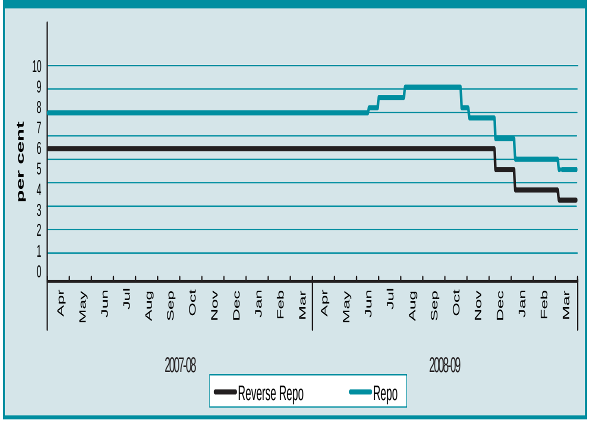


Figure 1.3(ii) : Repo and reverse repo rates



in stock market prices, exchange rates and inflation levels during a short duration necessitating reversal of policy to deal with emergent situations.

1.37 Before the onset of the financial crisis, the main concern of the policymakers was excessive capital inflows, which increased from 3.1 per cent of GDP in 2005-06 to 9.3 per cent in 2007-08. While this led to increase in foreign exchange reserves from US$ 151.6 billion at end-March 2006 to US$ 309.7 billion at end-March 2008, it also contributed to monetary expansion, which fuelled liquidity growth. WPI inflation reached a trough of 3.1 per cent in October 2007, a month before global commodity price inflation zoomed to double digits from low single digits. The rising oil and commodity prices, contributed to a significant rise in prices, with annual WPI peaking at 12.8 per cent in August 2008. The monetary policy stance during the first half of 2008-09 was therefore directed at containing the prices rise.

1.38 The policy stance of the Reserve Bank of India (RBI) in the first half of the year was oriented towards controlling monetary expansion, in view of the apparent link between monetary expansion and inflationary expectations partly due to the perceived liquidity overhang. In the first six months of 2008-09, year-on-year growth of broad money was lower than the growth of reserve money (Figure 1.3i), The Government also took various fiscal and administrative measures during the first half of 2008-09 to rein in inflation.

1.39 The key policy rates of RBI thus moved to signal a contractionary monetary stance. The repo rate (RR) was increased by 125 basis points in three tranches from 7.75 per cent at the beginning of April 2008 to 9.0 per cent with effect from August 30, 2008. The reverse-repo rate (R-RR) was however left unchanged at 6.0 per cent (Figure 1.3ii). The cash reserve ratio (CRR) was increased by 150 basis points in six tranches from 7.50 per cent at the beginning of April 2008 to 9.0 per cent with effect from August 30, 2008.

Exchange rate developments

1.40 The surge in the supply of foreign currency in the domestic market led inevitably to a rise in the price of the rupee. The rupee gradually appreciated from Rs. 46.54 per US dollar in August 2006 to Rs. 39.37 in January 2008, a movement that had begun to affect profitability and competitiveness of the export sector. The global financial crisis however reversed the rupee appreciation and after the end of positive shock around January 2008, rupee began a slow decline.

1.41 A major factor, which affected the emerging economies almost simultaneously, was the unwinding of stock positions by the FIIs to replenish cash balances abroad. The decline in rupee became more pronounced after the fall of Lehman Brothers in September 2008, requiring RBI intervention to reduce volatility. It is pertinent to note that a substantial part of the movement in the rupee-US dollar rate during this period has been a reflection of the movement of the dollar against a basket of currencies. The rupee stabilized after October 2008, with some volatility. With signs of recovery and return of FII flows after March 2009, rupee has again been strengthening against US dollar.

1.42 For the year as a whole, the nominal value of the rupee declined from Rs. 40.36 per US dollar in March 2008 to Rs. 51.23 per US dollar in March 2009, reflecting a 21.2 per cent depreciation during the fiscal 2008-09. The exchange rate was Rs. 51.20 per US dollar in March 2009. The annual average exchange rate during 2008-09 worked out to Rs. 45.99 per US dollar compared to Rs. 40.26 per US dollar in 2007-08.

Monetary policy developments

1.43 The outflow of foreign exchange, as a fallout of crisis, also meant tightening of liquidity situation in the economy. To deal with the liquidity crunch and the virtual freezing of international credit, the monetary stance underwent an abrupt change in the second half of 2008-09. The RBI responded to the emergent situation by facilitating monetary expansion through decreases in the CRR, repo and reverse-repo rates, and the statutory liquidity ratio (SLR). The repo rate was reduced by 400 basis points in five tranches from 9.0 in August 2008 to 5.0 per cent beginning March 5, 2009. The reverse-repo rate was lowered by 250 basis points in three tranches from 6.0 (as was prevalent in November 2008) to 3.5 per cent from March 5, 2009. The reverse-repo and repo rates were again reduced by 25 basis points each with effect from April 21, 2009 (Figure 1.3ii). SLR was lowered by 100 basis points from 25 per cent of net demand and time liabilities (NDTL) to 24 per cent with effect from the fortnight beginning November 8, 2008. The CRR was lowered by 400 basis points in four tranches from 9.0 to 5.0 per cent with effect from January 17, 2009.

1.44 The credit policy measures by the RBI broadly aimed at providing adequate liquidity to compensate for the squeeze emanating from foreign financial markets and improving foreign exchange liquidity. At the same time, it was necessary to ensure that the financial contagion arising from the global financial crisis did not permeate the Indian banking system. These measures were therefore supplemented by sector- specific credit measures for exports, housing, micro and small enterprises and infrastructure.

1.45 The monetary measures had a salutatory effect on the liquidity situation. The weighted average call money market rate, which had crossed the LAF corridor at several instances during the first half of 2008-09, remained within the LAF corridor after October 2008. Since mid-2008-09, the growth in reserve money decelerated after September 2008. The deceleration in M_0 was largely on account of the decline in net foreign exchange assets (NFA) of RBI (a major determinant of reserve money growth) due to reduced capital inflows. On the other hand, the net domestic credit (NDC) of the RBI expanded due to an increase in net RBI credit to the Central Government in the second half of the year. Taking the year as a whole, broad money (M_3) recorded an increase of 18.4 per cent during 2008-09, as against 21.2 per cent in 2007-08. The money multiplier, which is the ratio of M_3 to M_0 was 4.3 in end-March 2008 and increased to 5.0 in December 2008.

Fiscal developments

1.46 The extraordinary situation that emerged due to the crisis had led to a sharp shrinkage in the demand for exports. Domestic demand also had moderated considerably leading to a downturn in industry and in the services sector as seen in the GDP growth, especially for the third and the fourth quarters of 2008-09.

1.47 The situation necessitated a fiscal response beyond the measures enunciated in the 2008-09 Budget, the roll-out and actual outlays, however, took place in the second half of 2008-09. These included the payout of a part of the arrears to government employees, following the Sixth Pay Commission Report and the debt relief (farm loan waiver) package to alleviate the debt burden of the distressed farmers. By increasing the fiscal deficit, this expenditure, inter alia, helped to sustain domestic demand. These were supplemented by further measures during December 2008 to February 2009 consisting of increased plan expenditure, reduction in indirect taxes, sector-specific measures for textiles, housing, infrastructure, automobiles, micro and small sectors and exports and authorization to specified financial institutions like the India Infrastructure Investment and Finance Company Limited (IIFCL) to raise tax-free bonds to fund infrastructure projects.

1.48 With the release of provisional actual data on expenditure for the Union Government for 2008-09 and the revised estimates of GDP at market prices for 2008-09, the fiscal deficit to GDP ratio for 2008-09 works out to 6.2 per cent, while the revenue and primary deficit are estimated to be 4.6 per cent and 2.6 per cent respectively. Consequently, the fiscal measures taken together provided a fiscal stimulus of about 3.5 per cent of GDP. Further, below the line items can also be said to have contributed a stimulus of about 1.3 per cent of GDP, even though these merely offset the effect of the increase in the prices of oil and fertilizer imports on domestic income and demand.

1.49 The revenue and expenditure sides in the Interim Budget 2009-10, which was presented on February 16, 2009, were conditioned by the foregoing developments. Fiscal deficit for 2009-10 was estimated to go up to 5.5 per cent of GDP, thus

Figure 1.3(iii) : Stock price indices

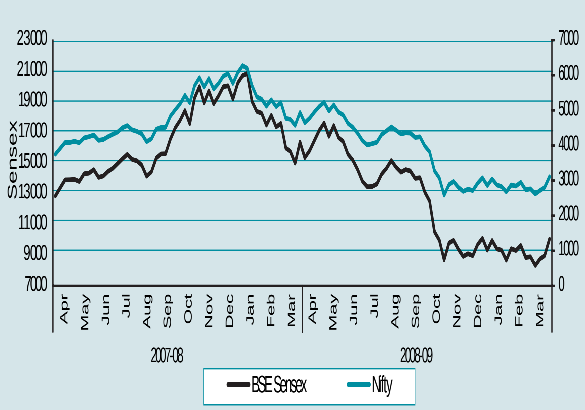
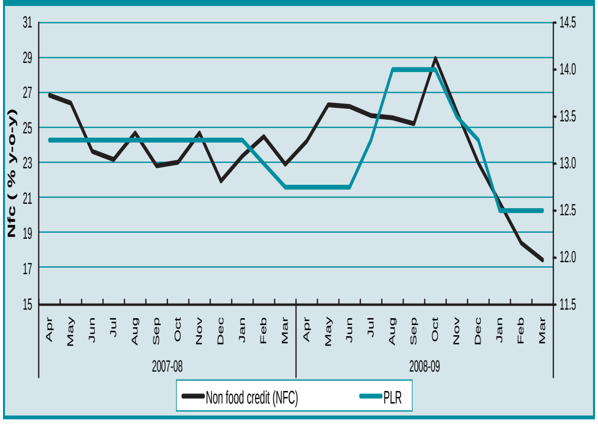


Figure 1.3(iv) : Prime lending rate & non-food credit growth



providing a continuing stimulus, relative to 2008-09, of 2.8 per cent of GDP. Further tax reduction measures were announced by the Finance Minister during the discussions. These were of the order of 0.5 per cent of the GDP. The Finance Minister's speech also indicated that an additional fiscal stimulus of 0.5 per cent to 1 per cent of GDP as additional plan expenditure could be considered, if needed, to offset the shock induced declines in aggregate demand.

1.50 Apart from the measures taken to restore and revive the domestic economy, India continued to engage actively at various international fora like the G-20 group of countries (of which India is a member) and at the multilateral institutional mechanisms on the range of issues that arose from the global financial crisis. At the meeting in early April 2009, leaders of G-20 countries (including India), collectively committed themselves to take decisive, coordinated and comprehensive action to revive growth, restore stability of the financial system, restart the impaired credit markets and rebuild confidence in financial markets and institutions.

Credit

1.51 The intra-year changes in credit flow could be attributed to several factors. The demand for bank credit increased sharply during April-October 2008 as companies found that external sources of credit were drying up in the wake of the global financial crisis. There was also a sharp increase in credit to oil marketing companies. However, towards the latter part of 2008-09, credit growth declined abruptly reflecting the slowdown of the economy in general and the industrial sector in particular (Figure 1.3iv). Working capital requirements also came down because of a decline in commodity prices and a drawdown of inventories by the non-financial companies. The demand for credit by oil marketing companies also moderated. In addition, substantially lower credit expansion by private and foreign banks muted the overall flow of bank credit during the year.

1.52 On a full year basis, bank credit growth fell from 22.3 per cent in 2007-08 to 17.3 per cent in 2008-09. Having regard to the structural rigidities associated with the money market, it was observed that the average PLR did not show much variation. From 12.5 per cent in April 2008, it increased to 13.9 per cent in September 2008 and thereafter declined to 12.0 per cent in March 2009.

Figure 1.4(i) : Foreign investment inflows

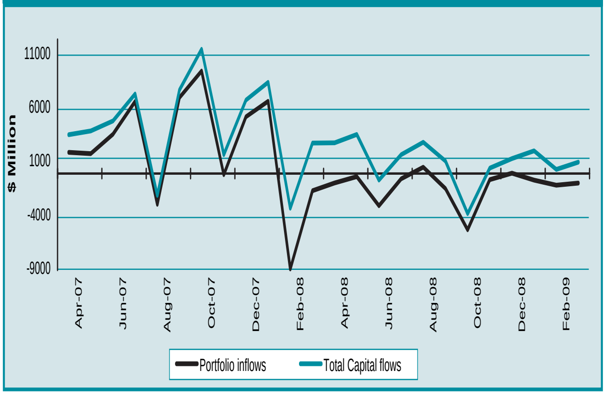


Figure 1.4(ii) : Foreign exchange reserves

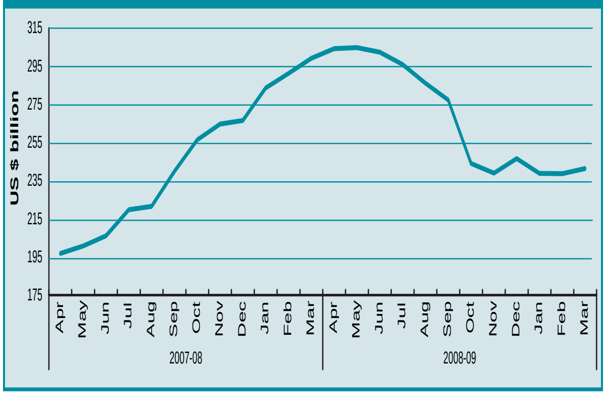


Figure 1.4(iii) : Exchange rate (Rupees/US$)

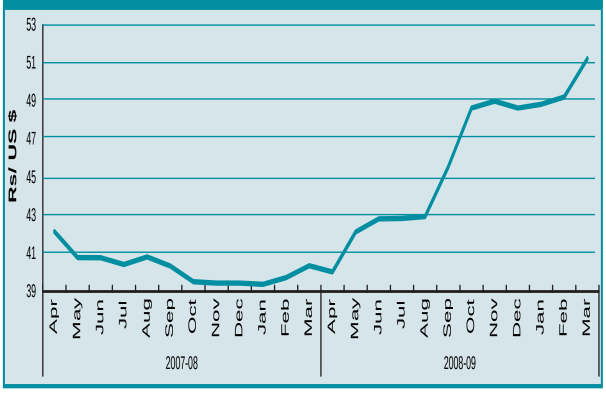
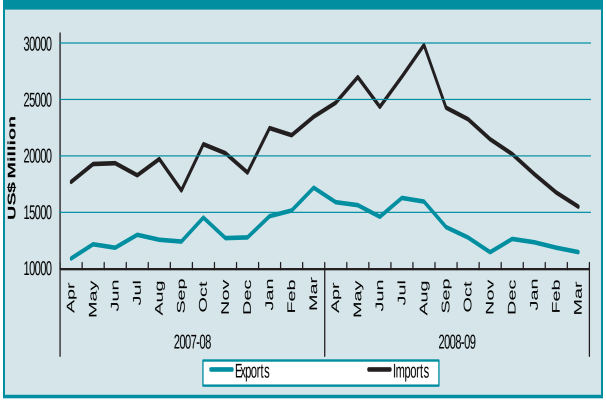


Figure 1.4(iv) : Trends in Exports and Imports



Balance of payments

1.53 The overall balance of payments (BoP) situation remained resilient in 2008-09 despite signs of strain in the capital and current accounts, due to the global crisis. During the first three quarters of 2008-09 (April-December 2008), the current account deficit (CAD) was US$ 36.5 billion (4.1 per cent of GDP) as against US$ 15.5 billion (1.8 per cent of GDP) for the corresponding period of 2007-08. The capital account balance declined significantly to US$ 16.09 billion (1.8 per cent of GDP) as compared to US$ 82.68 billion (9.8 per cent of GDP) during the corresponding period in 2007-08.

1.54 A positive development was higher private transfers and software earnings and increase in non-resident deposit flows and foreign direct investment vis-à-vis the corresponding period last year. Higher FDI flows in 2008-09 were also a reflection of the confidence of foreign investors in the growth prospects of the Indian economy.

1.55 Together with lower crude oil prices and decline in imports, the overall impact on the balance of payments was somewhat muted. This is reflected in reserve decline of only US$ 20.4 billion on BoP basis (excluding valuation change) during 2008-09 (April-December 2008). The total foreign currency assets (FCA) had declined from US$ 299.2 billion on 31.3.2008 to US$ 241.4 billion on 31.3.2009, reflecting a fall of US$ 57.8 billion. However, more than two-thirds of the decline in FCA was due to a valuation change i.e. appreciation of US dollar against the international currencies in which reserves are maintained. The foreign exchange reserves stood at US$ 252 billion at end-March 2009.

Trade

1.56 The adverse effect of the global financial crisis was also felt on the export sector, first, on account of the drying up of international financing and trade credit, followed by a fall in global demand.

1.57 During 2008-09, the growth in exports was robust till August 2008. However, in September 2008, export growth evinced a sharp dip and turned negative in October 2008 and remained negative till the end of the financial year. The continued decline in export growth was due to the recessionary trends in the developed markets where the demand had plummeted. For the year as a whole, the growth in merchandise exports during 2008-09 was 3.6 per cent in US dollar terms and 16.9 per cent in rupee terms (compared to 28.9 per cent and 14.7 per cent respectively in 2007-08). The large difference in growth in terms of the US dollar and in terms of the rupee was on account of the depreciation of rupee vis-à-vis US dollar during the year.

1.58 During the period (April-February) in 2008-09, the main drivers of exports growth were engineering goods and chemicals and related products. Petroleum products and textile exports witnessed a positive but low growth. However, handicrafts, primary products and gems and jewellery exports registered negative growth. The negative impact on the growth of India's exports becomes more evident from the fact that merchandise exports to the United States, which was the largest market, declined by 1.6 per cent during 2008-09 (April-February). On the other hand, merchandise exports to Asia (including ASEAN) grew by 6.9 per cent and to Europe by 10.2 per cent during this period. India's merchandise exports to South Asian countries also declined by 5.2 per cent.

1.59 Import growth began to decline from October 2008 (with one month lag from the decline in export growth) and was negative over the period January to March 2009. For the year as a whole i.e. 2008-09, the overall import growth was subdued at 14.4 per cent in US dollar terms and 29 per cent in rupee terms. Growth in POL and non-POL imports was 16.9 per cent and 13.2 per cent respectively (in US dollar terms). During 2008-09 (April-February) fertilizers and edible oils registered high import growth to meet domestic demand. The growth in the imports of POL was high in the first half of the year due to the unusually high prices but moderated in the second half of the year. The trade deficit increased from US$ 88.5 billion (as per customs data) in 2007-08 to US$ 119.1 billion in 2008-09.

1.60 The impact of global recession was relatively less on India's services exports till December 2008, though the growth rate of services export moderated to 16.3 per cent during April-December 2008-09. A negative growth in insurance and a sharp fall in the growth of travel services was registered during this period. Software services grew at 26 per cent, while financial services registered a robust growth of 45.7 per cent despite the global financial crisis and fall in growth rate in world financial services exports. Business services growth was, however at a lower rate of 3.9 per cent.

Prices

1.61 A positive fallout of decline in demand and fall in commodity prices due to the crisis was a sharp decline in headline inflation, as indicated by the WPI, which was 0.8 per cent at end-March 2009 on year-on-year basis for all commodities. However, there has been wide variation in the constituents of the Index, with WPI Food Index (combined) showing year-on-year inflation of 6.8 per cent at the same point of time, which has been a cause for concern. The average WPI inflation for 2008-09 was 8.4 per cent as against 4.7 per cent in 2007-08. There has also been significant variation in inflation rate in terms of WPI and the Consumer Price Indices (CPIs). Inflation rate as per Consumer Price Index for Rural Labourers (CPI-RL) was 9.7 per cent and on CPI for Industrial Workers (CPI-IW) was 8 per cent as of end-March 2009. The average inflation on CPI-RL and CPI-IW for the year 2008-09 was 10.2 and 9.1 per cent, respectively.

1.62 The implicit deflator for GDP_{MP} defined as the ratio of GDP at current prices to GDP at constant prices is the most comprehensive measure of inflation on an annual basis. Overall inflation, as measured by the aggregate deflator for GDP_{MP}, declined from 5.0 per cent in 2006-07 to 4.9 per cent in 2007-08 and is estimated at 6.2 per cent in 2008-09 as a result of the higher inflation experienced during most of the year.

Inclusive growth

1.63 Regardless of the impact of the global financial crisis on India, the fact remains that some of the challenges that India faces are of a continuing nature. These inter alia include eradicating poverty, improving its physical and social infrastructure, education and creating productive employment opportunities. In consonance with the commitment to ensure faster social development and achieving an inclusive pattern of growth, the government continued its focus on several initiatives and programmes towards that end.

1.64 Some of the major social sector initiatives for achieving inclusive growth and faster social sector development and to remove economic and social disparities in the Eleventh Five Year Plan, include the Bharat Nirman programme, Mid-day Meal Scheme, National Rural Health Mission, Jawaharlal Nehru National Urban Renewal Mission and the National Rural Employment Guarantee Scheme (NREGS). Central support for the social programmes has continued to supplement efforts made by the states.

1.65 Under NREGS, over four crore households were provided employment in 2008-09. This is a significant jump over the 3.39 crore households covered under the scheme during 2007-08. Out of the 215.63 crore person-days of employment created under the scheme during this period, 29 per cent and 25 per cent were in favour of SC and ST population respectively. 48 per cent of the total person-days of employment created went in favour of women. The agriculture debt waiver and relief scheme implemented during the year was able to restore institutional credit to farmers and helped to support demand and revive investment in the rural and the agriculture sector.