*For the Year July 1, 2007 to June 30, 2008**

PART ONE: THE ECONOMY: REVIEW AND PROSPECTS

I ASSESSMENT AND PROSPECTS

I.1 The Indian economy continued to perform well during 2007-08, although the growth moderated marginally. This was the third year in succession when the Indian economy achieved a growth rate of 9 per cent and above. This was the highest average growth rate achieved during any three year period in the history of independent India. During each of the last three years, the growth rate of agriculture was well above the trend growth rate with foodgrains production touching a new high in each of the last two years. Industry also registered robust growth with the growth rate in the previous year being in double digits. Services exhibited double digit growth in all the three years. Although the Indian economy has been generally performing well in the post-reform period, the performance during the last three years was indeed noteworthy and it was second only to China among the major countries.

I.2 The improved performance in the last three years was the result of the well thought out and calibrated reforms pursued in the various sectors during the last one decade and a half. The high growth rate was underpinned by a distinct improvement in the saving and investment rates mainly on account of a turnaround in the public sector saving rate and improvement in the corporate sector saving rate along with the sustained high saving rate of households. Under the rule-based fiscal consolidation programme, public sector savings witnessed a turnaround underpinned by a steady increase in the tax-GDP ratio and steady improvement in savings of non-departmental undertakings. This enabled a narrowing of public sector saving-investment gap in recent years, thereby releasing greater resources for the private sector. The significant financial restructuring of the corporate sector and consequent reduction in the overall debt-equity ratio has had a significant impact on the profitability of the corporate sector and its savings. Household savings have been high traditionally in India and their contribution to overall savings has remained steady in recent years. Improved savings and generally comfortable financing conditions from the domestic and international capital markets drove the private investment rate above 10 per cent of GDP beginning from 2004-05. Thus, improved corporate and public sector finances have played a critical role in the steady increase in both the overall saving and investment rates to new peaks for the fourth year in succession in 2006-07. Another major driver of the growth process has been improved levels of productivity as reflected in the stable and low incremental capital-output ratio. While studies show that both industry and services have recorded productivity gains, such gains have been more pronounced in respect of the services sector. Productivity gains in industry and services emanated from increased use of technology, reorientation of processes, increased capacity utilisation and continued restructuring of the corporate sector.

I.3 The slight moderation in growth in 2007-08 in comparison with 2006-07 was mainly due to some adverse developments in the second half of the year. Growth decelerated sharply in advanced industrial

* : While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated beyond March 2008. For the purpose of analysis and for providing proper perspective on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

economies in the last quarter of 2007 mainly on account of turbulence in the international financial markets. Domestic inflation, which was well below the projections till December 2007, started hardening from January 2008, both on account of supply side pressures such as the one-off increase in domestic petrol and diesel prices, continuous hardening of prices of petroleum products that were not administered, rise in prices of wheat and oilseeds and adjustment in steel prices, and increased demand side pressures. Concerns over slowdown in growth in relation to earlier expectations encouraged central banks in many advanced countries to reduce their policy rates. The resultant rise in liquidity led to a search for higher yields. India with strong macroeconomic fundamentals attracted large capital flows during 2007-08, driven by external commercial borrowings, portfolio flows and foreign direct investment (FDI) inflows. Capital flows significantly higher than the current account deficit (which widened on account of strong import demand and rise in crude oil prices) and hardening of inflation necessitated continuation and reinforcement of pre-emptive monetary policy actions to dampen excessive demand pressures, while providing a conducive environment for continuation of the growth momentum.

I.4 The short-term growth prospects are now faced with several downside risks, both global and domestic. Global economic conditions have worsened with the growth in major advanced economies decelerating and inflation hardening. In India, headline industrial growth after a sustained expansion that began in 2003-04 moderated from September 2007. Growth in the services sector has also showed some signs of moderation mainly due to somewhat lower growth in the financial and construction sub-sectors. Inflation has hardened further even though the pass-through of the rise in international crude oil prices remains incomplete. Finances of the Government are under some stress on account of several factors such as increased pressures from oil, fertilisers and food subsidies, the farm loan waiver scheme and the hike in wages following the implementation of the Sixth Pay Commission recommendations.

I.5 Notwithstanding some downside risks to macroeconomic activity in the short run, the medium to long term prospects continue to remain robust. The structural factors underpinning the growth process continue to be as robust as before. The rise in saving and investment rates and gains in productivity experienced in recent years are likely to be sustained. Public finances, despite some underlying pressures, have remained broadly on track so far as prescribed under the fiscal rules. The improvement in State finances, in particular, in recent years is encouraging. There has been a sharp improvement in the profitability, asset quality and soundness parameters of the banking sector. As a result, the banking sector has developed resilience and is better equipped to intermediate funds efficiently than before. The balance sheets of the corporate sector have also strengthened significantly over the years. On the external sector front, although India's current account deficit has been widening, its robust macroeconomic fundamentals have also facilitated some capital inflows even during periods of heightened global uncertainty.

I.6 Although the medium to long-term prospects remain robust, there is a need to persist with the reform efforts in all sectors of the economy to realise the full potential of the economy. Structural weaknesses, which have resulted in stagnation in productivity in agriculture, need to be addressed, particularly when food inflation is rising globally. For improving the industrial performance, it is necessary that infrastructure constraints are removed, particularly in electricity and energy as also roads, ports, airports, and urban and rural infrastructure. While services have remained the main driver of growth, measures are needed to step up efforts in the area of education at all levels, which would help absorb unemployed youth, especially in the rural sector, and at the same time help address the skill

shortages in the labour force that are emerging. In the fiscal sector, issues of subsidies on fuel, food and fertilisers need to be addressed urgently. In the external sector, the gradual process of fuller capital account liberalisation that is underway needs to continue. In the financial sector, keeping in view progress in reforms in real and financial sectors, further reforms need to be carried forward drawing appropriate lessons from the turbulence in the international financial markets, while addressing challenges in the context of inclusive growth and financial inclusion.

ASSESSMENT OF 2007-08

I.7 Real GDP growth was placed at 9.0 per cent during 2007-08, moderating from 9.6 per cent recorded during 2006-07 and 9.4 per cent during 2005-06. However, it was still significantly higher than the average of 7.8 per cent achieved during the Tenth Plan (2002–2007). Also, this is the first time since 1950-51 (from which the official data are readily available) that the Indian economy recorded a growth of 9.0 per cent or above for three years in succession. Moderation in 2007-08 was spread across several sub-sectors of industry and services, while the agricultural sector registered improved growth.

I.8 Growth in agriculture and allied activities recovered from 3.8 per cent in 2006-07 to 4.5 per cent in 2007-08, which was higher than the average growth of 4.0 per cent targeted for the Eleventh Plan (2007–2012). The overall foodgrains production was also estimated to touch an all-time peak of 230.7 million tonnes, underpinned by above normal and well distributed South-West Monsoon. Record high levels were touched by all foodgrains, led by pulses, coarse cereals and rice. Among non-food crops, oilseeds and cotton touched their peak levels, with the former witnessing a significant increase.

I.9 The industrial upturn, which started in April 2002 and peaked by the end of 2006-07, moderated during 2007-08. In terms of index of industrial production (IIP), industrial growth decelerated from 11.5 per cent in 2006-07 to 8.5 per cent in 2007-08. Manufacturing growth (9.0 per cent) was lower than that in the preceding three years. According to the use-based classification, industrial growth decelerated across all the sectors during 2007-08 with a marked slowdown in the consumer goods sector. While growth in non-durables segment decelerated, the consumer durables segment witnessed a fall in production, particularly in respect of items for which consumer preferences have shifted towards new products. The capital goods sector continued to record a strong growth of 18.0 per cent during 2007-08 on the back of strong investment demand. The growth of core infrastructure industries at 5.6 per cent slowed down from the high growth of 2006-07, reflecting deceleration in all industries, barring coal.

I.10 The services sector continued to record double digit growth for the third successive year, notwithstanding some moderation (to 10.7 per cent in 2007-08 from 11.2 per cent in 2006-07). The sector benefited from rise in tourism, retail trade boom, improved performance of railways and civil aviation, surge in exports of business process outsourcing and information technology (IT) enabled services, and higher demand for real estate. While 'trade, hotels, transport and communication' and 'community, social and personal services' continued to be buoyant, construction activity moderated to single digit growth after posting double digit growth for the preceding four years, reflecting rise in input costs, capacity constraints in steel and cement sectors limiting the availability of key raw materials, and slow down in the real estate segment. Financial sector activity also witnessed some deceleration.

I.11 The strengthening of economic activity in the Indian economy in recent years has been underpinned by a steady upward trend in the saving and investment rates and improvement in efficiency of capital use. The savings rate increased from 26.4 per cent of GDP in 2002-03 to 34.8 per cent in 2006-07, while the investment rate rose from 25.2 per cent to 35.9 per cent. The average saving and investment rates at 31.4 per cent of GDP each during the Tenth Plan were the highest in any of the five year Plan periods. This trend was maintained during 2007-08, the first year of the Eleventh Five Year Plan,

as gross fixed capital formation increased by 1.4 percentage points to 33.9 per cent of GDP.

I.12 As the sustained economic growth was accompanied by a decline in population growth, the average real per capita income growth rose from 3.3 per cent during the Ninth Plan (1997–2002) to 6.1 per cent during the Tenth Plan (2002–2007), which was the highest growth achieved during any Plan period. The poverty ratio (based on uniform recall period) also declined from 36.0 per cent in 1993-94 to 27.5 per cent in 2004-05. Employment growth (based on current daily status) accelerated from 1.25 per cent per annum during the period 1993-94 to 1999-2000 to 2.62 per cent during the period 1999-2000 to 2004-05. However, with the labour force expanding at a faster pace, the incidence of unemployment based on current daily status rose from 7.31 per cent in 1999-2000 to 8.28 per cent in 2004-05.

I.13 Growth in money supply (M_3) decelerated marginally from 21.5 per cent during 2006-07 to 20.8 per cent during 2007-08. Of the major components, buoyancy in time deposits continued during 2007-08, *albeit* there was some moderation in the last quarter of the year. Time deposits continued to grow at a robust rate, *albeit* somewhat lower than the last year, driven by strong economic activity, higher interest rates on bank deposits and availability of tax benefits under Section 80C for bank deposits. Demand deposits grew at a higher rate than in the previous year, with much of the expansion taking place in January and February 2008, when there was also increased volatility in the equity market. On the sources side, growth of bank credit moderated marginally during 2007-08, after three consecutive years of strong expansion. Demand for bank credit was broad-based with agriculture, industry and retail sectors absorbing 11 per cent, 43 per cent and 12 per cent, respectively, of the incremental expansion in overall non-food credit during 2007-08. Growth of credit to sectors such as commercial real estate remained high (year-on-year growth of 38 per cent at end-March 2008). Banks' SLR[1] investment, as a proportion of their net demand and time liabilities (NDTL), was 27.8 per cent at end-March 2008, almost the same level as at end-March 2007. Net foreign assets remained the key driver of reserve money. The Reserve Bank continued to actively modulate market liquidity conditions through the liquidity adjustment facility (LAF), open market operations, issuance of securities under the market stabilisation scheme (MSS) and use of cash reserve ratio (CRR).

I.14 Headline inflation, after easing up to an intra-year low of 3.1 per cent in mid-October 2007, increased subsequently to 7.7 per cent by end-March 2008, partly reflecting supply-side pressures on key agricultural commodities such as rice, wheat, oilseeds/edible oils, increase in iron and steel prices in line with international prices, partial pass-through of international crude oil prices to domestic prices and continued demand pressures. The increase in domestic primary food prices, however, was of a significantly lower order (6.5 per cent) compared with an increase of 45.3 per cent in international food prices, on a year-on-year basis, in March 2008. This, to an extent, reflected the impact of domestic supply-augmenting measures. International oil prices reached new peaks during 2007-08. The price of the Indian basket also increased by over 60 per cent in rupee terms between February 2007 (when domestic prices were last cut) and March 2008. However, domestic mineral oil prices increased by only 9.3 per cent, year-on-year, at end-March 2008, reflecting the restricted pass-through in the case of domestic petroleum products. While domestic prices of petrol and diesel witnessed a one-off upward adjustment in February 2008 (3-4 per cent), after a gap of almost a year, non-administered petroleum products prices hardened (39-42 per cent) in tandem with international crude prices. Domestic iron and steel prices increased, reflecting higher domestic demand as well as firm global prices, while prices of non-ferrous metals declined in response to sharp correction in international prices from their peaks in May 2007. Consumer price inflation, which had eased up to January 2008, increased subsequently mainly due to increase in food and services prices. Various

[1] Refers to investment in SLR securities as notified in the Reserve Bank notification DBOD No. Ref. BC. 61/12.02.001/2007-08 dated February 13, 2008.

measures of consumer price inflation at 6.0-7.9 per cent in March 2008 were placed lower as compared with 6.7-9.5 per cent a year earlier.

I.15 The upsurge in inflation in India occurred at a time when global commodity prices were volatile and at historically elevated levels and central banks in advanced and emerging economies alike were articulating heightened inflation concerns. Consequently, there were concerns that demand pressures, which had remained reasonably somewhat contained, were being coupled with supply-side pressures and, if not temporary in view of global demand-supply imbalances, could impact domestic inflation significantly. Accordingly, in order to contain inflation and inflationary expectations, the Reserve Bank continued to take pre-emptive monetary actions in a calibrated manner in line with the evolving monetary and liquidity conditions. While leaving the liquidity adjustment facility (LAF) rates unchanged during the year, the Reserve Bank increased the cash reserve ratio by a further 150 basis points during 2007-08. The Government also took various fiscal measures during 2007-08 in the form of reduction in customs duties and restrictions on exports of few essential commodities to augment domestic supply and check price spirals, especially in food items. In order to address the supply-demand mismatches on an enduring basis, the minimum support prices for key crops were also raised to encourage production.

I.16 The Central Government's provisional accounts for 2007-08 continued to reflect its formal commitment of staying on course with the path of fiscal consolidation under the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004. Gross fiscal deficit (GFD) and revenue deficit, as percentages to GDP, at 2.8 per cent and 1.2 per cent, respectively, in 2007-08 (provisional accounts) were lower by 0.7 percentage point each than those in 2006-07. The fiscal correction during 2007-08, thus, turned out to be higher than the minimum reductions of 0.3 per cent and 0.5 per cent (relative to GDP) for GFD and revenue deficit, respectively, stipulated per year under the FRBM Rules, 2004. Furthermore, the provisional accounts continued to show an improvement in primary surplus during 2007-08, reflecting containment of non-interest expenditure below the non-debt receipts. The reduction in deficit indicators was enabled by buoyant revenue growth and improved expenditure management. The gross tax/GDP ratio maintained the upward trend to reach 12.5 per cent in 2007-08 (provisional accounts). Expenditure management efforts focussed on moderating non-plan expenditure, while increasing plan expenditure. Capital outlay, however, continued to remain at a low level of 1.5 per cent of GDP. In this regard, it is noteworthy that the Centre continued to incur extra-budgetary liabilities on account of oil, food, fertiliser and special State Bank of India bonds issued during the year aggregating to 0.8 per cent of GDP (lower than around 1 per cent during 2006-07), of which special bonds to oil companies as partial compensation for their under-recoveries were 0.4 per cent of GDP (lower than that of around 0.6 per cent of GDP during 2006-07).

I.17 The consolidated fiscal position of the State Governments in 2007-08 (revised estimates) reflected further progress towards fiscal correction and consolidation in line with their respective Fiscal Responsibility Legislation (FRL). The consolidated revenue account surplus was placed at 0.5 per cent of GDP in 2007-08 (revised estimates), thereby continuing the surplus position achieved in 2006-07 (accounts) for the first time after 1986-87. In all, 23 States reported revenue surplus during the year, one year ahead of the target for achieving the revenue balance by 2008-09 as prescribed by the Twelfth Finance Commission (TFC). The improvement in the revenue account resulted from higher increase in revenue receipts over the budgeted level, aided by higher devolution and transfers from the Centre, while the States' own tax revenue declined marginally. The State Governments substantially increased capital outlay, especially for irrigation and flood control, transport and water supply and sanitation. The consolidated gross fiscal deficit (GFD) of States based on revised estimates was marginally lower than the budgeted level. Eleven States managed to

bring down the ratio of GFD to Gross State Domestic Product (GSDP) to less than 3 per cent, two years ahead of the TFC target. The financing of GFD underwent a compositional shift with the State Governments witnessing a sharp decline in accruals under National Small Savings Fund (NSSF), thereby resorting to higher market borrowings. The recourse to Ways and Means Advances (WMA) by the State Governments was higher during 2007-08 as compared with the previous year. The State Governments, however, continued to maintain high level of surplus cash balances.

I.18 Global financial markets witnessed turbulent conditions during the most part of 2007-08 as losses on US sub-prime mortgage loans escalated into widespread financial stress, raising fears about stability of banks and other financial institutions. The crisis in the sub-prime mortgage market gradually deepened and spilled over to markets for other assets. The surge in demand for liquidity, coupled with growing concerns about counterparty risk, led to unprecedented pressures in major inter-bank markets. Apart from taking action at an individual level, central banks in advanced economies also initiated collective measures in a collaborative manner to ease liquidity stress in financial markets, reflecting the ongoing globalisation of financial markets. Concerns about slowdown in the real economy propelled a broad-based re-pricing of growth risk by the end of 2007. Equity markets in advanced economies remained volatile during the most part of the year, while those in emerging market economies (EMEs) declined sharply from January 2008. Long-term government bond yields in advanced economies softened, reflecting flight to safety by investors and easing of monetary policy in the US. In the currency markets, the US dollar depreciated against major currencies. In contrast to the previous episodes of broad-based asset market weaknesses, EMEs proved to be more resilient than those in advanced industrial economies.

I.19 Financial markets in India remained, by and large, orderly during 2007-08, barring the equity market, which witnessed occasional bouts of volatility during the second-half of August 2007, second-half of December 2007 and beginning of the second week of January 2008 broadly in tandem with trends in international equity markets. The primary market segment of the capital market, which had witnessed increased activity till early January 2008, turned subdued thereafter due to volatility in the secondary market. Over the year, as a whole, however, the equity market registered further gains. Brief spells of volatility were observed in the money market on account of changes in capital flows and cash balances of the Central Government with the Reserve Bank. After the withdrawal of the ceiling on reverse repo acceptances under the liquidity adjustment facility (LAF) in August 2007, interest rates in overnight money markets moved broadly in the reverse repo and repo corridor for the most part of the year. Collateralised money market rates remained below the call rate during the year. Yields in the government securities market softened during the large part of the year.

I.20 India’s balance of payments remained comfortable during 2007-08. Merchandise trade continued to exhibit robust growth during 2007-08. According to the Directorate General of Commercial Intelligence and Statistics (DGCI&S) data, the growth of merchandise exports and imports accelerated to 25.8 per cent and 29.0 per cent, respectively, during 2007-08 as compared with 22.6 per cent and 24.5 per cent, respectively, in the preceding year. The growth in exports in recent years has been underpinned by structural factors like product diversification towards technology-intensive items as well as favourable terms of trade in respect of commodity exports amidst ongoing surge in their prices globally. India's exports also witnessed geographical diversification, as a result of which the share of developing countries in India's exports increased, while that of developed markets such as the European Union (EU) and the US declined. The growth of merchandise imports accelerated in the wake of an unprecedented rise in international crude oil prices and continued buoyancy in capital goods imports. While non-oil imports accounted for about

67 per cent of the total imports in 2007-08, petroleum, oil and lubricants (POL) imports continued to be the single largest component, accounting for about 33 per cent of India's imports. India's POL imports grew from US $ 17.6 billion in 2002-03 to US $ 79.6 billion in 2007-08, largely due to elevated international prices of crude oil. POL imports registered a high growth of 39.4 per cent during 2007-08, reflecting largely the price effect, as growth in volume terms remained relatively low. The 10.1 per cent growth of POL imports in volume terms during 2007-08 was lower than that of 19.3 per cent a year earlier.

I.21 Overall higher import growth relative to exports in recent years has resulted in widening of the trade deficit, on a balance of payments basis, from US $ 10.7 billion in 2002-03 to US $ 63.2 billion in 2006-07 and further to US$ 90.1 billion during 2007-08. The trade deficit, as percentage of GDP, thus widened from 2.1 per cent in 2002-03 to 6.9 per cent in 2006-07 and further to 7.7 per cent in 2007-08. However, the impact of widening of the trade deficit on the current account was contained by a rise in remittances from overseas Indians, growth in software exports and a growth, *albeit* modest, in business services. Gross invisible receipts inched closer to the level of merchandise exports. Net surplus under invisibles at 6.2 per cent of GDP offset a large part of the trade deficit, thereby containing the current account deficit at 1.5 per cent of GDP in 2007-08 as compared with 1.1 per cent in 2006-07.

I.22 Net capital flows to India increased sharply to US $ 108.0 billion (or 9.2 per cent of GDP) during 2007-08, which were 2.4 times higher than the level in 2006-07. Capital flows far exceeded the current account deficit. Both debt and non-debt flows were higher during 2007-08. Direct and portfolio investment inflows and outflows increased sharply. Net foreign direct investment (FDI) inflows to India increased from US $ 22.0 billion during 2006-07 to US $ 32.3 billion during 2007-08, while net FDI outflows rose from US $ 13.5 billion to US $16.8 billion. During 2007-08, portfolio investment, including FII flows, remained volatile. The gross inflows and gross outflows under portfolio investment, including FIIs, were of the order of US $ 235.6 billion and US $ 206.3 billion, respectively, resulting in a net inflow of US $ 29.3 billion during 2007-08 (US $ 3.2 billion in 2006-07). The debt flows (net) amounted to US $ 42.0 billion during 2007-08 led by external commercial borrowings, underpinned by increased financing requirements and arguably by widening of interest rate differentials. Short-term credit also rose sharply, reflecting increased import financing requirements, particularly by oil companies for crude oil imports. Large net capital flows, which were significantly higher than the current account deficit, led to an accretion of foreign exchange reserves, placing continued pressure on monetary management. Although India's stock of external debt rose during 2007-08, debt sustainability indicators remained at comfortable levels. Foreign exchange reserves provided a cover of 140.0 per cent to the stock of external debt at end-March 2008.

I.23 Notwithstanding moderate levels of current account deficit since the early 1990s, India's current receipts-GDP ratio increased from 8 per cent in 1990-91 to 26 per cent in 2007-08, while current receipts and current payments, combined together, increased from 19 per cent to 53 per cent. Gross capital inflows and outflows together constituted 64 per cent of GDP in 2007-08 as compared with 12 per cent in 1990-91. All these indicators suggest growing integration of the Indian economy with the global economy.

I.24 To sum up, the Indian economy continued to exhibit robust growth amidst growing uncertainties in the global economy. While there was moderate deceleration in real GDP growth in industry and services, the recovery in domestic agriculture supported the growth momentum, besides helping in containing inflationary pressures in key agricultural commodities. The growth momentum was underpinned by the continued acceleration in savings and investment rates and by the sustained productivity growth. The fiscal position of both the Centre and the States improved, notwithstanding higher interest payments, subsidies and extra-budgetary liabilities. Notwithstanding global uncertainties, growth in merchandise exports and

imports accelerated during 2007-08, reflecting India's well diversified foreign trade. While expansion in aggregate supply capacities alleviated domestic macro-imbalances during 2007-08 to some extent, the increased domestic demand spilled over to the external sector as reflected in the sharp widening of the merchandise trade deficit. Monetary expansion remained higher than the indicative trajectory of 17.0-17.5 per cent in the face of heightened pressures resulting from excess capital inflows on a sustained basis in 2007-08. Inflation picked up during the fourth quarter of 2007-08, necessitating fiscal and administrative measures by the Government to augment domestic availability of key commodities as a first public policy response. The upsurge in inflation in India, however, occurred at a time when global commodities prices touched historically elevated levels and India witnessed huge net capital inflows. Pre-emptive monetary measures were continued to contain inflation and inflationary expectations. However, it is critical to note that the monetary policy responses were calibrated in a manner that could contain the possible adverse impact of the measures on the growth momentum of the economy.

OUTLOOK FOR 2008-09

I.25 The global economy has continued to slow down during 2008 so far mainly due to slackness in growth in advanced economies such as the US, the UK and the Euro area. According to estimates of the International Monetary Fund (IMF), global GDP is expected to decelerate from 5.0 per cent in 2007 to 4.1 per cent in 2008 and further to 3.9 per cent in 2009. According to the IMF, a mild recession in the US economy is expected as the housing market correction continues to exacerbate financial stress. Although emerging and developing economies have not been significantly affected so far by financial market turbulence and have continued to grow at a rapid pace, economic activity is beginning to moderate in some countries, including China. Growth in world trade volume is also expected to moderate from 6.8 per cent in 2007 to 5.6 per cent in 2008 and 5.8 per cent in 2009.

I.26 During 2008-09 (April-August), global financial markets have witnessed generally uncertain conditions. The markets recovered during April-May 2008 in the wake of repeated actions by central banks individually as also in a coordinated manner. However, inter-bank money markets, failed to recover as liquidity demand remained elevated. Central banks continued to work together and consult regularly on liquidity conditions in financial markets. In view of the persistent liquidity pressures in some term funding markets, the European Central Bank (ECB), the US Federal Reserve, and the Swiss National Bank (SNB) announced an expansion of their liquidity measures in May 2008. Credit markets were buoyed by a cautious return of risk tolerance, with the spreads narrowing from the very wide levels witnessed in the first quarter of 2008. Market liquidity improved, allowing for better price differentiation across instruments. The stabilisation of financial markets and the emergence of a somewhat less pessimistic economic outlook also contributed to the turnaround in the equity markets. Government bond yields rose mirroring the developments in the credit and equity markets. Growing perceptions among investors that the impact from the financial turbulence on real economic activity might turn out to be less severe than was anticipated also improved investor confidence. Although the US Fed kept the policy rate unchanged in its meetings held on June 25, 2008 and August 5, 2008, in view of the inflation outlook remaining highly uncertain, it resolved that it would continue to monitor economic and financial developments and would act as needed to promote sustainable economic growth and price stability. Financial markets came under stress again in June and early July 2008 as concerns mounted about the losses and longer-term profitability of two US mortgage companies. In order to further enhance the effectiveness of its existing liquidity facilities, the US Federal Reserve announced a package of measures on July 30, 2008 which included: (i) extension of the Primary Dealer Credit Facility (PDCF) and the Term Securities Lending Facility (TSLF) through January 30, 2009; (ii) introduction of auctions of options on US$ 50 billion of draws on the TSLF; (iii) introduction of 84-day Term Auction Facility (TAF) loans as a complement to 28-day TAF

loans; and (iv) increase in the Federal Reserve's swap line with the ECB to US$ 55 billion from US$ 50 billion in May 2008. In association with this change, the ECB and the SNB also adapted the maturity of their operations. Equity markets recovered somewhat from end-July 2008 reflecting incipient decline in the crude oil prices.

I.27 Going forward, the overall balance of risks to the short-term global growth outlook remains tilted to the downside with growth in advanced economies expected to fall well below the potential. A critical risk comes from the ongoing financial market turbulence, and its possible ramifications for the health of the financial system as a whole. Interaction between negative financial shocks and domestic demand particularly through the housing market remains a concern for the United States and to a lesser degree for Western Europe and other advanced economies. The emerging market and developing economies, which have not been seriously impacted so far by the financial market turbulence, are expected to provide some cushion to the global economy. On the other hand, globally, inflation has risen considerably from its level a year ago in advanced economies and EMEs alike. Higher and more volatile prices of food, energy and other commodities such as metals have imparted a significant upside bias to inflation and inflation expectations across the world, leading to additional complexity in the conduct of monetary policy at a time of severe financial stress. The resurgence of inflationary pressures has also exacerbated the concerns regarding slowdown in economic activity through their impact on real disposable incomes and consumers' purchasing power. Furthermore, as monetary policy may be tightened to modulate demand due to increasing global concerns relating to inflation and inflation expectations, emerging markets are likely to witness some moderation in their growth momentum too. The outlook on capital flows to the emerging markets remains uncertain. The massive injections of liquidity that have been made by central banks in advanced economies in recent months to assuage financial market turbulence could lead to large capital flows to the EMEs. On the other hand, in the event of abrupt change in global sentiments, or monetary policy actions, the possibility of reversal of capital flows can also not be ruled out. While EMEs have remained resilient so far, there is uncertainty as to how long, and to what extent the divergence of growth performance between advanced economies and EMEs will persist in future.

I.28 According to the latest forecast by the India Meteorological Department, the rainfall during South-West Monsoon season (June to September 2008) is likely to be 100 per cent of normal, with a model error of +/-4 per cent. The cumulative rainfall during the season so far (up to August 13, 2008), has been 2 per cent above normal as compared with 5 per cent above normal in the corresponding period of the previous South-West Monsoon season. Although, in comparison with last year's monsoon the spatial distribution has not been as satisfactory, by and large, monsoon conditions have been favourable so far in large parts of the country. Deficient/scanty rainfall in some regions, however, could affect the prospects of some crops. As on August 7, 2008, the total live water storage of 81 major reservoirs was 37 per cent of the full reservoir level (FRL), which was lower than the last year (57 per cent) and also lower than the average of 40 per cent for the past ten years. The sowing of *kharif* crops has been progressing with the area coverage (as on August 8, 2008) under rice showing a significant increase. However, the area coverage in respect of pulses, sugarcane and cotton declined.

I.29 Industrial production growth during April-June 2008 at 5.2 per cent was lower (10.3 per cent growth a year ago) mainly on account of a slowdown in the manufacturing growth (to 5.6 per cent from 11.1 per cent a year ago) and electricity growth (to 2.0 per cent from 8.3 per cent a year ago). In terms of use-based classification, the slowdown was reflected in all the sectors, including that in the capital goods sector, which had performed exceedingly well during the previous few years. The capital goods sector recorded a growth of 6.5 per cent during April-June 2008 (19.1 per cent during April-June 2007). The growth of core infrastructure industries was placed at 3.5 per cent during April-June 2008 as compared

with 6.3 per cent a year ago, with all the industries witnessing deceleration, barring coal.

I.30 Available information on lead indicators of services sector activity presents a mixed picture. While growth in tourist arrivals, revenue earning freight traffic of the railways and export cargo handled by civil aviation accelerated during 2008-09 (up to May/June), growth decelerated in respect of some other indicators such as cargo handled at major ports and civil aviation. Some deceleration was also observed in respect of growth rates of commercial vehicles production, and cement and steel during April-June 2008, which are the lead indicators of transportation and construction, respectively.

I.31 The Central Government proposed to strengthen the fiscal consolidation process as stipulated under the FRBM Rules, 2004 by budgeting the revenue deficit and gross fiscal deficit (GFD) at 1.0 per cent of GDP and 2.5 per cent of GDP, respectively, during 2008-09. The gross tax-GDP ratio was budgeted at 13.0 per cent during 2008-09. The targets relating to fiscal deficit were set to be achieved as per the mandate, while those relating to revenue deficit were rescheduled primarily on account of a conscious shift in plan priorities in favour of revenue expenditure-intensive programmes and schemes and systemic rigidity in non-plan expenditure in the short term, particularly arising from committed and obligatory expenditure such as interest payments, pensions, salaries and defence. The ongoing reforms and fiscal correction initiatives would continue to support domestic demand and investment, both of which are the main drivers of growth in GDP. During the current financial year (April-June 2008), the Central Government's revenue deficit and GFD were at 1.4 per cent of GDP and 1.6 per cent of GDP, respectively, which were lower than those during the same period of the last fiscal year. In absolute terms, while the fiscal deficit was lower by Rs.26,278 crore during April-June 2008, the primary deficit was lower by Rs.27,916 crore. It, however, may be noted that the GFD and primary deficit during April-June 2007 included the capital expenditure to the tune of Rs.35,531 crore incurred by the Government on account of purchase of the Reserve Bank's stake in State Bank of India (SBI). After adjusting for the SBI related transaction, the GFD and primary deficit for April-June 2008 were higher by Rs.9,253 crore and Rs.7,615 crore, respectively, than GFD and primary deficit during April-June 2007. Adjusted for SBI related transaction, GFD, as percentage of budget estimates, at 64.6 per cent in April-June 2008 was higher as compared with 50.9 per cent in April-June 2007. Tax collections grew by 28.4 per cent during April-June 2008 as compared with the first quarter of the last fiscal year to reach 2.1 per cent of GDP, while Plan expenditure rose from 1.0 per cent of GDP to 1.2 per cent of GDP during the same period. Non-tax receipts also increased over the corresponding period a year ago. During 2008-09, gross and net market borrowings (up to August 14, 2008) amounted to 54.5 per cent and 57.8 per cent, respectively, of the full year estimates as compared with 51.5 per cent and 50.6 per cent, respectively, a year ago. The weighted average maturity of dated securities during 2008-09 (up to August 14, 2008) at 15.21 years was higher than 14.32 years during the corresponding period of the previous year. During the same period, the weighted average yield increased to 8.72 per cent from 8.24 per cent.

I.32 The State Governments budgeted for higher consolidated revenue surplus during 2008-09 than that in the previous year, which would facilitate a reduction in the GFD to 2.1 per cent of GDP from 2.3 per cent during 2007-08. The increase in revenue surplus would result primarily from higher revenue receipts. Capital outlay would be maintained at 2.7 per cent of GDP in 2008-09 (BE) as in the previous year. The State Governments budgeted to maintain the ratio of development expenditure at 10.5 per cent during 2008-09 as in the previous year. In all, 25 State Governments have budgeted revenue surplus for 2008-09, the final year of the TFC target of eliminating revenue deficit. Furthermore, as many as 17 State Governments budgeted GFD-GSDP ratio at 3 per cent or less, a year ahead of the TFC target. The achievement of the TFC targets ahead of the recommended schedule by a number of State

Governments reflects strong growth in tax revenues, both States' own and devolution from the Centre, and higher grants-in-aid. While States have been able to scale up capital outlay, there has been some rationalisation of revenue expenditure during the Fiscal Responsibility Legislation (FRL) period. The financing pattern of GFD would undergo a compositional shift with a decline in accruals under the NSSF. As a result, the market borrowings would emerge as the major source of financing of GFD. The State Governments continued to maintain a high level of cash surplus during 2008-09 (up to July), as reflected in their investments in intermediate and auction Treasury Bills.

I.33 Expansion of money supply (M_3), (y-o-y), as on August 1, 2008 (19.6 per cent) was lower than a year ago (21.8 per cent), but higher than the indicative projection of 17.0 per cent[2] set out in the First Quarter Review of Annual Statement on Monetary Policy (July 2008). Growth of aggregate deposits decelerated due to deceleration in both demand and time deposits. Growth in bank credit, on the other hand, accelerated with growth in non-food credit of scheduled commercial banks (SCBs), y-o-y, placed at 26.2 per cent on August 1, 2008 as compared with 23.5 per cent a year ago. Accordingly, incremental credit-deposit ratio of SCBs rose to 86.0 per cent from 67.2 per cent a year ago. Investments in SLR securities by SCBs were at 27.0 per cent of their net demand and time liabilities as on August 1, 2008 (27.8 per cent at end-March 2008) as compared with 28.6 per cent a year ago. Growth of reserve money, y-o-y, as on August 15, 2008 at 31.1 per cent (24.3 per cent adjusted for the first round impact of increases in the CRR) was higher than 24.1 per cent (14.2 per cent adjusted for the first round effect of increases in CRR) a year ago.

I.34 Headline inflation firmed up further to 12.6 per cent on August 9, 2008 from 7.7 per cent at end-March 2008 (and 4.2 per cent a year ago), partly reflecting the impact of another round of upward revision in the prices of administered petroleum products such as petrol (11.2 per cent), diesel (9.8 per cent) and LPG (13.9 per cent[3]) as well as increase in prices of freely-priced petroleum products. Prices of non-administered petroleum products increased in the range of 19–56 per cent over end-March 2008 as compared with an increase of around 30 per cent in international crude oil (Indian basket) prices between March 2008 and July 2008. As a result, fuel group inflation hardened to 18.0 per cent, year-on-year, on August 9, 2008 in contrast to a decline of 2.0 per cent a year ago.

I.35 Apart from fuel prices, the intermittent but sharp increases in basic metals prices in line with international trends, along with iron ore prices were the other major factors that have contributed to inflation during 2008-09 so far. Manufactured products' inflation hardened to 10.9 per cent on August 9, 2008 from 7.3 per cent at end-March 2008 (and 4.7 per cent a year ago) which, apart from metals, was due to increase in the prices of edible oils and oil cakes as well as recent firming up of textiles prices, which reflected, to an extent, the continued hardening in the prices of inputs such as oilseeds and raw cotton. The increases in the prices of fertilisers as well as machinery and machinery tools have also contributed to the hardening of manufactured products inflation. The generalised increase in manufactured products inflation suggests the persistence of demand pressures and the existence of supply inelasticities. Primary articles inflation firmed up to 11.8 per cent on August 9, 2008 from 9.7 per cent at end-March 2008, driven by the hardening of vegetables, raw cotton and oilseeds prices. Various measures of consumer price inflation were placed higher (7.3–9.4 per cent) in June/July 2008 than those in March 2008 (6.0–7.9 per cent).

I.36 Going forward, there are some upside risks to inflation. While the freely-priced petroleum products have been adjusting continuously, the administered petroleum product prices have been revised upwards only twice since February 2007. Thus, the prices of freely priced petroleum products

[2] The indicative projection for money supply for 2008-09 was revised from 16.5-17.0 per cent set out in the Annual Policy Statement (April 2008) to 17.0 per cent in the First Quarter Review (July 2008).

[3] The announced LPG price increase was 20.3 per cent in June 2008.

in India could be expected to move in tandem with international prices during the rest of the year, while those of administered products, barring kerosene and LPG to an extent, may necessitate some upward revision. As against the almost 134 per cent increase in prices of international crude oil (Indian Basket) from US $ 56.6 per barrel in February 2007 to US $ 132.3 per barrel in July 2008 (127 per cent increase in rupee terms), domestic prices of freely-priced petroleum products increased by around 87 per cent over the same period. In contrast, however, administered prices of petrol and diesel have increased by only about 14 per cent since February 2007. There, thus, remains a large overhang of pass-through from past increases in international crude oil prices. As such, any incremental increase in international crude prices, which at the current juncture cannot be ruled out even though spot prices have eased from the peak of around US $ 145 per barrel in early July 2008 to below US $ 120 per barrel in August 2008. This scenario will not only result in a further pass-through to freely-priced petroleum products prices, but also necessitate upward revision in administered prices of petrol and diesel as well. These revisions would push up inflation directly, besides feeding through the production chain indirectly. However, the total impact would depend both on the extent of pass-through to consumers and the pricing power of firms, on the one hand, and the potential contraction in aggregate demand due to comparatively reduced expenditure on other items, on the other. Furthermore, the extent of such immediate hardening of inflation would lead to the build up of inflationary expectations. This, however, needs to be assessed along with the second round effects of demand contraction that could have a moderating influence on overall inflation. Moreover, the adverse impact may neither be homogenous across various producing and using sectors nor instantaneous across sectors. Given the current structure of the Indian economy, whereby services constitute the predominant share of GDP, the adverse impact of fuel price pass-through on the GDP growth in India, may be somewhat lower relative to other EMEs.

I.37 The outlook on international crude oil prices continues to be uncertain and, if the forecast by the US Energy Information Administration (EIA) is any indication, oil prices (WTI) could rise further in future. Any further increase in international crude prices is likely to put further pressures on the oil import bill in view of sustained growth in domestic consumption demand for petroleum products. There is also a view that slowdown in global economic activity may moderate demand and speculation. Accordingly, it is argued that there is a possibility, *albeit* remote, of a drastic reduction in the level of crude prices in the period ahead. In the event of international crude oil prices falling below the level up to which pass-through to domestic petroleum and oil (POL) product prices has occurred, there could be some easing of domestic inflation. Similarly, there is also a view that international prices of other commodities, including metals could also moderate with the slowing down in aggregate demand globally. While such moderation in some global commodity prices in future cannot be ruled out, it may be prudent to assume that in all likelihood, the current elevated levels would continue in future. However, should oil prices continue to soften as in recent weeks and domestic inflation moderate from the current elevated levels to tolerable levels, the evolving stance of overall macroeconomic and monetary policy would need to be informed by such developments. At the same time, if oil prices continue to remain at an elevated level and inflationary pressures persist, it is critical to demonstrate on a continuing basis a determination to act decisively, effectively and swiftly to curb any signs of adverse developments in regard to inflation expectations by enabling an adjustment of overall demand on an economy-wide basis, particularly in an environment of limited supply elasticities in the short run.

I.38 Apart from oil, coal and electricity prices also pose upside risk to inflation. Although domestic coal prices have increased moderately during 2007-08, higher imports at increasingly higher prices could exert upward pressures on domestic coal prices. Looking at the past relationship, it is observed that the pass-through of increase in coal/oil prices into electricity prices has declined in recent years,

reflecting above average increase in domestic production of coal and electricity. However, in view of the sharp increase in international prices of crude oil, gas and coal, some pass-through to coal and electricity prices cannot be ruled out, especially as more than half of India's energy needs are coal based. Some hardening of domestic iron and steel prices, another major driver of inflation, is also expected on account of rising input costs of iron ore and coking coal globally, notwithstanding improved domestic and world steel production. Other metal prices are expected to ease somewhat in line with global trends, reflecting the slowing global manufacturing demand. Pressures from oilseeds/ edible oils/oil cakes prices may continue in view of lower domestic *rabi* production and lower than normal acreage under current *kharif* oilseeds crop as well as firm international prices. Furthermore, the hardening of domestic raw cotton prices in line with international prices is likely to continue during 2008-09 in view of sharp decline in *kharif* crop acreage up to August 8, 2008, which may feed into textiles prices, as has been observed in the recent past (the WPI of textiles has increased by almost 12.5 per cent over end-March 2008). Thus, inflationary pressures from the supply side during the rest of the year on account of both pass-through from international prices and domestic demand-supply imbalances of certain key commodities need to be carefully assessed.

I.39 At the same time, the surge in inflation also indicates intensification of pressures on domestic demand as reflected in continued strength in fixed investment, growth in monetary aggregates above the indicative trajectory, rise in incremental non-food credit-deposit ratio of banks and evolving fiscal conditions. While capital flows have slowed down, a possible change in direction of capital flows also needs to be continuously assessed. Fiscal developments in the early months of 2008-09 indicate some stress on the financial position of the Union Government. Growing extra-budgetary liabilities and enhanced expenditures on subsidies, loan waivers and salaries in the rest of the year may warrant close and careful monitoring of fiscal situation. Fiscal policy generally tends to operate as a counter cyclical stabiliser, whereby during periods of aggregate demand pressures, Government expenditure is contained and higher revenue is generated, and during downswing, the government expenditure is stepped up and the revenue generation activity is slowed down. However, in India, rigidity in Government expenditure hinders the operation of counter-cyclical fiscal policy. In fact, Government finances in India are under pressure at a time when the economy is already facing demand pressures.

I.40 Indian financial markets remained largely orderly during 2008-09 (up to August 20, 2008). Brief spells of volatility were observed in the money market mainly on account of variations in cash balances of the Central Government with the Reserve Bank and changes in capital flows. Interest rates in overnight money markets remained generally consistent with the informal corridor set by reverse repo and repo rates. Interest rates in the collateralised segment of the overnight money market remained below the call rate. In the foreign exchange market, the Indian rupee for the most part depreciated against the US dollar in the wake of hardened oil prices and increased demand for dollars. Yields in the Government securities market hardened. The Indian equity markets witnessed correction until mid-July 2008 amidst high volatility in tandem with trends in major international equity markets, reflecting the impact of global factors (apprehensions of global inflation, slowdown in corporate earnings and hardening of oil prices) as well as domestic factors (rise in inflation, higher borrowing costs and slowing industrial growth). From mid-July 2008, domestic stock markets recovered reflecting softening of crude oil prices and increase in the major global equity indices. As on August 20, 2008, domestic stock market indices, however, remained below their end-March 2008 levels.

I.41 Growth in merchandise exports accelerated, while imports showed moderation during the first quarter of 2008-09 as compared with the first quarter of 2007-08. According to DGCI&S, merchandise exports increased by 22.4 per cent during April-June

2008 (20.4 per cent a year ago). Imports expanded by 29.8 per cent (38.0 per cent a year ago), led by a higher growth in oil imports (50.4 per cent as compared with 23.9 per cent), and while non-oil imports growth decelerated (20.9 per cent as compared with 45.1 per cent). The acceleration in the growth of oil imports reflected mainly the impact of escalation of international crude oil prices. The trade deficit widened to US $ 30.4 billion during April-June 2008 from US $ 21.5 billion during April-June 2007.

I.42 Capital flows have been volatile during 2008-09 (up to early August 2008). Net capital flows during 2008-09 so far were lower than those in the corresponding period of 2007-08 mainly on account of outflows by foreign institutional investors (US $ 4.7 billion) during 2008-09 (up to August 8, 2008) in contrast to net FII inflows (US $ 10.1 billion) a year ago. On the other hand, net FDI flows into India were placed higher at US $ 10.1 billion during April-June 2008 as compared with US $ 5.0 billion during April-June 2007. The funds raised through issuances of ADRs/GDRs abroad were also significantly higher (US $ 999 million) during April-June 2008 as compared with April-June 2007 (US $ 316 million). NRI deposits recorded a net inflow (US $ 360 million) during April-June 2008 mainly due to inflows under the rupee deposit accounts as against a net outflow (US $ 446) during April-June 2007. As on August 15, 2008, foreign exchange reserves declined by US $ 13.5 billion over the end-March 2008 level.

I.43 The Reserve Bank, in its Annual Policy Statement for 2008-09 (April 2008), placed real GDP growth in the range of 8.0-8.5 per cent for policy purposes, assuming that (a) global financial and commodity markets and real economy would be broadly aligned with the central scenario as then assessed; and (b) domestically, normal monsoon conditions would prevail. In view of the lagged and cumulative effects of monetary policy on aggregate demand and assuming that supply management would be conducive, capital flows would be managed actively and in the absence of adversities emanating in the domestic or global economy, the Statement noted that the policy endeavour would be to bring down inflation from the then high level of above 7.0 per cent to around 5.5 per cent in 2008-09 with a preference for bringing it as close to 5.0 per cent as soon as possible, while recognising the evolving complexities in globally transmitted inflation. The resolve, going forward, according to the Annual Policy Statement, would continue to be to condition policy and perceptions for inflation in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent became a medium-term objective consistent with India's broader integration into the global economy and with the goal of maintaining self-accelerating growth over the medium-term.

I.44 In the First Quarter Review of the Annual Statement of Monetary Policy in July 2008, it was noted that while in the absence of unanticipated weather adversities, moisture conditions should support a continuation of the above medium-term trend growth in agriculture, moderation could persist in the industrial and services sectors in the short-term, notwithstanding the still robust momentum in these sectors. It also noted that according to the IMF, world GDP growth during 2008 was also expected to decelerate by close to one percentage point in relation to 2007 with second round effects on world GDP growth. Accordingly, it indicated that taking into account aggregate demand and supply prospects, for policy purposes, a projection of real GDP growth of around 8.0 per cent appeared a more realistic central scenario at the then prevailing juncture, barring domestic or external shocks. The First Quarter Review also pointed out that escalation in inflation had become a global phenomenon and the increase in inflation in India over the previous year was not proportionately different from elsewhere. While the policy actions, according to the Review, would aim to bring down the prevailing intolerable level of inflation to a tolerable level of below 5.0 per cent as soon as possible and around 3.0 per cent over the medium-term, a realistic policy endeavour would be to bring down inflation from the then prevailing level of about 11.0-12.0 per cent to a level close to 7.0 per cent by March 31, 2009.

I.45 The stance of monetary policy in 2008-09, according to the Annual Policy Statement, would be governed by the evolution of inflationary pressures from escalated and volatile food and fuel prices, which were common to both global and domestic economy with some elements of contagion. Overall, relative to the global economy, the Statement observed that there was less uncertainty about the prospects for the Indian economy. The moderation in growth in the Indian economy was likely to be lower in comparison with the global economy, which was likely to witness a significant slowdown in growth. Accordingly, domestic factors would continue to dominate the policy setting, with the emphasis on inflation expectations so as to maintain the hard-earned gains in terms of both outcomes of India's growth momentum and positive sentiment. While the demand pressures persist in India and investment demand continues to be strong, the supply response could be expected to improve further alongside a build up of additional capacities. Therefore, critical to the setting of monetary policy would be the anchoring of expectations relating to both global and domestic developments. Accordingly, the overall stance of monetary policy in the Annual Policy Statement was stated broadly to ensure a monetary and interest rate environment that accorded high priority to price stability, well-anchored inflation expectations and orderly conditions in financial markets while being conducive to the continuation of the growth momentum.

I.46 The First Quarter Review, while reiterating the Annual Policy stance for 2008-09, noted that there was an urgent need for monetary policy to address aggregate demand pressures, which were strongly in evidence, by continuing with measured responses on an ongoing basis, in a timely manner. Various measured responses beginning September 2004, which had moderated early signs of overheating that emerged in 2006-07, would continue to work in conjunction with supply side measures to bring down inflation to more acceptable levels in the near future. Consistent with the stance of monetary policy and on the basis of incoming information on domestic and global macroeconomic and financial developments, the Reserve Bank continued with its policy of withdrawal of monetary accommodation. In view of the progressive build up of underlying inflationary pressures, monetary policy recognised the need to smoothen and enable the adjustment of demand on an economy-wide basis so that inflation expectations were contained.

I.47 Accordingly, the Reserve Bank continued taking monetary tightening measures during 2007-08 (April-March) and 2008-09 (up to August). The cash reserve ratio (CRR) was increased by 150 basis points in three phases during 2007-08 from 6.0 per cent to 7.5 per cent. The CRR was raised by 50 basis points in two stages of 25 basis points each, effective fortnights beginning April 14, 2007 and April 28, 2007. This was followed by another hike of 50 basis points to 7.0 per cent with effect from the fortnight beginning August 4, 2007. The CRR was further raised by 50 basis points to 7.5 per cent effective from the fortnight beginning November 10, 2007. During 2008-09 (up to August 2008), the Reserve Bank further raised the CRR by 150 basis points in four phases to 9.0 per cent. The repo rate under the liquidity adjustment facility (LAF) was increased by 25 basis points effective June 12, 2008 and further by 50 basis points to 8.5 per cent effective June 25, 2008 and further to 9 per cent effective July 30, 2008. Thus, the cumulative increase in the CRR and the repo rate was 450 basis points and 300 basis points, respectively, since September 2004. This consistent and calibrated approach of measured monetary policy tightening reflected the Reserve Bank's clear commitment to the maintenance of price and financial stability, while maintaining the growth momentum at desired levels.

I.48 To sum up, going forward, apart from global risks, outlook for the Indian economy is also contingent upon unfolding of domestic risks. While industrial and services sector activity has moderated, the outlook for agriculture would continue to depend upon the progress of monsoon. The outlook for domestic food prices depends crucially on the behaviour of agricultural production. Imports can be used only to a limited extent to meet shortfalls in domestic production. In the short run, output largely depends on seasonal conditions (level and intra-

seasonal distribution of rainfall) and their regional pattern. Inflation risks have increased sharply and appear to be persistent. While inflationary pressures seem common to both advanced and emerging market economies, including India, with some elements of contagion, there is less uncertainty about the growth prospects of the Indian economy in comparison with other economies. Unlike the global economy, which is expected to slow down significantly, the Indian economy is likely to witness a slight moderation in the growth which continues at an elevated level. The conduct of monetary policy in the context of bringing down inflationary pressures is, however, getting complicated by global developments and domestic demand pressures.

REAL SECTOR

Agriculture

I.49 The ongoing surge in global prices of major food items, which began in 2006, has significant implications for the domestic agricultural sector and overall macroeconomic and financial stability. Global prices in July 2008 (y-o-y) for several food items such as rice (140 per cent), wheat (38 per cent), oilseeds (40-77 per cent), edible oils (34-68 per cent) and sugar (33 per cent) were significantly higher than their levels prevailing a year ago. Reflecting the sustained uptrend, the food price index (compiled by the IMF), which had increased by 10.5 per cent in 2006 and 15.2 per cent in 2007, rose sharply by 40 per cent, year-on-year, in July 2008, surpassing the levels previously witnessed in the late 1980s. On the demand side, apart from increase in consumption, driven by growth in population along with its dietary shifts, income, globalisation and urbanisation, the growing diversion of food for non-food uses such as bio-fuel production in the wake of surge in oil prices also contributed to food inflation. According to the IMF, rising corn-based ethanol production accounted for three-fourth of the increase in global corn consumption during 2006–07, which not only drove corn prices but also prices of other food crops. Arresting this diversion would be contingent upon (a) future correction of policies that continue to encourage the use of food for biofuel production; (b) advancement of technological development that enables viable 'second generation' biofuel production based on cellulosic feed stocks instead of food and feed crops; and (c) the future course of oil prices. Internationally, on the supply side, land and water constraints, underinvestment in rural infrastructure, lack of access to inputs, and weather disruptions have impaired productivity growth in agriculture and the needed production response. Inventory levels of those major food crops, whose production levels have not kept pace with rising demand growth in recent years, declined to levels last seen in the 1970s. Consensus is emerging about the absence of adequate policy incentives for farmers to increase their supply of food and other agricultural products to cope with the growing demand. Furthermore, drought conditions, possibly induced by climate change, in the main producing regions such as Australia and Ukraine also caused shortfalls in the production. Bad weather led to poor global wheat harvest for the second consecutive year in 2007, which bid up wheat prices, and created spillovers into other crops through substitution effects. Elevated oil prices increased production costs of food commodities and drove up transportation costs, thereby hindering production response to high output prices. Finally, in the wake of financial market turbulence, reductions in policy rates particularly in the US and investors' search for newer and safer assets, could have promoted financialisation of commodity trade by making inventory holding remunerative, thereby inducing greater volatility in food prices.

I.50 Food prices have also hardened in India in recent times. However, the increase in wholesale prices of various crops in India such as rice (7 per cent), wheat (5 per cent), oilseeds (18 per cent) and edible oils (17 per cent) at end-July 2008 over end-July-2007 was of a much lower order in comparison with the increase in global food prices. Scaling of a new peak in foodgrains production and significant improvement in procurement have resulted in comfortable stocks in the current period, thereby containing undue spurts in food prices in India. At the same time, some concerns have also arisen

relating to agriculture production. The performance in agriculture continues to be essentially monsoon-driven. The per capita availability of cereals and pulses also declined. The per capita consumption of cereals declined from a peak of 468 grams per day in 1990-91 to 412 grams per day in 2005-06, while that of pulses declined from 42 grams per day to 33 grams per day during the same period.

I.51 In India, although the share of agriculture in real GDP has declined below one-fifth, it continues to be an important sector as it employs 52 per cent of the workforce. Agriculture growth has remained lower than the growth rates witnessed in the industrial and services sectors. These inter-sectoral differences in the growth performance raise the issue of differential growth in per capita income of people engaged in agriculture relative to those employed in other sectors. Therefore, future policy needs to ensure greater absorption of labour into industry and services so that growth in labour productivity and level in incomes from agriculture can accelerate.

I.52 Stagnation in productivity in agriculture on the one hand, and growing incomes and changes in consumption patterns on the other, have led to demand-supply mismatches in the case of major agricultural commodities. Boosting agricultural production, through increase in gross cropped area (multiple cropping), enhancement in irrigation coverage and improvement in productivity, has remained a challenge in the wake of flattening out of increase in net sown area. Although total irrigation potential increased from 81.1 million hectares in 1991-92 to 102.8 million hectares in 2006-07 (still less than three-fourths of the ultimate irrigation potential), its utilisation was only around 85 per cent. Over the years, the Government's announcement of minimum support prices (MSPs) prior to the commencement of sowing season setting out floor prices (inclusive of bonus) has intended to incentivise crop production and facilitated procurement. The MSPs were revised upwards in 2007-08 over those in 2004-05 in respect of common paddy (33 per cent), wheat (56 per cent), moong and urad (23 per cent each), arhar (14 per cent) and jute (19 per cent). Productivity of crops in India, however, remains not only low relative to other countries, but also shows large inter-state variations. Furthermore, actual yields also lag the levels, which could possibly be achieved through improved practices, as noted by the Steering Committee on Agriculture for the Eleventh Plan.

I.53 According to the OECD-FAO Agricultural Outlook 2007-2016, the global prices of agricultural commodities are expected to rule much above their historic equilibrium levels in the next ten years. This could also have implications for India unless some concrete measures are initiated to address the issue of domestic demand-supply mismatches. While trade and fiscal measures along with imports can address supply-demand mismatches in the short run, in the medium to long run, there is a need to ensure that domestic food management enables maintenance of adequate levels of buffer stocks. Going forward, the overall improvement in foodgrains production and the rise in the level of buffer stocks would assuage supply shortages, dampen inflation expectations, economise on imports and fortify food security in the context of the intensifying food crisis worldwide. There is, however, a need to carefully avoid the possible unintended consequences of building up buffer stocks for market supplies at a time when demand-supply gaps are already strained, while ensuring food security and maintaining price stability.

I.54 The long-term solution lies in addressing structural weaknesses in agriculture such as exhaustion of yield potential of high yielding varieties of rice and wheat, unbalanced fertiliser use, low seeds replacement rate, inadequate incentive system and post harvest value addition. Lack of yield growth, limited varietal break-through, decline in agricultural investment, almost non-existent extension services and low resilience to moisture stress, pest infestation and rising input costs, especially fertilisers and fuel have inhibited agricultural productivity. Therefore, a comprehensive agricultural revamp programme needs to be a policy priority, whereby area-specific high yielding varieties are developed (particularly for wheat and pulses,

where domestic production capacity is still inadequate), area under assured irrigation is expanded and accelerated technology diffusion is undertaken through research and extension network. Furthermore, a regionally differentiated agricultural strategy needs to be implemented taking into account local resource endowments, capabilities as well as constraints.

I.55 Among the recent initiatives to overcome demand-supply mismatches, the Central Government launched the National Food Security Mission (NFSM) up in 2007, which set quantitative targets for the Eleventh Plan in respect of rice, wheat and pulses. The Mission's strategy is to bridge yield gaps in potential areas by introducing modern technologies and improved agronomic practices. This would be a significant way forward to meet the projected additional requirement of about 19 million tonnes of foodgrains by 2011-12. Second, the State Governments would also be incentivised to increase their share of public investment in agriculture and allied activities during the Eleventh Plan through *Rashtriya Krishi Vikas Yojana*, a State Plan scheme, which was approved in August 2007. Third, the National Policy for Farmers, 2007 was also approved by the Government, which would, *inter alia*, provide a holistic approach to development of agriculture. Fourth, in order to create an incentive structure to promote balanced use of fertilisers, the Cabinet Committee on Economic Affairs (CCEA) on June 12, 2008 approved a nutrient based pricing regime for all subsidised fertilisers. To ensure easy availability of fertilisers in all parts of the country, the Cabinet Committee also approved a uniform freight subsidy regime for all subsidised fertilisers, which would facilitate availability of fertilisers in all parts of the country, especially in areas which are far from the production facilities and ports by reimbursing freight on an actual basis.

I.56 Going forward, in order to reap the full potential in agriculture, greater focus needs to be placed on modernising the agricultural research system as success so far has been restricted to select crops. This is imperative in view of degradation of natural resource base, especially depleting groundwater table with particularly adverse impact on small and marginal farmers. According to the estimates of the Planning Commission, public expenditure on research would need to increase from the present 0.7 per cent of agricultural GDP to 1.0 per cent by the end of the Eleventh Plan. Second, although investment rates in agriculture have showed some increase in recent years, the levels are still inadequate. Productivity increase in agriculture is critically contingent on enhanced capital formation, both from the public and private sectors. Investment in agriculture as a proportion of GDP needs to be raised substantially. Third, there is a need to promote diversification of agriculture towards horticulture and livestock. Agricultural marketing would be critical for success of this diversification strategy. Since high value agriculture is based on perishable commodities, large investments would be required in modern methods of grading, post-harvest management and development of cold storage supply chains. Fourth, there is need to recognise the benefits of collective representation of farmers in the product and credit markets. Agricultural production is in the hands of a very large number of relatively small and fragmented holdings. Since most of farmers access input and output markets on an individual basis, they are at a great disadvantage both in terms of access to these markets and the terms on which they can get inputs and sell their produce. Creating a legal framework which enables and encourages the emergence of autonomous organisations (co-operatives, producer companies) is essential to improve bargaining power of farmers generally (and of small and marginal farmers in particular), thereby strengthening incentives of faster, more efficient and more equitable growth. In fact, the legislative and institutional arrangements appear to inhibit operation of genuine markets, thus adversely affecting farmers and agriculture as well as related sectors. Concerted and immediate actions to remove such bottlenecks in the related markets are critical. A legislative framework that enables small and marginal farmers to establish autonomous organisations through which they can collectively access inputs and sell produce, would make the

market respond more favourably to their needs, and provide the basis for increased investment in agriculture. Fifth, it is imperative to ensure the efficient use of inputs such as water resources, seeds and fertilisers. Appropriate sets of incentives and disincentives for enabling such efficient use of critical and valuable inputs should be very high on the agenda for meaningful policy response. For this purpose, farmers, may also be imparted necessary training by the local administration and research institutes. Finally, there is a need to recognise that access to food for a large section of the population is hindered due to chronic poverty, unemployment and lack of purchasing power. Nearly half of the population still suffers from chronic under-nutrition in the country. Despite significant increase in agricultural production, goals of self-sufficiency in food, food security and nutrition at the household level are yet to be achieved. The medium term prospects for agriculture – important both for sustaining rapid growth with price stability and for the growth of rural employment and incomes – depends on the realisation of targets of irrigation and watershed development and developing yield improving technologies for crops such as oilseeds and pulses and for rainfed areas. Equally important are concerted measures to improve the quality of implementation of these programmes as well as the functioning of institutions for their continuing management. These need to be combined with a pricing policy designed to induce farmers to make more prudent and economical use of key inputs. The challenge, thus, lies in continuously working towards implementing the Government's strategy of faster and more inclusive growth in its multiple dimensions. A comprehensive approach broadly on the lines as described above is most critical at this juncture not only for assuring price stability but also simultaneously serving the objectives of equity, employment-generation and output-augmentation impacting the welfare of an absolute majority of families, including the most disadvantaged.

Industry and Infrastructure

I.57 Industrial growth, which accelerated during the period 2002-03 to 2006-07, moderated in 2007-08 reflecting, apart from the base effect, some slowing down of domestic and external demand. While manufactured exports recorded a higher growth of 19.1 per cent during 2007-08 as compared with 17.0 per cent, a year ago, the performance of some export-oriented industries with low import intensity remained subdued. Hardening of crude oil prices and spike in commodity prices, which form inputs for the industrial sector, increased the costs of industrial production. As alluded to earlier, the deceleration in the consumer goods sector, particularly durables, was partly contributed by the decline in production of those items, which have now become outdated. Shifts in consumption patterns towards new items, however, are not being captured comprehensively in the present series of the IIP with base 1993-94. Thus, the recorded slowdown in the durables segment could be somewhat overstated. Furthermore, the industrial sector faced several supply constraints emanating from the shortages in the cement and steel sectors, which were reflected in a spurt in their prices. Other constraints included industry-specific capacity limitations, inadequate power availability, transportation bottlenecks and other infrastructural services, which exerted pressure on the output.

I.58 A relevant issue in the performance of the manufacturing sector relates to the input costs, particularly that of industrial raw materials and short-term inflation. An upsurge in demand for metals and minerals, which sustains the industrial growth, puts an upward pressure on both domestic and international prices. Fiscal measures in the form of lower duties and taxes were effected in the Budget 2008-09 to provide some relief from high prices. However, the medium-term solution lies in improving the supply response and developing the infrastructure. The coordinated efforts in this direction would remove bottlenecks, which hinder the growth in productivity and result in inefficiency.

I.59 In making the textile industry globally competitive, especially in the post-Multi Fibre Agreement regime, the Government has focused on three areas – stable policy environment,

modernisation through technological upgradation, and building of global brands for Indian textiles. In addition to rupee appreciation, demand conditions of the importing countries have also affected the textile exports from India. In order to enable textile exporters to tide over the difficulties, the Government announced a set of measures in July 2007 and in November 2007. For making the Indian textile industry globally competitive, there is need to focus upon technology improvements, better product designing and export diversification.

I.60 The hardening of international crude oil prices poses a serious downside risk to the manufacturing sector growth during 2008-09. Higher oil prices result in rise in transportation cost, which then raises the cost of production and product prices, which, in turn, have an adverse impact on overall demand conditions for the manufacturing sector. In particular, due to uneven availability of power, many manufacturing units in India depend on captive power plants that operate on diesel. The impact of rise in oil prices could be more severe on these units. The rise in input costs might also further affect the consumer durables industry.

I.61 Performance of the infrastructure sector continues to be an area of concern. The performance of the electricity sector was adversely affected by capacity constraints, which were caused, *inter alia*, by problems relating to coal and ash handling units, and water availability, and slow implementation of the setting up of new power capacities. Such issues restrained the operationalisation of new units commercially and hampered power generation in both thermal and hydro power plants. As uninterrupted quality power supply is the basic requirement for industrial development, the Eleventh Five Year Plan proposes to overcome the current power deficit of over 9 per cent by the close of the Plan period. However, the capacity addition programme of the Government shows that only about 64 per cent of the targeted capacity was added during the Tenth Five Year Plan (2002-07) in the power sector. As power is the basic input in almost all economic activities, project delays in the power sector could constrain the ability of the economy to sustain projected high rates of growth. During 2007-08, about 9,263 MW capacity has been added as against the target of 16,335 MW. Another 11,000 MW of capacity is expected to be added during 2008-09. The slow progress in capacity additions has accentuated the power supply deficits and any slippage in achieving the targets may worsen the situation further in the face of increasing demand for power from industry and other sectors. In this context, the concerns relating to the performance of new units and their commercial operationalisation are being examined by the Central Electricity Authority. The Union Budget 2008-09 has budgeted to provide Rs. 800 crore for the Accelerated Power Development and Reforms Programme in 2008-09. Furthermore, there is a proposal to create a national fund for transmission and distribution reforms. One of the major reasons for deficiency in the availability of power is the lower user charges, which in many cases do not reflect the cost of generation and transmission of power. The need is to adjust the user charges whereby the power companies find the generation of power a viable activity. Users are also likely to be willing to pay the appropriate charges if they are assured of good quality and uninterrupted power supply. For instance, according to some reports, some industrial units in a particular city agreed to make available excess electricity to the grid, which, in turn, was made available to consumers but at a higher price.

I.62 Among the core sectors, the coal sector was the only exception during 2007-08, which recorded accelerated growth. While measures have been initiated to increase the coal production to meet the growing demand not only from the electricity sector but also from other utilities, environmental concerns and issues relating to rehabilitation of displaced population due to mining activities and construction of dams also need to be addressed proactively. A new coal distribution policy seeks to facilitate supply of assured quantities and quality of coal to various categories of consumers at pre-determined prices in a regime of enforceable obligations on the part of both the suppliers and consumers of coal.

I.63 In view of shortages and rising prices of petroleum products in recent times, keen interest is being shown globally in setting up of thermal power plants that are not based on oil. As such thermal plants are dependent on coal and gas, the thermal based additions to capacity in India would have implications for the cost of power generation due to increasing prices of gas and coal, and erratic gas supplies would lower plant load factor. Besides, a rise in mineral oil prices could also have an impact on gas prices, which would hamper the production of power. At the margin, renewable energy sources offer an alternative for meeting the growing demand for power. A grid interactive renewable energy capacity of 11,449 MW has already been installed in the country by the end of March 2007. Capacity addition of 15,000 MW from the renewable energy sources has been proposed during the Eleventh Plan period, but progress in this direction is slow. Though the country has hydro potential of over 150,000 MW capacity, new projects in this sector are held up due to various disputes, and other implementation difficulties.

I.64 With rapid urbanisation, the issue of inadequacy of urban infrastructure, including, *inter alia*, mass rapid transport system, drinking water, sewage system, solid waste management, roads and lightings, has come to the fore. The improvement in urban infrastructure can lead to significant gains in productivity. So far, 26 projects with a total cost of Rs.1,766 crore, involving central grant of Rs.952 crore have been sanctioned under the industrial infrastructure upgradation scheme (IIUS). The work on these projects is at different stages of implementation, which would improve the urban infrastructure to some extent. Furthermore, to improve the urban infrastructure, the Union Budget 2008-09 increased the allocation to the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) from Rs.5,482 crore in 2007-08 to Rs.6,866 crore in 2008-09.

I.65 The Approach Paper to the Eleventh Plan (2007-12) has noted the absence of world class infrastructure as the most critical short-term barrier to the growth of the manufacturing sector. It is, thus, imperative that the existing infrastructure facilities, particularly roads, ports, airports, power and urban and rural infrastructure are strengthened to provide growth-enabling environment for the industry. This, in turn, would require augmentation of infrastructure investment. The Planning Commission has projected that the investment in the infrastructure sector should increase to 9.3 per cent of GDP during the Eleventh Plan period from 5.4 per cent in 2006-07. In order to facilitate such investment levels, private participation and public-private partnerships are envisaged to be encouraged.

I.66 While recent data indicate some moderation in the industrial growth, it is possible that some recent developments will improve the prospects for recovery in momentum. Fiscal concessions in the form of raising of income tax exemption limits and adjustment of tax slabs could enhance disposable income of middle-class, which may have a positive impact on consumption demand for industrial goods. Furthermore, reduction in excise duties in respect of various commodities could not only ease inflationary pressures but also lower the prices of a number of consumer goods, thereby making them more affordable. There are, however, also some downside risks to the industrial growth momentum during 2008-09. The under-performance of the power sector in the last couple of months, especially in respect of nuclear and gas-based power plants, might have an adverse impact on the industrial growth. Besides, the elevated global crude oil prices could further add to the inflationary pressures in the economy and dampen industrial growth prospects, both from demand and supply sides. During the past five years of industrial upturn, the core sector growth has not kept pace with the growth in the manufacturing sector, thereby causing apprehensions regarding the sustainability of industrial sector growth.

Services

I.67 The services sector continues to propel the overall growth momentum in India. The phase of robust growth in the Indian economy coincided with

marked acceleration in the growth of the services sector beginning from 2003-04. The services sector recorded double-digit growth during the three year period from 2005-06 to 2007-08, underpinned by a significant increase in demand for domestic services. The hotel and tourism industries recorded strong growth on the back of rise in domestic tourism and increased interest of foreign travellers in India. The 'trade, hotels and restaurants' sector grew at double digit rate in the last five years. The domestic retail boom supported the performance of trade, while the improved performance, especially of railways and civil aviation, provided a boost to the transportation sector. Furthermore, the civil aviation sector witnessed unprecedented upsurge in recent years with passengers flown in by domestic operators recording robust growth in the past five years. The operation of low cost airlines, which has made air travel attractive, has resulted in high growth in domestic air passenger traffic, apart from facilitating elevated levels of trade traffic. However, in recent months some moderation is noticed in expansion of activities in hotels, passengers handled at international/domestic terminals and airlines traffic due to several reasons. The rise in aviation turbine fuel (ATF) costs has led to a hike in air fares.

I.68 A surge in exports of business process outsourcing (BPO) and ITES in conjunction with higher demand for real estate and spurt in capital market activity led the growth of 'finance, real estate and business services' during 2007-08. India is a major force in the information technology sector. A number of multi-nationals have leveraged the relative cost advantage and highly skilled manpower base available in India, and have established shared services and call centres in India to cater to their worldwide needs. The IT/ITES sector's contribution to the country's GDP steadily increased from 1.2 per cent in 1997-98 to 6.0 per cent in 2007-08. The ITES sector's export earnings are expected to touch a level of US$ 40.3 billion in 2007-08. The direct employment in the IT/ITES sector is expected to have reached about 2.0 million by the end of 2007-08, an increase of about 375,000 professionals over 2006-07.

I.69 Rising merchandise trade, high inflow of FDI, encouraging investment climate, high level of non-food credit, buoyant domestic demand conditions, and rise in some categories of consumption are likely to provide the necessary growth momentum to the services sector from the demand side. Both domestic and external demand could continue to provide the necessary support to the services sector growth.

I.70 The telecom sector remains at the centre-stage due to strong demand for cellular phones largely in the rural areas, small towns and cities, and steady growth in broadband connections. The monthly addition to mobile subscribers has multiplied in recent years, making communications as one of the fastest growing segments. With growth of network and increased subscriber base, additional spectrum is allotted subject to availability as per the eligibility based on the number of active subscribers, peak traffic of the operator's network, and demographic features of the service area. These criteria are reviewed from time to time taking into account the relevant factors and technological developments. However, there is a need for a transparent spectrum allocation policy to induce healthy competition among operators and enable them to reach out to people in the rural areas.

I.71 There are some concerns that construction activity may be affected in view of the sluggishness in steel and cement production. There are some reports suggesting deceleration in growth of the construction equipment industry. While the slowdown in construction activity in commercial real estate is a welcome development, any deceleration of investment in infrastructure would be a matter of concern. There is, therefore, a need to carefully watch the developments in the construction equipment industry so that it does not affect the speed and quality of infrastructure development.

I.72 Services sector activity is labour intensive and adequate availability of skilled manpower in the economy is critical for its sustained growth. Furthermore, companies worldwide are trying to take advantage of India's labour force. There are signs that rapid growth has resulted in shortage of high

quality skills, especially in knowledge intensive industries. There is a need to bridge the demand-supply gap of skilled resources. On the one hand, there is a severe shortage of skilled labour, and on the other, there are a large number of people who are unemployed. The emerging skill shortages in the economy need appropriate policy intervention if India has to retain its competitive position in the services sector. There is need for an increased focus on education at all levels, which will facilitate absorption of unemployed youth in rural areas and at the same time provide skilled resources for the expanding economy, especially the services sector. Issues of both quality and quantity need to be given comparable weight. Vocational training institutes also need to be substantially expanded for meeting the industry requirements as well as generating self-employment opportunities.

I.73 At this juncture, several factors such as strong market demand, upbeat investments, surging new orders, vigorous technology transformation, and adoption in communications, business services, software exports and IT-enabled services are likely to provide strong anchor for the future growth of the services sector. However, rise in international mineral oil prices poses a downside risk to the outlook. Rise in mineral prices may particularly affect the performance of the transport sector, which had 10.4 per cent weight in the services sector and constituted 6.4 per cent of GDP as in 2006-07. A sharp increase in input prices of aviation fuels and petroleum products may also impinge on the pace of growth of this sector. The tourism sector, which heavily relies on various transport services, would also be impacted as tour package costs would soar impacting the hotel industry. Furthermore, as the services sector derives its demand to a large extent from the industrial sector, moderation in the industrial growth momentum might also impact the services sector growth prospects.

I.74 The global slowdown raises uncertainties about the prospects of external demand for both the industry and services sectors in India. Although the Indian industry remains primarily domestic demand driven, there are a few industries, including gems and jewellery, textiles and engineering goods, which have higher dependence on external demand conditions. In the event of some export demand compression for some of India's manufactured exportable items, there could be some impact on certain segments of the manufacturing sector. On the other hand, it could be expected that many global giants such as those in the global automobile sector could continue to outsource their manufacturing operations to low cost destinations like India. In the case of services, those sectors, that have significant dependence on global markets could be affected with a slowdown in global economy. In particular, deceleration in global economic activity could impact the domestic trade and transportation sectors. Furthermore, a loss in the growth momentum globally could also limit business and leisure tourism, which, in turn, could have implications for the performance of hotels. The Indian ITES-BPO industry remains highly dependent on external market conditions as India's ITES exports account for about two-thirds of its ITES-BPO revenues. The impact of lacklustre global economic activity on Indian ITES and BPO services, however, remains uncertain. While cost cutting measures in the developed countries might increase outsourcing to India, a reduction in IT spending in these economies, on the contrary, might work against Indian ITES industry. On the one hand, as the global economy slows down, companies – largely from the developed economies – in their quest for reducing their cost of production/operation might outsource some or a larger part of their operations to cheaper and efficient markets such as India. However, as the global slowdown this time has hit the financial services industry the most, it might see a decline in outsourcing activities to India as the financial services companies reduce their geographical operations.

FISCAL POLICY

I.75 The Central Government was mandated under the FRBM Act, 2003 to reduce its gross fiscal deficit-GDP ratio to three per cent and eliminate its revenue deficit by 2008-09. The fiscal correction

process was set to continue in 2008-09 in tune with the legislative mandate with the Centre's gross fiscal deficit-GDP ratio budgeted to decline to 2.5 per cent during 2008-09. It, however, budgeted revenue deficit-GDP ratio at 1.0 per cent and rescheduled its elimination by 2009-10, primarily in order to meet the necessary requirements of revenue expenditure-intensive programmes, particularly at the commencement of the Eleventh Five Year Plan. The systemic rigidity of containing non-Plan committed expenditures in the short run was another contributory factor. Nevertheless, the progress of the Central Government in achieving the quantitative targets has been satisfactory so far under the FRBM Act/Rules.

I.76 Fiscal consolidation of the Central Government under the FRBM Act, 2003 has been revenue-led, underpinned by a significant increase in the tax-GDP ratio. Robust economic growth and macroeconomic stability during the last four years have also resulted in higher than anticipated tax receipts. A steady increase in the tax-GDP ratio for the Central Government was led by direct tax revenues, the share of which in total taxes increased from 41.3 per cent in 2003-04 to 52.1 per cent in 2007-08 (RE). Within direct taxes, the share of corporation tax increased from 60.0 per cent in 2003-04 to 61.1 per cent in 2007-08 (RE). As proportion to GDP, corporation tax increased from 2.3 per cent to 4.0 per cent over the same period, while the personal income tax increased from 1.5 per cent to 2.2 per cent. The scope of deepening fiscal empowerment further through improved tax revenues lies in maintaining a moderate tax structure. In the case of indirect taxes, the services tax has emerged as a rapidly growing source of revenue. The share of the service tax in total indirect taxes increased from 5.3 per cent in 2003-04 to 18.0 per cent in 2007-08 (RE). As a proportion of GDP, the share increased from 0.3 per cent to 1.1 per cent over the same period. There is a need to bring more services into the tax net in consonance with the rise in the share of the services sector in GDP. On the indirect taxes side, the objective has been to integrate the taxes on goods (central excise) and services and finally move to a comprehensive Goods and Services Tax (GST). The stock of tax revenues raised but not realised increased by 10 per cent during 2006-07 to Rs. 99,293 crore at end-March 2007.

I.77 Expenditure management policy of the Central Government in recent years has aimed at containing non-developmental expenditure and providing adequately for priority spending on social development and infrastructure. However, the progress in this regard shows that the non-development expenditure of the Central Government declined from 8.8 per cent of GDP in 2003-04 to 8.3 per cent in 2007-08 (RE) and is further budgeted to come down to 7.4 per cent in 2008-09. Although 80 per cent of non-plan expenditure is obligatory in nature on items like defence, interest payments, subsidy and transfers to the State Governments, the Government has considered creation of further fiscal space through carefully calibrated fiscal consolidation in support of inclusive growth as an important part of its expenditure management. The share of expenditure on education in the combined expenditure of the Centre and States was budgeted to increase from 10.0 per cent in 2007-08 to 10.8 per cent in 2008-09, and that of health from 4.9 per cent to 5.0 per cent. It may, however, be noted that the share of public expenditure on education and health in India is low by international standards. According to the World Bank, the share of public expenditure on health in India at 1.0 per cent of GDP was lower than that in Brazil (3.5 per cent), China (1.8 per cent) and least developed countries (1.9 per cent) in 2005. Under the FRBM Act obligations, containing revenue expenditure and encouraging capital expenditure for productive assets are critical for sustaining the fiscal correction. Keeping this in view, Government expenditure has increasingly focused on improving the quality of implementation and enhancing the efficiency and accountability of the delivery mechanism for translating budgetary outlays into intended outcomes. In order to improve transparency and accountability, Ministries are being encouraged to release summaries of their monthly receipts and expenditure to general public (through their website)

and in particular, disclose scheme-wise funds released to different States. The consolidated monthly position of receipts and payments is being placed in public domain every month.

I.78 Finances of the Central Government may come under pressures with the implementation of the Sixth Pay Commission (SPC) award (estimated at 0.4 per cent of GDP), loss of revenues on account of reduction in duties on petroleum products (estimated direct impact of 0.4 per cent of GDP), likely increase in fertiliser subsidy due to sharp rise in international prices of raw materials and fertilisers and implementation of debt waiver and debt relief scheme for farmers (1.4 per cent of GDP spread over four fiscal years). Furthermore, as announced, the Government may additionally incur increasing liabilities towards additional issuances of oil and fertilisers bonds, which would impact the level of public debt. Interest expenditure on account of these bonds would, however, tend to increase revenue expenditure and widen revenue and fiscal deficits. Although the issuance of such bonds does not directly increase the conventionally measured fiscal deficit, the proceeds from such bonds are used to effectively fund current subsidy expenditures. Their macroeconomic and financial market impacts, and crowding out of resource availability to the private sector are similar to expansion of the fiscal deficit. Therefore, in order to ensure that fiscal imbalances do not diverge from the budget estimates, efforts are needed to improve tax buoyancy through widening of tax base and further improvement in tax administration. In the near term, tax buoyancy and the process of fiscal consolidation would also crucially hinge upon macroeconomic growth and stability.

I.79 Finances of the State Governments witnessed significant improvement with the implementation of Fiscal Responsibility Legislations (FRLs). As the State Governments come closer to meeting the objective of reduction in deficit indicators, they need to place greater emphasis on sustaining the progress. It would be important to generate adequate fiscal space through revenue augmentation that could be utilised for financing development expenditure. The generation of revenues through improvement in efficiency of tax collection and appropriate charges on public services assume added significance under the rule-based fiscal framework on account of implicit cap on financing of expenditure by borrowings. The States can, however, price a range of services that they provide appropriately only by improving the quality of delivery. While the fiscal consolidation efforts have enabled a reduction in key deficit indicators, the level of States' outstanding liabilities continues to remain high as compared with many emerging and developing countries. Although there has been some reduction in the debt-GDP ratio due to the debt consolidation and relief measures, the States continue to hold a large chunk of high cost debt. Some States have prepaid high cost debt on account of comfortable cash balance position. The States need to factor in the impact of higher staff remuneration based on the recommendation of the Sixth Pay Commission of the Central Government. The State Governments may incur revenue losses due to lower tax devolution on account of reduction in excise and customs duties on petroleum products by the Centre and reduction in sales tax on these products by some States. In the near future, State finances would be shaped by the recommendations of the Thirteenth Finance Commission that was set up in November 2007 (award period: 2010-15) and the implementation of the Goods and Services Tax (GST), which is expected to come into force from April 1, 2010.

I.80 The management of public finances during the last four years, mandated under FRBM Act, 2003, has been broadly on track so far. The robust economic growth and macroeconomic stability, in general, resulted in higher than anticipated tax revenues and created fiscal space for meeting the demand for resources. The revenue-led consolidation reflected the combined effect of a balanced and reasonable tax rate structure with fewer exemptions and wider coverage of tax base, and efficiency of tax administration. The ongoing reforms and fiscal correction initiatives, in turn, supported domestic demand and investment,

thereby propelling the economic growth. Notwithstanding the improved position, there are several underlying fiscal pressures that are not entirely evident in the headline fiscal indicators. Although implementation of fiscal rules have had a positive effect of focusing attention on fiscal issues, there has been an increased recourse to extra-budgetary fiscal liabilities, as alluded to above. The issue is not merely one of transparency in fiscal operations or a *de facto* larger Government borrowing programme than admitted, but of greater significance for the Government debt market and monetary management. The issuance of bonds has been resorted to frequently for financing not only fuel, food and fertiliser subsidies, but also deferred liabilities with regard to bank loan waivers and contribution to capital of public sector banks. The significant quasi-fiscal transactions to finance recurrent revenue expenditures through *de facto* borrowings create apprehensions about the quality of the fiscal consolidation process that is underway and poses challenges for fiscal, external and monetary management. There is, however, a need to recognise that while insulation of the economy from temporary shocks emanating from higher international commodity prices cannot be avoided, withholding the pass-through of the permanent component of the elevated levels of commodity prices may continue to maintain the demand at the elevated level.

I.81 While the need to eliminate revenue deficit and target a nominal limit on fiscal deficit is important, the mode of financing of the fiscal deficit and the appropriate use of resources so raised are equally important, particularly in the context of pressing requirements for adequate investment in social and financial infrastructure. Furthermore, there is a need to work towards durable fiscal correction and consolidation through fiscal empowerment, *i.e.*, by expanding the scope and size of revenue flows. Exclusive focus on fiscal deficit may tend to reduce the role of the Government, thereby hampering the process of growth, especially when the focus is on inclusive growth. The Indian economy is undergoing structural transformation and it needs large investments in social and financial infrastructure. There is, therefore, a need to step up investment in certain critical areas such as education, health care and physical infrastructure. The role of fiscal authority also assumes importance in the light of ongoing financial turbulence across the world as it must be recognised that when everything else fails, it is only the fisc that has to take the hit and come to rescue.

EXTERNAL SECTOR

I.82 India's balance of payments is increasingly being influenced by global developments, reflecting its growing linkages with the rest of the world through real as well as financial flows. The ratio of merchandise exports to GDP has risen since the early 1990s. During 2002-2007, India's export growth was placed higher than its key competitors in the Asian region (except China). Simultaneously, import intensity has also risen steadily as domestic entities have expanded access to internationally available raw material and intermediate goods as well as quality inputs for providing the cutting edge to domestic production and export capabilities. Services exports, led by buoyancy in software and business services, and overseas remittances, have progressively become larger and more stable since the mid-1990s, thereby imparting resilience to India's invisible receipts. The net invisibles surplus has offset a significant part of the expanding trade deficit and helped in containing the current account deficit to an average of around one per cent of GDP since the early 1990s. Gross current receipts (merchandise exports and invisible receipts) and gross current payments (merchandise imports and invisible payments) taken together now constitute more than one half of GDP, suggesting the growing integration of the Indian economy with the global economy. Unlike significant current account surpluses in many other Asian economies, India recorded current account deficits in recent years. In regard to capital account also, India's linkages with the global economy are getting stronger, underpinned by the growing openness of the economy and a two way movement in financial flows.

I.83 In the capital account, the liberalised external payments regime has been facilitating the process of acquisition of foreign companies by Indian corporates, both in the manufacturing and services sectors, with the objectives of reaping economies of scale, access to technology knowhow and capturing offshore markets to face the global competition. Notwithstanding higher outflows, capital inflows (net) increased to nine per cent of GDP in 2007-08 from an average of two per cent during 2000-01 to 2002-03. Net capital inflows during the period 2003-2008 on an average, amounted to US $ 44.8 billion. At this level, capital inflows (net) remained higher than the average for any five year period in the independent India. Inflows as well as outflows have shown significant increases in the recent period, reflecting the strong fundamentals of the economy as well as the conducive policy environment. Gross inflows and outflows constituted around 64 per cent of GDP during 2007-08. Persistently large capital inflows (net) above the current account deficit have implications for the monetary management. Similarly, persistently large outflows (net) would also complicate the task of monetary and liquidity management, particularly in the face of liquidity pressures.

I.84 In the medium term, the continued focus on financial market development could potentially mitigate the challenge of capital flows. However, it is important to recognise that the development of financial markets is a gradual process. Hence, while continuing to work on development of the financial markets, capital flows have to be managed through other tools in the short term. The gradual process of fuller capital account liberalisation could be pursued over the medium-term, keeping in view particularly the issues raised by the recent financial market turbulence in advanced economies. Therefore, the issue is not either financial market development or management of capital account, but how much of each approach should be adopted in a given situation and over time while recognising and taking into account the scope and prospects for reforms in the fiscal and real sectors.

I.85 The overall approach to the management of India's foreign exchange reserves would continue to take into account the changing composition of the balance of payments and endeavour to reflect the 'liquidity risks' associated with different types of flows and other requirements. Furthermore, the reserves would continue to be invested in major economies, adhering to the principles of according priority to safety, liquidity and return. As regards the reserve management, a related issue is the valuation of foreign exchange reserves on a marked-to-market basis on the balance sheet of the Reserve Bank. In this regard, the Reserve Bank has adopted a conservative accounting practice, whereby unrealised gains are not shown, while losses are booked.

I.86 In India, the foreign exchange reserves are reflected on the balance sheet of the Reserve Bank and are managed as per the provisions of the RBI Act, 1934 consistent with the global best practices. The Reserve Bank adheres to appropriate prudential norms and the transparency and data dissemination standards with regard to reserves management.

FINANCIAL SECTOR

I.87 In recent years, the Reserve Bank has emphasised credit quality, improvement of the credit delivery system (with specific focus on agriculture, micro, small and medium enterprises) and financial inclusion. The Reserve Bank has also been continuously upgrading risk management practices in banks and supervisory processes so as to meet the challenges arising from financial innovations and simultaneously laying down robust arrangements for dealing with stress in the financial system. The importance of adequate, timely and hassle free credit delivery, appropriate credit pricing related to risk and conducive credit culture need hardly be over emphasised. In response to the various initiatives taken by the Government and the Reserve Bank, there has been significant increase in the credit flow to agriculture, small and medium enterprises and crop loans at administered interest rates. Various measures such as one-time settlement (OTS) and rescheduling/restructuring schemes for distressed

farmers, simplification of procedures, adoption of business correspondent model and the use of smart cards have also facilitated increased credit to the rural sector. Furthermore, the linking of credit to a broader base of adjusted net bank credit, including their non-SLR investments, in respect of priority sector targets, also seeks to promote credit to the priority sectors. The regulations under the Credit Information Companies (Regulation) Act were notified and operation of credit information companies under the regulations is expected to reduce information asymmetries and facilitate efficient credit allocation and pricing, while fostering a better credit culture. While concessional credit and debt relief are intended to alleviate farmers' distress and reopen the credit lines that have been choked, sustaining an appropriate credit culture going forward would require incentive systems for greater flow and efficient allocation of credit.

I.88 The asset quality and soundness parameters of the Indian banking sector have improved significantly in the recent period, and are now comparable with global levels. In consonance with the policy emphasis on gradual harmonisation with the international best practices, foreign banks operating in India and Indian banks having presence outside India have already migrated to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks would migrate to these approaches under Basel II not later than March 31, 2009. The Pillar 2 guidelines were issued during the year. Certain amendments were also carried out in the Basel II framework issued earlier. Newer avenues of raising capital were provided to banks to accord them with greater flexibility in meeting the Basel II requirement. Special emphasis was laid on liquidity and asset liability management. The policy initiatives also focussed on strengthening the corporate governance practices in banks and improving customer service.

I.89 In contrast to the global situation, India has been, by and large, spared of global financial contagion resulting from the sub-prime turbulence for a variety of reasons. The credit derivatives market in India is in an embryonic stage. The originate-to-distribute model in India is not comparable to the ones prevailing in advanced markets. There are restrictions on investments by residents in such products issued abroad and regulatory guidelines on securitisation do not permit immediate profit recognition. Financial stability in India has been achieved through perseverance with prudential policies that prevent institutions from excessive risk taking, and financial markets from becoming extremely volatile and turbulent. As a result, financial markets remained orderly, and financial institutions, especially banks, remained financially sound. Supervision of financial institutions is exercised by a quasi-independent Board carved out of the Reserve Bank's Central Board. Close co-ordination also exists with other regulators on market regulation. A few such instances of pre-emptive regulation to ensure financial stability include, *inter alia*, prescription of a Board mandated policy in respect of real estate exposure of banks and increasing risk weights for various segments of the financial sector, provisioning against standard assets, norms on exposure to inter-bank liability, norms on financial regulation of systemically important NBFCs and banks' relationship with them, norms for securitisation and non-SLR investments and marking-to-market valuation norms. The regulatory guidelines are supplemented by moral suasion and supervisory review.

I.90 The Reserve Bank's broad approach to financial sector reforms has been to develop institutional and financial infrastructure and lay down appropriate regulatory and supervisory regime to ensure financial stability consistent with the overall objectives of growth with price stability. The pace of reforms has been contingent upon putting in place appropriate systems and procedures, technologies and market practices. As a result of various reforms, the financial markets have transited to a regime characterised by market-determined interest and exchange rates, price-based instruments of monetary policy, current account convertibility, phased capital account liberalisation and an auction-

based system in the government securities market. In recent years, a new challenge for the financial sector in the context of inclusive growth is how to extend itself and innovate to meet the demands for financial inclusion and respond adequately to new opportunities and risks. Innovative channels for credit delivery need to be developed, perhaps with greater use of information technology and intensified skills development in human capital. Strong demand for housing and buoyancy in real estate prices in an environment of non-transparency, could potentially pose risks to the banking system. In conjunction with the interest rate cycles, the banking system as well as the regulator would need to be vigilant to future non-performing assets (NPAs) and the US-like sub-prime woes. The vulnerability of financial intermediaries can be addressed through prudential regulations and their supervision. Risk management of non-financial entities could be addressed through further development of the financial markets, which enable them to manage their risks using appropriate products.

MONETARY POLICY

I.91 The conduct of monetary policy in India has been guided by the objectives of maintaining price stability and ensuring adequate flow of credit for sustaining overall growth. The relative emphasis between these two objectives has varied according to prevailing circumstances and the underlying macroeconomic conditions, which are set out in the Reserve Bank's policy statements issued from time to time. In recent years, there has been a confluence of several global and domestic factors impinging on inflation expectations, growth momentum and financial stability. The Reserve Bank, therefore, has been taking measures in a calibrated manner to contain inflation and inflationary expectations and maintain financial stability. Accordingly, the stance of monetary policy switched from 'a very close watch on the movements in the price level' (May 2004) to 'equal emphasis on price stability' to 'consideration of calibrated measures for stabilising inflationary expectations' (October 2004). Similarly, liquidity management was emphasised with a switch from provision of 'adequate liquidity' to 'appropriate liquidity'. Recognising the long and variable lags of monetary policy, the Reserve Bank had begun a phased withdrawal of monetary accommodation in September/October 2004, when it raised the CRR (50 basis points) and LAF reverse repo rate (25 basis points). The Reserve Bank continued to persevere with its calibrated monetary measures along with active management of liquidity, depending on the evolving global and domestic situation impinging on inflation expectation and growth momentum. Between September 2004 and April 2007, the Reserve Bank raised the CRR and the repo rate by 200 basis points and 175 basis points, respectively. The reverse repo rate was raised by 150 basis points. It may be recalled that the Reserve Bank had provided an unprecedented alert about 'early signs of overheating of the Indian economy' during 2006-07 on the back of some evidence of firming up of demand pressures, in particular, the combination of high growth and consumer inflation coupled with escalating asset prices and tightening infrastructural bottlenecks. In this context, to supplement monetary measures and in order to protect the banking system from a possible enduring asset bubble without undermining growth impulses, prudential measures were also initiated in the form of enhanced provisioning requirements and risk weights in specific sectors in addition to select supervisory reviews.

I.92 The monetary policy stance of withdrawing monetary accommodation continued during 2007-08. In view of unprecedented turbulence in global financial markets beginning August 2007 following the sub-prime crisis and the unconventional policy response of major central banks, monetary policy resolved to be vigilant and proactive in cushioning the real economy from excess volatility in financial markets (October 2007 and January 2008). This warranted more intensified monitoring and swift responses with all the available instruments to preserve and maintain domestic macroeconomic and financial stability. While domestic factors dominated the policy stance, monetary policy recognised the risks to inflation from high and volatile international food, fuel and metal prices. In view of these factors, the stance of monetary policy in January 2008

focussed on swift response to the evolving constellation of adverse international developments and to the domestic situation impinging on inflation expectations, financial stability and growth momentum, with both conventional and unconventional measures, as appropriate on a continuing basis. In view of heightened global uncertainties and mounting inflationary pressures from escalated and volatile food and energy prices, which possibly contained some structural components, and persistence of demand pressures, *albeit* with some improvement in supply response, Annual Monetary Policy Statement of April 2008 noted that while it had to respond proactively to immediate concerns, it could not afford to ignore considerations over a longer term perspective with respect to overall macroeconomic prospects. Accordingly, the Reserve Bank emphasised the need to demonstrate on a continuing basis the determination to act decisively, effectively and swiftly to curb any signs of adverse developments with regard to inflation expectations. In view of unprecedented uncertainties and dilemmas, it also emphasised the importance of taking informed judgements with regard to the timing and magnitude of policy actions based on an evaluation of incoming information on a continuous basis. In line with the stance set out in April 2008, monetary policy statement underlined the need to eschew any further intensification of inflationary pressures and firmly anchor inflation expectations.

I.93 Mirroring inflation trends in many advanced as well as emerging economies, inflation in India also hardened significantly in recent months above the Reserve Bank's tolerable level, amidst strong evidence of aggregate demand pressures, exacerbated by the slack in the supply response. Recognising that high and volatile energy prices were not a temporary phenomenon and the evolving complexities in globally transmitted inflation, the First Quarter Review (July 2008) accorded the highest priority to bringing down inflation from the prevailing high levels to a level close to 7.0 per cent by end-March 2009 and stabilising inflationary expectations. Furthermore, monetary policy reiterated its resolve to bring down inflation from the prevailing intolerable level to a tolerable level of below 5.0 per cent as soon as possible and around 3.0 per cent over the medium term. In this backdrop, the Reserve Bank felt the need to smoothen the adjustment of demand on an economy-wide basis to ensure that generalised instability did not develop. The stance of monetary policy of withdrawing monetary accommodation and appropriate prudential measures were supplemented by the fiscal and supply augmenting measures by the Government. As a result, although, the commodity prices have hardened in recent times, the order of increase in prices in India even in respect of commodities that were major contributors to domestic inflation was significantly lower than that in several developed and other emerging market economies.

I.94 The conduct of monetary policy has become more challenging recently for a variety of factors. First, it is necessary to recognise the global dimensions of the crisis, which is threatening the credibility of monetary policy world wide. The unfolding of global developments and the responses of monetary authorities seem to suggest that, on the one hand, there are threats to growth and financial stability particularly in the wake of ongoing turbulence in international financial markets. On the other hand, high and volatile international prices of fuel, food and metal prices pose a serious risk to inflation. Global developments have considerably heightened the uncertainty surrounding the outlook on capital flows to India, thereby complicating the conduct of monetary and liquidity management in India. While continued strong domestic fundamentals and massive injections of liquidity by central banks in advanced economies increase the possibility of sustained inflows, abrupt changes in sentiment or global liquidity conditions also raise the possibility of large and volatile capital outflows. Accordingly, monetary policy in India has to be vigilant and proactive in cushioning the real economy from excess volatility in financial markets while recognising that India cannot be totally immune to global

developments. In this context, it may be noted that apart from using monetary instruments flexibly in both directions, the Reserve Bank can also use the prudential measures flexibly, in the given context of capital account management.

I.95 Second, localised factors such as banks' balance sheet adjustments in the run-up to the year-end closure of accounts and advance tax flows have also influenced liquidity conditions. However, additional liquidity management operations in anticipation of these developments during 2007-08, by and large, smoothened market interest rates and enabled their orderly evolution. Another factor that has also produced large swings in market liquidity in recent years is the sizeable movements in Government cash balances. Uncertainty over the movement of Government cash balances can further complicate the management of liquidity, especially when the drawdown of cash balances by the Government coincides with an increase in capital inflows necessitating Reserve Bank's intervention in the foreign exchange market, thereby injecting liquidity into the system.

I.96 Third, the evolving fiscal situation in an atmosphere of persistent inflationary pressures poses severe challenges to monetary management, especially if supply inelasticities continue to prevail in the short-term. Thus, there is a need to ensure that effectiveness of monetary policy is not diluted by fiscal expansion. It is important to recognise that in an environment of limited supply elasticities in the short run, an adjustment of overall aggregate demand on an economy-wide basis is warranted to ensure that generalised instability does not develop and erode the hard-earned gains in terms of both outcomes of and positive sentiments on India's growth momentum. On the other hand, it is also necessary to nurture and consolidate the recent gains in augmenting supply capacities and improvements in productivity and efficiency which accrue over a longer term horizon. Fourth, it is necessary to recognise that monetary policy has also to reckon with the structural components embedded in the drivers of inflation which, unlike cyclical elements, are somewhat impervious in the short run to instruments of aggregate demand management.

I.97 Fifth, it needs to be recognised that existence of this stipulated SLR prescription of 25 per cent of net domestic demand and time liabilities of banks hampers the genuine development of the government securities market. The dilemma arises as to whether it can be assumed that there is a genuine government securities market, and hence reinforce more marketisation by rapidly reducing SLR or ensure a viable market borrowing programme and reduce SLR in tandem. In this context, there is a need to assess the sensitivity of the fisc to interest rate burden if SLR is reduced rapidly. The importance of SLR status for bonds issued by the Government has also come to the fore recently when oil bonds issued by the Government turned out to be illiquid despite carrying a yield of 25 basis points higher than the SLR-eligible bonds of similar maturity. It needs to be recognised that issuance of special bonds increases the overall supply of Government bonds and thus leads to an upward pressure on yields. The undoubtedly desirable reform of the debt markets in India needs to recognise these realities in addition to the ongoing reforms in the corporate debt market.

I.98 Sixth, the domestic financial markets continue to exhibit orderly conditions, except the equity markets which have reflected the risk aversion and increased uncertainty in line with the international financial market developments. The heightened uncertainty surrounding global financial markets and the unusual policy responses of major central banks suggest that the threats to global growth and stability that loom over the near-term horizon, continue to be significant, for the evolving monetary policy stance in 2008-09. The major source of the direct impact is through the financial flows, in particular, the equity market and the foreign exchange market.

I.99 Seventh, although growth rates of monetary and banking aggregates have started to dip since June 2008 in line with the projected trajectories, the demand for bank credit continues to be strong. While credit to the petroleum sector has risen sharply due to the funding requirements of oil companies in the

context of escalation in international crude prices, bank credit to other sectors has also picked up, particularly to infrastructure, cement, chemicals, transport operators and professional and other services, reflecting resilience of activity in these sectors. On the other hand, bank credit to agriculture, housing, real estate, construction, metal products, textiles, gems and jewellery and engineering has moderated on account of sector-specific factors. The growth in credit during 2008-09 (year-on-year up to August 1, 2008) resulted in increase in the incremental non-food credit-deposit ratio to 85.4 per cent. It needs to be recognised that banks cannot sustain such a high incremental credit-deposit ratio as they are required to maintain more than 33 per cent of their net demand and time liabilities in the form of CRR and SLR. Therefore, it is important that the banking system strives to maintain a balance between the credit growth and the deposit growth.

I.100 Finally, the continued dominance of administered interest rates in some form or the other indicates that the extent of monetary policy measures need to take cognisance of rigidities in transmission on this account.

I.101 In this background of severe challenges as well as prevailing structure of financial markets and institutions in India, it is important to take informed judgments with regard to the timing and magnitude of monetary policy actions; and judgments need to have the benefit of evaluation of incoming information on a continuous basis.

I.102 As the inflation rates have hardened beyond tolerable levels, monetary policy would continue to address aggregate demand pressures which appear to be strongly in evidence. However, at the same time, there is need to improve the supply position in some critical sectors. In order to tackle food price inflation, the demand-supply mismatches need to be addressed over the medium term, which, would necessitate raising crop yields through the use of modern technology, improved irrigation facilities as well as provision of market-based incentive systems for the farmers both in the credit and product markets. In view of large dependence on crude oil imports, limiting the adverse impact of higher international oil prices would require adopting strategies of greater decontrol of petroleum product pricing with targeted subsidies, rationalisation of applicable taxes and duties to appropriate levels, and gradual but regular pass-through of prices to consumers so as to avoid the risk of large one-off adjustments in headline inflation. As prices of manufactured products in an open economy are sensitive to both import and export prices, containment of manufactured products inflation would, apart from domestic demand, hinge upon creating conducive environment for industrial and productivity growth through the provision of adequate infrastructure as well as increased access to key industrial inputs. Trade and competition policies could aim at promoting flexible price setting behaviour of firms. As sectoral shocks in the face of even moderate increase in demand have the potential to raise inflation beyond levels justified by the overall supply-demand balance, fiscal and supply-side measures can help in containing sector-specific inflationary pressures from becoming generalised. An overriding priority for monetary policy would be to eschew any further intensification of inflationary pressures.

I.103 Notwithstanding some downside risks to growth and upward pressures on inflation in the near term, the medium to long-term prospects of the Indian economy continue to be robust. There is, however, a need to persist with the reform efforts in all the sectors of the economy to realise the full potential of the economy. The immediate challenge is to bring down inflation to a tolerable level as soon as possible and maintain financial stability while taking account of improvements in the fiscal sector and supply elasticities in the real sector.