Review of the Economy 2011/12

Economic Advisory Council to the Prime Minister

New Delhi

February 2012

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Economic Advisory Council to the Prime Minister
E-Hall
Vigyan Bhawan
Maulana Azad Road
New Delhi

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I. GROWTH PERFORMANCE AND PROSPECTS

Review of Economic Outlook

1. In July 2011 the Council had released its *Economic Outlook* taking the view that the Indian economy would grow by 8.2 per cent in 2011/12. This was lower than the provisional estimate of 8.5 per cent growth for the previous year (2010/11) and only marginally more than that in 2009/10 (8.0 per cent). The view took on board the early signs of a clear slowing down in the pace of investment and hence in the pace of economic growth, that had begun to show up in the second half of 2010/11. However, in the course of preparations of the *Economic Outlook* during June–July 2011, the Council had expected that it would be possible to visualize a modest revival in the investment climate and hence in the investment rate and in the pace of economic growth later in the year.

2. However, that did not transpire. Despite efforts taken at making investment easier, especially in the infrastructure space, the combination of worsening international conditions, particularly the crisis in the Eurozone and the difficult domestic political situation seem to have combined to slow the recovery in infrastructure investment. In the second quarter of the year, both industrial and investment activity slipped further southwards, with October marking perhaps the lowest ebb in the tide of events. There were signs of improvement in some key sectors of the industrial economy in November & December 2011 and January 2012. However, the expected lift in the pace of investment activity in the infrastructure area is something that has yet to happen. Getting this dynamic, moving faster must continue to be the focus of policy.

3. The Advance Estimates (AE) released earlier this month for 2011/12 place economic growth at 6.9 per cent. The Council is of the view that actual growth would turn out to be slightly higher at 7.1 per cent. The Quick Estimates (QE) released at the end of January 2012 has revised the growth estimate upward for 2009/10 from 8.0 to 8.4 per cent, while reducing that for 2010/11 marginally down from 8.5 to 8.4 per cent.

4. Gross fixed capital formation (GFCF) as a proportion of GDP had reached a peak of 32.9 per cent in 2007/08, the year preceding the global crisis. It dropped to 32.3 per cent in 2008/09 and then to 31.6 per cent in 2009/10. Initial estimates are that in 2010/11 this ratio slipped further to 30.4 per cent. The AE for 2011/12

suggest that there may have been further slippage to 29.3 per cent. That is a decline of almost 4 percentage points over the last four years.

5. Though India experienced a sharp turnaround in the rate of output growth – as measured by the Index of Industrial Production (IIP) and the rate of growth of quarterly and annual GDP – the recovery on the investment side did not however quite happen.

6. International conditions continued to worsen through 2011. The negative developments in the Eurozone outweighed the small improvements in evidence in the US economy. The repeated attempts to sort out the problems of the Eurozone in high profile Summits did not result in any lasting solution and to that extent by raising expectations made things worse. Large scale liquidity injection by the European Central Bank (ECB) since December 2011 has lowered yields on the government bonds of those countries under the magnifying glass.

7. Though there is yet no resolution in sight and affected countries have large volumes of debt due for roll over, there is some improvement in the situation, insofar as the potential for shocks are concerned. While the dangers are very real but they have often tended to be overstated. European leaders had perhaps underestimated the difficulty of dealing with the situation and had opened themselves and their actions up to an excess of public scrutiny and speculation. The degree of commitment of Germany to shore up the Eurozone was also perhaps not clear. In recent months things have crystallised to a much greater extent. Germany seems to be willing to provide extended support, partly as a result of which the European Central Bank (ECB) has provided large amount of finance through their banking system (€ 489 billion), which may go up further (to € 1 trillion). The Eurozone members appear to have signed up for a coordinated move towards a fiscal union – which is necessarily a precondition for a monetary union with a membership of heterogenous economic strength to survive. It is unclear whether in the final analysis this fiscal union will indeed materialise; however, they are likely to continue to take this path for the next couple of years. The principal objective is seemingly to stabilise Italy and Spain – the two countries that are too large to be bankrolled by other euro members. It also gives some breathing time for European banks to get their house in order. Developments in Italy have so far been positive and there seems to be public support for the reforms initiated by the new Italian Prime Minister. The newly elected Spanish Prime Minister has also stayed firmly on the course of reforms.

8. In the United States, the economic recovery has been much weaker than projected, either by the US administration or international financial institutions or the financial

TABLE 1
GDP Growth - Actual & Projected

Constant Prices

		Year-on-year rates of growth								
	ANNUAL RATES	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2011-12**	**2012-13**
	`						*QE*	*AE*	*EAC*	*Proj*
1	Agriculture & allied activities	5.1%	4.2%	5.8%	0.1%	1.0%	7.0%	2.5%	3.0%	2.5%
2	Mining & Quarrying	1.3%	7.5%	3.7%	2.1%	6.3%	5.0%	-2.2%	-2.2%	6.0%
3	Manufacturing	10.1%	14.3%	10.3%	4.3%	9.7%	7.6%	3.9%	3.9%	7.5%
4	Electricity, Gas & Water Supply	7.1%	9.3%	8.3%	4.6%	6.3%	3.0%	8.3%	8.3%	6.0%
5	Construction	12.8%	10.3%	10.8%	5.3%	7.0%	8.0%	4.8%	6.2%	6.5%
6	Trade, Hotels, Transport, Storage & Communication	12.0%	11.6%	10.9%	7.5%	10.3%	11.1%	11.2%	11.2%	10.2%
7	Finance, insurance, real estate & business services	12.6%	14.0%	12.0%	12.0%	9.4%	10.4%	9.1%	9.1%	9.5%
8	Community & personal services	7.1%	2.8%	6.9%	12.5%	12.0%	4.5%	5.9%	6.0%	6.0%
9	**GDP (factor cost)**	**9.5%**	**9.6%**	**9.3%**	**6.7%**	**8.4%**	**8.4%**	**6.9%**	**7.1%**	**7.6%**
10	Industry (2 + 3 + 4 + 5)	9.7%	12.2%	9.7%	4.4%	8.4%	7.2%	3.9%	4.3%	7.0%
11	Services (6 + 7 + 8)	10.9%	10.1%	10.3%	10.0%	10.5%	9.3%	9.4%	9.4%	9.1%
12	Non-agriculture (9 - 1)	10.5%	10.8%	10.1%	8.1%	9.8%	8.6%	7x.6%	7.7%	8.4%
13	**GDP (factor cost) per capita**	**7.8%**	**8.0%**	**7.8%**	**5.2%**	**6.9%**	**6.9%**	**5.5%**	**5.6%**	**6.2%**
	Some Magnitudes									
14	GDP at factor cost - 2004/05 prices in Rs lakh crore (Trillion)	32.5	35.6	39.0	41.6	45.1	48.9	52.2	52.3	56.3
15	GDP market & current prices in Rs lakh crore (Trillion)	36.9	42.9	49.9	56.3	64.6	76.7	89.1	89.3	101.7
16	GDP market & current prices in US$ Billion	834	949	1,241	1,234	1,365	1,688	1,866	1,831	2,083
17	Population in Million	1,106	1,122	1,138	1,154	1,170	1,186	1,202	1,202	1,218
18	GDP market prices per capita current prices in Rs	33,394	38,277	43,823	48,787	55,191	64,706	74,150	74,296	83,509
19	GDP market prices per capita in current US$	754	846	1,090	1,069	1,167	1,423	1,552	1,523	1,710

markets. However, there are clear signs that the economy is on the mend, including some improvement in the unemployment situation. It is possible that the US economy will grow by more than the 1.8 per cent projected by the International Monetary Fund (IMF) in September 2011 and reiterated in January 2012. Going forward, it would be most unsurprising that conditions will not improve further in 2013. However, the US will continue to have the problem of adopting an internally consistent and non-disruptive path for fiscal consolidation and for rolling back the enormously extended monetary stance.

9. Overall global economic and financial conditions are likely to remain under pressure for the better part of this year. Our main concern, however, is about shocks. That is unlikely to happen because: (a) In the Eurozone, the direction that member countries under the leadership of Germany and France have taken, is expressly designed to keep things on hold for the next few years; (b) The large amount of liquidity that has been created by the US Federal Reserve, and now by the ECB, will prevent the financial system from entering into a shock that is inevitably mediated by a drying up of liquidity. Our policy has to be adaptive, in order to ensure the necessary financing of both the current account deficit as well as the large component of corporate investment that is financed from foreign equity and debt flows.

Sectoral Developments

10. Farm sector output growth in 2011/12 has been strong, coming on top of the strong growth in the previous year. The average GDP growth rate that has been reported for the farm sector in the first half of 2011/12 is 3.7 per cent. The AE places full year growth at 2.5 per cent, but it is likely that this number will turn out eventually to be closer to 3 per cent. The second advance estimates for both *kharif* and the *rabi* season are very favourable, with new output records for rice, wheat and foodgrain being achieved. The Council expects that in combination with the strong trend growth in horticulture and in the animal husbandry sectors, the overall farm sector GDP growth for 2011/12 will average 3 per cent.

11. The mining & quarrying sector has shown particular weakness this year. This was a combination of weak coal output growth – which was negative in four months of the year – a sharp decline in natural gas production in the KG-D6 fields and negative growth in crude oil output in the third quarter of the year. There has been improvement in coal output from November 2011 onwards. However, natural gas output growth is likely to remain in the negative for the rest of this fiscal. Crude oil production showed a decline of 4 per cent in Q3 of 2011/12, but is expected to

recover in the last quarter. Moreover, restrictions imposed by the Courts on iron ore production in some parts of the country have also resulted in lower output. In consequence, the mining & quarrying sector is likely to report negative growth for the year as a whole – for the first time in three decades. The AE has placed this at (–) 2.2 per cent, an inference that appears to be accurate.

12. While the electricity sector has performed well, manufacturing and construction have disappointed – the former particularly so from the second quarter onwards with October marking the bottom of the trough. IIP output growth showed a massive decline of 5.7 per cent in October, a sizeable recovery in November (6.6 per cent), with however a low reported growth in December of 1.8 per cent. Contributing principally to the latter was a large decline reported for capital goods, a component that has shown large volatility. If the capital goods component were to be excluded, the rest of the IIP would be seen to have shown a growth of over 5 per cent year-on-year. On average, the GDP arising in the manufacturing sector for Q3 is likely to be close to 1 per cent. The Purchase Managers Index (PMI) for January 2012 suggests a sizeable expansion and the output growth in the last quarter may on average be around 4 per cent. In the construction sector there should be some improvement in the second half, a view that is reinforced by the strong uptick (13 and 17 per cent) in cement output in November and December 2011.

13. Growth of GDP in the services sector was 9.6 per cent in the first half of 2011/12. The Council expects that service sector growth will continue to be strong in the second half and will close the year with growth of 9.4 per cent, slightly less than that in the first half. The AE suggests a similar outcome.

14. The Council's revised estimate of economic growth for 2011/12 thus stands at 7.1 per cent. The aggregate growth rate and its sectoral components – for previous years, for the first half of 2011/12 and that projected for the full year is placed at Table 1

External Payments

15. The pressure on the Balance of Payments (BoP) – both in regard to a larger than expected Current Account Deficit (CAD) and lower than expected net capital inflows – resulted in a very sizeable depreciation in the external value of the Indian rupee. In the fiscal year to-date, the nominal terms of trade weighted 6-currency index fell by 14 per cent, while in terms of the inflation adjusted effective exchange rate (REER) the decline was 11 per cent. The decline of the rupee vis-à-vis the

US dollar was 19 per cent in the course of April–December 2011. However, there has been some recovery in the course of January and February 2012, with the rupee recovering about 7.5 per cent. The last few months have been about the most volatile period for the external value of the currency.

16. In July 2011, the Council had estimated a CAD of 2.7 per cent of GDP for 2011/12, marginally higher than the 2.6 per cent reported in 2010/11. The merchandise trade deficit was projected to rise to 7.7 per cent of GDP in 2011/12 compared to 7.5 per cent in the previous year. The Council had opined that it was not advisable to continue with this order of CAD and that while capital flows had increased, the effort should be to create conditions that limited the CAD to below 2.5 per cent of GDP. The Council had projected a total net capital inflow of $72 billion which after financing the CAD would have left about $18 billion to be absorbed by official foreign currency assets.

17. In the event, the CAD has weakened much more than was expected, averaging 3.6 per cent of GDP in the first half of 2011/12. Aggregating $33 billion it exceeded the Council's July 2011 estimate by $3 billion. On the capital account side, net capital inflows at $42 billion was close to the $41 billion that had been envisaged by the Council in July 2011. However, the merchandise trade deficit was $8 billion greater than projected, which was partially offset by a larger than expected positive balance on Net Invisibles of $5 billion. On the capital account side, equity inflows as FDI and portfolio capital was lower by about $3 billion, while net inflows through the banking channel were higher.

18. The position in the third quarter was much tighter than in the first two, as a result of a combination of a significant enlargement of the CAD and further weakness in capital inflows. The situation will improve in the on-going last quarter. However, for the year as a whole, the BoP position will be tight, which clearly underscores the desirability of keeping the CAD within certain limits.

19. In a medium term sense, the weakening of the currency – in nominal and even more so in real terms – not only reflects the current situation of demand and supply of foreign exchange, but outlines a scheme for the stabilization and improvement of the external payments situation. A weaker currency can by improving the prospect of exports – of both goods and services – and also by making the price of Indian assets more attractive to foreign investors, help to contract the CAD.

20. However, there are three problems that we must guard against. First, a sharp depreciation can impact the liability side of corporates to an extent that it weakens

their ability to invest. That can dampen the recovery in the pace of economic growth. Second, capital inflows are a steady activity over time and if the impression gains ground that depreciation is likely to be a recurring theme, investors will tend to factor in this aspect in their valuation and to that extent it will have a negative impact on the perceived value of Indian assets. Finally, the CAD in India has an idiosyncratic element. The import of gold, which is viewed by many, if not most, Indian buyers as an investment object, forms a large component in overall imports and variation in this element accounts for a very sizeable component in the change in CAD. The dynamics that influence the import demand for gold seems to be most closely related to those which influence asset holding, rather than those which influence merchandise imports.

Inflation and Monetary Policy

21. Very high rates of inflation have characterized the last two years. Much of the inflationary pressure came from primary foods, including cereals in the initial months. While, open market intervention and large releases under the public distribution system (PDS) helped to stabilize the price of cereals, pressure continued to come from rising prices from other primary food items – especially pulses, milk, eggs, meat & fish. Greatly improved output of *kharif* pulses in 2010 combined with marketing of imported pulses at controlled prices, helped to curtail the inflation in pulses by July 2010. However, prices continued to rise for fruit, milk, eggs and meat & fish. The prices of vegetables took an unexpected turn in December 2010 and January 2011, resulting in an increase in the wholesale price index of vegetables by 34 and 67 per cent respectively in these two months. In consequence, primary food price inflation stayed in the double digits.

22. Such a lengthy period of sustained high food price inflation had its expected impact on money wage rates and other cash expenses, which in turn began to get passed into the price behaviour of manufactured goods. Year-on-year inflation for manufactured goods rose from around 5 per cent to 8 per cent in September and October 2011. The net effect was that the headline rate of inflation stayed close to 10 per cent for an extended period of twenty two months. It should not be forgotten that throughout this period there has also been a suppression of the headline rate insofar as the prices of several refined petroleum products, especially diesel, continued to be restrained by policy – which has had an adverse impact on the subsidy bill and therefore on government finances and also on the finances of the public sector oil companies.

23. The effort of public policy, especially monetary policy, seems to have had its desired effect. The headline rate dropped to 9.1 per cent in November and further

to 7.5 per cent in December and has dropped further in January 2012. The welcome developments in the easing of inflationary pressures will enable the RBI to adjust its monetary stance over the next several months. However, the continued pressure from the fiscal side will continue to impose some limitations. Hopefully the extent of the fiscal burden may ease in 2012/13 and create conditions that are more conducive to investment and economic growth.

Prospects for 2012/13

24. **Investment & Growth**: The Council feels that with a return of price stability, appropriate supportive policy and administrative measures, it is possible to visualize an improvement in the investment rate, notwithstanding difficult conditions in the international financial markets. An improvement of 1.5 to 2.0 percentage points of GDP can be envisioned in the fixed investment rate in 2012/13. Price stability will also normalize consumption demand. The weaker currency is likely to improve the prospects for net export demand. However, there is a fairly wide range of outcomes both on investment side, on the financial side and on the trade front that may be reasonably envisaged. Under these circumstances the Council feels that the economy is likely to grow in the range of 7.5 to 8.0 per cent.

25. **Infrastructure**: As far as the role of Government is concerned, it can express itself most powerfully in the infrastructure area – in power, roads, railways, ocean ports and air ports, in rural and urban infrastructure. The inadequacy of infrastructure availability continues to act as a constraint for the expansion of economic activity across the country. It is likely that the targets set for 2011/12 in power and roads may be achieved. Government must set ambitious targets for 2012/13 for both capacity creation in key infrastructure areas and operational performance, especially in the coal sector, such that a fillip is provided to the improvement of economic activity in 2012/13, which is also the first year of the Twelfth Plan.

26. **Inflation:** There have to be adjustments made to the selling prices of sensitive refined petroleum products to cover costs and reduce the huge burden of subsidy being borne by Government and the oil companies. As a result the suppressed inflation on account of incomplete cost pass through in these sensitive refined petroleum products has now to be phased out in 2012/13 and will then express itself on headline inflation. The recovery of the currency may obviate the kind of adjustments in goods that are either imported or priced on import parity that was being envisaged in the closing months of 2011. On balance, however, the Council

expects that inflationary pressures will continue to ease through 2012/13 and average around 6 per cent for the year. It will be necessary to keep a sharp vigil on food prices and take proactive measures not only to encourage output increase but equally, if not even more urgently, to ensure the rollout of an adequate food logistics network that can do justice to the rising demand for and output of horticulture and animal husbandry products.

27. **External Payments**: It will not be prudent to proceed on the assumption that a high CAD will automatically be financed on the capital account side. After the 1991 crisis we had targeted an upper limit of CAD at 2 per cent of GDP. While the position in regard of capital flows has greatly improved, it will however be judicious to try and limit the CAD to between 2.0 and 2.5 per cent of GDP – especially as long as international financial markets continue to be adversely impacted by the troubles in the Eurozone. On the capital account side, capital inflows especially that in the form of equity must be encouraged and improved domestic conditions for investment and growth are the basic pre-requisites, along with fundamental macroeconomic stability, i.e. prices, exchange rate and fiscal balances.

28. **Fiscal deficit**: The fiscal balance of the Central government is likely to expand beyond its budgeted estimate of 4.6 per cent of GDP. This development has been occasioned primarily by much higher than budgeted subsidies – especially that on refined petroleum products. A large subsidy bill directly reduces the resources that are available for development expenditure, while also by expanding the borrowing needs of Government squeezes investible resources to an extent that undercuts productive investment by the private sector. In 2012/13, Government must strive to contain and improve the efficacy of subsidies, vis-à-vis the development needs that need to be carved out of the Union Budget. Adequate safeguards needs to be taken to prevent any negative fallout of the government borrowing programme on the financing needs of the private sector. It must be incontestably demonstrated that government finances are indeed on the path of fiscal consolidation thus reinforcing the final pillar of macroeconomic stability.

II. INTERNATIONAL ECONOMIC CONDITIONS

29. The Council in both this year's and last year's Economic Outlook (July 2010 and 2011) had dealt at some length on the adverse developments in the world economy, particularly in regard to troubled conditions in Europe and the weak recovery in the USA, the fiscal problems in both of these major areas of the developed world, as well as the adverse impact on the financial markets, resulting in volatile conditions on the one hand, and a pressure on commodity prices on the other. In the July 2011 *Economic Outlook*, the Council noted that it "does not see any change in these elements for the better." Between July and December, the sovereign debt crisis in the Eurozone deepened and there is as of yet no resolution in sight. The straightjacket that the common currency places the weaker economies in prevents the normal means of rehabilitation of weak economies via devaluation. The alternative which is "internal devaluation" is very bitter (and a one-sided) medicine and likely – as it indeed is happening – to cause considerable social unrest in many European countries. However, economic conditions in the US show marked signs of improvement.

30. The focus of concern in 2011 was the sovereign debt crisis in the Eurozone area. From the middle of the year, there was a series of unprecedented high profile Summit style efforts to stem the developing crisis and build up investor confidence and rekindle the spirit of a shared mission. The situation is the most severe in Greece, with the crisis already consuming one government and public disquiet regarding the actions required by the creditor nations. The economic conditions in Greece have not improved. In 2010 it had contracted by 4.4 per cent and in 2011 the IMF projects a contraction of 5 per cent. The rate of decline over the four quarters up to September 2011 averaged 7.4 per cent.

31. By contrast the economic condition in the other affected economies – Ireland, Spain and Portugal – are much better, with only Portugal averaging net decline in the year to September 2011, and that too of only (–) 0.3 per cent. Other Eurozone economies are experiencing slow growth, but not exactly recessionary conditions. Further, the course of reforms in Italy and Spain is looking much better on the basis of the experience in the past two months.

32. The Eurozone seems to be moving towards a situation where the strongest member, namely Germany, appears to be signalling that it is willing to a great extent to

underwrite the effort to bring private investors back into the sovereign debt market – at least for the next year or so. Central to this is a stabilization of Italy and Spain. It is yet quite unclear whether the proposals on a fiscal union will eventually materialize, but there is greater clarity on Germany willing to lend its own balance sheet in setting a floor under the sovereign debt of substantial issuers like Italy and Spain. Germany has not made this support explicit – and there may well be constitutional and political problems in the way of making such a commitment. However, the course of events since early December suggests that there is indeed a shared perception that such a commitment exists. To that extent it limits the degree of uncertainty that can persist and therefore limit the scope of shocks. In the interim, combined with better signals from the US, the euro may be expected to steadily weaken vis-à-vis the US dollar – as indeed has been the case in December and January. But as markets began to factor in the likelihood of the previously stated outline of stabilization, the Euro has again begun to gain strength.

33. The IMF in its January 2012 *Update* to the *World Economic Outlook* has marked down projected 2012 growth in the Eurozone from 1.1 to (–) 0.5 per cent, with Italy and Spain projected to be in recession through most of 2012. The IMF expects some easing of inflationary pressures in 2012 and also in the price of crude oil; the latter inference however appears unlikely. The Fund also expects that trade growth will slow down in 2012 – both in respect of imports into advanced economies, and even more so on account of a slowing of imports into developing ones.

34. According to the International Energy Agency (IEA), world crude oil demand has increased from 83.6 million barrels per day (mpbd) in 2005 to a projected 90.0 mpbd in 2012 – an increase of 6.4 mpbd over the 7-year period. During this time, North American demand will have *fallen* by 2.3 mpbd and that from Europe by 1.6 mpbd. The main contributors to the increase in net oil demand are China (3.2 mpbd or 60 per cent), West Asia & North Africa (2.1 mpbd or 42 per cent) and India (1.0 mpbd or 19 per cent). Consumption growth in the Middle East is tied in with oil revenues and with oil prices being relatively firm, there is unlikely to be a decline in demand growth. The increase in demand from China and India is linked to their pace of economic expansion – even as the proportionate increase in China is greater. As long as growth remains robust in these two economies and also in other parts of Asia, it is unlikely that demand growth for oil will slow very much in the near future, thereby helping keep a floor under prices. The cartelized character of the oil market enables these demand pressures to be greatly amplified. Further, in response to social unrest in West Asia & North Africa governments have

distributed more of their oil revenue to their public and budget needs therefore have served to put another floor under oil prices. Finally, the other tensions in the region keep prices on a hair trigger. This is why, the Council feels that despite the weakened state of the aggregate world economy, it is prudent to not only expect oil prices to remain elevated, but also to expect – on an average – some increase over the year from present dollar-price levels.

35. Both India and China have faced strong inflationary pressures in 2010 and 2011 – in part a fallout of the sharp increase in world commodity prices, especially that of crude oil, and in part a development from domestic factors ranging from strong demand, weakness in supply and/or in supply networks. The overhang of the fiscal stimulus initiated during the Crisis of 2008–2009 also played a major part in the price pressures – *albeit* in quite different ways in India and in China. The policy response by authorities in both India and China appear to have paid off and both economies are on course to some degree of price normalization.

36. Equity capital flows to developing economies, especially portfolio flows, were subdued in 2011, compared to the sharp rise in 2010 on the back of the global Crisis and the quick economic recovery in emerging economies. The difficulties that most developing economies faced – from slowing growth, high inflation and in some cases sharp swings in currency – saw varying degrees of sell-off in emerging markets. New issuance of both equity and bonds for the world as a whole fell off very sharply through 2011. Emerging market bond issuance in 2011 was weaker than in 2010 and a decline was marked in the second half of 2011. Purely on a cyclical basis, those markets like India which under-performed in 2011, stand a decent chance of experiencing a recovery, provided stabilization of basic macroeconomic conditions is ensured.

37. Direct investment flows in non-resource rich economies are a function of domestic investment conditions and the pace of its expansion. In India this would be especially true for investment conditions in infrastructure and heavy industry.

III. STRUCTURAL FACTORS

38. The Central Statistical Office (CSO), in the Quarterly Estimates (QE) for 2011/12 released in end-January 2012, revised the data for previous years. The rates of growth have been increased for 2009/10 from 8.0 to 8.4 per cent. A large downward adjustment in the GDP at market prices for 2009/10 and 2010/11 has been made on account of a reduction in the assessment of indirect taxes, offset to some extent by lower estimates of subsidies, and adjustments made to GDP at factor cost on account of the new price indices. In the case of 2008/09, subsidy estimates have been scaled down resulting in the GDP at market prices being raised significantly. The absolute value of estimates for fixed investment has been raised somewhat in both 2008/09 and 2009/10, while that for savings has been reduced in 2009/10. On account of the denominator being reduced in both 2009/10 and 2010/11, the ratios for these years are now higher.

39. The most notable element that emerges from an examination of the data release is the decline in the fixed investment rate (Gross Domestic Fixed Capital Formation) to 30.4 per cent in 2010/11 compared to 32.9 and 32.3 per cent in 2007/08 and 2008/09 and even the 31.6 per cent registered in 2009/10. Of this, the most significant decline has occurred in the private corporate sector where the ratio has fallen from 14.3 per cent in 2007/08 to 9.9 per cent in 2010/11. Basically the entire slowing down of fixed capital formation in the post-Crisis period has flowed from the private corporate sector, offset to an extent by investments made by households, including unincorporated businesses.

40. The second notable element is the decline in the domestic savings rate, from 36.8 per cent of GDP in 2007/08 to 32.3 per cent in 2010/11. That there would have been some drop on account of the fiscal expansion used to deal with the Crisis was expected. However, of this 4.5 percentage point decline, only 2.1 percentage points is on account of increase in government dissavings. A fall in the surpluses of non-departmental enterprises (public sector companies) and departmental enterprises (such as Railways) account for 0.9 and 0.2 percentage points of decline. The public sector as a whole has thus accounted for as much as 3.3 percentage points of GDP decline in domestic savings.

41. Slower market growth and margin pressures have seen private corporate savings fall by 1.4 percentage points of GDP. In the household sector, while overall savings

TABLE 2
Values of Key Macro-economic Parameters

	Invest-ment Rate	Gross Domestic Capital Forma-tion	Gross Domestic Fixed Capital Forma-tion	Domestic Savings Rate	Current Account Balance	Final Consumption Rate		Gross Domestic Capital Formation (GDCF)		GDCF in Fixed Capital only		Final Consumption Expenditure		
						Private	Govt.	Total	Pvt. Corp.	Total	Pvt Corp.	Private	Govt.	Total
	Ratio to GDP at market prices						Growth rate at Constant Prices							
2000/01 *	24.3	24.2	22.7	23.7	**–0.6**	64.0	12.6	**–4.0**	**–28.3**	**–0.01**	**–11.0**	**3.6**	**0.9**	**3.2**
2001/02 *	22.8	24.2	23.6	23.5	0.7	64.5	12.4	3.8	8.6	7.4	3.6	5.7	2.3	5.2
2002/03 *	25.2	25.2	23.8	26.3	1.2	63.3	11.9	10.9	17.1	6.8	3.5	2.8	–0.4	2.3
2003/04 *	27.6	26.8	25.0	29.8	2.3	61.8	11.3	12.9	24.6	13.6	23.2	6.0	2.6	5.5
2004/05	32.8	32.5	28.7	32.4	**–0.4**	59.1	10.9	22.3*	68.1*	18.9*	62.8*	5.5*	3.6*	5.2*
2005/06	34.7	34.3	30.3	33.4	**–1.2**	58.3	10.9	17.0	45.0	16.2	43.1	8.5	8.9	8.6
2006/07	35.7	35.9	31.3	34.6	**–1.1**	57.7	10.3	15.3	19.1	13.8	17.9	8.7	3.8	7.9
2007/08	38.1	38.0	32.9	36.8	**–1.3**	57.0	10.3	17.7	32.8	16.2	27.7	9.2	9.6	9.3
2008/09	34.3	35.5	32.3	32.0	**–2.3**	57.7	10.9	–2.5	–29.5	3.5	–21.9	7.1	10.4	7.6
2009/10	36.6	36.1	31.6	33.8	**–2.8**	57.4	12.0	9.8	23.9	6.8	15.2	7.0	14.3	8.1
2010/11 QE	35.1	35.8	30.4	32.3	**–2.7**	56.5	11.9	9.9	8.0	7.5	4.7	8.1	7.8	8.1
2011/12 est	*35.2§*	*35.3§*	*29.2§*	*31.6§*	***–3.6§***	*56.3§*	*11.5§*	*5.4§*	*5.2§*	*5.6§*	*3.8§*	*6.5§*	*3.9§*	*6.0§*
2012/13 proj	***35.5***	***36.2***	***31.3***	***32.5***	**–3.0**	***56.5***	***10.8***	***9.0***	***9.5***	***9.0***	***10.0***	***7.2***	***4.0***	***6.7***

<u>Note</u>: * For these years the GDP and component figures are as per the old NAS series;
§ Estimates

has improved marginally, there seems to have a shift away from financial to physical assets by 1.6 percentage points of GDP. These are developments that are not favourable for large scale fixed asset creation, economic capacity increase and therefore of growth. It also increases excess domestic demand and eventually the current account deficit (CAD).

42. The Council expects that the overall investment rate in 2011/12 will be about 35 per cent, similar to that reported for 2010/11. However, the fixed investment rate will probably show a decline from the 30.4 reported for 2010/11 and is likely to be close to the 29.3 per cent suggested in the Advance Estimate. The domestic savings rate is likely to drop further to 31.6 per cent in 2011/12 leading to an enhanced CAD.

43. In the next year (2012/13), the Council expects some improvement in the fixed investment rate to over 31 per cent. The overall investment rate will be only slightly greater than in the current year, since it is expected that were may be a decline in the extent of allocation by households to valuables, namely gold.

44. Private Final Consumption Expenditure (PFCE) has shown steady growth of between 7 and 9 per cent per year. The Advance Estimates suggest that in 2011/12 PFCE in real terms will grow by 6.5 per cent. It is likely that this number may see some upward revision. The Council expects that in 2012/13 the rate of growth is likely to revert to the normal values of 7 per cent or higher.

45. The investment and savings rate for the years up to 2010/11 and the advance estimates for 2011/12 clearly suggest that there is a need to alter the investment–savings dynamic in a manner that can lead to higher rates of fixed investment financed from a reduction in the government's negative savings, less of surpluses being expended in subsidies in the public sector companies and improvement in the mobilization of household financial savings by organized savings institutions.

46. Gross financial savings of households had peaked at 17.9 per cent of GDP in 2006/07, from where it has steadily fallen to 13.6 per cent in 2010/11. In 2006/07, the largest share (10 per cent of GDP) was in deposits. In the years that followed, the share of deposits has declined and that allocated to insurance and provident funds increased. In 2009/10, deposits were down to 7.2 per cent, while that of insurance funds had risen to 4 per cent of GDP. The amounts additionally accruing to insurance and provident funds in this period was 1.4 percentage points of GDP. In 2010/11 the savings mobilized by insurance funds fell to 2.8 per cent and that in provident funds from 2.0 to 1.5 per cent of GDP.

47. It is believed that premium collections in 2011/12 also have not been strong. The fund mobilized by mutual funds, shares & debentures were negative in 2010/11. Offsetting increases include household direct savings in physical assets and in investments in the form of valuables (gold and silver). There is clearly need to examine and rectify the situation so that household savings come back to the organized financial market and are used in the creation of the nation's modern infrastructure and industrial base.

IV. SECTORAL: FARM, INDUSTRY AND SERVICES

Agriculture & Allied Sector

48. The Second Advance Estimate for 2011/12 shows record foodgrain output in the year of 250.4 million tonnes (m.t.), more than the previous highest output of 244.8 m.t. last year. The *kharif* foodgrain production of 128.4 m.t. is also the largest ever *kharif* harvest, while the *rabi* crop now estimated at 122.0 m.t. is slightly lower than the final estimate and new record of 123.6 m.t. last year. However, it is likely that the final estimate may be higher than last year's.

49. Rice output at 90.2 m.t. in the *kharif* season, as also the total projected output of 102.8 m.t. will both be new records. The wheat output of 88.3 m.t. is also a new record. Coarse cereals at 42.1 m.t. is lower than last year's final estimate of 43.7 m.t., but is significantly greater than the 2nd AE of last year of 40.1 m.t.

50. Total output of pulses assessed by the 2nd AE in the current year at 17.3 m.t. is lower than the final estimate of 18.2 m.t. of last year. However, it is greater than last year's 2nd AE of 16.5 m.t., suggesting the possibility that pulse production in 2011/12 may turn out to be equal to or perhaps greater than last year's production. And 2010/11 had marked a complete break from the stagnant level of 12–14 m.t. production that characterised the previous three decades.

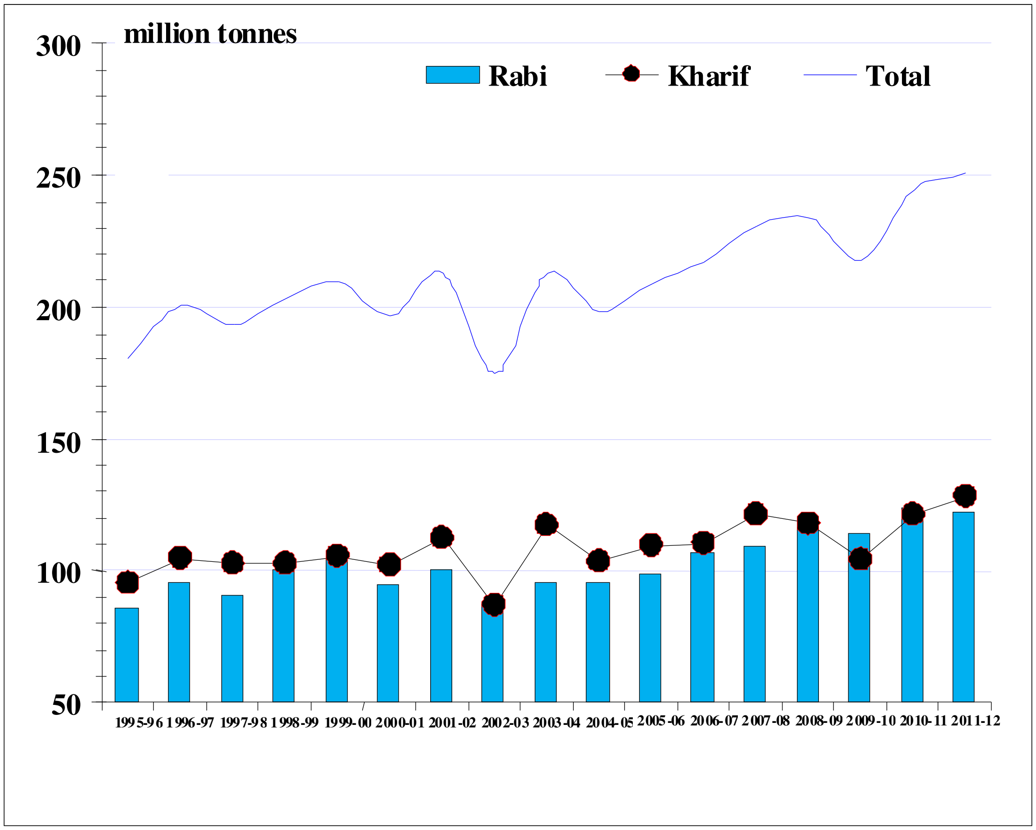
51. The production of oilseeds is assessed to have touched a new record of 30.5 m.t., which though less than last year's final estimate (32.5 m.t.) is greater than last year's 2nd AE (27.8 m.t.). Here again, it is possible that output in 2011/12 will equal or perhaps exceed the record output of last year. Both cotton and sugarcane are also set to hit new output records in 2011/12.

52. The 2nd Advance Estimates for 2011/12 along with final and 2nd AE of last year and final estimates for recent years are placed at Table 3. The magnitude of the large increase in foodgrain output in recent years is best captured graphically (see Chart 1).

53. In the area of horticulture, the initial estimates of output in 2011/12 suggest that for horticultural products as a whole – namely vegetables, fruit, spice, nuts, aromatic plants and plantation crops – there has been growth of over 5.5 per cent compared to the previous year. Expansion in spices, nuts and plantation crops has been

TABLE 3
Output of Crops

			2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11		2011/12
									2nd AE	Final	2nd AE
Rice	million tonnes	Kharif	72.23	78.27	80.17	82.66	84.91	75.91	80.16	80.65	90.18
		Rabi	10.90	13.52	13.18	14.03	14.27	13.22	13.85	15.33	12.57
		Total	83.13	91.79	93.36	96.69	99.18	89.13	94.01	95.98	102.75
Wheat		Rabi	68.64	69.35	75.81	78.57	80.68	80.71	81.47	86.87	88.31
Coarse Cereals		Kharif	26.36	26.73	25.61	31.89	28.54	23.63	30.56	33.37	31.84
		Rabi	7.10	7.33	8.31	8.87	11.49	10.14	9.52	10.32	10.24
		Total	33.46	34.06	33.92	40.76	40.03	33.77	40.08	43.69	42.08
Pulses		Kharif	4.72	4.87	4.80	6.40	4.69	4.30	6.45	7.12	6.39
		Rabi	8.41	8.52	9.40	8.36	9.88	10.29	10.06	11.12	10.89
		Total	13.13	13.39	14.20	14.76	14.57	14.59	16.51	18.24	17.28
Foodgrains		Kharif	103.31	109.87	110.57	120.95	118.14	103.84	117.17	121.14	128.41
		Rabi	95.05	98.73	106.71	109.83	116.33	114.36	114.90	123.64	122.01
		Total	198.36	208.60	217.28	230.78	234.47	218.20	232.07	244.78	250.42
Oilseeds (nine major)	lakh tonnes	Kharif	141.49	167.68	140.12	207.13	178.08	156.63	182.19	219.22	208.00
		Rabi	102.05	112.11	102.77	90.42	99.11	92.65	96.29	105.57	97.29
		Total	243.54	279.79	242.89	297.55	277.19	249.28	278.48	324.79	305.29
Cotton	Lakh bales, 170 kg		164.3	185.0	226.3	258.8	222.8	239.4	339.3	330.0	340.9
Jute & Mesta	Lakh bales, 180 kg		94.0	99.7	103.2	102.2	96.3	107.0	100.8	106.2	116.1
Sugarcane	Lakh tonnes		2,371	2,812	3,555	3,482	2,850	2,495	3,367	3,424	3,479



particularly strong and that in nuts and vegetables both are above 5.5 per cent. However, owing to significantly lower apple output, the overall output growth in fruits has been lower than that of the sector as a whole. Output in citrus and non-traditional fruits has been particularly strong.

54. Milk and other animal husbandry products have shown good output growth with milk output estimated to have increased by 4.5 per cent in 2011/12 over that of last year.

Industry and Services

55. In July 2011, the Council had flagged the very weak growth in the mining sector, especially in coal and natural gas, as also the extent to which export demand seemed to be driving manufacturing output expansion in certain areas, especially in motor cars and two wheelers. The Council has expected that there would be signs of a recovery in August and with some improvement in the investment situation, output growth should pick up in the second half of 2011/12, and especially so in the fourth quarter. Overall for the year, the Council has expected that manufacturing and also broad industrial growth reflected in the GDP would be about 7 per cent for the year.

56. The conditions governing both mining and manufacturing output growth however has turned out to be much worse than expected. Coal output showed declines of 15, 17 and 9 per cent on year-on-year basis in August, September and October 2011 respectively. However, since November coal output growth has come back to positive territory, being 4.7 and 5.6 per cent in November and December 2011 and is estimated to be 6 per cent in January 2012. There is reason to expect that output growth for coal in the last quarter of 2011/12 will be about 6 per cent.

57. Natural gas production has been declining ever since it touched a peak output level of 154.5 million cubic metres per day (mcmd) in March 2010, largely owing to difficulties faced in the large KG-D6 field. The Council had felt that the June 2011 output level of 132.5 mcmd was close to the bottom, but production has continued to decline to 128.2 mcmd in November and 126.3 mcmd in December 2011. Crude oil output has also been running below programme levels due to lower than programme production in Mumbai High as well as in joint venture off-shore fields. As a result year-on-year production was 5.7 per cent lower in November and this 5.6 per cent in December. However, the extent of decline is expected to become lower in the last quarter of 2011/12.

58. Output growth in the manufacturing sector has slowed by much more than the Council had expected in its July 2011 Economic Outlook. The weakening of output growth in the interest rate sensitive consumer durables was along expected lines. However, output growth in other classes of products, particularly intermediate and capital goods, was much weaker than what had been expected. The Advance Estimate of the CSO placed output growth in manufacturing GDP at 3.9 per cent. This has factored in the output record up to December 2011 and it does not seem likely that the outcome for the full year will be significantly different from this.

59. On account of a combination of more capacity coming on line, better fuel availability with nuclear power plants and improved hydro-resource position, electricity generation has grown rapidly, averaging 9.4 per cent in the first nine months of the year. Generation growth in January (4.1 per cent) and the first week of February 2012 has been slower on account of fuel-related reasons, especially in gas based plants and for the year as a whole will be less than in the first nine months. Here again the Advance Estimate of 8.3 per cent for the electricity and utility sector is likely to be an accurate reflection of what would turn out to be for the full year.

60. Construction activity seems to have picked up in the second half, reflected by the increased output of cement and construction steel. In consequence, the Council is

of the view that activity levels in the construction sector will be higher at 6.2 per cent for the year as against the Advance Estimate of 4.8 per cent.

61. On the services side, the Council had extrapolated on the basis of the actual data for the first two quarters and some indicators available for the period up to the end of December. Most of this turns out to be close to that presented in the Advance Estimate. The overall projected service sector growth is placed at 9.4 per cent for the full year, which is the same as that in the Advance Estimate of the CSO.

62. In light of the above, the Council feels that overall GDP growth in the second half of 2011/12 will be slower than that recorded in the first half (7.3 per cent). It is likely that third quarter growth will be significantly weaker than that reported for the second (6.9 per cent), but that in the final quarter of 2011/12 should show some improvement. Overall for the 2011/12, GDP growth is estimated at 7.1 per cent.

V. EXTERNAL SECTOR

63. The Balance of Payment (BoP) estimates are available for the first half of 2011/12. In the second half, export growth is much weaker and the trade deficit has expanded. Coupled with lower net capital inflows the BoP was under particular pressure in the third quarter. In the ongoing fourth quarter, the current account position is expected to be better, largely on account of higher net invisible inflows. This coupled with stronger capital inflows has and will continue to relieve the pressure on the BoP that came into sharp focus in the third quarter.

64. However, for the year 2011/12 as a whole, the BoP situation cannot be regarded to be satisfactory. The merchandise trade deficit is expected to average 9.3 per cent of GDP, with the ratio in the second quarter at 9.8 per cent, which possibly touched 10 per cent in the third. In the fourth quarter this ratio is expected to drop to close to 8 per cent of expected GDP. For the year as a whole, merchandise exports (on BoP basis) is projected at $304 billion, imports at $479 billion and a trade deficit of $175 billion or 9.3 per cent of GDP.

65. In the first half of 2011/12, the balance on invisibles stood at $53 billion, which was 15 per cent higher than in the same period of 2010/11 and amounted to 5.9 per cent of GDP. For the year as a whole, the Council is projecting a net balance on invisibles at $108 billion or 5.8 per cent of GDP.

66. The current account deficit (CAD) in the first half stood at $32.8 billion or 3.6 per cent of GDP. In the second half it is likely to be only marginally different at $33.9 billion or 3.5 per cent of GDP. For the year as a whole the CAD would thus be $66.8 billion or 3.6 per cent of GDP.

67. Growth in earnings from export of services has slowed down over the past two years. The growth in net invisible earnings has dropped sharply from 30 per cent per annum in the period between 2004/05 and 2008/09. In 2009/10 the net balance on invisibles had fallen due to the global crisis, as also an increase in the net outflow on account of investment income. Growth coming from the positive balance on net invisibles was modest at only 7 per cent in 2010/11, but improved in the first half and is expected to be 25 per cent for 2011/12. With slower growth in the business of service exports, the ability to finance the enlargement of

TABLE 4

Balance of Payments - Actual and Projected

US$ billion	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12			2012/13
								1st half	2nd half	Full Year	
Merchandise Exports	85.2	105.2	128.9	166.2	189.0	182.2	250.5	150.9	153.3	304.2	333.4
Merchandise Imports	118.9	157.1	190.7	257.6	307.7	300.6	380.6	236.7	242.2	478.8	517.6
Merchandise Trade Balance	**–33.7**	**–51.9**	**–61.8**	**–91.5**	**–118.7**	**–118.4**	**–130.2**	**–85.8**	**–88.9**	**–174.7**	**–184.2**
	–4.7%	***–6.2%***	***–6.5%***	***–7.4%***	***–9.7%***	***–8.5%***	***–7.5%***	***–9.5%***	***–9.2%***	***–9.3%***	***–8.8%***
Net Invisibles	31.2	42.0	52.2	75.7	89.9	80.0	85.8	52.9	54.9	107.8	121.0
	4.3%	*5.0%*	*5.5%*	*6.1%*	*7.4%*	*5.8%*	*4.9%*	*5.9%*	*5.7%*	*5.8%*	*5.8%*
o/w Software & BPO	14.7	23.8	27.7	37.2	44.5	41.0	52.3	28.3	31.3	59.6	68.0
Private Remittances	20.5	24.5	29.8	41.7	44.6	53.5	53.4	31.0	33.3	64.3	72.0
Investment Income	–4.1	–4.1	–6.8	–4.4	–4.0	–5.5	–14.5	–9.4	–11.1	–20.5	–22.0
Current Account Balance	**–2.5**	**–9.9**	**–9.6**	**–15.7**	**–28.7**	**–38.4**	**–44.4**	**–32.8**	**–34.0**	**–66.8**	**–63.2**
	–0.3%	**–1.2%**	**–1.0%**	**–1.3%**	**–2.3%**	**–2.8%**	**–2.6%**	**–3.6%**	**–3.5%**	**–3.6%**	**–3.0%**
Foreign Investment	13.0	15.5	14.8	45.0	3.5	51.2	38.0	13.5	12.1	25.6	34.0
o/w FDI (net)	3.7	3.0	7.7	15.4	17.5	18.8	7.7	12.3	8.3	20.6	24.0
Inbound FDI	6.0	8.9	22.7	34.2	35.0	33.1	24.0	20.6	18.8	39.4	50.0
Outbound FDI	2.3	5.9	15.0	18.8	17.5	14.4	16.3	8.3	10.5	18.8	26.0
Portfolio capital	9.3	12.5	7.1	29.6	–14.0	32.4	30.3	1.2	3.8	4.9	10.0
Loans	10.9	7.9	24.5	41.9	4.1	14.3	27.9	17.2	19.0	36.2	37.6
Banking capital	3.9	1.4	1.9	11.8	–3.2	1.5	5.0	19.3	12.2	31.5	24.0
Other capital	0.7	1.2	4.2	9.5	4.5	–13.0	–10.4	–9.1	–12.0	–21.1	–12.0
Capital Account Balance	**28.0**	**25.5**	**45.2**	**108.0**	**8.7**	**53.4**	**60.0**	**41.1**	**31.3**	**72.3**	**83.6**
	3.9%	*3.1%*	4.8%	8.7%	0.7%	3.9%	3.5%	4.6%	3.2%	3.9%	4.0%
Errors & Omissions	0.6	–0.5	1.0	1.2	1.1	–1.6	–2.6	–2.5	–2.0	–4.5	–
Accretion to Reserves	26.2	15.1	36.6	92.2	–18.9	13.4	13.0	5.7	–4.7	1.0	20.4
	3.6%	*1.8%*	*3.9%*	*7.4%*	*–1.5%*	*1.0%*	*0.8%*			0.1%	1.0

merchandise imports and therefore the trade deficit stands sharply diminished, in comparison with years before the global crisis.

68. The rate of expansion of merchandise exports (as revised recently) in the last year and in the first half of the current year was very strong at 25–50 per cent in each of the four quarters. In the current year this pace of expansion was sustained in the first half. Thereafter, export growth fell to single digit numbers. It must be said that associations of exporters had stated that this outcome was a certainty at the beginning of the fiscal year, based on the order position and the interest from their overseas buyers. The difficult economic conditions in Europe and the USA – the major export markets for a wide range of our goods – make it hard for our exporters to grow their business. In exports the fastest growing items have been transport equipment, refined petroleum products, gems & jewellery, pharmaceuticals, textiles and leather. However, for many of these items the big growth was in the first half and not the second.

69. While exports have slowed down in the second half of 2011/12, merchandise imports have continued to grow at a rapid pace in the second half. In the third quarter, as against an export growth of 7 per cent, imports increased by 27 per cent. In the fourth quarter it is expected that export growth will be low, but import growth is likely to stay at around 20 per cent. The oil import bill has touched $117 billion in the first ten months and is expected to cross $142 billion in the full year. Import of gold was $50 billion to January and may be expected to be around $58 billion in the full year.

70. Software, Information Technology Enabled Services (ITES) and remittances that had taken a hit in from the third quarter of 2008/09 to the third quarter of 2009/10, recovered thereafter – in both 2010/11 and the first half of 2011/12. Expected growth in the current year is about 14 per cent. Private remittances picked up well in the first half of 2011/12 and continue the trend in the second half. Net outflow on investment income has become a growing and large number, partly on account of the low return on the unchanged level of reserve assets and the sharp increase in outbound investment income – both on debt and on equity.

71. The experience has been that capital inflows can be readily tapped as long as the CAD remains in the region of 2.0–2.5 per cent of GDP. Once it begins to exceed that level, investors tend to be concerned and are reluctant to commit risk capital (equity). In consequence, the funding of higher CAD is not only harder, but the quality of financing can also become an issue. This is even truer of the current global conditions where risk perceptions are elevated.

72. On the capital account side, Foreign Direct Investment (FDI) on a net basis was $12.3 billion in the first half of 2011/12 – a marked improvement over the corresponding period in the previous year. However, most of the increase was in the first quarter. In the second half, the net FDI inflows last year were painfully low and the modest increase expected in the second half of 2011/12 would be a big increase. For the year as a whole net FDI inflows, are expected to be $20.6 billion compared to $7.7 billion last year.

73. Portfolio equity inflows were negative in the second and third quarters. Although there is some recovery recently, the total of equity portfolio inflows is unlikely to be much greater than the $4.9 billion projected at Table-4. There have however been very substantial portfolio debt inflows, likely to be in excess of $10 billion in the full year, of which $9 billion had come in by the end of January 2012.

74. Overseas loan growth (external commercial borrowings) reported in the BoP in the first half of 2011/12 stood at $10.6 billion. In the third quarter issuance was at $8.5 billion and in the last quarter perhaps $10 billion will be issued. On the basis of known repayment obligations, the total ECB net inflows in the current year are placed at about $17 billion.

75. Inflows into NRI deposits have been strong this year and for the year as a whole the net inflow is placed at $12 billion, of which $8 billion is the estimate for the second half. Bank transactions (other than NRI deposits) have been a large item of inflow aggregating $15 billion in the first half which is expected to be augmented by another $4 billion in the second.

76. Overall, the Council estimates that the capital account surplus will be $31.3 billion in the second half of 2011/12 and for the full year it will be $72.3, significantly larger than the $60 billion, recorded in the previous year. As a ratio to GDP the surplus on the capital account will be 3.9 per cent which is only slightly more than last year's and about the same as that in 2009/10.

77. The surplus left in the BoP to be absorbed by the central bank's foreign currency assets will be only $1 billion for the year as a whole. In the first half the surplus was $5.7 billion. Between November 2011 and January 2012 there was a sizable reduction in the foreign currency reserve assets as the excess of the CAD over the net capital inflows that needed to be financed. It is likely that some of this will be offset in the closing two months of 2011/12, but overall in the second half there is likely to be a reduction in foreign currency reserve assets by $4–5 billion.

78. The Council is of the view that in 2012/13 there will continue to be pressure on the CAD. Crude oil prices are expected to increase by about 10 per cent on the

average in 2012/13 compared to the current fiscal year. As mentioned elsewhere the order of increase in oil prices in this and the previous year has been 30 and 25 per cent respectively and in that sense the further increase expected in 2012/13 may be seen as a minor relief. However, to the extent that there is an increase, it will push up the oil import bill.

79. The stabilization of basic macroeconomic conditions at home is expected to curtail the demand for imported gold to be held as an asset by Indian households somewhat. It is projected that the value of bullion imports will be lower at $38 billion, compared to the expected $58 billion in the current year and more in line with the $33 and $30 billion of the previous two years.

80. The value of total merchandise exports on BoP basis is expected to increase by about 10 per cent from that projected for 2011/12 to $333 billion in 2012/13. Merchandise imports other than gold is expected to increase by 28 per cent, but on account of the expected decline in gold imports, the value of total merchandise imports is expected to increase by 8 per cent to $518 billion. The resultant merchandise trade deficit will be $184 billion or 8.8 per cent of expected GDP.

81. Earnings from export of software and related items are expected to grow by 14 per cent in 2012/13, while that of private remittances by 12 per cent. Overall, the net earnings from Invisibles – including these items, net investment income and net balance on tourism and transport – is expected to increase from the current year's projected level of $108 billion to $121 billion in 2012/13, a growth of 12 per cent.

82. The persistence of a large CAD in 2012/13 seems likely, even as it is not desirable. There is a need to take measures to ensure that the CAD is stabilized at a lower level of around 2.0–2.5 per cent of GDP. However, even in the event that this outcome is successfully achieved, we would nevertheless require that capital inflows of sizeable magnitude also occur. The magnitude of the CAD reflects the growth dynamics of the domestic economy and the extent of excess demand.

83. Investment conditions at home to a great extent determine its attraction to Foreign Direct Investment, as well as to investors in the equity of Indian companies. In order to be able to finance these large current account deficits in a manner that does not stress the external payment account, and therefore the otherwise favourable macroeconomic growth conditions in the Indian economy, there must be a clear focus on facilitating capital inflows, especially of equity.

84. The best means of limiting the appetite for gold is to work towards making other kinds of assets more attractive, especially such financial assets as lends themselves to ready mobilization for funding infrastructure and industrial asset creation. The

first part of this task is to improve domestic growth and investment conditions – a function of overall macroeconomic stability. The second part will be to make investment in life insurance and mutual fund schemes at least as attractive, as was the case till Match 2010, where the data show net inflows were sizeable and sustained.

85. Overall the stance must be to encourage capital inflows which are critically needed. Capital flows have their own dynamics. They flow towards countries which grow fast in an environment of low inflation and modest fiscal deficit. These are also our domestic goals. The world today is seized by fear of risk and the evidence suggests that most asset managers would rather choose the terribly meagre returns on advanced country bond assets than accept risk. It is necessary to be proactive in attracting foreign investment which is anchored much more to an elevated sense of a perception of risk in emerging countries, including India, than being driven to move large chunks of their assets to such foreign domains.

86. The approach to policy on the external value of the currency must be guided by concerns of both the current and capital account. While excessive real strengthening is undesirable, adjustments must also be steady and calibrated to ensure that flows on the capital account do not face disruption. For a variety of reasons, including the inadequate availability of large pools of finance at home, our companies do raise a sizeable amount of their financing from overseas markets. The inter-linkages that result in consequence must also inform the way we approach this issue.

VI. PRICES

87. In the Economic Outlook (July 2011), the Council had said that "WPI inflation rate would continue to be at 9 per cent or higher in the months of July–October 2011. There will be some relief starting from November, but even in December the headline numbers are unlikely to be less than 8 per cent. However, there is likely to be further easing in the last quarter of the year and the RBI's projected target of 6.5 per cent in March 2012 seems to be reasonable and achievable".

88. In the event, the headline inflation rate did fall to 7.5 per cent, i.e. below 8 in December 2011, but that was due to the non-revision of diesel prices. The RBI has since revised its inflationary expectations to 7 per cent in March 2012. The Council feels that given the record of till date – including monthly inflation number of 6.55 per cent for January 2012, it is likely that the headline rate for March will be around 6.5 per cent.

89. The normalization of inflation in the current year has to a great extent being driven by easing of prices of primary food articles, especially of foodgrain, vegetables and fruit. While there has been some moderation in the inflation rate for milk, eggs, meat & fish, rates in recent months are still in double digits. There has been strong output response from our farmers and we need to quickly improve our storage, processing and logistics facility to improve efficiency. This will ensure that not only will the consumer get a better price, but the farmer too will be able to secure better realization – all at the expense of avoided wastage and unacceptably inefficient and pre-modern intermediation. There is also a great degree of synergistic inter-linkages between crops, horticulture, animal husbandry, water harvesting and fishing, which can be exploited much more intensively in order to obtain economies of operation through better resource use.

90. We are almost at the end of 2011/12 and the pertinent issue is what might occur in the next fiscal year. The rice and wheat harvest and procurement are going to be very comfortable – as far as prices go, even if they strain the resources of the Food Corporation of India. Pulses output is comparable to last year and too much price pressure may not be expected next year. On the basis of this and assuming that the monsoon is moderately normal, we should be able to maintain stability in food prices, especially given that global food price pressures seem to have eased.

91. On the fuel side, we have a large backlog in the adjustment of prices of sensitive petroleum products, especially diesel. While some rationalization may help to

make the shortfalls in revenue for LPG and kerosene more manageable, there is an overdue need to make some adjustments in the price of diesel, even if this is done in a phased fashion. In many States the electricity tariffs are also overdue for resetting and there has been a sharp increase in the fuel component of electricity generation. Thus, on the energy price front it is only reasonable to expect further upward price adjustments.

92. In general, commodity prices have tended to stabilize and the downward revisions in developed world output growth in 2012 should keep these prices range-bound. Manufactured goods inflation averaged 7.7 per cent in the first nine months, but will ease somewhat in the last quarter. If food prices remain stable, it is likely that inflationary pressures upon, and arising from, manufactured goods in 2012/13 may also remain within tolerable limits of about 5 per cent.

93. Keeping these factors in mind, the expectation of a moderate growth rate projected for 2012/13 and a consolidation of the fiscal situation, the Council is of the view that it will be reasonable to expect that the headline inflation rate will remain around 5–6 per cent for the year, notwithstanding lagged adjustments made to fuel and power prices.

94. Monetary policy has played a key role in the stabilization of prices over the past one year. The sharp and unexpected changes in food prices last year posed a danger to unsettling the anchor to inflationary expectations. In January 2012, the RBI has signalled that it feels that its task of re-anchoring inflationary expectations has been completed to some extent and on the basis of that comfort decided to reduce the cash reserve ratio (CRR) by 50 basis points. It has correctly linked its future course of action insofar as easing the monetary stance is concerned to the moderation in inflation and the extent to which the central government can trim its borrowing requirements in 2012/13.

VII. GOVERNMENT FINANCES

95. Government finances have come under severe strain in 2011/12. In the Economic Outlook presented in July 2011, the Economic Advisory Council had emphasized that containing the revenue and fiscal deficit by the Central government at the levels indicated in the Budget would be a major challenge. Subsequent developments have confirmed these concerns and fiscal consolidation has had a setback during the year. It is clear that the Central government will unable to contain the revenue deficit, the financing gap and the fiscal deficit at the budgeted levels of 3.4, 5.1 and 4.6 per cent of GDP respectively.

96. Up to end-December 2011, the financing gap of the Central government was Rs. 383,755 crore which is 85 per cent of the amount budgeted for the current fiscal. On account of weak conditions in the equity market, the disinvestment programme has also stalled and as a result the overshooting of the fiscal deficit was more than that of the financing gap. Up to end-December 2011, the accumulated fiscal deficit was already 92 per cent of the total budgeted for the year.

97. The setback to the fiscal consolidation process during 2011/12, will also pose additional difficulties in achieving the medium term target of creating a revenue surplus of half a per cent of GDP and containing the fiscal deficit at 3 per cent of GDP by 2014/15.

98. There are several reasons for the fiscal slippage in the current year. The Budget had estimated that gross tax revenue collections will increase by 18.5 per cent over the revised estimate (RE) of the previous year. However, the actual collections last year was in excess of that reported in the RE and the required growth over provisional actual (PA) collections was 17.3 per cent for gross taxes and 16.0 per cent for net taxes to Centre.

99. The weaker than expected economic growth in 2011/12 has hit tax collections. The target for direct taxes was 21 per cent expansion over provisional actual (PA) and that for indirect taxes was 15 per cent over PA. The reduction in the excise duty on diesel and abolition of customs duty on the import of crude petroleum in May 2011 (estimated at Rs 38,000 crore in a full year) placed further stress on the likelihood of tax collections meeting Budget targets. In the event, it is commendable that indirect tax collections have stayed the course. Collections for the first ten

months (April to January) show that customs and excise collections combined increased by 15 per cent compared to the same period last year. The strong growth of service tax collections of 37 per cent in the first ten months (as against the 15 per cent target) has been greatly responsible. The Central Board of Excise & Customs (CBEC) has expressed confidence of meeting their Budget target.

100. The impact of the slowing down of the economy in the current year has resulted in considerable slippage in direct tax collections, especially of corporate taxes. This was perhaps compounded by a front loading of refunds of about Rs 72,000 crore in the first eight months of the year. As against the budgeted growth of 21 per cent over PA, the actual collection for the first ten months (Apr–Jan) was about 15 per cent. Income tax collections were up 20 per cent (as against target of 24 per cent), while corporate tax collections were 12 per cent (as against target of 20 per cent).

101. On the expenditure side, the major problem concern has been the inability to contain subsidies. This has become the major hurdle to the process of fiscal consolidation. While the issue of decontrolling diesel prices has been under discussion for a considerable period of time, not much has been done and the partial decontrol of the prices of motor spirit has resulted in additional distortions. Similarly, the partial reform in the fertilizer subsidy regime of introducing nutrient based subsidisation will not be effective unless the price of urea is decontrolled or at least raised substantially. The large volume of food subsidy continues to be plagued by poor targeting. Of course, the volume of subsidies on both oil and fertilizers has continued to proliferate due to continued elevation in the price of crude oil and the depreciation of the rupee. Thus, both fuel and fertilizer subsidies, especially fuel, are likely to exceed the Budget estimate by wide margins. Similarly, spending on wages and salaries has continued to rise in the wake of continued inflationary pressures. Although to some extent, these expenditure increases may be accommodated by lower utilization of allocated funds on some of the flagship schemes and compression of capital expenditures, the financing gap is likely to be substantially higher than the Budget

102. The government has not been able to mobilise the budgeted disinvestment receipts of Rs. 40,000 crore and receipts from broad band wireless auction of Rs. 13,000 crore. The proposal that was mooted to raise this revenue by disinvesting the shares of public enterprises to other cash rich public enterprises was not a desirable option. This would have only reduced the investible resources of the enterprises and failed to convince market participants – who in any case mark down the reported deficits by all exceptional items, i.e. one-off items such as divestment proceeds and other asset sales, including spectrum auctions.

103. Not only private market participants, even international financial institutions make this basic adjustment to assessing what the sustainable deficits are. Non-debt financing of the financing gap is of course a preferred option to the extent that it is possible because it directly reduces the draft on the loan market and in the longer term reduces the interest and repayment (amortization) burden on the exchequer.

104. The aggregate fiscal situation at the State level, however, would broadly conform to the target recommended by the Thirteenth Finance Commission, though the power sector losses and the fiscal implications of this are worrisome. According to the State budgets, the aggregate fiscal deficit of the all the States add up to about 2.1 per cent of GDP. Though this is likely to be higher in some of the States, particularly in Kerala, Tamil Nadu and West Bengal where the newly elected governments will seek to fulfil their election promises, the slippage may not be large and the actual fiscal outcome may not exceed the target of 2.5 per cent of GDP set by the Thirteenth Finance Commission by a large margin. However, the power sector deficits have shown a substantial increase due to the non-revision of tariffs and also in partly because the States have not disbursed subsidies due to power utilities. Recently, Tamil Nadu and Rajasthan have increased tariffs sharply, but the problem of losses continues to be a concern. Some estimates have put the losses at over 1 per cent of GDP. It is necessary for Government of India to come out with a clear incentive linked plan to persuade the States to reform their electricity utilities.

105. The problem of containing the government's deficit is not confined to the current year. Reducing the fiscal deficit to 4.1 per cent of GDP in 2012/13 as set out in the Medium term Fiscal Policy statement of the government in the last Union Budget may not be possible, particularly at a time when there are additional spending commitments on the Food Security Bill and *Rashtriya Madhyamik Sikhsa Abhiyan* (RMSA). The medium term challenges are even more formidable. The Thirteenth Finance Commission has set the target of containing the fiscal deficit at 3 per cent of GDP for the Central government by 2014/15 and that would require compressing the fiscal deficit by about 2.5 percentage points over the next three years. Further, the high powered committee on universalising healthcare appointed by the Planning Commission has recommended a significant increase in public spending on medical and public health by at least one percentage point to GDP in the medium term.

106. Thus, containing the consolidated deficit of the Centre and States at 5.4 per cent of GDP by 2014/15 and making additional provision for public spending on education, healthcare and food security would require an adjustment of almost 5 to

6 percentage points of GDP in the next three years which is a formidable task. In fact, the Twelfth Plan has to be formulated in this constrained fiscal environment and it poses serious difficulties in making adequate allocation to the much needed physical infrastructure. Achieving the targeted level of fiscal adjustment without compressing expenditures on much needed infrastructure, will require significant increase in revenues and phasing out subsidies and transfers.

107. Government will have to come out with a new fiscal responsibility and budget management (FRBM) Act and Rules that is based on the recommendations of the Thirteenth Finance Commission in the forthcoming Budget session. In order to impart effectiveness to the process, the Thirteenth Finance Commission had made a series of recommendations to make the FRBM process (i) transparent and comprehensive; (ii) sensitive to counter-cyclical changes and (iii) institute a system to effectively monitor the compliance.

108. The objective of the entire exercise will be to make it a "commitment" and not a declaration of "intent". It would be useful to bring out the detailed strategy and the various policy initiatives and instruments proposed to achieve fiscal consolidation until 2014/15 which is the last year of the Thirteenth Finance Commission's recommendation. It is important to achieve fiscal consolidation and bring down the outstanding debt of the government in the medium term, while ensuring adequate resources for infrastructure spending. In particular, it is necessary to contain the subsidies and transfers that have proliferated in the last few years not only to contain the fiscal deficit but also to minimise distortions. Equally important is the need to allocate substantially larger resources for physical and social infrastructure and effectively target the spending on various flagship schemes.

109. Returning to the path of fiscal consolidation necessarily involves significant enhancement of revenue productivity of the tax system. The tax-GDP ratio reached its peak in 2007/08 when the Centre's tax ratio was 12 per cent and the total tax-GDP ratio of the Centre and States was 17.7 per cent. Subsequently, there has been a sharp decline in both central and total tax ratios to 10 and 15.4 per cent respectively in 2010/11 and is likely to remain at the same level in 2011/12 as well. Increasing the ratio at least to the 2007/08 levels is important to achieve fiscal consolidation and the process should be initiated in the forthcoming budget of 2012/13. Two major reform areas on the tax side are the enactment of the Direct Taxes Code (DTC) and the introduction of Goods and Services Tax (GST).

110. Although it may not be possible to accomplish these reforms immediately, the forthcoming budget could initiate a number of measures to facilitate them. As

regards DTC is concerned, the Bill is being deliberated by the Parliament's Standing Committee on Finance. Nevertheless, some important elements of DTC may be implemented in this year's Budget and these include the enactment of the concept of residence in the case of companies incorporated outside India and amendment of general anti-avoidance rule to bring in clarity when there is a conflict between double tax avoidance rule and domestic law. It is important to enact DTC as soon as possible to bring in clarity to the statute and enhance revenue productivity. From the viewpoint of business sentiments, clarity in the tax statute is essential to minimise litigations.

111. A number of measures will be needed and a lot of consensus building between the Centre and States and among the States *inter se* will have to be accomplished before a full-fledged GST is implemented. The most important enabling first step is the amendment of the Constitution to empower the central government to levy taxes beyond the manufacturing stage and the States to levy taxes on services. Although it has been decided not to place the tax in any of the three lists of the seventh Schedule, but to have a separate Article specifying concurrent power to levy the tax to both the Centre and States with no power for one level of government to override the decision of the other, the details of the amendment will have to be worked out. Although the Constitution Amendment Bill has been introduced in the *Lok Sabha*, there are some elements that are not acceptable to the States. In particular, the provision in the Bill for setting up a GST dispute settlement authority for resolving disputes between the various GST levying authorities is strongly resisted by the States who argue in favour of trust and mutual interaction for conflict resolution rather than having a settlement authority.

112. Apart from the Constitutional amendment, there are a number of important issues on which the States and the Centre will have to agree. These include:

a. **Exemption threshold**: The states are in favour of the centre continuing to have a high threshold for exemption Central GST (CGST) mainly due to the potential difficulties and higher rate of tax that a small trader/manufacturer would face in dealing with two tax administrations.

b. **Rates of tax**: Although it is agreed by the States that there will be two rates of tax on goods and one rate on services, the actual rate of tax to be levied by the centre as well as States are still to be decided. In fact, some states are actually in favour of specifying the floor rates to provide flexibility to them.

c. **Place of supply rules for inter-state services**: There are a number of services transactions of which span across multiple states and therefore, it is important to have clearly defined rules for determining the right to tax and allocation of revenues from the transactions in such services. While some general principles have been discussed, clearly defined and published rules are yet to be put in place.

113. Other major issues requiring discussion and resolution relates to the administration of GST. The presently agreed proposal to have two separate administrations for the purposes of CGST and State GST (SGST) would create high administrative and compliance costs. The proposal of the States that the Union government should retain a high threshold for taxation of goods to minimise the perceived compliance costs cannot be a long term solution. It is therefore, important to initiate measures at coordination in tax administration. This implies, first, it is necessary to ensure uniformity in forms and procedures among the States and harmonise them with that of the centre. The second issue relates to the IT system. Assigning the task of incubating the technology and system for GST with NSDL has been an important development and this will help in coordinated use of the information system between the income tax and GST. Further, both the Union government and the states have agreed to setting up of a common GST portal for registration, filing of returns and payment of taxes. However, there is as yet no consensus on the form of the return to be adopted. Further, for the implementation of GST on inter-state supplies, the mechanism for tracking of such supplies on a timely basis is yet to be developed and this is necessary to phase out CST which is an important step in the implementation of GST.

114. On the service tax, the two papers released for public discussion this year provides the direction for reforms and if implemented will not only broaden the base of consumption tax in the country but also will infuse a lot of confidence to the States by demonstrating the revenue and administrative gains from adopting the negative list approach. Rather than continuing with the positive list of more than 100 services, the new approach seeks to tax all services with a small negative list of services which are not taxable. This reform is overdue and hopefully will be undertaken in the forthcoming budget. This could expand the tax base significantly, reduce clamour for non-inclusion, minimise litigations and facilitate the introduction of goods and services tax (GST). The government has already put out two discussion papers in public domain and moving ahead on this front is both desirable and feasible. If the negative list is kept to the minimum and with input tax credit generalised for both goods and services, this measure will, in effect, bring in a

goods and services tax at the manufacturing stage even without constitutional amendment. In fact, it would also be useful to rationalize the excise duties by converting the specific duties into ad valorem and unifying the rates by moving up the items taxed at lower rates. Surely, items like cement could be taxed at ad valorem rate and there is no need to tax processed food items like breakfast cereals at a lower rate. In addition, the Finance Minister will do well to revisit the tax on tobacco products which by international standards is low. Besides revenue, increasing taxes on tobacco products can save many lives.

115. Other measures to augment revenues include phasing out the tax preferences and reducing the tax arrears. The volume of tax-expenditures is large and so is the amount held up in tax disputes.

116. The fiscal situation in the country is a cause of serious concern. Since 2007/08, there has been a steady deterioration in the situation and at present, it is not very different from the precarious position that existed in 2001/02. It is also important to note that the problem is not structural and needs to be remedied without much loss of time. The government will have to follow the roadmap charted out by successive Finance Commissions and that calls for a clear enunciation of the strategy and effective implementation to enhance tax revenues, contain subsidies and transfers and increase social and physical infrastructure spending. At the state level, reforming the power sector to prevent the losses is a priority to prevent the gains from fiscal consolidation achieved so far from being frittered away. These require decisive and tough measures and the government must initiate them in the forthcoming Budget itself to bring the economy back on the high growth path.