Review of the Economy 2007/08

Economic Advisory Council to the Prime Minister

New Delhi

January 2008

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REVIEW OF THE ECONOMY 2007-08

I – Overall Economic Growth in 2007/08 – A Review

1 With nine months of the fiscal year 2007/08 behind us, it is a good time to review our Economic Outlook 2007-08 released in July 2007 in the light of availaibility of more upto date data and come to some clearer conclusions about the economy's performance this year and offer some inferences about the likely situation in the coming fiscal year, that is, 2008/09.

Developments in Q1 and Q2 of 2007/08

2. The economy grew by 9.3% in the first quarter (April to June) and by 8.9% in the second quarter (July to September) of 2007/08. The average rate of growth in the first half of the fiscal year was 9.1%, compared to 9.9% during the comparable period of the previous fiscal year. For the record, the economy had grown at the rate of 9.6% and 10.2% in the first and second quarters of 2006/07. This may be seen to suggest that the process of economic acceleration that has characterised the economy over the past five years has lost some of its pace, after having peaked in the first part of calendar 2006.

3. After having crossed 10% GDP growth in the second quarter of 2006/07, the economy appears to be stabilising at a rate above 8.5% and close to 9.0%. The non-farm sector after having accelerated from 7–8% in 2002/03 to 11.6% in the second quarter of 2006/07 appears likely to stabilise in the range between 10% and 10.5%. It may be noted that over the past 20 quarters (with steadily accelerating rates of expansion) the average rate of growth of GDP has been 8.0% and that of the non-farm sector 9.6%. Also, the growth rate in the farm sector has shown a distinct improvement moving up to 3.5% in each of the previous three quarters from the average level of 2.4% for the past 20 quarters. We expect farm sector GDP to grow at around 3.5% in 2007-08. Combined with non-farm sector growth of 10.0 to 10.5%, the overall rate of growth is expected to be around 8.9%.

4. *Table-1* gives the overall rates of GDP growth for the past several quarters, along with disaggregated growth rates for the farm, industry and services sectors.

Table 1: Quarterly Rates of Growth for overall GDP along with that for the Farm, Industrial and Service Sectors

Fiscal Year	Quarter	Overall GDP	Agriculture & allied activities	Non-Farm GDP			
				Aggregate Non-Farm	Industry		Services
					Total Industry	Mfg.	
2002 / 03	Q-1	5.2%	–0.6%	7.1%	5.3%	4.3%	8.1%
	Q-2	5.8%	–4.0%	8.1%	7.3%	7.0%	8.6%
	Q-3	1.6%	–12.5%	7.3%	6.9%	7.1%	7.5%
	Q-4	3.8%	–8.0%	7.3%	6.8%	7.6%	7.6%
2003 / 04	Q-1	5.5%	0.1%	7.1%	5.8%	6.1%	7.8%
	Q-2	8.8%	7.2%	9.2%	6.3%	6.9%	10.7%
	Q-3	11.0%	18.2%	8.6%	6.3%	7.0%	9.9%
	Q-4	8.5%	8.2%	8.5%	8.3%	7.9%	8.6%
2004 / 05	Q-1	8.1%	1.1%	10.1%	8.2%	6.7%	11.1%
	Q-2	6.9%	–2.1%	8.9%	8.4%	8.4%	9.2%
	Q-3	5.5%	–6.5%	9.9%	9.8%	9.2%	9.9%
	Q-4	8.9%	0.4%	11.2%	8.6%	8.2%	12.4%
2005 / 06	Q-1	8.4%	4.0%	9.6%	10.5%	10.7%	9.2%
	Q-2	8.0%	4.0%	8.8%	7.7%	8.1%	9.3%
	Q-3	9.3%	8.7%	9.5%	9.6%	8.2%	9.5%
	Q-4	10.0%	6.2%	10.9%	10.4%	9.4%	11.1%
2006 / 07	Q-1	9.6%	2.8%	11.3%	10.6%	12.3%	11.7%
	Q-2	10.2%	2.9%	11.6%	11.3%	12.7%	11.8%
	Q-3	8.7%	1.6%	10.9%	10.6%	11.8%	11.0%
	Q-4	9.1%	3.8%	10.3%	11.2%	12.4%	9.9%
2007 / 08	Q-1	9.3%	3.8%	10.6%	10.6%	11.9%	10.6%
	Q-2	8.9%	3.6%	9.8%	9.1%	8.6%	10.2%

5. The level of overall GDP growth is greatly influenced by weather-induced fluctuations in farm output. Non-farm GDP on the other hand more accurately reflects the acceleration that has been underway in the Indian economy, which suggests that after having touched a peak in the first half of 2006/07, growth appears to be stabilizing close to the 10% level. There are constraints to output expansion – be they industry-specific capacity or power, transportation or other infrastructural services. However, it is also a fact that considerable investment is

underway to augment capacity in both the manufacturing and infrastructure sectors. Therefore, it may not be inappropriate to infer that a further round of acceleration in industrial and related services sector output is probable further down the road.

II – Global Economic Developments in 2007/08 and Outlook

6. At the time of the Outlook 2007-08 the global environment looked benign. The situation has changed dramatically since in wake of the sub prime housing mortgage crisis in the United States. There are roughly two streams of opinion about what is happening in the economies of the developed world, in particular that of the USA, and its implications for global growth. There is a general consensus that the US economy is likely to slow in 2008, but there are differences on the expected intensity of the slowdown. It must also be mentioned that the idea that after several years of growing at rates much higher than the long-term trend, the US economy was due for a year or two of slower growth pre-dates the sub-prime crisis and continues to roil financial markets.

Sub-Prime Fall-out and Fear of Recessionary Conditions

7. Since August 2007, the world's financial markets and US and European lenders have been taking a beating as the sub-prime mortgage asset problems unravelled. This added to the uncertainty of downside risks for 2008. The difficulties of banks and other intermediaries, as also the increase in risk pricing, suggests that credit delivery is likely to slow down and would in any case occur at elevated prices resulting in a slowdown in US consumer spending. The decline in home prices (through the wealth effect) is expected to further add to the compression of consumer expenditure since homeowners will no longer be able to borrow against rising house prices. There are fewer reasons to expect that Europe would follow suit, except for the fact that many European banks seem to have surprisingly large exposures to US sub-prime assets. Barring the UK where many deposit and non-deposit taking financial companies are in serious difficulty, there is no evidence to suggest that there is a home-grown problem in either the mortgage or consumer lending markets in Europe.

8. Thus, while the extreme view that the US economy is actually headed for a recession in 2008, defined as two successive quarters of negative growth, does not have too many takers, there is nevertheless a large body of opinion which argues that there is a strong likelihood of "near recessionary" conditions emerging in the US economy in 2008 wherein growth would be close to, or even below 1%, rather than at the recent trend of 3%. In recent days the warnings about a prospective recession in the USA have been getting more vocal.

9. The alternate view is that while growth in the US may slip a bit, the slippage would be small. This argument derives from the fact that the US economy has recorded strong growth (2.8% year-on-year) even as late as the third quarter of 2007. Anecdotal reports on the Christmas shopping season do not suggest a slowdown in spending either. In fact, except for the home building sector, all other sectors seem to be doing rather well, with GDP growth excluding the problem-stricken housing sector still growing at about 2.0% in the third quarter of 2007. Indeed, the US economy grew more strongly in the third quarter of 2007, than it had in the first and the second. This conclusion is also supported by the employment figures. Unemployment in November 2007 was reported to be 4.8% which is more or less unchanged from the beginning of the year and is low by historical standards. The data on non-farm employment creation has also continued to be healthy through 2007 including in October and November. However, in December 2007 the unemployment number rose to 5.0% and new non-farm job creation was at a low level.

10. The Euro-zone has been experiencing a revival of strong growth since the beginning of 2006. In the third quarter of 2007 the region grew by 2.8%. None of the major economies of the region – Germany, France, Italy, Netherlands and Spain – showed signs of any weakness. Japan expanded at a brisk pace of 2.1% right up to the third quarter of 2007. However in December 2007 official sources lowered the (quarter-on-quarter) growth estimate for the July-September quarter from 2.6% to 1.5% and then proceeded to significantly reduce growth projections for the current fiscal year ending March 2008. Expected growth in the next fiscal year has however been maintained at 2.0%.

11. In its *World Economic Outlook* of October 2007, the International Monetary Fund (IMF) has slightly reduced its earlier estimate of US economic growth for 2007 to 1.9%, and drastically reduced its 2008 estimate to 1.9% from 2.8% earlier. Growth in the Euro area has been reduced by a smaller margin to 2.1% for 2008 while growth in Japan has been lowered to 1.7% in 2008. The IMF expects a relatively small reduction in growth of world output in 2008 to 4.8%, slightly less than that likely to be achieved in 2007, as a result of the altered role of developing economies in becoming “the major engine of global growth”

12. Taking on board the two opposing views, and considering that the IMF view may have been somewhat overtaken by adverse economic developments, including the big rise in oil prices that followed, on balance, we believe that the greatest likelihood is of a situation that is akin to what the IMF had suggested in October, but with a bias towards greater economic weakness.

Outlook for Emerging Economies

13. The slower growth in the developed world is likely to impact emerging economies by reducing demand for their exports in rich country markets, and that in turn would affect the level of economic activity in the emerging world. However, the extent of the slowdown is likely to be mild. An additional possible factor in the expected 'mild' impact of the slowdown in the developed world is the intra trade amongst the emerging markets. Further, there is a large domestic component of demand in the major emerging economies which would offset the effect of any possible contraction in export markets.

14. The IMF sees major downside risks in 2008 as emerging from "financial market strains (that) could continue and trigger a more pronounced global slowdown. Thus, the immediate task for policymakers is to restore more normal financial market conditions and safeguard the continued expansion of activity. Additional risks … include potential inflation pressures, volatile oil markets, the impact on emerging markets of strong capital inflows, and continued large global imbalances."

15. The strains on the financial market are self-evident, and the limited ability of home-country regulators to resolve the problem is also palpable. Delinquencies and home repossessions continue to rise in the US, and many leading American and European banks have announced large write-downs as well as unconventional recapitalisation from sovereign funds in Singapore, the Arab Emirates and China.

16. The big crunch in credit of all kinds that was so feared has not come to pass, as is evident from expansion in monetary and banking data available for US and Western Europe, although the interbank market continues to be stressed Undoubtedly, the exceptional refinancing facilities (through the extended repo window) offered by the European Central Bank, the US Federal Reserve, the Bank of Japan and the Bank of England have helped in stabilising financial intermediaries by infusing their assets with the necessary liquidity. The risk of a financial meltdown involving a freezing of markets for banking assets appears largely to have passed, replaced by the individual woes of banks as they seek to repair the damage to their balance sheets through bouts of capital infusion.

Inflation – Energy & Food

17. In this global scenario, inflation poses the biggest challenge for 2008, together with managing the fallout of continued large capital flows into emerging

economies. The demand for those commodities – crude oil, industrial raw materials, grain and other food – which have been stoking inflation numbers during the past years is likely to persist; nonetheless it will, at best grow at a rate smaller than in the past few years. In all these cases, the reason for price rise has been driven by supply constraints and in the absence of a significant decline in demand it is unlikely that there will be any respite on the price front.

18. Crude oil prices are likely to stay firm. However, the main lesson of the past months has been that the world can live with $80 to $90 per barrel. Cartelized oil producers are thus likely to be emboldened to use production quotas, if necessary, to keep oil prices close to their present highs, and higher still, if market conditions permit. The impact of crude oil at close to $100 per barrel through most of 2008 may have a dampening impact on economic activity, though it would add to the complexity of managing a larger inflationary burden for the rest of the world.

19. Over the past several years, adverse weather related factors and diversion of land to non-food use has caused world wheat output levels to fall since the late 1990s. In fact, world wheat output fell more or less continuously after 1998/99 to its recent lowest level in 2003/04. In the meanwhile, consumption continued to grow steadily causing world wheat stocks to fall by 76 million tonnes, or 37%, during this period. Production recovered in the past three years (including 2007/08) but not sufficiently to catch up with consumption, leading to further erosion of stocks by an estimated 22 million tonnes or 17%. Not surprisingly, wheat prices have soared. International wheat prices had begun to inch upwards in August/September 2005. In the two-year period between November 2005 and 2007 wheat prices have nearly doubled. The problem has been rendered more complex by the rise of bio-fuels and diversion of both land and production to meet these demands – a development that has a longer-term bearing on grain prices. In December, wheat prices for March 2008 delivery in US markets rose by a further 10%.

20. Though more acreage is reportedly being brought under wheat in response to higher prices, it is unlikely that the augmented output will soften wheat prices by much in 2008/09 – though over the medium-term that is a distinct possibility. It is thus likely that we will continue to see high global wheat prices – and for a range of other agricultural commodities too – through 2008.

III – India: The Growth Outlook

21. From the discussion in the previous section it would appear that some slowdown in the pace of expansion of the US economy is likely and this may lead to slower growth in developing economies as a result of lower rate of export expansion. This is however likely to be offset by continued growth in domestic markets and the relatively mild nature of the slowdown. The Indian economy is much less dependent on the external markets than the Chinese economy, for example. Thus, while some export demand compression is likely to put an additional burden on our exporters of goods and services, it is unlikely to be large enough to significantly depress growth. However, the flip side to this is that the pressure on the prices of oil, food and other raw materials is likely to continue, making inflation management in 2008/09 quite challenging.

Growth Estimate for 2007/08

22. It is our assessment that the rate of growth of GDP in 2007/08 would be 8.9%, marginally lower than our previous estimate in July 2007. The main difference stems from lower than expected expansion in manufacturing output and lower growth in the output of energy utilities, which has been partially offset by better than expected expansion in the farm sector. The estimated rate of expansion by broad industry of origin for 2007/08 is given in Table 2.

23. The ***Outlook*** had stated that the primary downside risk to our economic performance in 2007-08 derived from uncertainties on account of the southwest monsoons. As things turned out, the monsoons were good and agricultural growth is better than what was anticipated in the ***Outlook.*** The current estimates are based on a reasonably good *rabi* crop and an absence of serious weather anomalies. Industrial growth on the other hand, which was predicated on a benign external environment, is likely to be slower than what was assumed in the ***Outlook.*** It is still possible that output growth in manufacturing may show a stronger recovery than what is assumed by us. However, on the whole we believe that in the final analysis the rate of overall expansion of the economy would be close to 8.9% for the fiscal year ending March 2008, with per capita income rising by 7.2% in real terms – the third successive year of above 7% real increase in per capita GDP. At market exchange rates the Indian economy would have a size of nearly US$ 1.2 trillion which translates into per capita incomes of over US$ 1,000.

Table 2: Estimated Growth of the Indian Economy in 2007/08
Sectoral Composition and Investment and Savings Rates

Unit: Percentage

	2003/04	2004/05	2005/06	2006/07	2007/08 outlook	2007/08 review
Agriculture & Allied Activities	10.0	0.0	6.0	2.7	2.5	3.6
Mining & quarrying	3.1	7.5	3.6	5.1	5.5	5.5
Manufacturing	6.6	8.7	9.1	12.3	11.3	9.8
Electricity, gas & water supply	4.8	7.5	5.3	7.4	8.0	7.1
Construction	12.0	14.1	14.2	10.7	11.3	11.4
Trade, hotels, transport, communications	12.1	10.9	10.4	13.0	12.5	11.4
Finance, insurance, real estate & business services	5.6	8.7	10.9	10.6	9.5	10.6
Community, social & personal services	5.4	7.9	7.7	7.8	7.3	7.8
GDP at factor cost and constant prices	**8.5**	**7.5**	**9.0**	**9.4**	**9.0**	**8.9**
Industrial sector	7.4	9.8	9.6	10.9	10.6	9.7
Services sector	8.5	9.6	9.8	11.0	10.4	10.3
Non-Farm GDP	8.1	9.6	9.7	11.0	10.4	10.1
Per Capita GDP	6.7	5.8	7.3	7.7	7.3	7.2
Memo Items						
Investment Rate	28.0	31.5	33.8	35.1	36.3	36.3
Savings Rate	29.7	31.1	32.4	34.7†	35.7	35.6
Average* WPI Inflation	5.5	6.5	4.4	5.4		4.5
Current Account Balance as ratio to GDP**	(+) 2.3	(–) 0.4	(–) 1.1	(–) 1.1	(-) 1.5	(–) 1.3

Note: * Average of weeks

** (+) sign indicates a current account surplus, while (–) indicates a deficit

† Obtained by reducing private final and government consumption expenditure from gross national disposable income, both estimates as provided in CSO Press Note of 31 May 2007.

Investment and Savings

24. The prime mover in achieving high growth rates is the increasing share of investment in gross domestic expenditure. Gross fixed investment as a proportion

of GDP has risen progressively from 24.8% in 2003/04 to 29.5% in 2006/07 by nearly equal increments in each year. We had estimated that in 2007/08 it would increase further to 30.5%. Likewise, the aggregate gross investment rate has increased from 28.0% in 2003/04 to 35.1% in 2006/07, also in more or less equal increments in each intervening year. We had estimated that in 2007/08 the gross investment rate would rise to 36.3%.

25. Using the new CSO tables for quarterly GDP by expenditure classes, it is seen that the ratios of gross fixed investment and total gross investment to GDP rose in each case by about 2 percentage points in the first two quarters of 2007/08 relative to comparable periods of 2006/07. The annual rate of increase in gross fixed investment at constant prices also appears to be stable at between 15 to 16%. The quarterly ratios of gross investment, gross fixed capital formation to GDP at current prices and the real growth rate in gross investment for the recent period are given below (Table 3).

Table 3: Quarterly Rates of Investment and Real Increase in Capital Formation

Fiscal Year	Quarter	Gross Fixed Investment Rate	Total Gross Investment Rate	Real growth in Gross Fixed Investment
2005-06	Q1	27.5%	31.7%	
	Q2	29.2%	33.5%	
	Q3	26.8%	30.7%	
	Q4	28.7%	32.8%	
2006-07	Q1	29.3%	33.9%	15.8%
	Q2	29.9%	34.5%	13.3%
	Q3	28.6%	32.7%	15.5%
	Q4	30.2%	34.5%	14.1%
2007-08	Q1	31.3%	35.9%	15.9%
	Q2	32.3%	37.1%	15.2%

26. The gross financial savings of households were 13.9% of GDP in both 2003/04 and 2004/05. This rose significantly to 16.7% in 2005/06 and is provisionally estimated at 18.4% in 2006/07. However, at the same time the borrowings of households from the banking sector for mortgages and consumer loans have resulted in an increase in their liabilities to almost the same extent.

Hence, the net financial savings of households have barely risen from 11.3% in 2003/04 to 11.6% of GDP in both 2005/06 and 2006/07. This means that the expansion of investment has been financed mainly from other domestic sources – principally a rise in retained private corporate earnings from 4.7% in 2003/04 to 8.1% in 2005/06. The estimates for 2006/07 are likely to be released shortly, but would probably be in the region of 9% of GDP.

27. Reduction in the negative savings of government administration (that is, the excess of current consumption expenditure over the current revenues) has also been a significant contributor to financing investment. The magnitude of government dis-saving reached a low point in 2001/02 at 6.2% of GDP. Sustained efforts at both the Centre and the States towards prudent fiscal management have seen this ratio fall to 3.6% in 2003/04 and to 2.5% in 2005/06. In 2006/07, it is estimated to be close to 2.0% of GDP. In essence this has meant that government through better management of its finances was able to release over 4 percentage points of GDP towards the financing of investment, which accounted for one-third of the increase of 12 percentage points in the aggregate investment rate between 2001/02 and 2006/07.

28. In the aggregate, rising levels of investment have been financed from domestic sources – through a combination of higher retained corporate earnings and improved fiscal balances of government. There has been little absorption of net foreign savings which is, by definition, equivalent to the Current Account Deficit (CAD). Till 2003/04, we had run a sizable current account surplus which has since 2004/05 turned into a deficit. The magnitude of the deficit has however remained close to or below 1% of GDP. Thus, the capital inflows which were in excess of the CAD have in an accounting sense, become part of the foreign currency reserves of the central bank and "re-exported" overseas.

29. However, individual Indian companies have greatly benefited from foreign investment in their stocks and through overseas listing. As a result, Indian companies that have been in the forefront of the global growth process over the past decade have had access to much greater equity investment and hence resources for risk-taking and growth than what the accounting equivalence between CAD and absorption of net foreign savings may suggest. The interaction between global investors and Indian companies has directly benefited the latter, by improving their ability to tap into global markets and internalise best practices. It has also enabled the acquisition of businesses by Indian companies overseas, possibly the most important instrument for accessing world class technology and research & development, besides gaining a foothold in foreign markets and distribution networks.

Farm Sector

30. Foodgrain output during the *kharif* season for 2007/08 has been provisionally estimated at 112.2 million tonnes (mt), which is 1.5% higher than what it was in 2006/07, but lower than the all-time high of 117.0 mt recorded in 2003/04. The output levels of principal *kharif* crops in 2007/08 and 2006/07 are given below (Table 4). It is not uncommon for crop output levels to be revised, generally upwards, over the course of the year and hence for the purpose of comparison, the level of output in 2006/07 as per the *First Advance Estimate* has also been reproduced. If in fact crop output is revised upward akin to last year, how much the degree of improvement will be in evidence this year is indicated in the last column in the second part of Table 4.

Table 4: Output Level of Principal *Kharif* Crops and Rate of Growth

	Final Estimates				First Advance Estimate	
	2003/04	**2004/05**	**2005/06**	**2006/07**	**2006/07**	**2007/08**
	Absolute Levels of Output in million tonnes					
Rice	78.6	72.2	78.3	80.1	75.7	80.0
Coarse cereals	32.2	26.4	26.7	25.7	24.5	26.6
Pulses	6.2	4.7	4.9	4.7	5.0	5.5
Foodgrain	**117.0**	**103.3**	**109.9**	**110.5**	**105.2**	**112.1**
Oilseed	16.7	14.1	16.8	13.9	13.2	16.1
Cotton (million bales)	13.7	16.4	18.5	22.7	18.1	22.9
Sugarcane	233.9	237.1	281.2	345.3	283.4	345.6

Growth Rate

	2005/06	**2006/07**	**2007/08**	**2007/08 (2)**
	With respect to Final Estimate of the previous year			**With respect to the First Advance Estimate of the previous year**
Rice	8.4%	2.4%	–0.1%	5.6%
Coarse cereals	1.4%	–4.0%	3.5%	8.4%
Pulses	3.2%	–2.7%	16.2%	10.9%
Foodgrain	**6.3%**	**0.6%**	**1.5%**	**6.7%**
Oilseed	18.5%	–16.9%	15.7%	21.8%
Cotton	12.6%	22.7%	1.1%	26.5%
Sugarcane	18.6%	22.8%	0.1%	22.0%

31. There were reports in December 2007 that the progress of sowing for the *rabi* season has been slow and that the acreage under wheat had fallen, despite the substantial increase in the Minimum Support Price (MSP) for wheat announced months before the season commenced. It has been reported that the likely acreage under wheat this year will be about 27.5 million hectares (m HA), which is 0.5 m HA (1.8%) lower than what was sown last year. It appears that because of adverse moisture conditions about 0.7 m HA *less* will come under wheat this year in central India, which will be partly offset by an additional 0.2 m HA being sown with wheat in Punjab, Haryana, Gujarat and Bihar. Overall it appears that total wheat output in the 2007/08 *rabi* season will come close to the target of 75.5 mt which is 0.8% higher than the output last year. While estimates of production of *rabi* food grains as a whole are not yet available, current indications are that this might be slightly higher than last year's level of 105.6 MT. This is subject to normal weather conditions prevailing during the season.

32. The output of *kharif* oilseeds was significantly higher than in the previous year primarily on account of a strong recovery in the production of groundnut, which increased by 58% from 3.3 mt to an estimated 5.2 mt in 2007. The output of soybeans, which is the second largest *kharif* oilseed, is estimated to have increased by 2% to 9.0 mt this year. Overall, oilseed production in the *kharif* season is estimated to have risen by nearly 16%. There are reports to suggest that sowing of the largest *rabi* oilseed, namely mustard (and rapeseed), may have been significantly lower than last year, on account of relatively better economic prospects from growing wheat and trade estimates put the acreage under mustard this year at up to a fifth lower than last year. However, this is not easy to reconcile with the information that wheat acreage has fallen in central India, which is an important growing area for mustard and rapeseed.

33. The output of raw cotton in 2007/08 as estimated by the Ministry of Agriculture is 22.9 million bales (of 170 kg) indicating 1% increase over output levels last year. However, estimates of the *Cotton Advisory Board,* which are considered to be more accurate by trade and industry, had placed this year's output at nearly 31 million bales at the beginning of the season, an increase of 9% over last year. More recently, trade sources have reported that due to flood related and other losses, output may be lower than 30 million bales. The increase in output of cotton is attributed to a combination of expansion of BT cotton, acreage increase of 8% and extension of irrigation facilities in the Gujarat region. Improvement of the domestic supply position will help stabilise prices and make

available some raw cotton for export which is estimated to be 7 million bales this year.

34. 2006/07 saw an all-time record of 345 mt of sugarcane and 28.4 mt of sugar production. This increased the stocks of sugar with mills to record levels, brought about a significant decline in domestic market prices of sugar and raised cane payment dues in many regions of the country. Given the multi-year character of sugarcane cultivation, corrections in acreage take at least a couple of years, if not more. It is generally expected that there may not be any decline in output - indeed there may be some increase - in 2007/08, given the amount of fresh acreage planted in the previous season. Sugar output may consequently be around 32 mt, i.e. 4% higher than last year. However, in part due to weather-related problems in Maharashtra, and the late start of the crushing season in Uttar Pradesh due to disputes over the recently notified State Advised Price (SAP), it is now believed that output of mill sugar will be around 30 mt. The expectation is that there will be a sizeable decline in sugarcane acreage as well as sugar output in the next crop year, i.e. 2008/09, since the current weak economics of the business is likely to persist for a while.

35. Production of fruits and vegetables has risen impressively by 5% to 25%, depending upon the item, and this seems to have become a trend over the past several years. India, which is the largest producer of diary milk in the world, crossed 100 mt of output in 2006, and in the current year, the output is expected to rise by 3%. The proportion of milk distributed by the organised sector is also expected to increase. Egg production is expected to increase by 4 to 5% to 55 billion eggs, while broiler meat production is believed to rise by 10% to 2.2 mt in 2007. Increasingly, horticulture and animal husbandry are gaining as a proportion of farm income thus more than making up for the relative stagnation of cereal production. Given the generally small size of our holdings and the available labour with farm families, this is a beneficial trend.

36. The overall prospects in 2007/08 support our assessment of 3.6% GDP growth in the farm sector in 2007/08.

Power Sector

37. Over the course of the Tenth Five Year Plan (2002–07) accretion to power capacity had fallen well behind the targets set in the Plan, as indeed had been the case in previous plan periods as well. However, since economic growth was also lower, the delay in commissioning power capacity may have exacted a lesser cost

on potential growth. With economic growth taking off in the Tenth Plan period, the constraints imposed by project delays in the power sector impose a more direct and severe constraint on the ability of the economy to sustain high rates of growth.

38. In 2007/08 the anticipated increase in power generation capacity was 12,039 MW – much of which is a spill-over from delays in previous years. Till the end of December 2007, 6375 MW was actually completed. Optimistic estimates suggest that in the balance part of the year a further 4429 MW would be commissioned, bringing the annual total to 10,804 MW, which would be about 10% short of what was planned.

39. It may be remembered that over the past several years considerable direct intervention and administrative pressure has been brought to bear on accelerating power capacity creation. Thus, there are two ways to look at what has happened in 2007/08. One is to bemoan the extent of the shortfall and the other is to note that the annual increment of about 10,000 MW is more than double that achieved in previous years. Another 10,000 MW of generation capacity is expected to be added in 2008-09. The marked step up in addition to installed capacity was not enough to make a significant dent on power supply deficits on account of increasing demand. At the all-India level, the power supply deficit for the period April–Nov. 2007/08 was 7.9% (it was 8.4% during the same period last year); the deficit was highest in the western and northern regions of the country at 13.2% and 8.0% respectively (corresponding to 12.7% and 11.4% in the same period last year).

Industrial Output

40. During the period April–Oct. 2007/08, the cumulative expansion of industrial output was 9.7%, lower than the 10.2% registered in the comparable period of the previous year. Manufacturing output expanded by 10.4% during April–Oct. 2007/08, which was also lower than the 11.2% recorded in the comparable period last year. The rate of expansion of electricity generation stayed at the same level (7.1 to 7.2%) in the April-Oct. period of both the current fiscal and the previous year. Mining output in April–Oct. 2007/08 grew a little bit faster (4.8%) than it had (3.4%) in the comparable period of 2006/07. Thus, the principal reason for lower rates of industrial expansion is the slower rate of growth in manufacturing output.

41. The lower rate of manufacturing output growth in 2007/08 has become pronounced since June 2007. The main contributory factor is the drop in the rate

of expansion in consumer durable output, unsupported by a matching offset from expansion in other product categories. The output of durable consumer goods slipped from high double-digit numbers to low single digit ones in the third quarter (Oct–Dec) of 2006/07. This proceeded in an uninterrupted fashion till May 2007 when output began to decline even in absolute terms, *albeit* by a small percentage. Provisional estimates show a big bounce back to 9.3% growth in October 2007, but there is reason to see this as a one-off aberration caused by the unusually low level of output in October 2006. Non-durable consumer output growth has also weakened, but not as sharply as that for durables. A considerable part of the decline in the output of non-durable consumer goods derives from lower export volumes of textiles.

42. The lower level of output growth in consumer durables can be attributed to tighter loan norms and interest rates that emerged as the joint product of monetary policy and banks' own credit experience with several categories of consumer loans. As a result, borrowing possibly became harder to come by, and certainly more costly. This may have blunted leveraged consumer demand and this is seen reflected in lower output growth in consumer durables.

43. Output growth for capital goods continues to remain strong, while that of basic and intermediate goods has been somewhat erratic in the past months, but on average remain reasonably high. This may be seen in Table 5 which provides a break-up of industrial growth for recent years, recent quarters and for the preceding months of the current fiscal year.

44. Cement production in the April-Nov period of 2007/08 has risen by 7.7%, reflecting an increase of nearly 8 mt. Capacity additions have been slower than expected but have totalled nearly 6.5 mt in the first eight months of 2007/08 suggesting a level of capacity utilization that is slightly higher than in the comparable period of last year.

45. Output of passenger cars increased by 15.0% in the period April–Nov 2007/08 over the comparable period last year. This was close to the 17.6% expansion registered in output of cars in the same period last year relative to 2005/06. In *Light Commercial Vehicles*, output growth in the April–Nov 2007/08 period is 13.6%, a significant drop from the 30.6% growth last year. Output of *Medium & Heavy Commercial Vehicles* has fallen in absolute terms with production volumes down by 2.9% compared to a growth of 32.4% in the same period last year. Likewise output of two-wheelers has declined by 6.2%, compared to a

Table 5: Industrial & Manufacturing Output Growth – Recent Period

Unit: percent

		Sectoral Classification				Use-Based Classification					
		General	*Manufacturing*	*Electricity*	*Mining*	*Basic*	*Capital*	*Intermediate*	*Cons Goods*	*Durables*	*Non-durables*
weights		100.0	79.4	10.2	10.5	35.6	9.3	26.5	28.7	5.4	23.3
2003/04		5.2	7.4	5.1	7.0	5.5	13.6	6.4	7.0	11.6	5.8
2004/05		4.4	9.2	5.2	8.4	5.5	13.9	6.0	11.7	14.3	10.8
2005/06		1.0	9.1	5.2	8.2	6.7	15.7	2.6	12.1	15.3	10.9
2006/07		5.4	12.5	7.2	11.6	10.3	18.2	12.0	10.2	9.2	10.4
Apr-Oct 06/07		3.4	11.2	7.1	10.3	9.1	15.7	10.2	9.3	12.7	8.1
Apr-Oct 07/08		4.8	10.4	7.2	9.7	8.9	20.1	10.5	6.4	–1.3	9.3
2005/06	Q1	10.4	11.3	7.7	4.3	7.8	13.8	3.6	18.4	16.4	19.2
	Q2	6.5	7.8	2.0	–2.1	4.6	17.1	2.6	9.5	10.8	7.8
	Q3	7.1	8.1	4.8	–0.8	5.8	16.1	1.0	10.3	14.9	9.5
	Q4	8.7	9.6	5.3	2.5	8.5	15.7	3.1	10.9	19.1	8.4
2006/07	Q1	10.5	11.7	5.3	3.6	9.0	21.0	10.8	8.5	14.9	6.4
	Q2	11.8	13.0	8.0	2.6	8.7	14.4	11.0	14.6	15.5	14.2
	Q3	10.8	11.8	9.2	6.9	11.7	20.5	12.1	7.7	3.9	8.3
	Q4	12.5	13.5	7.5	7.7	11.5	17.5	14.1	10.4	3.6	12.8
2007/08	Q1	10.4	11.1	8.3	2.7	9.4	19.1	9.3	9.0	–0.7	12.4
	Q2	8.2	8.8	7.1	7.6	9.3	20.9	10.4	2.0	–5.3	4.8
2007/08	Apr	11.3	12.4	8.7	2.6	8.6	10.9	10.6	14.7	2.4	18.7
	May	10.9	11.3	9.4	3.8	10.3	22.4	8.8	8.7	–0.7	12.1
	Jun	9.0	9.7	6.8	1.5	9.2	23.1	8.6	3.6	–3.6	6.3
	Jul	7.1	8.8	7.5	3.2	8.7	12.3	7.7	7.1	–2.7	10.5
	Aug	10.7	10.5	9.2	15.4	12.8	30.0	13.1	0.2	–5.8	2.6
	Sep	6.8	7.1	4.5	4.9	6.5	20.5	10.4	–0.9	–7.2	1.6
	Oct	11.8	13.3	4.2	3.7	6.2	20.5	14.2	12.5	9.3	13.9

growth of 15.4% in the same period last year. The decline in the output levels of M&HCV and two-wheelers has occurred despite a sharp pick-up in exports as manufacturers have sought to compensate for declines in domestic sales.

46. On balance it would appear that manufacturing output growth for the full year 2007/08 would fall short of 10%, but will still be over 9%.

Service Sector

47. Revenue earning freight traffic of Indian Railways increased by 8.0% in Apr-Oct 2007, that was lower than 9.9% recorded in the corresponding period last year. However, the slower expansion was mostly in the summer months of 2007 and growth rates in the three months since August 2007 were close to or above 10%, suggesting that the pace of expansion for the year as a whole is likely to be close to last year's level of about 9%. Cargo traffic at major ports rose by 13.0% during Apr-Oct 2007/08, almost double the rate in the corresponding period last year, and overall growth for the year is likely to be in excess of last year's 9.5%. Domestic and international traffic at airports increased by 27%, somewhat lower than 36% last year and appears to be set to register a strong expansion in 2007/08, though it is lower than 31% registered last year.

48. GSM cellular connections increased by 67% in the period Apr-Oct 2007/08, a substantive increase over the already large base of 121 million subscribers in March 2007. The total of landline, GSM and WLL cellular connections continued to grow by about 45% on year-on-year basis through the first seven months of 2007/08, with the total subscriber base touching 256 million at the end of October 2007.

49. Financial sector activity has continued to expand, as evidenced by the accretion to bank balance sheets, the premium collected by insurance companies and the sharp increase in the corpus of funds under the management of mutual funds.

IV. External Payments Situation

50. For some years now, the external payments situation has been characterised by a current account deficit (CAD) that is quite small considering what might well have been expected given the pace of growth and investment in the economy. That the CAD is as low as around 1% of the GDP despite record levels of import of crude oil, capital goods, manufacturing intermediates and non-monetary gold, is a testimony to the structural strength of the country's Balance of Payments (BoP). It appears that foreign investors have also reached a similar conclusion and it is their confidence in the economy as a whole, and the BoP in particular, that has laid the foundation of capital account surpluses that are far larger than what is needed to finance the CAD.

51. In the first eight months of April–Nov. 2007/08, India's merchandise exports rose to $98.4 billion, an increase of 22.1% over the comparable period last year. Export growth during the same period last year was 26.0% (over 2005/06). Merchandise imports during April–Nov. 2007/08 increased to $151.0 billion, an increase of 27.0% over that in the corresponding period last year, while import growth in the same period last year was 23.6%. The merchandise trade deficit in the first eight months of 2007/08 aggregated $52.8 billion, 37% higher than what it was during the corresponding period last year.

52. It appears that export expansion is driven more by productivity increases that have partially counteracted the adverse impact of an appreciating rupee and slowdown in developed countries while import growth is driven both by domestic economic growth as well as by the appreciation of the rupee.

Oil and Gold Imports

53. The value of oil imports rose by 10% to $43.3 billion in the first eight months of 2007/08, largely in line with increasing international prices of crude, which increased by 11% during the period April–Nov. 2007 over the corresponding period of the previous year. However, in the balance months of 2007/08, the impact on the oil import bill is likely to be much greater. In 2006/07, world crude prices were much lower during the period December - March, with the Nymex benchmark spot price for sweet crude at $59 per barrel. In contrast, the benchmark Nymex sweet crude has stayed above $80 since September 2007, and over $90 since late October. If world oil prices remain at these levels, the increase in the average price of imported crude is likely to increase by 50% or more in the

remaining months of 2007/08. This will be reflected in fairly substantial increases in the dollar value of oil imports in the period December to March 2007/08.

54. Gold imports totalled $6.7 billion in the first quarter of 2007/08, an increase of 124% over the same period of last year. This is a big jump, notwithstanding the base effect of the sizeable decline in imports in the first quarter of 2006/07. The value of gold imported in the first quarter of 2007/08 was 69% more than in the record first quarter of 2005/06. Up to the end of August 2007, for which detailed trade data is available, the value of gold imports in the current fiscal year aggregated nearly $10 billion, a 116% increase over what was imported in the corresponding period last year. Extrapolating from data on gold imported through major airports, it is estimated that up to the end of November 2007, the total value of gold imports for the current fiscal year has recorded an increase of about 30% in US dollar value.

Other Imports

55. The value of non-oil imports in April–Nov. 2007/08 rose by 35%. While this was partly on account of the large increase in gold imports, the fact remains that the value of non-oil, non-gold imports in this period also rose by 36%, indicative of the strength of import demand generated by the rapid pace of investment and economic expansion.

56. Information on the composition of imports and exports is available up to August 2007, that is, for the first five months of the current fiscal. While total imports increased by 34% during this period, non-oil, non-gold, non-diamond imports rose by 33%. The import of investment goods – machinery and project goods – increased by 30% and comprised over 12% of the value of total merchandise imports. If the definition of investment goods is widened to include ferrous & non-ferrous metals, professional instruments, cement, and computer software in physical form, their share in imports rises to 20%, and the growth over the corresponding period of last year to 35%.

57. If all items that are, or could be, considered as final consumption items (including food and all electronic imports) are aggregated, and unspecified items added to this category, it is seen that this category of goods increased by 34% during April-August 2007, their share in total imports being a little over 14%. The overwhelming bulk of imports into the country thus continue to comprise crude oil, gold, capital, raw materials and intermediate goods for the use of industry.

Table 6: Composition of Imports April–August 2007/08						
	April to August				**Change**	**Share in Imports 2007/08**
	2006/07		**2007/08**			
	US $ Million				**per cent**	
Total Imports	**70,521**		**94,668**		34.2	100.0
Petroleum crude & products	24,412		28,792		17.9	30.4
Gold & Silver	4,635		10,645		129.7	11.2
Foodgrain		235		494	110.5	
o/w Pulses		214		473	121.2	
Edible Oil		894		1,246	39.4	
Other agricultural products		723		808	11.6	
Total Agro-based products		**1,852**		**2,547**	**37.6**	**2.7**
Metalliferrous ores & prod.	2,719		3,623		33.3	
Coal, coke & briquettes	1,741		2,373		36.3	
Total of Minerals excl. Oil	4,646	6,253	34.6	6.6		
Chemicals, resins & products		5,140		6,492	26.3	6.9
Ferrous/non-ferrous metals		3,400		5,167	52.0	5.5
Manufactured fertilizers		896		1,540	71.8	1.6
Pulp, waste paper, newsprint		987		1,153		
Textile intermediates		879		935		
Wood and wood products		394		515		
Non-met. minerals incl. cement		310		392		
Manufacturing Intermediates		12,478		16,713	33.9	17.7
Manufactures of metals		588		822		
Professional instruments		934		1,234		
Machinery & Project Goods		8,874		11,539		
Project goods		747		503		
Investment goods		11,144		14,098	26.5	14.9
Electronic goods		6,454		8,236	27.6	8.7
Medicinal & pharm. mfrs.		463		696	50.4	0.7
Other Commodities		1,801		2,576	43.1	2.7

Source: Department of Commerce, website

Exports

58. In the first five months of 2007/08, the value of exports rose by 19% in US dollar terms and by 6% in Indian rupees. In the period up to November 2007, export growth more-or-less followed the same pattern of growth in US dollars at 22% and 8% in Indian rupees. The rate of growth in the April-Aug period was the same for non-petroleum products (18%) and non-POL, non-gems & jewellery (17%) in US dollar terms, and 5% and 4% respectively in Indian rupees.

59. The impact of the appreciation of the Indian rupee vis-à-vis the US dollar and other major currencies has been a major source of concern. Industry apprehends a decline in India's share in export markets as well as possible adverse consequences on the competitiveness of Indian manufacturing, or at least in some sections of it. At Table 7 we have presented the commodity composition of exports during the first five months of 2007/08 in US dollars. The table indicates *absolute declines* in cotton yarn, fabric & made-ups, apparel, natural silk textiles and handmade carpets. The decline in the value of exports of such items when measured in Indian rupees is obviously larger.

61. It is interesting to note however that several items have bucked the trend, notably engineering goods and man-made textiles and made-ups, which registered smart gains in US dollar terms that translate into sizeable gains even when measured in rupees, namely of 8% and 9% respectively. Gems & jewellery was up by 12% in rupee terms and refined petroleum products by 9%. In the majority of goods, especially those that formed an important component of the resurgence of Indian exports after 1991, there has however been erosion in export value when measured in Indian rupees. Thus, apparel was down by 13%, cotton yarn, fabric & made-ups by 12%, handmade carpets by 18%, and handicrafts by 50%. The rupee export value of leather products fell by 5% and chemicals by 2%. In these businesses, therefore, there was a contraction of export business and to the extent the domestic market could not accommodate diversion of output, a contraction of business in absolute terms as well.

63. While a complete analysis of the exact nature of the impact of rupee appreciation on export volumes and unit realisation will have to await the availability of more comprehensive data, some tentative points may be noted. In a separate exercise, an investigation was made into the level of exports and their unit values for the months of April–May and Sept–October for select export products, including textile items, shipped from certain key ports. The finding was

Table 7: Composition of Exports April–August 2007/08					
	April to August		Change in '07/08		Share in Imports 2007/08
	2006/07	2007/08	In US$	In Rs.	
	US $ Million			per cent	
Total Exports	**50,335**	**59,719**	**18.6**	**6**	**100**
Rice	533	961	80.4	61.2	1.6
Marine Products	588	559	–5.0	–15.2	0.9
Sugar & Molasses	481	510	6.1	–5.2	0.9
Proc. Foods, incl. fruit & vegetables	480	507	5.6	–5.6	0.8
Meat & poultry products	316	436	37.9	23.2	0.7
Oil Meals	298	337	13	1	0.6
Total of agricultural and agro-based products	**3,695**	**4,397**	**19**	**3.3**	**7.4**
Iron Ore	1,284	1,525	18.8	6.1	2.6
Ores and Minerals	2,457	2,785	13.4	1.3	4.7
Leather & leather manufactures	1,228	1,312	6.9	–4.5	2.2
Cotton yarn, fabric and made-ups	1,763	1,736	–1.5	–12.0	2.9
Apparel	3,747	3,633	–3.0	–13.4	6.1
Manmade textiles & made-ups	910	1,111	22.1	9.1	1.9
Natural silk textiles	179	150	–16.1	–25.1	0.3
Carpets – handmade	366	337	–7.9	–17.7	0.6
Textiles and products	**6,823**	**6,845**	**0.3**	**–10.8**	**11.5**
Engineering goods	10,199	12,350	21.1	8.2	20.7
Chemical & related products	7,141	7,814	9.4	–2.3	13.1
Electronic goods	1,152	1,240	7.7	–3.8	2.1
Unclassified products	1,578	3,778	139.3	113.8	6.3
Total manufacturing, excl agro-based & petro-products	**29,680**	**34,637**	**17.7**	**5.1**	**55.8**
Gems & jewellery	6,131	7,667	25.1	11.7	12.8
Refined petroleum products	8,372	10,233	22.2	9.2	17.1

Source: Department of Commerce, website

that in many cases there was a decline *both* in levels (rupees crore) and in unit value (Rs per unit) – which conforms to the broad story of difficulties on the export front. However, it was also found that the unit value of exports had actually risen (all in rupees) in almost as many cases as there were declines in levels. In a few cases, both levels and unit export values had gone up in rupee terms.

64. The explanation underlying these findings seems to lie in a general erosion of export profitability, where more competitive units (which also have higher unit export values) were able to maintain volumes, but the less competitive units experienced significant declines in business volume. Without doubt, export businesses are under considerable stress. There are reasons to believe that most Indian businesses are able to adjust to small changes in relative prices, including the exchange rate of the rupee, through some productivity gains from year-to-year. However, if the magnitude of change in the exchange rate is much in excess of these incremental productivity gains, export businesses become vulnerable. Exports apart, the change in relative world prices attendant on significant changes in the exchange rate equally impinge upon the competitiveness of domestic manufacturing in general and upon its relative profitability in particular.

Balance of Payments

Current Account

65. The current account deficit (CAD) in Q1 (Apr–Jun) of 2007/08 was initially estimated at $4.7 billion. This has been revised upwards slightly to $5.2 billion. In Q2 (July-Sept) 2007/08, the CAD has been provisionally estimated to be $5.5 billion. Thus the combined CAD for the first half of 2007/08 is $10.7 billion, about the same as in the corresponding period last year ($10.3 billion). However, as a proportion of GDP the CAD in the first half of 2007/08 at 1.8% was actually lower than for the same period last year (2.3%). Merchandise trade deficit as a proportion of GDP was also slightly lower in the first half of 2007/08, compared to the same period last year

66. There is an ongoing structural shift in India's total export earnings towards services whose share in total export (goods and services) earnings increased from an average of 18% during 1990-95 to 39% in 2006-07. The key development on the services & remittances side was the big increase in the net surplus on invisible transactions to $31.7 billion in the first half of 2007/08, representing an increase of 35% over the corresponding period last year. The other notable feature is the actual *decline* by 3.5% from $ 15.84 billion to $ 15.39 billion in the net receipts

on account of international trade in software and business process outsourcing (BPO). This is matched by very large increases in net receipts from private transfers (up 69%) though this possibly has more to do with the change in the accounting treatment of the salary and other incomes of employees of Indian companies working in off-shore locations, than to any fundamental change in the direction of either software earnings or remittances *per se*. The net result is that that the current account deficit is now estimated at –1.3% of the GDP, marginally lower than the –1.5% projected in the July 2007 Economic Outlook.

Capital Flows

67. In the first half of 2007/08, the largest items accounting for net capital inflows were portfolio capital ($18.3 billion) and loans ($17.0 billion). Net inflow on account of banking capital was surprisingly high at $5.3 billion, flowing from net inflows of $6.2 billion in Q2. This was not on account of NRI deposits which increased by a mere $0.4 billion in Q2 and registered a small *decline* for the first half as a whole. The other large entry in Q2 is that under "Other capital" at $7.1 billion.

68. Net inflow of foreign direct investment (FDI) in the first half of the year was $3.9 billion, the same as in the first half of 2006/07. Inflows of Private Equity (PE) investments have also been quite large. Since in most cases PE flows constitute less than 10% of the capital of the company being invested they should ideally be reported under Portfolio Capital, and not under FDI. It is not clear what the current accounting practice is.

69. In Q1 of 2007/08, there was a difference of about $2.5 billion between the sum of net purchases by foreign institutional investors (FII) and overseas equity issuance by Indian companies (GDR/ADR). It is possible that represented PE investments, in full or part measure since as per the RBI definition what is reported is the "inflow of funds (net) by Foreign Institutional Investors (FIIs)" and not necessarily investments by FIIs in listed securities and also bearing in mind that many PE investors are either themselves registered or under common ownership of registered FIIs. In the second quarter, the excess of RBI reported inflows by FII and that reported by SEBI to be total net purchases amounted to $1.6 billion. However, the quantum of PE investments is reported to be in the region of $17 billion in calendar year 2007. It is thus possible that there may be some recasting of the BoP statement as it gets finalised and PE investments will hopefully be separately reported under Portfolio Capital. In the process we may

Table 8: Balance of Payments: Projected for second half of 2007/08, and total for year							
US$ Billion	**2004/05 R**	**2005/06 PR**	**2006/07 (P)**	**Proj. (prev)* 2007/08**	**2007/08 H1 Prov**	**2007/08 H2 Proj.**	**2007/08 Est. (H1+H2)**
1	**2**	**3**	**4**	**5**	**6**	**7**	**8 = 6+7**
Current Account							
Merch. Exports	85.2	105.2	127.1	148.0	73.7	83.0	156.7
Merch. Imports	118.9	157.0	192.0	232.4	116.1	135.0	254.7
Merchandise Trade Balance	–33.7	–51.8	–64.9	–84.4	–42.4	–55.6	–94.4
	–4.8%	*–6.4%*	*–7.1%*	*–7.3%*	*–7.2%*	*–8.7%*	*–7.9%*
Net Invisibles	31.2	42.7	55.3	67.0	31.7	47.4	79.1
o/w Software & BPO	14.7	24.6	32.1	41.0	15.3	17.5	32.8
Remittances	20.5	24.1	27.2	30.0	18.4	28.7	47.1
Investment Income	–4.1	–4.9	–4.3	–5.0	–1.2	–1.7	–2.9
Current Account Balance	–2.5	–9.2	–9.6	–17.4	–10.7	–4.6	–15.3
	–0.4%	*–1.1%*	*–1.1%*	*–1.5%*	*–1.8%*	*–0.8%*	*–1.3%*
Capital Account							
Foreign Investment	13.0	17.2	15.5	27.5	22.2	27.8	50.0
o/w FDI (net)	3.7	4.7	8.4	15.0	3.9	5.0	7.9
Inbound FDI	6.0	7.7	19.4	25.0	9.9	5.0	22.9
Outbound FDI	2.3	2.9	11.0	10.0	6.0	–	6.0
Portfolio capital	9.3	12.5	7.1	12.5	18.3†	14.8	33.1
Private Equity						8.0	8.0
Loans	10.9	6.1	21.1	25.0	17.0	18.0	35.0
Banking capital	3.9	1.4	2.1	2.5	5.3	4.0	9.3
Other capital	0.7	0.7	6.4	3.0	6.0	3.0	9.0
Capital Account Balance	28.0	23.4	44.9	58.0	50.4	52.8	103.2
	4.0%	*2.9%*	*4.9%*	*4.9%*	*8.6%*	*8.9%*	*8.7%*
Errors & Omissions	0.6	0.8	1.3	–	0.7	–	0.7
Accretion to Reserves	26.2	15.1	36.6	40.6	40.4	48.2	88.6
with RBI	*3.8%*	*1.9%*	*4.0%*	*3.5%*	*6.9%*	*8.1%*	*7.4%*
Memo Items							
GDP in US$ billion	695.9	805.7	911.8	1,152.0	587.9	587.9	1,175.8

Note: * These projections were made in the *Economic Outlook* report of the EAC, July 2007.

† Possibly includes Private Equity

Figures in per cent are with respect to GDP at market and current prices

see a decline in the amounts booked under "Other" capital or perhaps even banking capital.

Projections for the second half of 2007/08

70. The merchandise trade account numbers up to November 2007 have been taken into account in woking out the figures for Q3 (i.e. for December). Q4 numbers have been estimated after factoring in the impact of much more expensive imported crude oil, the trend in the import of gold up to November 2007 and understanding of the nature of change in non-oil, non-gold imports, based on the experience of the first six months of this fiscal year.

71. Overall, in the second half of 2007/08 it is expected that the value of the oil import bill will increase by 45% over the corresponding period last year and by 31% over the first half of 2007/08. For the year as a whole, the oil import bill is projected at nearly $73 billion. Gold imports had shot up in Q1; they have slowed since, recording only a small rise in Q2. It is projected that for the year as a whole the value of bullion imports will be close to $17 billion, representing an increase of 14% over the previous year. Non-oil, non-gold imports rose by 32% in the first half of 2007/08 and is expected to rise by 40% in the second half of the year.

72. The computation of levels for each entry has been first done for Q3 and Q4 separately, and combined to give the second half estimate. The reported figures for the first two quarters have been added to the projections for the second half to obtain the full year estimates for 2007/08. Merchandise exports in 2007/08 are thus expected to be nearly $156 billion (increase of 23%) and imports nearly $240 billion (rise of 29%). The trade deficit (on DGCI&S) basis is thus expected to be about $85 billion, compared to $59 billion in the previous year (up by 43%). There are some adjustments that need to be made for arriving at the BoP trade equivalents, which have been done for the second half by using the reported numbers for the first half of 2007/08. The BoP merchandise trade deficit in the second half of 2007/08 has accordingly been computed at $52.0 billion. This yields a total trade deficit for 2007/08 of $94.4 billion, equivalent to 7.9% of the expected GDP for the year, which is about $ 10 billion higher than what was estimated in the July 2007 Economic Outlook.

73. In computing net invisible earnings in Q3 and Q4 of 2007/08, the levels have been scaled up bearing in mind developments in the first half of the year. The changing trend in respect of software earnings and private remittance has

been taken forward. Thus, there are differences between the figure for software earnings previously projected in July 2007 and that being estimated now, both on account of the projected growth of earnings and also in the distribution between software earnings and private remittances.

74. The projected CAD for the second half of 2007/08 is $4.6 billion which gives us a total for the year of $15.3 billion or 1.3% of expected GDP for the year. The main difference in these projections and those made previously derives from a more rapid increase in the surplus of net invisible earnings than what was previously estimated by the Council.

75. Net FDI receipts for the second half of 2007/08 have been projected at the same level as in the corresponding period last year, bearing in mind the experience of the first half of the current fiscal. Net purchases by FIIs in Q3, according to SEBI, were $6.3 billion. We project a somewhat smaller figure for Q4, bearing in mind the experience of net selling in March during previous years. To this must be added the proceeds of GDR/ADR issuance, estimated at about $3.0 billion in the second half of 2007/08. The aggregate of portfolio flows thus comes to $14.8 billion in the second half. Inflows on account of Private Equity are shown separately and placed at $8.0 billion for the second half of 2007/08. Total foreign investment in the second half is thus estimated at $27.8 billion, a little more than that in the first half. Loans have been kept at about the same level as the first half, while banking capital and “other” capital have been scaled down.

76. The total surplus on the capital account is thus estimated at $52.8 billion for the second half of 2007/08, somewhat larger than in the first half. For 2007/08 as a whole, the surplus on the capital account is thus estimated to be a little over $103 billion or 8.7% of the expected GDP for the year. This is significantly higher than $ 58 billion projected in the July 2007 Economic Outlook.

Reserve Accretion and Exchange Rate Movement

77. The large excess of capital inflows over and above that required to finance the CAD has resulted in reserve accretion to the tune of $40.4 billion (excluding revaluation) in the first half of the year. The nominal increase in the value of foreign currency assets of RBI in Q3 was over $27 billion. The EAC’s assessment is that accretion in Q4 will not be smaller. On the basis of projections of the BoP for Q3 and Q4, likely accretion to reserves will be $48 billion in the second half of 2007/08. Total accretion for the year will thus be close to $89 billion.

78. This order of reserve accretion is a consequence of the central bank's efforts to prevent a runaway appreciation of the currency as capital flows surge beyond the financing need of the current account deficit. To offset the monetary effect of its intervention, the RBI has issued instruments under its market stabilization scheme. The inflation adjusted currency weighted or *Real Effective Exchange Rate* (REER) has risen between March 2007 upto the middle of November by 7.2% both in respect of the 1993/94 base and the 2005/06 base. Almost all this appreciation took place in April and May 2007.

79. As has been the case in recent years, there has been considerable movement in the exchange rates between the major currencies of the world. In 2007, one prominent characteristic has been the appreciation of some emerging market currencies. A summary is provided at Table 9 of exchange rate developments in 2006 and 2007. The rates are expressed in US dollars both for convenience as also for reasons discussed subsequently.

80. In the calendar year 2007 the Indian rupee was amongst the three emerging market currencies that appreciated the most, after the Brazilian *real* and Thai *baht*, recording appreciation in double digits. In the advanced economies, Canada, Norway and Australia led the appreciation surge, also in double-digits. To appreciate the extent of change in the nominal exchange rate, the last column in Table 9 represents the ratio of the current account balance to GDP. It is interesting to note that India was one of the very few emerging and NIC (newly industrialised country) economies in this list whose currency appreciated strongly despite having a current account deficit. Almost all other emerging & NIC economies have sizable current account surpluses, and yet have seen their currencies gain by much less than India. The reason is the widespread practice of managing exchange rate movements through central bank intervention – even where the current account surplus as a proportion of GDP is 10% or more. It may be noted that the large appreciation in Australia and New Zealand and to some extent the British pound, is wholly on account of high interest rates maintained there for several years.

81. To be fair, the Indian rupee had barely budged in 2006, despite a large overall BoP surplus, whilst the currencies of most other emerging & NIC economies had moved up by 3% to 8%. However, the gradualist path adopted by so many economically successful countries, notwithstanding colossal current account surpluses, underscores the ability of enterprises to adjust to changes in the exchange rate. In recent times, India has had the additional disadvantage of

Table 9: Developments in Foreign Exchange Rates in US $ during 2006 & 2007						
Country	**Last trading day of the calendar year**			**Appreciation (+) / Depreciation (–)**		**Current A/C Balance proj by IMF**
	30 Dec 2005	**29 Dec 2006**	**31 Dec 2007**	**During 2006**	**During 2007**	**for 2007 to GDP***
Emerging and Asian NIC countries						
Thailand	40.99	35.80	29.50	12.7%	17.6%	1.6%
Brazil	2.33	2.13	1.78	8.6%	16.6%	1.3%
India	44.95	44.11	39.41	1.9%	10.7%	–1.1%
Russia	28.78	26.33	24.54	8.5%	6.8%	9.8%
China	8.07	7.81	7.29	3.3%	6.6%	9.1%
Singapore	1.66	1.53	1.44	7.8%	6.4%	23.3%
Malaysia	3.78	3.53	3.31	6.7%	6.3%	15.8%
South Africa	6.33	7.04	6.86	–11.2%	2.5%	–6.0%
Taiwan	32.80	32.59	32.43	0.6%	0.5%	6.7%
South Korea	1,010.00	930.00	936.00	7.9%	–0.6%	0.2%
Mexico	10.63	10.80	10.92	–1.6%	–1.1%	–0.2%
Indonesia	9,830.00	9,020.00	9,419.00	8.2%	–4.4%	2.7%
Advanced Economies						
Canada	1.17	1.17	0.99	0.0%	15.2%	1.7%
Norway	6.74	6.23	5.43	7.6%	12.8%	16.7%
Australia	1.36	1.27	1.14	6.9%	10.2%	–5.4%
Euro-zone	0.84	0.76	0.68	10.3%	9.6%	–0.2%
Denmark	6.30	5.65	5.10	10.3%	9.6%	2.0%
New Zealand	1.46	1.42	1.30	2.9%	8.2%	–8.8%
Switzerland	1.31	1.22	1.13	7.2%	7.1%	18.5%
Japan	117.88	119.02	111.71	–1.0%	6.1%	3.9%
Sweden	7.94	6.83	6.46	13.9%	5.5%	7.4%
U.K.	0.58	0.51	0.50	12.2%	1.3%	–2.9%
U.S.A.	1.00	1.00	1.00	–	–	–5.7%

Source: * From *World Economic Outlook*, October 2007

Exchange rates are 12 noon rates of the Federal Reserve Bank of New York. Exchange rates for Russia and Indonesia taken from the IMF website.

having higher inflation than in East and South East Asia. In theory, the effect of higher relative inflation should be neutralised by a corresponding devaluation; in fact the tendency has been for the currency to consistently appreciate in nominal terms.

82. India is a relatively small player in world trade, even when compared with other Asian economies. For most products, especially manufactures, Indian enterprises are price takers, with benchmark prices set by major East Asian suppliers whose currencies are tied to the US dollar. Certainly there are manufactures where Asian markets may not determine the price, but in most cases these are high technology products where Indian enterprises at best figure at the margin. For the bulk of the market serviced by Indian enterprises, it is the Asian markets that are of greater relevance. Under the circumstances, irrespective of the destination market, it is the US dollar price of manufactured commodities that directly or indirectly determines the ability to survive in a highly competitive market. In other words, the actions of some large central banks in the region set constraints that limit the ability of any one currency to get ahead in the appreciation game, without incurring an avoidably large economic cost.

83. In the Council's earlier report, the approach towards dealing with the exchange rate was spelt out in terms of a judicious combination of intervention and sterilisation, liberalisation of outflows and some appreciation. The rise of the currency in April and May 2007 appears to have exhausted the last instrument for some time now, unless other economies allow their currencies to appreciate by much more than what was witnessed in recent months. Steps have been taken to remove administrative and other procedural hurdles to outflows, but perhaps more can be done. The introduction of limits on external borrowings for funding rupee expenditure appears to have channelled corporate borrowing energy into the financing of capital goods import and overseas acquisitions. For the balance of 2007/08, it is hard to see any other substantial instrument other than continued intervention, accompanied by adequate sterilisation. Since the pressure on the rupee to appreciate is likely to continue in the immediate future, given that the capital account surplus is several multiples of the current account deficit, clear signals should be given to the Indian industry to make adjustments through productivity increases and to tap the booming domestic market. However some transitional package targeted specifically at labour intensive industries may be called for.

V. Prices, Monetary, Financial and Fiscal Management

Inflation – Wholesale and Consumer Price

84. In the July 2007 Economic Outlook of the Council, the assessment was that wholesale price (WPI) inflation would drop below the 4% level in Aug/Sept 2007, which assuming an overdue upward revision in prices of refined petroleum products, would enable the headline rate to be maintained close to 4%. In the event, gasoline and diesel prices have not yet been revised, and as a result, the headline rate has dropped to between 3.0% and 3.5%.

85. The pressure on prices from primary food, including foodgrain, has abated but the story can yet turn sour later in the year if world grain prices continue to remain strong, while domestic output gains are limited and pressure mounts to raise support prices further. In manufactured goods, inflation has dropped from between 5% and 6% in the summer of 2007 to 3.6% at the end of December 2007. Part of this is a consequence of the falling price of sugar and cotton textiles, the result of less than happy circumstances in these industries, and may be reversed to some extent in the coming fiscal year. The decline in inflation in manufactured goods is also partly on account of the decline in highly volatile prices of non-ferrous metals, a development that may be quickly reversed if global sentiment turns optimistic. In fact, the core inflation rate is still at 4.2% (in part due to strong prices for raw cotton and oilseeds) reflecting the lower room for manoeuvre than indicated by the current headline rate.

86. Inflation, as measured by the CPI, has been consistently higher than that indicated by the WPI primarily on account of the greater weight of food in the CPI compared to the WPI. Though there was no corresponding decline in the CPI when the WPI began to decline in recent months the CPI has also fallen. The CPI (UNME) and CPI (IW) show inflation in November 2007 at 5.1% and 5.5% respectively, a significant drop from 6.4% to 7.3% in August 2007.

87. On a cumulative basis – that is, from the last week of March onwards – inflation represented by the WPI has been 2.6% up to the middle of December compared to 5.7% for the same period last year and 4.0% and 4.5% respectively for the previous two years. The same trend is visible in the CPI. The CPI (UNME) saw a cumulative increase of 4.2% in the period upto November in 2007/08, compared to 6.7% in the corresponding period last year. Likewise the CPI (IW)

saw a cumulative increase of 5.5% during the period compared to 6.7% in the comparable period of 2006/07.

88. Even adjusting for some increase in prices of automotive fuels, the year-to-date WPI inflation is likely to be about 3.2% up to mid-December 2007.08, which may seem comfortably low by our own recent experience. The problem however is that inflation in India has been uncomfortably higher vis-à-vis our competitor economies in the region. This has made handling of the exchange rate that much more difficult. 2007 was the first year where Indian inflation was not the highest in the region – an outcome that needs to be sustained.

89. If automotive fuel prices are indeed revised soon, the headline WPI inflation rate should go to a little over 4.0%, and remain stable there till the end of the fiscal year. The impact would depend on the extent of revision in automotive fuel prices. The CPI is likely to show inflation at close to 5% at the end of 2007/08.

Monetary & Credit Developments

90. The large increase in foreign currency assets of the RBI has meant counterpart injection of high-powered (M0) money, a large part of which has however been sterilised by the issue of instruments under the *Market Stabilisation Scheme* (MSS). As on December 21, 2007 a total of Rs. 162,665 crore of MSS bonds were outstanding – an increase of Rs 99,691 crore during the course of 2007/08. The purchase of excess capital inflows by the RBI is represented by equivalent increase in bank deposits (of the private beneficiaries of the capital inflow).

91. A part of this was impounded by the increase in the Cash Reserve Ratio (CRR), and a larger part absorbed by the issue of MSS bonds. In addition, to the extent of negative cash injection (acceptance of deposits) under the Liquidity Adjustment Facility (LAF), liquidity is further impounded by the RBI. A rough and ready assessment for the week ending December 21, 2007 suggests that on a year-to-date basis about Rs 260,000 crore of foreign exchange had been purchased by RBI in 2007/08. Of this, about Rs 100,000 crore was absorbed through issuance of MSS bonds over and above that outstanding at the end of March 2007. About Rs. 51,000 crore was the additional increase in bank reserves with RBI. Further Rs 22,400 crore was absorbed under the LAF facility on Dec 21, 2007.

92. The reported increase in Reserve Money for 2007/08 upto Dec 21, 2007 was Rs. 98,513 crore. This is equivalent to an increase of 13.9% over the end-March figure. The broad money aggregate (M3) increased on a year-to-date basis by 11.2% up to Dec 7, 2007, exactly the same order of increase as in the comparable period of 2006/07. The extent by which intervention has been higher in 2007/08 relative to the comparable period last year has been offset by greater use of sterilisation and reserve requirement instruments. It may be recollected that up to the end of December, in 2006 the real accretion to reserves was just $16 billion, compared to a likely figure of $66 billion for the same period in 2007/08 – an almost 4-fold increase. The increased level of intervention of about $50 billion or Rs. 200,000 crore is more than the total of MSS issuance (about Rs. 100,000 crore). Hence, the rise in reserve money has been at a faster pace than last year. The expansion of M3 at a pace comparable with last year is a consequence of more careful lending this year and a greater allocation to investment in securities, aside from the decelerating impact of higher prescribed CRR.

93. Off-take of both non-food credit and total bank accommodation to the commercial sector has slowed sharply in the first and second quarters of 2007/08. At the end of September 2007, the year-to-date increase in non-food credit was 6.0%, more than 4 percentage points lower than in the first half of 2006/07 and 2005/06. The trend in total accommodation has not been markedly different from that for non-food credit in the current fiscal. In the third quarter of 2007/08, and especially since November 2007, the off-take of both non-food credit and total accommodation has increased with the Q3 increase in non-food credit on year-to-date basis being 9.4% upto 7 Dec 2007, compared to 14.0% for the same period last year.

94. The slowdown in credit growth has not only slightly lightened the task of monetary management, it has also provided a respite to banks which have been reassessing some of their lending operations, especially on the retail side. In the aftermath of the sub-prime crisis world-wide attention is being refocused on the importance of credit quality and risk management and this is as good a time as any for the Indian banking system to invest some human and organisational capital towards improving risk mitigation in retail lending.

Fiscal Developments

95. Central government finances have continued with their improving trend, propelled by a sharp increase in direct tax collections which far outstripped

budget estimates upto the end of November 2007. Gross tax collections for the first eight months of the year rose by 25% compared to 17% envisaged in the 2007/08 Union Budget. According to current estimates, direct tax collections would cross Rs 300,000 crore in 2007-08, an increase of about 30% over the last year. Direct taxes have now overtaken indirect taxes in the Centre's tax revenues. This tax buoyancy has come about to a great extent from an outstanding collection record in Income Tax, consequent on the vast improvements in the tax information network, even as corporation tax collections have remained very strong. The high buoyancy in the service tax collections witnessed in recent years has also continued. Overall net central government revenues have risen in the first eight months by 24% as compared to expectations of 15% in the Budget.

96. Even as revenue expenditures have outstripped budget estimates, deficit indicators have improved in absolute terms relative to the comparable period last year. The combined gross fiscal deficit of the Centre and States is expected to decline further from 6.4% of the GDP in 2006-07 to 5.6% in 2007-08.

97. While fiscal consolidation has been an unmitigated good, making available much larger resources for financing the sharp increase in productive investment in the economy, it has avoided the need to take a hard look at expenditure. Indeed almost the entire reduction in the deficit since 2001-02 is accounted for by increase in direct tax collections in the Centre, through the switchover to VAT in the states, and reduction in interest payments. It had been pointed out in the July 2007 Outlook that the practice of taking subsidy expenditures below the line in the form of issuance of securities in lieu of outright subsidies is not desirable. The July 2007 Outlook had estimated off balance sheet liabilities at about 2% of the GDP. In view of rising oil, fertilizer and food prices, there is reason to believe that these might in fact be higher.

VI – Prospects for 2008/09

98. This section takes a preliminary view of prospects for the economy in 2008/09. The underlying dynamics that have characterised the rapid expansion of the economy in recent years are: robust investment growth, strong corporate performance, high rates of domestic savings, good tax buoyancy that has helped government at the Centre and in the States to move ahead on fiscal consolidation and perhaps, most importantly, strong confidence amongst our citizen-consumers and entrepreneurs. These factors are not likely to change much in the coming fiscal year.

99. Nevertheless there are several perceptible risks going forward. The first, is the extent of slowdown that may manifest in the economies of the developed world. As discussed in the first part of this review, the Council is of the opinion that the slowdown will be a modest one which would not significantly impact India's next year's growth prospects by much. There could however be continued inflationary pressure. On balance, with the usual caveat of a normal monsoon, the Indian economy is likely to grow by about 8.5% in 2008/09. The reasons why growth next year is expected to be a bit lower than in the current fiscal can be ascribed to: (a) continuation of slower growth in the demand for consumer goods; (b) slightly slower growth in the trade, hotels, transport & communication sectors; and (c) farm sector growth closer to the trend of 2.5%, than to the stronger performance evident in 2007/08. The figure of 8.5% may be seen to be a baseline projection that would be impacted if the underlying assumptions were to change.

100. However, there is a possibility that the slowdown may turn into recessionary conditions in the US, especially if there are adverse geo-political developments, which, at times, act as triggers. In such an event, a decline in business confidence at the general level can combine with a prospective compression of export demand, to cause a significant slowing of the domestic economy. The effects are likely to be felt through both trade and capital flows, with Indian companies experiencing greater challenges in gaining market share, as also to finance ambitious investment projects or overseas acquisitions.

101. The second downside risk stems from the availability of power. As has been noted, in 2007/08 a record level of capacity will have been incorporated in the public sector, but that has not seen a decline in supply deficits or in the strained capacity utilisation of plants. In 2008/09 sustained pressure at all levels must be maintained, not only to bring into generation the capacity spill-over from

the current fiscal, but also to target a significantly higher level of capacity creation, compared to 2007/08. The economy is growing fast, so is the demand for power – and inadequate provision of this key ingredient has the potential of causing significant economic slowdown by both reducing the absolute availability and causing factories to depend more on captive power that is often very expensive.

102. The third downside risk stems from the 2008 South West monsoon. India has been fortunate to witness five successive good monsoon seasons. Were that run of good luck to be broken, the farm sector would undoubtedly suffer loss of output and income. This may in turn exacerbate the pressure on food prices and therefore on the general level of prices.

103. The farm sector also presents a possible upside. It has been seen that in the current year, the strong growth in agricultural GDP has come mostly from activity other than food grain production, namely commercial crops, horticulture and animal husbandry. Were the South West monsoon rains to be good in 2008, it is possible that the farm sector may grow at a pace that is similar to this year, thereby pushing the overall rate of economic growth, both directly and indirectly.

104. There are some downside risks that can stem from not being able to take much needed decisions. Among them are the early and appropriate revision in the selling prices of automotive fuel and a longer-term policy on fertilisers that can encourage fresh investment into the sector. The impact of the Sixth Pay Commission may also have to be taken into consideration in 2008-09.

105. Taking all factors into consideration, the Council expects the economy to grow at about 8.5% in 2008-09.