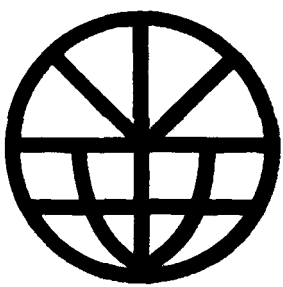
Mid-Year Review of the Indian Economy 2004-2005

Saumitra Chaudhuri



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SAUMITRA CHAUDHURI
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Preface

The Mid-Year Review of the Indian Economy for 2004-2005 was presented by Shri Saumitra Chaudhuri, Economic Advisor to ICRA (Investment and Credit Rating Agency), on 27 November 2004 at India International Centre. His presentation was followed by observations made by three invited discussants whose contributions are reproduced here in the 'Comments on the Review by the Discussants' chapter. Shri Bimal Jalan, former Governor of the Reserve Bank of India, now a Member of the Rajya Sabha, chaired the meeting. The Centre is thankful to Shri Chaudhuri for giving a holistic picture of the Indian economy and the international trends that influence it, and to the three Discussants, Mr. K. L. Datta of ICRIER, Ms Kavita Rao of National Institute of Public Finanace and Policy, and Ms Ila Patnaik of the *Indian Express*, for their insightful observations on the main Review.

The Review covered the state of the external economic environment of India; the outlook for 2004-05 in terms of the expected growth, inflation, balance of payments, fiscal balances, savings and investment trends; the state of important sectors of the economy, including the financial and corporate sectors; the medium-term prospects for 2005-06 and beyond; and the impact of oil prices and inflation.

Mr Bimal Jalan's observations on Shri Chaudhuri's Review were that the assessment of the state of the economy at mid-2004-05 was very positive, with expected growth of 6.5-7%, manageable inflation and fiscal deficit and external accounts in good shape. Whether the upsurge in sectors, including corporate growth, would be maintained in 2005-06 and beyond depended on the extent to which the present growth was structural rather than cyclical. However, there were long-term problems of the economy which would not all be resolved by high growth alone.

Participants emphasized that a sustained rise in the growth of agricultural and allied activities was crucial for industrial growth as well as the expansion of both farm and non-farm employment. Regional disparities in agricultural performance were a matter of concern. This was an important factor in the comparative economic stagnation of the states in eastern and central India. Diversification of agriculture was necessary to spread risks. While out-migration from areas of low agricultural productivity was desirable, the resulting spread of urbanization was not adequately planned. The prospect of growth of 7-7.5% in the medium-term was regarded by the participants as being unduly optimistic, given the fact that the domestic savings rate was stagnant and the absorption of foreign capital inflows was inadequate.

Shri Chaudhuri's assessment that India's economy was now sufficiently resilient to absorb the shock of the recent rise in world oil prices was generally accepted. He pointed out that price of crude paid by India is only in the range of $33-36 per bbl rather than $50-55 in the case of most industrializing countries.

Considering the fall in the value of the dollar and India's surplus on current account, the question whether the rupee should be allowed to appreciate further was discussed. Indian exports, it was noted, had risen substantially. Shri Bimal Jalan explained the rationale of RBI's exchange rate management policies, which essentially curbed excessive volatility, but otherwise followed the market. Some other countries were now following this approach.

There was considerable discussion about the level of reserves, now about $125b—whether these were excessive—and their possible utilization. It was suggested that more studies should be undertaken to determine an optimum level, possibly on the basis of analytical models. With continuing rise and a current account surplus, the economics of converting some of the reserves into investment—public and private—especially in infrastructure, has assumed importance.

Responding to an observation from the floor on the of need for a mid-year review of the economy, Shri Bimal Jalan felt that the annual mid-year Reviews of the Indian economy organized by the Centre were 'vitally important, in fact more important than they were earlier when the economy was much better known, although the data may not have been there. We knew (then) what was going on and there were very few areas of freedom of action for policy..today economic policy and economic discussion has to respond to circumstances as they change and emerge.' The Mid-Year Review of the Centre provided an occasion for discussing some of these issues. He was appreciative of the fact that the India International Centre has continued to organize this annual event and hoped it will continue to do so in the future too.

The Centre expresses it gratitude to Dr Ajit Mozoomdar for his sustained support for and interest in this annual event and for his succinct summary of the half-day seminar, a large part of which substantiates this Preface. Special thanks go to Dr B. S. Minhas, Dr S. S. Mehta, Dr Charanjit Chanana, Shri T. N. Ninan, Shri R. K. Modi, Shri Biswajit Bhattacharya, and Shri V. B. Easwaran, who participated in the discussions, and to the Malcolm Adiseshiah Trust, Chennai, which has been supporting this event at the Centre since 2001 in memory of the late Dr Malcolm Adiseshiah, a Life Trustee of the Centre, who steered its Economic Affairs Group till his passing away in 1994.

Finally, a word of thanks to all those who were present and added to the overall value of the discussions and to Mr. D. Kumar of Shipra Publications for bringing out this volume.

Bela Butalia
Editor

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The World: Strong Growth Despite Uncertainties

Calendar year 2004 has been a strange year in many senses. It has seen robust economic growth across almost every region, despite continuing violence and turmoil and all manner of uncertainty. With 2004 mostly behind us, the economic recovery in many senses has indeed outperformed expectations, while in another sense it been weaker than expected. This mixed picture appears further confused, as at the present moment events appear to be increasingly entangled in a web of unexpectedly high energy prices, exchange rate uncertainties and uncertain politics. One year ago, the International Monetary Fund (IMF) in its World Economic Outlook (WEO) of September 2003 had placed world output growth in 2004 at 4.1 per cent. A year later, in September 2004, it has assessed that this figure will indeed be higher at 5.0 per cent—which is a significant increase.[1]

This increase in the pace of growth has been all across the globe. Growth in the advanced economies is likely to 3.6 per cent in 2004, compared to the assessed 2.9 per cent in September 2003. Growth in the developing world—both in Asia and elsewhere—is turning out to be a full 1 percentage point higher than had been assessed a year back, at 6.6 per cent against the 5.6 per cent assessed earlier. So too in the UK, growth has turned out to be 1 percentage point stronger—at 3.4 per cent according to the September 2004 WEO, from the 2.4 per cent, which had been assessed, one year back. The materialised upside has been the largest in Japan. Economic growth in 2004 is now expected to be 4.4 per cent, compared to 1.4 per cent in September 2003. Even in the euro-zone, growth has been higher at 2.2 per cent,

relative to the expectations of 1.9 per cent made one year earlier. The IMF notes that at 5 per cent, global growth is well above the trend rate and the highest in nearly three decades.

This geographically well-distributed three-decade high in economic growth has however been tempered by caution arising from several factors:

First, most of the rebound was located in the first part of the year–in continuation with what was happening in the last two quarters of 2003. Since the middle of 2004 there has been a weakening of the growth momentum in the US and Japan—the so-called 'soft patch'—the blame for which has variously been assigned to a number of factors, including high oil prices, slackening housing activity and political uncertainty.

Second, the principal global structural imbalances—the large current account and fiscal deficits in the US—rather than showing any sign of correction, continue to expand and compound. That generates considerable uncertainty in relation to prospective bond yields and exchange rates as between the major currencies.

Third, the on-going threat of terrorist attacks, conflict in Iraq and the specifics of US foreign policy in the years to come. The situation in Iraq has, on the one hand, the potential of some kind of pacification or, on the other, of becoming an enlarged and intensified conflict. There also exists potential of conflict in other parts of the globe—as outstanding issues of nuclear weapons and/or sponsorship of terrorism begin to build up further momentum—particularly with respect to North Korea and Iran.

The great positive feature of 2004 was that while all of these three characterising factors were very much in play, yet global growth has turned out to be strong. Thus, perhaps an excess of caution ought not to colour anticipation of the year to come.

For 2005, the IMF has now placed aggregate world output growth at 4.3 per cent, marginally below the estimate it had made in April of this year (4.4 per cent), which of course is closer to the trend rate of 4 per cent, and much below the estimated 5 per cent of 2004. The IMF anticipates

economic growth that is significantly slower in 2005 (compared to 2004) across all categories of economies, but more pronounced in the industrialised economies and in China, than in the rest of the developing world.

At Table 1.1, we have presented contemporary growth projections of the IMF and two leading international banking groups. What is perhaps interesting to observe is that the private sector's assessments about 2005 are not—as has been often the case—more optimistic than that of the IMF. The view on the industrialised economies is more or less the same, but in respect of the developing world, the two banks cited here clearly have slower growth in mind.

Components of Economic Growth in the Developed World

United States of America

On the basis of data a big increase of 22 per cent was evident on annualised basis in private investment in the third quarter of 2003 in the United States. It eased in the next two quarters but stayed well in the double-digit region, before jumping to 19 per cent in the second quarter of 2004. This period of growth expressed itself in increases in both residential and business fixed investment, as well as a build-up in inventories. In the third quarter of 2004, however, residential investment gained only modestly, while inventories are estimated to have declined. Investment in business equipment however grew by a healthy 15 per cent. Expenditure on durable consumer goods grew 17 per cent in the third quarter enabling aggregate personal consumption expenditure to grow by 4.6 per cent on annualised basis.

With imports much larger and also growing faster than exports, *net* exports of goods and services have declined further contributing a larger negative number to overall GDP growth for the fourth successive quarter.[2] The rate of expansion at constant prices in the domestic sales of final goods (domestic and imported) has stayed well ahead of GDP. Thus for 2003 as a whole, while GDP rose by 3 per cent, final domestic sales increased by 3.4 per cent. In 2004,

Table 1.1: Forecasts for Real GDP Growth-World, Major Regions & Select Economies
IMF's and Private Banks Estimates, October 2004

Unit: *per cent*

	2002*	2003* Actual	2004 IMF	2004 JP Morgan	2004 Citi Group	2005 IMF	2005 JP Morgan	2005 Citi Group
1	2	3	4	5	6	7	8	9
Regions and principal economies								
World	3.0	3.9	5.0	4.0	4.4	4.3	3.4	3.7
Industrial Economies	1.6	2.1	3.6	3.5	3.5	2.9	3.1	2.9
USA	1.9	3.0	4.3	4.3	4.5	3.5	3.6	3.9
Euro-zone	0.8	0.5	2.2	2.0	1.8	2.4	2.6	2.0
Japan	-0.3	2.5	4.4	4.3	4.3	2.3	2.5	2.1
Developing Asia	6.6	7.7	7.6	7.0	6.9	6.9	6.0	6.1
Latin America	-0.1	1.8	4.6	5.8	5.0	3.6	3.9	3.6
East Europe & CIS**	5.0	6.6	7.1	6.6	6.8	6.0	5.3	5.4
Australia	3.8	3.0	3.6	3.5	3.4	3.4	3.4	3.2
Western Europe - major economies								
France	1.1	0.5	2.6	2.6	2.3	2.3	2.5	2.0
Germany	0.1	-0.1	2.0	1.6	1.3	5.2	2.4	1.8
Italy	0.4	0.3	1.4	1.3	1.2	1.9	2.1	1.3

1	2	3	4	5	6	7	8	9
Sweden	2.1	1.6	3.0	3.2	3.5	2.5	2.6	3.2
Switzerland	0.2	−0.5	1.8	1.8	1.8	2.5	2.1	2.0
United Kingdom	1.8	2.2	3.4	3.4	1.2	2.5	2.9	3.0
			East Asia					
China	8.3	9.1	9.0	8.6	9.2	7.5	7.6	7.8
Hong Kong	1.9	3.2	7.5	7.7	7.0	4.0	4.6	4.0
South Korea	7.0	3.1	4.6	5.2	4.3	4.0	4.7	3.8
Taiwan	3.6	3.3	5.6	5.7	5.6	4.1	4.0	4.1
			South and South East Asia					
India	4.0	7.2	6.4	6.0	5.4	6.7	6.5	7.0
Indonesia	3.7	4.1	4.8	4.7	4.8	5.0	4.0	5.0
Malaysia	4.1	5.3	6.5	7.3	7.0	6.3	6.0	5.5
Philippines	4.4	4.7	5.2	5.7	4.8	4.2	4.0	4.0
Singapore	2.2	1.1	8.8	8.8	8.8	4.4	3.7	5.0
Thailand	5.4	6.8	6.2	6.0	6.2	6.4	5.0	5.7
Vietnam	5.8				7.3			7.1

1	2	3	4	5	6	7	8	9
				Other emerging economies				
Argentina	-10.9	8.8	7.0	8.5	7.0	4.0	4.0	3.2
Brazil	1.9	-0.2	4.0	4.5	4.6	3.5	3.5	4.0
Chile	2.2	3.3	4.9	5.0	5.4	4.7	4.8	5.1
Mexico	0.8	1.3	4.0	4.5	3.8	3.2	4.0	3.5
Czech Republic	1.5	3.1	3.3	3.7	3.8	3.4	3.8	4.0
Poland	1.4	3.8	5.8	6.0	5.8	5.1	4.8	5.0
Russia	4.7	7.3	7.3	7.5	8.0	6.6	6.4	6.5
South Africa	3.6	1.9	2.6	2.8	2.9	3.3	3.8	3.7

Note: ** Actual growth rates for 2003 and 2004 are from WEO (IMF). The country-wise weights are based on GDP valued at PPP (purchasing power parity) exchange rates, unlike JP Morgan and CitiGroup which are based on market exchange rates. The IMF estimates using market exchange rates for valuation give estimates of 4.1 per cent for 2004 and 3.4 per cent for 2005.

* The IMF reports this separately for Commonwealth of Independent States and Eastern Europe, which have been combined using weights based on PPP values of GDP for 1999.

Source: (i) *World Economic* Outlook, International Monetary Fund, September 2004; (ii) Global Data Watch, J.P. Morgan, October, 2004. (iii) Global Economic Forecasts, CitiGroup, Economic & Market Analysis, October 2004

Table 1.2: Relative Contribution by Expenditure Category to GDP Growth in USA

Figures are in percentage points of GDP annualised

	Year-on-year growth components			Quarter-on-quarter growth components annualised*								
	2001	2002	2003	2002		2003				2004		
	Calendar Years			Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8	9	10	11	12	13
Total GDP	**0.8**	**1.9**	**3.0**	**2.6**	**0.7**	**1.9**	**4.1**	**7.4**	**4.2**	**4.5**	**3.3**	**3.7**
Percentage point contribution to overall real GDP growth by expenditure category												
Personal consumption expenditure	1.7	2.1	2.3	2.1	1.7	1.8	2.7	3.6	2.5	2.9	1.1	3.2
of which: *Durables*	*0.4*	*0.6*	*0.6*	*1.2*	*-0.2*	*-0.0*	*1.6*	*1.4*	*0.3*	*0.2*	*-0.0*	*1.3*
Non-durable goods	0.4	0.5	0.7	-0.1	1.0	1.0	0.3	1.4	1.0	1.3	0.0	0.8
Services	1.0	1.1	0.9	1.0	0.9	0.9	0.8	0.8	1.2	1.4	1.1	1.1
Residential fixed investment	0.0	0.2	0.4	0.1	0.2	0.4	0.4	1.1	0.5	0.3	0.9	0.2
Non-residential fixed Inv.	-0.5	-1.0	0.3	-0.1	-0.3	-0.0	1.1	1.5	1.1	0.4	1.2	1.2
O/w: Equipment & s/ware	-0.4	-0.5	0.5	0.3	-0.2	0.3	0.8	1.5	0.9	0.6	0.6	0.2
Change in pvt. inventories	-0.4	0.4	-0.1	0.6	0.1	-0.5	-1.0	0.6	0.5	1.2	0.8	-0.5

1	2	3	4	5	6	7	8	9	10	11	12	13
Net exports of goods & services	–0.2	–0.7	–0.4	–0.4	–1.7	0.1	–0.5	0.6	–0.7	–0.8	–1.1	–0.6
Government expenditure	0.6	0.8	0.5	0.4	0.8	0.1	1.4	0.0	0.3	0.5	0.4	0.3
O/w: *Federal defence*	*0.2*	*0.3*	*0.4*	*0.1*	*0.5*	*–0.1*	*1.5*	*–0.4*	*0.5*	*0.5*	*0.1*	*0.4*

Note: * These are annualised increases in each quarter with respective to the immediately preceding quarter, using de-seasonalised data series. The components do not necessarily add-up to the total increment for total GDP. This is due to the fact that different prices indices are used for deflating factor incomes (aggregate GDP) by industry of origin and the corresponding expenditures.

Source: *Gross Domestic Product Third Quarter 2004 (Advance),* Table 2, Bureau of Economic Analysis, US Department of Commerce, October 29, 2004.

while the first quarter did indeed see GDP expand faster than domestic sales (as was the case in the third quarter of 2003), the relative pace of expansion changed in the second and third quarters of 2004, with final sales rising faster. In the third quarter of 2004, domestic final sales rose by 4.6 per cent, while GDP increased by 3.7 per cent—which, of course has meant that the trade deficit expanded further to touch new record levels. Or to put it differently, domestic demand in the US spurred economic expansion overseas.

Euro-zone—modest recovery

The countries of the Euro-zone have had a torrid time over the past few years, with economic growth grinding down to 0.8 per cent in 2002 and then to 0.5 per cent in 2003 (Table 1.3). The larger economies in the euro-zone—Germany, Italy and Netherlands—were in recession in 2003, in the sense of having contracted in two successive quarters. Since the middle of 2003, there has been an improvement in circumstances, which has continued into the first three quarters of 2004, although there has been some slowing in the third quarter. Growth in Germany—the largest EU economy—picked up to over 1 per cent (annualised) in the last two quarters of 2003 and has risen to touch 2 per cent in the second quarter of 2004, but was again down to 0.4 per cent in the third quarter. In France, the pick-up has been somewhat stronger with growth at nearly 3 per cent in the second quarter of 2004,[3] but here too the third quarter has seen a decline to 0.4 per cent. Italy, which hardly grew at all in the last quarter of 2003, expanded by 2 per cent in the first quarter of 2004 and by over 1.5 per cent in both the second and third quarters. In the Netherlands, as per the data there was some contraction in the second quarter of 2004, after two strong quarters of growth, but third quarter growth has been positive though small at 0.8 per cent.[4] The European Commission estimates that in 2004 the aggregate euro-zone economy will grow by 2.1 per cent and has forecast growth at 2.0 per cent in 2005.[5]

In the non-euro member countries of the EU, the United Kingdom and Sweden have registered steady growth through 2003, with overall expansion of 2.2 and 1.7 per cent growth respectively. In the UK growth has been robust

ranging between 3 and 4 per cent in four successive quarters, but in the third quarter it was also down to 1.6 per cent. In Sweden too, economic growth has been stronger with the first two quarters of 2004 registering 3.6 and 4.0 per cent growth respectively.[6] Denmark has bounced back from *negative* growth in the second quarter of 2003, with 2.5 per cent growth (annualised) in the second half of the year and 4.0 and 0.8 per cent annualised growth in the first two quarters of 2004.

In 2003, the strongest expenditure category in terms of growth was government consumption, while personal consumption expenditure growth was depressed at 1.0 per cent. This situation as may be seen from Table 1.3 has changed somewhat in 2004. In the first quarter of 2004, personal consumption expenditure showed a healthy increase of 2.8 per cent, while public expenditures rose by only 0.4 per cent. In the second quarter, public expenditure however has again taken the lead, with personal consumption expenditure rising by 1.2 per cent, while public expenditure increased by 2.0 per cent.

Net exports of goods and services are positive and these balances have been within the range of 1.5 and 2.0 per cent of GDP for the past several years. In the second quarter of 2004, net exports were 2.2 per cent of GDP.[7]

The structural challenge before the EU is the absorption of the ten new 'accession' economies[8] of Eastern Europe into the Union. These regions are far poorer and with institutions and economic organisations that are relatively underdeveloped, being barely a decade out of the devastation left behind by the collapse of Soviet socialism. Successful integration will be the great challenge and is likely to have adverse short to medium-term costs in terms of foregone economic growth. In the longer-run, the benefits are likely to be quite significant. There are several East European nations[9] that remain outside present accession list and the time will soon come when they too have to be fully integrated. Over the next decade, and maybe for longer, the predominant issue driving policy and markets in the EU will be the challenge and focus of most attention.

Table 1.3: Growth of GDP and Key Elements thereof in Advanced Economies

Change over the previous period at seasonally adjusted annual rates †

Unit: All figures are in per cent

	Year-on-year growth components			Quarter-on-quarter growth components annualised*								
	2001	**2002**	**2003**	**2002**		**2003**					**2004**	
	Calendar Years			Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8	9	10	11	12	13
						Real GDP						
USA	0.8	1.9	3.0	2.6	0.7	1.9	4.1	7.4	4.2	4.5	3.3	3.7
Euro-zone	1.6	0.8	0.5	1.3	0.3	0.0	–0.8	2.0	1.6	2.8	2.0	1.2
Japan	0.4	–0.3	2.4	4.1	0.7	–0.3	4.4	2.3	7.6	6.3	1.1	0.3
						Personal (household) Final Consumption Expenditure						
USA	2.5	3.1	3.3	2.9	2.5	2.7	3.9	5.0	3.6	4.1	1.6	4.6
Euro-zone	1.9	0.6	1.0	1.8	1.5	0.0	0.0	0.8	0.0	2.8	1.2	
Japan	1.6	0.9	0.8	5.6	–3.1	–0.4	0.8	2.2	4.7	4.5	3.1	3.7
						Private Gross Fixed Capital Formation						
USA	–3.0	–4.9	5.1	0.2	–0.8	2.4	10.9	18.0	10.5	4.5	13.9	8.5
Euro-zone	–0.3	–2.7	–0.6	0.5	1.0	–2.8	–0.4	0.4	3.6	–0.4	0.4	
Japan	–0.1	–6.6	7.5	1.7	6.6	5.2	19.0	1.8	23.1	7.2	2.6	–0.6
						Government Expenditure (Consumption & Investment)						
USA	3.4	4.4	2.8	2.1	4.0	0.2	7.2	0.1	1.6	2.5	2.2	1.4
Euro-zone	2.5	3.1	1.7	1.9	1.1	1.2	2.0	2.4	2.0	0.4	2.0	
Japan *	0.8	0.4	–2.2	0.6	–2.4	–2.4	–3.8	–3.6	–0.6	–2.0	–5.5	–1.7

1	2	3	4	5	6	7	8	9	10	11	12	13
						Exports						
USA	-5.4	-2.3	1.9	3.1	-4.2	-1.5	-1.6	11.3	17.5	7.3	7.3	5.1
Euro-zone	3.4	1.7	0.1	8.1	-1.6	-5.6	-3.2	10.4	1.2	5.4	12.4	
Japan	-6.4	8.0	10.1	2.3	16.0	3.3	4.9	17.0	21.9	18.7	15.1	1.5
						Imports						
USA	-2.7	3.4	4.4	5.4	9.6	-2.0	2.5	2.8	17.1	10.6	12.6	7.7
Euro-zone	1.7	0.3	2.1	8.0	2.2	-0.8	-2.4	5.2	8.4	2.0	11.2	
Japan	0.1	2.0	5.0	10.0	5.7	2.7	-3.7	10.0	11.3	13.4	9.3	11.1

Note: † All at constant prices. For full year the numbers are the increase over the previous year. For quarters, the numbers are the increase over the immediately preceding quarter using seasonally adjusted data series, which are then expressed on annualised basis. The data corresponds to the latest revised series.

* Figures are for government consumption and investment expenditure only. Those for the USA and EU are for consumption expenditure alone

Source: **USA**: *Gross Domestic Product: Third Quarter 2004 (Advance)*, Bureau of Economic Analysis, US Department of Commerce, October 29, 2004. www.bea.doc.gov
Eurozone: European Central Bank, *Monthly Bulletin*, October 2004 & previous issues, Statistical Annex and Euro-Indicators news release STAT/04/123 dated October 14, 2004 and Eurostat News Release 134/2004 November 12, 2004 which is only a flash estimate with no detailed decomposition
Japan: *The 1st Preliminary Estimate of Gross National Expenditure* (July-September 2004), November 12, 2004, www.esri.cao.go.jp/en/sna/]

Japan

Japan's economy rebounded in 2003 after two successive years of poor economic conditions, clocking a healthy 2.4 per cent growth. Much of this growth was in the last quarter of the year in which the economy grew by 7.6 per cent and to some extent in the second quarter (4.4 per cent). In 2004, first quarter growth was quite high at 6.3 per cent, but has since fallen back to 1.1 per cent in the second and a mere 0.3 per cent in the third quarter.

Net exports continued to be an important contributor to the recovery of growth. In 2003, *net* exports (at constant prices) rose at a rate close to 28 per cent annualised and in the first two quarter of 2004 has remained on this trajectory at above 30 per cent. In the third quarter it is *negative* at 19 per cent, but later revisions are likely to move it up. Domestic demand after growing strongly in the last quarter of 2003 (6.3 per cent) and in the first quarter of 2004 (5.4 per cent) has slowed down almost totally (0.1 per cent) in the second quarter and 1.3 per cent in the third quarter of 2004. Private fixed investment after two big upward spikes in the second and last quarters of 2003 has slowed down, and registered under 3 per cent expansion in the second quarter and *declined* by 0.6 per cent in the third quarter of 2004. This is however off-set by the progressive decline of public investment which is into its tenth consecutive quarter of contraction. The fact that private consumption demand growth which crossed 4 per cent in the last quarter of 2003 and first quarter of 2004, still remained at over 3 per cent in the second and third quarters, is a positive factor. One might note that private consumption demand actually contracted in the fourth quarter of 2002 by as much as 3.1 per cent and has been generally at lower levels in recent times.

China

The economy of China has averaged 8 per cent growth over the past five years (1999-2003) after a scorching pace of expansion that averaged over 10 per cent annual growth in each of the decades of the 1980s and 1990s. In the years immediately following on the Asian currency crisis, growth in China had slowed to well below 8 per cent—but this has

changed in 2003 and 2004. This year the IMF estimates economic growth in China at 9.1 per cent. The rapid expansion of the Chinese economy has not only provided an enormous source of demand for minerals and other commodities world wide, it has been of an order large enough to influence global prices very strongly. While the overall pace of world output growth has been the principal factor behind the strength of commodity prices, surging demand in China has surely served to top off the price bouquet delivered to commodity producers—certainly in steel and coal, and to an extent in petroleum. Ever since the summer of 2003, the government and central bank of China, has tried to slow down the pace of investment by restricting the pace at which banks were growing their loan books. The recent move on October 28, 2004, to raise interest rates by 27 basis points (the first in a decade) has been the latest in this series of moves to bring about what the outside world has decided to term a 'soft landing'.

With the relative close integration with much of the rest of East and South East Asia, conditions in China have a bearing on the rest. The IMF says:

> From mid-2003 to the first quarter in 2004, the regional growth rate averaged over 10 per cent, with particularly rapid growth in China and the Asian newly industrialised economies. This has raised fears that China, despite some slowing in the second quarter, is at risk of overheating; some other economies, including Singapore, also appears to be increasingly close to capacity. Looking forward, on the assumption of a soft landing in China, the regional outlook is for continued solid but slowing growth.[10]

The IMF sees regional growth moderating to 6.5 per cent in 2005 (from 7.3 per cent in 2004), 'with the revisions largely reflecting a more delayed slowdown in China'. The conventional wisdom sees merit in a slowing down of the Chinese economy—*albeit* from 9 *plus* to 7.5 per cent—both in light of its internal macroeconomic and financial stability, and the spill-over effects in the region that a cooling in China would have for the moment (mainly beneficial) and

avoiding the bigger risks of a serious adjustment crisis if China continues to accelerate.

The signs of over-heating in China are evident from the movement in inflationary pressure. The Chinese economy has for many years now been often cited as 'a source of global deflation', because of the combination of a negative domestic inflation and what is widely believed to be an undervalued currency—the renminbi. However, domestic prices in China began to move up since the autumn of 2003 and have continued to rise. On year-on-year basis, producer price inflation for the month of October 2004 rose to 8.4 per cent from 7.9 per cent in September and 6.8 per cent in August. The higher October inflation figure implies that notwithstanding the recent increase interest rates, there has in reality been a decline in the real 12-month benchmark lending rate, to a new post-Asian crisis low of - 2.8 per cent. The anticipation is the central bank of China will raise rates further. Market observers underscore a recent central bank statement that stressed a desire to 'expand the role of the market in resource allocation'—a phrase that is broadly understood to mean a move away from directed credit and toward more market-determined lending.

Inflation, Productivity and Interest Rates: US and the Euro-zone

Inflation—consumer and producer prices

Consumer Price Inflation (CPI) (with respect to the index 12 months back) in the US in the month of October 2004 was 3.2 per cent for both CPI–All Urban Consumers (CPI-U) and CPI–Urban Wage Earners and Clerical Workers (CPI-W)—a significant increase from about 2.5 per cent in September 2004. This represents a reversal of the slight decline from the position in mid-summer (May through July) when this indicator had climbed over 3 per cent. For the 9-month period of 2004 (January to September) CPI-U overall has increased by 3.5 per cent compared to 1.9 per cent for the whole of 2003. Energy prices have climbed 18.6 per cent in 2004 up to September, compared to an increase of 6.9 per cent for all of 2003. Were we to exclude food and energy, the

CPI-U index would have risen 2.4 per cent in January-September 2004, compared to 1.5 per cent in 2003.

In October 2004, the CPI-U index excluding food and energy rose by 2.0 per cent, while the corresponding number for the CPI-W index was 1.9 per cent—which are identical to the position in September 2004. The increase in CPI inflation therefore from 2.5 to 3.2 per cent was thus entirely brought about by food and energy prices. However, developments on the price front in October 2004 were no source of comfort. In September 2004, the seasonally adjusted 3-month annual rate (SAAR) for the movement of the index over the immediately preceding 3-month period (in this case July to September) were lower than the year-on-year value for inflation in September for both the indices, at 1.8 and 1.9 per cent respectively, indicating modest inflationary pressures. However, in October the value of 3-month trailing SAAR had risen to 3.4 to 3.5 per cent for the two indices. Energy prices which had risen by over 33 per cent on an annualised basis in the first two quarters, actually declined somewhat in the third quarter and in October.[11]

Producer Price Inflation (PPI—all commodities) in the USA has been running at around 5.0 per cent and over (on year-to-year basis) ever since January 2003. In May 2004 it touched 7.4 per cent, from which level it has declined somewhat and in September it stood at 6.6 per cent, which has gone up even further to 7.5 per cent in October 2004. The driving force behind this inflationary pressure was of course higher energy prices, but also tightness in other commodity markets, in a backdrop of strong global economic growth. The PPI index for finished goods also rose, but by less than overall PPI, averaging 3.3 per cent in the last 21 months. The recent peak was at 4.9 per cent in May 2004, and in September it stood at 3.3 per cent, but has gone up to 4.4 per cent in October 2004.

If food & energy are *excluded,* them PPI (finished goods) rate of inflation is seen to have increased steadily from marginally negative changes (year-on-year) in the first half of 2003 into positive territory touching 1 per cent in December 2003. For 2003 as a whole this index rose by only

0.2 per cent. The trend of increase was reinforced in 2004, touching 1.5 per cent in May and eventually 1.9 per cent in September and 1.8 per cent in October 2004.[12] The fact that with more rapid economic growth and big increases in energy prices, the *core* of inflation has failed to breach 2 per cent derives most possibly from continued productivity gains.

In the EU, consumer price inflation as reflected in the Harmonised Index of Consumer Prices (HICP) was expected to rise to 2.5 per cent in October 2004, according to flash estimates, up from 2.1 per cent in September.[13] Most of the major EU economies experienced an inflationary rate close to the average for the euro-zone, with a few exceptions. In the latter category were Spain with 3.2 per cent inflation in September 2004 (euro-zone *average* 2.1 per cent) and Netherlands with 1.1 per cent. In the UK inflation in September stood at 1.1 per cent, much below the euro-zone level, as also in Sweden (1.2 per cent), notwithstanding the much faster pace of growth that these economies have been experiencing. Thanks largely to the strength of the euro, the impact of higher energy prices has been limited—with the index for energy rising by 6.4 per cent in September 2004 (over the same month in the previous year)—because the impact of increase in the price of crude oil has been more subdued in the EU than elsewhere (see *Chart 3*). Thus while the overall HICP was 2.1 per cent in September, excluding energy would bring the number down to only 1.8 per cent. Items that showed strong inflationary movement in September 2004 were health care (8.5 per cent), alcohol & tobacco (8.0 per cent), transport (4.0 per cent) and education (3.2 per cent).[14]

Productivity growth and the implications

In the US the persistent low values for 'core' inflation that show an absence of over-heating, appears to be a consequence of the combination of high labour productivity growth, lagging employee costs and therefore lower labour costs. In 2003 (compared to 2002) in the business sector, output increased by 3.8 per cent, while labour hours worked *declined* by 0.7 per cent, leading to productivity growth of 4.5 per cent. Inflation-adjusted labour compensation per hour rose by 1.8 per cent leading to unit labour costs *falling*

by 0.4 per cent, compared to a *decline* of 1.1 per cent in 2002 (over 2001). The average for the first three quarters of 2004 (relative to the first three quarters of 2003) show higher output growth of 5.4 per cent, slight *increase* in labour hours worked (1.1 per cent), a resultant productivity growth of 4.3 per cent and *lower* unit labour costs by 0.1 per cent. However, since 2002, unit labour costs have been falling, but the rate of decline has been dropping off. In the third quarter of 2004 the provisional figures indicate that increase in hourly real wages had exceeded the increase in output per hour, as a result of which unit labour costs *rose* by 0.9 per cent. In other words, the productivity-linked ability of the economy to contain inflationary pressures might have become limited.[15]

Interest rates

There has been a series of four rate hikes of 25 basis points each, by the US Federal Reserve which has brought the fed fund rate up from 1 per cent to 2 per cent, and the discount rate up to 3 per cent. The first of the series was on June 30, 2004 and the latest on November 10, 2004. The European Central Bank has left rates unchanged for a long while at 2 per cent, while the Bank of England began to raise its monetary policy rate from November 2003 by steps of 25 basis points from 3.5 per cent to 4.75 per cent, the last hike coming in August 2004. The Reserve Bank of Australia began to raise rates in May 2002, when it in four steps of 25 basis points each brought the cash rate up from 4.25 per cent to 5.25 per cent in December 2003.[16]

At *Chart-1* is presented the movement of some key monetary policy rates over the past four years. The extent to which there has indeed been a divergence in the accommodation of liquidity in major markets is quite clearly evident especially towards the end of 2002 and the beginning of 2003.

The unprecedented surge of liquidity that the US Federal Reserve injected in a bid to curb recessionary trends, and particularly after the terrorist attacks of September 11, 2001 has brought interest rates in the US to historical lows. Rates in much of the rest of the world more or less also followed suit. It was a certainty that the process

Chart 1: Movement of key policy rates in recent years

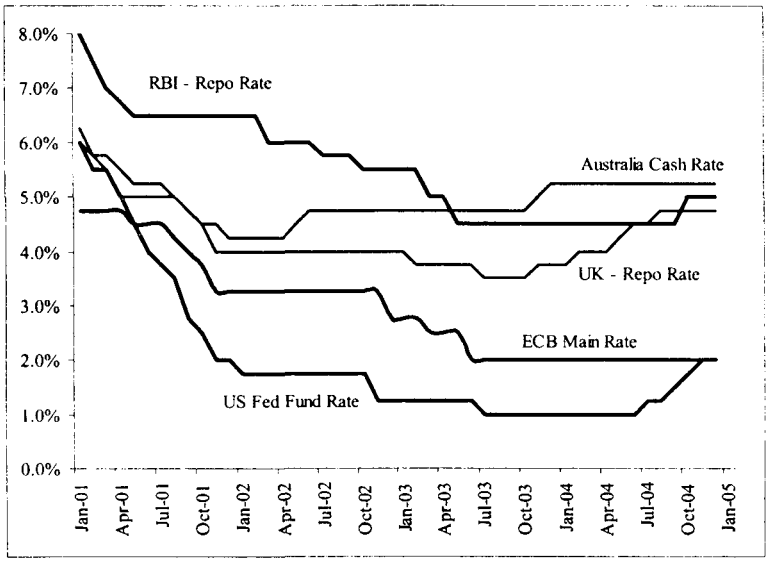
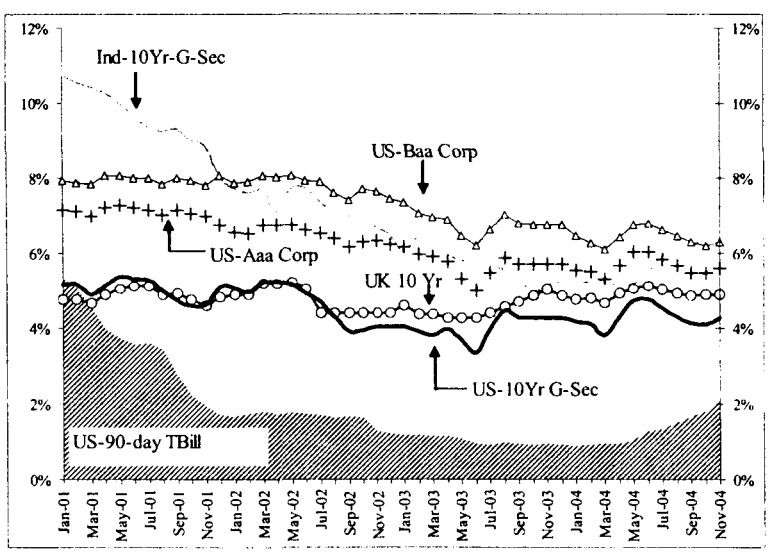


Chart 2: Movement of key US bond yields and 10-year Government of India security along with corporate bond and other yields



of lowering rates would have to be reversed as economic growth gained some momentum. In that respect the US Fed initiated the rate rise cycle a bit later than expected. In fact documents indicate that as early as January 2004, the US Fed had made up its mind about setting about reversing the interest rate cycle.

With changing expectations in regard to the strength of the economic recovery, long term yields have been very volatile. The yields on constant maturity 10-year US government securities had begun to harden in the third quarter of calendar 2003, climbing from a low of 3.2 per cent in mid-June to a high of 4.5 per cent in early September 2004. However, a combination of the economic news coming out little lower than expectations and strong appetite of some Asian central banks for US treasuries saw yields drop off to 3.75 per cent by March 2004. Yields rose furiously thereafter anticipating a turn in the liquidity cycle and touched 4.8 per cent in mid-May 2004. The economic news again eroded yields—despite the burgeoning US federal budget deficit, the expanding current account deficit and the rate hike by the US Fed—down to 4 per cent on 10-year paper in September and October 2004. Burgeoning crude oil prices were perhaps the major factor as it clouded over prospects of economic growth and therefore the demand for funds. As we go to press, the 10-year US treasury yields 4.20 per cent and for the record Moody's average corporate (industrial) bonds rated Aaa had yields of 5.45 per cent and those rated Baa had yields of 6.15 per cent.[17]

With the US dollar hitting new lows vis-à-vis the euro, which has primarily picked up (along with the sterling, Australian and Canadian dollars) the strain of the adjustment called for by the enormous US current account deficit, foreign exchange volatility is bound to be one of the major contours of the general uncertainties likely to characterise 2005. It is more than likely that the twin deficits in the US may continue to expand through 2005 and the strength of the dollar (and market yields on US bonds) are going to be greatly determined by the appetite of Asian central banks for US treasuries—as indeed it has been for some time. Given the non-transparent and non-market

motivated programme of intervention of the Asian central banks, the currency markets are quite leery of the business. Small disturbance can thus push the value of the dollar down quite significantly—with concurrent impact on a range of commodity and asset markets. The recent drop in the dollar vis-à-vis the euro to historical lows of 1.33 is to some extent motivated by nervousness of China's central bank to move a bit out of dollars and into other currencies.[18]

World Crude Oil Prices

Current Atlantic benchmark crude prices of close to, and on occasion, over $55 per barrel (/bbl) for WTI and $50/bbl for UK Brent, was certainly not something that anyone expected at the beginning of 2004. For much of 2003, UK Brent was fairly steady at around or over $30/bbl and that was the way the year ended. The prospect that with the fall of Saddam Hussain, Iraqi crude would flow in quantity into the world market had seen prices fall sharply to $25/bbl in April and May 2003, but that expectation soon changed into a longer wait as the grim post-war situation in Iraq began to unfold. The increase by as much as $20/bbl or by a whopping 40 per cent between January and September 2004 was not the outcome of any single event, but the fallout of a complex set of factors.

First, the widespread assumption that the resumption of Iraqi crude in substantial volume was only a matter of months, had the result through 2003 of building into market expectations a kind of complacence. Iraq was producing 2.8 to 3.0 mb/d through much of 1999 and 2000. It was widely believed at the outset of the 2003 invasion of that country, that it was capable of producing 4 million barrels per day (m/bd) with some investment to bring its creaking oil infrastructure up to standard, leave alone the much larger volumes that its deposits are capable of yielding with significant development investment. Iraq was producing between 2.0 and 2.5 m/bd till the end of 2002; following on the US-led occupation of that country its output has been below this level and continually threatened by interruption due to insurgent activities. That amounts to an expectation

gap in excess of 2 mb/d—which given that world output is currently straining at 83 mb/d to meet global oil demand—is a very sizeable gap indeed.

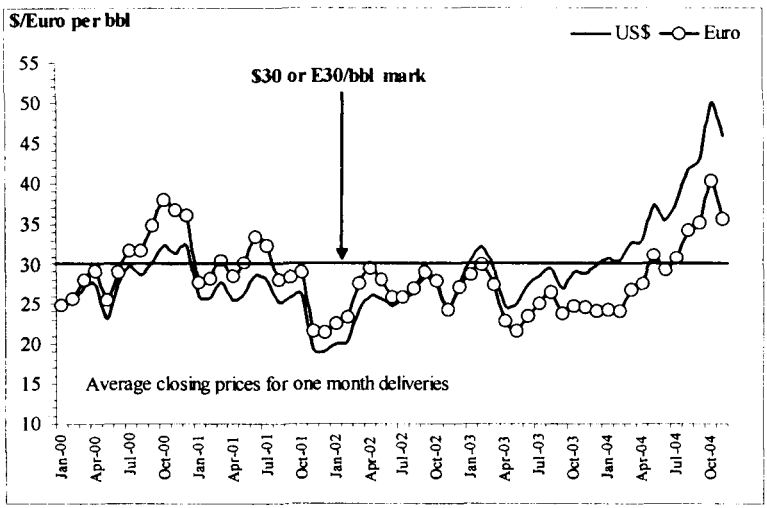
Second, demand growth has been much stronger than expected—due to unexpected increase in demand from Asian economies, primarily China and India, which together amounted for over 1 mb/d of additional demand in 2004. Moreover, demand growth in the US has also been robust despite higher retail prices.

In this context of unexpectedly tight supply and burgeoning demand, other developments came to be imbued with much greater destabilising potential, than they might have had in easier supply conditions. The crackdown by Russian tax authorities on Yukos, the largest oil producer in that country, did not actually disrupt production seriously, but the possibility was sufficient to spook markets. Similarly, the political developments in Venezuela, the likely disruption in Nigeria, the series of hurricanes in the Gulf of Mexico, and the agitation by Norwegian oil workers, each one of them sequentially helped to tilt market expectations towards fears of further supply disruptions and hence towards higher prices.

On top of all this, has been the possible impact of a weaker US dollar—the currency in which oil prices have traditionally been expressed. Although, it is unclear to what extent dollar weakness has had a role to play in higher oil prices, if any, it is not unreasonable to speculate that producers and exporters do indeed use different exchange rates to calibrate what their output responses ought to be in such a fluid and dynamic situation.

The oil business has been a cartel for about as long as it has existed. Only the cast of characters has changed, with OPEC nations in charge (more-or-less) ever since 1973. A cartel exists through its ability to restrict output. Demand is given from outside, so if I and my cronies who control the supply agree to cut back production, then the price will rise. Those outside of the cartel also gain by not rocking the boat overmuch such that prices begin to slide. On occasion—as during the Asian crisis—demand falls so precipitately, that the discipline of the cartel fails, and prices plummet as they

Chart 3: Crude prices – Brent US$ and UK£ per barrel
Prices for one-month deliveries (spot) from January 2000 to November 2004
Prices are averages for the month, except for November 2004



Note: A barrel is a measure of volume, and therefore the density of the crude governs the volume to weight relationship. Little over 7 barrels make a metric tonne, the heavier the crude the smaller the conversion factor, and vice versa. All prices are closing or settlement prices and these have been computed by averaging daily prices for the month. Euro-dollar exchange rates from Federal Reserve Bank of New York, daily noon rates.

Source: International Petroleum Exchange, United Kingdom, Federal Reserve Statistics (H.10).

did so memorably to $10/bbl in December 1998. But there is a plus side to this cartel business, which is that, there ought in theory to be a supply cushion which producers can fall back upon if demand rises more strongly than expected.

Why should producers not simply smile with glee and watch prices soar? Because they have an interest in price stability; prices that are too high can spur technological changes that can reduce demand in the long-term—as

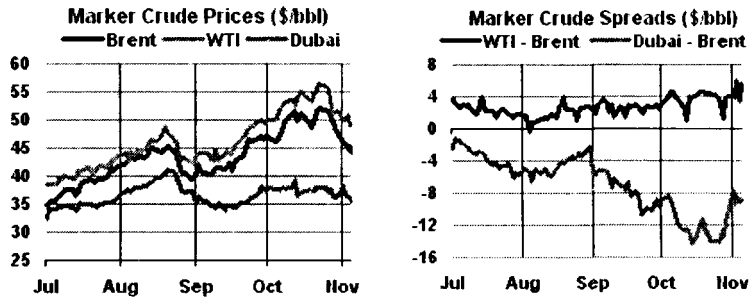
happened in the OECD, especially Europe, in the 1980s after the second oil price shock. Prices that are too high can also spur exploration and kick-in marginal high-cost sources. Most crucially, if oil prices rise too fast and to too high a level, it impacts economic growth adversely and then future period demand for oil is less than it would otherwise have been. For all of these reasons, the OPEC has always operated with some kind of a price band in mind: if prices were to fall below this they would cut back on production and if prices were to rise above the band, then they would step-up output.

The inability of the OPEC cartel, particularly of its Arab members, to maintain its traditional supply cushion and prevent prices to rise as much as they indeed have, has much to do with the reasons enumerated above. In addition, the collapse of oil prices in 1998 and 1999 had undermined the confidence of Western oil companies in allocating financial resources to develop new sources and as a result there simply was not enough new capacity to accommodate the unexpected surge in demand from developing Asia.

Something about crude benchmark prices need to be mentioned here. Traditionally, WTI (West Texas Intermediate) is the benchmark crude for US markets and rules a couple of dollars per barrel more than UK Brent, and the latter trades another two to three dollars over Persian Gulf light crude oils. *Chart 4* traces the three benchmark crude prices over the past few months as well as the differentials between them.

While the WTI-Brent differential has not changed much, the Brent-Dubai spread rose to $4 in August 2004, then to $8 in mid-September and has increased further to $12/bbl in the first half of October. Thus, while WTI has soared to $55 and Brent to above $50, Dubai crude prices are still below $40/bbl. As Atlantic crude prices began to drop in the closing days of October and early November, the spread also fell and now stands at about $8/bbl. How much longer this favourable differential will last, is another matter, but for India which purchases the bulk of her imported crude from the Persian Gulf, it is indeed considerable relief. Note the greater stability of Dubai crude prices *(Chart-4)* and the

Chart 4: Critical benchmark crude petroleum prices and spreads



Source: International Energy Agency, *Oil Market Report*, November 2004

very slight turn down when WTI and Brent began to fall off their highs in late October and early November. As of November 25, 2004 the average spot price for Dubai and Oman crude was $36.22c/bbl, about one-and-a-half dollars lower than its peak value some weeks back.

Over the past couple of months, OPEC members have raised production to try and ease the supply tightness and raised supply by 925 kb/d (thousand barrels per day). OPEC raised supply by 715 kb/d in September 2004 (compared to August), largely because of a 540 kb/d increase in Iraqi supplies (from a low of 1.8 mb/d in the previous month) and more output from Saudi Arabia, which country was reported to be able to raise output by 1 mb/d over a period of some months. But non-OPEC supplies had fallen in September (for the third month in a row) by 100 kb/d—largely because of hurricanes in the Gulf of Mexico. But in October, non-OPEC sources with hurricanes and maintenance problems behind them were able to raise supply by 685 kb/d, which together with a smaller increment from OPEC saw world oil supplies rise by 890 kb/d in October.

On the demand side, there seems to be evidence that demand in China is easing with growth in August 2004 slowing down to 6 per cent, from 12 per cent in July and 25 per cent in the April-June quarter. The International Energy Agency in its October report writes that: 'Meanwhile,

preliminary data for July have been adjusted downwards, to 6.19 mb/d, close to original forecast levels. The demand forecasts for the fourth quarter and 2005 have been reduced in anticipation of further demand slowdowns.' Further, the November report of the IEA reports that slowing demand in China has been supplemented by 'weaker-than-expected Indian August data'. So even if prices move glacially in our country, they do move and do have real effects.

Heating oil stocks in the USA were currently believed to be relatively low and that had contributed to hardening prices in October. However, these conditions have begun to ease and will do so further in December and in January 2005. But given the current tightness of supply and strength of demand, as well as the ability of demand to apparently withstand such high prices, it will be unreasonable to expect a significant easing of crude oil prices (that is, relevant to India, namely Persian Gulf prices) till perhaps the spring of 2005.

Political Developments—The International Backdrop

The year 2004 has been a year of elections—some three dozen in all—including of course, in the world's oldest and largest democracies, namely the USA and India. In that sense, there ought to be greater predictability about the turn of events over the next few years. However, in regard to the conflict in West Asia and the scourge of *jehadi* terrorism, there continue to be great uncertainties. The Bush administration in its second term would certainly seek to make something of a success in Iraq by instituting a local government capable of maintaining order mostly on its own; and perhaps bring to an end the positioning of tens of thousands of US troops in conditions of active warfare in West Asia.

It is pertinent to point out that in Afghanistan there was a sizeable domestic armed opposition in the form of the Northern Alliance to the Taliban regime, and hence there was no political vacuum after the expulsion of the medievalist mullahs, and no insurgency after the fall of Kabul, excluding isolated attacks by Pakistan-based Taliban elements. Even then, the popularly elected local government still needs international troops for security and will do so for time to come.

Conditions in Iraq are incomparably worse. Insurgency conditions are widespread, the sole coercive force in place to quell this insurgency is US troops, the neighbourhood is hostile and a post-conflict reconciliation seems difficult and some distance away. It is indeed very difficult not to be a pessimist on Iraq—at least for the near term. Which of course means that conflict and tension centred in Iraq might well continue to define the greater part of 2005. To the extent, that is, that the international *jehadists* do not further insert themselves into the focus of attention by executing terrorist attacks in various other parts of the world. It is difficult to see how these masters of terror tactics would be content with working on the canvas of Iraq alone.

Then there are the unresolved issues of North Korea and Iran and their respective programmes of nuclear weapons. It is extremely unlikely that the US would get embroiled in anything military with North Korea. It is too much of a problem for the immediate neighbours—China, Japan, South Korea and Russia. They have a much greater stake in sorting out the madness that the people of North Korea have had to put up with for so long—as long, that is, as the US does not interject itself into the forefront, which it has avoided doing so far—the rhetoric notwithstanding.

Iran is a more difficult issue. That country is on the verge of acquiring nuclear weapons, it has a history of acute hostility with respect to the US, it supports and finances the Hezbollah who figure high on the US's list of terrorist organisations, and most crucially has a very real interest in what happens in neighbouring Iraq. The largest civil group—if it may be so called—which has a critical role in the future success of any civilian government in Iraq is the clerical leadership of the majority Shia sect who have close bonds of identity with their counterparts in Iran. West Asia will continue to hold the world's attention in 2005, and not just because it supplies much of the world's petroleum needs.

India—Policy and Politics

The security environment in India remains stable, having improved dramatically through 2003. The UPA (United Progressive Alliance) government of Prime Minister

Manmohan Singh has continued to move to de-escalate tensions with Pakistan, and the evidence of infiltration across the Kashmir line of control (LoC) this summer, does tend to indicate further improvement. However, internal difficulties within Pakistan, as General Musharraf's government tries to contain the *jehadist* Frankenstein, continues to imbue the western front with security concerns. Insurgent activities in the north eastern parts of India, assisted by the nebulous nature of state control and accountability in the bordering regions have heated up in spots and also pose a serious concern. The inability of the political establishment in Nepal to achieve pacification of the Maoist guerrillas also continues to create unsettled conditions. However, if the normalisation of relations with China proceeds with speed and the ground conditions in Pakistan improve, the other hotspots that continue to fester on India's other borders will perhaps become somewhat easier to deal with.

The UPA government is now into its seventh month. It has been a fractious existence till date, with the Left parties clearly bent on distinguishing themselves from the Congress-led government by opposing practically every measure of reform which the government has advocated. That however, should not be all that surprising. The rationale of the Left supporting the Congress is based on keeping the Bharatiya Janata Party (BJP) out of power. The politics is about 'secularism' and there is little, if any, economic content to this platform.

The Left parties have always made it known that they detest 'economic reform' and 'market economics'; that they yearn for the heady days of the late 1960s and 1970s—socialist slogans, nationalisation, anti-market policies and plenty of controls. That after all was what the socialist paradise of the USSR and China was all about, till the Soviet Union crumbled and Deng Xiaoping took China on the capitalist path to economic progress and great power status. The Indian Left has not shed any of its ideological spots. In the late seventies it was appalled by Deng's pragmatism—'the colour of the cat does not matter as long as it catches mice'. Today, with China still a socialist country by declaration, and the ruling party still calling itself a

communist party, if the Indian Left is appalled by the revisionism of its Chinese comrades, it keeps that opinion to itself. China's achievements command respect across the ideological spectrum—and there is no percentage in not trying to cash in on some of the reflected glory.

Change in communist parties has always been violent and transformational. Deng Xiaoping certainly had the gentlest touch and a golden one at that. He had to await the demise of some of those who he could never have hoped to challenge and then did many battles to win out against the obvious legatees of Mao's political inheritance. The enormous economic success of more than a decade did not settle the discomfort amongst the old guard of the party. Deng used to say that 'reform is China's second revolution'. But perhaps there were many who longed for the rigours of the Long March. As late as in 1992, Deng felt compelled to say that 'we should be bolder than before in conducting reform and opening to the outside and have the courage to experiment. We must not act like women with bound feet.' It should not surprise that Deng projected his iron will beyond his death, naming all those who were to succeed him to the top job, as well as the auxiliary ones. They include the present incumbent Hu Jintao and his predecessor Jian Zemin. Under Deng's guidance, the Chinese communists have changed in a fundamental sense. They have found their own path, inspired by the history of a great nation, much more Confucian, barely Marxist-Leninist.

The Indian Left has remained stuck in the debates of an era long past. There is no evidence to believe that it has sought to learn from the transformative changes in China. Ideologically the Left remains the party of opposition. Only in West Bengal and Tripura, repeated electoral mandates have forced the Left to become a party of government. With their revolutionary aims restricted to the text of their party programmes, for the Indian Left it is as important to win re-election in these states, as it is to sound ideologically pure. Governance however needs pragmatism and this Dengist-essential always trumps the facade of purity.

The travails of the UPA have become an agony to watch. The government wants to do the obvious, what it finds reasonable, what it sought votes for. The Left does not wish

to be polluted by the shadow of the untouchable market principle. It is difficult to see a resolution to this problem, unless an artifice is devised whereby it is not the Brahmins in the Left with whom the government negotiates, but the less pollution concerned people who have the responsibility for running the governments in West Bengal and Tripura. These gentlemen are presumably more bothered about development and jobs, than the polluting shadow of globalisation. Since the Left's seats in Parliament are hostage to their success in getting development and employment opportunities going, pragmatism can be given a chance of pushing aside the deadweight of dead ideas.

The challenge of the traditional opposition to the UPA government is surprisingly weak. The Congress-NCP alliance has won re-election in Maharashtra and the hopes of the BJP in making an impression in the elections that are due in the next few years are very slender. Considerable division and internal squabbling has put the BJP into further disarray.

In that sense it is difficult to imagine a more favourable political situation for the Congress-led UPA government to successfully implement its programme for economic advancement and social progress. Provided it can circumvent the negativism of the ideologues of the Left.

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2. In fact the 7.4 per cent growth in the third quarter of 2003 owed nearly as much to the sign reversal in this item, as to the higher level of sale of durable consumer goods, particularly of automobiles.
3. Euro-indicators New Release STAT/04/123 dated October 14, 2004.
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5. *Commission's Autumn Economic Forecasts 2004-2006*, EU, Brussels, October 28, 2004 IP/04/1297. These forecasts indicate that, Germany the largest EU economy will grow by only 1.9 per cent and 1.5 per cent in 2004 and 2005, respectively; corresponding figures for Italy are 1.3 and 1.8

per cent, and that for Netherlands are 1.4 and 1.7 per cent. France is expected to do better at 2.4 per cent in 2004 and 2.2 per cent in 2005.

6. ibid.
7. *Statistical Pocketbook*. EU. October 2004, *Table 4.1.*
8. Viz, Czech, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia.
9. Namely, Romania, Bulgaria, and the several splinter nations of the Balkans. Belarus and Ukraine remain tied to Russia; whether that relationship will consolidate or break is uncertain.
10. *World Economic Outlook*, IMF, September 2003, pp. 32-33.
11. *Consumer Price Indices–October 2004*, Bureau of Labor Statistics, US Department of Labor, November 17, 2004 and data available at BLS website.
12. *Producer Price Indexes–October 2004,* BLS, US Department of Labor, November 16, 2004, plus data at website.
13. *Euro-zone inflation estimated at 2.5 per cent in October,* Eurostat, Euro-indicators news release STAT/04/129 dated October 29, 2004.
14. *Euro-zone and EU25 annual inflation down to 2.1 per cent,* Eurostat, Euro-indicators news release STAT/04/124 dated October 18, 2004.
15. *Productivity and Costs–Third Quarter and Annual Averages, 2004*, BLS, November 4, 2004. The annual estimates referred to are revised figures.
16. Except for the US fed fund target rate, all the others basically refer to the rate at which the central banks lend to commercial banks as part of normal transactions. In the case of the US Fed, the rate at which the central bank normally lends to commercial banks is determined by the discount rate which currently is 100 basis points above the fed fund rate, that is, at 3 per cent.
17. *Statistical Release H15*, Board of Governors, US Federal Reserve, trading day November 24, 2004.
18. *Chinese whispers frighten currency markets*, Financial Times, London, November 27, 2004. The story led by saying that: 'The dollar fell to new lows on Friday on rumours that China might shift some of its currency reserves away from the greenback, highlighting the dollar-related jitters in financial markets. The fragility in currency and bond markets has centred on fears that Asian central banks might dump US assets to avoid large losses as the dollar's value falls. The markets' nerves were highlighted by Friday's investor reaction to a report, later retracted, that China's central bank was offloading US Treasury bonds.'

The Indian Economy
Prospects for Accelerating Growth, Savings, Investment, Inflation and External Payments Front

At the end of September 2004, the Central Statistical Organisation (CSO) estimated that GDP growth in India in the first quarter (April–June) 2003-04 was 7.4 per cent. In sectoral terms that comprised a 3.5 per cent expansion in GDP arising out of agriculture and allied activities, 6.8 per cent growth in industry and 9.5 per cent growth in services [see Table 2.2]. The expansion in agriculture in the first quarter derived mostly from the bumper *rabi* (winter) crop of the previous year, quite a bit of which is harvested and processed in the months of April and May. The strong outturn in the service sector had much to do with the growth of 9.3 per cent in 'community, social and personal services' (that includes government), which quite plausibly was linked to the parliamentary elections held in May 2004. Had 'community, social and personal services' expanded at a more normal rate of 6 per cent, then service sector growth would have been 8.6 per cent (comparable to the annual average of 8.7 per cent in 2003-04) and overall GDP growth in the April–June quarter of 2004 would have been 7.0 per cent. The expenses associated with the May 2004 elections, it is thus not entirely indefensible to conclude, provided at least a 0.4 percentage point boost to first quarter GDP growth in 2004-05.

The estimate of GDP growth in 2003-04 was revised marginally upward in June 2004 from 8.1 per cent to 8.2 per cent. In sectoral terms this comprised of 9.1 per cent expansion in agriculture, 6.7 and 8.7 per cent growth in industry and services respectively (see Table 2.1), with non-agriculture growing at the rate of 8.0 per cent.

The large volatility of growth in the agriculture sector, which following the waywardness of the monsoon, is largely

responsible for the observed volatility in aggregate GDP growth over the years. In some contrast, the non-agricultural sector—that is, industry and services—has demonstrated lower volatility and that too, at a fairly high level of growth. For the 7-year period between 1997-98 and 2003-04, the average of annual GDP rates of growth was 5.9 per cent, that for agriculture 2.1 per cent, industry 5.1 per cent and services 8.0 per cent. The non-agricultural sector as a whole grew by 7.0 per cent. The purpose of taking the period starting from 1997-98 is because it: (a) excludes the very rapid expansion in manufacturing that followed after the initiation of the reform programme; and (b) it excludes the effect of the big bounce that agriculture received in 1996-97, in part courtesy of a contraction in the previous year. Taking standard deviation as a measure of volatility, aggregate GDP growth in the period had a value of 1.36 per cent, while for the non-agricultural sector it had a much lower value of 0.90 per cent. Agriculture and allied activities quite unsurprisingly had a much higher standard deviation of 5.13 per cent.

It has been argued that some of the growth in the latter part of the 1990s was due to the effects of the higher salary pay outs arising from the implementation of the Fifth Pay Commission, beginning 1997-98. The direct impact of this is of course evident in the 'public administration' component of the services sector, though surely second order and subsequent effects would have been manifest in other sectors. If we take the 'public administration' component out, then for the period 1997-98 to 2003-04, the average annual growth rate of GDP less this component was 5.6 per cent and the standard deviation was 1.46 per cent. Similarly, for the non-agricultural sector (with public administration excluded), the average annual growth was 6.9 per cent and the standard deviation was 0.81 per cent.

The upshot of all this is the reiteration of a point being made in this survey, namely that in looking at the outlook for economic growth, one must take explicit cognizance of the fast growing and more stable trajectory of growth of the non-agricultural sector, quite separately and distinct from what happens to agriculture. Undoubtedly there are

Table 2.1 : Sectoral Annual Growth Rates in the Decade Post-Reform

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	*2005* (forecast)*
GDP at factor cost	**5.9**	**7.3**	**7.4**	**7.8**	**4.8**	**6.6**	**6.0**	**4.4**	**5.8**	**4.0**	**8.2**	***6.3***
Agriculture & allied activities	4.1	5.0	–0.9	9.6	–2.4	7.1	0.5	–1.4	6.8	–5.2	9.1	*–1.0*
Non-agriculture	**6.7**	**8.5**	**10.9**	**7.1**	**7.6**	**6.4**	**8.1**	**6.3**	**5.5**	**6.9**	**8.0**	***8.4***
Of which:												
Industry	5.2	10.2	11.7	7.0	4.3	3.4	5.3	6.5	3.3	6.4	6.7	*7.6*
Services	7.7	7.1	10.4	7.2	9.8	8.2	9.7	6.2	6.6	7.1	8.7	*8.8*
Memo items												
Manufacturing—registered and unregistered	8.5	12.0	14.9	9.7	1.5	2.5	4.4	7.1	3.7	6.2	7.3	*8.0*
Trade, hotels, transport, & communication	7.1	10.4	13.3	7.8	7.7	7.1	8.3	7.8	8.6	7.0	11.2	*10.5*
Finance, insurance, real estate & business services	13.4	5.6	8.2	7.0	11.6	8.4	9.6	3.5	4.5	8.8	6.8	*7.5*
Community, social & personal services	3.5	3.2	7.9	6.3	11.7	9.9	12.1	6.1	5.3	5.8	6.0	*7.1*

Note: Forecast for financial year 2004-05 based on available data and general indicators

Source: Data for all years up to 2003-04 from Central Statistical Organisation, various press notes up to June 30, 2004.

Table 2.2: Sectoral Quarterly Growth Rates—Year-on-Year Basis

	2001-02				2002-03				2003-04			2004-05	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
GDP at factor cost	**4.7**	**5.4**	**6.2**	**6.6**	**5.1**	**5.5**	**2.0**	**3.7**	**5.3**	**8.6**	**10.5**	**8.2**	**7.4**
Agriculture & allied activities	4.3	7.0	6.2	9.7	0.6	-2.9	-9.8	-6.3	0.1	6.8	16.5	16.0	3.8
Non-agriculture	**4.8**	**5.0**	**6.2**	**5.7**	**6.5**	**7.6**	**6.8**	**6.7**	**6.9**	**9.0**	**8.4**	**7.7**	**8.5**
Of which: Industry	1.9	2.6	3.8	4.9	5.3	7.2	6.8	6.4	6.0	6.3	6.4	7.9	6.8
Services	6.5	6.4	7.5	6.2	7.2	7.8	6.8	6.9	7.4	10.4	9.5	7.6	9.5
Memo items													
Manufacturing—registered and unregistered	3.2	3.4	3.7	4.4	4.0	6.7	6.9	7.3	6.6	7.4	7.5	7.5	8.0
Trade, hotels, transport, & communication	7.7	9.0	8.1	9.6	6.4	7.4	6.5	7.7	7.3	9.9	13.3	13.0	10.5
Finance, insurance, real estate & business services	4.4	5.0	4.8	3.9	9.6	9.8	8.6	7.5	5.7	6.4	6.5	8.0	7.0
Community, social & personal services	6.5	3.4	9.2	2.9	6.2	6.4	5.6	5.1	9.4	15.2	5.3	4.0	9.3

Source: Central Statistical Organisation, *Quarterly Estimate of Gross Domestic Product*—Press Notes up to September 30, 2004.

linkages, but at best they are numerically not that significant. Furthermore, the dominant factor defining whatever linkage truly exist, is likely to be the fact that the geographical sub-set of agriculture that makes up a disproportionately large share of the rural market for manufactures and other modern services, namely the richer farm belts of north western India, and some of the fertile southern deltaic and commercial crop growing regions, are relatively insulated from the vagaries of the monsoon.

Outlook for 2004-05

The exceptionally high rate of growth in 2003-04 was owed in large measure to the rebound of agriculture from the depths that it had plunged to in the previous year, because of the widespread failure of the South West monsoon of 2002. Even if the monsoon in 2004 had been a satisfactory one, it is most unlikely that we would have had more than a marginal expansion of incomes in the farm sector. In the event the SW monsoon 2004 turned out to be deficient to the extent of 13 per cent in terms of total precipitation. While in 2003 only 3 meteorological sub-divisions had suffered deficient rainfall, in 2004 the figure was thirteen. It is difficult to see how there will not be a contraction in aggregate output, even if the irrigated north-west, which bore the brunt of the deficiency, is less susceptible compared to the dry lands of the peninsula. It is reasonable to expect that the *kharif* (summer) crop will be smaller than last year, and even if the *rabi* (winter) crop does well, on the aggregate some contraction in overall GDP arising from the sector for the full year is very likely. We estimate a 1 per cent decline in the GDP from the farm sector (see Table 2.1).

Our estimates for the different components of industry and services are based on a combination of the trends apparent over the past several quarters, industrial production and trade data available up to September/ October and other indirect indicators of output expansion, besides the anecdotal evidence—admittedly mostly gleaned from the corporate experience. On that basis we see a stronger performance in manufacturing and other industrial

sectors and a continuation of the expanding trend in other parts of the service sector. Key numbers are placed in the extreme right hand column of Table 2.1, with the estimate of aggregate GDP growth at 6.3 per cent; that for industry at 7.6 per cent and for services at 8.8 per cent, with non-agriculture together doing 8.4 per cent. Manufacturing output growth has averaged over 8 per cent for calendar year 2004 (January to September), and we expect that its GDP counterpart would approximate this value for the complete fiscal year 2004-05.

Official Forecast for 2004-05

The Reserve Bank of India (RBI) in its mid-term review the *Annual Policy Statement*, on October 26, 2004, lowered its growth forecast to 6.0–6.5 per cent, down from the pre-monsoon estimate of 6.5–7.0 per cent. Though not explicitly stated, it would appear that the revised growth forecast not just builds in lower, perhaps negative growth in agriculture, but also stronger industrial growth than might have been expected in May 2004. The RBI has however chosen to insert the caveat that its revised forecasts assume that 'the combined downside risks of high and uncertain oil prices, and sudden changes in international liquidity environment remain manageable'.[1] Our analysis is in broad agreement with the central bank's present position.

Savings and Investment—An Estimate for 2003-04

National accounts data for GDP by disposition continue to be made available with nearly a year's delay at the end of January of the following year, and the provisional figures generally are significantly revised in the next year. Thus, at the moment we still have to make do with the provisional estimates for 2002-03 and the revised estimates for 2001-02. However, the RBI does make available the savings of households that are made in the form of financial assets for the previous financial year in its *Annual Report* for the year. Households in the parlance mean individuals and unincorporated business. In 2003-04, gross financial savings of households increased to 15.1 per cent of GDP from 13.6

per cent in the previous year. The liabilities of households to the banking system rose to 3.2 per cent of GDP, from 2.9 per cent in the previous year. Thus, the net financial savings of the households available for the rest of the economy (including government) to borrow stood at 11.8 per cent of GDP in 2003-04, up from 10.7 per cent in 2002-03—a significant increase of 1.1 percentage point of GDP.

The RBI *Annual Report* estimates that the revenue deficit of the central and state governments declined from 6.6 per cent in 2002-03 to 6.2 per cent of GDP in 2003-04 on the basis of revised estimates (RE). Although there is some difference between RE and the audited accounts it generally is not large enough to make a difference beyond the second place of decimals. The revenue deficit as computed by the budgetary process is not the same as that done by the national accounts process and hence there is a difference between the budgetary revenue deficit and the measure of the negative savings or dissavings by the government system in the national accounts statistics (NAS). For 2002-03 the NAS estimate of government dissavings was 5.7 per cent of GDP, somewhat lower than the 6.1 per cent of 2001-02. The budgetary revenue deficit in 2001-02 had been 7.0 per cent and had come down to 6.6 per cent in 2002-03, which was a 0.4 percentage point of GDP decline—exactly of the same magnitude as the reduction in the NAS measure of government dissavings (from 6.1 to 5.7 per cent of GDP). By the same token it is plausible to infer from the reduction in 2003-04 of the budgetary revenue deficit from 6.6 to 6.2 per cent of GDP that the NAS measure of government dissavings in 2003-04 must have declined by close to 0.4 percentage points relative to 2002-03. That gives us an estimate of 5.3 per cent for the negative savings of government in 2003-04.

Starting with the numbers for net financial savings of households and the dissavings of government, we can work our way towards making a reasonable estimate of what might have been the magnitude of savings in the economy in 2003-04. That is, excluding the 'savings in physical assets'—a number that broadly corresponds to the physical assets (and inventory) constructed by households and

unincorporated business. Total domestic savings less 'savings in physical assets' basically corresponds to the financial resources that are available to the private corporate and public sector (government and state-owned companies) for capital accumulation. The current account deficit, which is the net foreign savings available for financing domestic investment, links this savings estimate to investment made by corporates and government. For the sake of convenience, we shall refer to the ratio of this component of investment (representing the domestic and international financial resources used by private corporates and the public sector for capital formation) to GDP, as (part) investment ratio, so as to distinguish it from the overall investment ratio, which includes the 'savings in physical assets'.

We take a marginal improvement in the retained earnings of state-owned corporates to 3.8 per cent in 2003-04, relative to 3.7 per cent in 2002-03 and no change in the retained earnings of departmental enterprises. That gives us an overall dissavings for the public sector at 1.4 per cent, compared to 1.9 per cent of the previous years and the 2.7 per cent of 2001-02.

Private corporate savings (retained earnings) have improved significantly in 2003-04, relative to the previous year and we estimate that this number as a proportion of GDP would be 3.6 per cent, which is a small improvement over the 3.4 per cent of the previous year.

The combination of the above gives us an estimate of 14.1 per cent for gross domestic savings in 2003-04, compared to the reported NAS number of 11.9 per cent in the previous year. However, if we were to factor in the RBI revised estimate of household financial savings in 2002-03 as available in this year's *Annual Report*, then assuming all other things unchanged, the aggregate domestic financial savings number for 2002-03 would be 12.3 per cent—but still quite a bit lower than the estimate of 14.1 per cent for 2003-04.

Net capital inflow (NAS current account deficit) was–0.5 per cent of GDP in 2002-03 and has risen to–1.4 per cent in 2003-04. The negative sign of course indicates that there was

a current account surplus. Knocking this off, what we get is that the financial resources available to government and private corporate sector for capital formation in 2003-04, that is, 12.6 per cent of GDP, represented an increase by 1.7 percentage points of GDP over the reported number, and perhaps 1.3 percentage points of GDP greater than what might eventually be the revised number for 2002-03.

That gives us an improvement in the range of 10–14 per cent in the (part) investment ratio. While such an order of increase in the (part) investment ratio is quite significant, one must hasten to add that the same measure has had higher values for much of the 1990s.

An increase in the (part) investment ratio actually means that the real growth in the relevant variable was indeed larger. Thus, investment by corporates and government in 2003-04 must have grown by between 18 and 22 per cent in real terms (using the implicit GDP deflator, not an investment-specific deflator). We of course do not know what happened with the category 'investment/savings in physical assets', i.e. the household and unincorporated sector. Assuming that this ratio remained unchanged (12 per cent) in 2003-04, then, the overall investment rate would have risen from 23.9 per cent in 2002-03 to 24.6 per cent of GDP in 2003-04. That is, an increase of between 5.4 and 7.1 per cent in the aggregate investment ratio, which corresponds to a real growth of 13.6 to 15.3 per cent. If we remember that this comes on top of 10.7 per cent increase in real fixed capital formation in 2001-02—we get a sense of what might be happening in investment activities and what is driving the current growth process.

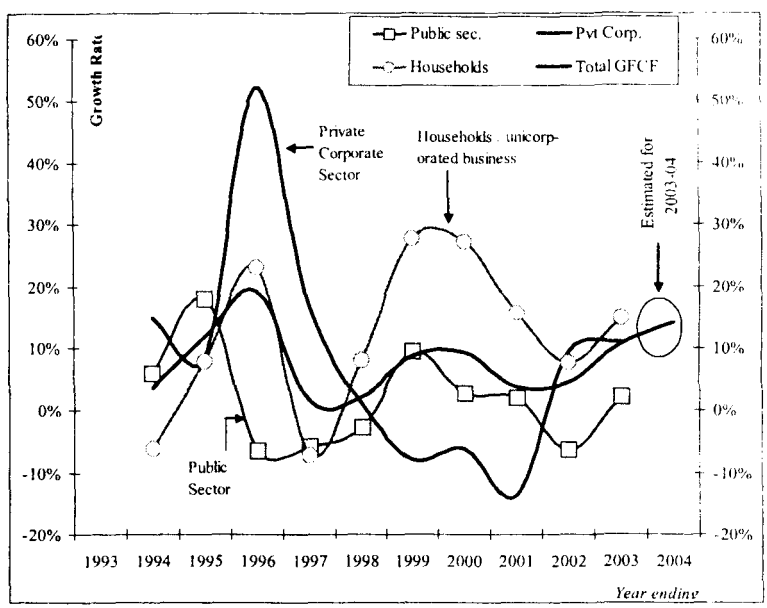
Investment and accelerating growth on a sustained basis

We present a chart plotting the rate of increase in fixed capital formation at constant prices in terms of institutional classes that reinforces the anecdotal evidence that there is an in-phase expansion of fixed asset creation by the private corporate sector, public corporate sector, unincorporated businesses and government. Although no data is available beyond that for 2002-03, we present at *Chart* 1 these figures.

There is considerable live interest in light of the evidence of rising investment in the form of higher credit off-take by the commercial sector from the banking system, the strong growth of both output of the domestic machinery sector and the import of equipment, besides the anecdotal corporate investment story. We have also placed the estimate that we have made above for 2003-04 in the chart for total investment only—the portion marked out in a circle.

The divergent behaviour of private corporate and unincorporated businesses has been a notable feature in recent years. After the splurge of investments in the immediate post-reform period, many large firms that had grown up in a culture of permissive bank lending and protective tariffs, suddenly found themselves over-leveraged and in poor shape to take on competition—both domestic and global. Since 1998, there has been an on-going process of consolidation in the Indian private corporate sector—the first in its history in fact. In consequence, firms that had

Chart 1 : Rate of change in fixed capital formation by ownership categories



the financial capacity to expand focused their attention on acquiring revenue-earning assets. In consequence, fresh investment in fixed asset creation was temporarily swamped by investment in acquisition, write-offs and laying-off surplus labour. This behaviour was restricted to large corporates and held little meaning for unincorporated businesses, where fresh investment almost inevitably had to mean fresh asset creation. Hence the variation in the behaviour between the two parts of the Indian private sector.

Over the first three years of the new millennium (2000-01 to 2003-04), average GDP growth has been 5.6 per cent, while average per capita GDP has risen by 3.8 per cent, certainly not much comfort, and at a great distance away from the promise of the early years following economic reform. Leave alone the years of strongest growth between 1993-94 and 1996-97, even that for the entirety of the decade of the 1990s post-reform (including 1993-94), average GDP and per capita GDP growth were much higher at 6.5 and 4.6 per cent respectively. Sluggish agriculture in this case is not the culprit, as the non-agricultural component of the economy which grew at an average rate of 7.9 per cent through the post-reform 1990s, registered a growth of 6.7 per cent in the immediate post-2000 years. The urgency to accelerate economic growth—both as the obvious imperative for achieving higher employment and incomes and lower poverty and as an outcome, conditions that permit success in re-election—has encouraged the political establishment to raise the bar, so to say. The previous National Democratic Alliance (NDA) government had some years ago decided that the target rate of economic growth in the Tenth Plan (2002-07) period ought to be raised to 8 per cent. The UPA government has unsurprisingly taken a more realistic call at above 7 per cent, perhaps 7.5 per cent.

The baseline and accelerating from it

Where is the economy today, in terms of the baseline—that is, the level of economic growth which would be sustainable if things were to continue more or less as they presently obtain? Agriculture and allied activities have over the past decade averaged growth of 2.8 per cent, but through

the year-to-year gyrations it has been falling and the average rate over the previous five years is 2.0 per cent, and were it to include the current fiscal, the underlying rate may well be discerned to be a little lower than 2.0 per cent—somewhere closer to 1.75 per cent. Industry and services—that is, non-agriculture—were more tightly clustered around 7.0 per cent in the previous 5-year period, but this is on the rise, and the sustainable rate is probably 7.5 per cent. That gives us a baseline growth for aggregate GDP of 5.9 per cent, say 6.0 per cent.

If we wish to lift this to 7.0 per cent, and agriculture does not slip any more (that is, it continues to grow at close to 2 per cent annually on an average basis), the non-agricultural component, namely industry and services will have to accelerate to 8.5 per cent. If the level of investment optimism that exists currently can be maintained, then it is not inconceivable that industry and services will be able to average output expansion of 8.5 per cent on a sustained basis, with some help from the policy side and some easing of infrastructural bottlenecks, which again for the most part emanate from policy constraints. Sustained GDP growth of 7.0 per cent would see per capita GDP rise annually by over 5.3 per cent, which in the presence of other policy instruments should result in considerable reduction of poverty and increase in employment.

Raising the sustainable level of growth to 7.5 per cent and more (and per capita income growth closer to 6 per cent), in the absence of a very large increase in the rate of growth of agricultural incomes (to above 4 per cent), would need that non-agriculture output expansion is lifted up to over 9 per cent. That is not inconceivable, but would need a much larger magnitude of creative policy intervention. Significant changes in the policy regime and the structure by which such policies are effectuated will be needed to provide a big boost to manufacturing activity, which in the present stage of economic development, appears to be the only way to push non-agricultural output growth on a sustained basis to over 9 per cent.

That includes removing the clutter that makes, for instance, electricity generation and distribution an unviable

business proposition in most parts of the country, and forces enterprises to choose to remain in the 'unorganised' sector, rather than enter the regulatory jungle that the 'organised' sector is rewarded with. It certainly includes improving the efficiency of public expenditure which accounts for a very sizeable 30 per cent of GDP and improving the channels by enterprises being given access to the credit and capital markets. These are not infeasible, nor implausible targets, but they are very tough to get significant traction on.

The regulatory problems with most infrastructure businesses—power generation and distribution, bulk water supply and urban economic infrastructure are too well-known to bear repetition. It is worth reiterating that the principal constraint to higher levels of investment in this economy, at least in the present context, are the burdens of bad regulation—both in the sphere of legislation and often more so in the sphere of administration.

The private corporate sector following significant restructuring is much stronger today. The extent to which the principal growth agent—private enterprises from farm to corporate—can be provided the space to maximise his/her efforts is something that is the outcome of the governance process. How successfully the UPA government will traverse this path is a call that is difficult to make, for intentions alone do not craft the final outcome. The political hurdles that have been clearly presented by some of the government's allies to several of its stated intentions make the whole business somewhat difficult to predict.

Finances for investment and the issue of remittances

Indians working abroad send money home to their families—first it was from the Persian Gulf, now from North America and Europe too. In the old days of the licence raj, the rupee was over valued, customs duties and restrictions on imports were both murderous. Enter the professional smuggler and *hawala* man: a sizeable chunk of the remittances never made it through banking channels, but financed the smuggling of gold, electronic goods and other goodies. Now that the unintended consequences of control have been thrown overboard, most, if not all, the

remittances enter India through regular banking channels and are accounted for in the balance of payments (BoP).

In 1990 the total of such remittances amounted to $2 billion. It steadily rose in the aftermath of reforms to $8 billion and then to $12 billion in 1996-97. Thereafter, it stayed at that level before climbing to $15 billion in 2002-03, approaching $23 billion in 2003-04 and is likely to cross $25 billion in the current fiscal. Part of the reason for the increase is the tens of thousands of Indians who have joined the expatriate workforce overseas as IT people, and there is little reason to believe that the level of such remittances has peaked.

The size of such remittances is big in every way. Not just in terms of the fact that our current account surplus in 2003-04 was just above $10 billion, but also as a proportion of gross domestic product (GDP) private remittances amounted to as much as 3.3 per cent. Now, these remittances are part of the GDP of the economies expatriate Indians are working in—be it the UAE or the USA. When they send back money home, it is treated as factor income inflow and become part of India's national income. That national income is expended on consumption and the balance becomes the national savings. In the absence of these remittances, (all other things being unchanged) the savings ratio in 2003-04 would have been 3.3 percentage points of GDP *less*. And the current account balance, instead of being in surplus to the extent of 1.5 per cent of GDP, would have been in a deficit of 1.8 per cent. Other than this obvious fact, namely, that there is in a sense an excess of savings in the Indian economy in recent years, is there any other material implication?

There indeed is. Government in India spends 30 per cent of GDP and still has a fairly heavy hand in the macro-management of the economy—as evidenced by the fact that the Central Plan alone amounts to over 5 per cent of GDP. The Tenth Plan[2] for instance in working out its macro-balances was left with a current account deficit of over 2 per cent of GDP over the Plan period, instead of which we landed up in surplus. A ready explanation for this is of course that this happened because investment fell far short

of what was assumed and so did economic growth—which is true in a way.

However, look at it like this: the investment-savings balances that result from the domestic growth process are by definition linked to what activities go on within the physical domain of this economy, that is, in India. The net consequence of these outcomes on the external payments front is indeed a current account deficit of 1.8 per cent of GDP. It so happened that savings made out of the GDP of some other country were remitted to India amounting to 3.3 per cent of our GDP and as a result the current account went into surplus. The economic process which generated these incomes and savings were completely independent of what has been going in this country. Thus, even with both lower-than-planned investment ratio and GDP growth, the Indian economy was actually still short of capital. Therefore savings matter, especially government savings, which are of course currently a big negative number.

Something else matters more. Which is that, in looking at the economic growth process, we ought to look more favourably at imports as augmenting the availability of raw materials, intermediates and capital goods within India, so as to provide the real resources for higher investment and faster economic growth. This can be facilitated by lower import duties and a somewhat stronger rupee. Because, the resultant current account deficit (CAD), that is the direct outcome of the domestic economic process, will have ready financing up to 3 per cent of GDP from remittances—inflow of incomes that is generated in other economies and of savings made out of such income.

Net capital inflows into the country in 2003-04 amounted to 3 per cent of GDP and 2 per cent in the previous year. There is every reason to believe that Indian equity assets remain attractive to both foreign direct and portfolio investors, and Indian corporates have the ability to borrow overseas to a significant extent. With reasonable economic performance it is difficult to see how net capital inflows could fall below 2 per cent of GDP.

Now, if the level of remittances is over 3 per cent of GDP, surely we can set our parameters to target a CAD of 5 per

cent and above, such that we will be left at the end of the day with an eventual CAD of about 2 per cent of GDP—which would find easy financing from the capital side. Any downside is mitigated by the fact that we have over $120 billion of foreign exchange reserves. Clearly there is much to be gained by making imports more competitive by way of further lowering duties and letting the rupee strengthen somewhat. Higher levels of imports can add to customs revenues, and a stronger rupee will mean lower inflation.

There is some urgency for us to move on this path, for some of the earnings of software and BPO, are not dissimilar to that of remittances, in the sense that they are part of the economy of another country and are thus exogenous to the domestic economic process, and these businesses are going to only get bigger.

Larger policy implications of exchange rate policy

Before we go any further a few comments on the issue of rupee appreciation need to be emphasized. The market for the rupee is very thin and any sudden change in policy away from managing through intervention will cause the rupee to appreciate very rapidly indeed. The principle that financial markets 'overshoot' would be magnified enormously by virtue of the fact that the rupee market is as thin as it indeed is.

The next issue that we need to bear in mind are what the other constraints are: the IT/BPO and (possibly off-shore medical services soon) are becoming big successes and are the only sectors to create good quality jobs for hundreds of thousands of our educated young people. India has not done too good a job in manufacturing exports, but things look far more positive now. It is no longer an idle daydream to conceive of flourishing manufacturing businesses coming up in the SEZs insulated from our Mad Hatter employment regulations. This is the only way we can hope to offer jobs to the hundreds on thousands of our young people with 8 to 10 years of schooling who will not find jobs in IT, but can do so in factories.

Then there is our neighbourhood—our fastest growing market and our principal competitors—with whom at long

last we are looking to build deep economic and political integration: China, rest of East Asia, South and Southeast Asia. We have to keep in mind the policies that they adopt and adapt, when looking forward in developing our own policy stances.

It would be a monumental stupidity to think of exchange rate policy without considering the impact that such policy might have on the outlook for these businesses.

Accelerating growth—the challenge and the reality

The numbers for recent years suggest that a reasonable baseline growth for aggregate GDP is just shy of 6.0 per cent. If this is to be raised to 7.0 per cent, and agriculture does not slip further (that is, it continues to grow at close to 2 per cent annually on an average basis), the non-agricultural component, namely industry and services, will have to *accelerate* to 8.5 per cent. If the level of investment optimism that exists currently can be maintained, this is eminently conceivable, that is, with some help from the policy side and an easing of infrastructural bottlenecks. Sustained GDP growth of 7.0 per cent would see per capita GDP rise annually by over 5.3 per cent, which in the presence of other favourable policy instruments, should result in considerable reduction of poverty and increase in employment.

Raising the sustainable level of growth to 7.5 per cent and more (and per capita income growth closer to 6 per cent), in the absence of a very large increase in the rate of growth of agricultural incomes (to above 4 per cent), would require non-agriculture output expansion to be lifted to over 9 per cent. That is not inconceivable, but would need a much larger magnitude of creative policy intervention and at the moment is a bit speculative.

The private corporate sector's significant restructuring is much stronger today. The extent to which the principal growth agent—private enterprises from farm to corporate—can be provided the space to maximise their efforts is something that is the outcome of the governance process. How successfully the UPA (United Progressive Alliance) government will traverse this path is a forecast that is

difficult to make, for intentions alone do not craft the final outcome. The political hurdles that have been clearly presented by some of the government's allies to several of its stated intentions make the whole business somewhat difficult to predict.

The dual economy–lagging agricultural growth and job creation

The purpose of this discussion is to highlight the importance of seeing the Indian economy in terms of this basic duality. On the one hand, a rural sector that is primarily dependent on agriculture and allied activities where two-thirds of the population live. On the other, an urban sector that is primarily dependent on industry and services where one-third of the population currently resides.

GDP arising in agriculture and allied activities has for most of the past fifty years grown at a trend rate of between 2.5 and 2.8 per cent, with some acceleration in the mid-eighties to just over 3 per cent for the decade of the eighties. During this five-decade period, major changes in technology have positively impacted agriculture—extension of irrigation, multiple crops, introduction of high-yielding varieties, increased mechanisation of farm activities and in consequence higher productivity of land. In addition animal husbandry, horticulture, private forestry, floriculture and fish farming have grown manifold. Thus, this 2.5–3.0 per cent growth has been the consequence of the many successful initiatives that have been taken with respect to the farm sector and the large public investments that have often been behind such initiatives.

However, the inescapable fact is that in 1951, India's population was 359 million, of whom 295 million lived in the countryside and the remaining 64 million lived in urban areas. Five decades later, of a total population of 1,025 million, rural India had 740 million people—that is 72 per cent. In the five decades that have elapsed, the country's landmass has, of course, not changed. But the rural population is 2.5 times larger and the number of people engaged in agriculture for their livelihood has at least doubled. The vast pool of underemployed people live in

India's half a million villages. They are the potential producers, who can produce to their potential only if moved out of agriculture and into other operations—and the potential consumers if such a re-deployment could happen. The process of migration from village to town has happened despite of an avowed policy that has been unfriendly to urban development, preferring instead to pretend to believe in a pastoral utopia in which Indians would choose to live in the village.

Economic growth and its medium-term prospects

The fact is, incomes arising in agriculture and allied activities cannot rise by very much over the trend rate of 2.5–2.8 per cent. This has several implications.

1. The use of scarce public resources to boost output in the sector will generate at best limited growth dividends.
2. The best way of raising per capita incomes in the sector is to facilitate the redeployment of additions to the rural labour force away from agriculture.
3. The redeployment of elements of the underemployed rural workforce into more productive areas, in industry and the service sector, has tremendous potential for raising overall GDP growth.
4. Higher rural incomes and higher overall incomes would result in a rapid reduction in poverty.
5. To drive this redeployment, the natural process of urbanisation—the expansion of the smaller towns and cities—must be facilitated, instead of continuing as at present, hampered by a political entitlement system that militates against the development of urban economic infrastructure in these locations.
6. For the limited purpose of looking ahead in the near term, the fact is that most of the growth in the economy will come from non-agricultural activities. The latter's rapid growth will continue to be offset by the slow growth of the agricultural sector which still has a one-fifth share in the economy.

It is best to look at the agriculture and allied activities sector as being somewhat exogenous to the activities of the

non-agricultural sector. Thus, it would not be far-fetched to expect a repetition of this year's (2003-04) 8.0 per cent growth rate in non-agriculture in the next year, gravitating to above 8 per cent, given a favourable policy environment. After all that would mean a not insignificant, but feasible, improvement that is just over the trend rate of 7 per cent over the past one-and-a-half decades. However, it would be unrealistic to expect that agricultural GDP would behave in any fashion that is materially different from that in the past—which means at most average growth of between 2.5 and 3 per cent.

Let us take the reasonably optimistic values of, say, 2.8 per cent in agriculture and 8.5 per cent in non-agriculture operative up to 2010. We would then get average growth of 7.4 per cent over the next several years, and by 2010 the share of agriculture in the economy would have further fallen to below 17 per cent.

The lessons of the general elections of 2004 have re-emphasized the need to make the necessary transformation, while at the same time adopt a policy stance that provides relief to the farm sector. While the latter will have some output side effects and it will be welcome in itself, the principal idea must be to actively engage farming India and its voters into the economic process of reform, which, in an electoral democracy like India, is perhaps the only means of ensuring that it becomes possible to build a genuine national consensus on economic reforms.

Prospects for Growth in the Medium Term—2005-06 and Beyond

In the medium-term, a strong probability exists of acceleration in the rate of economic growth, from the present underlying one of 6.0–6.5 per cent to 7.0–7.5 per cent. This can happen through the agency of investment-friendly and employment-friendly policies—given that the basic soundness of the economy provides the balance of the necessary conditions.

If our forecast for 2004-05 turns out to be tolerably accurate, then in the next year, that is, 2005-06, overall GDP

growth should rise to 6.8 per cent. This assumes that there will be a normal monsoon and a resultant small increase by less than 2 per cent in farm output; some deceleration in manufacturing and mining output, offset to an extent by stronger activity in construction leading to slightly lower industrial GDP growth at 7.2 per cent, and expansion in the service sector by 8.5 per cent, little slower than in 2004-05.

Policy measures that are taken in the balance five months of 2004-05 can affect outcomes in 2005-06. If investment-friendly decisions are taken and implemented, if the regulatory bottlenecks limiting investment in infrastructure is even partially cleaned up, investment activity and growth could both be stronger in 2005-06 than indicated. A good monsoon and we could have better farm output; or higher investment and there could be stronger industrial growth. These can separately, or together, push the estimate of GDP growth from 6.8 per cent to over 7.0 per cent.

The UPA government has made oft-repeated statements on facilitating investment—domestic and foreign; on moving ahead on Special Economic Zones (SEZ) where the employment policies will be less arcane and rigid, and reasserting support for extensive public, private and public-private initiatives in infrastructure creation and a through-going revamp of the development expenditure system. Moves have also been made towards greater regional economic co-operation, including the free trade agreement (FTA) signed with Thailand, the comprehensive economic agreement being negotiated with Singapore and other integration processes with the economies of Southeast Asia, East Asia and West Asia. However, in order to capture the economic gains from such arrangements, investment, employment and infrastructure conditions must be rectified on an urgent basis. If the stated policy stance of the UPA government does indeed materialise, then over the next couple of years, medium-term rate of growth of 7 to 7.5 per cent can be readily visualised.

Informal sector

The 55th round of surveys done by the National Sample

Survey Organisation (NSSO) has brought out a volume on the status of the informal sector in India.[3] The survey covered 197,637 enterprises, or which 114,506 were in rural and 83,131 in urban locations. It is necessary to take note of some of the key features of this sector that is normally bedevilled by lack of data.

The NSSO estimates that in total there are as many as 44.4 million enterprises coming within the fold of this sector, of which 19.3 million are in rural areas and 25.1 million in urban locations. They employed in 1999-2000 a total of 79.8 million people, about 40.0 million in urban enterprises and 39.8 million in rural enterprises. In sharp contrast the total employment in the formal or organised sector was a mere 27 million, of which as much as 19 million was in the public sector alone—government, railways, electricity boards and public sector companies. In other words there are only 8 million jobs in the formal part of the private sector. Which means that in the private sector (outside of agriculture and allied activities) the informal sector employs as much as 10 times the number of people that the the organised or formal sector does. Employment in the formal sector appears to have actually declined by a bit over the last decade and new employment has come up only in the informal sector.

The largest number in the informal sector was employed in manufacturing—some 29.7 million—closely followed by trade and repair (small shops and workshops) that employed 28.4 million people. The other main components were: transport and storage (5.2 million), hotels and restaurants (4.3 million), construction (2.7 million), education (1.7 million) and health care (1.2 million).

The survey seeks to measure value added per worker and the findings indicate that it amounted to Rs 24,242 per worker, with urban valued added at 2.2 times that of rural value added. As a proportion of the non-agricultural GDP at current prices and factor cost that works out to 15.3 per cent and as a proportion of total GDP it is 11.3 per cent. It is very likely that in measuring the value added, it is the wage component that has been more accurately captured with the return on capital perhaps underestimated to a significant extent. If we assume that the value added was

under-reported by a factor of 25 per cent, then the share of the informal sector in GDP would work out to 15 per cent.

In 1999-2000 agriculture and allied activities had amounted to 26 per cent of GDP at current prices. That is, the balance 74 per cent came from non-agriculture—both in the formal and informal sector. And the 80 million people working in the informal sector produced perhaps 15 per cent of GDP and the 27 million in the formal sector produced 59 per cent. That means that productivity in the formal sector per employee was as much as 11.6 times that in the informal sector. *Prima facie* there is good evidence to believe that access to better technology (hard and soft) and economies of scale should make large-scale production (in general) more productive (efficient in use of factor resources) than tiny enterprises. However, that the difference is as much as a factor of 11.6 times does come as a surprise. It also points the way forward to increasing productivity and therefore overall economic growth—by creating conditions whereby more and more informal sector units move up into the formal sector.

One thing we do know that is preventing this from happening (and reverse movement actually takes place) are the antiquated set of labour laws and practices that India has inherited and does not seem able to shrug off. The importance of SEZ in this context as providing the regulatory space for the expansion of large-scale business insulated from the extreme rigours of our employment unfriendly rules, can hardly be over-emphasized.

Inflation

Wholesale price index inflation

The issue of wholesale price index (WPI) inflation has pushed itself on to the forefront of economic policy-making these past months. WPI inflation has been strong in 2003—buoyed by rising commodity prices, namely, cotton, edible oil and steel. In 2004, while cotton and edible oil prices have largely subsided, steel prices have continued to rise. In this context, the hardening of crude oil prices since the summer of 2003, which reached unprecedented levels in September and October 2004, has given an impetus to the inflationary

process that was much stronger than what any one could have conceived. To be fair, if the world economy, as we have seen, grows at the rate of 5 per cent, in the backdrop of extreme monetary accommodativeness, and this growth is spread across both the developed and developing world, it ought not surprise that the prices of tradable goods, particularly petroleum, should rise, as they indeed have.

In its *Annual Policy Statement* of May 2004, the RBI had put WPI inflation at 5.0 per cent in March 2005. In October, the RBI in its mid-term review has revised this number upwards to 6.5 per cent.

The year-on-year overall WPI rates of inflation for the past few years and most recent weeks are presented at Table 2.2, along with that for broad categories and a few synthetic categories as well. The latter is designed to throw light on the principal forces driving inflation

Provisional and revised estimates of WPI inflation

The WPI rate of inflation for the week ending November 15, 2004 was reported at 7.3 per cent (provisional). For the week prior to that it had been higher at 7.8 per cent and the revised estimate for the week ending September 4, 2004 stood at 8.2 per cent. Revised estimates are made available for WPI with a 6-week lag. The difference between the provisional estimate of inflation and the revised one has a tale to tell. Whenever inflation is on the rise, the revised estimates of inflation tend to exceed the provisional numbers by a large and rising amount. When inflation starts to stabilise, the obverse begins to happen and finally when inflation is indeed stable there is not much of a difference.

Thus in February through April of 2004, the revised inflation number was barely 0.1 to 0.2 percentage points higher than the provisional figures. This situation changed in May 2004, with the difference rapidly rising to 0.6 percentage points for the last week of May. In June it rose further approaching 1 per cent and remained at this level for the first three weeks of July 2004. The period of the largest difference was in the months of June and July, which is, of course, when the current round of inflation gained momentum. For manufactured goods the difference between

Table 2.3: Components of Wholesale Price Inflation—Year-on-Year Rates
Base 1993-94=100

Unit: per cent

Calendar Year	All Commod-ities	Foodgrain (cereal & pulses)	Other Primary Food items	Oilseeds & Edible Oil Cotton & Cotton textiles	Commercial Energy	Manufact-ured Goods	Core(x) =
Weight	*100%*	*5.01%*	*10.39%*	*6.78%*	*14.23%*	*63.75%*	*70.37%*
Average of weeks for the completed calendar year up to 2003 and part year for 2004							
1998	5.8	4.9	14.8	9.9	6.0	3.9	4.4
1999	3.5	18.4	-2.0	-3.2	5.5	3.4	2.9
2000	6.3	0.9	5.7	-4.1	25.6	2.7	2.4
2001	5.2	-1.5	4.6	2.6	14.7	2.9	3.2
2002	2.5	0.2	3.9	3.7	4.5	1.7	1.8
2003	5.3	2.1	1.1	14.5	6.7	5.0	5.9
For the last week of January to October 2004							
31-Jan-04	6.9	0.5	1.3	15.1	7.4	6.3	6.7
28-Feb-04	5.2	0.1	2.2	14.7	3.6	6.7	6.7
27-Mar-04	4.6	-0.5	1.2	8.7	2.5	6.7	6.4
1-May-04	4.6	-2.2	4.1	4.7	6.0	5.0	4.8
29-May-04	5.6	-1.4	4.3	4.6	7.3	5.2	5.9
26-Jun-04	7.0	-2.1	-0.3	3.3	12.0	7.2	7.4

Weight	*100%*	*5.01%*	*10.39%*	*6.78%*	*14.23%*	*63.75%*	*70.37%*
31-Jul-04	8.0	0.6	4.8	5.9	10.1	8.0	8.5
28-Aug-04	8.7	1.8	8.6	7.9	12.8	7.2	8.0
25-Sep-04*	7.4	1.3	1.9	6.5	10.6	7.2	7.8
2-Oct-04*	7.2	1.3	1.9	4.7	10.7	7.0	7.5
9-Oct-04*	7.1	1.2	1.0	5.2	10.7	7.1	7.4
16-Oct-04*	7.1	1.1	1.9	3.6	11.0	6.9	7.3
23-Oct-04*	7.4	1.7	3.1	3.2	11.2	7.0	7.4
30-Oct-04*	7.1	1.0	3.4	0.0	10.6	6.8	7.0
6-Nov-04*	7.8	0.9	5.1	–0.7	14.2	6.6	6.7

Notes: * Figures for weeks marked with asterisk are on the basis of provisional estimates. All previous periods are based on revised estimates.

= Core (by exclusion) rates of inflation, which excludes primary food items and energy from the index—the standard procedure.

Source: Office of the Economic Adviser, Ministry of Commerce & Industry, Government of India, up to press release for the week ending November 19, 2004.

provisional and revised numbers remained above 0.7 percentage points till mid-August, declining further to 0.5 per cent at the end of August and to 0.3 per cent for the first fortnight of September 2004.

Table 2.4: Sources of Wholesale Price Inflation in 2004
Base 1993-94=100

Unit: per cent

	Weight	31 Jan 2004	27 Mar 2004	26 Jun 2004	31 July 2004	28 Aug 2004*	2 Oct 2004*
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Overall WPI inflation	*100.0*	**5.9**	**4.6**	**6.1**	**8.0**	**8.3**	**7.2**
Foodgrain	*5.01*	0.5	-0.5	-2.0	0.6	1.6	1.2
Other primary food	*10.39*	1.3	1.2	-1.2	4.8	8.6	1.9
Raw cotton	*1.36*	30.5	12.3	3.8	4.6	3.8	-5.4
Oilseeds	*2.67*	6.2	-0.5	-1.6	7.3	11.7	9.5
Commercial Energy	*14.23*	**7.4**	**2.5**	**11.8**	**10.1**	**12.5**	**10.7**
Petroleum products	*6.99*	8.9	0.2	15.8	14.2	19.2	16.8
Manu-factured Goods	*63.75*	**6.3**	**6.7**	**6.6**	**8.0**	**6.7**	**7.0**
Dairy products	*0.69*	9.0	11.6	9.1	8.1	6.2	3.4
Grain mill products	*1.03*	10.0	11.8	2.1	2.3	2.1	2.0
Sugar, *(khandsari & gur)*	*3.93*	10.3	14.5	18.8	12.2	14.3	14.6
Edible oil	*2.76*	8.9	7.1	-0.3	2.0	.3.2	1.9
Tea & coffee processing	*0.97*	20.3	20.3	-0.4	7.5	0.8	9.2
Cotton textiles	*4.22*	20.2	15.3	10.9	10.2	8.3	6.8
Iron and steel	*3.64*	34.6	34.2	43.8	45.1	30.4	26.5
Non-ferrous metals	*1.47*	4.5	4.2	4.1	4.8	5.1	6.5
Chemicals, man-made textiles, rubber & plastics products	*19.04*	0.6	0.3	2.5	2.6	2.0	3.1

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Non-metallic minerals	*2.52*	4.4	3.0	6.2	7.2	7.7	7.9
Machinery & m/c tools	*8.36*	2.0	3.0	2.6	5.1	4.1	5.6
All other mfgd. goods	*15.14*	3.0	5.1	2.6	6.8	5.9	6.5
Contribution to overall WPI inflation—in percentage points							
Primary Food articles	*15.40*	0.03	−0.02	−0.10	0.49	0.89	0.20
Oilseeds & Edible Oil	*5.42*	0.41	0.18	−0.05	0.25	0.40	0.31
Cotton & Cotton Textiles	*5.57*	1.27	0.81	0.51	0.49	0.40	0.22
Dairy, grain mill, sugar, and tea & coffee items	*6.62*	0.77	0.97	0.82	0.63	0.63	0.71
Iron & steel	*3.64*	1.26	1.24	1.59	1.64	1.10	0.96
Non-ferrous metals	*1.47*	0.07	0.06	0.06	0.07	0.07	0.09
Chemicals, manmade textiles, rubber & plastics products	*19.04*	0.14	0.05	0.55	0.56	0.48	0.60
Non-metallic minerals	*2.52*	0.11	0.08	0.16	0.18	0.19	0.20
Machinery & m/c tools	*8.36*	0.17	0.25	0.22	0.43	0.34	0.47
All other mfgd. goods	*15.14*	0.46	0.77	0.39	1.03	0.90	0.98

Notes: * Figures for 28 August and 2 October 2004 and are on the basis of provisional estimates. All previous periods are based on revised estimates.

Source: as in Table 2.2.

Composition of inflation

The composition of inflation had a narrow basis with a small selection of items doing most of the inflating. In the first round of inflation in 2003, this came from a combination of oilseeds and edible oil, raw cotton and fabrics, with steel joining the party in August 2003. In the current round it has been petroleum products, steel, iron ore, cotton textiles, sugar and non-metallic minerals.

As may be seen from Table 2.3, oilseeds, edible oil and raw cotton had run out of fuel by early 2004 and cotton textiles by the end of August 2004. In fact, over the past few weeks prices of raw cotton had fallen significantly and for the week ending October 23, 2004 annualised inflation for the items was running at -14 per cent. It is likely that prices of cotton textiles will follow suit and the combination should have a small dampening impact on overall inflation.

Presently, other than petroleum products, it is an inflation story centred around steel, sugar and to some extent non-metallic minerals (mostly cement). While early in 2004 and in 2003, items other than those highlighted above, showed benign inflation, that picture is changing in recent months as becomes evident from a perusal of Table 2.3. Non-ferrous metals, machinery items, chemicals have all begun to see prices beginning to rise. The residual item of 'all other manufactures' that accounts for 15 per cent of the base year weight has seen inflation move from 3 per cent in the first quarter of 2004 steadily to 6.5 per cent by the beginning of October 2004. Clearly the inflationary phenomenon is becoming broader-based. Hence, the impact potential for a policy that sets out to alter inflationary expectations is greatly enhanced.

Policy response to inflation

In August 2004, as price levels rose sharply, government took a series of measures relating to reducing import duties on commodities that have had the most to do with the present round of inflation. The import duty on steel was cut to 5 per cent and similarly so for a range of items. The import and excise duties on refined petroleum products were altered, effectively reducing refining and marketing margins and easing the price impact on the consumer. The RBI continued to tighten liquidity through its sales of bonds/ treasury bills under the Market Stabilisation Fund and eventually in September by raising the Cash Reserve Ratio (CRR) by 50 basis points. These underlying changes in liquidity conditions served to raise the call money rate from about 4.25 per cent by over 50 basis points to over 4.80 per cent, just prior to its policy statement on October 26, 2004, in which, the RBI raised the *repo* rate (deposit facility for

banks) by 25 basis points to 4.75 per cent. This was a move that indicated further tightening, since an effective rate (call money) which does not exceed the deposit facility by a significant margin does not make for a meaningful setting of monetary parameters, something that is discussed subsequently.

Estimated inflation–2004-05

Our estimates of WPI inflation at the end of 2004-05, that is, in March 2005 is 6.4 per cent; and that at the end of December 2004 at 7.3 per cent. Prices of refined petroleum products were raised in the first week of November and further revisions are possible in the course of the balance months of 2004-05. It is unlikely that there would be a significant easing of crude oil prices till spring 2005 and given that the backlog of price adjustments may yet be large, there may not be much of a scope to cut product prices, since it is unlikely that crude (Dubai light) will readily fall much below $35 per barrel. It should be noted that declining prices of cotton, cotton textiles and some other farm products have helped by off-setting part of the push to inflation from energy, steel and other such commodities.

Consumer price inflation

One of the reassuring factors of inflationary behaviour in recent years was that consumer price inflation had consistently stayed at moderate (by historical standards) levels and much below the WPI inflation rates. However, consumer prices inflation picked up from below 3 per cent in April 2004, to over 4 per cent in September 2004. The CPI-UNME (urban non-manual employee) crossed 4 per cent in August, but has gained no further in September and October 2004. The CPI-IW (industrial worker) touched 4.6 per cent in August, and 4.8 per cent in September 2004. Both CPI-UNME and CPI-IW inflation are still significantly below the WPI inflation rate. The variance possibly reflects the difference in the composition of the basket of the consumer and wholesale price indices. Food has a much larger weight in the consumer price index and food prices have of course remained soft. Final services such as transportation, which for regulatory reasons have lagged

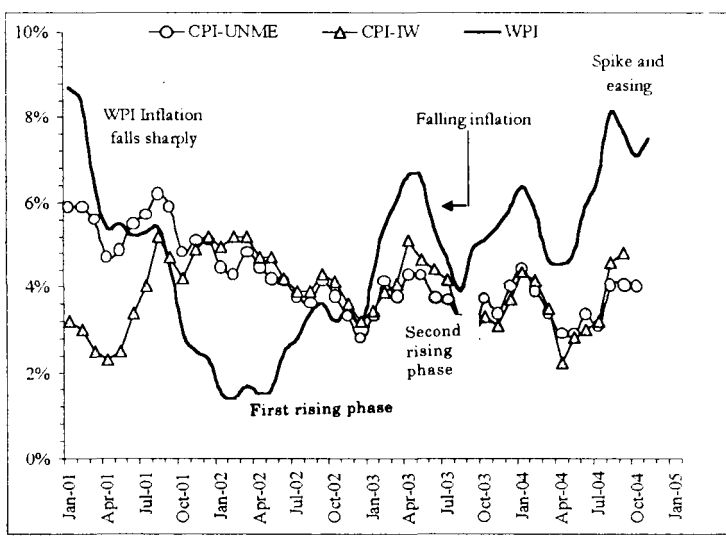
due to the rise in energy prices, also make up part of the CPI basket.

Inflation—Different Measures and Implications for Policy

The practice internationally is to link the conduct of monetary policy with that of consumer price movements, not the inflation contained in producer price indices, and certainly not wholesale prices of a mixed bag of final and intermediate goods. In India however, for historical reasons the WPI inflation has been at the centre of attention. For one, it comes out every week, is fairly up-to-date and gives a commodity-wise decomposition. In the case of consumer prices indices, the periodicity is monthly, there is in consequence a greater lag and there is no (publicly) available decomposition in terms of commodity-groups.[4]

However, if consumer price inflation is that much lower than WPI inflation, it is necessary to bear this fact in mind when looking to possible shifts in monetary policy. While WPI inflation was above 8 per cent in August 2004, CPI

Chart 2: Consumer and wholesale rates of inflation
Monthly Basis—January 2000 to October/November 2004



inflation had at most touched 4.8 per cent in September (for CPI-IW).

The question asked could be: why should the monetary authorities react with alacrity to the sudden shifts in WPI inflation brought about by price increases in a selection of manufactured commodities and petroleum products, when the broader-based CPI index indicates more benign inflation? The argument is bolstered by the distinction between prices of tradeables and non-tradeables, with the presumption that inflation that derives more from non-tradeables is what one ought to be more sensitive about. However, there are two problems with this.

First, continuing inflation in tradeables will eventually spill over into non-tradeables, as has indeed happened on every past occasion. Second, the CPI indices are constructed with base year in the 1980s. Thus the CPI-IW has a base year of 1982 and the CPI-UNME one of 1984-85. We surely understand that the consumption basket has changed very considerably in the intervening two decades, with a decline in the weight for food and a greater share for items that are, or behave like tradeables. The WPI is on a 1993-94 base, and it itself has certainly become outdated, but much less so, than have the CPI indices.

Implicit GDP deflator

There is a third and useful measure of inflation, which comes a bit late on annual basis—namely, the implicit GDP deflator. In 2002-03 the value of the implicit GDP deflator was 3.5 per cent and in 2003-04 it was 3.7 per cent. For non-agricultural GDP, the value of the implicit deflator was however higher. In 2002-03 it was 3.7 per cent and rose to 4.5 per cent in 2004-05.

While some caution needs to be borne in mind when dealing with the quarterly estimates of GDP, it is of course possible to compute the implicit deflator from the series. That tells us that on year-on-year basis (that is, one quarter compared to the corresponding quarter of the previous year), the implicit GDP deflator in the first (April–June) quarter of 2004-05 was 4.6 per cent, up from 3.7 per cent in the January-March quarter of 2003-04. The corresponding numbers for non-agricultural GDP were unsurprisingly

higher at 5.3 per cent in the first quarter of the current fiscal and 4.8 per cent in the last quarter of 2003-04.

There is something else that is possible, which is to try and estimate what are the quarter-to-quarter changes. For measuring change in this way we need a de-seasonalised series, which is not officially estimated. In computing the implicit deflator, the problem with quarter-on-quarter numbers is principally the varying weights of different industries in terms of the GDP that arises in them in each of the four quarters. Remembering this drawback, we compute the quarter-on-quarter GDP implicit deflator for non-agriculture and find that on a quarter-on-quarter basis the annualised deflator had risen in the April-June quarter of 2004-05 to 12.3 per cent, compared to 4.9 per cent in the last quarter of 2003-04. If anything, this points to the relevance on the WPI measure of inflation, and the inappropriateness of drawing too strong a lesson from the trends indicated by the CPI, in periods when the WPI and CPI measure are at odds.

Balance of Payments Position

Surging merchandise imports, assisted by nearly 60 per cent increase in the oil import bill, have continued to characterise external trade in India. Although export growth also has been strong, on balance the merchandise trade deficit has increased. The data released by the Director General of Commercial Intelligence & Statistics (DGCI&S) indicate that for the first half of the current fiscal year imports grew by 32 per cent, compared to 21 per cent in the corresponding period of 2003-04. Exports rose by 24 per cent in the April-October period of 2004-05, relative to 10 per cent for the same period last year. The merchandise trade deficit expanded by 62 per cent this year, a somewhat smaller expansion than the 98 per cent increase registered in the corresponding period of the previous year. Basically, notwithstanding the 56 per cent increase in the value of oil imports during April-October 2004 and the 23 per cent increase in non-oil imports, the expansion of the trade deficit has been kept in check by the strong performance in exports.[5] A more detailed discussion about the composition

and direction of merchandise trade is given at the end of this chapter.

At Table 2.5, we present a summary of the Balance of Payments (BoP) for the first six months (January-June) of calendar years 2003 and 2004. Notable are:

- The sharp expansion in merchandise exports (32 per cent) which exceeds the proportionate increase in merchandise imports (25 per cent);
- A 265 per cent increase in the net balance on miscellaneous general services;

Table 2.5: Major Balance of Payments Aggregates
First six months of calendar years 2003 and 2004
Unit: US $ million

	January–June 2003			January–June 2004		
	Credit	*Debit*	*Net*	*Credit*	*Debit*	*Net*
Merchandise Trade	**28,097**	**36,048**	**-7,951**	**37,173**	**44,917**	**-7,744**
Total Invisibles	**22,828**	**13,466**	**9,362**	**33,184**	**17,045**	**15,403**
of which:						
Travel & Transportation	3,160	3,195	-35	4,035	3,726	309
Misc. General Services	7,384	6,278	1,106	12,981	8,949	4,032
Of which: software	*5,342*	*367*	*4,975*	*7,041*	*301*	*6,740*
Private remittances	9,888	284	9,604	11,052	260	10,792
Investment income*	1,731	3,189	-1,458	3,010	3,131	-121
Current Account Balance	**50,925**	**49,514**	**1,411**	**69,621**	**61,962**	**7,659**
Foreign Investment	8,257	4,798	3,459	21,748	15,769	5,979
O/w Direct Investment**	2,255	765	1,490	3,239	1,075	2,164
Portfolio Investment	6,002	4,053	1,969	18,509	14,694	3,815
Loans (incl. Bonds)	8,366	9,675	-1,309	13,930	11,073	2,857
Banking Capital	9,633	4,690	4,943	7,188	5,688	1,500
'Other' capital	2,161	737	1,424	2,416	2,852	-436
Total Capital Account	**28,417**	**20,317**	**8,100**	**45,282**	**35,731**	**9,551**
Overall Balance of Payments	**79,609**	**69,831**	**9,778**	**115,288**	**97,693**	**17,595**

Note * After adjustments made for re-invested earnings of foreign owned companies operating in India and net of direct investments of Indian owned companies overseas.

** Including re-invested earnings as above.

Source: *India's Balance of Payments in Dollars*, Reserve Bank of India, September 30, 2004 and *Monthly Bulletin*, Reserve Bank of India, November 2004, Statement No. 43.

- The massive change in the *net* balance in investment income from a large negative number to a very small negative one.

These have brought about a 5-fold increase in the current account surplus.

On the capital account side, noteworthy are, (a) the doubling of portfolio investment and (b) the large decline in banking capital by 70 per cent, and (c) higher overseas issuance of bonds.

The RBI has made revisions to the BoP data for each of the quarters of the last four years and released the revised numbers on September 30, 2004. What is noteworthy in these revisions are:

- There is a significant increase in the assessed current account surpluses for all of the years. In the first year affected (2001-02) there is a decline in the current account deficit.
- This has happened because of, first, a higher assessment of merchandise exports, with imports largely unchanged and hence a smaller estimate for the merchandise trade deficit. Thus for the January-June period of 2004, the merchandise trade deficit has come down from $10.3 billion to $7.7 billion. Largely in consequence of this, the current account surplus has risen for the period from the earlier estimate of $5.3 billion to $7.7 billion
- A rearrangement between miscellaneous general services and private remittances, with a decline in the former and an increase in the latter. As a result, the net balance on private remittances has risen from the older estimate for the January-June 2004 period of $8.4 billion to $10.8 billion.
- On the capital account side the largest net impact has been on the item 'other capital' where the net estimates have been significantly reduced—by as much as $1 billion for the January-June 2004 period.

Current account

In 2003-04, the BoP merchandise trade deficit was $15.4 billion, representing an increase of 44 per cent over the previous year. The net balance on invisibles amounted to $26.0 billion, deriving from a surplus of $6.6 billion from service exports, $22.8 billion from private remittances and negative net factor income of $4.0 billion. That left a current account surplus of $10.6 billion (1.5 per cent of GDP), up from $6.3 billion from the previous year (0.6 per cent of GDP).[6]

In the first quarter (April-June) of the current fiscal, the BoP goods deficit was placed at $6.3 billion, representing a 13 per cent increase over the corresponding quarter in the previous year. The *net* balance on invisibles rose by 65 per cent year-on-year to $8.2 billion, which was 13 per cent higher than that of the immediately previous quarter (January-March 2004). The resultant current account surplus at $1.9 billion was in sharp contrast to the small deficit in the corresponding quarter of the previous year.

At Table 2.6, the pattern of expansion of key elements in the category 'Invisibles' which include both the export of services, as well as the flow of factor income, is presented. At Table 2.7, key elements of the BOP for the previous nine quarters are reported. Earnings from export of software services show consistent year-on-year growth in excess of 30 per cent, while the export of services other than software (miscellaneous general services less software) is erratic.

Investment income has in the last two quarters (January-March and April-June 2004) turned direction completely, possibly due to the positive sign and magnitude of reinvested earnings by Indian-owned companies overseas (about $1 billion in 2003-04).

The biggest change has come in the accounting of remittances. For 2003-04 this item at the *net* level has increased from the previously assessed value of $19 billion, to a whopping $23 billion. Basically it would seem that flows that had been previously classified under 'miscellaneous general services' have been identified to construe repatriation of savings made by Indian nationals working overseas, most probably in the IT/BPO sector. Hence, in the

Table 2.6: Changes in Key Items of Invisible Earnings on a Quarterly Basis: Total Value and Change = *2000-01, 2001-02, 2002-03, 2003-04 and 2004-05*

Unit: US dollar millions

			Q1		Q2		Q3		Q4	
			$ million	Change	$ million	Change	$ million	Change	$ million	Change
		2000-01	2,037		2,306		2,486		2,973	
		2001-02	3,273	61%	2,448	6%	2,574	4%	2,741	-8%
	Credit	2002-03	3,712	13%	3,274	34%	3,494	36%	3,773	38%
		2003-04	3,611	-3%	4,052	24%	4,298	23%	4,904	30%
		2004-05	8,077	124%						
Miscellaneous		2000-01	1,217		1,467		2,254		2,734	
general		2001-02	1,405	15%	1,824	24%	1,514	-33%	2,029	-26%
services	Debit	2002-03	2,762	97%	1,954	7%	1,628	8%	3,585	77%
		2003-04	2,693	-2%	3,575	83%	1,622	0%	4,051	13%
		2004-05	4,898	82%						
		2000-01	820		839		232		239	
	Net	2001-02	1,868	128%	624	-26%	1,060	357%	712	198%
		2002-03	950	-49%	1,320	112%	1,866	76%	188	-74%
		2003-04	918	-3%	477	-64%	2,676	43%	853	354%
		2004-05	3,179	246%						

			$ million	Change	$ million	Change	$ million	Change	$ million	Change
		2000-01	1,198		1,611		1,421		1,520	
of which		2001-02	1,700	42%	1,683	4%	1,770	25%	1,731	14%
Software	Net	2002-03	1,963	15%	2,054	22%	2,415	36%	2,431	40%
services		2003-04	2,544	30%	2,750	34%	3,092	28%	3,364	38%
		2004-05	3,376	33%						
		2000-01	3,154		2,619		4,169		3,123	
Private		2001-02	5,196	65%	3,109	19%	3,388	-19%	4,067	30%
remittances		2002-03	3,937	-24%	4,085	31%	4,296	27%	4,971	22%
from	Credit	2003-04	4,917	25%	6,509	59%	5,914	38%	5,843	18%
overseas		2004-05	5,209	6%						
India										
		2000-01	-1,721		-941		-1,013		-989	
Investment		2001-02	-1,040	-40%	-731	-22%	-1,049	4%	-1,024	4%
Income	Net	2002-03	-1,025	-1%	-626	-14%	-1,218	16%	-675	-34%
		2003-04	-783	-24%	-515	-18%	-2,020	66%	27	-104%
		2004-05	-148	-81%						
		2000-01	**930**		**2,331**		**4,033**		**2,500**	
Total of all		2001-02	**5,094**	**448%**	**2,356**	**1%**	**3,495**	**-13%**	**4,029**	**61%**
Invisibles	**Net**	2002-03	**3,196**	**-37%**	**4,271**	**81%**	**5,135**	**47%**	**4,433**	**10%**
		2003-04	**4,927**	**54%**	**6,621**	**55%**	**7,240**	**41%**	**7,225**	**63%**
		2004-05	**8,178**	**66%**						

Note: = The change is the variation with respect to the same quarter in the previous year
Figures above are revised numbers, except for April-June 2004, which are initial estimates and subject to revision.

Source: As in *Table-5* above

Table 2.7: Net position—Major Balance of Payments Aggregates
Previous nine consecutive quarters

Unit: US $ million

	2002-03				2003-04				2004-05
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**
Merchandise Trade	**-2,067**	**-2,456**	**-3,781**	**-2,386**	**-5,565**	**-3,794**	**-4,625**	**-1,470**	**-6,274**
Total Invisibles	**3,196**	**4,271**	**5,135**	**4,433**	**4,929**	**6,621**	**7,240**	**7,225**	**8,178**
Of which:									
Travel & transportation	-394	-459	199	-111	76	218	649	597	-288
Misc. General Services	950	1,320	1,866	188	918	477	2,676	853	3,179
O/w Software	*1,963*	*2,249*	*2,415*	*2,431*	*2,544*	*2,750*	*3,092*	*3,364*	*3,376*
Private remittances	3,551	3,957	4,073	4,806	4,,798	6,472	5,890	5,673	5,119
Investment income	-1,025	-626	-1,218	-675	-783	-515	-2,020	27	-148
Current Account Balance	**1,129**	**1,815**	**1,354**	**2,047**	**-636**	**2,827**	**2,615**	**5,755**	**1,904**
Foreign Investment	977	401	1,421	1,362	2,097	3,025	4,922	4,662	1,317
O/w Direct Investment	1,240	532	676	769	721	889	881	929	1,235
Portfolio Investment	-263	-131	745	593	1,376	2,136	4,111	3,733	82
Loans (incl. Bonds)*	-1,050	-779	248	-2,269	960	1,036	-4,854	10	2,847
Banking Capital	599	3,805	4,689	3,012	1,931	300	3,620	380	1,120
Other capital	485	283	262	90	1,334	1,185	1,230	-990	554
Capital Account Balance	**659**	**3,162**	**4,940**	**2,079**	**6,021**	**5,544**	**4,987**	**3,990**	**5,561**
Overall BoP Balance	**1,662**	**4,927**	**6,082**	**4,314**	**5,464**	**8,592**	**7,294**	**10,071**	**7,524**

Note: * This category includes external assistance.
Figures above are revised numbers, except for Q4 of 2003-04 and Q1 of 2004-05 which are initial estimates and subject to revision.

Source: As in *Table-5* above

process of revision a sum of $4.4 billion has been transferred from 'miscellaneous general services' to 'private remittances'. However, the adjustment against 'software services' has been relatively small at about $0.45 billion and the balance of nearly $4 billion appears to have been made on 'miscellaneous general services' other than 'software services'.

Capital account

Net inflows on the capital account in the first quarter of 2004-05 were placed at $5.6 billion, which was only marginally lower than that of the last quarter of 2003-04 that had seen record portfolio investment flows. However, quite unlike the preceding quarter, the April-June quarter of 2004 witnessed negligible portfolio inflows, but significant stepping up of inflows on account of loans (including bonds and external assistance), banking activities and foreign direct investment.

Oil Import Bill in 2003-04 and Expectations for 2004-05

The oil import bill in 2003-04 was $20.6 billion, a 17 per cent increase from $17.6 billion in the previous year. Indian refineries however export surplus refined petroleum products, and on net basis the oil import bill was $17.1 billion in 2003-04, 13 per cent higher than in the previous year.[7]

In quantitative terms, import of crude oil rose to 91 m.t. in 2003-04, an increase of 11 per cent over that of the previous year (82 m.t.). Including other refined petroleum products the total quantity of petroleum and products imported in 2003-04 amounted to 99 m.t., an increase of 11 per cent over that of the previous year (89 m.t.)[8]. The implicit price increase in the value of imports in 2003-04 was thus about 3 per cent.

In the first half of 2004-05, refinery throughput has expanded by little over 8 per cent, indicative of strong demand. Although the domestic market has for the most part not been exposed to the impact of the full increase in crude prices, there has nonetheless been an increase of 11

per cent over the course of the past six months, and demand (as measured by refinery throughput) in the second quarter (July to September) was certainly weaker than in the first. Given that further increases in domestic prices are inevitable, higher prices are bound to negatively impact demand growth in the last five months of the fiscal year. For the full year, it is thus likely that demand growth will be lower than that for the first half, and may be between 5 and 6 per cent. However, the prices that will have to be paid in the second half of the current fiscal will be higher than was paid in the first half, by a factor of 12 to 15 per cent. We know that the oil import bill in the first half was $14.5 billion and $17.2 billion for the first seven months, and that there has been some moderation in expansion in September and October.

Assuming continued demand moderation in the course of the second half, the oil import bill for 2004-05 is thus likely to be between $30 and $32 billion—which will represent an increase of $9–11 billion (or by 40 to 55 per cent) over the previous year. Increased value of exports or refined products will pare the value of the increment in *net* terms by $1 billion. Even so, at the trade deficit stage, the combined impact of higher crude oil prices and expanded consumption should add about $10 billion to the BoP merchandise deficit for 2004-05.

Current account outlook for 2004-05

For the first half of the year, DGCI&S exports in dollar terms were higher by 24.4 per cent, which includes the impact of higher value of refined petroleum products as well as non-oil items that make up the overwhelming bulk of India's exports. Taken that oil exports had risen in value by 45 per cent, the non-oil component of exports would then have expanded by 23 per cent. Assuming a slowing down of non-oil exports to 17 per cent in the second half, we get an export growth of non-oil items for the year as a whole at 20 per cent. That would mean overall merchandise exports growth by a little over 21 per cent on BoP basis to cross $77 billion in 2004-05, up from $63.6 billion in 2003-04.

On the import side, non-oil imports have grown 26 per cent in the first half, and we can expect this trend to hold

for the rest of the year, giving us on BoP basis, non-oil merchandise imports of $74 billion. Oil imports, as estimated above, would be in the range of $30–32 billion and the total value of merchandise imports on BoP basis would be between $104 and $106 billion. That leaves us with an estimate of $27 to $29 billion for the BoP merchandise trade deficit—an increase of 60 to 75 per cent from the previous year. However, export growth of non-oil items could turn out to be stronger than has been assumed here for the second half.

If such exports do not slow down to 17 per cent, but continue more or less on the same trajectory as in the first half, the merchandise trade deficit could be lower at between $24 and $27 billion. On balance, a figure of $27 billion for the BoP merchandise trade deficit for the full year would seem to be a reasonable estimate, with the possibility that it might be a couple of billion dollars on either side of the estimate—that is, $27 ± 2 billion or $25 to $29 billion.

On the invisibles front, *net* service exports registered an increase of 80 per cent in 2003-04, while private remittances went up by 39 per cent and *net* investment income (outgo) was slightly smaller. As suggested above, this is likely to have been due to the magnitude of reinvested earnings by Indian owned companies overseas, which approached $1 billion in 2003-04. In the first quarter of 2004-05, on year-on-year basis, net service exports rose by 220 per cent, remittances were up 7 per cent and there was a small drop in net investment income outflows. Service exports will continue to expand, perhaps not in the fashion of the first quarter and likely to be proportionately less than in 2003-04. Remittances have shown a trend of steady increase and there is no reason to believe that this will not persist. The investment income outflow picture ought to change in the subsequent quarters (and might do so on revision for the first quarter too) and a very conservative assumption is that of a level similar to the previous year. On this basis, it appears that the net surplus position on invisibles in 2004-05 is likely to be about $32 billion. However, if remittances and software exports grow faster than assumed, then this figure will be higher at $32 billion, *albeit* with further upside

potential, if the net balance on invisibles turn out stronger than has been assumed here

That would leave a current account surplus of some $5 billion ($32 *minus* $27 billion). This will have a downside of up to $2 billion due to the possibility of a larger merchandise trade deficit, and a corresponding upside of up to $4 billion higher on account of favourable goods, trade balances *plus* a stronger showing in invisibles, that is, a current account surplus of between $3 and $9 billion, with the most likely outcome falling between $4 and $6 billion.

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1. *Mid-term Review of Annual Policy Statement for the year 2004-05*, Governor, Reserve Bank of India, October 26, 2004, *para*.4
2. The *Tenth Five Year Plan (2002-07)* document envisaged a current account deficit of 1.6 to 2.9 per cent of GDP under alternate scenarios of tariff reduction.
3. *Informal Sector in India 1999–2000: Salient Features*, Report No. 459(55/2.0/2), National Sample Survey Organisation, Ministry of Statistics and Programme Implementation, Government of India, May 2001
4. The available detail corresponds more to a design crafted when location-wise dearness allowance was perhaps seen to be the principal driving force in estimating inflation in the first place.
5. Press Release, *'India's Foreign Trade Data: April-October 2004-05'*, Ministry of Commerce and Industry, Government of India, November 17, 2004.
6. *Monthly Bulletin*, Reserve Bank of India, November 2004, Statement No. 43.
7. *Appendix Table VI.3*, *Annual Report*, Reserve Bank of India, August 2004.
8. *Appendix Table 1.30, Commodity Balance of Petroleum and Petroleum Products*, Economic Survey 2003-04, p. S-30.

Performance of Different Sectors
Agriculture, Industry, Inflation and Commodity Composition of Trade and its Direction

Monsoon

South West (SW) monsoon in 2004 (June to September) was at an aggregate level deficient to the extent of 13 per cent of the long period average. It of course makes a big difference whether the below-normal precipitation is in relatively wet or semi-arid/arid regions, since the impact on the latter is far more damaging. At Table 3.1, the outcome in all the years from 2000 to 2004 of the SW monsoon is given in those meteorological sub-divisions that are indeed relatively more dependent on the rains.

In the parlance, if rainfall is 20 per cent and below of normal in a meteorological sub-division, it is termed as being 'deficient', while if it is 60 per cent and less it is termed 'scanty'. While a total of 13 sub-divisions at the national level were deemed to have received 'deficient' rainfall, of the more rain-dependent regions, a total of five sub-divisions (including Himachal Pradesh) fell into this category in 2004. This is certainly not as bad as it was in 2002, when ten of these sub-divisions were in the 'deficient' and two in the 'scanty' category, and not even as bad as in 2000 when six geographically large sub-divisions fell into the 'deficient' category. This year, a large part of the shortfall in precipitation was in the Indo-Gangetic belt that is otherwise well-watered and irrigated. Hence, while an adverse impact of a sub-normal monsoon is inevitable the magnitude should be milder than say in 2000-01. Then again there were good late rains in October and the prospects of the *rabi* (winter) harvest has to that extent improved.

Agriculture

Outlook for 2004-05

The preliminary estimates that have been emanating from the Agriculture Ministry in late September 2004 are that the *kharif* (summer) foodgrain harvest would be about 100 m.t., about 11 per cent less than that of last year. That there would be some decline in output in foodgrain production is self-evident given the performance of the monsoon. However, it has been the experience that the initial estimates have always erred on the side of caution and going by previous years, the *kharif* foodgrain output is more likely to be 4 to 5 per cent more than the initial estimates. The Centre for Monitoring the Indian Economy (CMIE) has a close working relationship with the Agriculture Ministry and has estimated that the *kharif* foodgrain crop would be 105m.t. Price signals show decline in the price of foodgrain items and that too is indicative of a fairly good harvest, especially given that official stocks of grain have come down significantly and are presently hovering around the minimum buffer stock requirements.

It is also reported that the Agriculture Ministry, on the basis of good late rains in September and October, is expecting an enormous *rabi* (winter) crop of up to 125 m.t. of foodgrain which would involve a 25 per cent increase over last year's fairly good-sized crop. While an increase over last year's crop, which was lower than that of 1999-2000, is eminently plausible, it might be more reasonable to expect something like 103m.t. to, at most, 108m.t. of foodgrain output. That would mean total foodgrain output for the year at between 203m.t. and 213m.t.–between a *decline* of 4.25 per cent and an increase of 0.4 per cent. With something like 208m.t. as being a likely output level, the *decline* in foodgrain production would be of about 1.9 per cent. Using the 1993-94 weighting diagram (which is a modified version of the 1981-82 weights), the impact of foodgrain output on agricultural GDP would be between *nil* and -2 percentage points.

The summer groundnut and other oilseed crop has been reportedly stronger than that of last year and the winter oilseed output should also be good, lending possibility to at

Table 3.1: South West Monsoon
Rain Dependent Meteorological Sub-divisions-Current and Previous Monsoons

	Rain Dependent Areas – Meteorological divisions	Normal* Precipitation in millimetres		*Variation** from normal in per cent* 1 June – 30 September				
		Annual	S.W. monsoon	2000	2001	2002	2003	2004
1	Gangetic W. Bengal	1,593	1,136	8	–5	5	–19	–1
2	Orissa	1,417	1,160	–19	22	–19	5	–10
3	Jharkhand	1,400	1,105	–2	10	3	–14	–19
4	Bihar	1,248	1,048	14	4	1	10	–11
6	South Interior Karnataka	1,216	659	21	–8	–44	–26	–6
5	Himachal Pradesh	1,181	774	–7	–16	–20	3	–46
7	Chhattisgarh	1,173	1,206	–22	6	–16	20	–15
8	East Madhya Pradesh	1,173	1,097	–33	–12	–13	20	–20
9	Vidarbha	1,080	976	–3	–9	–3	–5	–30
10	Coastal Andhra	1,072	575	24	–5	–26	4	–8
11	Gujarat region	962	934	–31	–10	–24	20	5
12	Telangana Andhra	956	767	22	–12	–23	6	–26
13	West Madhya Pradesh	919	904	–37	–20	–22	3	–15
14	Madhya Maharashtra	886	700	–9	–7	–15	–8	16
15	Tamil Nadu	869	316	1	–16	–45	6	9
16	Jammu & Kashmir	854	514	–1	6	22	–10	–25

		Annual	S.W. monsoon	2000	2001	2002	2003	2004
17	Marathawada	847	704	11	–13	–3	–15	–16
18	Rayalseema Andhra	833	381	47	11	–33	9	–8
19	North Interior Karnataka	741	491	17	–15	–31	–35	–12
20	East Rajasthan	626	624	–30	–17	–60	–6	–9
21	Saurashtra, Kutch & Diu	442	486	–54	–9	–25	29	–6
22	West Rajasthan	335	263	–22	–10	–71	22	–39

Note: * *Annual precipitation* is the median value for the 8-year period 1995-2002, while that for the *SW monsoon* is the long-period (moving) average for 2004 as reported by the Meteorological Department. Although the annual rainfall data is available up to 2002 from the *Statistical Pocketbook*

** *Shading* indicates that rainfall during the SW monsoon was deficient (less than –20 per cent) or scanty (less than –60 per cent) relative to the long-period average

Sources: *Southwest Monsoon End-of-season report*, Indian Meteorological Department;
Table 2.2, *Annual Rainfall, Statistical Abstract, 2002*, Central Statistical Organisation. Table 22.3 *Annual Rainfall, Statistical Pocketbook 2003*, Central Statistical Organisation.

Table 2.2: Output of Principal Agricultural Commodities

Unit: Million Tonnes except for cotton & index

	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
Rice	86.1	89.7	85.0	93.3	72.7	86.4	84.0
Wheat	71.3	76.4	69.7	72.8	65.1	72.7	72.1
Coarse cereals	31.3	30.3	31.1	33.4	25.3	36.8	37.8
Pulses	14.9	13.4	11.1	13.4	11.1	14.9	15.2
Kharif foodgrain	*102.9*	*105.5*	*102.1*	*112.1*	*87.8*	*112.0*	*100–105*
Rabi foodgrain	*100.7*	*104.3*	*94.7*	*100.8*	*86.4*	*100.0*	*103–108*
Total of Foodgrain	**203.6**	**209.8**	**196.8**	**212.9**	**174.2**	**212.1**	**203–213**
Groundnut	9.0	5.3	6.4	7.0	4.4	8.3	8.0
Rape and mustard	5.7	5.8	4.2	5.1	3.9	5.8	6.5
Soybean	7.1	7.1	5.3	6.0	4.6	7.9	8.0
Total of nine oilseeds	24.8	20.7	18.4	20.7	15.1	25.1	25.6
Cotton =	12.3	11.5	9.5	10.0	8.7	13.8	15.5*
Sugarcane	288.7	299.3	296.0	297.2	281.6	236.2	200–220**
Index of Agri Prodn (1981-82=100)	***177.8***	***176.8***	***167.3***	***178.3***	***150.5***	***179.6***	

Notes: = In million 170 kg bales

* Taken from the trade estimate (Cotton Advisory Board) and converted using last year's respective CAB and government output figures to arrive at a number comparable to the data of previous years.

** See text for explanation. This is below official estimates

Sources: (i) Department of Agriculture & Co-operation for output data up to 2003-04. Index of Agriculture Production (1981-82=100) from Economic Survey, Government of India 2003-04.

(ii) Estimates for 2004-04 from Press reports on Agriculture Ministry's *Rabi* Conference September 17-18, 2004 and Centre for Monitoring the Indian Economy, October 2004, pp.20-22

least a maintenance of total output at last year's level and at best a modest increase.

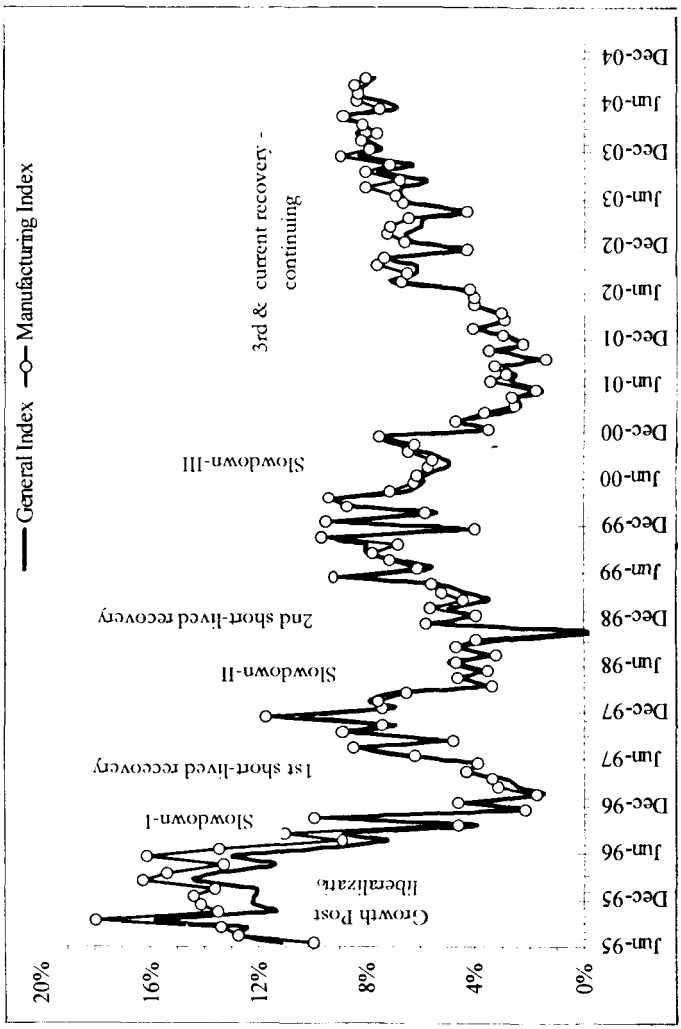
Cotton output is set to increase considerably this year, going by the trade estimates (Cotton Advisory Board—CAB), but sugarcane is expected to have another disappointing year. It has been reported that acreage is significantly lower in major growing states and the industry expects a significant decline in the manufacture of centrifugal sugar in mills. Compared to last year's (sugar year: October 2003 to September 2004) output of 13.6 m.t., it is expected that in the current sugar year, production of centrifugal sugar might be as low as 11.0 m.t. Working backwards that translates to a sugarcane output of between 200 m.t, which under more favourable circumstances might go up to 220 m.t, and implies a reduction in sugarcane output by 7-15 per cent.

Market gardening, horticulture, fishing and animal husbandry generally show increase year-on-year. Thus, non-foodgrain output could be between -0.8 and +0.5 percentage points–the possibility of *contraction* arising entirely from sugarcane.

Recently it has been reported that rice procurement is likely to touch 22 million tonnes, which is only marginally lower than the 22.8 million tonnes procured in the last marketing year (October to September 2003-04). That reinforces the belief that *kharif* 2004 rice output has perhaps largely been untouched by the vagaries of the monsoon and the bulk of output shortfalls may have been concentrated on coarse grains.

Were we to combine the outlook for foodgrain, and non-foodgrain crops, it would seem that we could be looking at a change in the GDP arising from such activities in 2004-05 lying in a range from -3.0 to +0.5 per cent. While it is entirely legitimate to expect that yield improvements might improve the production of sugarcane, the reasonable thing to conclude from this is that the GDP arising from farm activities (including animal husbandry, fishing and forestry) would *contract* by 1 per cent in 2004-05.

Chart 1: Industrial growth in general and manufacturing IIP
Annualised rates up to September 2004



Industry

Over the first six months of fiscal 2004-05, industrial output as measured by the general Index of Industrial Production (IIP) rose by 7.9 per cent, compared to 6.2 per

Table 3.3: Index of Industrial Production: Growth Rates (annualised) by sectors

Unit: per cent

Year	Period	General	Manu-facturing	Electricity	Minin
1995-96		13.0	14.1	8.1	9.7
1996-97		6.1	7.3	4.0	–1.9
1997-98		6.7	6.7	6.6	6.9
1998-99	Full Year	4.1	4.4	6.5	–0.8
1999-00		6.7	7.1	7.3	1.0
2000-01		5.0	5.3	4.0	2.8
2001-02		2.7	2.9	3.1	1.2
2002-03		5.8	6.0	3.2	5.8
2003-04		7.0	7.3	5.1	5.2
2001-02	Q-1	2.2	2.6	2.2	–1.6
	Q-2	2.4	2.5	4.0	–0.2
	Q-3	2.7	2.9	2.1	1.7
	Q-4	3.3	3.3	4.1	1.6
2002-03	Q-1	4.3	4.1	3.7	6.8
	Q-2	6.5	6.9	3.3	6.2
	Q-3	5.8	6.1	4.5	4.7
	Q-4	6.2	6.9	1.5	5.7
2003-04	Q-1	**5.7**	**6.0**	**4.2**	**5.6**
	Q-2	**6.6**	**7.6**	**1.9**	**2.9**
	Q-3	**7.3**	**7.9**	**4.3**	**4.4**
	Q-4	**8.1**	**7.9**	**9.8**	**8.1**
2004-05	Q-1	**7.8**	**8.2**	**5.9**	**5.7**
	Q-2	**8.0**	**8.2**	**9.5**	**4.2**
	Q-3 (forecast)	***7.5***	***8.3***	***4.0***	***4.0***

Note: Quarterly growth rates are with respect to the corresponding quarter in the previous year. Figures for the second quarter of 2004-05 (July–September) are estimates based on the data up to August 2004 and forecast for September 2004. Third quarter figures are forecast values.

Source: Central Statistical Organisation, Press Note on Index of Industrial Production, issues up to November 11, 2004.

cent during the same period in the previous year, and 5.4 per cent in 2002-03. The same trend of a lifting growth rate is seen in the manufacturing IIP that grew by 8.2 per cent in the first six months of 2004-05, compared to 6.7 and 5.5 per cent in the two preceding years respectively. Machinery and equipment has seen strong output expansion to 26 per cent in April-September 2004-05, sharply up from 7.8 and 1.6 per cent in the first-half year periods of 2003-04 and 2002-03 respectively. Production expansion of transport equipment however has come down sharply this year, but

Table 3.4: Index of Industrial Production: Growth Rates (annualised) by Use-based Classification

Unit: per cent

Year	Period	Basic Goods	Capital Goods	Inter-mediates	Consumer Goods		
					Total	Durables	Non-durables
Weight out of 1,000		*355.65*	*92.57*	*265.14*	*286.64*	*53.65*	*232.99*
1995-96		10.7	5.4	19.3	12.8	25.8	9.8
1996-97		3.0	11.4	8.1	6.2	4.6	6.6
1997-98		6.5	5.8	8.0	5.5	7.8	4.9
1998-99	Full Year	1.5	11.5	5.9	1.9	4.6	1.2
1999-00		6.3	8.0	9.0	6.0	15.3	3.2
2000-01		4.3	1.7	4.7	8.0	14.6	5.8
2001-02		2.4	-3.4	1.6	6.0	11.5	4.1
2002-03		4.8	10.5	3.9	7.1	-6.3	12.0
2003-04		5.5	13.6	6.4	7.0	11.6	5.8
2001-02	Q-1	1.4	-6.0	3.3	4.8	7.4	3.9
	Q-2	2.4	-7.4	2.5	6.0	17.3	1.6
	Q-3	2.2	-0.9	0.2	6.9	11.6	5.3
	Q-4	3.7	0.6	0.4	6.2	9.6	5.1
2002-03	Q-1	5.5	5.2	0.2	6.6	-1.7	9.9
	Q-2	4.5	13.4	3.5	9.8	-10.4	18.8
	Q-3	4.5	13.3	4.5	6.3	-4.3	10.2
	Q-4	4.9	10.0	7.3	5.8	-8.2	10.4
2003-04	Q-1	**4.4**	**8.4**	**2.8**	**8.6**	**4.0**	**11.1**
	Q-2	**4.2**	**11.6**	**7.1**	**7.3**	**9.3**	**6.7**
	Q-3	**5.2**	**10.2**	**9.4**	**6.7**	**13.8**	**4.5**
	Q-4	**8.0**	**23.0**	**6.1**	**5.6**	**19.0**	**2.0**
2004-05	Q-1	**4.6**	**13.6**	**11.0**	**7.3**	**11.7**	**4.8**
	Q-2	**5.8**	**15.5**	**4.9**	**10.9**	**18.1**	**8.7**
	Q-3 (forecast)	***4.9***	***14.7***	***6.5.***	***8.9***	***16.6***	***6.3***

Note: As in Table 3.3 above
Source: As in Table 3.3 above

more about that later. Electricity generation has picked up smartly by 7.7 per cent in this fiscal to September, compared to a nearly flat 3 per cent growth last year. Mining activities have been lifted, *albeit* by a much smaller extent to 4.9 per cent this year, from 4.2 per cent in the last.

That story also appears to hold mostly good if we look at IIP by use-base for the comparable period of April to September. Thus, capital goods output rose by 14.5 per cent in 2004-05, relative to 10 per cent in the same period in 2003-04 and 9.4 per cent in 2002-03. Consumer goods output growth too has strengthened marginally to 8.8 per cent in 2004-05, from 8.3 and 8.2 per cent for the two respective previous years. However, while durable consumer goods output has picked up over the three years, non-durable consumer goods output has decelerated–from 14.4 per cent in the first half of 2002-03 to 8.9 per cent in 2003-04 and 6.7 per cent in the current year. Production of intermediate goods has also picked up strongly to 7.7 per cent in the current fiscal from 5.0 and 1.9 per cent in the prior two years.

The continued use of 1993-94 as the base year without doubt introduces some element of distortion in the measurement of industrial output. The Indian economy has changed significantly over the past decade and the base-year basket of goods, either at the aggregate level or sub-sectoral levels in at least some cases, leaves much to be desired. Undoubtedly some of this may emerge from response problems–with individual producing units less keen to co-operate in the post-licensing era–but even where the data is otherwise fairly obvious, problems exist and these most certainly have to do with the composition of the base year basket. The most obvious case is that of transport equipment. The production data is readily available for all varieties of commercial vehicles, passenger cars, off-road vehicles, two- and three-wheelers and tractors. A quick look at the statistics currently available till August/September 2004 indicates very strong growth in all categories. However, the corresponding 2-digit IIP category indicates that transport equipment saw output expansion of merely 0.4 per cent in this fiscal up to August.

Direct industry data for the April-September 2004 period indicates that production of medium/heavy commercial vehicles grew by 40 per cent, up from 35 per cent last year; output of light commercial vehicles expanded by 27 per cent, the same as in the corresponding period of last year; production of passenger cars and multi-utility vehicles grew 29 per cent, slightly down from 36 per cent last year. Production of 2- and 3-wheelers was up by 14 per cent, compared to 9 per cent last year. The domestic sales of tractors rose 39 per cent this fiscal to August, compared to a *decline* by 13 per cent in the comparable period of last year. While some of the sales growth of tractors was due to de-stocking, production too has picked up; in August 2004 output grew by 52 per cent and cumulative production for April to August is believed to have grown by between 15 and 20 per cent. Ignoring for a moment that the industry has been moving in the direction of greater value addition, the principally relevant output data seem to indicate output expansion in the range 15 of 47 per cent: something that surely does not gel with an aggregate measure of 0.4 per cent.

In the case of transport equipment a look at the 1993-94 base year indicates two things. First, the great change that have come about in the relative importance of different kinds of equipment–the lower volumes for shipbuilding, locomotives and wagon-building and the incomparably larger volumes for trucks, passenger cars and two wheelers. Second, the measure used in the base year weights are in terms of numbers, not value. We know that the transport equipment business has been transformed not only by the increase in overall volumes, but also by the expansion of higher-priced vehicles. It is thus completely unsurprising that the IIP measure of transport equipment greatly underestimates actual volume growth in the business. It is of course not possible to say, how true this is for other industries. However, if we look at the 2-digit level growth figures it is obvious that some of the worst performing ones are the businesses that have or are going under or where the 'organised' sector is a fraction of the overall business. That includes jute in the first category, and textile products (including wearing apparel) in the second. If it is by and

large true that the industries with lower growth are the ones that are over-represented in the base year and vice versa for the industries like transport equipment that are racing ahead, then it would be unquestionably correct to conclude that the IIP is under-estimating industrial, particularly manufacturing, growth in a systematic fashion.

2-digit level analysis

Several industrial groups, which had consistent poor records of growth in the recent years, did experience a reversal of fortunes in 2003-04, but in the current fiscal there has been a slowing down. Notable examples are:

- Paper and paper products: From -9 and 3 per cent in 2000-01 and 2001-02, up to 6.8 per cent and 15.6 per cent in the next two year. However, in the current fiscal up to September, growth has slid back to 3 per cent.
- Basic metal and alloys: From below 2 and 4 per cent in 2000-01 and 2001-02, up to 9.2 per cent in each of the subsequent two years. But in the current fiscal up to September there is a decline by 0.5 per cent.

Some categories began to show big improvements only in 2003-04 and have continued to strengthen in 2004-05:

- Machinery and equipment (excluding transport): From growth of between 1 and 2 per cent in 2001-02 and 2002-03, up to 16 per cent in 2003-04 and 26 per cent in the first five months of 2004-05.
- 'Other' manufacturing industries: From an average of 1.2 per cent in the 4 years between 1999-2000 and 2002-03, to 7 per cent in 2003-04 and 15 per cent in the first six months of 2004-05.

Basic chemicals and chemical products, which by weight is the single largest manufacturing 2-digit category in the IIP, had taken a dip in 2001-02 and 2002-03, growing by 4.8 and 3.7 per cent respectively in these years. The weak patch began in December 2001 and reached its nadir in April 2003 (a month in which it had a year-on-year growth of -5 per cent, the weakest monthly result in the present data series). Since April 2003, the sector has seen strong output recovery

Table 3.5: Annualised Growth Rates for Manufacturing at the 2-digit level

Unit: per cent

Group	Description of sector	Weight in 1000	Average 1995-1998*	Average 2000-2004=	1999-00	2000-01	2001-02	2002-03	200304	2004-05 (April Sept)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	The faster growing industry groups: 7 per cent and higher									
22	Beverage, tobacco etc.	*23.82*	15.4	12.1	7.6	4.3	12.2	27.9	8.6	8.4
35-36	Machinery (excl. transport)	*95.65*	9.8	8.7	17.7	7.3	1.3	1.6	15.6	26.0
37	Transport equipment & parts	*39.84*	10.8	8.4	5.7	-2.0	6.8	14.6	17.0	1.4
	Industry groups with moderate growth: Above 5 and up to 7 per cent									
30	Basic chemicals & chemical products	*140.02*	10.1	6.9	10.0	7.3	4.8	3.7	8.7	17.6
32	Non-metallic mineral products	*43.97*	15.0	6.6	24.4	-1.2	1.2	5.1	3.6	-0.4
24	Man-made fibres, wool & silk yarn	*22.58*	14.6	6.4	11.9	5.8	4.4	3.0	6.8	6.4
31	Rubber, plastic, coal & refined petroleum products	*57.28*	5.0	6.3	-1.1	11.8	11.1	5.5	4.5	3.2
33	Basic metal & alloys	*74.53*	8.4	5.9	5.0	1.8	4.3	9.2	9.2	-0.5

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	Industry groups with slow growth: 3 to below 5 per cent									
20-21	Food Products	*90.83*	5.1	4.6	4.2	10.1	-1.6	11.0	-0.5	-6.3
28	Paper & paper products	*26.52*	10.5	4.5	6.3	-9.1	3.1	6.8	15.6	3.1
29	Leather, leather & fur products	*11.39*	8.4	4.5	13.8	10.7	5.3	-3.3	-3.9	5.4
26	Textile products incl RMG	*25.37*	17.9	3.9	2.0	4.0	2.4	14.4	-3.2	3.1
	Industry groups with negative growth: Flat and up to -7 per cent									
34	Metal products & parts (excl. Machinery)	*28.10*	8.8	2.6	-1.2	15.0	-10.0	6.4	2.6	6.5
38	Others industries	*25.59*	25.3	2.3	-16.0	11.7	8.9	0.1	7.2	15.4
23	Cotton textiles	*55.18*	8.3	0.3	6.7	2.9	-2.2	-2.7	-3.1	7.8
25	Jute & mesta	*5.90*	12.3	-0.4	-0.9	0.8	-5.9	8.3	-4.2	-5.0
27	Wood, products & furniture	*27.01*	15.6	-7.0	-16.2	2.9	-11.0	-17.6	6.8	-10.8
2-3	**Overall manufacturing**	***793.58***	**9.4**	**5.7**	**7.1**	**5.3**	**2.9**	**6.0**	**7.3**	**8.2**
	Distribution of rates of growth									
	Median Value		9.1	4.6	5.7	4.3	3.1	5.5	6.8	3.2
	25 percentile value		5.0	2.6	-0.9	1.8	-1.6	1.6	-0.5	-0.4
	75 percentile value		10.5	6.6	10.0	10.1	5.3	9.2	8.7	7.8
	Nos. of industry groups > mean		11	6	6	8	9	8	6	4
	Nos. industry groups < 1/3 rd of mean		0	5	6	4	5	5	5	6

Note: * Averages for 3 years–1995-96, 1996-97 and 1997-98
= Average growth rate for the 5-year period–1999-2000 to 2003-04. Ranked in descending order of 5-year average growth, that is, column (5).

Source: As in Table 3 above

with last year's growth averaging 8.7 per cent and in the current fiscal 18 per cent till September.

The beverage and tobacco category, which has generally experienced strong growth in recent years, though growing strongly has slowed down somewhat 2003-04. Food products continue to show negative output growth, largely on account of lower sugar production. Cotton textiles, textile and leather products that have been in negative territory in the past one or two years, are all showing some progress in the current fiscal.

In Table 3.5 is listed the annualised rates of output growth for each of the seventeen 2-digit industry groups, ranked in descending order of average growth for the 5-year period 1999-00 to 2003-04. The industry groups can be categorised into four principal categories:

I. The top 3 groups–beverage, tobacco etc.–had average growth of between 8.4 and 12.1 per cent in the previous five-year period. These groups account for 20 per cent of base year (1993-94) output. The best performer in 2003-04 was transport equipment, followed by machinery and equipment (excluding transport). In the current fiscal it is machinery that has shown explosive growth.

II. The second category of 5 industry groups (43 per cent of base year output)–from basic chemicals *through* to basic metals & alloys–had average growth lying within a band of between 5.9 to 6.9 per cent. Basic chemicals and products, which have the largest weight of 18 per cent in manufacturing, recovered since August 2003 and have experienced strong growth since, continuing into the first five months of the current fiscal year. Manmade fibres picked up last year and more so in the current fiscal. Non-metallic mineral (mostly cement) which has grown at quite a modest pace in recent years, including 2003-04, has tended to stagnate this year. Basic metals and alloys after smart output expansion in the two previous years, have contracted this year.

III. The third category of 4 groups–food products *through* apparel–had average growth of between 3.9 and 4.6

per cent. The category accounted for 19 per cent of base year (1993-94) manufacturing output. Within this, food products showed marked recovery in 2002-03 but had been flat last year and shown significant contraction this year, mostly due to weak sugar cane crop and hence lower sugar production.

IV. The fourth and last category of 5 industry groups–metal products *through* wood products–averaged growth of -7.0 to 2.6 per cent in the five-year period. It accounted for 18 per cent of base year (1993-94) manufacturing output. Here 'other manufacturing' industries have shown a sharp recovery in output expansion both in 2003-04 and in 2004-05.

There do seem to be some signs of a narrowing of the growth base. The number of 2-digit industries with growth above the mean value is down to 4 (see Table 3.6). Median growth is also down to 3.2 per cent which is only comparable to 2001-02–a very poor year for industrial growth with overall manufacturing growth of only 2.9 per cent. Moreover these measures have only been deteriorating over the past several months. Strong growth in machinery & equipment, basic chemicals and now 'other' manufacturing industries has been keeping the average high. However, as we have noted earlier the IIP is indeed underestimating transport equipment. The anecdotal evidence is indicative of temporary supply-side bottlenecks in some areas such as steel production, while textiles are an area where the IIP coverage is uncertain and is also liable to significant revisions later.

On the whole it is our assessment that manufacturing output growth will sustain, perhaps at a slightly lower level, for the rest of this financial year. If our assessment regarding the investment cycle is accurate, manufacturing output growth should hold strong into the next financial year as well.

External Merchandise Trade–Composition and Direction

This section has six tables that provide information on

Table 3.6: Summary of Changes in the Rupee Value of Merchandise Imports
Financial years of 2002-03, 2003-04 and April–May (2 months) of 2004-05

Unit: Rs. crore

	2002-03	2003-04			2004-05 (Apr–May)		
		Amount	*Change from full year of 2002-03*		*Amount*	*Change from April–May of 2003-04*	
			Amount	%		*Amount*	%
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Food Products	14,279	2,748	17,027	19	1,917	–853	–31
of which: Edible oil	*8,780*	*2,904*	*11,683*	*33*	*1,300*	*–783*	*–38*
Other agricultural products	3,202	3,626	425	13	408	–186	–.31
Ores & minerals	11,924	13,421	1,497	13	3,941	1,851	89
Manufactured intermediates & consumer goods	**90,992**	**114,266**	**23,274**	**26**	**19,651**	**3,340**	**21**
Electronic goods	27,099	34,491	7,393	27	5,977	1,144	24
Organic chemicals	9,125	12,689	3,565	39	2,206	254	13
Non ferrous metals	3,226	4,360	1,134	35	752	132	21
Wood & wood products	1,946	3,270	1,324	68	517	43	9
Manmade filament/spun yarn	1,922	1,912	–10	neg	290	15	5
Chemical material & products	2,187	2,902	715	33	495	124	34
Artificial resins, plastic material	3,784	4,972	1,188	31	855	165	24
Iron & steel	4,267	6,493	2,225	52	1,477	468	46
Inorganic chemicals	5,516	5,838	322	6	778	25	3
Fertilisers (manufactured)	1,731	2,301	571	33	86	–152	–64
'Other' commodities	11,268	11,949	681	6	2,505	849	51

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Capital goods	**41,358**	**51,987**	**10,629**	**26**	**7,086**	**471**	**7**
All kinds of machinery*	24,291	29,739	5,448	22	4,855	508	12
Professional instruments	5,494	5,655	159	3	926	96	12
Transport equipment	9,183	14,833	5,650	62	952	-147	-13
Gold	**18,608**	**29,946**	**11,338**	**61**	**9,557**	**3,127**	**49**
Diamonds & gem stones	29,341	32,757	3,416	12	3,612	-1,283	-26
Crude petroleum and products	85,367	94,520	9,153	11	19,983	5,206	35
Total	**297,206**	**359,108**	**61,902**	**21**	**66,516**	**11,641**	**21**
Memo							
Non-oil, non-bullion imports	191,086	233,082	41,996	22	36,787	3,511	11
Non-oil, non-bullion, non-diamond imports	161,745	200,324	38,580	24	33,175	4,794	17

Note: * Including all project goods.

Source: *Monthly Foreign Trade Statistics of India (principal commodities & countries)*, Imports and Exports & Re-exports, Directorate General of Commercial Intelligence & Statistics, Government of India, March and May issues of 2004, both released in October 2004.

the composition and direction of India's external merchandise trade.

Imports

In 2003-04, while total imports rose by 21 per cent, gold imports soared by 60 per cent. The value of crude petroleum imports rose by only 11 per cent and non-oil, non-bullion imports were up by 22 per cent. Import of capital goods and several manufacturing intermediates rose strongly–from chemicals to metals (see Table 3.6). We have disaggregated data for the current year only up to May 2004. In the first two months of fiscal 2004-05, while overall imports have risen at the same pace as that of the previous year, oil imports have risen much faster and non-oil imports were up only by 16 per cent, while non-oil, non-bullion imports increased by 11 per cent. However, from the aggregate data available up to September, we do know that non-oil imports rose by 26 per cent, which is in line with the experience of 2004–namely 25 per cent.

Exports

In 2003-04, exports overall in rupee terms increased by 15 per cent. During the first two months (April–May 2004) of the current fiscal year, the expansion of exports was faster at the rate of 25 per cent (see Table 3.7). Within exports, the fastest growing items were engineering goods, metals and metal manufactures, chemicals and products thereof. This was as true of the full year, as for the first two months of 2004-05. Textiles–yarn, fabrics, apparel, made-ups and carpets–expanded by only 5 per cent in 2003-04 and contracted by a small amount in the first two months of the current year. Leather and manufactures picked up a bit in 2003-04, but have had a lacklustre performance in the first two months of 2004-05. Export of gems and jewellery showed modest growth last year, but expanded by 42 per cent in the first two months of 2004-05. Export of refined petroleum products rose by 32 per cent in 2003-04 and by 74 per cent in the first two months of 2004-05. The relatively weaker export performance in textiles–and individually in the major categories of cotton apparel, cotton yarn, fabrics and made-ups and man-made fibre yarn and apparel, is of some

Table 3.7: Summary of Changes in the Rupee Value of Merchandise Exports
Financial years of 2002-03, 2003-04 and April–May (2 months) of 2004-05

Unit: Rs. Crore

Categories	2002-03	2003-04			2004-05 (Apr-May)		
		Amount	*Change from full year of 2002-03*		*Amount*	*Change from April–May of 2003-04*	
			Amount	*%*		*Amount*	*%*
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Agricultural Products	31,413	33,500	2,087	*7*	5,755	884	*18*
Ores & minerals	9,660	10,885	1,225	*13*	2,354	988	*72*
Leather & manufactures	8,946	9,940	994	*11*	1,323	–89	*–6*
Textiles and products	56,220	58,777	2,557	*5*	8,506	–142	*-2*
Chemicals and products	33,942	40,776	6,834	*20*	7,072	1,238	*21*
Metals and products	20,309	25,725	5,416	*27*	4,,628	854	*23*
Engineering goods	17,141	22,985	5,844	*34*	4,299	1,214	*39*
Other manufactured goods	76,244	89,308	13,064	*17*	17,649	5,694	*48*
Total 255,137	**293,367**	**38,230**	***15***		**43,540**	**8,771**	***25***
		Memo Items					
		Agricultural & mineral produce					
Oil meals	1,487	3,348	1,861	*125*	1,090	948	*667*
Marine products	6,928	6,106	–822	*–12*	569	–263	*–32*
Meat & meat preparations	1,337	1,714	337	*24*	235	3	*1*
Rice–*basmati* & *non-basmati*	5,831	4,168	–1,663	*–29*	697	–145	*–17*
Tea and coffee	1,856	1,840	–16	*–1*	414	47	*13*

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Wheat	1,760	2,391	631	*36*	447	220	*97*
Iron ore	4,200	5,173	973	*23*	1,352	814	*151*
Manufactured Goods							
Apparel–cotton	21,510	22,009	499	*2*	3,282	146	*5*
Drugs & pharmaceuticals	12,826	15,213	2,387	*22*	2,302	–47	*–2*
Cotton yarn, fabrics & made-ups	16,218	15,600	–618	*–4*	2,159	–187	*–8*
Iron and Steel	8,982	11,385	2,403	*27*	2,029	211	*12*
Machinery and instruments	9,720	12,757	3,037	*31*	2,120	176	*9*
Manufacture of metals	8,942	11,150	2,208	*25*	1,952	352	*22*
Plastic & linoleum products	5,912	8,054	2,142	*36*	1,946	965	*98*
Transport equipment	6,455	8,988	2,533	*39*	1,934	929	*92*
Man-made fibres–yarn & apparel	6,639	8,093	1,454	*22*	1,247	38	*3*
Inorganic/organic/agro-chemicals	4,930	5,293	363	*7*	945	88	*10*
Dyes & intermediates	3,440	4,710	1,270	*37*	945	88	*10*
Select items categorised under 'other manufactured goods' in above							
Gems & jewellery	43,701	48,586	4,885	*11*	8,620	2,560	*42*
'Other' commodities	5,770	8,640	2,870	*50*	2,308	1,118	*94*
Petroleum refinery products	12,469	16,397	3,928	*32*	4,131	1,751	*74*
Electronic goods	6,063	7,942	1,879	*31*	1,228	99	*9*
Handicrafts	3,801	2,296	–1,505	*–40*	135	–223	*–62*

Source: As in Table 3.6

concern, given that the MFA quota system is set to be phased out with effect from January 2005 and the challenge to occupy competitively additional space will be facing the Indian textile business as a current reality.

Direction of Trade

Imports

The largest regional source of non-oil imports into India is Western Europe, followed by East Asia and Southeast Asia (see Table 3.8). However, the most sizeable increases in imports have come from East and Southeast Asia. Imports from South Korea and Australia have nearly doubled in 2003-04 over that in 2002-03, while those from Sri Lanka,

Table 3.8: Summary of Changes in the Sources of Indian Imports by Region
Financial years of 2002-03 and 2003-04

	2002-03		2003-04		
	Complete financial year–12 months				
	Value in Rs. crore	Share in total imports in %	Value in Rs. crore	Change from 2002-03 in %	Share in total imports in %
Western Europe	72,596	24.5	84,565	*16.5*	23.5
North America	24,119	8.1	26,471	*9.8*	7.4
East Asia incl. Japan	37,691	12.7	54,285	*44.0*	15.1
West Asia	15,290	5.2	20,851	*36.4*	5.8
South East Asia	24,912	8.4	34,156	*37.1*	9.5
Africa	16,545	5.6	14,694	*-11.2*	4.1
South Asia	2,491	0.8	3,259	*30.9*	0.9
Latin America	5,068	1.7	5,480	*8.1*	1.5
C.I.S.	3,642	1.2	5,796	*59.2*	1.6
Oceania	6,869	2.3	12,623	*83.8*	3.5
Transitional Europe	1,090	0.4	1,409	*29.2*	0.4
Unspecified sources*	86,066	29.0	95,367	*10.8*	26.6
Grand Total	201,519	100	263,590	*30.8*	100

Note: * This is mostly crude petroleum which is almost invariably not identified by source in trade data. Much of India's imports of crude petroleum are sourced from the Persian Gulf region, and to a much lesser extent from South East Asia. Had the details been available would have been incorporated into the group 'West Asia' and to some extent under the category 'South East Asia'.

Source: As in Table 3.6 above

UAE, Norway and Afghanistan have indeed more than doubled (see Table 3.9).

The USA is the origin of the largest single share of India's imports at over 6 per cent, but growth of 7-8 per cent in each of the two previous years has been relatively modest. Belgium (the source of much of the diamonds imported into India) had the second largest market share at 6 per cent in 2002-03, but growth last year was weak,[1] and has yielded the second spot to China. In 2003-04, China became the second largest supplier of India's imports with a market share of 5.2 per cent and 38 per cent growth during the year. Imports from Switzerland grew by 35 per cent, bringing that country up to fourth place in terms of market share. Imports from Norway, Italy, Sweden, Norway, the Netherlands and Finland, all grew strongly through 2003-04. So too did imports from Spain, Greece and Ireland, though on a relatively small base. Imports from France actually fell, while that from Germany and our largest European trading partner, the UK, grew at a relatively modest pace.

Table 3.9: Summary of Changes in the Sources of Indian Merchandise Imports–Selected Countries
Financial years of 2002-03 and 2003-04

	2002-03		2003-04		
	Complete financial year–12 months				
	Value in Rs Crore	Share in total imports %	Value in Rs crore	Change from 2002-03 in %	Share in total imports %
(1)	(2)	(3)	(4)	(5)	(6)
		North America			
USA	21,379	*7.2*	23,136	*8.2*	6.4
Canada	2,740	*0.9*	3,336	*21.7*	0.9
		Western Europe			
Belgium	17,962	*6.1*	18,270	*1.7*	5.1
Switzerland	11,273	*3.8*	15,223	*35.0*	4.2
UK	13,446	*4.5*	14,862	*10.5*	4.1
Germany	11,504	*3.9*	13,411	*16.6*	3.7
France	5,298	*1.8*	5,010	*-5.4*	1.4
Italy	3,927	*1.3*	4,922	*25.3*	1.4
Sweden	2,504	*0.8*	3,211	*28.2*	0.9
Netherlands	1,867	*0.6*	2,461	*31.8*	0.7

(1)	(2)	(3)	(4)	(5)	(6)
Norway	347	*neg*	1,392	*300.9*	0.4
Finland	963	*0.3*	1,241	*28.9*	0.3
		East Asia			
China	13,466	*4.5*	18,625	*38.3*	5.2
Hong Kong	4,706	*1.6*	6,859	*45.8*	1.9
Japan	8,852	*3.0*	12,258	*38.5*	3.4
Korea, South	7,374	*2.5*	13,000	*76.3*	3.6
Taiwan	3,206	*1.1*	3,533	*10.2*	1.0
		West Asia			
U.A.E	4,610	*1.6*	9,465	*105.3*	2.6
Saudi Arabia	2,442	*0.8*	3,390	*38.8*	0.9
Israel	2,945	*1.0*	3,078	*4.5*	0.9
Iran	1,249	*0.4*	1,226	*–1.8*	0.3
Jordan	1,080	*0.4*	1,058	*–2.0*	0.3
		South East Asia			
Indonesia	6,681	*2.3*	9,751	*46.0*	2.7
Singapore	6,937	*2.3*	9,583	*38.1*	2.7
Malaysia	7,090	*2.4*	9,404	*32.6*	2.6
Thailand	1,832	*0.6*	2,799	*52.7*	0.8
Myanmar	1,626	*0.5*	1,879	*15.6*	0.5
		South Asia			
Nepal	1,356	*0.5*	1,314	*–3.1*	0.4
Sri Lanka	441	*0.1*	895	*102.7*	0.2
Bangladesh	263	*0.1*	357	*35.7*	0.1
Pakistan	215	*0.1*	265	*23.0*	0.1
Bhutan	125	*neg*	241	*91.9*	0.1
Afghanistan	88	*neg*	186	*111.3*	0.1
		Oceania, Africa, CIS and Latin America			
Australia	6,453	*2.2*	12,174	*88.7*	3.4
South Africa	10,113	*3.4*	8,727	*–13.7*	2.4
Russia	2,853	*1.0*	4,410	*54.6*	1.2
Argentina	1,956	*0.7*	2,408	*23.1*	0.7
Brazil	1,532	*0.5*	1,441	*–6.0*	0.4

Source: As in Table 3.6

Exports

The largest regional destination of Indian exports continues to be Western Europe, but the share of this market declined to 22.9 per cent in 2003-04 from 23.3 per cent in 2001-02 (see Table 3.10). The USA is the single largest destination country, but export growth slowed to 8.2 per cent in 2003-04, compared to 29.4 per cent in 2002-03,

as a result of which the share of the US market in Indian goods export declined to 18.2 per cent in 2003-04, from 20.6 per cent in 2002-03 (see Table 3.11). In Europe, the United Kingdom continues to be largest country destination, followed by Germany. Exports to Italy have grown the fastest in 2004-05. The UAE has been the second largest destination country for Indian exports for some years and in 2004-05 its share increased further to 8 per cent. Hong Kong has moved to the third sport ahead of the UK in 2004-05. If we take Hong Kong and China as a single economic entity, its share was 8.5 per cent in 2003-04 and 9.7 per cent in 2004-05–second only to that of the US as a market for Indian exports. Export growth to both Japan and Taiwan were slow in 2003-04 and the trend has continued into 2004-05.

The other fast growing export destination has been Singapore to which export growth was as high as 42 per cent in 2003-04 that came on top of a 49 per cent expansion in

Table 3.10: Summary of Changes in the Destination of Indian Exports by Region
Financial years of 2002-03 and 2003-04

	2002-03		2003-04		
	Complete financial year – 12 months				
	Value in Rs Crore	**Change from 2001-02 in %**	**Value in Rs crore**	**Change from 2002-03 in %**	**Share in total exports %**
Western Europe	57,289	16	67,038	17	22.9
North America	55,879	*29*	56,306	*1*	19.2
West Asia	35,001	*39*	45,975	*31*	15.7
East Asia incl. Japan	37,135	*34*	43,140	*16*	14.7
South East Asia	20,418	*24*	26,752	*31*	9.1
South Asia	12,824	*31*	19,729	*54*	6.7
Africa	15,097	*10*	17,654	*17*	6.0
Latin America	6,578	*35*	5,491	*-17*	1.9
C.I.S.	4,404	*-5*	4,727	7	1.6
Oceania	2,929	*20*	3,257	*11*	1.1
Transitional Europe	1,501	*22*	2,277	*52*	0.8
Grand Total	255,137	*22*	293,367	*15*	100.0

Source: As in Table 3.6 above

2002-03. In the region, export growth to Bangladesh and Sri Lanka has been strong, while that to Australia has lagged behind import growth. Export growth to major Latin American markets slowed in 2003-04, as well as that to Russia–which has been something of a continuing trend. In Africa, while export growth to South Africa has grown relatively slowly, that to Nigeria and Egypt has picked up some momentum.

Table 3.11: Summary of Changes in the Destination of Indian Merchandise Exports–Selected Countries
Financial years of 2002-03 and 2003-04

	2002-03		2003-04		
	Complete financial year – 12 months				
	Value in Rs Crore	Share in total exports %	Value in Rs crore	Change from 2002-03 in %	Share in total exports %
(1)	(2)	(3)	(4)	(5)	(6)
		North America			
USA	52,536	*20.8*	52,799	*0.5*	18.0
Canada	3,343	*1.3*	3,507	*4.9*	1.2
		Western Europe			
UK	11,968	*4.7*	13,892	*16.1*	4.7
Germany	9,973	*3.9*	11,693	*17.2*	4.0
Belgium	7,976	*3.2*	8,298	*4.0*	2.8
Italy	6,483	*2.6*	7,947	*22.6*	2.7
Netherlands	4,960	*2.0*	5,924	*19.4*	2.0
France	5,107	*2.0*	5,886	*15.3*	2.0
Spain	3,896	*1.5*	4,607	*18.2*	1.6
Switzerland	1,722	*0.7*	2,067	*16.6*	0.7
		East Asia			
Hong Kong	11,829	*4.7*	14,989	*26.7*	5.1
China	9,491	*3.8*	13,579	*43.1*	4.6
Japan	8,990	*3.6*	7,854	*-12.6*	2.7
Korea, South	3,120	*1.2*	3,515	*12.7*	1.2
Taiwan	2,796	*1.1*	2,447	*-12.5*	0.8
		West Asia			
U.A.E	16,037	*6.3*	23,553	*46.9*	8.0
Saudi Arabia	4,552	*1.8*	5,162	*13.4*	1.8
Iran	3,171	*1.3*	4,219	*33.0*	1.4
Israel	3,071	*1.2*	3,327	*8.4*	1.1
Turkey	1,780	*0.7*	2,589	*45.4*	0.9
Kuwait	1,212	*0.5*	1,466	*21.0*	0.5
Iraq	1,037	*0.4*	345	*-66.7*	0.1

(1)	(2)	(3)	(4)	(5)	(6)
		South East Asia			
Singapore	6,885	*2.7*	9,764	*41.8*	3.3
Indonesia	3,997	*1.6*	5,180	*29.6*	1.8
Malaysia	3,614	*1.4*	4,102	*13.5*	1.4
Thailand	3,440	*1.4*	3,822	*11.1*	1.4
		Latin America			
Brazil	2,318	*0.9*	1,267	*-45.4*	0.4
Mexico	4,457	*0.5*	1,215	*-4.1*	0.4
		South Asia			
Bangladesh	5,297	*2.1*	7,999	*51.0*	2.7
Sri Lanka	4,457	*1.8*	6,062	*36.0*	2.1
		Africa, Oceania and C.I.S.			
Russia	3,376	*1.3*	3,280	*-2.8*	1.1
Australia	2,433	*1.0*	2,685	*10.4*	0.9
South Africa	2,307	*0.9*	2,478	*7.7*	0.8
Nigeria	2,177	*0.9*	2,599	*19.4*	0.9
Egypt	1,443	*0.6*	1,689	*17.0*	0.6

Source: As in Table 3.6

References

1. Most probably because Indian gem polishers are increasingly purchasing their rough diamonds directly from producer countries.

Finances
Government Finances, Money, Credit and Capital Markets*

Union Government Finances

This summer government notified the rules of the *Fiscal Responsibility and Budget Management Act* (FRBMA) that was first introduced as a Bill in December 2000, eventually found passage in Parliament in 2003, and received the assent of the President in August 2003. The FRBMA requires the revenue deficit to be reduced to nil within five years, at the rate of at least 0.5 per cent of GDP in each year, and thereafter enjoins the accumulation of revenue surpluses. It may be recollected that government finances till the end of the 1970s has significant revenue surpluses which were used to finance a large part of the capital expenditure. The UPA government has set out 2008-09 as the target year for the elimination of the revenue deficit and in the July 2004 Budget has actually proposed a very significant reduction in the revenue deficit by 23 per cent in absolute terms and in excess of 1 percentage points of GDP. That is indeed an ambitious target, but the best way to stay on target is to get as far ahead of the milestone as is possible in the very beginning of the journey.

The FRBMA rules have also set targeted reduction in the fiscal deficit of the Centre, progressively reducing to 3 per cent of GDP at the end of the adjustment period, that is, 2008-09. The fiscal deficit in 2003-04 has turned out to be somewhat lower than in the revised estimates. The budgeted reduction is to 4.4 per cent of GDP, which translates to a 0.2 percentage point reduction from the provisional actual figure of 4.6 per cent in 2003-04 (the revised estimate was at 4.8 per cent). However, it must be

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remembered that some of the reduction in the fiscal deficit in 2002-03 and more so in 2003-04 was achieved by transferring the deficit to the State governments. Basically State governments pre-paid NSSF 'high-cost' debt by issuing additional bonds under the Open Market Borrowings (OMB) scheme. Thus, while there has been something of an improvement in the revenue deficit of the Centre and State combined over the last couple of years, the decline of the Centre's fiscal deficit from 6.2 per cent in 2001-02 to 4.6 per cent in 2003-04, owed in *some* measure (and decidedly in part only) to this transfer of the deficit from Centre to State.

The combined fiscal deficit of the Centre and the States has been hovering close to 10 per cent of GDP for some years now—in fact ever since 1999-2000. In 2002-03 the ratio was 9.5 per cent marginally down from 9.9 per cent of the previous year. The revised estimates for 2003-04 indicate a further reduction to 9.4 per cent, but we must await the audited accounts for a clear view.

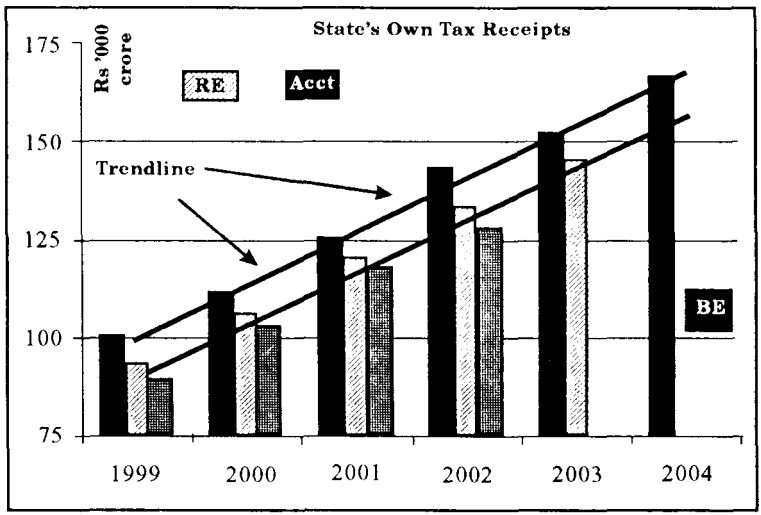
It ought to be noted that the fiscal deficit does not capture some deficits that are *quasi* financial in nature—as for instance off-Budget borrowings, financial losses of the State-owned electricity boards (or their successor entities).

The *Budget Estimates* for 2004-05 indicate a decline in the *combined* fiscal deficit to 7.9 per cent, largely because of budgeted fiscal improvement in the States. However, we know that budgetary marksmanship has been particularly poor in most States since the late 1990s, involving in most part the over-estimation of revenues at the time of drawing up the Budget.

The poor marksmanship has gone to the extent where the revised estimates and actual figures have come to have considerable variance—again mostly by way of over-estimating revenues and expenditure. This artifice justifies the unrealistic projections made for the next year and the process goes on. By over-estimating both sides, the deficit is generally portrayed with some accuracy, but the *raison d'etre* of the budgeting exercise is greatly compromised.

At *Chart-1*, we show the unfortunate consistency that has developed in the incorrect reading of State's own tax receipts (for all States) in recent years. Thus, we must wait

Chart 1: Variance in State's own tax receipts—all States



Source: State Finances, Reserve Bank of India, various years

and see to what extent there is indeed some fiscal consolidation in the States. However, one thing is certain in this. That is, the Centre must provide the leadership both by thought and example for the States to be able to take the political difficult steps in the direction of fiscal consolidation.

The fiscal numbers of the central government for the first six months of 2004-05 are available and have been presented at Table 4.1. Given alongside are the numbers for the corresponding period last year, the provisional actual for 2003-04, budget estimates for 2004-05 and percentage change envisioned in the budget and that indicated by the six-month performance. Also given in the table are the tax collection figures that are available up to October 2004 and have been compared to the position in the corresponding period in the two previous years.

The revenue receipts in the first six months were higher by 13 per cent from the corresponding period of last year, but not by as much as envisioned in the Budget. However, that position ought to have improved considerably with gross (before devolution) tax collections being up by 26 per cent in the first seven months of the fiscal.

Table 4.1: Finances of the Union Government April–August 2004 and Tax Collections (before devolution to States) April–October 2004

Unit: Rs in crore

APRIL TO SEPTEMBER	2003-04 Provisional	2004-05 BE	2003-04 April – September	2004-05 April – September	Change in % for Year/BE	Change in % for 6 months
Revenue Receipts	263,000	309,322	95,998	106,507	17.6	13.3
Tax receipts (net)	186,932	233,906	63,057	77,860	25.1	19.7
Non-Tax receipts	76,068	75,416	28,941	28,647	–0.9	–1.0
Plan Revenue Expenditure	78,537	91,843	29,878	34,742	16.9	2.5
Non-Plan Rev. Expenditure	282,771	293,650	129,547	131,716	3.8	1.7
o/w Interest	124,261	129,500	51,806	55,399	4.2	6.9
Non-interest Rev. Expenditure	237,047	255,993	107,619	111,059	8.0	3.2
Total Revenue Expenditure	361,308	385,493	159,425	166,458	6.7	4.4
Revenue Deficit	***98,308***	***76,171***	***65,427***	***59,951***	***–22.5***	***–8.4***
Non-Plan Capital Expenditure	20,414 †	38,589	30,664	10,583	89.0	–74.0
Plan Capital Expenditure	43,612	53,747	17,012	18,532	23.2	8.9
Total direct Capital Exp.	35,287	62,051	44,108	16,784	75.8	–61.9
Loans recovered	20,326 †	27,100	40,991	35,639	33.3	–13.1
Capital Exp. + Net Lending	43,700	65,236	16,685	–6,524	49.3	–139.1
Total Expenditure	405,008	450,729	176,110	159,934	11.3	–9.2
Gross Financing Gap	142,008	141,407	82,112	53,427	–0.4	–34.9
Other capital receipts	16,048	4,000	1,098	192	–75.1	–34.9
Fiscal Deficit	***125,960***	***137,407***	***81,014***	***53,235***	***9.1***	***–34.3***
Primary Deficit	***1,699***	***7,907***	***29,208***	***–2,164***	***365.4***	***–107.4***

April to October	2002-03	2003-04	2004-05	2003-04	2004-05
		Rs in crore		Change in % over previous year corresponding period	
Corporation Tax	15,586	20,931	23,314	34.3	11.4
Income Tax	17,059	17,359	28,333	1.8	63.2
Customs duties	25,749	27,843	30,742	8.1	10.4
Union excise duties	41,203	41,229	52,685	0.1	27.8
Service tax	3,595	5,001	5,951	39.1	19.0
Gross tax collections	**103,192**	**112,363**	**141,025**	**8.9**	**25.5**

Note: † We have knocked out an amount of Rs. 46,602 crore from both the loan recovery and capital expenditure side in order to achieve greater comparability with the current year. In fiscal 2003-04, State governments directly raised funds through issue of securities and used it to pre-pay Central loans made in earlier years under the prevailing small savings arrangement. Although, the underlying liability of the Centre, which are the outstanding liabilities under these schemes do not need to be discharged, the pre-payments needed to be credited into the small savings account. Upon the credit the moneys are available for the use by the Central government by issuing securities in the credit of the schemes. Budget 2004 provides for an investment of Rs 46,602 crore in the NSSF *vide* Statement 4 of Expenditure Budget Vol. I.
However, these adjustments have been made for April-September 2003-04 or in that for 2004-05

Source: i) ***Budget 2004-05***, Government of India, 8 July 2004.
ii) Union finances provisional accounts – Controller General of Accounts (CGA)
iii) Union finances up to August – monthly accounts (CGA)
iv) Taxes collected – for current year newspaper reports, for previous year CGA.

In the first six months, the revenue deficit reduced by 8 per cent compared to the same period last year, while the Budget had envisioned a 23 per cent reduction. We as of yet do not know what the direction has been with respect to revenue expenditures after September. However, had tax receipts in the first six months gone up by 26 per cent, as they did in the first seven months, the revenue deficit for the April to September period would have been 10.3 per cent (not 8.4 per cent) lower than in the first half of 2003-04. The other thing that is worth taking note of is that for the month of September 2004, Union finances had a small revenue *surplus* of Rs 818 crore, compared to the revenue *deficit* in September 2003 of Rs 19,902 crore.

It may be noted that the increase in tax revenue envisioned in the Budget at 25 per cent is comparable to what has been achieved before devolution in the first seven months up to October 2004. There is little reason to believe that there will be a significant variation in the non-tax receipts. Hence, if government can stick to its tax collection performance and adhere to its budget expenditure, the revenue deficit target does not appear to be yet beyond reach, notwithstanding some scepticism on that score amongst commentators.

Over the first six month period of 2004-05, the fiscal deficit has been lower than the revenue deficit. That is because loan recoveries exceed direct capital expenditures and disbursal of fresh loans. Given that the loan recovery figure in the first six months at Rs. 40,991 crore is well in excess of that slated for the entire year, it seems likely that some of these recoveries are linked to the pre-payment facilities extended to States on the small savings scheme. In which case, as done last year, an expense item may have to be included under capital expenditure, crediting these pre-payments into the National Small Savings Fund (NSSF). Last fiscal, a sum of Rs. 46,602 crore was collected as pre-payment and then credited into the NSSF, thereby expanding both capital receipts and expenditure by this amount. It may not be unsafe to assume that something similar, though on a smaller scale, may have to be done this year too. From that it is a reasonably safe presumption that capital expenditure and *net* lending, aside from NSSF

operations are unlikely to exceed the budgeted amount significantly.

The same conditions that govern the realisation of the revenue deficit target in 2004-05 clearly obtain in the case of the fiscal deficit target being realised too.

Monetary Conditions

The partial monetisation of the accretion to the foreign currency assets of the RBI in the past several years has been fairly significant in the past few years. A rough computation of the proportion of accretion to foreign currency assets that was *not* sterilised, that is, that *was monetised* is given below, with the proportion to GDP in parentheses.

1999-2000	68% (1.4%)	2000-01	80% (1.2%)
2001-2002	96% (3.3%)	2002-03	65% (2.2%)
2003-2004	46% (2.4%)		

This of course created a rapid growth in reserve money, but because credit growth in this period was weak, the impact on measures of broad money was less than it would otherwise have been. The most immediate impact of this increase in high powered money, in the context of strong appetite for government securities that banks had, was to cause the yield on government securities to precipitately come down. For instance, the yield on 10-year government security fell from over 11 per cent at end of 2000 to 5 per cent in October 2003, while the yield on 3-month treasury bills fell from over 10 per cent in September 2000, to 4.2 per cent at the end of 2003. Although there was some easing of interest rates on commercial loans, the magnitude was far smaller than for bond yields. However, consumer loans, including mortgages that are linked to the short-end of the yield curve, declined significantly over the past four years and helped build up the rapidly growing and profitable retail finance segment of the banking industry.

The expansion in the monetary base was pointed out in the *Annual Policy Statement* of the RBI in May 2004. It had noted that: 'increase in reserve money during 2003-04 at 18.3 per cent was higher than that of 9.2 per cent in the

previous year', and 'during 2003-04 money supply (M3) increased by 16.4 per cent as compared with 12.8 per cent in the previous year'.[1] The reason why reserve money did not grow any faster was that the excess liquidity in the system was being parked by banks in the *repo* (deposit) facility of the RBI—as much as Rs. 55,000 in March 2004, going up to Rs. 74,000 crore in April and May 2004.[2]

The expansion of liquidity was a global feature since the middle of 2001, up to sometime in 2003. It was meant to soften the rigours of recessionary conditions in developed economies and off-set any loss of business confidence arising from the terrorist attacks of September 11, 2001. It is something of a moot question as to what were the macro-economic consequences of the generous creation of liquidity in India—how much liquidity and how much inflation? It is without doubt that easy money conditions did fuel the retail boom for one thing. Companies that were strong enough to issue commercial paper (CP) and other capital market debt instruments were able to directly reduce the cost of servicing their debt, besides helping some to renegotiate interest on bank loans downward. This helped corporate profitability pick up and has laid the ground conditions for investment possibilities today. But it also created a mirage in the bond market—precipitately falling bond yields in the presence of a fiscal deficit that stood at 10 per cent of GDP. The corrections that banks will have to make in the up-phase of the interest rate cycle will be that much harder to make if bond yields had not fallen as much as they did. It also diverted attention from the credit side and in this the public sector banks may have lost out more.

Inflation at the end of the day is a monetary phenomenon. It would not be inaccurate therefore to suggest that the enormous excess liquidity created the pre-conditions for an inflationary spike—and we have had two full-blown ones so far. The first in 2002-03, that fed into the rising prices of some commodities (cotton, cotton textiles, oilseeds, edible oil and steel). And the second on the rising prices of petroleum and steel. It is important to remember that (excessive) monetary accommodation always precedes inflation. It is a simpler causal relationship than the

chicken-and-egg conundrum. For the record, China broadly appears to have done something similar; different conditions there got China much more growth, but now is giving it a strong inflationary headache (8.4 per cent in October up from *negative* inflation a couple of years back).

In 2004-05, the RBI introduced the Market Stabilisation Scheme (MSS), bonds for which are issued by the central bank to mop up the liquidity arising from accretion to foreign currency assets, the interest to be borne by the central government. The MSS calendar for each quarter is notified. The RBI has issued treasury bills and short-dated paper amounting to nearly Rs. 55,000 to date, that is, end-November 2004, though it did not issue any MSS paper in November.

Before we move further, let us discuss what did indeed happen with the increase in reserve money over the past several years and how was it that so much fund found its way into the RBI's deposit facility (repo).

Inflation and the Movements in Bond Yields

In central banks in advanced economies, the key policy rate is either the rate at which they lend to private agents (banks) or a target rate that is an outcome of open market operations. The European Central Bank (ECB) calls it a refinance rate (currently at 2 per cent) and the Bank of England calls it the repo (presently at 4.75 per cent). The US Fed has a similar rate which it calls the primary credit rate (presently at 2.5 per cent), but its key policy rate is the federal fund target (now 2 per cent) which it achieves by injecting or soaking up liquidity through open market operations. The ECB has a deposit facility (at 1 per cent now), but the other two central banks do not. The deposit rate, if it exists, is always the floor. In India, the effective policy rate has come to be what we call the repo rate, which is the rate which banks get when they park excess cash with the RBI. What makes a rate 'effective'—other than the central bank's intention?

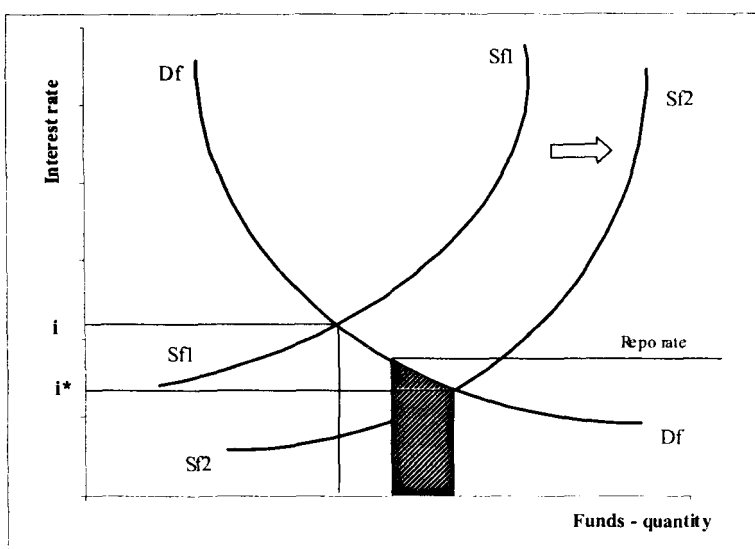
It is where overnight market rates tend to gravitate.

How did our repo rate become the arbiter of short-term interest rates?

In the immediate history the story runs from the considerable liquidity that was pumped into the system since 1999-2000, as BoP surpluses were monetised, not sterilised. As the inflows became larger in 2001-02—partly in consequence of the current account turning positive—the liquidity injections became larger and larger still, aggregating some Rs. 250,000 crore over the past 5 years. That's high powered reserve money that expands by a large multiple in the form of broad money. So as liquidity was awash in the markets, and private demand for credit remained subdued, the price of government bonds rose and their yields fell: from 11 per cent in January 2001 to 5 per cent by the end of 2003.

Thus, there came to be some magic conjured. An economy with growth of close to 6 per cent, a fiscal deficit of 10 per cent (Centre and States combined), underlying inflation of 4 to 5 per cent—in the context of global fears of deflation—managed to have long-term yields that rivalled those in the advanced economies. But magic, alas, is an

Figure 1 : Constraining impact of repo rate in the context of liquidity injection



illusion and must come to pass. So, something had to give—and it was prices (of goods) that did.

There might have been some growth effects of the liquidity creation—through lower-priced consumer loans (including) mortgages and the expenditures these loans financed. We focus here a bit narrowly on the effects on the interest rate structure. At the time that RBI was injecting high powered money over the past several years, it did not want to run into a situation where the rupee might tank.[3] So it kept the short-end floor rate at a relatively high level.

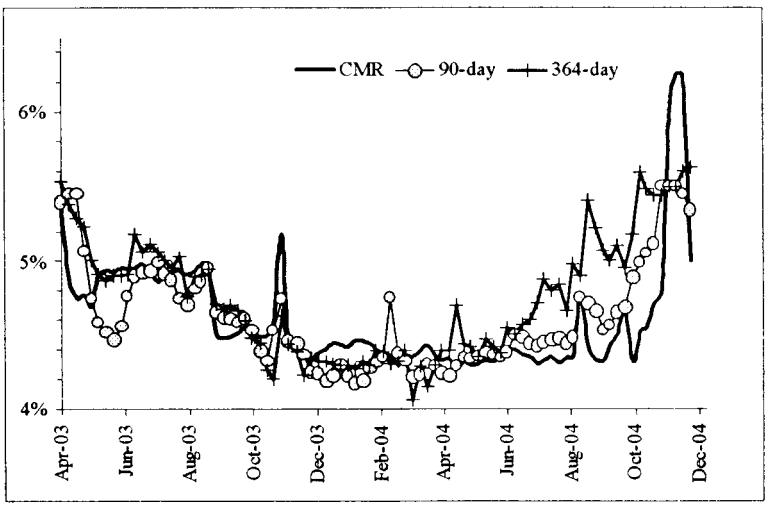
The best way to look at the problem is by thinking of a simple demand-supply schedule (see *Figure 1*). We have a demand curve (Df) for funds that slopes down and a supply curve (Sf1) that slopes up. The intersection gives you the interest rate (i) where the market clears, that is, demand = supply. Now, if the central bank issues high powered money, it causes the supply curve to shift downwards and to the right (Sf2). There will be now a new point of intersection and it will give us the interest rate (i*) at which the market will clear, and i* is of course less than i.

However, if the floor rate has been fixed at a level higher than the equilibrium one (that is, i*), as has been the case here, several things will happen. First, the market will not clear and there is an excess supply of funds which will be parked in the deposit facility. That is the shaded area in *Figure 1*. Second, since everybody can see that this is not a market clearing price, the expectation will be formed that the floor rate will fall further. This is the combination of outcomes that have over the past few years caused long-term bond yields to fall much faster, since only the prices of longer tenor bonds are fully in play, given liquidity conditions. Leading thereby, to a nearly flat yield curve—something that makes no sense in a growing economy.

Tightening liquidity

Seeking to correct this anomaly, the RBI has over the past several months aggressively sought to absorb the excess liquidity through issuance of bonds and treasury bills under the Market Stabilisation Scheme (MSS), a process that has been assisted by a very sharp increase in bank credit. The case could be made that the existing liquidity conditions

Chart 2: Movement at the short-end of the yield curve up to early November 2004

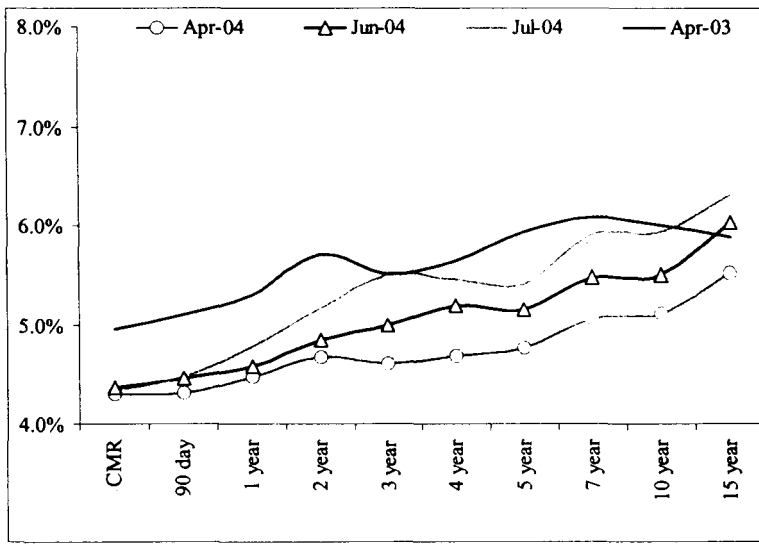


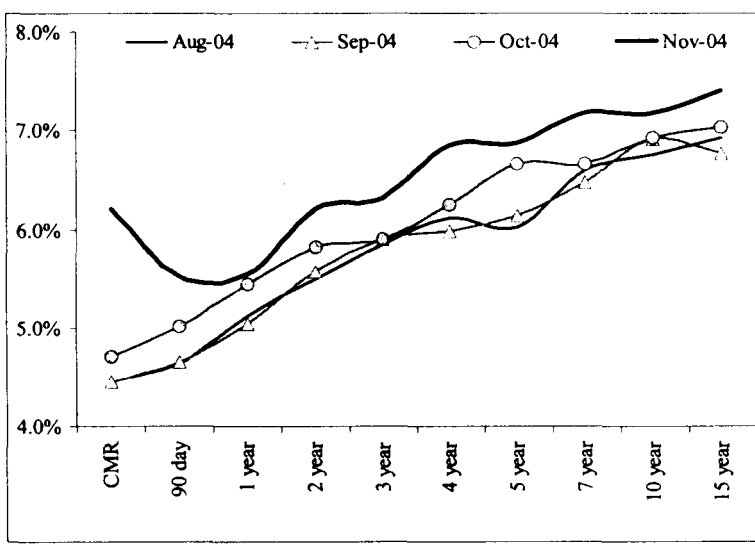
were still too high for an increase in the floor rate, for sufficiency conditions would appear when overnight market rates began to exceed the floor—which they had not, till just before the October credit policy was announced.

In the weeks after the October credit policy was announced, liquidity conditions have tightened significantly. As recently as in August up to Rs 5,000 crore was being parked in the 7-day *repo* (deposit) facility and another Rs. 35,000 crore in the overnight *repo* facility. This, it must be emphasized, was despite the monies absorbed by the MSS auctions and even just before the CRR increase, overnight repos were collecting Rs 20,000–25,000 crore. The call money rate was of course much below the repo rate. Following on the increase in CRR, unsurprisingly, the repo amounts declined. By the middle of October had fallen to below Rs. 5,000 crore—almost wholly in overnight repos—and the call money rate slowly rose till in the run-up to the Credit Policy it was marginally above the repo rate.

As discussed subsequently there has been a huge increase in credit off-take and the expansion in October and the first half of November was truly huge. This, together

Chart 3: Yield curve movement over first half of 2004-05
First chart has April, June and July 2004 with April 2003 for comparison
Second chart has August, September, October and as on November11, 2004





with the monetary policy measures put into place, has caused market rates to rise sharply. Call money rates which were 4.87 per cent on November 1 rose sharply to 5.3 per cent on November 3 and to 6.24 per cent on November 9, 2004. This has quite naturally reversed the direction of the transactions that banks have with the RBI. While overnight repo volumes have fallen to below Rs. 100 crore, the reverse repo window saw nearly Rs. 4,000 crore borrowed by banks from the RBI, and this amount has gone up to nearly Rs. 8,000 crore in subsequent days. However, as we go to press, liquidity conditions have become more orderly and call money rates have come down sharply and are likely to hover around and above 5 per cent for some time. That would also mean that both reverse repo and repo would become inactive—except at the margin; that is, for accommodating players towards the end of the trading day who might suddenly find themselves long or short of cash.

What has been the net effect? Short-term yields, as defined by the call money rate, have increased from 4.2 per cent to 6.2 per cent—that is, an effective increase of 200 basis points. Little wonder that the RBI is now contemplating adjusting the MSS auction calendar in order to maintain liquidity in the system. The jump in credit off-take and reduced capital inflows since the second quarter (July to September) of the year are the proximate reasons for the sharp tightening of liquidity in face of a particular monetary stance. It is believed that capital inflows are and will be on the rise again and to that extent that affords an easy way out, if the RBI wishes to purchase these foreign currencies.

The central government has borrowed Rs. 68,000 crore (*net* of MSS bonds) at the gross level up to the end of November 19, 2004. This is about Rs 36,000 crore (or 35 per cent) *less* than what it had borrowed at the same point in time last year, namely, Rs. 104,434 crore. This is despite the fact that the budgeted gross borrowing programme for 2004-05 is larger than that for 2003-04. As we have seen earlier, it is most possibly a matter of the lower fiscal deficit (at least till September), arising from the net cash inflows arising from prepayment of small savings loans by State

governments. Even if the fiscal deficit rises once the adjustments in the NSSF are made, the cash position of government will continue to be stronger to the extent of the loan pre-payments and to that extent it might be possible for the Union government to live with a smaller-than-budgeted borrowing programme. To the extent that eventually government will have to issue more of the slated securities for the year, then, in the context of rising yields and tightening liquidity, it will take some dextrous management.

The RBI may be thus constrained not to have an excessively heavy hand on the currency markets and let the rupee go with the flow—at least to some extent. The other alternative which the Governor has touched upon is to go easy on the MSS issuance, that is, let the MSS collections be redeemed in the market and thereby re-inject liquidity. The big trade-off is of course vis-à-vis inflationary expectations. But with market liquidity now in line with the interest rate band–*repo* as the floor and reverse *repo* as the ceiling—the distortions have been excised and dealing with issues become relatively easier.

Bank Credit and Investment

Credit off-take from the banking system by commerce and industry (C&I) has been very strong in 2004-05, coming on top of rapid credit expansion in 2003-04 as well. Investments continue to be depressed and there has been some reduction in the food credit position. The credit expansion has been in non-food credit—that is, conventional working capital advances and loans.

In the first half of 2004-05, non-food credit had gone up by Rs. 92,000 crore, which is an unprecedented increase. Investments continue to be depressed in 2004-05, and in consequence, the increase in total accommodation at Rs. 88,000 crore has been less than that for non-food credit. It may be noted that non-food credit had risen by nearly Rs. 120,000 crore in 2003-04 and that too on top of a Rs 100,000 crore expansion in the previous year.

Up to the first fortnight of November 2004, credit flow has expanded enormously. Increase in non-food credit off-

take (over end-March) on November 12, 2004 was Rs. 116,783 crore, compared to a mere Rs. 47,382 crore in the same fortnight in 2003-04. On year-to-year basis, total accommodation has jumped by 24 per cent for the fortnight ending mid-November 2004, while non-food credit has risen by 27per cent. At this point last year, the comparable year-on-year growth figures were 14 and 16 per cent respectively.[4]

This unprecedented increase in credit flow signifies strong underlying economic activity. It is not clear however to what extent this enormous increase in credit flow in September, October and November 2004 is a consequence of the unattractiveness of treasury operations for commercial banks in an environment of rising yields.

Non-Bank Sources of Commercial Finance

First, the role of mutual funds in providing commercial finance through subscription to commercial paper and debentures continue to rise much faster than does the stock of bank finance. Second, there has been increasing resort to external sources by companies that have been tempted both by the lower offshore interest rates and the perceived strength of the rupee against the US dollar, accounting in part for the increased inflow of capital into the country. To the extent that these important additional financing sources have both risen on narrow bases, the rate of expansion of non-food credit (and of total accommodation) perhaps understates the real conditions of credit demand by the commercial sector. In the October 2004 Policy Statement, the RBI has estimated that the 'total flow of resources to the commercial sector including capital issues, global depository receipts (GDRs)/American depository receipts (ADRs) and borrowings from banks and FIs increased by Rs. 108,510 crore up to October 1, 2004 as compared with Rs. 66,863 crore in the corresponding period of the previous year'.[5] These numbers are with respect to the end-March stock and what they indicate is that the share of non-bank sources have declined sharply from 41 per cent in the first half of 2003-04, to 19 per cent in the first half of the current year, while the share of the banking system has risen from 59 per cent last year to 81 per cent in this year. That of course fits

Table 4.2: Changes in Major Items of Bank Accommodation to the Commercial Sector

Unit: Rs crore

	Non-food Credit				Food Credit			
FY	**01-02**	**02-03**	**03-04**	**04-05**	**01-02**	**02-03**	**03-04**	**04-05**
Q-1 (June)	-2,367	19,308	3,091	34,926	10,349	7,030	586	7,100
Q-2 (Sept) *	24,454	46,834	41,034	92,443	10,211	-752	-12,107	2,677
mid-November	**26,549**	**51,315**	**47,382**	**116,783**	**11,245**	**226**	**-14,040**	***5,267***
Q-3 (Dec)	35,955	64,765	64,484		12,285	-2,031	-13,127	
Q-4 (Mar)	64,302	100,356	119,684		13,987	-4,499	-13,516	

	Investments <				Total Accommodation			
FY	**01-02**	**02-03**	**03-04**	**04-05**	**01-02**	**02-03**	**03-04**	**04-05**
Q-1 (June)	1,060	-5,724	-4,705	-2,440	-1,471	6,111	-1,385	32,551
Q-2 (Sept) *	2,976	-5,675	-1,838	-3,920	27,920	40,825	39,484	88,218
mid-November	**3,213**	**-3,570**	**-1,895**	**-2,595**	**30,252**	**47,341**	**45,775**	**113,863**
Q-3 (Dec)	3,025	-2,719	-3,445		39,762	61,472	61,363	
Q-4 (Mar)	3,446	-339	-3,937		67,862	99,406	116.877	

Table 4.3: Year-on-Year Changes in Major Items of Credit Flow to the Commercial Sector

Unit: per cent

FY	Non-food Credit 01-02	02-03	03-04	04-05	Food Credit 01-02	02-03	03-04	04-05
Q-1 (Jun)	9.9	16.8	16.2	22.2	51.7	21.2	–17.1	–14.8
Q-2 (Sept) *	11.4	17.5	15.8	24.5	52.7	6.0	–29.8	3.4
mid-November =	**11.8**	**17.9**	**16.0**	**26.7**	**44.6**	**5.8**	**–34.6**	**16.3**
Q-3 (Dec)	10.2	18.4	16.2		39.6	–0.6	–30.0	
Q-4 (Mar)	13.6	18.7	17.6		35.0	–8.3	–27.3	

FY	Investments < 01-02	02-03	03-04	04-05	Total Accommodation 01-02	02-03	03-04	04-05
Q-1 (Jun)	17.6	–2.0	0.5	–1.7	10.8	14.3	14.1	19.4
Q-2 (Sept) *	24.3	–4.4	3.8	–6.5	12.9	14.3	14.0	21.0
mid-November =	**19.8**	**–2.1**	**1.3**	**–5.1**	**13.1**	**15.0**	**14.1**	**23.2**
Q-3 (Dec)	14.5	–0.7	1.4		11.0	15.5	14.1	
Q-4 (Mar)	7.3	–0.4	–4.2		12.7	16.1	15.1	

Note: Data used for estimating changes in the quarter is the last Friday of the month.
* For previous years since in the second quarter, the fortnight straddles the end of September and the first week of October. Hence the aggregates as at the end of the first week of October has been used, that is 1st, 3rd, 4th, 5th, and 6th October of 2004, 2003, 2002, 2001and 2000 respectively.
= Fortnights ending on 16th, 15th, 14th and 12th in 2001 through 2004 respectively
< Figures are with one fortnight lag in comparison with the other aggregates

Source: Reserve Bank of India, *Weekly Statistical Supplement* various issues up to November 27, 2004.

in with what we know about changes in lending practices in the banks this year.

Foreign Investment

Fresh net foreign direct investment (FDI) inflows, in the fiscal up to August 2004, stood at $2.3 billion, which is of course a significant increase from the $0.6 billion in the corresponding period of last year (see Table 4.4). However, it ought to be remembered that FDI flows had been very weak in the beginning of last year and to that extent the inflow to date in the current year is still relatively modest. If the FDI proposals that were made in the Union Budget in July 2004 are given effect to, there could be a sizeable increase in these flows in the balance of the year.

Overseas issuance in the form of Global Depository Receipts (GDR) and American Depository Receipts (ADR) are down in the first half of 2004-05, but these will increase in the second half of the year. There are several overseas equity issuances that have already been announced, including that from manufacturing companies and banks. Net portfolio inflows on account of foreign institutional investors (FII) did not recover from the post-election shock till July, but such flows have picked up in September and October. Total FII inflows for the months of August, September and October (up to 26th) are $630, $515 and $490 million respectively—totalling $1.64 billion.

External commercial borrowings (ECB) have aggregated $5 billion, including fully convertible bonds for the calendar year up to the end of October 2004. There are several big-ticket prospective issuance likely before the end of this fiscal, including a $1 billion 3-5 year note from State Bank of India (SBI) and substantial offerings from large Indian private corporates. A figure of $2 to $3 billion ECB offerings till the end of 2004-05 is not unlikely.

Equity Markets

Primary market

Financial resources raised in the primary market for equity aggregated Rs. 37,800 crore in the first seven months

Table 4.4: Inward Foreign Investment—Stock and Changes

Unit: US dollars millions

As on 31 Mar	For the year/month Portfolio flows					Cumulative Portfolio flows				
	FDI	Overseas Issuance	FII	Sub-total	Total foreign inv.	FDI	Overseas Issuance	FII	Sub-total	Total foreign inv
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1993	315	240	1	244	559	541	240	1	254	795
1994	586	1,520	1,665	3,567	4,153	1,127	1,760	1,666	3,821	4,948
1995	1,314	2,082	1,503	3,824	5,138	2,441	3,842	3,169	7,645	10,086
1996	2,144	683	2,009	2,748	4,892	4,585	4,525	5,178	10,393	14,978
1997	2,821	1,366	1,926	3,312	6,133	7,406	5,891	7,104	13,705	21,111
1998	3,557	645	979	1,828	5,385	11,363	6,536	8,083	14,619	25,982
1999	2,462	270	-390	-61	2,401	13,825	6,806	7,693	14,499	28,324
2000	2,155	768	2,135	3,026	5,181	15,980	7,574	9,828	17,402	33,382
2001	4,029*	831	1,847	2,760	6,789	20,009	8,405	11,675	20,080	40,089
2002	6,131*	477	1,505	2,021	8,152	26,130	8,882	13,180	22,062	48,192
2003	4,660*	600	377	979	5,639	30,790	9,482	13,557	23,039	53,829
2004	4,675*	459	10,918	11,377	16,052	35,465	9,941	24,475	34,416	69,881
2003-04 : monthly data										
April	58	15	285	300	358	58	15	285	300	358
May	122		469	469	591	180	15	754	769	949
June	168		629	629	797	348	15	1,383	1,398	1,746
July	180	17	408	425	605	366	32	1,791	1,823	2,351
August	196	286	494	778	974	562	318	2,285	2,601	3,325

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
September	262	29	904	933	1,195	824	347	3,189	3,534	4,520
October	127		1,622	1,622	1,749	951	347	4,811	5,156	6,269
November	142	6	883	889	1,031	1,093	353	5,694	6,045	7,300
December	270	50	1,549	1,599	1,869	1,363	403	7,243	7,644	9,169
January	122	14	1,147	1,161	1,283	1,485	417	8,404	8,805	10,452
February	382	42	696	738	1,120	1,867	459	9,100	9,543	11,572
March	168		1,834	1,834	2,002	2,035	459	10,934	11,377	13,574
				2004-05: monthly data						
April	217	35	846	881	1098	217	35	846	881	1,098
May	217	135	–457	–322	–105	434	170	389	559	993
June	380	0	–477	–477	–97	814	170	–88	82	896
July	173	0	–432	–432	–259	1,585	170	–520	–350	1,585
August	619	0	448	448	1,067	2,204	170	98	268	2,302

Note: FDI adjusted as per new method relating to estimation of foreign direct investment
Source: *Monthly Bulletin*, Reserve Bank of India, Statement No 46, S-1023, November 2004.

Table 4.5: NRI Deposits—Stock and Changes

Unit: $ million

	As at the end of Month				Flows for the year / month			
	FCNR (B)	NR(E) RA	NR(NR) RD	Total	FCNR (B)	NR(E) RA	NR(NR) RD	Total
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Previous fiscal years								
Mar–1995*	10,114	4,556	2,486	17,156	–294	1,033	732	1,471
Mar–1996*	9,975	3,918	3,542	17,435	–139	–638	1,056	279
Mar–1997*	9,802	4,983	5,604	20,389	–173	1,065	2,062	2,954
Mar–1998	8,468	5,637	6,262	20,367	–1,334	654	658	–22
Mar–1999	7,836	6,045	6,618	20,499	–632	408	356	132
Mar–2000	8,172	6,758	6,754	21,684	336	713	136	1,185
Mar–2001	9,076	7,147	6,849	23,072	904	389	95	1,388
Mar–2002	9,673	8,449	7,052	25,174	597	1,302	203	2,102
Mar-2003	10,199	14,923	3,407	28,529	526	6,474	–3,645	3,355
Mar-2004	10,979	20,496	1,773	33,248	–22	–17	–141	–180
2003–04								
April	10,009	15,933	3,274	29,306	–100	901	–158	643
May	9,994	16,673	3,063	29,730	–105	627	–233	289
June	10,080	17,745	2,965	30,790	86	876	–133	829
July	9,880	18,451	2,796	31,127	–200	580	–189	191
August	9,924	18,765	2,646	31,335	44	193	–168	69
September	9,952	19,023	2,496	31,471	28	287	–146	169
October	10,547	19,983	2,397	32,927	595	699	–133	1,161
November	10,668	19,772	2,209	32,649	121	60	–158	23
December	10,845	20,233	2,111	33,189	177	304	–116	365

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
January	10,929	20,357	1,997	33,283	84	28	–124	–12
February	11,040	20,553	1,881	33,474	111	153	–120	144
March	10,961	20,559	1,746	33,266	–79	–13	–138	–230
			2004–05					
April	10,889	21,251	1,630	33,770	–72	301	–150	79
May	11,020	20,272	1,500	32,792	131	–512	–95	–476
June	11,054	19,731	1,379	32,164	34	–318	–105	–389
July	11,183	19,442	1,302	31,927	129	–145	–67	–83
August	11,064	19,286	1,210	31,560	–119	–105	–89	–313

Note: * For these years FCNR(A) has been included.
All figures are inclusive of accrued interest.

Source: Statement No. 45: *"NRI Deposits–outstanding"*, RBI Bulletin, S-1022, November 2004.

of the current fiscal, as compared to Rs. 19,200 crore in the corresponding period of last year. It might be worth noting that the last five months of 2003-04 were far more active and saw Rs. 37,500 crore raised. The more notable public issues made in the first half of 2004-05 included the large issues of Tata Consultancy Services (TCS) (Rs. 5,400 crore) and National Thermal Power Corporation Limited (NTPC) (Rs. 4,500 crore), both of which were several times over-subscribed. It is reported that about half a dozen offer documents were cleared by the Securities Exchange Board of India (SEBI) and more are presumably in the pipeline. Several public sector and private sector banks are also lined up for further issue of equity capital in order to be able to comply with Basel II capital adequacy standards. The general improvement of procedures, dematerialisation of shares, a positive investor perception and a significant broadening of the investor base (including institutional investors) has made for circumstances where raising equity capital has become less of a challenge for well-run companies—than it was since the scandals and melt downs of the mid-1990s.

Secondary market

In the context of strong economic performance and a market-oriented reform programme of the previous NDA government, the equity market rose briskly through the winter of 2003-2004 to touch what is still a record level of 6,250 for the Mumbai Stock Exchange's Sensitive-30 Index (BSE Sensex) in mid-February 2004. Prices fell thereafter in pre-poll nervousness and the (what has now become usual) post-Budget profit-booking. The defeat of the NDA government and the angry ranting of some Left leaders spooked the market and it fell precipitately by nearly 800 points in a single day. With the Manmohan Singh government sworn-in and a return of sanity to the discourse, the markets recovered, but continued to remain weak till July. Thereafter, as investors took a close second look at a government, which, despite some of its more rambunctious supporters, had been largely true to what could be expected of a Manmohan Singh–Chidambaram–Montek Singh Ahluwalia–Y.V. Reddy economic management team, money

Table 4.6: Level of Key Stock Indices and Some Pricing Parameters—November 1993 to 2004

	Nov-93	Nov-94	Nov-95	Nov-96	Nov-97	Nov-98
			Closing price			
BSE Sensex	2,852	4,035	3,159	3,139	3,578	2,945
BSE 100	1,373	1,933	1,433	1,395	1,548	1,312
BSE 200				308	348	304
			Price / Earnings			
BSE Sensex	34.42	36.32	16.46	12.41	13.39	11.62
BSE 100	33.91	40.11	17.16	11.99	11.75	9.49
BSE 200					12.86	11.02
			Price / Book Value			
BSE Sensex	4.44	5.22	2.99	2.44	2.52	2.15
BSE 100	4.32	5.43	2.84	2.17	1.63	1.23
BSE 200					1.60	1.24
			Dividend Yield			
BSE Sensex	0.92	0.78	1.43	1.76	1.64	1.96
BSE 100	0.97	0.78	1.55	1.92	2.10	2.71
BSE 200					2.09	2.56

	Nov-99	Nov-00	Nov-01	Nov-02	Nov-03	Nov-04
			Closing price			
BSE Sensex	4,586	3,947	3,180	2,987	4,940	5,997
BSE 100	2,151	2,016	1,490	1,502	2,551	3,201
BSE 200	503	432	328	361	633	784
			Price / Earnings			
BSE Sensex	19.90	19.96	14.80	13.10	15.78	18.12
BSE 100	23.03	22.59	13.40	11.05	13.73	14.63
BSE 200	24.11	18.37	12.49	10.13	13.10	15.17
			Price / Book Value			
BSE Sensex	3.32	2.85	2.17	2.06	2.97	3.46
BSE 100	2.64	2.33	1.56	1.66	2.67	2.98
BSE 200	2.44	1.88	1.37	1.43	2.35	3.00
			Dividend Yield			
BSE Sensex	1.23	1.55	2.20	2.38	2.12	1.99
BSE 100	1.20	1.34	2.27	3.23	2.64	2.16
BSE 200	1.25	1.67	2.49	3.26	2.65	2.08

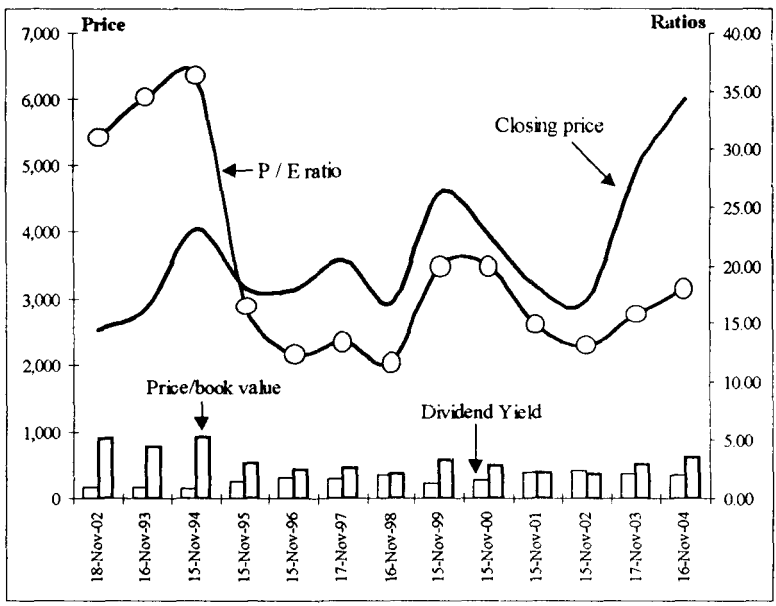
Note: The selected day is November 15, 16, 17 or 18 in that order of preference, depending on when the market was open.

Source: Mumbai Stock Exchange

started pouring in once again. The effects began to be felt from August, but more so in September and later.

At the end of November 2004, the BSE Sensex stood at little over 6,000. It is worth asking the question: are the markets priced way too high? Is it a set-up for a collapse once again?

Chart 4: BSE Sensex-30 levels and some pricing parameters: 1993 to 2004



It is interesting to note that notwithstanding the sharp rise in the overall market indices, stocks have actually become cheaper—not more expensive—in light of the underlying valuation parameters. One must hasten to add that this is a rough and ready exercise, using some select parameters and very far from being anywhere close to a thorough going exercise in valuation. However, one can conclude with some degree of confidence that any appropriate valuation procedure will broadly come to the same conclusion as that indicated in the table and charts above.

In terms of investment, what these conditions underscore is the relative ease with which Indian companies can hope to raise fresh equity in order to finance an enlarged scope of operation.

References

1. *Annual Policy Statement for the year 2004-05*, Governor, RBI, May 18, 2004, *para* 9 and 11.
2. *Annual Report* 2004-05, RBI, pp.128-129
3. As it did in April–May 2000, when for the first time the RBI lowered rates, only to have to completely reverse course over the next few months after the rupee went for a toss.
4. This is *net* of the impact of the conversion of IDBI into a bank with effect October 11, 2004—which increases the stock of loans by about Rs. 32,000 crore with effect from October 11, 2004. *Weekly Statistical Supplement*, Reserve Bank of India, November 27, 2004.
5. Statement by Dr Y. Venugopal Reddy, Governor, Reserve Bank of India, on *Mid-Term Review of Annual Policy* for the year 2004-05, para 8.

Comments on the Review by the Discussants

K. L. Datta

The review presented by Shri Saumitra Chaudhuri is an excellent review of the Indian economy, eloquently presented. Here, I may suggest picking up a few targets to see where we are and how far we are to travel. I have in mind the medium and long-term targets set by the Planning Commission or the short-term goals set by the Finance Ministry.

The review is a well-researched document. However, I am not inclined to share its optimism in meeting the targets of revenue and fiscal deficits. In direct contrast to the calculations of the Review, I maintain that the targets of both revenue deficit and fiscal deficit of the central government are going to be missed in 2004-05. The tax revenue collection is good, but it may fall short of the target set in the Budget. There is no apparent sign of reduction of expenditure, particularly revenue expenditure. The revenue deficit has touched more than 75 per cent of the Budgeted Estimate in the first six months. In the last year, it was 58 per cent. So, there is going to be a greater revenue deficit in 2004-05 as compared to the Budget Estimate. The Budget has set the revenue deficit target as 2.5 per cent of GDP. This is based on a combination of real GDP growth and price inflation of about 11 per cent. Even if inflation rises by 2 per cent point more than that assumed in the budgetary calculation, the revenue deficit may reach 3.2 to 3.3 per cent of GDP in 2004-05. The fiscal deficit of the central government may be low for the reasons already stated.

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The emphasis is squarely on the growth rate, and its maximization. India's forecast growth rate seems to be overtaking other countries, whose performance in the recent past we wanted to emulate. The forecasts show that in East Asia, China and Hong Kong will have higher growth than India in 2004, but in 2005 only China will have a higher growth than India. This augurs well for India, but before that, an observation on the calculation of World Growth Rate.

The forecast World Growth Rate made by the three organizations, viz., the IMF, JP Morgan and Citi Group, are 5 per cent, 4 per cent and 4.4 per cent respectively in 2004 and 4.3 per cent, 3.4 per cent and 3.7 per cent respectively in 2005. This yields the range of estimates 4 to 5 per cent in 2004 and 3.4 per cent to 4.3 per cent in 2005. This is a wide range, the reason being a higher IMF estimate. Actually, the range is not so wide as it is made out to be. The IMF estimate of world growth of 5 per cent in 2004 and 4.3 per cent in 2005 are averages of country-specific GDPs measured at PPP (Purchasing Power Parity) exchange rates. The World GDP estimates made by JP Morgan and Citi Group are valued at market exchange rates. The IMF estimate of world growth becomes 4.1 per cent in 2004 and 3.4 per cent in 2005 if the country-specific GDPs are valued at market exchange rates. The World GDP Growth then would range from 4.0 to 4.4 per cent in 2004 and 3.4 to 3.7 per cent in 2005. These ranges are much narrower, and this is the reality.

With regard to Indian growth rate in 2005 as 6.3 per cent forecast in the Mid-Term Review, it lies within the range forecast by the Reserve Bank of India. The emphasis at the moment is on maximizing the growth rate to 7-8 per cent. This is a must in order to effectively address the long-term problems of the Indian economy, viz., employment generation and poverty alleviation.

There should not be any let up in the effort. In fact, one should not forget that the growth momentum that the Indian economy acquired in the initial years of economic reforms was lost subsequently, and India slipped into a regime of reduced growth. Excluding the year 1991-92

(a year of unusually low growth) and terminating at 2001-02, as the GDP data for later years are not firmed up, yet it will be noted that the growth pattern changed after 1996. The rate of economic growth in 1992-97 was 6.7 per cent per year. It reduced to 5.5 per cent per year in 1997-2002. The economic growth in the two periods is also distinguishable from the significantly lower growth in agriculture and manufacturing after 1996.

Not only did the growth rates slip, the growth rate of tax collections also became much lower after 1996, and in the background of rising expenditure, the revenue deficit and fiscal deficit increased.

The fact is that India slipped into a low growth regime with a rising revenue and fiscal deficit after 1996. This coincides with three events. First, Manmohan Singh, who spearheaded the reform process, was no longer the Finance Minister. Was the absence of Manmohan Singh from the Finance Ministry responsible for this low growth? Second, four governments were installed in quick succession within three years. Was the instability in the political system responsible for lowering the growth rate? Third, is it that agriculture after 1996 was not so lucky with weather as it was before 1996?

Kavita Rao

I must compliment the author for putting together a huge amount of data and analyzing it for us, to give us a flavour of where we are headed, not just in the current fiscal year but potentially into the next four to five years. What I propose to do is not really look at the numbers or even at the speaker's assessment of the growth prospects for the first year. I propose to deal with the potential sources of growth. The speaker identifies non-agriculture as generally being the primary source of growth. I would like to suggest that there is too much neglect of agriculture. It would possibly be incorrect to argue that there are no linkages between agriculture and industry. Economic research

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indicates that there are positive linkages between these two sectors possibly running in both directions.

The reason why fluctuations in agriculture in the short-term do not seem to be manifested in terms of fluctuations in industrial and non-agricultural output can possible be related to the PDS (public distribution system) and government operations in the last year (2002) when India had a bad agricultural year. There was a huge offtake from the PDS and a decline in the buffer stocks. It was a policy decision to reduce these stocks, but it came at a time when agricultural production fell way below the historical numbers. That meant that net availability did not show the same fluctuations as production. So short run mismatches should not be read as implying that there are no long-run relationships between growth in agriculture and industry. Why is this important? Though 2 per cent growth for agriculture may not seem very exciting, there is potential for much higher growth through diversification of agriculture, sustained and supplemented by an appropriate insurance mechanism.

Most of the efforts in diversification of agriculture today face the risks that come with diversification. The foremost example that comes to our mind is that of the suicides by cotton farmers, where the individual took the risk without appropriate support mechanisms. The blame for the suicides may rest with diversification but with appropriate insurance mechanisms it should be possible to have a more diversified agriculture which can sustain a higher growth rate that contributes to higher growth in GDP as well. Again, since the Review does talk about poverty, I think it is crucial to bring to this forum the fairly accepted notion that increase in GDP in agriculture tends to provide better trickle-down as compared to non-agricultural growth. The non-agricultural growth of the urban variety is recognized to have smaller employment potential as compared to rural non-agriculture.

The speaker gave us some information about the informal sector in the rural areas as well as agricultural growth. A step up in agricultural growth leads to higher wages which is a reliable mechanism for ensuring lower

incidence of poverty. So if poverty is our focus factor it would be useful to look at agricultural growth as a means of achieving this particular end.

The other issue that one would like to flag, discussed at slightly greater length in the paper, relates to the relationship between high powered money, money supply and inflation. This has some implications for the discussions on fiscal deficit as well. Besides, there is the concern about inflation. I am not sure whether the present inflation is completely benign. The RBI seemed to opine otherwise in the last fiscal year when there was a statement that low inflation seemed to be hurting growth in the economy.

I am not very sure how one can infer the relationship between high powered money and inflation. There seem to be two levels to the argument. The first relates to high powered money, a large part of the link operating through credit. Lower offtake in the credit market will ensure that the multiplier effect of high powered money is limited. A lower credit offtake, at least in the last fiscal year, has been highlighted in the report. The second link is between money supply and inflation and here once again I am not sure how the link works. A pure monetarist school argument will be that the increase in money supply results almost directly in an increase in prices. In that case the increase in prices would be expected to be across the board. The evidence provided in the paper suggests that these were not sustained increases and were restricted to certain commodities not even covering 30 per cent of WPI base. This therefore seems to suggest that the stimulus to inflation came not through the relaxed money supply situation but more through the international price spikes or, in the case of oil seeds, maybe even through the domestic price spikes.

There are just a couple of other points that I would like to make about the fiscal situation. First, the debt swap and the implications on the central finances. The paper makes a statement that the debt swap resulted in the Centre passing off some of its fiscal deficit to the States. I think it would not be correct to assert that. While it is true that the Centre's fiscal deficit comes down in any given year as a result of debt swap, because the States are paying off NSS

bonds and doing open market borrowings-hence one can argue that this is not a sustainable long-term decline in fiscal deficit-but the fiscal deficit of the States has definitely not been going up in the process; so it is not a shift of the deficit from the Centre to the States.

The second point follows from one of the slides that the speaker showed where he said there had been very poor fiscal marksmanship. There are two ways of looking at marksmanship. One way is that the budget revenues and the budget expenditures are reached. The other approach-and that is where we needed the Fiscal Responsibility and Budget Management Act-is where you budget certain numbers and in the event that you are not reaching those targets, specially on the revenue front, you have mechanisms and institutions whereby your expenditures are rolled back so that your deficit targets are met. The Review documents that while deficit targets tend to be met, the amounts that were budgeted were not necessarily achieved. I think this marks some progress from the situation in which the States found themselves, where you would see revenues being over-budgeted and expenditures under-budgeted, so that you would have lower budget deficit figures which would be over-shot subsequently down the line where expenditures would increase during the year and tax collections would actually decline. From that situation we have moved at least to where the targets of deficits are sought to be met.

Ila Patnaik

First, my compliments to the speaker, Shri Chaudhari, for an excellent report. I do not really have much disagreement with him but I would like to add a few things to the report. For example, one of the extremely important things which he raised and for which he provided evidence is the investment cycle. At the beginning of the year there was evidence that India was on the upswing of a cycle. January to March, when corporate results were coming in, one could see the increase in sales and in profits. These are

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leading indicators of an increase in investment and it was expected that, this was clearly a time of an upswing of a business cycle. However, two events raised doubts about this. The first was when the government changed, with the support of the Left, and, after the reaction of stock markets on May 17, there seemed to be a lot of gloom and doom. People thought that perhaps reforms would no longer be on the agenda of the new government and this could hurt the upswing and the new investment projects.

The second thing that went wrong was the monsoon which did not do as well as one might have hoped. Again what had been seen in the past, at least in the pre-nineties, was that whenever the monsoon did badly, agriculture did badly, and agriculture then accounted for a much larger portion of GDP than it does now. In the past the impact on manufacturing was more adverse; so it was feared that the performance of the monsoon this year would also pull down investments that had been planned. As Shri Chaudhuri has shown-and I would like to share with you some of the evidence that I brought with me-there has been a major pick up in investment activity. In fact after 1995-96 we have seen such a rise in investment only this year.

There is an investment survey done by the CMIE called the Capex. The Capex data shows that there has been a 27 per cent increase in investment compared to the previous year. The last time the investment was double-digit. These figures relate to outstanding projects, some recently announced, some ongoing and others in the process of being completed. The last time Indian witnessed such a high investment was in 1995-96. We are seeing a revival, though it was feared that it might not happen because of the change in the government or because of a poor monsoon. It is interesting to see that for the first time no investment projects were shelved in the months of July and October, the last two points when this survey was done. This is a kind of confidence in the economy has not been seen for the last ten years and it is extremely encouraging. So despite all our problems, despite the oil-price hike, despite the problems on FDI and the Left, I think we should be very, very optimistic about the fact that investment seems to be picking up very

sharply. In manufacturing, investment is up by 72 per cent and again it is an all time high not seen after the 1995-96 period.

Again, I wanted to talk about something that the speaker actually seems to have missed out in his report, and that is the performance of banks. From the half-yearly results that we have this year (I will just put together data for 29 banks and compare the results of different segments for this year over the same half-year last year) treasury profits are down by 33 per cent; this was expected as interest rates were going to rise, and banks were still sitting on very high interest rate risks. The reason why that has happened is because banks have cut down on provisioning. For the 29 banks for which I have data, provisioning for bad loans has gone down by 22 per cent. Operating profits came down by 8 per cent because of the sharp decline in the treasury profits, though banking operations did see about 20 per cent increase. Banks cut down on provisioning to show good net profits to the market. That is something to worry about.

Another thing that I wanted to draw attention to is that in the last few months, after July, we have witnessed some reforms that are encouraging, as, for example, on taxes. Though custom duties on petro products might have been cut because of inflation, it is a good thing that the duties were brought into line and closer to tariff rates on crude oil. Then, there has been an improvement in the IT system applied to direct tax collection and that appears to have yielded results in terms of improved tax collections. That is the TIN (or the tax information network) through which there is now a system of checking an improved compliance on the tax deduction at source.

One more reform that appears to be on its way is the State VAT. The States have committed to going ahead and implementing the State VAT by April 2005. But when one looks at the details it is a little worrying because it is not exactly as if India is moving towards one national market, because every state is setting up its own state VAT and they don't have an IT system which transfers input credit from one State to another. You actually have to wait to see if this is dividing the national economy into a number of smaller

entities. Hopefully that would not happen. Then, two weeks ago (i.e. in early November 2004) the Finance Minister said in a speech that India would have a Goods and Services Tax in another two years: that is one of the proposals of the Kelkar Task Force. Whether it happens in two years or in five years, one can be hopeful that something is going to happen.

The last point that I would like to make is to look forward on one issue that is very important in terms of the where the rupee would go (inflation and interest rates) in India: that is, what is going to happen to the dollar? Last week Alan Greenspan said in a speech in Frankfurt to a group of bankers that given the current account deficit of the US it is likely that the demand for US treasuries would reduce, suggesting that the US dollar is going to decline. What would the RBI's (Reserve Bank of India) stand be? Is RBI still going to try and peg the rupee to the dollar and not let the rupee appreciate vis-à-vis the dollar when other currencies are appreciating? What would be its effect on forex reserves, what would be its impact on the Indian economy, because the RBI has limited sources to sterilize their inflows? And what would its impact be on money supply, interest rates and inflation? I think that is one of the very interesting things that would unfold in the next few months.

The mid-year Review of the Indian economy for the current year gives a holistic picture of the Indian economy, its prospects in 2004-2005 and the international trends that influence it.

In ascertaining the outlook for economic growth, explicit cognizance is taken of the fast growing and more stable trajectory of growth of the non-agricultural sector, quite separately and distinct from what happens to agriculture. A stronger performance in manufacturing and other industrial sectors is predicted as well as a continuation of the expanding trends in other parts of the services sector. Estimated GDP growth is placed at 6.3 per cent.

The focus, however, is more on the important role of management of economic policy. The present government is seen as facing a most favourable political situation for successfully implementing its programme for economic reform, as the challenges from the traditional opposition are weak.

Saumitra Chaudhuri studied economics at Jawaharlal Nehru University and worked for several years in various departments of government that were entrusted with setting prices, tariffs and issuing industrial licences; to that extent has had first hand experience of the control system prevalent in the eighties. He worked with State Bank of India and Steel Authority in a period that the system began its early forays into taking cognisance of market signals and started entertaining the idea of competition. For more than a decade he has been Economic Advisor with ICRA Ltd. a full service credit rating agency, an assignment which has been enriching in terms of gaining an understanding of both corporate and public finance, and of their dynamics. He is the Executive Editor of ICRA's quarterly publication, *Money & Finance*, and writes extensively in the print media.

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