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Economic Outlook for 2006/07

Economic Advisory Council to the
Prime Minister

New Delhi

August 2006

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(Report submitted to the Prime Minister on Aug14, 2006)

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ECONOMIC OUTLOOK FOR 2006/07
Executive Summary

I. Growth Performance and Outlook

1. The economy averaged growth of 8.1% in the past three fiscal years (2003/04 through 2005/06). Growth during this period was driven largely by the acceleration in industry and services save in 2003/04 when agriculture, recovering from the severe drought in the previous year, had a role to play. The sub-sectors that were key drivers of growth were manufacturing, construction, communication, and financial & business services.

2. As per our assessment, the economy will grow at 7.9% during 2006/07. This will come from agriculture growing at 1.5%, industry at 9.7% and services at 9.5%.

3. Industrial output has expanded at a rate of 10.1% in April-June 2006, while export and import volume growth are indicative of reasonably strong external demand for Indian manufactures and domestic demand for raw materials and intermediates. Reflecting this outlook, we are projecting a higher growth in industry this year (9.7%) than in the previous year (8.7%). In the service sector, the trade, hotels transport, storage and communication sub-sector is expected to decelerate from 11.5% growth last year to 10.5% this year. Consequently, the non-agriculture sector (industry and services) is projected to grow at 9.6%, the same as last year.

4. Any uncertainty in our short-term growth prospects arises mainly from the performance of the agriculture sector which is still largely dependent on the quantum as well as the distribution, spatial and temporal, of the rainfall. As on August 9, 2006, the SW monsoon whose onset was delayed in several parts of the country was 2% below normal for the country as a whole with only Rayalaseema meteorological sub-division being 20% in deficit. If the weather conditions for the winter crop turn out to be adverse and growth in agriculture declines to 1%, the overall growth rate will drop to 7.8%. On the other hand, in the event of a very good monsoon and agriculture growth of 2.0%, the overall growth could rise to 8.0%.

5. A summary of the principal projected numbers is presented at Table 1.

Table 1: Growth - Past Performance and Projections for 2006/07

Annual Rates	**2003-04**	**2004-05 QE**	**2005-06 Rev**	**2006-07 Projected**
	Percentage change over previous year			
1. Agriculture & allied activities	10.0	0.7	3.9	1.5
2. Mining & Quarrying	5.3	5.8	0.9	7.0
3. Manufacturing	7.1	8.1	9.0	9.5
4. Elect., Gas & Water Supply	4.8	4.3	5.3	5.5
5. Construction	10.9	12.5	12.1	12.5
6. Trade, Hotels, Transport, Storage & Communication	12.0	10.6	11.5	10.5
7. Finance, insurance, real estate & business services	4.5	9.2	9.7	9.5
8. Community & personal services	5.4	9.2	7.8	7.5
9. Gross Domestic Product (factor cost, constant prices)	**8.5**	**7.5**	**8.4**	**7.9**
Industry (2 + 3 + 4 + 5)	7.6	8.6	8.7	9.7
Services (6 + 7 + 8)	8.2	9.9	10.0	9.5
Non-agriculture (9 – 1)	8.0	9.5	9.6	9.6
GDP (factor cost, constant prices) per capita	**6.6**	**5.9**	**6.7**	**6.3**
Some Magnitudes				
GDP factor cost – 1999/00 prices (Rs lakh crore i.e. Rs trillion)	22.3	23.9	26.0	28.0
GDP market & current prices (Rs lakh crore i.e. Rs trillion)	27.6	31.2	35.3	39.9
Population (million)	1,073	1,090	1,107	1,125
GDP at factor cost per capita current prices (Rs)	23,704	26,091	28,985	32,119

Global Demand Concerns

6. In the context of greater global integration, external conditions can influence our growth prospects more than in the past. As per IMF projections, world output grew by 4.8% in 2005, and is projected to grow by 4.9% in 2006 and 4.7% in 2007. Despite the continued increase in crude oil price which looks likely to be closer to $70/bbl in calendar 2006 and tighter monetary policy, world growth has continued to be very buoyant. While there have been some signs of slowing as in the US in the second quarter and in some European economies, there also has also been some recovery in Japan. Overall the available growth and trade data do not indicate any significant external trade constraints for the expansion of the Indian economy in 2006/07.

II. Has Our Growth been Consumption Driven?

7. There has been some concern about the sustainability of our growth performance. It is argued that growth over the last three years has been driven largely by consumption demand, including demand for homes, financed by loans from the banking system. This consumption demand has been fuelled largely by monetary factors such as easy liquidity conditions and low interest rates, and benign inflation. The domestic comfortable monetary situation was further aided by easy liquidity and low interest rates at the global level which facilitated capital flows into India. This fortuitous combination of circumstances has now begun to reverse. Interest rates have increased and inflation is on the rise. Globally too, the era of cheap money has effectively ended with major central banks around the world all tightening monetary policy. The revised situation will dampen consumption demand and impede growth.

8. In order to test this hypothesis, we analysed data on the sectoral deployment of bank credit during 2002-06. That led to two inferences: first, credit expanded rapidly in the period 2002-05, and second, during the first two years of this period, a larger share of incremental credit had gone to finance consumption including home finance. A plausible explanation of the economic dynamics underlying the above trends will be the following. The easy liquidity conditions in recent years encouraged a surge in demand for personal loans during 2002/03 and 2003/04. However, there was adequate capacity in the manufacturing sector, and the increased consumption demand could be met by stepping up production. This also facilitated the recovery of the manufacturing sector.

9. The above analysis validates the hypothesis that growth over the recent period has been more consumption driven than investment driven. The credit market has since become tighter and this will restrain consumption demand to some extent. However, this need not necessarily result in a growth downturn. A consumption boom that lasts for a period has the potential to create an investment boom. In fact, the growth momentum can be accelerated if the government responds with a strong and credible policy to create a conducive climate for investment. Two specific responses are particularly important:

(i) First, government will have to supply more and better infrastructure. Investment in infrastructure can come by way of direct public investment or through public private partnership (ppp).

(ii) Second, investment capital needs to be made available at reasonable rates of interest. A critical requirement for this is for the government to reduce its fiscal deficit, particularly revenue deficit.

III. Composition of Demand

Agriculture

10. As per the fourth advance estimates released on July 15, 2006 by the Ministry of Agriculture and Cooperation, foodgrains output is projected to increase by 5% from 198.4 million tonnes in 2004/05 to 208.3 million tonnes in 2005/06, short of the original target of 215.0 million tonnes (8.4 per cent increase). The anticipated output, even if fully realized, would still be lower than the peak level of 213.5 million tonnes registered in 2003/04.

11. A major concern in our foodgrain production arises from stagnation in production; output in 2005/06 was lower than the peak reached in the past 10 years for virtually every food crop. The gap is most glaring in the case of wheat, followed by coarse cereals and pulses. Yields too have stagnated with the yields rates in 2005/06 lower than the peak reached in the past across almost the entire range of crops. The only exception to this disappointing trend has been oilseeds where production and productivity have shown some, albeit modest, improvement. This clearly points to the need for a vigorous push for new technologies, particularly for rain-fed crops, their active dissemination through extension supported by inputs, credit and rural infrastructure.

Industry

12. The mining sector is projected to grow at 7%, a sharp jump from just 0.9% last year, since ONGC production has recovered from the slump of last year caused by the damage to its off-shore platform. Manufacturing output growth has averaged over 9% in the past two years. This rate accelerated to 11.2% in April-June 2006 with basic, capital and intermediate goods leading the way. There was, however, deceleration in the production of consumer goods, substantial in the case of non-durable consumer goods reflecting negative growth in food products, and marginal in the case of durable consumer goods reflecting tighter credit conditions.

13. Our current assessment is that the growth of the industry sector comprising mining & quarrying, manufacturing, electricity, gas and water supply and

construction will accelerate to 9.7% in 2006/07 (see Table 1 for details). However, over the medium term, the main constraint to industry growth will emanate from infrastructure, particularly energy.

Services

14. The services sector has been the key driver of our growth, registering growth rates of 8.2%, 9.9% and 10.0% over the last three years. We expect the growth rate to moderate marginally to 9.5% this year since some of the sub-sectors such as communication which saw very rapid growth in recent years are likely to confront subdued demand.

IV. Trade and Balance of Payments

BoP - 2005/06 Outcome

15. The current account deficit (CAD) in 2005/06 was 1.3% of GDP – about double the level of the previous year, viz. 0.7% of GDP.

Bop - 2006/07 Outlook

16. As per DGCI&S data, during the first quarter of this year (April - June 2006) exports grew by 16.9%, and imports by 17.7%; the resultant trade deficit widened by 19.7%.[1]

17. Imports may be viewed as comprising three broad components - oil, gold and the rest - each of which is driven by very different factors. In the first quarter of 2006/07, the oil import bill increased by 39%, of which about 33% was due to price increase and the balance due to volume increase. Taking into account the price movement of crude oil in the first four months of 2006/07, the impact of marginally higher domestic production on account of restoration of Bombay High output to 2004/05 levels, we expect the oil import bill for 2006/07 to be 33% higher than in 2006/07. Gold imports slackened by 15% in the first two months, but we expect this to be neutralized during the rest of the year and overall imports may be marginally higher than in 2005/06. Non-oil, non-gold imports increased by 14% in the first quarter of 2006/07. Given the general expectations of continued strong economic growth, the growth in non-oil, non-

[1] Growth rates computed with reference to revised data for the previous period which is different from the newly initiated practice of DGCI&S of computing growth rates with reference to the provisional numbers of the previous period.

gold imports is projected to average 17% for the year as a whole. Total imports (DGCI&S) are expected to increase by 21.8% over last year. We expect exports to grow at 17%.

18. Net invisibles, including non-factor service exports, worker remittances, income from tourism & travel and investment income flows is expected to increase by about 27% to reach $52 billion in 2006/07, mainly on account of continued strong growth in software exports, modest increase in remittances and the absence this year, of the one-time hit due to accumulated interest payments on India Millennium Deposits (IMD) in 2005/06.

19. The above estimates result in a current account deficit of 1.2% of expected GDP, roughly the same level as last year. Net accretion to reserves will be $16.4 billion, compared to $15.1 billion of last year.

Table 2: Projected Balance of Payments for 2006/07

		2005/06 RBI (BoP)	2006/2007 EAC Estimate
		US$ billion	
Merchandise Trade Balance		(-) 51.6	(-) 63.0
Net Invisible receipts		40.9	52.0
	Of which: Software	22.3	29.3
	Worker remittances	24.1	27.5
	Investment income	(-) 5.0	(-) 4.1
Current Account Balance		(-) 10.6	(-) 11.1
Capital Account Balance		24.7	27.5
	Of which: FDI	5.7	8.5
	Portfolio flows	12.5	5.0
	Loans	4.7	12.0
	Banking capital	1.4	1.0
	Other capital	0.9	1.0
Accretion to Reserves		15.1	16.4

V. Prices

Wholesale and Consumer Price Indeces

20. As per the latest data available, inflation as measured by the Wholesale Price Index (WPI) was recorded at 4.6% for the week ending 29 July 2006.

However, the consumer price inflation was much higher, measuring in June 2006, at 7.6% as per CPI-Industrial Workers and 6.5% as per CPI-Urban Non-manual Employees. Another notable feature in recent months has been that since November 2005, CPI has ruled above WPI, in a reversal of the trend over the past several years. This could be due to: (i) differences in weights between the two indices; and (ii) increase in margins in the distribution chain between wholesale and retail trade.

21. What has driven up both WPI and CPI this year were foodgrain prices, particularly of wheat and pulses. The wholesale price of wheat began to rise in January 2006, while that of pulses had begun to increase in late October 2005. Wheat prices rose by 12.9% at the end of March just before the rabi harvesting season. The inflation rate has since declined, but remained over 10% in early June, and reached 7.9% by July 29. The prices of pulses have risen sharply and continuously from 18-20% in January 2006 to over 25% in March and to 33% between April and June. Although there has been some moderation in recent weeks, this has been modest with the inflation rate as at the end of July still as high as 28%.

22. Up to 29 July 2006, the cumulative inflation since the beginning of the fiscal year was 3.5% compared to 3.0% for the comparable period in the previous fiscal year. It is our assessment that even assuming further revision to refined petroleum product prices later in the year, aggregate WPI inflation at the end of March 2007 would be contained around 5.5%, compared to 4.1% at the end of the previous fiscal year.

Inflation Management - Policy Framework

23. Inflation management requires both sectoral responses as well as management of the macroeconomic situation at the aggregate level. The year on year growth in broad money (M3) had accelerated to 19.5% as on July 21, 2006, up from 14.0% a year earlier. In view of the increase in prices across several sectors, containing money supply growth has to be an integral part of inflation management.

Wheat

24. Sectoral responses are required for both wheat and pulses. The recent increase in the price of wheat is clearly because of demand exceeding supply – a situation arising out of lower market arrivals, lower procurement during the rabi

season, decline in the buffer stock below the norm and hardening of international prices because of lower projected wheat harvest in the US and Canada. The prevailing international price is higher than the domestic price. Since wheat is a tradeable commodity, there will be upward pressure on the domestic price towards convergence with the border price. In this context, the recent decision of the Government to allow import of 4.5 million tons of wheat should help to manage expectations on the wheat price. Going forward, Government needs to do two things: first, manage expectations by buying futures options in the international markets, and second, by implementing a strategy for improving production and productivity of wheat; by evolving a flexible procurement and pricing policy; and through a programme of imports spread over several years aimed at smoothing the domestic supply-demand gap and structured such that the imports take advantage of the global price trends and stocks are augmented when the global prices are low.

Pulses

25. The policy response with respect to pulses should be similar to that for wheat: (i) in the short-term, examine and correct any inadequacies that may exist in the market; and (b) In the medium-term, improve the technology as well as the incentives for growing pulses. It should be borne in mind that pulses, being leguminous in nature, fix atmospheric nitrogen and are an excellent rotation crop that improves the fertility of the soil.

VI. Financial Sector

26. Credit expansion was very strong in 2005/06, registering an increase of 32% for the full year. The pace of expansion has persisted in part into the first quarter of the current fiscal, when non-food credit grew by 1.1% over the March-end position.[2] The large credit expansion combined with increase in net foreign

[2] Since the "year-end" statistic for non-food credit is commonly the last reporting Friday, the comparison of credit growth in the first quarter of 2006/07 has often erroneously been made with respect to the growth during the period from the last reporting Friday of 2004/05 (18 March 2005) and the end of June 2005. However, given that in 2005/06 the last reporting Friday was 31 March 2006, it is more appropriate to take 1 April 2005 as the starting point for 2005/06. In which case we can see that the credit expansion in the current year is slightly ahead (1.1%) than in the same period of the previous year (0.4%), than is indicated by the conventional interpretation (5.4%) and so too if the comparison is made with the first quarter of 2004/05.

With effect from the *Weekly Statistical Supplement* of 28 July 2006, the RBI has begun to use 1 April 2005 as the starting reference point for computing the increase in credit for the comparable period of the previous year.

assets (reserves) which were not offset by sterilised intervention led to an expansion in broad money (M3) in 2005/06 by 21.1%.

27. In its *Annual Policy Statement* in April 2006, the RBI indicated that it would have a "policy preference" for "maintaining a lower order of money supply growth in 2006-07," than 15%. RBI expects non-food credit growth to decelerate to 20% in 2006/07 from the growth of 32% last year.

28. The continued flow of private funds into Indian companies through domestic and foreign equity markets and specialist venture funds requires the maintenance of stable macro-economic conditions – on both domestic and external fronts. Sharp increases in demand-supply gaps together with increases in money supply can fuel an inflationary spiral. It is important to preserve stability in prices to sustain steady investment and growth. International experience demonstrates that investment flows from business confidence and the latter is adversely affected by instability in macroeconomic parameters – particularly inflation (which is about the domestic price of money) and exchange rate volatility (which is about the international price of money).

29. Even as monetary tightening will curb a part of the leveraged consumer demand, the overall growth will still be high as investment demand and expectations remain buoyant.

VII. Stock Market

30. Since mid-May 2006, equity markets across the world have been negatively affected by a widespread re-rating of risk arising from the uncertainty on the extent of monetary tightenng in major economies, petroleum price movements and intensification of conflict in the Middle East. These developments have reflected a big increase in risk perception which has resulted in the withdrawal of funds from some of these markets. During the current financial year, net sales by foreign institutional investors (FII) in India amounted to nearly US$ 1 billion (most of it in May) till the end of July 2006 although year-to-date inflows for calendar 2006 continue to be positive at over US$ 2.9 billion. Nevertheless, the Indian market continues to enjoy fairly high price earning (historical) multiples with the figure being 19.4 for the BSE 30 Sensex and 18.4 for the NSE Nifty.

31. The market began to adjust to the heightened risk perceptions soon thereafter. By the middle of June, volatility had reduced somewhat and some recovery had materialised, a process that has been taken forward in July. The

strength of the recovery of equity markets must be viewed in the context of continuing and heightened tensions in West Asia and its implications for oil prices. It must be noted that in the process of adjustment the Indian market has lost 1,400 points or little over 11% in terms of the BSE Sensex 30, and 480 points or 13% in terms of the more broad-based NSE Nifty.

32. In India, corporate results for the first quarter of 2006/07 have varied across firms, but in general have been good enough to assuage apprehensions about immediate and long-term prospects. Notwithstanding some further possible bumps in the days ahead, broadly the market appears to have adjusted, stabilized and come into a largely neutral position.

VIII. Conclusion

33. The overall growth in 2006/07 is projected to be in the narrow range of 7.8%-8.0%. There have been questions about whether our growth is consumption driven and whether it can be sustained. The growth momentum can be maintained if the government can create a conducive climate for private investment through a strong supply side response, mainly in two ways: improving the quality and quantity of infrastructure and making a credible fiscal adjustment so as to release resources for private investment. Some hardening of interest rates is inevitable to restrain inflation and we expect the WPI inflation by the year-end to be contained around 5.5%. In view of the increase in prices across several sectors, containing money supply growth has to be an integral part of inflation management. The current account deficit for the year is projected at 1.2% of GDP, broadly the same level as of last year.

Economic Outlook for 2006/07

Full Report

I. GROWTH PERFORMANCE AND OUTLOOK

1. The economy averaged growth of 8.1% in the past three fiscal years (2003/04 through 2005/06). While in 2003/04, the strong rebound in agriculture (recovering from the severe drought in the previous year) had a role to play, in 2004/05 and 2005/06 it was the acceleration in industry and services that sustained the higher trajectory of economic growth. It is significant that over the past eight quarters, the rate of growth in industry and services (that is, non-agriculture) has remained in a tight band of 9.0% to 10.4%, averaging 9.5%. The comparable figures for the previous eight quarters was 8.5% with a greater spread ranging from 7.1% to 9.2%. The three sectors that showed a significant pick-up in growth over the past 8 quarters (compared to previous quarters) were manufacturing, construction, and financial & business services.

2. Industrial output has expanded at a rate of 10.1% in April-June 2006, while export and import volume growth are suggestive of reasonably strong external demand for Indian manufactures and domestic demand for raw materials and intermediates. In light of these facts, we are projecting a higher growth in industry (9.7%) than in the previous year (8.7%). In the service sector, the trade, hotels transport, storage and communication sub-sector is expected to decelerate from 11.5% growth last year to 10.5% this year. Consequently, the non-agriculture sector (industry and services) is projected to grow at 9.6%, the same as last year.

3. On the assumption of normal south-west (SW) monsoon, the agriculture sector is estimated to grow at 1.5%. It may be noted that in the past, years of strong growth in agriculture (e.g: 2005/06) were followed by relative stagnancy (1995/96, 1999//2000, 2000/01, 2004/05) or negative growth (1991/92, 1997/98, 2002/03). In 2006, the onset of the monsoon was delayed in several parts of the country. As on August 9, 2006, rainfall was 2% below normal for the country as a with only Rayalaseema meteorological sub-division being deficient (20% below normal). On this basis we expect that agriculture will do somewhat better than it normally does in a year immediately succeeding a good harvest.

4. Based on agriculture growth of 1.5% and non-agriculture growth of 9.6%, the projected overall growth of the economy for the current fiscal is expected to be 7.9%. If the weather conditions for the winter crop turn out to be adverse and

growth in agriculture declines to 1%, the overall growth rate will drop to 7.8%. On the other hand, in the event of a very good monsoon and agriculture growth of 2.0%, the overall growth could rise to 8.0%.

5. A summary of the principal projected numbers is presented at Table 1.

Table 1: Growth - Past Performance and Projections for 2006/07

Annual Rates	**2003-04**	**2004-05 QE**	**2005-06 Rev**	**2006-07 Projected**
	Percentage change over previous year			
1. Agriculture & allied activities	10.0	0.7	3.9	1.5
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7. Finance, insurance, real estate & business services	4.5	9.2	9.7	9.5
8. Community & personal services	5.4	9.2	7.8	7.5
9. Gross Domestic Product (factor cost, constant prices)	**8.5**	**7.5**	**8.4**	**7.9**
Industry (2 + 3 + 4 + 5)	7.6	8.6	8.7	9.7
Services (6 + 7 + 8)	8.2	9.9	10.0	9.5
Non-agriculture (9 – 1)	8.0	9.5	9.6	9.6
GDP (factor cost, constant prices) per capita	**6.6**	**5.9**	**6.7**	**6.3**
Some Magnitudes				
GDP factor cost – 1999/00 prices (Rs lakh crore i.e. Rs trillion)	22.3	23.9	26.0	28.0
GDP market & current prices (Rs lakh crore i.e. Rs trillion)	27.6	31.2	35.3	39.9
Population (million)	1,073	1,090	1,107	1,125
GDP at factor cost per capita current prices (Rs)	23,704	26,091	28,985	32,119

Global Demand Concerns

6. As per IMF projections, world output grew by 4.8% in 2005, and is projected to grow by 4.9% in 2006 and 4.7% in 2007. Despite the continued increases in crude oil prices which look likely to be much closer to $70/bbl in calendar 2006 than what the Fund had assumed ($61.25/bbl), and tighter monetary policy, world growth has continued to be very buoyant. During 2006, growth in

the US during the first half-year and in the Euro zone in the first quarter was stronger than during the corresponding periods last year. In both India and China, economic growth in first half of calendar 2006 was very strong at 9.3% and 10.2% respectively.

7. Import demand of industrial countries has continued to expand through 2006. In the US, during the first half of 2006, imports of goods increased by over 6.6% and of services by 4.5% compared to the same period last year. In the Euro-zone, during the first 4 months (Jan–May) of 2006, imports from outside the EU increased by 13% compared to 10% in the comparable period of last year.

8. Overall there seems to be no threat to our growth prospects from global demand concerns. While there have been some signs of slowing as in the case of the USA in the second quarter and in some European economies, and oil prices continue to be high, there also has also been some recovery in Japan. Overall the available growth and trade data does not indicate any significant external trade constraints for the expansion of the Indian economy in 2006/07.

Growth Projections Made by Others

9. The Reserve Bank of India, in its *Annual Statement* in April 2006, projected growth for 2006/07 in the range of 7.5%-8.0% "assuming accelerated growth in agriculture under normal monsoon conditions and barring domestic or external shocks"[3]. Other projections of likely growth rate in 2006-07 include: International Monetary Fund (7.3%); NCAER (7.7%); Confederation of Indian Industry (8.0%); JP Morgan (7.5%); Citibank (7.6%)

[3] *Annual Policy Statement for the year 2006-2007,* Governor RBI, 19 April 2006, para.90

II. HAS OUR GROWTH BEEN CONSUMPTION DRIVEN?

Consumption Driven Growth - the Argument

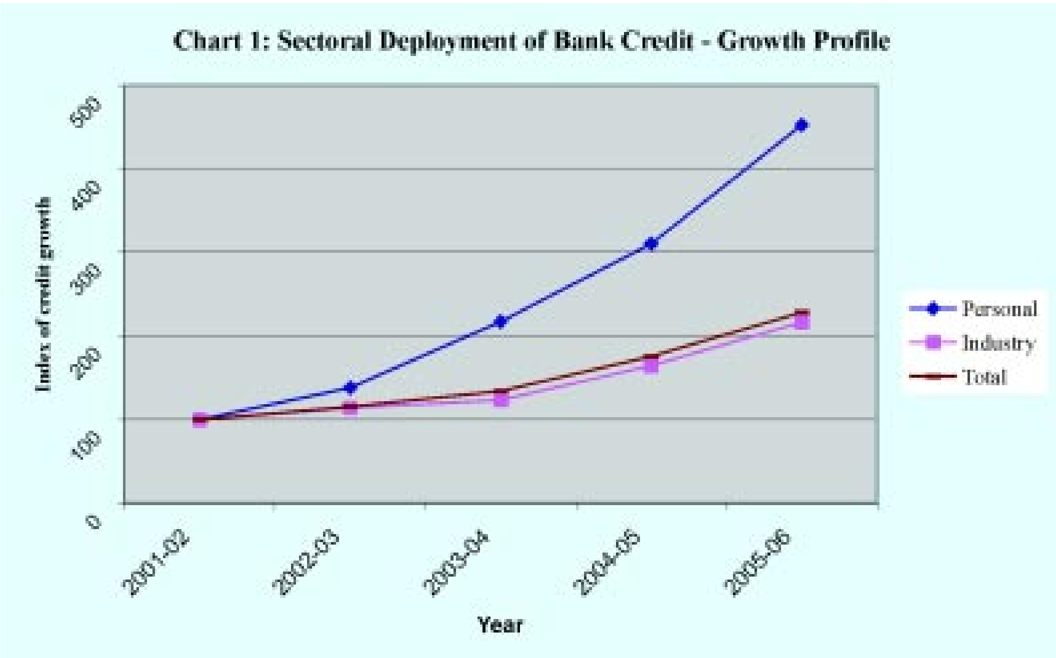
10. There has been an increasing concern about the sustainability of our growth performance. This concern stems from an argument which runs roughly as follows:

- Growth over the last three years has been driven largely by consumption demand, financed by loans from the banking system. 'Consumption' here is used in a loose sense to include home building.
- This consumption demand has been fuelled largely by monetary factors such as easy liquidity conditions and low interest rates, and benign inflation.
- The domestic comfortable monetary situation was further aided by easy liquidity and low interest rates at the global level. Positive global investor sentiment and a lowered risk perception combined with strong domestic growth and a big recovery in corporate profitability attracted capital flows into India which further eased the liquidity conditions in the domestic economy.
- This fortuitous combination of circumstances has now begun to reverse. Interest rates have increased and inflation is on the rise.
- Globally too, the era of cheap money has effectively ended. For the first time in 15 years, all three major central banks around the world, the US Fed, the European Central Bank and the Bank of Japan are all tightening monetary policy.
- The revised situation will dampen consumption demand and impede growth.
- It is therefore not inevitable that India will continue on the high growth trajectory.

Growth Drivers - Analysis

11. There is some validity to this argument. It is important to understand to what extent recent growth has been consumption (including home finance) driven and the possible impact of the tighter credit situation on demand in order to design appropriate policy responses.

12. Table 2 shows the sectoral deployment of bank credit from 2002/03 to 2005/06. The data for 2002/03 to 2004/05 are drawn from Banks Statistical Returns (BSR). For 2005/06, BSR is not yet available. The figures for 2005/06 shown in the Table are therefore extrapolations from the partial data up to January 20, 2006 reported in the Macro-economic and Monetary Developments released by the RBI in April 2006. The extrapolations have been made scaling up in proportion to the total outstanding food and non-food credit as at the end of March 2006.



13. From Table-2, it is clear that credit outstanding has nearly doubled in absolute terms in the three-year period 2002/03 to 2005/06. Reflecting this, the ratio of outstanding credit to GDP has jumped from 36.8% in 2002/03 to 58.0% in 2005/06.

14. Further, using only the published data for the three-year period 2002/2003 to 2004/05 shown in Table 2, the following inferences can be drawn.

Table 2: Sectoral Deployment of Bank Credit

	2002/03	2003/04	2004/05	2005/06	CAGR 2003-05	CAGR 2003-06
	Outstanding Credit as at Year End (Rs crore)				**Percent**	
Personal	113,942	179,087	255,981	373,373	49.9	48.5
Agriculture	75,935	96,245	124,385	182,644	28.0	34.0
Industry & Infrastructure	309,828	334,803	446,825	587,661	20.1	23.8
Transport & other services	43,318	55,099	68,987	50,781	26.2	5.4
Food procurement	47,503	36,850	40,039	45,671	–8.2	–1.3
Other trade	56,547	64,588	89,607	85,668	25.9	14.9
Finance	50,645	58,964	73,277	na	20.3	na
Others	58,252	54,675	53,368	na	–4.3	na
Total	**755,969**	**880,312**	**1,152,468**	**1,496,474**	**23.6**	**19.4**
	Composition of Outstanding Credit (%)					
Personal	15.1	20.3	22.2	25.0		
Agriculture	10.0	10.9	10.8	12.2		
Industry & Infrastructure	41.0	38.0	38.8	39.3		
Transport & other services	5.7	6.3	6.0	3.4		
Food procurement	6.3	4.2	3.5	3.1		
Other trade	7.5	7.3	7.8	5.7		
Finance	6.7	6.7	6.4	na		
Others	7.7	6.2	4.6	na		
Total	100	100	100	100		
	Share of Incremental Credit Flow (%)					
Personal	31.4	52.4	28.3	34.1		
Agriculture	11.9	16.3	10.3	16.9		
Industry & Infrastructure	38.2	20.1	41.2	40.9		
Transport & other services	6.3	9.5	5.1	–5.3		
Food procurement	–4.4	–8.6	1.2	1.6		
Other trade	7.6	6.5	9.2	–1.1		
Finance	13	6.7	5.3	na		
Others	–4.1	–2.9	–0.5	na		
Total	**100**	**100**	**100**	**100**		

- Outstanding credit for personal loans expanded at a compound average annual growth rate of 49.9% as against 20.1% for industry and infrastructure.
- Reflecting the above, the share of personal loans in total outstanding credit increased from 15.1% in 2002/03 to 22.2% in 2004/05 while the corresponding share for industry and infrastructure dropped from 41.0% to 38.8%.

15. If we also include the projected data for 2005/06 in the analysis, the following inferences can be drawn for the four-year period 2002/2003 to 2005/06.

- Outstanding credit for personal loans expanded at a compound average annual growth rate of 48.5% as against 23.8% for industry and infrastructure.
- Correspondingly, the share of personal loans in total outstanding credit increased from 15.1% in 2002/03 to 25.0% in 2005/06 while the corresponding share for industry and infrastructure dropped from 41.0% to 39.3%.

16. A plausible explanation of the economic dynamics underlying the above trends will be as follows.

17. The easy liquidity conditions in recent years encouraged a surge in demand for personal loans during 2002/03 and 2003/04. However, there was adequate capacity in the manufacturing sector, and the increased consumption demand could be met by stepping up production. This also facilitated the recovery of the manufacturing sector.

18. By 2004/05, investment picked up to reach 30.1% of GDP. This is reflected by the higher share of incremental credit (41.2%) flowing into the industry and infrastructure sector as compared to the personal loan segment (28.3%) in a reversal of the pattern of the previous year.

19. The above analysis yields two conclusions: first, credit expanded rapidly in the period 2002-05, and second, during the first two years of this period, a larger share of incremental credit had gone to finance consumption including home finance.

Growth Slow Down – Inevitable?

20. The above analysis validates the hypothesis that growth over the recent period has been more consumption driven than investment driven. The credit

market has since become tighter and this is necessary to contain inflation. However, a consequence of this will be that consumption demand would abate. There is an argument that this would dampen growth.

21. However, such a downturn need not necessarily be the case. A consumption boom that lasts for a period has the potential to create an investment boom. In fact, the growth momentum can be accelerated if the government responds with appropriate, strong and credible policy to create a conducive climate for investment.

22. It can be argued that if an increase in interest rates inhibits consumption demand, it will inhibit investment demand too. That is a misperception. Investors typically take long-term positions spread over several interest rate cycles. Indeed what drives investment is not so much the interest rate as the expectations on long-term return on investment vis-à-vis the interest rate. Such expectations currently remain buoyant.

Supply Side Response

23. In order to encourage private investment, government will have to come up with two important supply side responses.

(i) First, government will have to supply more and better infrastructure. Investment in infrastructure can come by way of direct public investment or through public private partnership (ppp).

(ii) Second, investment capital needs to be made available at reasonable rates of interest. A critical requirement for this is for the government to reduce its fiscal deficit, more particularly revenue deficit.

Quality of Adjustment

24. At one level, there is a tension between the above two supply responses required of the government. It will be difficult for the government to increase investment in infrastructure while at the same time reducing its fiscal deficit. This calls to attention the challenge of the quality of fiscal adjustment, i.e. compressing unproductive expenditure and increasing productive expenditure.

India and China – Contrast and Congruence

25. Interestingly, the past growth performance, the present outcomes and the future challenges of India are a mirror image of those of China. China's growth was driven by an expansion of manufactures which were largely exported, and a

large part of the incremental income was saved and invested in infrastructure. China's saving rate increased from about 35% of GDP in the mid-1980s to 50% by 2005. India's growth, on the other hand, was fuelled by services while also benefiting from buoyant external demand. However, our savings rate has increased only slowly and modestly from about 20% in mid 1980s to 29% in 2005.

26. The growth prospects of both India and China face some risk from the demand side. China is vulnerable to a decline in its export demand especially from the US while India is vulnerable to a decline in domestic demand. Going forward, the challenge for China is to generate a stronger domestic demand, reduce the relative importance of external markets by encouraging domestic consumption, while the challenge for India is to generate a strong supply response, by encouraging investment, boosting manufacturing growth and expanding the export base.

III. COMPOSITION OF DEMAND

Agriculture

27. As per the fourth advance estimates released on July 15, 2006 by the Ministry of Agriculture and Cooperation, foodgrains output is anticipated to increase by 5.0% from 198.4 million tonnes in 2004/05 to 208.3 million tonnes in 2005/06, short of the original target of 215.0 million tonnes (8.4% increase). The anticipated output, even if fully realized, would still be lower than the peak level of 213.5 million tonnes registered in 2003/04. A major contribution to the growth in foodgrains output comes from cereals, particularly rabi season paddy. Pulses registered practically no increase in output. More disappointing, however, is the negligible contribution that wheat production is likely to make to the total of foodgrains output; wheat output is estimated to have increased only modestly from 68.6 million tonnes in 2004/05 to 69.5 million tonnes in 2005/06. Clearly, the disappointing performance in domestic foodgrains production is a cause for concern.

28. The disaggregated picture of foodgrains and oilseeds production in 2005/06, compared with the peak production registered during the past ten years, clearly reflects the continuing ailment of the crop sector in Indian agriculture (Table 3). Across all major components of our foodgrains, there has been no significant increase in output, and output in 2005/06 was lower than the peak reached in the past 10 years for virtually every component. The gap is most glaring in the case of wheat, followed by the total of coarse cereals and pulses; small gaps are discernible for rice as well. It is only in the case of oilseeds that the anticipated output for 2005/06 is likely to exceed, *albeit* marginally, the peak reached in 2003-04.

29. The slow pace of agricultural production in general, and foodgrains production in particular, is due to a combination of technological, institutional and marketing factors that have handicapped the performance of Indian agriculture for some years now. Technological slackness that overtook a wide range of irrigated crops during the nineties, most ostensibly the two original green revolution crops of wheat and rice, combined with the continuing inability of our farm research system to develop alternative technologies for rain-fed crops has adversely affected the yield-augmenting performance of various crops and crop-groups to varying degrees.

Table 3: Change in Level of Output of Principal Foodgrains and Oilseeds		
Crop	**Anticipated output in 2005/06 (4th Advance Estimates)**	**Peak output during the past ten years (year of peak output in parenthesis)**
	million tones	
Rice (Paddy)	91.0	93.3 (2001/02)
Kharif	78.0	80.5 (2001/02)
Rabi	13.0	13.4 (1998/99)
Wheat	69.5	76.4 (1999/00)
Coarse Cereals	34.7	37.6 (2003/04)
Pulses	13.1	14.9 (1998/99)
Foodgrains	208.3	213.5 (2003/04)
Kharif	109.7	116.9 (2003/04)
Rabi	98.6	104.3 (1999/00)
Oilseeds	27.7	25.2 (2003/04)
Kharif	16.8	16.7 (2003/04)
Rabi	10.4	10.2 (2004/05)

Source: Ministry of Agriculture and Cooperation, Fourth Advance Estimate of Foodgrains Production for 2005/06, Directorate of Economics and Statistics, July 15, 2006

30. Table 4 shows the story of yield slackness in a fairly telling manner. For the past five years (2001-02/2005-06), yield levels for most crops or crop-groups stood almost frozen with the worst performance in 2001/02. That, during these years, even wheat and rice yields showed no improvement is an indication of the technology fatigue that has, of late, afflicted Indian agriculture. The marked contrast between the yield growth rates during eighties and the nineties followed by the most depressing yield growth rates since 2001-02 practically for all segments of crop production clearly signals the crisis of Indian agriculture on the production front. Indeed, after a three-decade long experience marked by the rate of growth of food output comfortably exceeding the rate of growth of population, Indian economy has, in recent years, been regressing to the pre-green revolution realities of growth of food output precariously balancing itself with population expansion. The only silver lining discernible in the crop sector is in respect of oilseeds where the rate of growth of yield has picked up well during 2001-02/ 2005-06 compared with 1995-96/2000-01. In total terms, crop production in general, and foodgrains output in general, are threatening to become restrictive bottlenecks in agricultural growth which may, in turn, affect the pace of rural non-farm growth, earnings of rural households and thereby rural poverty reduction.

Table 4: Yield of Individual Crops and Crop-Groups – Level and Growth Rates 1980/81 - 2005/06

Year	Rice	Wheat	Coarse Cereals	Total Cereals	Total Pulses	Food-grains	Oil-seeds
	Quintal/hectare						
1980-81	13.4	16.3	7.00	11.4	4.7	10.2	5.3
1985-86	15.5	20.5	6.7	13.2	5.5	11.8	5.7
1990-91	17.4	22.8	9.0	15.7	5.8	13.8	7.7
1995-96	18.0	24.8	9.4	17.0	5.5	14.9	8.5
1996-97	18.8	26.8	10.7	18.3	6.3	16.1	9.3
1997-98	19.0	24.9	9.9	17.8	5.7	15.5	8.2
1998-99	19.2	25.9	10.7	18.6	6.3	16.3	9.4
1999-00	19.9	27.8	10.3	19.3	6.4	17.0	8.5
2000-01	19.0	27.1	10.3	18.4	5.4	16.3	8.1
2001-02	20.8	27.6	11.3	19.8	6.1	17.3	9.1
2002-03	17.4	26.1	9.7	17.5	5.4	15.3	6.9
2003-04	20.8	27.1	12.4	19.9	6.4	17.3	10.7
2004-05	20.3	27.2	11.7	19.2	6.0	16.5	8.9
2005-06*	20.9	26.1	-	19.9	5.9	17.1	10.0
	Compound Annual Growth Rate (CAGR)						
1980-81/85-86	1.67	2.10	0.27	1.69	1.49	1.63	1.08
1985-86/90-91	1.75	1.38	3.75	2.52	0.96	2.12	3.13
1990-91/95-96	0.73	0.92	0.90	1.11	0.29	1.08	1.57
1995-96/00-01	0.65	0.85	0.59	0.86	0.08	0.95	-0.53
2001-02/05-06	1.63 (0.24)+	-0.71	1.71**	1.03	0.22	0.52	4.53

Notes: * 4th Advance Estimate;

** Covers the period 2001-02 to 2004-05

+ Growth rate for the period 2003-04/2005-06.

Sources: (i) Ministry of Agriculture and Cooperation, Fourth Advance Estimates of Foodgrains Production for 2005-06, Directorate of Economics and Statistics, July 15, 2006.

(ii) Ministry of Agriculture and Cooperation, Agricultural Statistics at a Glance, Directorate of Economics and Statistics, November 2005.

Industry

Mining

31. The projected growth of 7% of the mining sector, a sharp jump from just 0.9% last year. It derives primarily from the expectation of full restoration of production in the ONGC off-shore platform damaged in an accident last summer which was the main reason for the low overall rates of growth for the mining sector last year. No significant improvement in output expansion in coal and other mining sectors is being factored in for the current fiscal, although such improvement will be critical to support high rates of growth in the coming years

Manufacturing

32. The expansion of manufacturing output began in July 2002 and has continued more or less unabated since then, barring an occasional month which recorded poor output growth (Table 5). Manufacturing output growth has averaged over 9% in the past two years. In the first quarter of the current fiscal year (April-June), the average rate of growth of industrial output was 10.1% and that for manufacturing output was 11.2%.

Table 5: Industrial Output Growth - Sectoral Disaggregation

	2003/04	2004/05	2005/06	2006/07 April-June
	per cent year-on-year			
Overall industrial output	**7.0**	**8.4**	**8.0**	**10.1**
Manufacturing output	**7.4**	**9.2**	**9.0**	**11.2**
Bottom quartile (Mfg)	–0.5	3.5	0.2	–0.6
Top quartile (Mfg)	8.7	10.8	12.5	15.1
Capital goods	13.6	14.0	15.8	22.9
Basic goods	5.5	5.5	6.7	8.8
Intermediate goods	6.4	6.0	2.4	9.1
Durable consumer goods	11.8	14.3	14.9	16.4
Non-durable consumer goods	5.8	10.8	11.1	5.4

33. Besides the sustained strong growth in capital goods output, the other notable features are the following:

- In the top quartile of the 17 sub-groups at the 2-digit level of classification for manufacturing, the top performing quartile accelerated to 12.5% growth in 2005/06, up from 8.7% in 2003/04.

- The weaker growth of intermediate goods in 2005/06 was primarily due to a modest increase in electric power and crude oil output. In both of these cases, production is likely to improve in 2006/07, in part due to higher electricity generation (in evidence over the past four months) and in part due to the restoration of production from the off-shore oil well in Bombay High which was damaged last summer.
- The sustained strong growth in durable consumer goods, which partly reflects leveraged demand, may abate in the current fiscal as the credit market tightens.
- The growth in non-durable consumer goods was due to both buoyant external demand (e.g. textiles) as well as domestic consumer demand. However, this sub-sector has shown a decline in the first two months of 2006/07 arising primarily from negative growth in food products.

34. Our current assessment is that the growth of the industry sector comprising mining & quarrying, manufacturing, electricity, gas and water supply and construction will accelerate to 9.7% in 2006/07 (see Table 1 for details). However, over the medium term, the main constraint to industry growth will emanate from infrastructure, particularly energy.

Services sector

35. The services sector has been the key driver of our growth, registering growth rates of 8.2%, 9.9% and 10.0% over the last three years. We expect the growth rate to moderate marginally to 9.5% this year since some of the sub-sectors such as communication which saw very rapid growth in recent years are likely to confront subdued demand.

IV. TRADE AND BALANCE OF PAYMENTS

BoP - 2005/06 Outcome

36. Differences in trade data as put out by the DGCI&S and the RBI persist. As per DGCI&S figures, in US$ terms, merchandise exports rose by 25% in 2005/06 while imports increased by nearly 32%, as a result of which the trade deficit (DGCI&S) increased by 53% to nearly $40 billion (all changes in US dollar terms). As per RBI (BoP) figures, the merchandise trade deficit was $51.6 billion in 2005/06 reflecting an increase of over 40% over the previous year.

37. The current account deficit (CAD) in 2005/06 was $10.6 billion, which works out to 1.3% of GDP – about double the level of the previous year, viz. $5.4 billion and 0.7% of GDP.

38. Persistent increases in crude oil prices have caused the oil import bill to rise sharply, but non-oil/ non-bullion imports also recorded a strong increase of 22% (in rupee terms) for the year. The increase was evident in all manufactured intermediate items – from chemicals to metal to textile intermediates – besides machinery (increase of 43%). However, the sharp import increase was also in evidence for electronic goods (50%) and finished consumer products (36%). It is possible that higher borrowing costs might dampen the import demand for electronic goods (to the extent that they are not re-exported after value addition) and finished consumer goods. However, it is manufacturing intermediates that constituted the larger part of the increase in imports. In the context of continuing economic growth, it is unlikely that there might result a significant contraction in import demand.

39. Exports of manufactured goods (including refined petroleum products) rose by 21% (in rupee terms) in 2005/06; however, the value of refined petroleum product exports rose by 62% and the value of non-oil manufactured goods increased by a more modest 17%.

40. The value of textile export in 2005/06 – one year after the end of MFA quotas – increased by 16.6%, with cotton textiles up by 18.5%. The expansion came mostly in the second half of the year. Export of cotton textiles in the first half of 2005/06 was a mere 0.2%, but that in the second half shot up to 35%. The

entirety of the expansion was however to the former restrained (MFA quota) countries, where exports for the year was up by 31% (first half was 13% and second half 45%). In the countries formerly outside MFA, exports for the year declined by 3%; this combined a first half *decline* of 21% and a second half increase of 15%.

41. The fastest growing sub-sector was engineering goods which registered growth of 41%, with machinery exports up by 27% and transport equipment up by 59%. Our largest trading partner, accounting for 10.2% of our total trade (export+import), remained the USA, with whom we had a positive trade balance of $9.0 billion (up from $6.7 billion in the previous year). The second most important trading partner was China + Hong Kong (9.8% of total) with whom we had a negative trade balance of $ (–) 1.7 billion, a reversal form a positive trade balance of about $0.5 billion in the previous year.

BoP - 2006/07 Outlook

42. Export growth in the first quarter (April, May and June) of 2006/07 was 16.9%, while import growth was 17.7%; the resultant trade deficit (DGCI&S) rose by 19.7%.

43. In April 2006, DGCI&S initiated a significant change by reporting the year-on-year growth with respect not to the revised numbers for the comparable period of the previous year, but the provisional numbers. In consequence the reported growth in the period April–June 2006 was 32.4% for exports, 24.5% for imports and 10.0% for the trade balance. It has been the practice till date – with respect to all economic data series – to report growth for the most recent period with respect to the revised data for the comparable period of the previous year. It is entirely another matter to what extent the data for the most recent period is eventually revised upward, for no determinate view can be taken on either the direction or the magnitude of such prospective revision.

44. Thus, reading the data correctly, an export growth of 16.9% and import growth of 17.7%, has quite a different implication on expectations for the full year, compared to the reported 32.4% and 24.5% for export and import respectively.

45. Imports may be viewed to comprise of three broad components each of which is driven by very different factors. The first is oil imports where the import bill, in today's context of sharply rising prices, is mostly determined by the price, with the increase in consumption having only a marginal impact. The second is

the import of gold which totalled $11 billion or 1.4% of GDP in 2005/06, which is mostly driven by factors that relate to its function as an investment option in many Indian households. The third is the residual, what is neither oil nor gold, comprising raw materials, general intermediates, capital goods and to some extent durable consumer goods and the intermediates used to manufacture them, where volumes are driven by the level of economic activity.

46. The oil import bill rose by 47% to $43 billion in 2005/06, mostly on account of price increase and a small rise in volumes. In the first quarter of 2006/07, the oil import bill increased by 39%, of which about 33% was derived from price increase and the balance from volume increase. Taking into account the price movement of crude oil in the first four months of 2006/07, the impact of marginally higher domestic production on account of restoration of Bombay High output to 2004/05 levels and factoring in the way prices have moved through the course of the past few years (that is, up on any bad news, followed by some relief subsequently), we expect the oil import bill for 2006/07 to be $58 billion or 33% higher than in 2006/07.

47. Gold imports that had been rising sharply till the second quarter of 2005/06, dropped off sharply in the third and fourth quarter resulting in total import levels to remain unchanged at around $11 billion. In April 2006, gold imports continued to decline by about 15% and it is expected that the trend will hold in the first and second quarter with some recovery in the third and fourth, leading overall to imports that are likely to be only slightly more than that in 2005/06.

48. Non-oil, non-gold imports increased by 23% in 2005/06 and by 14% in the first quarter of 2006/07. Given the general expectations of continued strong economic growth, the pace of expansion is expected to rise somewhat in coming months to eventually average 17% for the year as a whole. Total DGCI&S imports are expected to be thus $172 billion in 2006/07, an increase of 21.8% over the previous year.

49. On the basis of about 17% growth for exports, and import growth as computed above, the projected DGCI&S merchandise trade deficit for 2006/07 comes to $53 billion. Higher than expected export growth, or lower import growth, could place this number in a range of $50 billion to $55 billion. It may be noted that in the Council's February 2006 report on BoP, the projected trade deficit on DGCI&S basis for 2006/07 had been $55 billion.

50. The merchandise trade deficit on BoP basis in 2005/06 was $12 billion higher than the DGCI&S deficit. Assuming that the difference between the DGCI&S and BoP merchandise trade deficits will be roughly a similar order in 2006/07, the BoP merchandise trade deficit in 2006/07 would be about $63 billion.

Table 6: Projected Balance of Payments for 2006/07

	2005/06 RBI (BoP)	2006/2007 EAC Estimate
	US$ billion	
Merchandise Trade Balance	(-) 51.6	(-) 63.0
Net Invisible receipts	40.9	52.0
Of which: Software	22.3	29.3
Worker remittances	24.1	27.5
Investment income	(-) 5.0	(-) 4.1
Current Account Balance	(-) 10.6	(-) 11.1
Capital Account Balance	24.7	27.5
Of which: FDI	5.7	8.5
Portfolio flows	12.5	5.0
Loans	4.7	12.0
Banking capital	1.4	1.0
Other capital	0.9	1.0
Accretion to Reserves	15.1	16.4

51. Net invisibles, including non-factor service exports, worker remittances, income from tourism & travel and investment income flows, amounted to $41 billion in 2005/06, which was 31% higher than in the previous year. This may be expected to increase by about 27% to reach $52 billion in 2006/07, mainly on account of continued strong growth in software exports, modest increase in remittances and the absence this year, of the one-time hit due to accumulated interest payments on India Millennium Deposits (IMD) in 2005/06. On this basis it is thus expected that the current account deficit will amount to $11 billion, which will be about 1.2% of expected GDP.

V. PRICES

Wholesale Price Index

52. As per the latest data available, inflation as measured by the Wholesale Price Index (WPI) was recorded at 4.6% for the week ending 29 July 2006. The behaviour of WPI inflation for the major components of the index is at Table 8.

Table 8: WPI Inflation – Major Items for Comparable Weeks This Year and Last

	2005/06		2006/07	
	2-Apr-05	30-July-05	1-Apr-06	29-July-06
	Percent change			
Overall WPI Inflation	**5.7**	**4.2**	**4.0**	**4.6**
Primary Articles	**1.1**	**1.4**	**4.8**	**4.6**
Primary foods	2.6	4.5	5.9	4.4
Foodgrain	3.3	4.6	9.0	7.3
Other primary food	2.3	4.5	4.5	3.1
Raw cotton	–23.0	–23.2	–1.7	6.6
Oilseeds	–5.5	–5.5	–9.2	–5.8
Other non-food primary	10.9	2.7	12.2	13.3
Commercial Energy	**11.1**	**10.9**	**8.3**	**7.6**
Petroleum products	17.2	15.9	12.0	13.7
Commercial Energy excl. POL	4.0	4.8	3.5	–0.4
Manufactured Goods	**5.5**	**2.8**	**1.9**	**3.4**
Dairy products	–2.0	–1.1	3.1	4.2
Grain mill products	–2.8	5.2	13.5	10.2
Sugar, *khandsari* & *gur*	18.3	13.8	5.8	3.9
Edible oil	–7.4	–6.9	–3.3	0.5
Tea & coffee processing	2.6	–8.4	–8.0	–18.5
Cotton textiles	–10.7	–13.1	2.3	4.0
Manmade textiles	0.1	–3.8	–3.6	0.2
Paper & paper products	2.7	1.6	4.7	6.3
Rubber and Plastics	0.4	1.2	2.5	5.8
Chemical materials & products	4.4	4.2	3.3	4.3
Drugs & medicines	4.0	3.7	7.3	5.8
Non-metallic minerals	10.1	8.1	9.6	11.9
Iron and steel	25.9	7.4	–4.2	–2.9
Non-ferrous metals	8.4	10.9	17.5	25.3
Machinery & machine tools	8.0	5.2	3.2	4.1
All other manufactured goods	5.8	2.2	–0.7	1.9

53. In the context of the recent concerns about inflation, the following features warrant notice:

- WPI inflation for primary food had touched 8.3% in the first week of June 2006, a sharp step-up from the beginning of April when it was 5.9%. This has since declined to 4.4% by the end of July 2006.
- Foodgrain prices were higher by 9.5% at the end of the second week of June, but have since declined to 7.3% by end-July 2006.
- Wheat prices rose by 12.9% at the end of March just before the rabi harvesting season. The inflation rate has since declined, but remained over 10% in early June, and reached 7.9% by July 29.
- The prices of pulses have risen sharply and continuously from 18-20% in January 2006 to over 25% in March and to 33% between April and June. Although there has been some moderation in recent weeks, this has been modest with the inflation rate in end-July still as high as 28%.
- The WPI price index for fruits & vegetables remained subdued till the end of May and rose to 6.3% by the first week of June. Much of the agitation on this front came from retail prices which skyrocketed in certain markets in May and June. In the most recent week, the index for fruit & vegetables has declined by as much as 6.8% from its peak value in the third week of June.

Wheat and Pulses

54. The WPI index for food shows that much of the inflation came from wheat and pulses. The wholesale price of wheat began to rise in January 2006, while that of pulses had begun to increase in late October 2005. A summary of the monthly average for WPI inflation rates in major food items is at Table 9.

55. Clearly, there has been much greater inflation in the prices of wheat and pulses than in rice and fruits & vegetables.

Consumer Price Index (CPI)

56. Consumer price inflation measured both by the CPI-UNME (Urban Non-Manual Employee) and CPI-IW (Industrial Worker), which had stabilized around 4% in 2005, started to move up beginning November 2005, when both the above indices reported inflation of 5% or higher. An analysis of the CPI-IW by

Table 9: Monthly Average Inflation of Major Food Items				
	Wheat	**Pulses**	**Rice**	**Fruit & Veg.**
	Percent			
Oct 2005	1.3	7.1	4.7	4.9
Nov 2005	2.3	13.4	4.5	9.5
Dec 2005	4.5	17.0	3.0	14.7
Jan 2006	8.9	20.7	2.6	10.9
Feb 2006	10.2	26.2	1.8	2.5
Mar 2006	11.8	28.7	2.0	–0.8
Apr 2006	10.0	35.9	2.2	–4.5
May 2006	10.7	36.3	2.6	–1.9
June 2006	9.4	34.1	1.9	4.1
July 2006	8.0	28.8	0.8	–2.6

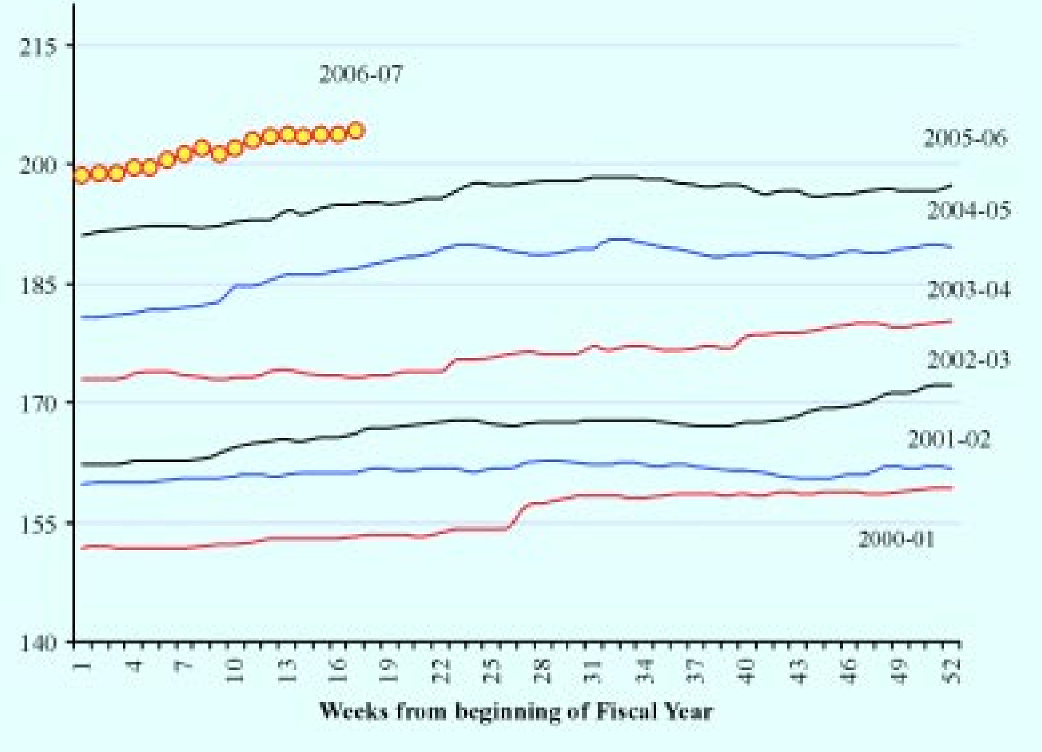
component indicates that the principal contributor to inflation has been food. The rate of inflation in the CPI-IW index of food (weight of 46% in the new series) went up from an average of 2.5% during the 10-month period Jan-Oct 2005 to 5.8% during the next 6-month period of Nov 05-Apr 06. In May 2006 this went up further to 8.0%. Thus, of the total CPI-IW inflation rate of 6.3% in May 2006, as much as 58% (higher than its weight in the index) was on account of food items alone. The other important contributor to CPI-IW inflation was housing which had averaged a rate of 6.6% in the first 6 months of 2006. In June 2006, the CPI-IW had risen to 7.6% and the CPI-UNME to 6.5%.

Price Outlook

57. The behaviour pattern of WPI during a year has been for it to rise from the beginning of April through September to November and stabilize thereafter largely due to seasonal factors (see Chart 2). For the past several years, WPI has ruled over CPI. This trend has reversed since November 2005 when CPI has gone above WPI. This could be due to: (i) differences in weights; and (ii) increase in margins in the distribution chain between wholesale and retail trade.

58. Up to 29 July 2006, the cumulative inflation since the beginning of the fiscal year was 3.5% compared to 3.0% for the comparable period in the previous fiscal year. It is our assessment that even assuming further revision to refined petroleum product prices later in the year, aggregate WPI inflation at the end of March 2007 would be contained around 5.5%, compared to 4.1% at the end of the previous fiscal year.

Chart 2: Movement in the WPI index through the course of the fiscal year



Inflation Management - Policy Framework

59. Inflation management requires both sectoral responses as well as management of the macroeconomic situation at the aggregate level. The year on year growth in broad money (M3) had accelerated to 19.5% as on July 21, 2006, up from 14.0% a year earlier. More importantly, money supply growth over the end of March was 4.0% (July 21, 2006) as compared to 1.8% during the corresponding period (up to July 22, 2005) last year. In view of the increase in prices across several sectors, containing money supply growth has to be an integral part of inflation management.

Wheat

60. With respect to sectoral prices, a major area of concern is foodgrain prices, particularly of wheat. The recent increase in the price of wheat is clearly because of demand exceeding supply – a situation arising out of lower market arrivals, lower procurement during the rabi season, decline in the buffer stock below the

norm and hardening of international prices because of lower projected wheat harvest in the US and Canada. The prevailing international price is higher than the domestic price. Since wheat is a tradeable commodity, there will be upward pressure on the domestic price towards convergence with the border price. In this context, the recent decision of the Government to allow import of 4.5 million tons of wheat should help to manage expectations on the wheat price.

61. Keeping this in view, the present situation points towards two other policy directions aimed at managing the price situation as well as managing inflation expectations.

> **Manage expectations:** In order to manage inflation expectations, besides the imports already in the pipeline, Government can consider buying futures options in the international markets.
>
> **Evolve a medium term policy:** As noted earlier, if the supply-demand gap in wheat is structural, it will persist into the medium term. Government will need to address this in three ways: first, by a strategy of improving production and productivity of wheat; second, by evolving a flexible procurement and pricing policy; and third, through a programme of imports spread over several years aimed at smoothing the domestic supply-demand gap and structured such that the imports take advantage of the global price trends and stocks are augmented when the global prices are low.

Pulses

62. India is the largest grower and consumer of pulses. In general the domestic output of pulses is insufficient to meet domestic demand and we import the balance of our requirements. In 2005/06, the total production of pulses was 13.9 million tonnes, 6% more than in the previous year but still 7% lower than the record output of 2003/04. This was short of our requirement and we imported 1.6 million tonnes of pulses. Our exports are comparatively smaller in volume amounting to just 0.4 million tonnes in 2005/06.

63. On average, the unit value of imports rose by 10% from Rs. 13.27/kg. in 2004/05 to Rs.14.59/kg in 2005/06. Even though the magnitude of increase varied widely across importing sources, at the aggregate level import prices increased by just 10%.

64. The policy response with respect to pulses should be similar to that for wheat: (i) in the short-term, examine and correct any inadequacies that may exist in the market; and (b) in the medium-term, improve the technology as well as the incentives for growing pulses. It should be borne in mind that pulses, being leguminous in nature, fix atmospheric nitrogen and are an excellent rotation crop that improves the fertility of the soil.

VI. FINANCIAL SECTOR

65. Credit expansion was very strong in 2005/06, registering an increase of 32% for the full year. Within the year, credit expansion was particularly strong in the last quarter (Table 10). The pace of expansion has persisted in part into the first quarter of the current fiscal, when non-food credit grew by 1.1% over the March-end position.[4]

66. Given the large credit expansion, it is not surprising that broad money (M3) expanded rapidly in 2005/06 by 21.1%, with fourth quarter growth being as high as 7.7% (nearly 30% on annualised basis). For the record, M3 grew by 12.3% in 2004/05 and by 16.7% in 2003/04. The sharp acceleration in M3 during the last quarter of 2005/06 was driven by a combination of surging credit demand from corporates and increase in net foreign assets (reserves) which were not offset by sterilised intervention, possibly in response to the very tight liquidity conditions that had emerged in the middle of December 2005. From small amounts of surplus cash being tendered to the RBI by the banking system under the reverse repo window, from about the middle of December 2005, banks started to borrow increasingly large amounts under repo, the daily volumes rising to Rs. 27,000 crore by the end of the month. The situation continued through January (average daily volume Rs 13,800 crore) and February (Rs. 12,800 crore). By March the position had improved and daily repo volumes fell off sharply through the month, with occasional net use of the reverse repo window.

[4] Since the "year-end" statistic for non-food credit is commonly the last reporting Friday, the comparison of credit growth in the first quarter of 2006/07 has often erroneously been made with respect to the growth during the period from the last reporting Friday of 2004/05 (18 March 2005) and the end of June 2005. However, given that in 2005/06 the last reporting Friday was 31 March 2006, it is more appropriate to take 1 April 2005 as the starting point for 2005/06. In which case we can see that the credit expansion in the current year is slightly ahead (1.1%) than in the same period of the previous year (0.4%), than is indicated by the conventional interpretation (5.4%) and so too if the comparison is made with the first quarter of 2004/05.

With effect from the *Weekly Statistical Supplement* of 28 July 2006, the RBI has begun to use 1 April 2005 as the starting reference point for computing the increase in credit for the comparable period of the previous year.

Table 10: Expansion of Non-Food Credit					
	Change quarter-to-quarter (%)				Change over full year (%)
	Q1	Q2	Q3	Q4	
1999/00	3.7	8.2	5.3	4.0	13.0
2000/01	4.0	4.3	3.4	2.4	16.5
2001/02	–0.5	5.7	2.3	5.6	13.6
2002/03	9.7	5.9	2.9	6.2	26.9
2003/04	0.5 (–2.3)	5.6	3.6	7.7 (12.2)	19.9
2004/05	3.8 (–0.2)	7.7	6.9	7.6 (13.0)	32.7
2005/06	5.4 (0.4)	9.0	6.5	13.2	31.8
2006/07	1.1				

Notes: (i) Figures in parentheses are the increases in non-food credit with respect to the first reporting Friday of April in 2003, 2004 and 2005, rather than the last reporting Friday of March. In these quarters it makes a material difference if the comparison is made with respect to the last reporting Friday or the first Friday of April.

(ii) The change for the full year is with respect to the first reporting Friday (2 April 2004 and 1 April 2005) for the years 2003/04, 2004/05 and 2005/06. In the other years the change is on the basis of last reporting Friday of the fiscal year.

(iii) The reporting does not adjust for conversions/mergers of financial institutions into banks and to that extent overstates the increase in 2002/03 (ICICI) and 2004/05 (IDBI). Adjusted for mergers the total increase in 2002/03 would be 19.5% (instead of 26.9%) and in 2004/05 it would have been 27.6% (instead of 32.7%).

67. There has been a small lag in the pricing of loans, with banks perhaps underestimating the squeeze on liquidity attendant on sustained and rapid credit expansion. However, through the course of the last quarter of 2005/06, some adjustments in pricing and distribution seems to have been made, the consequences of which can be seen in some easing of aggregate credit growth in the first quarter of 2006/07 and the reappearance of sustained excess liquidity to the extent represented by the regular tendering of between Rs 20,000 and 40,000 crore on a daily basis in the reverse repo window through April, May and June 2006. Further adjustments in loan pricing are in evidence in recent weeks.

68. In its *Annual Policy Statement* in April 2006, the RBI indicated that it would have a “policy preference” for “maintaining a lower order of money supply growth in 2006-07,” than 15%. RBI expects non-food credit growth to decelerate to 20% in 2006/07 from the growth of 32% of the previous year. It also noted that Indian companies have been obtaining significant funding from both equity and loan markets overseas and that the domestic mutual fund industry had acquired significant size in terms of fund flow. Indian companies in addition to the large

volumes of bank credit absorbed in the past few years have raised Rs. 13,482 crore and Rs. 21,154 crore in each of the immediately preceding years from the domestic stock market. In addition, there have been inflows in the form of overseas listing and foreign investments through venture funds, with the latter estimated to have been in excess of $2 billion (Rs. 9,000 crore) in 2005/06.

69. The continued flow of private funds through domestic and overseas equity markets and specialist investors like venture funds into Indian companies requires the maintenance of stable macro-economic conditions – on both domestic and external fronts. Sharp increases in demand-supply gaps together with increases in money supply can fuel an inflationary spiral. It is important to preserve stability in prices, to sustain steady investment and growth. There is enough evidence around the world to demonstrate that investment flows from business confidence and the latter is adversely affected by instability in macroeconomic parameters – particularly inflation (which is about the domestic price of money) and exchange rate volatility (which is about the international price of money).

70. Even as monetary tightening will curb a part of the leveraged consumer demand, the overall growth will still be high as investment demand and expectations remain buoyant.

VII. STOCK MARKET

71. Since the second week of May 2006, equity markets across the world have been negatively affected by a widespread re-rating of risk, from interest and exchange rates to petroleum prices to intensification of conflict in West Asia. These developments have reflected a big increase in risk perception (or premium) which has resulted in the withdrawal of funds from some of these markets. During the current financial year, net sales by foreign institutional investors (FII) in India amounted to nearly US$ 1 billion (most of it in May) till the end of July 2006 although year-to-date inflows for calendar 2006 continue to be positive at over US$ 2.9 billion. Nevertheless the Indian market continues to enjoy fairly high price earning (historical) multiples with the figure being 19.4 for the BSE 30 Sensex and 18.4 for the NSE Nifty. A summary of changes in stock indices for 2005 and since March 2006 in major markets is at Table 11, giving both the changes during the month and the year-to-date position in calendar 2006.

72. The sharp weakening of equity markets after 10 May 2006 was due to mounting disquiet with regard to the aggressive pricing of risk that had characterised a long period of robust growth, high levels of business confidence and strong recovery in corporate profitability. Other global factors fuelled this concern further. Uncertainty regarding the extent of monetary tightening triggered off a world wide sell-off in financial assets, with equities expectedly bearing the largest burden of adjustment. Equity prices fell much more in emerging markets than in mature economies – reflecting in part the sharp run-up that equities in emerging markets had accumulated in preceding years. Broadly emerging markets lost between 5% (e.g. Poland, Czech Republic and Mexico) and 15% (India, Indonesia, Thailand, Taiwan and Russia). Amongst industrial economies, losses were somewhat lower from 2% in Britain and Switzerland to 7% in Germany and 10% in Japan, Sweden and the US (Nasdaq). China (Shanghai) has been an outlier in 2006, but that is partly due to its poor performance in 2005 and in 2004.

73. The market began to adjust to the heightened risk perceptions soon thereafter. By the middle of June, volatility had reduced somewhat and some recovery had materialised, a process that has been taken forward in July. The strength of the recovery of equity markets must be viewed in the context of continuing and heightened tensions in West Asia and its implications for oil prices. In the process of adjustment the Indian market has lost 1,400 points or

little over 11% in terms of the BSE Sensex 30, and 480 points or 13% in terms of the more broad-based NSE Nifty as at week ending 11 August 2006.

74. In India, corporate results for the first quarter of 2006/07 have varied across firms, but in general have been good enough to assuage apprehensions about immediate and long-term prospects. Notwithstanding some further possible bumps in the days ahead, broadly the market appears to have adjusted, stabilised and has come into more-or-less a neutral position.

Table 11: Changes in Level of Stock Indices in Major Markets											
		2005	**2006**								
Country	**Index**		**Change during the period**								
		Full Year	**YTD to March**	**April**	**YTD to April**	**May**	**YTD to May**	**June**	**YTD to June**	**July**	**YTD to July**
China	SSE Comp	–8.3%	11.8%	10.9%	24.0%	14.0%	41.4%	1.9%	44.0%	–0.6%	43.1%
Russia	RTS-Rouble	92.2%	22.9%	13.8%	39.9%	–13.0%	21.7%	2.6%	24.9%	3.2%	28.9%
Poland	WIG20	35.4%	7.9%	11.5%	20.3%	–11.9%	5.9%	2.8%	8.8%	10.4%	20.2%
Indonesia	JKSE	16.2%	13.8%	10.7%	26.0%	–9.2%	14.4%	–1.5%	12.7%	2.1%	15.0%
S Africa	JSE	43.0%	12.5%	3.9%	16.8%	–2.7%	13.6%	3.3%	17.4%	–2.4%	14.6%
Hong Kong	HangSeng	4.5%	6.2%	5.4%	12.0%	–6.4%	4.8%	4.4%	9.4%	4.2%	14.0%
Mexico	IPC	37.8%	8.3%	7.1%	16.0%	–9.5%	4.9%	2.5%	7.6%	5.8%	13.8%
India	**Sensex 30**	**42.3%**	**20.0%**	**6.8%**	**28.1%**	**–13.7%**	**10.6%**	**2.0%**	**12.9%**	**0.7%**	**13.6%**
Brazil	IBovespa	27.2%	13.9%	6.4%	21.1%	–9.5%	9.6%	0.3%	9.9%	2.0%	12.2%
Spain – Madrid	SMSI	20.6%	10.0%	1.9%	12.1%	–4.8%	6.7%	1.5%	8.3%	2.9%	11.4%
Philippines	PSI	15.0%	4.8%	3.4%	8.3%	1.1%	9.5%	–5.1%	3.9%	6.9%	11.1%
Argentina	Merval	11.2%	17.8%	6.0%	24.8%	–14.2%	7.1%	4.5%	11.9%	–1.3%	10.5%
France	CAC40	23.4%	10.7%	–0.6%	10.0%	–5.0%	4.6%	0.7%	5.3%	1.3%	6.6%
Britain	FTSE100	16.7%	6.2%	1.0%	7.2%	–5.0%	1.9%	1.9%	3.8%	2.4%	6.3%
Germany	DAX	27.1%	10.4%	0.7%	11.1%	–5.3%	5.3%	–0.2%	5.1%	0.4%	5.5%
Italy	MiBTel	13.8%	9.5%	0.4%	9.9%	–5.1%	4.3%	–0.1%	4.1%	0.9%	5.1%
Canada	S&P TSX	21.9%	7.4%	1.0%	8.5%	–4.0%	4.2%	–1.1%	3.0%	1.8%	4.9%
Switzerland	SM	33.2%	5.8%	0.3%	6.1%	–5.5%	0.3%	0.6%	0.9%	3.8%	4.8%
Australia	All Ord	16.2%	8.0%	2.4%	10.6%	–4.5%	5.6%	1.2%	6.9%	–2.0%	4.8%
USA	Dow Ind.	–0.6%	3.7%	2.3%	6.1%	–1.7%	4.2%	–0.2%	4.0%	0.6%	4.7%
Netherlands	AEX	25.5%	7.3%	0.1%	7.5%	–6.2%	0.8%	0.0%	0.8%	3.6%	4.5%

Contd..

Table 11: Contd..

		2005	2006								
Country	**Index**		**Change during the period**								
		Full Year	**YTD to March**	**April**	**YTD to April**	**May**	**YTD to May**	**June**	**YTD to June**	**July**	**YTD to July**
Malaysia	KLSE	–0.8%	3.0%	2.4%	5.5%	–2.3%	3.1%	–1.4%	1.7%	2.2%	3.9%
Singapore	STI	13.6%	7.9%	3.1%	11.2%	–8.7%	1.6%	2.2%	3.8%	–0.2%	3.5%
USA	S&P 500	3.0%	3.7%	1.2%	5.0%	–3.1%	1.7%	0.0%	1.8%	0.7%	2.4%
Sweden	SAX	32.6%	12.0%	–0.9%	11.0%	–8.5%	1.5%	0.6%	2.2%	–0.6%	1.5%
Taiwan	TWII	6.7%	1.0%	8.4%	9.5%	–4.5%	4.6%	–2.1%	2.4%	–3.3%	–1.0%
Czech Rep	PX50	42.7%	3.5%	–2.0%	1.4%	–11.0%	–9.8%	4.6%	–5.6%	3.2%	–2.6%
Thailand	SET	6.8%	2.7%	4.9%	7.7%	–7.6%	–0.5%	–4.5%	–5.0%	2.0%	–3.1%
Japan	Nikkei225	40.2%	5.9%	–0.9%	4.9%	–8.5%	–4.0%	0.2%	–3.8%	–1.0%	–4.8%
USA	Nasdaq	1.4%	6.1%	–0.7%	5.3%	–6.2%	–1.2%	–0.3%	–1.5%	–3.6%	–5.0%
Denmark	OMXC20C	37.6%	0.4%	0.4%	0.8%	–6.0%	–5.2%	–0.5%	–5.7%	0.1%	–5.6%
South Korea	Kospi	53.9%	–1.4%	4.4%	2.9%	–7.2%	–4.5%	–1.7%	–6.1%	0.1%	–6.0%

VIII. CONCLUSION

75. The overall growth in 2006/07 is projected to be in the narrow range of 7.8%-8.0%. There have been questions about whether our growth is consumption driven and whether it can be sustained. The growth momentum can be maintained if the government can create a conducive climate for private investment through a strong supply side response, mainly in two ways: improving the quality and quantity of infrastructure and making a credible fiscal adjustment so as to release resources for private investment. Some hardening of interest rates is inevitable to restrain inflation and we expect the WPI inflation by the year-end to be contained around 5.5%. In view of the increase in prices across several sectors, containing money supply growth has to be an integral part of inflation management. The current account deficit for the year is projected at 1.2% of GDP, broadly the same level as of last year.