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India Economic Update



Economic Policy and Poverty Team

South Asia Region

The World Bank

Overview

In 2011, India's economic growth has slowed to below 7 percent and the stock markets mirrored the weakening economic conditions, but recovered somewhat in early 2012. Industrial sector output growth briefly slipped into negative territory. On the demand side, fixed investment and consumption growth slowed. India's exports were growing very strongly through 2011 despite the worsening economic conditions in Europe, which continued to be India's most important export market. The balance of payments continued to be in surplus during April-September 2011, but the RBI's reserves declined by a small amount since then. The rupee nevertheless depreciated by 20 percent between August and December, before recovering somewhat in early 2012.

Inflation slowed markedly in December 2011 and January 2012, after sustained inflationary pressures over the last two years. Food price increases were pushing inflation initially, but core inflation has been the main component of overall inflation since September 2010. While food prices fell in December and January, core inflation still remained elevated.

Macroeconomic policies presented a mixed picture: the central government is likely to miss the ambitious target for fiscal consolidation it had set in the FY2011-12 budget by about 1 percent of GDP. Slippages are due to lower-than-expected revenues and increasing outlays on subsidies, which had been given low budgetary allocations in anticipation of strong policy changes, which failed to materialize. Adjusting for the emerging macroeconomic imbalances was therefore left to monetary policy. After raising policy rates 13 times starting in early 2010, the RBI paused and held them steady in the last two reviews in December 2011 and January 2012. Credit growth slowed following the increase in real lending rates.

The global economic environment deteriorated in the second half of CY2011 with concerns over fiscal sustainability in Europe, and increased risk aversion around the world. Hardening credit constraints and risk aversion have transferred financial sector difficulties to the real economy. For developing countries in general, the contagion has been broad-based, with higher funding costs and sharply weakened capital flows, although that does not yet seem to have affected India. Global economic conditions are fragile, and there remains great uncertainty as to how markets will evolve over the medium term.

In India, the slowdown in GDP growth witnessed over the last two quarters is likely to extend into the coming fiscal year because of the weakness in investment. In FY2011-12 and FY2012-13, GDP growth is forecast to reach around 7-7.5 percent, a significant slowdown from the 9-10 percent growth in the run-up to the global financial crisis. The slowdown is at least partly caused by structural problems (power projects facing delays due to the lack of coal and gas feedstock, mining and the telecom sectors hit by corruption scandals, unavailability of land and infrastructure). Tighter macroeconomic policies, slow growth in the core OECD countries and worries about another global recession, and the base effect of high growth in FY2010-11 in agriculture also weigh down on growth.

The slow growth expected in core OECD countries adds to the urgency of overcoming structural problems and enhancing domestic growth drivers. Important signals could come from the reform of direct taxes, the implementation of the long-delayed GST, and passage of the land acquisition and mining bills.

¹ Prepared by Ulrich Bartsch and Maria Mini Jos.

The downside risks to growth are high because of the risks to global growth from the precarious situation in Europe. A worst-case international scenario would lead to a collapse of demand for India's exports and strong contraction in private sector spending. Even without a strong worsening of the global scenario, India's external financing requirements are high, and likely to expand in the coming years. Short-term debt (by residual maturity) stood at \$142bn at end-September 2011, in addition to the current account deficit of around \$60bn. The RBI's foreign reserves reached \$293bn at end-February 2012.

In a worsening international scenario, macroeconomic policy room is much more limited now than it was in 2008. However, fiscal stimulus could come from rationalizing government expenditure by expanding investment and cutting subsidies. Investments in infrastructure could alleviate supply bottlenecks and crowd in private investment, with social safety nets cushioning the impact of rising prices.

The RBI could pursue confidence-building measures, such as highlighting the (limited) exposure of Indian banks to global shocks, and ensuring adequate liquidity in the banking system (outside of the usual LAF window if needed). Interest rate cuts would be warranted if a global crisis scenario led to a collapse in commodity prices and domestic economic activity, as happened in 2008-09. The flexibility of the exchange rate as a shock absorber, if maintained, would help protect reserves and confidence at the times of outflows, but the competitiveness of India's exports is also important and it could be maintained with the RBI continuously adding to reserves. In this regard, the depreciation of the rupee in the second half of 2011 was a correction for earlier appreciation, and presented an opportunity to build reserves and maintain a better aligned exchange rate when capital inflows resumed in early 2012. The RBI could usefully look more closely at corporate balance sheets in order to identify which of them would face refinancing difficulties, which in turn could affect domestic loan portfolios, and at requirements at least for trade finance in the event of a standstill in foreign credit.

While food inflation has relented recently, food prices continue to be much higher relative to non-food prices than they were five or so years ago. This India Update takes a closer look at agriculture. Food production, in particular production of high-protein foods, fruits and vegetables has not kept pace with demand growth in recent years. At the same time, production and marketing of perishable agricultural goods is hampered by a lack of infrastructure, including roads and cold storage. Rules and regulations deter private investment in the supply chain to varying degrees in India's states, with some states adopting more liberal legal regimes than others. These rules and regulations are arguably a bigger deterrent to private investment than the rules on FDI in multi-brand retail, which have received much attention recently. The government's interventions, on the other hand, are narrowly focused on supporting the production of wheat and rice, where supply currently exceeds demand by a wide margin leading to high stocks.

Foreign direct investment fell after the 2008 global financial crisis, and has only shown a modest recovery since then. We discuss possible explanations for the slower inflows, including lower demand for Indian exports of services in the BPO and IT areas, increased scrutiny by the Ministry of Environment and Forests of environmental safeguards, media coverage of alleged cases of corruption, and an enhanced scrutiny of off-shore bank accounts and investments from tax havens.

I. Recent Economic Developments

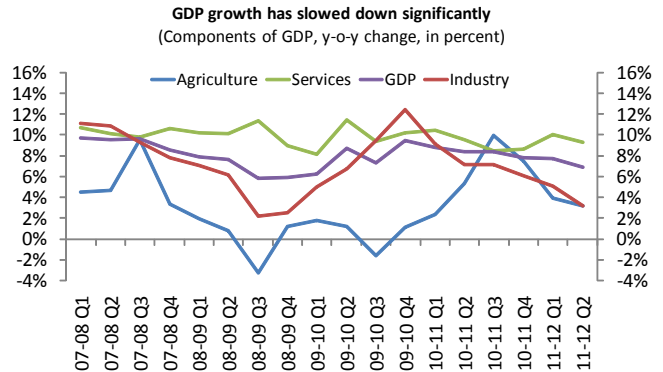
GDP and its Components

Real GDP growth has slowed to 6.9 percent in Q2 of FY2011-12. The slowdown was led by industry, which had previously led the recovery from the slump following the global financial crisis. Industrial production in turn was affected by a strong decline in investment demand, which was not sufficiently compensated by strong export growth.

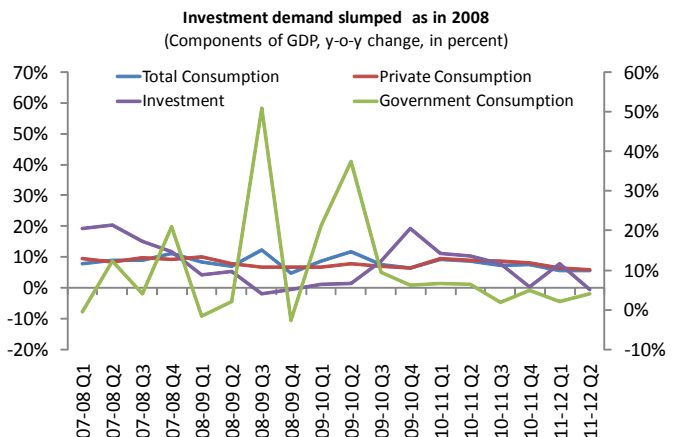
A negative base effect weighs down agriculture. In FY2010-11, GDP growth had greatly benefited from a rebound in agricultural production following on the near-drought conditions of FY2009-10, while agriculture is now back to trend growth of around 2.5 percent (against 7 percent in FY2010-11). Food crop production is forecast to reach 250 million tons in FY2011-12, as compared with 232 million tons in the previous year.

Industrial sector output growth fell particularly strongly in the second quarter of FY2011-12. When India's economy rebounded in FY2009-10 from the global financial crisis in the previous year, the industrial sector took the lead, with a growth of 12.4 percent in the last quarter of FY2009-10. Its growth slowed to 3.2 percent in the quarter to September 2011. The slowdown was driven by a deceleration in the manufacturing sector and a contraction in the mining sector by 2.9 percent. The latter came on the back of restrictions imposed on the sector after large-scale illegal activities were discovered in Orissa and Karnataka. Industrial output growth as measured by the Index of Industrial Production (IIP) averaged 5 percent in the first half of FY2011-12 compared to 8.2 percent in the same period of FY2010-11. The slowdown was to a large extent due to a contraction in the production of capital goods, which is in line with the picture of falling investment demand on the expenditure side of the National Accounts.

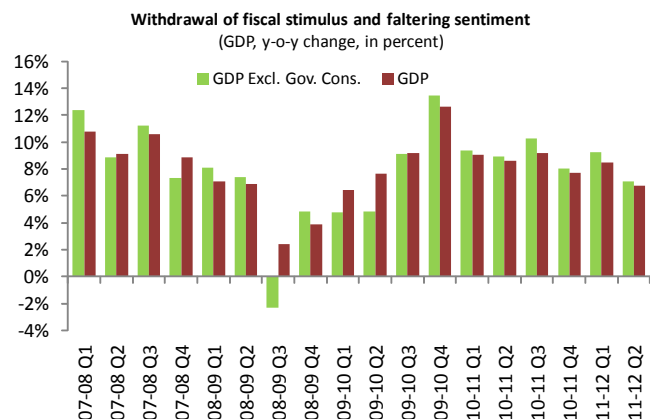
Industrial production diverged negatively from global production trends highlighting domestic factors of the slowdown. The industrial production index (IIP) is quite strongly correlated with the global index. In fact, RBI calculates the correlation as 0.72. However, the slump in the second half of 2011 strongly diverges from the much more modest weakness in global industrial production.



Source: CSO.



Source: CSO.



Source: CSO. Note: Expenditure GDP growth not always same as production.

The services sector remained buoyant and grew at an average of 9.6 percent in the first half of FY2011-12. Trade, transport and communication (12.8 percent) led the growth in the first quarter of FY2011-12 while finance and insurance (10.5 percent) led in Q2 of FY2011-12.

On the demand side, fixed investment fell in Q2 of FY2011-12. Gross fixed capital formation declined by 0.6 percent in Q2 FY2011-12 and private consumption growth stood at 5.9 percent. Fiscal consolidation continued to dampen aggregate demand (the chart shows that private demand plus public investment grew faster than overall demand, indicating a negative impact of government consumption).

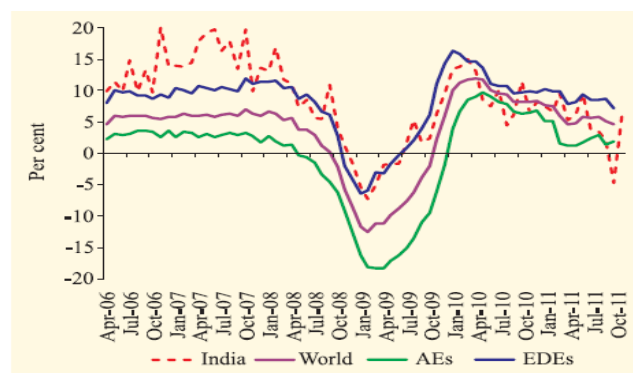
Balance of Payments

Notwithstanding the slowdown in the global economy in the second half of 2011, India's exports remained strong during the year. Merchandise exports growth reached 45 percent in September, but slowed to 30 percent by December 2011 (measured as 12-months cumulative exports up to September or December 2011 compared with the 12 months to September or December 2010). India exported close to \$300bn worth of goods in the 12 months to December 2011, almost triple the amount it exported in the same period five years earlier. At the same time, import growth accelerated and the trade deficit expanded. The trade deficit reached \$132bn for the first three quarters of FY2011-12, nearly 20 percent higher than for the previous fiscal year as a whole. While the increase in oil prices played a role, the import growth acceleration was mainly due to a pick-up in non-oil imports, which grew at a rate of 30 percent in Q2 of FY2011-12 (y-o-y). A rise in the invisibles surplus and strong remittances (19 percent growth) contributed to offset some of the trade deficit.

The balance of payments continued to be in surplus in H1 FY2011-12. An 11-percent increase in the current account deficit (H1 FY2011-12 over H1 FY2010-11) was compensated by an 8-percent increase in the capital account surplus, and reserve additions amounted to \$5.7bn.

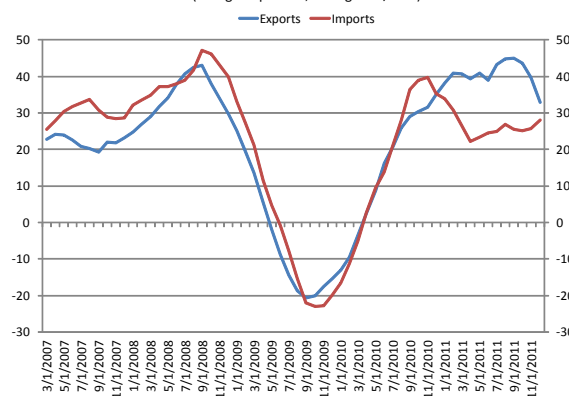
Capital inflows in the first half of the fiscal year relied heavily on external borrowing with a continuing slump in FDI. Interestingly, H1 of FY2011-12 also brought significant inflows of banking capital of \$19bn despite the worsening international environment. The capital account surplus increased to \$41bn in H1 FY2011-12, as compared with \$38bn in the first half of the previous year. In addition to the large inflow of banking capital, external commercial borrowings nearly doubled to \$10.5bn. While comprehensive BoP data for Q3 of FY2011-12—which covers more of the period after the downgrade of the US sovereign debt rating and significant worsening in investor perception of the EU debt situation—was not yet available for this India Update, portfolio investment seems to have held up well with a small net positive inflow in Q3.

Industrial growth slumped in Q3 of 2011, much more than in the rest of the world (y-o-y percentage change)



Source: RBI

Export growth was strong during H1 FY2011-12, but has filtered in recent months. (change in percent, rolling 12m/12m)



Source: Ministry of Commerce

India's Main Trading Partners 2004-11

Starting in September 2011, the rupee depreciated sharply against the US dollar, but recovered somewhat in early 2012. Without sizeable capital outflows, the 20 percent depreciation by December seems to have been guided by sentiment rather than fundamentals. The rupee recovered somewhat in January to about 10 percent lower than the average it had held with remarkable stability for two years before August/September. The RBI tightened foreign exchange derivatives trading rules to clamp down on speculation and intervened sporadically in the foreign exchange market, and reserves dropped to \$293bn by end-January 2012, from \$308bn at the beginning of December 2011. The depreciation lowered the REER (36-currency trade based) to a level closer to its long-term average, from which it had appreciated in 2010-11.

India's export market is shifting, both in terms of products and destination, but the EU is still the biggest trading partner. Geographically, exports are shifting away from the 'old OECD' (EU and the US) and toward emerging markets in Asia and the Middle East. The share of the EU and the US in India's exports has fallen below 20 percent in 2011, from 30 percent in 2004. In contrast, the share of the main trading partners in Asia (China, Indonesia, Pakistan, Sri Lanka, Singapore) has increased to almost match the share of the 'old OECD'. In the first half of CY2011, when looking at individual countries the UAE contributed most to overall export growth, followed by Singapore, the US, Indonesia and China. When aggregating exports to the EU member countries, their combined contribution to export growth was 11 percent, significantly larger than the combined share of Singapore and China. It should be noted that at the end of 2010, China contributed most to export growth, even ahead of the EU, but China's economy has slowed markedly in 2011. In the twelve months to September 2011, exports to the EU amounted to \$55bn, to the US \$30bn, and to China \$23bn.

EU	55,031
UAE	38,175
US	30,294
China	23,198
Singapore	16,098
Total	294,369

Source: Min. of Commerce

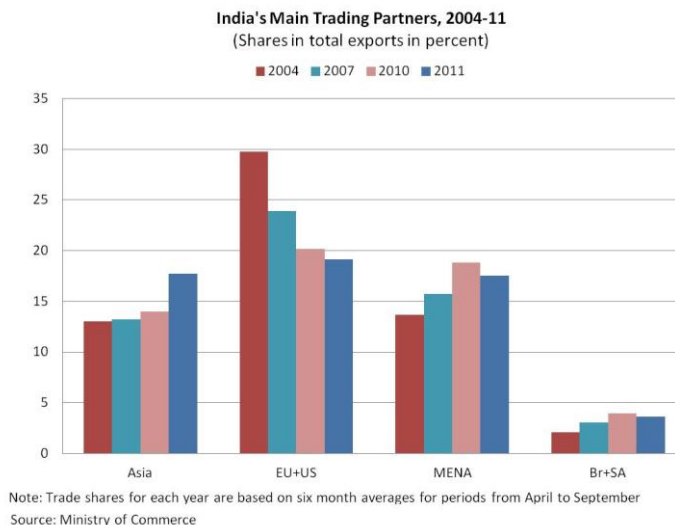
Regarding the goods India is exporting, both raw materials and more sophisticated manufactured products are displacing traditional exports such as leather, gems, and jewelry. In H1 of CY2011, export growth benefited most from growth in petroleum products, transport equipment, and gems and jewelry. India's exports of petroleum products are partly driven by a strategic investment of Reliance into a world-class refinery designed to produce for the global market, and located strategically on the sea route from the Middle East to Asia—with Gujarat having been chosen among several potential international sites. However, the government's pricing policy also does not allow the private sector profitable participation in the domestic market: Indian retail prices are not sufficient to cover the full costs (including taxes) of petroleum products, and oil companies are only partially reimbursed for 'under recoveries'. Private companies are barred from receiving subsidies, and

India: Exports by Country and by Commodity, 1/2011-6/2011
(percentage point contribution to overall growth, 6-month average)

<i>Overall exports growth</i>	55.2		
<i>EU</i>	11.1	Petroleum and Crude Products	10.9
United Arab Emirates	6.2	Transport Equipment	7.9
Singapore	5.2	Gems and Jewellery	6.1
United States	4.3	Primary and Semi-finished Iron and Steel	3.8
Indonesia	3.2	Non-ferrous Metals	3.7
Netherlands	2.3	Manufactures of Metals	3.6
China	2.1	Electronic Goods	3.2
Sri Lanka	2.1	Machinery and Instruments	3.1
Brazil	2.0	Sugar	2.7
Belgium	1.9	Other Ores and Minerals	1.6
Germany	1.7	Processed Minerals	1.6
South Korea	1.6	Ferro Alloys	1.4
Iran	1.5	Readymade Garments, Cotton incl. Accessories	1.2
United Kingdom	1.5	Drugs, Pharmaceuticals and Fine Chemicals	1.1
Italy	1.1	Plastic and Linoleum Products	1.0
Saudi Arabia	1.1	Dyes Intermediates and Coal Tar Chemicals	0.9
Thailand	0.9	Inorganic, Organic, Agro Chemicals	0.8
Turkey	0.9	Manmade Yarn Fabrics Madeups	0.7
Taiwan	0.9	Cotton Yarn Fabrics Madeups etc	0.5
Austria	0.8	Oil Meals	0.5
Bahrain	0.7	Aluminium other than Products	0.5

Source: Ministry of Commerce, CEIC.

therefore export refined products from their refineries in India rather than selling in the domestic market, whereas the public sector companies import the same products to supply the domestic market. Petroleum products accounted for about 11 points of the 55 percent export growth. This can be ascribed in part to an increase in international oil prices (average oil prices for the last six months of 2010 were 9 percent higher than in the second half of 2009), while volumes were also increasing in line with private refining capacity. However, value-added of refining in India is quite low, as the refiners import almost the entire feed stock of crude oil.



External debt reached \$327 billion by end-September 2011. Short-term debt and external commercial borrowing rose by around 11 percent during H1 FY2011-12. However, the official foreign reserves of the RBI remained at a comfortable level. The ratio of short-term external debt (by residual maturity) to foreign exchange reserves was 45.5 per cent at end-September 2011. The ratio has shown a steady increase from 38.6 percent in end-March 2010. Foreign exchange reserves reached \$293 billion at end-January 2012.

India's stock markets slumped. India's stock markets started declining at the end of 2010, much earlier than most other EM stock markets. The SENSEX index fell 28 percent from its recent peak in November 2010, and India's market underperformed those of its peers. In 2012, the SENSEX clawed back about half of the losses by mid-February. Investors in the Indian stock market have so far not seen their portfolios gain the values they held in early 2008, before domestic cyclical pressures and the worsening international climate led to a steep decline, which lasted until after the general elections in March 2009. However, the SENSEX trades at more than 4 times the level it held in the early 2000s.

Rating agencies maintained their India ratings, but the business outlook is worsening. Both Moody's and Fitch upgraded their local currency ratings in early 2010. While Moody's upgraded its rating from Ba2 to Ba1 with a positive outlook, Fitch revised its rating from negative to stable. Industrial outlook surveys show a worsening of the business climate in Q1 of FY2011-12. Company managers are seeing a decline in the financial situations of companies, while profit margins are shrinking. The deterioration in conditions is also supported by Purchasing Managers' Indices, which sank to their lowest in two years, although they have shown a small uptick in January 2012.

Inflation

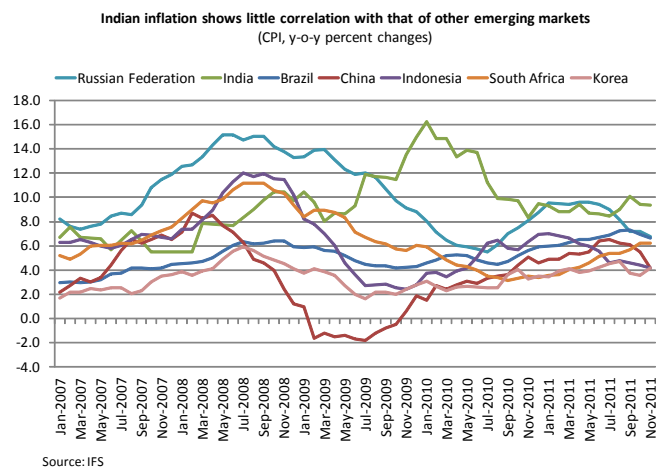
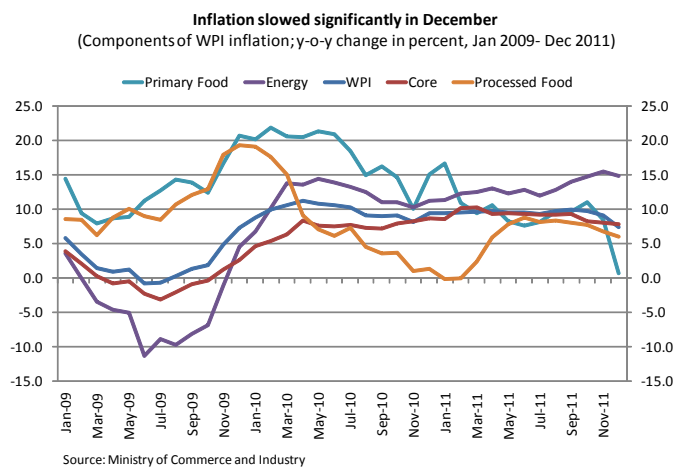
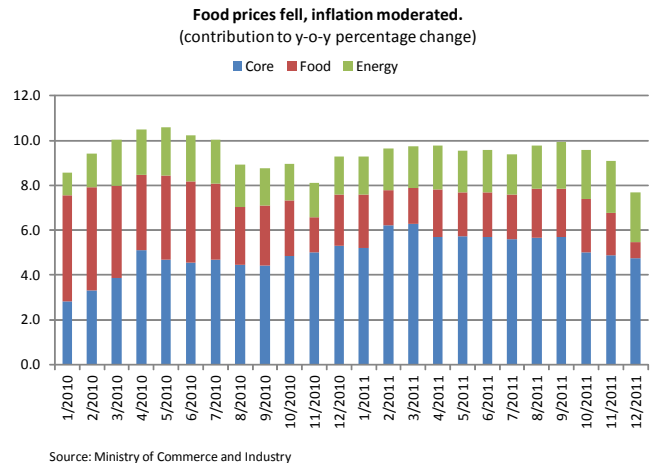
Inflation slowed markedly in December 2011 and January 2012, after sustained inflationary pressure over the last two years. Inflation reached 6.5 percent (WPI, y-o-y) in January 2012, an important deceleration from earlier months, when it hovered between 9.5-10 percent.² The moderation came largely on the back of a drop in food inflation to 2 percent. Energy price inflation continued around 14 percent with the delayed pass through of international energy price increases.

² A new nationwide consumer price index was introduced in January 2011; in January 2012 it showed the first y-o-y inflation indicator of 7.7 percent.

Core inflation has been the main component of overall inflation since September 2010. It reached a high of 10.3 percent during February-March 2011 and moderated to 7 percent by December 2011. Core inflation indicates that pricing power and pass-through of higher input and wage goods prices persists.

Seasonally adjusted data supports the disinflation picture, but it is too early to claim victory. On a seasonally adjusted basis, wholesale food prices fell in November and December 2011 (seasonally adjusted annual rate, saar, of month-on-month price changes), but core inflation (calculated by excluding food and energy prices from the wholesale price index) showed again an uptick. With the moderation in food prices came a moderation in the CPI measures of inflation. The CPI for industrial workers has declined steadily to below 5 percent in November 2011 (m/m saar), from a high of 11.6 percent in March 2011.

India's CPI inflation trajectory shows little correlation with that in other important emerging markets. In India, inflation continued accelerating even after the Lehman collapse, when it moderated strongly in most other EMs, and India's CPI inflation has been higher than that of other EMs with the exception of Russia. In the other EMs, inflation has been accelerating during the first three quarters of 2011, but shows again some moderation in line with slowing growth and some commodity price weaknesses. India's CPI inflation is strongly linked to domestic food prices, which are not well correlated with international food prices.



Fiscal Developments

The central government's fiscal deficit target is likely to be missed by about 1 percent of GDP. The wider fiscal stance comes from lower than expected revenue, including near-zero revenue from disinvestment, and higher spending mainly on subsidies. The deficit is likely to reach 6 percent of GDP, as compared with a budget target of 5 percent.³ On the revenue side, tax revenue increased by 13.9 percent during H1 FY2011-12 as compared with a budget target of 17.3 percent, while disinvestment so far has only brought in about Rs.27bn of the budgeted Rs.400bn. In part, lower tax revenue comes on account of high direct tax refunds having been paid out at the beginning of the fiscal year, which could indicate over-zealous collection in FY2010-11 in a bid to meet last year's budget target. The refunds amounted to Rs.622bn, or about 0.7 percent of GDP. Revenue also suffered from a reduction in excise duties on petroleum and crude products implemented in order to cushion the impact of higher

India: Central Government Budget, 2007/08-2011/12

% of GDP	2007/08	2008/09	2009/10	2010/11	2010/11	2011/12
			Est.	Budget	Est.	Budget
Total revenue and grants	10.9	9.7	8.7	9.3	8.7	8.8
Net tax revenue	8.8	7.9	7.0	7.7	7.3	7.4
Gross Tax Revenue	11.9	10.8	9.5	10.8	10.1	10.4
Corporate tax	3.9	3.8	3.7	4.3	3.8	4.0
Income tax	2.1	1.9	2.0	1.8	1.8	1.9
Excise tax	2.5	1.9	1.6	1.9	1.8	1.8
Customs duties	2.1	1.8	1.3	1.7	1.7	1.7
Other taxes	1.4	1.4	0.9	1.0	1.0	0.9
Less: States' share	3.0	2.9	2.5	3.0	2.8	2.9
Less: NCCF expenditure netted from receipt	0.0	0.0	0.0	0.0	0.0	0.0
Non tax revenue 1/	2.1	1.7	1.8	1.6	1.5	1.4
Total expenditure and net lending	14.2	15.7	15.5	15.9	14.8	13.8
Current expenditure	11.9	14.2	13.9	13.8	13.2	12.2
Interest payments	3.4	3.4	3.3	3.6	3.0	3.0
Subsidies	1.4	2.3	2.2	1.7	2.1	1.6
Defense expenditure	1.1	1.3	1.4	1.3	1.1	1.1
Capital expenditure and net lending	2.3	1.5	1.6	2.1	1.6	1.6
Gross fiscal deficit (WB defn)	3.3	6.0	6.8	6.6	6.0	5.0
<i>Memo items</i>						
Disinvestment + 3G licenses receipts	0.8	0.0	0.4	0.6	0.3	0.4
Gross fiscal deficit (GoI defn)	2.5	6.0	6.4	6.0	4.7	4.6
Revenue deficit	1.1	4.5	5.2	4.0	3.1	3.4
Primary deficit (WB Defn.)	-0.1	2.6	3.5	2.5	3.1	2.1
Primary deficit (GOI Defn.)	-0.9	2.6	3.1	1.9	1.7	1.6
Central government domestic debt 2/	41.6	44.4	44.3	47.0	41.0	40.2
Central government debt (including external debt) /2	45.9	49.1	48.1	50.9	45.3	44.2
GDP (market prices, y-o-y change in percent)	16.1	12.0	17.3	5.9	13.6	14.0

Source: Ministry of Finance.

1/ Excludes revenues from 3G licenses.

2/ Net of Liabilities under MSS and NSSF not used for financing CG deficit

³ This will measure 4.6 percent of GDP under the government's accounting rules with disinvestment proceeds of 0.4 percent of GDP counted as revenue.

international prices on the subsidy bill. During the first half of FY2011-12, the fiscal deficit reached 62.6 percent of the budget estimate (BE) for the year,⁴ while the fiscal responsibility and budget management guideposts suggest limiting the deficit to 45 percent of the BE. Total revenue for the first half of FY2011-12 increased by 4.5 percent over the first half of FY2010-11 and reached 38.7 percent of the BE, the lowest realization in five years.⁵ Expenditure and net lending increased by 10.4 percent in H1 FY2011-12 against the target of 7 percent in the budget. The current expenditure for the first half of FY2011-12 was 48.1 percent of BE, with expenditures on major subsidies up 22 percent on a cash basis (underrecoveries to oil companies had not been paid), against the budget target of a strong contraction in subsidies. The government submitted two supplementary budgets to parliament for a total of Rs.100bn, out of which Rs.45bn (0.4 percent of GDP) were earmarked for food, fertilizer and petroleum subsidies.

The central government budget for FY 2011-12 had set an ambitious target for fiscal consolidation.

The budget had envisaged high revenue buoyancy and a reduction in the ratio of subsidies to GDP of 0.5 percentage points, or a contraction in the nominal spending amount by 12.5 percent. On the revenue side, the budget estimates were based on the projection of 9 percent growth in real GDP and an inflation rate of 4 percent. The revenue expectations were on the high side without tax policy measures. In fact, some of the tax cuts implemented in the wake of the global financial crisis have not yet been reversed. Despite higher inflation, the tax refunds and moderation in economic growth in the first half of FY2011-12 has made fiscal consolidation challenging. In fact, tax revenue as a ratio to GDP may fall short of the modest improvement seen in FY2010-11 and come closer to the 7 percent ratio in the post-crisis year FY2009-10, while the expenditure ratio will show little improvement.

⁴ Fiscal deficit as defined based on government's accounting rule for first half of FY 2011-12 reached 68 percent of BE. The government counts revenue from disinvestment as 'above the line', rather than as a financing item 'below the line'.

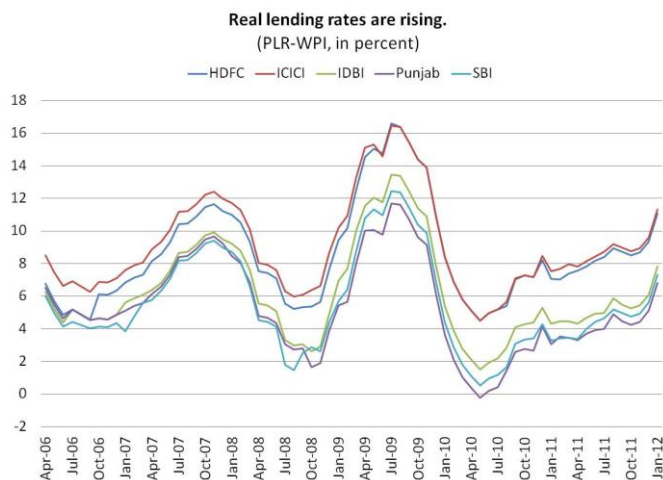
⁵ To compare, we have excluded one-off receipts from 3G licenses from total revenue for the first half of FY2010-11.

Monetary Developments

After raising policy rates 13 times starting in early 2010, the RBI paused and held them steady in the last two reviews in December 2011 and January 2012. In Q3 of FY2011-12, credit growth slowed to under 16 percent, lower than the 17 percent RBI indicative growth rate. And while reserve money growth declined steeply, an increasing money multiplier kept broad money growth relatively stable. The money multiplier increased with a large increase in deposits in the banking system related to the liberalization of interest rates on savings accounts earlier in the year.

While monetary policy was aimed at cooling aggregate demand growth, the RBI injected large amounts of liquidity into the banking system through its overnight borrowing facility. Liquidity injections amounted to Rs.1-1.5 trillion during the second half of 2011, equivalent to \$20-30bn. The banking system has been borrowing from RBI since the beginning of the fiscal year. RBI's foreign exchange interventions during Q3 of FY2011-12 drained some liquidity, but the RBI also purchased government securities to sterilize the interventions. This has effectively transferred a large amount of government borrowing onto the RBI's balance sheet – the macroeconomic equivalent of printing money to finance the government. The RBI prefers the banking system to be short in liquidity to keep overnight interbank rates close to the policy rate and increase monetary policy transmission. Nevertheless, it lowered the statutory cash reserve ratio to 5.5 percent from 6 percent on January 24, 2012, to improve the liquidity situation. The move was too small to have an effect on interbank rates, because banks continued to rely heavily on overnight borrowing from RBI.

Despite policy tightening, real lending rates have been trending up rather slowly. The policy rate increases together with a switch in the interbank call rate from the lower to the upper bound of the RBI's policy rates amounted to 525 basis points (bps). Real lending rates (prime lending rate, PLR, is taken as proxy, although banks lend at lower rates to some customers) reached a low of 0-4.5 percent in April 2010, but rose by about 400 basis points up to October 2011. Since then, falling inflation and continued liquidity constraints led to a sharp rise in real lending rates to 8-11 percent.



II. The Global Economic Environment⁶

In the second half of CY2011, Christine Lagarde of the IMF warned that the global economy had “entered a dangerous phase.” Concerns over fiscal sustainability in some high-income countries, notably in Europe, has led to increased risk aversion around the world, which is visible in falling stock market indices, increased sovereign debt funding costs, and currency depreciation vis-à-vis the US dollar, which is once again the safe haven currency. Hardening credit constraints and risk aversion has transferred financial sector difficulties to the real economy, and economic growth has slowed, including in major emerging markets, most notably in China.

However, the US economy’s recovery from the 2008 global financial crisis looked increasingly robust at end-2011 despite the downgrade of its credit rating by Standard & Poor’s in August of 2011. The world’s investors once again made it clear that the US enjoys an “exorbitant privilege” with issuing the foremost reserve currency, which strengthens whenever there are stability concerns, even if those concerns are triggered from within the US itself.⁷ The downgrade was triggered by the protracted negotiations in the US Congress over an extension of the government borrowing ceiling. Political brinkmanship raised fears of a previously unthinkable US debt default. In late 2011, unemployment in the US was finally showing signs of abating after a long lag from other signs of a strengthening recovery, which turned the US into the only bright(-ish) spot among high-income economies. After the immediate threat of a US default had abated with a last-minute compromise, investors returned their attention to sovereign debt in some EU countries, and a series of emergency summits of EU policy makers have since been held to reassure markets that policies are being put in place to deal with unsustainable debts in some countries, most notably Greece.

For developing countries, the contagion has been broad based. By early January, emerging-market bond spreads had widened by 117 basis points (bps) on average from their end-July levels, and developing-country stock markets had lost around 8.5 percent of their values through a combination of asset repatriation by US and European banks to shore up balance sheets and capital flight to perceived safer options. In addition, the economic slowdown in Europe has translated into lower demand for exports from emerging markets, which has been most strongly felt in highly export dependent East Asia. The asset market corrections around the world have translated into wealth losses of \$6.5 trillion, or 9.5 percent of global GDP.

Amidst this market turmoil, capital flows to developing countries weakened sharply. Investors withdrew substantial sums from developing-country markets in the second half of the year. Overall, emerging-market equity funds concluded 2011 with about \$48 billion in net outflows, compared with a net inflow of \$97 billion in 2010. According to JP Morgan, emerging-market fixed-income inflows did somewhat better, ending the year with inflows of \$44.8 billion — nevertheless well below the \$80 billion of inflows recorded in 2010. In the second half of 2011 gross capital flows to developing countries plunged to \$170 billion, only 55 percent of the \$309 billion received during the corresponding period of 2010. Most of the decline was in bond and equity issuance. Equity issuance plummeted 80 percent to \$25 billion with exceptionally weak flows to China and Brazil accounting for much of the decline. Bond issuance almost halved to \$55 billion, due to a large fall-off in East Asia and Emerging Europe. In contrast, syndicated bank loans held up well, averaging about \$15 billion per month, slightly higher than the \$14.5 billion in flows received during the same period of 2010.

⁶ Prepared on the basis of inputs from DEC Prospects Group.

⁷ The “exorbitant privilege” is a term coined in the 1960s by Valéry Giscard d’Estaing, then the French Minister of Finance, regarding the US’ advantages from issuing reserve currency. Barry Eichengreen’s “Exorbitant Privilege: the Rise and Fall of the Dollar and the Future of the International Monetary System” illuminates the issue.

Reflecting the reversal in bond and equity flows in the second half of the year, developing country currencies weakened sharply. Most depreciated against the US dollar, with major currencies such as the South African rand, Indian rupee, Brazilian real, Turkish lire and Mexican peso having lost 15 percent or more against the dollar since July. Although not entirely unwelcome (many developing-country currencies had appreciated strongly since 2008), the sudden reversal in flows and weakening currencies prompted several countries to intervene by selling off foreign currency reserves in support of their currencies.

Declining commodity prices and inflation are further indicators of the real-side effects of recent turmoil. Commodity prices, which increased significantly during the second half of 2010, stabilized in early 2011 and, except for oil whose price picked up most recently, have declined since the beginning of August. Prices of metals and minerals, historically the most cyclical of commodities, averaged 19 percent lower in December compared with July, while food and energy prices are down 9 and 2 percent, respectively. Despite recent declines, commodity prices remain significantly higher in 2011 than in 2010 (14.4, 29.9 and 23.9 percent higher for the prices of metals and minerals, energy, and food respectively).

Weaker commodity prices have contributed to lower inflation. Partly reflecting the initial stabilization and then decline in commodity prices, but also the slowing in economic activity, headline inflation has eased in most of the developing world (second panel figure 8). The annualized pace of inflation has declined from a peak of 9.0 percent in January 2011, to 6.0 percent during the three months ending November 2011. Domestic food inflation has eased as well from a 15.7 percent annualized rate in February 2011, to about 6.2 percent during the three months ending June 2011.

An uncertain outlook

Overall, global economic conditions are fragile, and there remains great uncertainty as to how markets will evolve over the medium term. The pronounced weakness of growth and the cut-back in capital flows to developing countries will doubtlessly weigh on prospects. Analysts have made downward corrections to their economic growth forecasts, including the World Bank. We now expect the global economy to expand by 2.5 and 3.1 percent in 2012 and 2013 (3.4 and 4 percent when calculated using purchasing power parity weights), versus the 3.6 percent projected in June for both years. High-income country growth is now expected at 1.4 percent in 2012 (-0.3 percent for Euro Area countries, and 2.1 percent for the remainder) and 2 percent in 2013, versus a June forecast of 2.7 and 2.6 percent for 2012 and 2013 respectively. Developing country growth has been revised down to 5.4 and 6 percent versus 6.2 and 6.3 percent in June. Reflecting the growth slowdown, world trade, which expanded by an estimated 6.6 percent in 2011, is expected to grow only 4.7 percent in 2012, before strengthening to 6.8 percent in 2013.

However, even achieving these much weaker outturns is very uncertain. The downturn in Europe and the slow growth in developing countries could reinforce one another more than is anticipated in the baseline scenario, resulting in even weaker outturns and further complicating efforts to restore market confidence. Meanwhile, the medium-term challenge represented by high debts and slow trend growth in other high-income countries has not been resolved and could trigger sudden adverse shocks. Additional risks to the outlook include the possibility that political tensions in the Middle East and North Africa disrupt oil supply, and the possibility of a hard landing in one or more important middle-income countries.

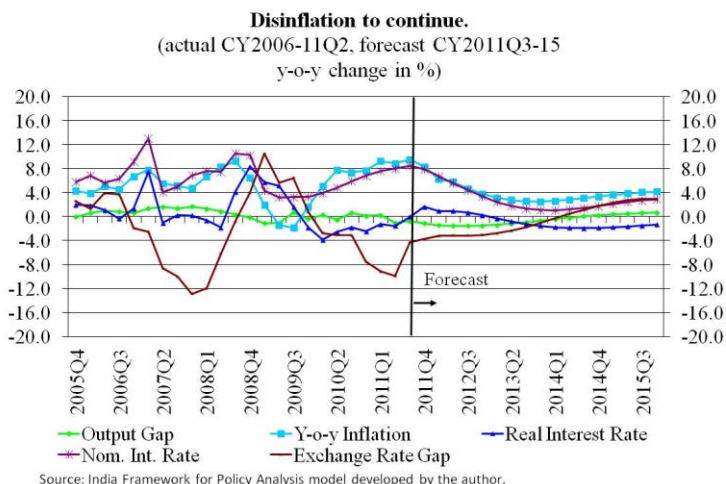
While the situation in high-income Europe is contained for the moment, if the crisis expands and markets deny financing to several additional European economies, outturns could be much worse, with global GDP more than 4 percent lower than in the baseline. Although such a crisis, should it occur, would be centered in Europe, developing countries would feel its effects deeply, with developing country GDP declining by 4.2 percent by 2013. In the event of a major crisis, the downturn may well be

longer than in 2008/09 because high-income countries do not have the fiscal or monetary resources to bail out the banking system or stimulate demand to the same extent as in 2008/09. Although developing countries have some maneuverability on the monetary side, they could be forced to pro-cyclically cut spending – especially if financing for fiscal deficits dries up.

III. India's Outlook

In India, the slowdown in GDP growth witnessed over the last two quarters is likely to extend into the coming fiscal year. In FY2011-12 and FY2012-13, GDP growth is forecast to reach around 7-7.5 percent, a significant slowdown from the 9-10 percent growth in the run-up to the global financial crisis, and the v-shaped recovery from it in FY2009-10 and FY2010-11. The slowdown is caused by structural problems, tighter macroeconomic policies, slow growth in the core OECD countries, and a base effect: growth in FY2010-11 was buoyed by the strong rebound in agriculture, while agricultural growth is expected to revert to trend (2.5 percent) in FY2011-12. Fiscal consolidation and higher interest rates are also likely to have a dampening effect on aggregate demand. The successive interest rate hikes by the RBI and recent decline in inflation have brought the real policy interest rate (nominal policy rate minus WPI y-o-y inflation) into positive territory for the first time since Q2 FY2009-10.⁸ This impacts in particular some long-term investments and demand for housing and consumer durables. Domestic interest rates could have a stronger effect on domestic investment than they hitherto had, because of the lower availability of external loans in the more uncertain international environment.

Disinflation is likely to continue. Lower aggregate demand would result in an output gap opening up, i.e. actual output would fall below potential. This reduction of capacity utilization would mean lower pricing power for companies, and therefore downward pressure on core inflation. However, inflation is unlikely to show a significant decline in the last quarter of FY2011-12 because of built-up momentum (as indicated by seasonally adjusted monthly data) and continuing pressure from energy price increases (already implemented and upcoming) and increases in minimum support prices announced for the upcoming harvest.⁹ The disinflation process should continue until the beginning of FY2013-14, when inflation is projected to fall to 4 percent. The real policy interest rate would again reach negative territory to allow faster growth and re-inflation to the RBI's target rate of around 5 percent. Naturally, the projections do not take into account any possible external shocks, such as a worsening of the situation in Europe into another global financial crisis, or a flaring up of oil prices because of an escalation of tensions in the Strait of Hormuz.



⁸ The real interest rate was negative in 2008 up to the onset of the global financial crisis because of rapidly increasing inflation in line with the global commodity price boom; when Indian inflation dropped rapidly in line with global commodity prices and Indian GDP, the real rate turned positive as RBI's policy rate was lowered with a lag. The medium-term average real interest rate was 1.5-2 percent.

⁹ Price increases in June 2011 for diesel, LPG, and Kerosene amounted to 9, 14.8, and 19.8 percent, respectively.

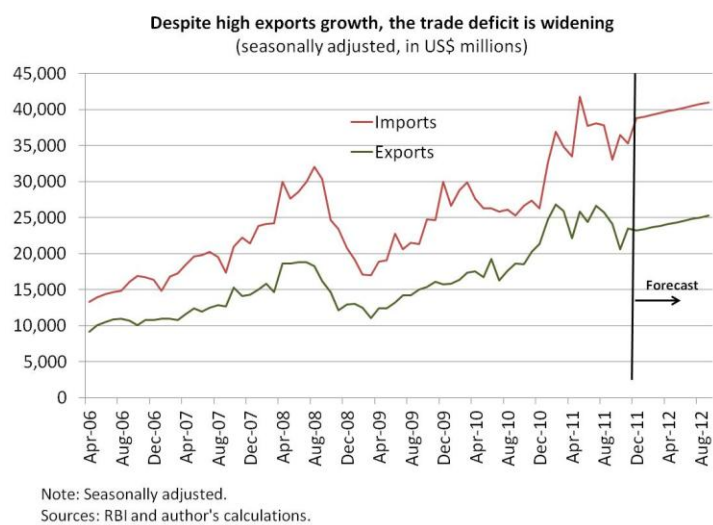
With the slow growth expected in core OECD countries, India's GDP growth will have to rely on domestic growth drivers. The slowdown in investment, capital outflows, and decline in the stock market witnessed in 2011 point to deeper structural problems: banks are highly exposed to power projects facing delays due to the lack of coal and gas feedstock, and to some State Electricity Boards with rising revenue-expenditure imbalances, mining (especially of iron ore) has been hit by recent scandals in Karnataka and Orissa putting the future growth of the steel industry in doubt, and the telecom sector has been hit by the alleged corruption surrounding the granting of licenses in 2008, and recent cancellation of all those licenses by the Supreme Court. Major structural reforms aimed at reducing uncertainties and improving the investment climate would strengthen domestic growth drivers. India's Planning Commission points the way: 'To achieve rapid growth, the economy will have to overcome constraints posed by limited energy supplies, increase in water scarcity, shortages in infrastructure, problems of land acquisition for industrial development and infrastructure, and the complex problem of managing the urban transition associated with rapid growth. Greater efforts also need to be made in agriculture, health and education to ensure inclusion of the most excluded and sometimes invisible parts of our population.'¹⁰

Confidence building measures would include progress on reducing macroeconomic imbalances. Withdrawal of fiscal stimulus is hotly debated in developed countries in light of anaemic growth and a possible 'double dip' recession, with some arguing that continued public sector borrowing crowds out private investment, while others calling for continued support to aggregate demand in light of weaknesses of private demand because of deleveraging. However, the situation presents itself quite differently in India, where growth has been around 7 percent, and supply side problems contributed to high inflation. The case for rationalizing public spending, lowering borrowing, and supporting private investment through lower interest rates and structural reforms aimed at improving the business climate is strong.

Despite moderating domestic demand and relatively level international commodity prices, the current account deficit is likely to expand. While the trade deficit was shrinking at the end of 2010 and beginning of 2011, higher import growth since then is likely to continue. Moreover, as the composition of India's exports is changing towards higher technology content, increasing import content is likely. The trade deficit could reach around \$160 billion in FY2011-12, as compared with \$97 billion in FY2010-11. Growing services surpluses and net transfers should be sufficient to at least partially compensate. The current account deficit is therefore likely to reach around 3 percent of GDP in FY2011-12.

Financing requirements are high, and capital inflows have slowed significantly.

Short-term debt (by residual maturity) stood at \$142bn at end-September 2011, in addition to the current account deficit of around \$60bn. A continuation of capital inflows in line with the first half of FY2011-12 could see a capital account surplus of about equal magnitude, or perhaps a small reserve loss. A shortfall in capital—a drying up of refinancing of short



¹⁰ Planning Commission (2011), Faster, Sustainable, and more Inclusive Growth, An Approach to the 12th Five Year Plan, New Delhi.

term debt, withdrawal of banking capital,¹¹ or additional FII withdrawals from the stock market could see a more disruptive shortfall in the capital account, which would put pressure on the rupee. Under the baseline forecast for the global economic environment of a relatively benign resolution of the recent turmoil, capital inflows could continue and finance the increase in the current account deficit.

Volatility of capital flows is likely to remain high. While FDI held up well during the global crisis, it has since declined. A rebound seemed to be underway in Q1 FY2011-12, but it was not sustained. A rebound also brought significant inflows of portfolio capital in Q1 FY2011-12, but the heightened uncertainty that led to sharp asset price corrections around the world in August 2011 also led to portfolio outflows from India. Going forward, volatility of portfolio flows could be high because of continuing uncertainty about the health of the global economy. Renewed shocks to the global financial system could quickly change investor perceptions and lead to another “flight to safety”. The risk of such shocks occurring is high in light of the unsettled debt issues in some European countries. On the other hand, global liquidity remains unusually high with little prospect of monetary policy tightening in major developed countries in 2012. High liquidity could lead to sudden FII surges in emerging markets. The RBI has demonstrated its ability to react quickly to short-term capital flows and its reserves remain sufficient to prevent unwanted volatility of the rupee.

The downside risks to growth are high because of the risks to global growth from the precarious situation in Europe. A worst-case international scenario would lead to a collapse of demand for India’s exports, and strong contraction in private sector spending. After the Lehman collapse in 2008, higher public sector spending set in at exactly the right time largely because of the implementation of the recommendations of the 6th Pay Commission. The RBI was able to lower policy rates significantly when inflation fell in line with international commodity prices. While a possible renewed crisis would have very different origins from the one in 2008, policymakers would do well to review their preparedness for another global shock and prepare contingency measures. These would involve confidence building measures, such as highlighting the (limited) extent of exposure of Indian banks to global shocks, and ensuring adequate liquidity in the banking system (outside of the usual LAF window if needed). There is much less room for fiscal stimulus now than there was in 2008. However, fiscal stimulus could come from rationalizing government expenditure by expanding investment and cutting subsidies. Investments in infrastructure could alleviate supply bottlenecks and crowd in private investment, with social safety nets cushioning the impact of rising prices. On the monetary policy side, interest rate cuts would be warranted if a global crisis scenario led to a collapse in commodity prices and domestic economic activity, as happened in 2008-09. The flexibility of the exchange rate as a shock absorber, if maintained, would help protect reserves and confidence at the times of outflows, but the competitiveness of India’s exports is also important and it could be maintained with the RBI continuously adding to reserves.¹² In this regard, the depreciation of the rupee in the second half of 2011 was a correction for earlier appreciation, and presented an opportunity to build reserves and maintain a better aligned exchange rate when capital inflows resumed in early 2012. The RBI could usefully look more closely at corporate balance sheets in order to identify which of them would face refinancing difficulties, which in turn could affect domestic loan portfolios, and at requirements at least for trade finance in the event of a standstill in foreign credit.

¹¹ At the peak of the global financial crisis, during Q4 of CY2008, and Q1 and Q2 of CY2010, banking capital outflows amounted to a cumulative \$11bn. Some of that capital has since returned. India’s exposure to European banking capital is estimated at only \$10bn in total.

¹² RBI’s international reserves are just short of \$300bn, almost twice the level of short-term debt (by residual maturity). The RBI has intervened to stem the rupee depreciation with relatively small amounts in the last three months. It tightened regulations for currency forwards, however, to reduce opportunities for speculation. It allowed the rupee to recover ground in January and February 2012, rather than using the opportunity to rebuild reserves and help exports with the more competitive real exchange rate coming from the depreciation.

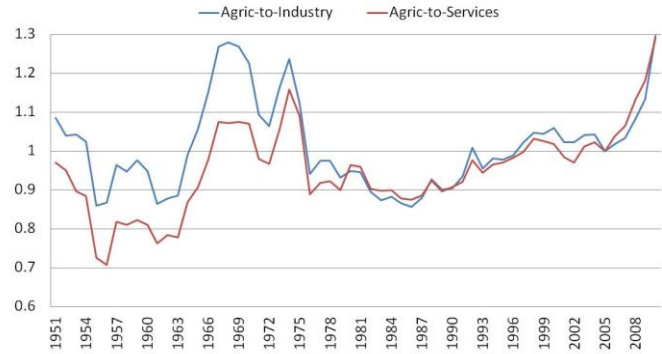
IV. Food Inflation and the Agricultural Supply Chain¹³

Food inflation in India over the last three years was to a large extent due to increases in the prices of perishable goods (fruits and vegetables, milk and milk products). While demand for perishable goods is high, supply is constrained by insufficient market infrastructure. A large proportion of production does not reach consumers because of the lack of roads and cold storage. Traders and middlemen put a wedge between the prices faced by consumers and farmers, and geographical and temporal market segmentations lead to regional and temporal price variability. In fact, the constraints discourage farmers from producing more of these otherwise high-value crops in the first place. Better functioning of markets and availability of marketing channels would therefore greatly increase the supply of perishable items.

This section discusses government policies affecting agriculture and food marketing. The central proposition is that restrictive policies disallow or discourage private investment in agriculture and food marketing, while the public sector interventions are narrowly focused on food grains, of which there is currently an excess of supply over demand leading to a large accumulation of stocks. Reducing the burden of regulation could lead to more private investment to alleviate supply bottlenecks, higher incomes for farmers (who could sell more high-value crops rather than grains), and lower prices for consumers by increasing supply and reducing wastage, and by reducing the role of middlemen. Rules and regulations are arguably a bigger deterrent to private investment than those against Foreign Direct Investment (FDI) in multi-brand retail, which have received much attention recently.

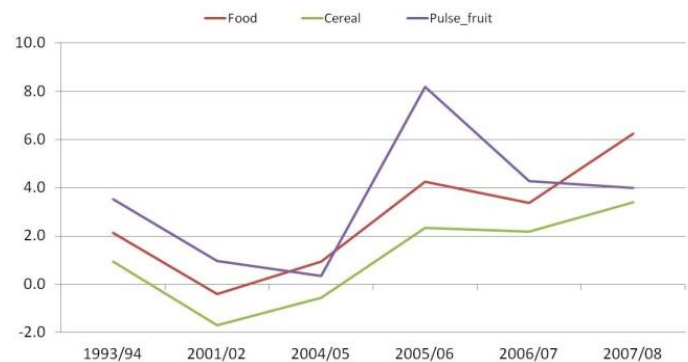
Food prices have risen significantly in relation to prices of non-food articles over more than two decades, but the shift in the domestic terms of trade has accelerated in the last few years. After the rapid advances during the 'Green Revolution' in the 1960s and 1970s, agricultural growth rates have been low and fairly stable, although short-term volatility of agricultural output has been high. The production of cereals and pulses has been increasing by around 2 percent per year since the early 1980s, while the growth in the production of vegetables and fruits has been around 4 percent. With population growth continuing at around 2 percent per year and rising incomes, consumption growth has been accelerating and is now significantly higher than production growth for major food groups. Household surveys suggest that the consumption of food is increasing by around 3 percent per year. Accordingly, the domestic terms of trade have been shifting in favor of agriculture ever since the late 1980s, when the productivity advances of the "Green Revolution" petered out.

The domestic terms of trade shifted in favor of agriculture
(ratios of WPI price indexes)



Source: CEIC.

Demand for non-cereal food items grows faster than that for cereals
(y-o-y changes in percent)



Source: CSO NSS different rounds, author's calculations.

¹³ Prepared with inputs from Baskar Reddy, FICCI, and Madhur Gautam, SASDA.

Demand for food is undergoing structural shifts as incomes rise.

Within the food group, growth in consumption of pulses, fruits, meat, eggs, and dairy items is around 4 percent, while the growth rate in consumption of cereals is around 1.5 percent. While the data from Indian household surveys are highly volatile, they do indicate a gap between accelerating demand and slowing supply growth. Within this overall picture, the demand pressure on cereals is relatively lower as demand is shifting toward a higher-protein diet. However, prices of cereals, high-protein foods, and fruits and vegetables rose more or less in tandem until 2008, when the marked increase in prices of proteins and fruits and vegetables started. Accordingly, higher protein food articles and fruits and vegetables have been the main drivers of food inflation since 2008.¹⁴

Investment in agriculture is low, and private corporate investment is negligible.

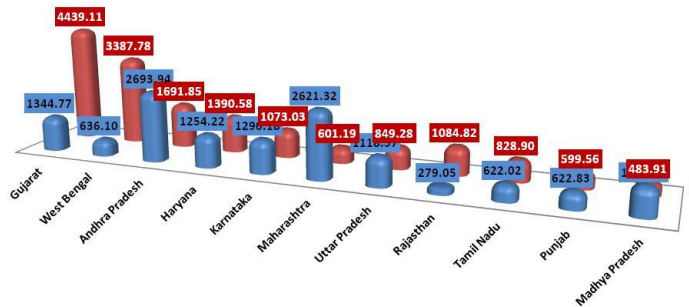
Agricultural investment has increased to about 3 percent of GDP in FY2008-09 and FY2009-10, from 2.6 percent in the five years prior to that. With the falling share of agriculture in overall GDP, this is brought about by a significant increase in investment as a share of agricultural GDP: this climbed to about 20 percent in FY2009-10 from 13.5 percent in FY2004-05. Data for private corporate investment is incomplete. According to the Federation of Indian Chambers of Commerce and Industry (FICCI), 661 projects (completed and under construction) between 1992 and 2012-13 amounted to a total of about Rs.200bn in real terms, a very small amount when looking at average yearly flows.

The government plays an important role in the marketing of food grains and imposes strong restrictions on private-sector storage and trading. The government notifies Minimum Support Prices (MSPs) for 24 food articles on the basis of costs of production, although only wheat, rice, and coarse grains are procured in meaningful quantities by the Food Corporation of India (FCI).¹⁵ Covering sometimes vast distances, the FCI transports grains from surplus to deficit states and releases grains to the Public Distribution

Private corporate investment in agriculture increased marginally

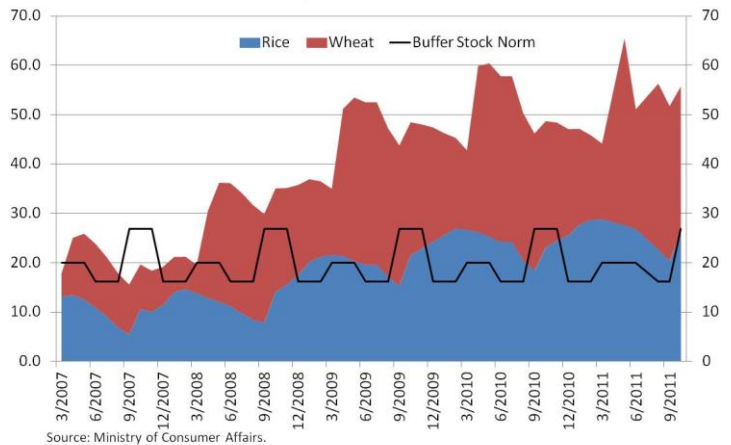
(in crores of rupees)

■ 1992-2002 ■ 2003-2013



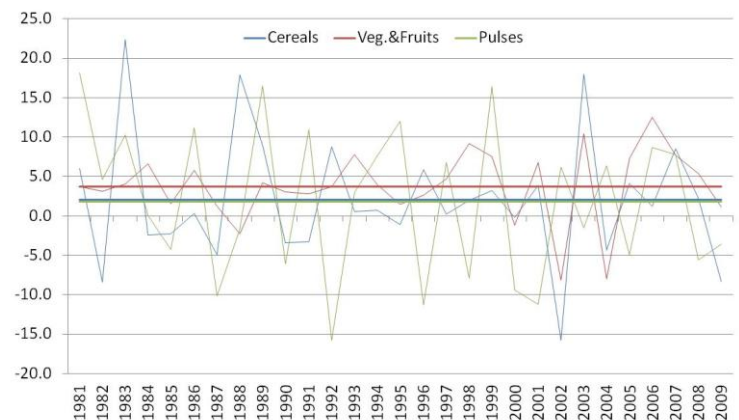
Stocks of rice and wheat exceed buffer norms by a wide margin

(in million tons)



Production growth of major food groups is low.

(y-o-y change in percent)



¹⁴ This is explored in more detail in *South Asia Economic Focus: Food Inflation*, World Bank, 2011.

¹⁵ Purchases are made in bulk only, which excludes marginal and small farmers from the price guarantee offered by FCI.

System (PDS) to be sold at subsidized prices.

The FCI also holds buffer stocks in wheat and rice. It procures about one third of overall production of wheat and rice.¹⁶ The FCI maintains an open procurement policy, which means it buys at the MSPs any quantities of grain being delivered to its procurement centers within a specified time period. The amount of procurement therefore depends on the attractiveness of the MSPs relative to the prevailing market conditions.¹⁷ Record quantities of procurement after the MSP increases in 2008 and 2009 resulted in stocks of 50-60 million tons in 2011, which was more than twice the level the government deems necessary as buffer stocks and far exceeded the FCI's secure storage capacity. The "problem of plenty" of the large accumulation of stocks is not new: in 2002, stocks had reached 60 million tons under similar circumstances.

Partly because of the need to procure adequate quantities for the PDS, the private sector faces many restrictions in agricultural marketing. State-level Agricultural Produce Market Regulation Acts (commonly known as APMC Acts) adopted in the 1960s and 1970s regulate the buying and selling of agricultural products in India's states. Through the Acts, states have established Agricultural Marketing Commissions, which operate more than 7,000 wholesale markets (also known as *mandis*), and regulate all aspects of marketing, including the levy of a user fee, or cess. The APMC Acts mandate *mandis* as the only places for the trading of agricultural produce. A limited number of licenses issued to traders and commission agents restrict the choice of sellers and buyers. This stifles competition, and generates economic rents for license holders. It also leads to under-investment in physical infrastructure and, ultimately, lowers the prices received by farmers and increases the prices paid by consumers.

Reforms of the basic legislation were proposed by the central government in 2003. Recognizing the "malfunctioning of regulated markets" and the "need for more transparency and accountability in the functioning of these markets",¹⁸ the Government of India (GoI) proposed that states adopt reforms along the lines of a model APMC Act. The model act provides for, among others, establishment of private markets, direct purchase centers, farmer markets for direct sale, contract farming, electronic trading, and promotion of public-private partnerships in the management and development of agricultural markets in the country. Most states have amended their APMC Acts or changed various provisions since then. However, progress in modifying legislation has been uneven; as the GoI noted last year, "the manner of implementation in most states reveals serious weaknesses which discourage the entrance of new players".¹⁹

The model APMC Acts gives significant opportunities to the private sector. It enables any person, grower or local authority to establish new markets in any area, removes compulsion on growers to sell their produce through existing regulated markets, allows establishment of direct purchase centers and farmers markets for direct sale, promotes public-private partnerships in management and development of markets, and establishes special markets for commodities like onions, fruits and vegetables, flowers, etc. In order to support contract farming arrangements, model specifications and supporting legislation requiring amendment to the state APMC Acts have been formulated. The model act also limits the collection of market fees, which in many states are collected at multiple points with a cascading effect on prices.

¹⁶ Procurement by the FCI absorbed 57 million tons and 55 million tons of mainly rice and wheat in fiscal 2009 and 2010. Procurement of other crops is limited and may not influence prices as much.

¹⁷ This is true to the extent that farmers are able to decide whether to sell to the FCI or private traders, a choice which is not always available because of crowding out of the private sector.

¹⁸ GoI, 2007: "Report of the Steering Committee of Agriculture and Allied Sectors for the Formulation of the Eleventh Five Year Plan 2007-2012."

¹⁹ GoI 2010: "Mid-Term Appraisal for Eleventh Five Year Plan 2007-2012", Planning Commission, New Delhi.

Although most of India's states have amended their APMC Acts since 2003, only a few have followed the true spirit of the model act. While the reforms differ greatly between states, Bihar has gone to one extreme and completely repealed the Act, while Kerala did not have an APMC. Details are shown in the table below.

Status of APMC Reforms in Various States

Reforms for direct marketing, contract farming and markets in private and cooperative sectors	Andhra Pradesh, Arunachal Pradesh, Assam, Chhattisgarh, Goa, Gujarat, Himachal Pradesh, Jharkhand, Karnataka, Madhya Pradesh, Maharashtra, Mizoram, Nagaland, Orissa, Rajasthan, Sikkim, Uttarakhand, and Tripura
Partial reforms	Direct Marketing: NCT of Delhi Contract Farming: Haryana, Punjab and Chandigarh Private Markets: Punjab and Chandigarh
No APMC Act	Bihar, ²⁰ Kerala, Manipur, Andaman & Nicobar Islands, Dadra & Nagar Haveli, Daman & Diu and Lakshadweep
APMC Act already provided elements of the model act	Tamil Nadu
Reforms under preparation	Meghalaya, Haryana, J&K, West Bengal, Pondicherry, NCT of Delhi and Uttar Pradesh

Even in states which have made significant APMC reforms, such as Maharashtra, Karnataka and Andhra Pradesh, private sector enthusiasm for investing in marketing is lacking. Some of the reasons are described below.

- **Restrictive implementing rules and regulations continue to impede private sector activity.** For example, in UP the APMC license issued to ITC to buy through electronic trading and delivery to its own centers (e-Choupals) is valid for one year. In both 2008 and 2009, the license renewals were issued only after the peak wheat marketing season was over, making it redundant. In Madhya Pradesh, there is a stipulation that the buying point cannot be inside a factory, which leads to increased transaction costs and doesn't serve the very purpose for which buying points are set up. In Rajasthan, buying points have to be far away from existing *mandis*, which means they are far out of towns, making farmers markets and ITC's *Choupal Saagar* unviable.²¹
- **The reformed APMC Acts allow private operators to set up markets only with a hub-and-spoke procurement system, with at least 20 decentralized collection points for each market.** For example, Premium Farm Fresh Private Limited (PFFPL) has 6 licenses in Gujarat for establishing private markets. Each market will have a minimum of 20 collection centers, making a total of 120 for the 6 markets spread over the entire state. However, it has so far managed to set up only one market and collection centers, which required applying separately for each collection center, acquiring land, effecting a land-use change, etc. In the case of Maharashtra, a provision for a single unified license exists for traders but not for the private market authorities.

²⁰ APMC Act has been abolished.

²¹ ITC has set up a number of purchase-cum-retail centers called Choupal Saagar, which procure agricultural produce as well as offer extension services to farmers, and sell to the public in the same places.

- **Strict rules limit the profitability of private markets.** PFFPL faces restrictions on the built-up area on the land it purchases, and restrictions on how much land can be devoted to ‘non-core’ activities as defined by the regulator. This limits services normally associated with markets, such as porter services, logistics centers, and tea stalls, which could contribute significantly to the profitability and attractiveness of the market.
- **Licenses in production and consumption centers are treated differently.** While most of the states in which APMC Acts have been amended to attract private investment are production centers for fruits and vegetables, amendments have not taken place in consumption centers such as Delhi, Kolkata, Chennai, Mumbai and Bangalore. In these major consumption centers, licenses to wholesale or retail marketing are not available. Therefore, a private investor cannot benefit from price arbitrage, for example by purchasing onions during harvest time, storing them in a warehouse and selling them in Delhi and Kolkata when prices are high. The lack of reforms in major consumption centers prevents companies from entering the market in major production centers, such as Maharashtra and Gujarat.
- **The Essential Commodities Act hampers private activity.** The Act dates back to 1955 and continues to regulate trade in certain commodities, including major foods. In an effort to remove restrictions on storage and movement of agricultural goods, amendments to the Act were made in 2002 and 2003 to allow dealers to freely buy, stock, sell, transport, and distribute any quantity in respect of specified foodstuffs. However, in the wake of rising wheat prices in 2006, the government suspended some of the amendments, and has again issued stock control orders restricting storage of agricultural produce.
- **Stock control orders have been issued for commodities such as pulses, edible oils, edible oilseeds, rice, paddy, wheat and sugar.** These stock orders are mostly ad hoc in nature and come into immediate effect from the date of notification. As a result of a stock control being imposed, procurement plans go haywire and the flow of raw materials to their processing units is disrupted. For instance, a stock control order issued in February 2010 limited the storage of sugar to cover not more than 10 days average consumption of industrial units. Companies therefore had to dispose of sugar they already had in their warehouses in order to comply with the stock control order, and had to change their supply chain to function with the limited storage policy. The uncertainty coming from ad hoc re-regulation deters the private sector from making new investments.
- **Export Restrictions.** The government resorts to banning agricultural exports in the event of a sudden rise in domestic prices, in a similar ad hoc fashion as it limits storage. Export bans usually allow the execution of existing delivery contracts, thereby avoiding serious immediate consequences for traders under contractual obligations, but they nevertheless have serious ramifications because of the need to build and maintain relations with international clients. Companies exporting even niche commodities such as Basmati rice have been affected by the government’s decision to either ban exports or increase minimum export prices (MEP). Not only are export companies affected by these bans, but also farmers, as domestic prices crash following the bans. Bureaucratic and political processes also mean that export bans are sometimes imposed in an untimely fashion, i.e. the government reacts long after domestic prices have peaked because of low supplies, which exacerbates the seasonality of prices when new supplies arrive in the markets. The recent ban on exports of onions (9th September 2011) and lifting of the export ban (20th September, 2011), all within a period of 11 days, is a case in point and shows the ad hoc nature of government decisions.

The current system shows considerable resilience because it provides ample room for political patronage. Market fees in the *mandis* contribute funds which go far beyond paying for the market infrastructure. The fees have become an important source of financing of rural infrastructure. *Mandi* officials are able to provide patronage by influencing for example road building and electrification. The

FCI's procurement is concentrated on a few states, while farmers are left to the vagaries of the market in others, including eastern UP, Bihar and MP. As a result, private brokers purchase wheat and rice from smallholder farmers against immediate cash payment at a price lower than MSPs and sell to FCI in the neighbouring states at MSP, where transporting grain across state borders is allowed—for example, buying in eastern UP where the FCI is not generally present and selling in western UP, Punjab or Haryana is legal, whereas buying rice in Andhra Pradesh and selling in Tamil Nadu is not. The FCI also specifies minimum lot size for its procurement, and private brokers purchase wheat and rice from smallholder farmers at a discount from the MSPs for aggregation and delivery to the FCI's collection centers. Farmers in some states therefore receive market prices which are often below MSPs, and the funds of the FCI – coming out of central government food subsidies – enrich middlemen. There is a strong nexus of alliances between middlemen, and *mandis*, both the licensed traders and officials. Farmers also face a limited number of traders, non-transparent grading and weighing systems, and arbitrary deductions from prices in non-MSP commodities.²²

Recent Notifications regarding Export Bans in Agriculture Commodities

Wheat		
8.10.2007	Ban on export of wheat	33/2007, 08/10/2007
09.09.2011	Removal of ban on export of wheat.	72(RE-2010)/2009-14
RICE		
15.02.2007	Ban on export of Non basmati Rice	38(RE- 2007)2004-09
09.09.2011	Removal of ban on export of non-Basmati rice.	71(RE-2010)/2009-14
Onion		
22.12.2010	Ban on export	13(RE-2010)/2009-14
18.02.2011	Removal of ban on export of Onions.	24(RE-2010)/2009-14
09.09.2011	Ban on export of Onions	73(RE-2010)/2009-14
20.09.2011	Removal of ban on export of Onions.	75(RE-2010)/2009-14
Cotton		
22.12.2010	The export of cotton yarn has been restricted and export permitted under licence	No. 14(RE-2010)
31.03.2011	The export of cotton yarn was earlier “Restricted” with export allowed against licence. Now, the export of cotton yarn is “Free”	40 (RE-2010)/2009-14
09.06.2011	Quantity restriction of 65 lakh bales on export of cotton during Cotton Season, 2010-11	57(RE-2010)/2009-14
01.07.2011	Exemption for export of cotton waste including yarn waste and garneted stock [ITC (HS) Code 5202] from the quantity restriction on export of cotton during Cotton Season, 2010-11.	58(RE-2010)/2009-14
Sugar		
03.6.2011	Exemption for export of organic sugar	52 (RE-2010)/2009-14
04.7.2006	Govt prohibits exports of sugar till end of fiscal	18/2006
18.1.2007	lifted the ban imposed on export of sugar	

The support extended by state governments to farmers is a key factor in the private sector investment decisions. By way of example, subsidies for power for irrigation pumps are near universal, but states differ greatly in the way they provide this. Many of the states have taken the populist step of providing free electricity to farmers, but supply is limited to a few hours a day, and voltage fluctuations lead to high maintenance costs. In contrast, Gujarat and West Bengal charge for electricity delivered to

²² Report of the working group on agricultural marketing infrastructure and policy required for internal and external trade for the XI Five Year Plan 2007-12, Planning Commission, January 2007.

farmers, with dedicated, metered supply lines separate from supplies to residential areas. The added revenue and ability to identify distribution losses because all supplies are metered has enabled the state electricity boards to provide regular and quality power for more than 8 hours daily to farmers. Similarly, the way the drip irrigation subsidy is administered in Gujarat or farm machinery subsidies are delivered in Bihar is more farmer friendly compared to what is done in other states.

States provide a bewildering number of incentives for agro-industries, as shown in the table below.

Agro-Industrial Policies of Various States

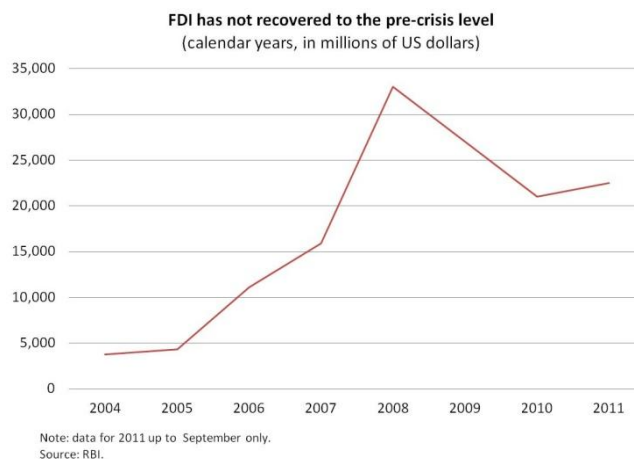
Andhra Pradesh (Source: Food Processing Policy)	<p>Reimbursement of Power at Rs.1 per unit to food processing units.</p> <p>25% cost reimbursement for infrastructure (power, water, approach roads); limited to Rs. 20 million.</p> <p>Tax reimbursement for Mega Food Parks during start-up for a period of 2 years limited to Rs.20 million.</p> <p>Food processing units also eligible for benefits under the Industrial Investment Promotion Policy 2010-2015.</p>
Bihar (Source: Industrial Policy)	<p>Exemption from stamp duty and registration fees on land for the first transaction.</p> <p>80% reimbursement of VAT for a period of ten years; ceiling for reimbursement 300% of the capital invested.</p> <p>New MSME industrial units granted 20% capital subsidy limited to Rs. 750,000.</p> <p>New large industrial units granted 20% capital subsidy limited to Rs. 50 million.</p> <p>New industrial units exempted from luxury tax for seven years.</p> <p>Re-imburement of electricity duty for seven years.</p> <p>Exemption from land conversion charge.</p> <p>Re-imburement of 25% of VAT and entry tax for existing units.</p> <p>For SPV grant up to 40% of the project cost, subject to limit of Rs. 100 million for common cluster infrastructure and up to 35% of the project cost subject to limit of Rs 50 million for individual investor.</p>
Chattisgarh (Source: Industrial Policy)	<p>Interest Subsidy at 75% of total interest paid up to 7 years, limit Rs.1 million p.a.</p> <p>Fixed capital investment subsidy at 25% of total capital cost, maximum Rs.3.5 million.</p> <p>Electricity duty exemption for 15 years from the date of commencement of commercial production.</p> <p>Exemption from entry tax for a period of 9 years, 50% exemption from land premium allotted in industrial areas.</p> <p>Subsidy of 50% of expenses incurred for preparation of project report. Limit Rs.200,000.</p> <p>Subsidy of 40% of interest paid for technology for a period of 5 years, limit Rs.2.5 million p. a.</p> <p>Quality certification subsidy of 50% to all new industries established, limit Rs.75,000.</p>
Gujarat (Source: Agro Industrial Policy)	<p>Interest subsidy for agro-infrastructure of 6% for first 5 years, from commencement, limit Rs. 40 million.</p> <p>Provision of government land on long-lease basis at reasonable rates.</p> <p>Reimbursement of 50% of the cost of project report for new agro-industrial units, limit Rs.500,000.</p> <p>Support for setting up of center of excellence, specific crop development institute: land will be provided at concessional rate and 50% initial seed capital matching the industry contribution within a ceiling of Rs.50 million.</p> <p>Exports: (a) Air Freight Subsidy of 25% for specified produce, limit Rs.1 million per beneficiary per year.</p> <p>Subsidy for sending samples, marketing abroad, limit Rs. 50,000 per beneficiary, not to exceed 50% of the costs.</p> <p>50% subsidy for sponsored research work up, limit Rs.2 million.</p>
Haryana (Source: Food	<p>Interest Free Loan at 75% of the tax paid on the sale of goods produced for a period of 5 years from start-up, repayable after 5 years.</p>

Processing Policy)	Exemption from electricity duty for 5 years for start-up. Change of land use charges levied at 50% of normal rates. 50% concession on the stamp duty for land purchase. No market fee charged on vegetables and fruits grown in the state. Excise duty exemption on alcohol made from fruits and barley.
Jammu and Kashmir (Source: Industrial Policy)	75% subsidy for tube well, limit of Rs. 2.25 million. Up to Rs. 200,000 subsidy for pre-investment studies and feasibility reports. Exemption from stamp duty. Exemption from central sales tax on sale of finished goods outside the state. Interest subsidy of 3% on working capital. 100% Capital subsidy on testing equipment, limit Rs. 2.5 million. Air freight subsidy of 50% on finished goods and raw materials limit Rs. 500,000 per year per unit. Up to Rs. 40 million subsidy on agro-based projects. Research and Development subsidy of 50%, limit Rs. 500,000.

V. Trends in Foreign Direct Investment

Foreign Direct Investment in India faced an unexpected decline in FY2010-11 when inflows in other countries recovered strongly from the slump in the wake of the global financial crisis. We show a few salient facts about FDI inflows in India, and explore possible reasons for the slowdown.

FDI inflows have increased substantially in the wake of liberalization of the investment rules in the early 1990s. Starting from a low of \$1.66bn at the end of 1990, the stock of FDI jumped to \$17.5bn by the end of 2000, doubled in the period 2000-04, and more than quadrupled during 2004-10.²³ However, after a high of 3.2 percent of GDP in 2008, FDI inflows in 2009 declined in India as well as in other large emerging markets. In 2010, when FDI into other developing countries recovered with a nearly 10 percent increase, inflows into India declined further by some 32 percent in U.S. dollar terms to reach about 1.5 percent of GDP, the lowest since 2005. FDI has recovered somewhat in 2011 on the basis of some large deals. On a sectoral basis, FDI in services (which accounts for around 20 percent of total FDI) was down sharply in 2010, but FDI in manufacturing appears to have held up better. As in other countries, mergers and acquisitions rose, while greenfield investments fell. In 2011, the most visible M&A deal was the \$3.7bn acquisition of Piramal Healthcare by US-based Abbott Laboratories.



Outward FDI from India has been on the rise, reflecting the global ambitions of Indian companies and improving economic conditions in several markets. Two recent examples are Bharti Airtel's \$10.7bn acquisition of the telecoms giant Zain Africa BV, and the \$4.8bn petroleum and natural gas investment in Venezuela's Carabobo Block by a syndicate of Indian investors. However, it should be noted that outward FDI is financed abroad to a large extent and is therefore not captured as capital outflow in India's Balance of Payments.

	FDI by sector (shares in percent)				
	2007	2008	2009	2010	2011 (Jan- Sep)
Services (Financial & Non financial)	21.68	24.35	21.17	17.54	16.84
Construction Activities	7.96	7.52	9.09	7.43	4.70
Housing and Real Estates	9.45	8.11	11.83	7.07	2.48
Telecommunications	6.72	7.80	9.46	7.25	9.94
Power	1.59	4.05	6.08	5.75	6.74
Metallurgical Industries	3.19	4.61	1.74	4.98	6.80
Computer Software and Hardware	15.18	5.53	2.65	4.73	2.42
Automobile Industry	2.31	3.43	4.95	6.06	3.47
Industrial Machinery	0.14	0.47	0.72	3.40	1.71
Petroleum and Natural Gas	2.19	4.14	1.38	2.82	0.70
Mining	2.64	0.13	0.63	0.47	0.60
Drugs and Pharmaceuticals	1.76	0.80	0.76	1.04	13.82
Chemicals (excluding fertilizers)	1.56	1.82	1.67	2.14	2.58

Source: CEIC database

²³ UNCTAD, World Investment data.

The geographical spread of source countries for FDI in India is heavily skewed by tax rules. Mauritius has the highest share in total FDI inflows in India because of the Double Taxation Avoidance Treaty (DTAA) between the two countries. Apart from Mauritius, Singapore, and Cyprus have similar tax status, and they figure prominently on the list of source countries. FDI from Mauritius and Singapore recorded the largest decline in 2010, with inflows falling by 37 and 27 percent from 2009, respectively.²⁴ FDI from the US, Germany, and Cyprus also saw declines, while FDI from European countries increased

Major Source Countries for FDI Inflows (in percent, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2011 (Jan-Sep)
Mauritius	26.7	48.5	43.9	40.3	42.8	42.7	34.3	34.2
Singapore	1.7	7.4	5.6	7.6	11.4	11.3	10.1	15.4
U.S.A	17.3	10.8	6.6	4.6	5.4	7.6	6.7	3.0
Japan	3.1	3.9	1.0	3.5	1.2	4.7	6.2	9.7
Netherlands	13.2	2.7	4.5	3.6	3.0	3.1	5.5	4.5
Cyprus	0.1	1.6	0.5	2.8	4.0	6.0	4.4	4.0
Switzerland	1.8	1.9	0.6	1.1	0.4	0.5	4.2	0.8
UK	3.8	5.0	15.7	2.5	5.1	1.7	3.6	12.5
France	3.1	0.7	0.8	0.7	1.4	1.1	3.6	2.0
Germany	4.2	1.9	2.8	1.8	2.4	2.2	0.9	6.2
UAE	0.8	1.1	2.2	1.1	0.9	2.3	1.7	0.7
Total (US\$bn)	3.8	4.4	11.1	19.2	33.0	27.0	21.0	22.5

Source: CEIC database, DIPP

Private equity/venture capital and hedge funds (PE/VC/HF) seem to be disproportionately choosing tax haven jurisdictions for their incorporation. PE/VC/HF mostly enter India from tax haven jurisdictions. From there, they have invested in telecom, information technology, construction, and real estate. Inflows from PE/VC/HF stagnated around \$4bn during 2009 and 2010, about half the level of inflows India received in 2007-08.

A recent study estimates that about 20 percent of FDI inflows in 2009 were round tripped, i.e. they actually originated in India—a steep rise from low single-digit percentages five years ago.²⁵ The study tracked close to 3,000 individual FDI transactions into India comprising about 88 percent of the total inflows for the five year period 2005-2009. The authors estimate the extent of round-tripping by counting investments by individuals or

FDI Inflows by Categories of Investors
(in millions of U.S. dollars)

	2005	2006	2007	2008	2009
FDI	2,482	6,184	5,962	12,526	11,154
PE/VC/HF	540	2,056	4,947	6,959	3,796
Portfolio	209	625	785	3,738	2,093
NRI	17	536	770	2,167	706
Round-tripping	47	126	1,304	3,443	3,400
of which: round tripped PE/VC/HF	65	276	409	1,115	1,387
Unclassified	24	17	8	50	228
Total	3,384	9,820	14,185	29,998	22,764

Note: PE/VC/HF stands for private equity, venture capital and hedge funds.

Source: Rao and Dhar (2011).

companies with main bases in India and which have expanded out of India. They estimate that 23 percent of the total FDI inflows analyzed were inflows from PE/VC/HF, and close to half of their investments involved round-tripping. According to these estimates, round-tripping increased to about \$4.8bn in 2009 from \$4.5bn in 2008 in an environment in which overall inflows fell. Round-tripping increased rapidly in the last few years from 2-4 percent of inflows in the period 2004-06.

Possible explanations for the decline in FDI in 2010 are the sluggish growth in developed countries, a change in enforcement of environmental legislation in India, a clamp down on tax evasion and corruption, and general concerns regarding the prospects of the Indian economy. While hard data to support each of these possible factors is not available, some detail on each of them may be illustrative.

²⁴ Data for Jan. – Nov. 2010 was extrapolated to compare with full-year data for 2009.

²⁵ Rao, K.S., and Biswajit Dhar (2011), 'India's FDI Inflows : Trends & Concepts', Working Paper, Institute for Studies in Industrial Development, New Delhi.

- The growth of exports of software and business process services was sluggish in 2010, owing to weak demand in advanced economies (the main destination for these exports). Investors may thus be in a “wait and see” mode until there is more certainty on the outlook for service sector exports. Sectors whose output is destined for the domestic market (automobiles, power, petroleum, metallurgical industries) have seen continued strong inflows.
- Recently increased scrutiny by the Ministry of Environment and Forests of environmental safeguards has delayed some investment projects, but there is no apparent change in rules and regulation which could have a long-lasting impact on these projects. Some projects that appeared to have had all necessary clearances were halted, some stopped altogether. Most notably, decisions include the cancellation of an alumina refinery in Orissa’s Kalahandi District and a bauxite mine in the Niyamgiri Hills, the scrapping of three hydro-electric projects in the Bhagirathi basin, the withholding of environmental clearance to any other hydro-electric project planned in the Bhagirathi and Alaknanda basins (tributaries of the Ganges). Delays of a more temporary nature seem to have hit the Korean steel venture POSCO, the construction of the new city of Lavasa in Maharashtra, and licenses for coal mining.
- Foreign investors may have been cautioned by recent scandals around the auction of the 2G wireless spectrum, widespread media coverage of alleged cases of corruption, and an enhanced scrutiny of off-shore bank accounts and investments from tax havens. Income tax officials have been deputed to Mauritius, for example, to intensify checks on FDI coming from there, especially into India’s real estate sector.
- Some analysts also cite concerns about high inflation, and large fiscal deficits which constrain fiscal space to deal with the economic slowdown.

Table 1: India: Selected Economic Indicators

	2008/09	2009/10	2010/11	2011/12	2012/13
			Est	Proj.	Proj.
Real GDP (at factor cost)	6.7	8.4	8.4	6.9	7.5
Agriculture	0.1	1.0	7.0	2.5	3.0
Industry	4.4	8.4	7.2	3.9	6.0
<i>Of which:</i> Manufacturing	4.3	9.7	7.6	3.9	6.0
Services	10.0	10.5	9.3	9.4	9.2
Prices (average)					
Wholesale Price Index	8.1	3.1	9.6	8.7	6.0
Consumer Price Index	9.1	12.3	10.5
GDP Deflator	8.7	6.0	8.5	8.7	6.0
Consumption, Investment and Savings (% of GDP)					
Consumption	70.8	71.1	70.4	72.0	70.4
Public	10.9	12.0	11.9	12.1	12.6
Private	59.9	59.1	58.6	59.9	57.8
Investment	34.2	34.3	33.7	33.7	35.3
Public	9.4	9.2	8.8	9.0	9.2
Private	24.8	25.2	24.9	24.8	26.1
Gross National Savings	35.2	37.2	34.9	34.4	35.3
Public	1.0	0.2	1.7	3.3	5.0
Private	34.2	37.0	33.2	31.1	30.3
External Sector					
Total Exports (% change in current US)	15.0	-5.8	37.6	23.5	16.1
Goods	13.7	-3.6	37.4	29.9	19.6
Services	17.3	-9.6	37.8	11.4	8.3
Total Imports (% change in current US)	16.6	0.0	29.0	23.9	16.8
Goods	19.8	-2.6	26.7	25.2	17.1
Services	1.1	15.3	40.4	17.7	15.5
Current Account Balance (% of GDP)	-2.3	-2.8	-2.6	-2.5	-2.9
Foreign Investment (US billion)	5.8	51.2	37.4	35.0	60.0
Direct Investment, net	19.8	18.8	7.1	25.0	28.0
Portfolio Investment, net	-14.0	32.4	30.3	10.0	32.0
Foreign Exchange Reserves (US billion) 1/	241.4	254.7	274.3	269.3	309.4
General Government Finances (% of GDP)					
Revenue	19.4	18.4	20.4	19.8	20.1
Expenditure	27.8	28.5	29.1	27.9	26.8
Deficit	8.4	10.1	8.7	8.0	6.7
Total Debt	74.8	74.5	69.7	61.1	60.2
Domestic	70.1	70.3	65.9	57.1	56.5
External	4.7	4.1	3.8	4.0	3.7
Monetary Sector (% change)					
Money Supply (M3)	19.1	17.1	16.0	14.3	18.9
Domestic Credit	23.4	24.5	19.9	14.8	16.6
Bank Credit to Government	42.0	29.1	18.5	14.7	12.1
Bank Credit to Commercial Sector	16.9	22.5	20.6	14.8	18.5
Velocity	1.2	1.2	1.2	1.2	1.2

Note: 1/ Excluding gold, SDRs, and Reserve Tranche Positions in the IMF.

Sources: Central Statistical Organization, Reserve Bank of India, and World Bank Staff Estimates.