CHAPTER I

THE ECONOMIC SITUATION IN 1988-89

The economy has shown a strong recovery in agricultural production and sustained the momentum of industrial growth in 1988-89. This is reflected in an expected GDP growth rate of 9 per cent. This performance has to be seen in the context of severe drought in the preceding year. These two years have demonstrated certain basic strengths in the economy. The first is the resilience of the economy in the face of severe weather stress and the second is the sustained growth performance in the sphere of industry and infrastructure. These strengths are reflected in the fact that in both years growth performance has been significantly higher than in earlier drought and post-drought years. Inflation rates, as measured by the WPI, are also significantly lower than in most earlier episodes of drought. The sources of strength lie in the capacities built up over the four decades of planned development, recent policy changes directed at improvements in capacity utilisation and efficiency, the ability of development administration to respond to emergencies and prudent management of the food economy. At the same time the performance of the economy in these two years has highlighted the need for more effective action to tackle the linked problems of the balance of payments deficit and budgetary imbalances.

1.2 Droughts like that of 1987-88 usually lead to a steep fall in both agricultural and industrial production, large scale distress in rural areas, very high rates of inflation and the erosion of purchasing power. Inspite of the severity of the drought, however, Government policy succeeded in limiting the fall in agricultural production to only about two per cent last year. Industrial production remained buoyant and grew at 7.5 per cent. As a consequence real GNP recorded an increase of 3.6 per cent. The overall inflation rate was contained at 10.6 percent. The setback in economic performance was limited partly because of long term structural changes which have now made the economy less sensitive to vagaries of the weather and partly thanks to the comprehensive and timely policy measure introduced by the Government. These ranged from accelerated irrigation and other input delivery programmes in agriculture for optimising Rabi production to large scale supply management operations in critical commodities like foodgrains, relief programmes to arrest the loss of rural incomes and aggregate demand management measures. The latter were aimed at financing the huge expenditure on drought relief without either introducing undue cuts in real plan expenditure or allowing the budget deficit to grow beyond projected levels.

1.3 These measures made it possible for the economy to make a quick recovery. In 1988-89 both agriculture and manufacturing are expected to register high rates of growth, while most of the key infrastructure sectors have continued to perform well. The Wholesale Price Index (WPI) annual inflation rate has also come down from over 10 per cent at the end of March 1988 to less than 5 per cent in January 1989 on a point to point basis. The inflation rate in terms of the Consumer Price Index (CPI) had come down from around 10 per cent at the end of March 1988 to around 8 per cent by September 1988. Subsequently, the dislocation of food supplies following floods in Punjab and Haryana led to a spurt in prices, with the result that the CPI inflation rate rose sharply in October and November. By December 1988, the latest month for which data is so far available, the CPI inflation rate had again started declining with the correction in market expectations. It is expected to fall further, following with a lag the WPI inflation rate, which had also risen sharply in October 1988 and has continued to decline thereafter.

1.4 The major challenges of economic management this year have come from a difficult balance of payments situation and the continuing strain on public finance. On the external payments front the effect of several adverse medium term factors has been aggravated during the current year by the surge in imports. Apart from the spillover of additional imports necessitated by last year's drought, the sharp increase in imports also reflects buoyant demand conditions arising from the strong economic recovery this year and the steep rise in several critical international commodity prices. On the resources front, the challenge has been one of adequately financing plan expenditure in a non-inflationary manner, in order to maintain the momentum of economic recovery, while at the same time accommodating the increase in major items of non-plan expenditure such as interest payments, subsidies and defence expenditure.

Gross National Product, Savings and Investment

1.5 The Quick Estimates of national income aggregates recently released by the Central Statistical Organisation indicate that the Gross National Product at constant factor prices increased by 3.6 per cent in 1987-88. This is only marginally lower than the growth of 3.8 per cent recorded in 1986-87 and rather remarkable in view of the adverse conditions experienced last year. Agriculture and allied activities recorded a decline of only one per cent in gross value added, though the fall in production volume was larger. The other sectors of the economy also experienced only a mild deceleration in rates of growth of value added compared to the previous year. Manufacturing recorded a growth rate of 7.4 per cent in 1987-88 as against 9.2 per cent in 1986-87; electricity, gas and water supply grew at 7.7 per cent compared to 10.1 per cent a year ago and transport, storage and communications registered a growth rate of 5.8 per cent as against 6.8 per cent in 1986-87.

1.6 A more disquieting feature is the decline in the rate of domestic savings which, as a proportion of GDP (new series), declined from 21.6 per cent in 1986-87 to 20.2 per cent in 1987-88. The rate of gross capital formation fell from 23.4 per cent in 1986-87 to 22.1 per cent in 1987-88. Capital inflow from abroad, as a proportion of GDP, increased from 1.7 per cent in 1986-87 to 1.9 per cent in 1987-88.

TABLE 1.1

Selected Economic Indicators

(Percentage change over previous year)

	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88 (P)	1988-89 (P)
1	2	3	4	5	6	7	8	9	10	11	12	13
Gross National Product at 1980-81 prices[1] .	8.7	5.8	–4.7	7.4	5.9	2.6	8.0	3.9	5.1	3.8	3.6	9*
Agricultural Production	14.3	3.3	–15.2	15.6	5.6	–3.3	13.7	1.2	2.4	–3.7	–2.1	17 to 20*
Foodgrain Production .	13.7	4.3	–16.8	18.1	2.9	–2.8	17.6	–4.5	3.4	–4.7	–3.5	20 to 23*
Industrial Production[2]	4.2	7.6	–1.7	4.0	9.3	3.2	6.7	8.6	8.7	9.1	7.5	9.3[3]
Electricity generated (Utilities only) .	3.4	12.2	2.1	5.9	10.2	6.7	7.6	12.0	8.5	10.3	7.6	8.5[4]
Wholesale prices (on point to point basis)	0.3	4.6	21.4	16.7	2.4	7.3	8.2	7.6	3.8	5.3	10.6	5.0[5]
Monetary Resources (M_3)	18.4	21.9	17.7	18.1	12.5	16.1	18.1	18.9	15.9	18.6	15.9	15.0[6]
Imports (at current prices) . .	18.7	13.1	34.2	37.3	8.4	5.0	10.8	8.2	14.7	2.8	10.9[9]	27.4[7]
Exports (at current prices) . .	5.2	5.9	12.1	4.6	16.3	12.8	11.0	20.2	–7.2	14.3	26.4[9]	24.4[7]
Foreign exchange reserves (including gold & SDRs—end of period (Rs. crores) . .	4862	5821	5934	5544	4024	4782	5972	7243	7820	8151	7687	5967[8]

1. Growth rates upto 1980-81 are at 1970-71 prices, based on old series. *Anticipated
2. Growth rates are based on the old index of industrial production (Base 1970=100) upto 1980-81 and on the new index (Base 1980-81=100) thereafter.
3. April—November 1988.
4. April—December 1988.
5. March 26, 1988 to January 21, 1989.
6. Between March 31, 1988 and January 13, 1989.
7. April—December 1988 over the same period of 1987.
8. January 31, 1989.
9. Over the corresponding partially revised figures of the preceding year.

(P) Provisional.

Agricultural Production

1.7 In 1987-88 the country experienced a major drought, with as many as 21 out of 35 rainfall sub-divisions having received deficient or scanty rainfall. Despite this the fall in agricultural production was contained at around 2 per cent, the main crops adversely affected being rice, pulses, groundnut, cotton and jute. The extent of crop loss would have been greater but for the structure of input delivery, research and extension developed over the years, which has given considerable resilience to the agricultural economy and the advance measures taken last year to contain the impact of drought. Thanks to these efforts, the decline of over 9 per cent in Kharif foodgrain production was off-set to some extent by an increase of 2 per cent in Rabi foodgrain production.

1.8 The succession of poor monsoons culminating in the drought last year underlined the urgency of extending effective irrigation cover, especially for foodgrains, and ensuring adequate and timely availability of other inputs, including credit, for a sustained recovery. The Government has accordingly drawn up a Special Programme for Foodgrains incorporating all these elements in order to achieve the original target of 175 million tonnes of foodgrains production by the end of the Seventh Plan. This Programme, which is now under implementation, concentrates on five major crops, *i.e.*, rice, wheat, maize, arhar and gram in 169 districts distributed across 14 States. The districts were selected as being the most promising for yielding quick results.

1.9 Agricultural production is likely to increase by around 17 to 20 per cent this year, while foodgrain production is expected to exceed the target of 166 million tonnes and perhaps even cross the 170 million tonnes mark. The sharp recovery in agricultural production is primarily attributable to the good rains this year, with as many as 32 out of 35 meteorological sub-divisions receiving excess or normal rain. The package of measures introduced last year prepared the agriculture sector for a quick recovery. This made it possible to take full advantage of the good monsoon in optimising foodgrains production during the current year under the Foodgrains Special Programme.

1.10 Apart from cereals, high levels of production have also been recorded in oilseeds, cotton and sugarcane this year. In oilseeds, in particular, recent policy initiatives have succeeded in more than halving the level of imports within a year. However, the persistent stagnation in production of most pulses is a cause for serious concern since it is a major source of protein for Indian consumers and the per capita availability of pulses has been declining.

Industry and Infrastructure

1.11 During 1987-88 industrial production grew at about 7.5 per cent. Though lower than the growth rate recorded during the preceding three years, this is still above the trend rates of growth which had been recorded upto the early eighties. Such good performance under adverse conditions is attributable to basic policy reforms which promoted efficient competition and to long-term changes in industrial structure which have made the sector less sensitive to fluctuations in agricultural production. It was also facilitated by the excellent supporting performance of key infrastructure sectors, especially power generation, where the shortfall in hydel power generation was more than off-set by higher thermal generation and improvements in power plant efficiency.

1.12 Apart from these positive factors, buoyant industrial performance last year was also made possible, in large measure, by policies which helped to sustain the growth in demand for industrial products. Large-scale relief programmes were added to the usual employment generation programmes in order to contain the loss of incomes in drought affected areas. Since the huge expenditure on these relief operations and other drought related programmes were financed without cutting plan expenditure in real terms, this helped to maintain aggregate investment demand, while the package of anti-inflationary measures arrested the erosion of household purchasing power and thereby sustained aggregate consumption demand.

1.13 Despite these favourable conditions, it was not possible to completely insulate industry from the setback in agriculture. As expected, there was a slow down in industrial growth during the last two quarters of 1987-88, thus yielding an annual growth rate which was lower than the high rates recorded during the previous three years. However, there was a quick recovery of industrial production from the beginning of the current year and data available upto November, 1988 indicates a growth of 9.3 per cent over production during the corresponding period last year. The manufacturing sector, which accounts for about four-fifths of industrial production, has grown at an even higher rate of about 10 per cent. Furthermore, the high growth has been quite well dispersed within the sector, with more than half of the industries growing at over 10 per cent.

1.14 High industrial growth during the current year has also been supported by the good performance of key infrastructure sectors such as coal, steel, cement, fertilisers, railways and power generation. Within the power sector growth in generation of thermal power has decelerated and there has been some slippage in the plant load factor. This is mainly on account of preponement of planned maintenance shut down and backing down of some thermal plants. These had been postponed last year in order to maximise thermal generation at a time when hydel power was in short supply. This year the position has been reversed, with the spurt in hydel power generation compensating for the slow down in thermal generation. In the petroleum sector crude production has improved after suffering a decline last year. However, there has been no significant improvement in refinery throughput. Adequate availability of POL products has therefore been maintained through higher imports.

1.15 During the current year a number of major steps have also been taken in the on-going process of industrial policy reforms aimed at promoting greater competitiveness and cost efficiency in domestic industry. Some of the new measures will facilitate expansion of output within existing capacities while others are directed at encouraging the creation of new capacity. Important steps have also been taken to simplify the administration of industrial policy and eliminate procedural impediments.

1.16 The strong performance of industry, advances in policy reform and fresh fiscal concessions have been reflected in a buoyant stock market, with the RBI index of ordinary shares rising to 285.6 for the week ending December 31, 1988. The capital market also saw a number of major institutional developments during the year such as launching of the Securities and Exchange Board of India (SEBI), new mutual funds subsidiaries of nationalised banks and the establishment of a framework for launching new venture capital companies.

1.17 Despite the various positive developments on the industrial front cited above, some disturbing trends continue to cause concern. One of these is the virtual stagnation of employment growth in the organised sector. The other trend which seriously threatens the prospects of future industrial growth is the increasing incidence of industrial sickness. Both these issues will have to be accorded high priority in the next phase of industrial policy reform.

Prices and Price Management

1.18 Monsoon failures like that of 1987-88 generate strong inflationary pressures via the supply squeeze in agriculture. These pressures usually spillover to the subsequent financial year until the supply situation is eased with the arrival of the next kharif harvest. However, the inflation rate last year was contained at 10.6 per cent as compared to 21 per cent recorded during the previous major drought year of 1979-80 and did not spill over to the current year. Thus the overall inflation rate, measured in terms of the WPI on a point to point basis, came down from over 10 per cent at the end of March 1988 to less than 5 per cent in January 1989.

1.19 Movements of the CPI within a year tend to follow the movement of the WPI with a time lag of two to three months. In line with this pattern the CPI inflation rate had come down from around 10 per cent at the end of March 1988 to around 8 per cent in September 1988. Subsequently food procurement operations were disturbed by floods in Punjab and Haryana , resulting in a temporary spurt in prices and the CPI annual inflation rate again rose to 10 per cent in November 1988. The decline of the CPI was resumed in December 1988, the latest month for which data is so far available, the CPI inflation rate having come down to 8.8 per cent. It is likely to have declined further during January and February, following the movement of the WPI inflation rate, which had also increased sharply in October 1988 but resumed the seasonal decline thereafter.

1.20 Containment of the inflation rate at 10.6 per cent last year was possible mainly on account of the timely introduction of a range of anti-inflationary measures. On the demand side the huge additional expenditure on drought relief was financed through economies elsewhere, additional resource mobilisation and additional external assistance. The budget deficit was not allowed to grow beyond manageable levels. This stance, along with the tightening of selective credit controls and a restrictive monetary policy pursued by the Reserve Bank of India last year, helped to keep inflationary pressures in check at the macro level.

1.21 On the supply side Government ensured adequate availability of foodgrains and other essential commodities through a vastly expanded public distribution system, the various employment programmes and the relief operations. Additional imports were undertaken where necessary, as in the case of edible oils and pulses, in order to maintain supplies. The effectiveness of these measures was enhanced by tighter vigilance and an elaborate monitoring system which promptly signalled localised shortages.

1.22 The success of the foodgrain operations last year entailed a huge draw down of stocks. Consequently stocks remained low during most of the current year and a little over two million tonnes of foodgrains had to be imported in order to maintain a minimum level of food security stocks. Good rains and a bumper Kharif harvest have now considerably improved the availability of food grains. The position is expected to improve further with the arrival of a good Rabi harvest after March this year.

1.23 In edible oils the Government has introduced some important policy measures this year to rationalise the management of the oil economy and stabilise edible oil prices in support of the objectives laid down for the Technology Mission on Oilseeds (TMO). Thus imports of edible oils during the new oil year November 1988 to October 1989 are expected to be less than half the level of the preceding year. The supply of such imported edible oils at concessional rates to the vanaspati industry has been terminated while the issue price of imported oils supplied through the Public Distribution System has been raised. Meanwhile, the National Dairy Development Board has been appointed as a market intervention agency for stabilising the open market prices of edible oils within a reasonable range through its open market operations.

1.24 The stabilisation of consumer prices of key essential items such as foodgrains, edible oils, sugar etc. is one aspect of the price policy pursued by the Government. The other aspect of price policy is the maintenance of prices at a level which will yield an adequate return to producers after covering costs. With regard to agricultural commodities the desired procurement/support prices are determined by the Commission on Agricultural Costs and Prices every year while agencies like the Food Corporation of India, NAFED, Jute Corporation of India, Cotton Corporation of India and State Government agencies undertake procurement operations to support agricultural prices. Similarly, for industrial products which are either wholly or largely produced by public enterprises, the Government modifies the administered prices from time to time in line with cost changes in order to ensure that the enterprises are able to realise a reasonable rate of return under efficient operational norms. During the current year the administered prices of coal, steel and aluminium have been revised in accordance with this policy. The prices of non-ferrous metals such as nickel, copper and zinc have also been revised to accommodate the sharp increase in international prices of these metals since the bulk of domestic requirement of these items is met through imports.

Fiscal and Monetary Policy

1.25 Fiscal management during 1988-89 has been directed at restoring the momentum of growth in a post-drought year and reinforcing the priority given to exports. Important fiscal measures such as concessions to agriculture based activities, reintroduction of investment allowance, duty reliefs in selected industries and further incentives for export growth have all been directed at these two objectives. Restoring high growth also served as a guiding principle for overall financial management during the year. Thus Central Plan Outlay was stepped up by nearly 17 per cent as compared to the 1987-88 level, ensuring for the first time, that over four-fifths of the targetted Central Plan expenditure in real terms has actually been incurred within the first four years of a five year plan. Notwithstanding the increase in Central Plan Outlay, budgetary support for the plan was reduced from over 61 per cent in 1987-88 to around 56 per cent in 1988-89. Simultaneously, the required resource contribution of public enterprises has been raised from around 39 per cent to over 44 per cent of the plan outlay. This corresponds to about 63 per cent of total Plan investment in Central Public Enterprises in the current year.

1.26 The economic and functional classification of the budget reclassifies expenditure into those which directly generate a demand for goods and services by the Government and those that are transfers to other spending organisations and individuals. This classification of the Central Government Budget shows that budgetary allocation for capital formation has declined from around 40 per cent in 1980-81 to around 36 per cent in budget estimates for 1988-89. During this period transfer payments from the Central Government Budget to the States, Union Territories and other sectors of the economy increased sharply from around 31 per cent in 1980-81 to around 39 per cent in budget estimates for 1988-89. The bulk of this increase is accounted for by the increase in share of interest payments from around 10 per cent in 1980-81 to nearly 17 per cent in 1988-89. The share of Government consumption expenditure i.e. total budgetary expenditures less financial transfers and capital formation in 1988-89 is estimated to be around one quarter of total budgetary expenditure. This is about the same level as that prevailing in the early eighties, a small decline during the year 1983-84 to 1985-86 being off-set by a corresponding increase since 1986-87. Defence expenditure accounts for around 70 per cent of total government consumption expenditure.

1.27 The overall fiscal policy stance of government during the current year has been supported by a monetary policy which sought to provide adequate credit to accommodate strong growth during the current year without allowing undue growth of liquidity in the system. Money supply (M_3) growth, which the Central Government has been targetting jointly with the RBI during the past few years, was therefore projected to be lower than the average growth of 17 per cent recorded during the past few years. The actual rate of M_3 growth upto January 13, 1989, has been only 15 per cent despite the strong resurgence of growth in the real sector. The banks have been able to accommodate a larger volume of non-food commercial credit this year, compared to last year, thanks to the substantial decline in food credit during the year.

1.28 During the year there were a number of important developments relating to the structure of interest rates and related institutional arrangements. The interest rates on short-term agricultural loans upto Rs. 15,000 were brought down from 1st March, 1988 to give relief to farmers. The ceiling on interest rates for trade and industry, fixed earlier at 16.5 per cent, was replaced by a floor rate of 16 per cent effective October 10, 1988 to lend greater flexibility to the structure of interest rates. Since October 1988 the system of prior sanction of credit limits for bulk advances to the non-food commercial sector under the Credit Authorisation Scheme (CAS) has been terminated and replaced by only a requirement of post sanction scrutiny of such advances. Borrowers under consortium lending arrangements have also been permitted now to transfer accounts from one bank to another without obtaining a no objection letter from the former. Important institutional developments include the establishment of the National Housing Bank as a new apex bank for the housing sector, the setting up of the Discount and Finance House of India (DFHI) to promote development of the money market, the establishment of the Security and Exchange Board of India (SEBI) to promote orderly and healthy growth of the securities market and the launching of Credit Rating and Investment Services of India Ltd. (CRISIL) as the first professional credit rating agency in the country.

The External Sector

1.29 The external payments situation continues to be under pressure. Throughout the Seventh Plan period the balance of payments has remained difficult on account of several adverse factors such as deceleration in the growth of domestic oil production, protectionist tendencies abroad, volatility of major international currencies, bunching of repayment obligations to the IMF and other sources and an unfavourable international climate for concessional assistance. The pressures arising from these factors have been aggravated during 1988-89 by a surge in the import bill.

1.30 While the merchandise trade account continues to show a large deficit, invisible earnings which earlier financed a large part of this deficit are now playing a progressively smaller role in this regard. The share of net invisibles earnings in financing the trade deficit declined from around 72 per cent in 1980-81 to only around 38 per cent in 1986-87, mainly on account of rising interest payments on foreign debt. Net inflows of capital from abroad have accordingly played a growing role in financing the trade deficit.

1.31 The Government has been according high priority to an improvement of the balance of payments situation. This is sought to be achieved through acceleration of export growth, efficient import substitution and prudent allocation of scarce foreign exchange. Policy measures adopted to promote exports have yielded good results during the last two years. Provisional data available so far indicate that during the period April—December 1988 exports have grown by 24.4 per cent in rupee terms compared to the corresponding period last year. This growth has come on top of the estimated increase of over 26.4 per cent during 1987-88.

1.32 However, imports have grown at an even higher rate of 27.4 per cent during the period April—December 1988 on account of the lagged effect of a shortfall in domestic production of foodgrains and some other essential commodities last year, high demand growth this year, a sharp increase in international prices of imported metals, chemicals and edible oils and changes in the exchange rates. The provisionally estimated trade deficit for April—December 1988 had accordingly increased to Rs. 6601 crores or Rs. 1688 crores more than the deficit recorded during the corresponding period of 1987. The balance of payments, therefore, must be a priority area for attention in short term economic management.