I THEME OF THE REPORT

1.1 The external payments crisis of 1991 induced a comprehensive policy response comprising macroeconomic stabilisation and structural adjustment. The adjustment was reflected in wide-ranging reforms in terms of liberalisation, privatisation and globalisation.

1.2 Economic reforms are now more than a decade old. As such, firm statistical information is available for a period of 10-years or more for most sectors of the economy. This period is momentous in India's economic history as it witnessed a successful transition of India from a closed, slow growing economy to a reasonably open economy that has now found a place amongst the fastest growing in the world. Of course, the success has not been without its share of deficiencies. On the whole, the opportunities presented by the crisis of 1991 were seized, but there are areas where the full potential of change has not been realised. Economic policies have been formulated to chart a definite, *albeit* somewhat slower, path to reforms. Reversals have been far and few. But this has added to the credibility of the process. On the other hand, some old impediments have persisted, even as new ones have emerged. Faced with a combination of internal and external constraints, growth has slowed down since 1997-98. In other areas, especially in the external sector and on the price front, the economy has gained strength and resilience. Given this mixed performance, it is important to make a policy evaluation and understand better the impediments that we face so that reforms can be sustained and the welfare of a billion people could be improved further. This issue of the Report on Currency and Finance attempts to provide a staff assessment in that direction.

1.3 The rest of the Report is organised as under: Chapter II, as the opening Chapter, provides a detailed review of recent developments in the Indian economy. This review is focused on the fiscal 2002-03 so far and serves as an update on macroeconomic developments before taking up a longer-term review and sectoral analyses that follow.

1.4 The touchstone of any reform process is the impact it has on the real economy. Chapter III provides an assessment of how reforms have impacted the real sector of the Indian economy. The Chapter provides a direct comparison of the 1980s and the 1990s in terms of real activity and efficiency parameters. Although the decadal growth rates do not appear to be different substantially, the average growth rates mask two important facets. First, from an impressive growth performance in the initial period of reform (1992-93 to 1996-97), real GDP growth decelerated considerably. Major shocks included the contagion from the East Asian crisis, global economic slowdown, the recent downward spiral in global asset markets specially the new economy segment, uncertainty in global oil markets and the severe drought in the year 2002. Second, growth in the relatively trouble free period of the 1980s was excessively leveraged through large fiscal deficits and build up of external debt. In this sense, the growth before the reform was unsustainable. In contrast, the high growth after the reforms was accomplished to an extent, with adjustment. The Chapter attempts to explain these facets and also highlights the emerging weaknesses in the reform process which would have to be addressed so that real sector reforms gather further momentum. The potential of Indian economy to sustain the targeted high growth exists, but hinges critically on improvement of the domestic saving rate, increased public investment supported by marked improvement in public saving rate, higher inflow of foreign capital in gross as well as net terms and better credit delivery mechanisms.

1.5 The external disequilibrium of the early 1990s was linked to the fiscal gaps of the 1980s. Deterioration of the fiscal position in the 1980s was manifest in all major indicators of Government finances. GFD-GDP ratio for the Central Government rose substantially in the 1980s. For the State Governments, the increase was relatively moderate due to restrictions placed on their borrowing. Particularly worrisome has been the emergence of revenue deficits in the accounts of the Centre and States. The combined liabilities of the Centre and States expanded to an unsustainable proportion on the eve of the crisis in 1991. Against this backdrop, Chapter IV presents the rationale, assessment and impact of fiscal reforms. The Chapter details the areas of fiscal restructuring undertaken, as also the rigidities in the fiscal structure that have restrained progress in this area. This Chapter analyses the factors responsible for deterioration of fiscal situation of the

Centre and States during the 1990s. A key element for a sustainable fisc remains the size of internal debt and growing volume of interest payments. Formal evidence provided suggests that internal debt could become unsustainable, if adequate progress is not made in fiscal reforms. Unless the debt burden is lowered by innovative steps, especially through an accelerated disinvestments programme, the fiscal scenario would continue to be a cause for serious concern.

1.6 Chapter V covers money, credit and prices. Reforms during the 1990s were supported by a shift in the monetary policy framework in which monetary policy has been conducted. The Reserve Bank had moved in the 1980s from direct quantitative controls through credit budgeting to a formal monetary targeting framework. Monetary targeting was conducted in an environment where interest rates were substantially regulated. The system, however, was not efficient in resource allocation. It supported a large draft on household savings by the Government. The reforms that began in 1991 were supported by a change in operating procedures for the conduct of monetary policy. From a pure monetary targeting framework, a change to a multiple indicator approach was effected with a greater reliance on interest rates. The Chapter assesses this shift in the context of monetary transmission channels. Among other changes, market borrowings of the Government began to be conducted at market determined interest rates. This was aimed at introducing a sense of fiscal discipline and freeing larger resources for private investment. It also enabled the conduct of open market operations, enabling monetary authorities to move to full-fledged use of indirect instruments of monetary policy. Focus has since shifted to operating on the short-end of the money market through Liquidity Adjustment Facility operations in addition to using the conventional tools like the Bank Rate and the CRR. In the milieu of the changed framework, the Chapter analyses the inflation record during the reform period and explains the monetary and non-monetary factors that have helped lower inflation rate since the end of 1995. Empirical evidence on transmission of the impact of monetary policy actions to output and inflation is also presented in some detail.

1.7 Finance provides an important link between reforms and growth. Perhaps no area of the Indian economy has been as much influenced by impulses of reforms as the financial sector. Chapter VI provides an account of these changes with special focus on what these reforms portend for stability and efficiency of the financial system. Several stability and efficiency parameters are analysed for different classes of financial intermediaries, such as commercial banks, cooperative banks, development finance institutions and mutual funds. The Chapter analyses legal and institutional constraints that have weighed down the progress. The Chapter also appraises the impact of reforms in terms of the functioning of various financial markets, specially the money market, the government securities market, the capital market and the foreign exchange market. Evidence regarding growing integration of money, debt, equity and foreign exchange markets is also analysed. In spite of increased integration that could bring volatility spillovers, the volatility in the Indian financial markets has been kept low through a modicum of regulatory interventions and the general policy design for the financial sector put in place during the 1990s.

1.8 The reform process was triggered with the problems in the external sector. It started with marked changes in this area, where the pressing needs for stabilisation and adjustment were addressed within three years or so of the crisis. The balance of structural changes in the external sector have been spread over and their pace has been controlled keeping in view the transition made in other sectors of the economy. Chapter VII takes stock of the calibrated liberalisation on current and capital account of the balance of payments. Shifts in composition and direction of foreign trade during the 1990s have been discussed. On capital account, foreign investment flows – direct and portfolio – have grown sharply since 1993-94. The Report argues that these levels are still lower than those realised by some other emerging markets and the scope for some widening of CAD-GDP ratio remains. On balance, policy reforms in the external sector have been a success. The exchange rate has depreciated smoothly in spite of severe exogenous shocks affecting the Indian markets. India's trade performance has been analysed *vis-à-vis* other East Asian countries. The opening of the capital account to allow inflows and outflows of foreign capital has helped financing of investments. This, however, brought new challenges for macroeconomic management. Surges of capital inflows and reversals had to be moderated by dampening excessive volatility in exchange rates. This was attained with unprecedented build up of foreign exchange reserves. While providing comfort on the external front, the high reserves raise questions of their optimality and the future concern on monetary management. These issues have been addressed at length in this Chapter.

1.9 Approaching reforms with gradualism had a well-founded rationale and on the whole this has placed Indian reforms on a firm footing that have transcended political regime shifts. Changes have been carried out with broad consensus. The road to economic restructuring has been traversed in the 1990s by four different Governments. The country has gained significantly from policy reforms in the 1990s. Further gains are there for taking. With broad consensus driving the course, the unfinished agenda could be addressed in the coming years. In the concluding part, Chapter VIII delineates the unfinished agenda for reform and draws inferences in an integrated manner.