EMERGING ECONOMIC SITUATION

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I greatly appreciate the opportunity given to me by the commerce and industry fraternity of Calcutta to speak to you once again on the theme of the emerging economic situation and the monetary and credit policy of the Reserve Bank of India.

As I survey the current economic scene, I find that there are several strong fundamentals as well as some areas of major concern. During the past decade, the average growth rate of the economy was 5.6 per cent per annum, and the economy broke out of the long-term trend growth rate of 3.5 per cent per annum. The average rate of inflation measured by the wholesale Price Index was 7.7%. During the last four years of the Seventh Plan exports were buoyant and grew at the rate of over 10 per cent in volume terms. However, the 1980s also saw growing fiscal imbalances and widening current account deficits on external account.

Talking of the immediate period, the economy performed reasonably well in 1989-90, with the gross domestic product (at 1980-81 prices) registering a further growth of 4.5 per cent on top of an impressive growth of 10.4 per cent in 1988-89. Agricultural production improved by 1.5 per cent following a record rise of 20.8 per cent in 1988-89. Industrial production also exhibited a satisfactory increase of 8.3 per cent in 1989-90. Data on investment intentions of the private business sector and those on its estimated capital expenditures in 1989 showed considerable buoyancy. The primary as well as secondary capital market exhibited considerable spurt in activity with capital issues by non-Government public limited companies doubling from Rs.3,164 crore in 1988-89 to Rs.6,344 crore in 1989-90 and the average index of equity prices rising sharply by 45.2 per cent in 1989-90 on top of a 19.4 per cent rise in the previous year. The external sector showed an impressive performance : a 36.3 per cent rise in exports and a 25.6 per cent increase in imports giving a slight reduction in trade deficit in rupee terms. Even in US dollar and SDR terms, the growth of exports accelerated strongly, import growth decelerated, and the trade deficit fell. With invisible receipts maintained at the previous year's levels; the ratio of current account deficit declined from 2.7 per cent in 1988-89 to 2.3 per cent in 1989-90. There was also a fall in the debt-service ratio from 24 per cent in 1987-88 to 23 per cent in 1988-89 and further to about 22 per cent in 1989-90.

Prospects for 1990-91

The growth prospects for 1990-91, particularly in the commodity-producing sectors, seem encouraging. With an exceptionally good monsoon, well distributed over time and space, the outlook for agricultural production is decidedly encouraging. The foodgrains production target of 176.5 million tonnes is likely to be exceeded. *Kharif* foodgrains production is estimated to be over 101 million tonnes against a target of 95.0 million tonnes and with the favourable weather conditions for *Rabi* sowings, the *Rabi* output may exceed the target of 81.5 million tonnes. Almost all cash crops, namely, raw cotton, jute, sugarcane, oilseeds, tea and coffee, are likely to record impressive performance. Thus, the economy is poised for a record production of foodgrains and other crops for the third year in succession.

The index of industrial production during the first five months April-August 1990 has shown a higher growth of 12.4 per cent as against 3.8 per

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cent in the comparable period of 1989-90. The manufacturing sector experienced a significant growth of 14.2 per cent against 1.5 per cent in the previous year; the infrastructural sector, however, showed a deceleration in the growth rate. The overall growth of industrial production of 12.4 per cent during the first five months of 1990-91 is, however, over a low base and this would show a deceleration in the remaining months of the current financial year.

During the first half of the current financial year, the capital market has witnessed considerable buoyancy in the secondary market but the trend in the primary market was subdued. Several companies with large-size projects, which were given approvals in the previous two years, came to the market for raising capital during 1989-90, and this led to the substantial growth in the primary market. Such a high level of capital issues has of course not been sustained in the current year. Equity prices have witnessed a rise of over 40 per cent during the period April-October 1990. Other indications of the investment climate also show a mixed trend. Disbursements of all-India financial institutions during April-September 1990 increased by 11.0 per cent as compared with a decline of 3.3 per cent in the corresponding period of the previous year. While industrial licences and letters of intent issued were somewhat lower, the approvals for foreign collaboration were higher during the same period.

There has been a deterioration in the performance of the external sector in the current financial year. During the first five months of 1990-91, the pace of export growth in rupee terms was 22.5 per cent as against 38.1 per cent during the corresponding period of the previous year; in US dollar terms the deceleration was from 16.7 per cent in the first five months of 1989-90 to 15.4 per cent in the comparable period of the current year. The import growth in rupee terms in the current year up to August 1990 was at 21.2 per cent as against 18.5 per cent during the comparable period of last year; in US dollar terms the increase was 14.2 per cent this year against only 0 .2 per cent last year. This has resulted in a widening of the trade deficit. Though pressures on the balance of payments have persisted for some years as reflected in a widening current account deficits, considerable increase in external debt and a rise in debt service ratio; the steep rise in the price of imported crude oil and petroleum products following the unexpected Gulf crisis has confronted the country with a difficult situation. This development comes at a time when recessionary trends are emerging in some leading industrialised countries. I would, however, wish to assure the business community— both domestic and foreign — that the balance of payments situation would be kept within control and the impeccable record in servicing external obligations would be fully maintained. Several measures have been taken towards an adjustment and any further steps which may be necessary will be taken to ensure the viability of the external payments position. It is against this background that the Reserve Bank has been constrained to take some measures regarding the financing of imports by commercial banks such as the charging of a higher rate of interest on credit extended for the financing of capital goods imports, prescription of a 50 per cent margin for financing the import of raw materials, and laying down more stringent norms regarding the inventory holdings of imported raw materials. The government has taken many important measures such as the hike in petroleum product prices, reduction of items under the OGL and the constraint on canalised bulk imports. While all these measures are necessary to meet an unexpected and difficult situation, the main emphasis on correcting the external account has to be on expanding exports, and industry and trade have to play a major role in their own best interests. It is well known that the contribution of large industry to exports has been inadequate, despite highly supportive export incentives and that its export earnings have generally been below its draft on scarce foreign exchange resources. This must change and change fast. There is also evidence that there is a lag in the receipt of export proceeds. Exporters need to ensure that this lag is reduced to the minimum. And all of us need to do much more on energy conservation.

To a considerable extent the external deficit reflects the domestic fiscal imbalances which have

grown strongly in recent years. Rising budgetary deficits, especially on current account, have serious implications regarding domestic debt, growth of liquidity and inflation. Apart from its distorting effects on domestic saving and investment and on all project calculations, inflation is highly inequitable in its impact as it hits the poor the hardest and thus militates against social justice. It is, therefore, essential that the fiscal deficits be effectively addressed.

There are several elements in the current situation which are a cause for concern. The Wholesale Price Index as on November 17, 1990 showed an increase of 10.2 per cent over the corresponding index a year ago. During the current financial year, the rate of increase in the Wholesale Price Index began to outpace last year's increase somewhat before the imposition of the 25 per cent Gulf surcharge on petroleum products. The rate of increase in wholesale prices in the current financial year up to November 17, 1990, was 7.8 per cent against 6.7 per cent in the comparable period of the previous financial year. There has not occurred this year a seasonal decline in prices which normally sets in around the end of August and which mainly comes about as a result of the decline in the prices of 'primary articles'. Prices of essential items such as cereals, pulses, fruits and vegetables, eggs, fish and meat, tea, coffee, sugar, khandsari, *gur* and oilseeds and edible oils, have all experienced sharp increases despite an excellent monsoon and a third year of bumper crops. The cascading effects of the hike in petroleum prices, coupled with the constraints on augmenting supplies through larger imports, have given rise to further apprehension. It should, however, be noted that the public stocks of foodgrains are being rebuilt to comfortable levels and together with availability of other commodities should restrain inflationary expectations.

An important cause for the persistence of inflation has been the unmitigated growth of liquidity arising from high levels of fiscal deficits and monetisation of a substantial part of government debt. Given the large overhang of liquidity and the resurgence of inflation, it is necessary to bring about a sharp break in the pace of monetary expansion.

The overall pace of monetary expansion during the current financial year so far has been subdued. Between the end of March 1990 and November 16, 1990, M_3 grew by 8.2 per cent, that is, 4.6 percentage points below the expansion of 12.8 per cent in the corresponding period of the previous year. Net bank credit to Government at Rs.18,837 crore, shows an increase of 16.2 per cent against Rs.15,610 crore or 16.1 per cent in the comparable period of 1989-90. Net Reserve Bank credit to Central Government has also turned out to be somewhat higher at Rs.11,945 crore as against Rs.10,731 crore in the previous year. The bank credit to the commercial sector has, however, grown at a slower pace than in the corresponding period last year. Non-food credit extended by scheduled commercial banks has registered an increase of Rs.3,261 crore against Rs.8,228 crore in the corresponding period of 1989-90; this is attributable to a number of factors. First, the size of non-food credit expansion in the past two years was unduly high. Secondly, there has occurred better generation of internal resources by companies due to improved overall corporate results during the past two years. Thirdly, recourse to the use of non-bank sources of financing this year has apparently been larger.

As the business community is aware, while the immediate objectives of supporting productive activity and containing inflationary pressures remain the cornerstone of the Reserve Bank's credit and monetary policies, the Bank has been also pursuing the longer-term objectives of promoting efficiency and competitiveness in the operations of the financial system. Towards that end, several changes in financial policy have been initiated during the past few years including the easing of operational constraints in the credit delivery system, the introduction of new money market instruments and strengthening of the existing instruments.

The stipulations for issue of Certificates of Deposit(CD) and Commercial Paper (CP) have been eased. The outstanding amount of CDs

issued by 43 major banks as on September 21, 1989, was of the order of Rs.2,480 crore or 85.4 per cent of the total limits of these banks. The outstanding amount of CP was Rs.190 crore as on November 14, 1990.

With a view to widening the call and notice money market and to bringing about a greater integration of various segments of the money market, all the participants in the bills rediscounting market have been granted entry into the money market, as lenders, effective October 20, 1990. The money market interest rates have been extremely volatile in the recent period with rates rising to phenomenal levels during certain periods and this has created some distortion in the financial system. The Reserve Bank has taken measures to reduce these distortion by modulating its refinance policies and this has had a salutary effect.

For reducing the complexity of the interest rate regulatory system, a measure which has been overdue and which has now been effected from September 22, 1990 relates to the rationalisation of the lending rate structure of scheduled commercial banks. The structure of lending rates, as it had evolved over time, had been characterised by an excessive proliferation of rates. There were not only a number of rate prescriptions for each activity but also borrowers were charged vastly different rates for the same loan amount. Loan rates depended on the size, the purpose, the duration, the geographical location and the sector of financing. With a view to rationalising the structure, new lending rates of scheduled commercial banks linking interest rates to the size of the loan have been prescribed and this has significantly reduced the existing multiplicity and complexity of lending rates. Under the new lending rate structure linking interest rates to the size of the loan (except for DRI advances and export credit), the rates range from 10.0 per cent to 16.0 per cent (minimum). All loans above Rs.2 lakhs, irrespective of the purpose, would have a minimum interest rate of 16 per cent (except for some adjustments for term loans to certain select sectors viz. agriculture, small-scale industry and transport operators with up to two vehicles).

Before I conclude, I ought to refer to a perennial problem which both the Reserve Bank and the commercial banks have been experiencing. This relates to the question of large unutilised credit limits. This phenomenon has tended to create constraints in enforcing credit discipline and implementing macro-credit policy goals. With a view to bringing about greater discipline in the availment of bank finance by borrowers and facilitating better funds management, it was decided to levy a minimum commitment charge of 1 per cent per annum on the unutilised portion of the working capital limits, effective from January 1, 1991, in the case of all borrowers with working capital limits of Rs. one crore and over. With a view to providing a reasonable degree of flexibility to borrowers, a tolerance level of 15 per cent of the quarterly operating limit has been provided for and the charge would be imposed only if the unutilised portion is in excess of the tolerance level. With a view to encouraging the bill culture, it was indicated that, effective April 1, 1988, the credit limits sanctioned by a bank to parties against book debts should not be more than 75 per cent of the aggregate limits sanctioned to such borrowers for financing inland credit sales. Sufficient time has already elapsed since the setting up of this stipulation. In the case of fund-based working capital limits of Rs. 5 crore and over, effective January 1, 1991, interest at 2 percentage points above the relevant cash credit interest rate would be levied on that portion of the book-debt finance which will be in excess of the prescribed norms of 75 per cent of limits sanctioned to the borrowers for financing inland credit sales. With the remission of stamp duty on usance bills routed through banks, a major hurdle in the way of using bills in genuine commercial and trade transactions has now been eliminated. The number of financial institutions permitted to operate in the bills rediscount market has been enlarged. It is hoped that the large business organisations in the private as well as public sector would accept the bill discipline with a view to improving the payments system.

A process of liberalisation also involves a process of self-regulation, and industry and trade must ensure that there is no misutilisation of credit facilities. In this context, they must eschew drawing more credit than their legitimate needs and in particular I must urge that industry and trade associations should ensure that their constituents do not violate basic credit norms. Drawal on cheaper sources of credit with a view to lending in the money market is clearly not permissible.