SPEECH

THE MACRO ECONOMIC SCENARIO AND CREDIT POLICY+

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It gives me great pleasure to be in your midst this evening. It so happens that this is my first public address to a business gathering after taking over as Governor of the Reserve Bank of India. I would like to take this opportunity to share some of my thoughts on the emerging economic situation and the role of monetary and credit policy in that context.

1991-92 was a landmark year in many ways. It was a year of crisis, but it was also a year which saw far reaching changes in India's economic policy. The crisis the economy had to face in mid-1991 was a grim one. The balance of payments situation had deteriorated sharply and the foreign exchange reserves had fallen so low that the possibility of default in payment was imminent. Orthodox and unorthodox measures had to be taken urgently to restore our credibility in the international markets. On the domestic side while the economy had done extremely well in terms of real growth between 1985 and 1990, the fiscal situation had also deteriorated sharply. The fiscal deficit of the Centre alone had touched 8.5 per cent of GDP.

The policy changes that were brought into force since July 1991 fall broadly into two categories. The first set of measures is part of what is normally known as stabilisation policy. The second set of measures comes under the category of structural reforms. While the stabilisation policies are intended to correct the lapses and put the house in order in the short run, the structural reform policies were intended to accelerate economic growth over the medium term. Structural reform policies cannot succeed unless a degree of stabilisation has been brought about. But stabilisation by itself will not be adequate unless structural reforms are undertaken to avoid recurrence of the problems faced in the recent years.

The new economic policy comprises the various policy measures and changes that were introduced since July 1991. There is a common thrust running through all of these measures. The objective is to improve the efficiency of the system. The regulatory mechanism involving multitude of controls has fragmented capacity and reduced competition even in the private sector. The thrust of the new economic policy is towards creating a more competitive environment in the economy as a means to improving the productivity and efficiency of the system. This is to be achieved by removing the barriers to entry and the restrictions on the growth of firms. While industrial policy seeks to bring about greater competitive environment domestically, the trade policy seeks to improve the international competitiveness subject to the protection offered by the tariffs. This is indeed a challenge to business units, both in the public and private sectors. The challenge can be met only if business organisations equip themselves adequately to work in a competitive environment.

It is sometimes argued that the low rate of economic growth in 1991-92 was due to the implementation of the new economic policy. Nothing can be farther from truth than this. The low rate of growth was contributed by a poor performance in agriculture and it is well known that the performance of agriculture from year to year is more a function of weather. The collapse of industrial production in 1991-92 can be attributed in a large measure to the high degree of import compression that was brought about which would have been inevitable in any case.

The economic prospects for 1992-93 appear to be distinctly better. The real GDP growth in 1992-93 may be around 4 per cent, thus taking the economy closer to the Eighth Plan target growth rate of 5.6 per cent. The higher growth rate in the current year will be largely attributed to a substantially improved performance in

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agriculture. The anticipated growth rate in agricultural production is around 5 per cent. This is in contrast to the decline of 2 per cent last year. The overall foodgrain production is likely to be 180 million tonnes — a substantial improvement from the level of 167 million tonnes last year. As regards cash crops, oilseeds, cotton and sugarcane are likely to record an impressive performance.

The trends in industrial production are however, not that encouraging. The index of industrial production during the first four months of 1992-93 rose by 2.1 per cent. There was a distinct improvement in the performance of industrial production in August and September so that the index of industrial production during the first six months shows a rise of 3.9 per cent. This is in contrast to a decline of 1.2 per cent during the comparable period last year. The growth rate of around 4 per cent is still a far cry from the average annual rate of growth of 8 per cent achieved in the '80s. Several factors have contributed to the slackening of industrial growth. To some extent, attempts to reduce the fiscal deficit, which once again has a bearing on government expenditures, must have affected the demand for certain goods. The demand for industrial consumption goods must have been affected by the rising trend in prices. However, there are some encouraging factors in the overall economic scenario with respect to industrial production. With the improvement in production of cash crops, agro-based industries which still have a weight of 30 per cent in the index of industrial production may not face any supply constraints. With larger imports, the availability of foreign components and raw materials must also ease. With the improvement in agricultural production, rural incomes will pick up which can again create more demand for industrial consumption goods.

There is as yet no indication of private investment going down. A study done by the Reserve Bank of India on the forecast of corporate investment indicates that in 1992-93 corporate investment might be higher than in the previous year by 15.9 per cent. In fact, the primary capital market has been characterised by significant buoyancy, both in terms of number and amount of new capital issues by non-Government public limited companies. During the first eight months of the current financial year, the number of new issues more than doubled — increasing from 259 to 596 and the average amount per issue also increased substantially, as a result of which, the total amount of issues increased more than five-fold — from Rs. 2,020 crore to Rs. 13,723 crore; nearly two-thirds of the total new issues were on rights basis. Public investment, however, could have suffered to some extent as a consequence of the overall attempts to contain fiscal deficit. The Annual Plan outlays of State governments may show a shortfall of 10 per cent as compared with the original estimates because of the inability of States to raise adequate resources.

There are signs of revival in the external sector although there is a need for continuous monitoring of trends in order to take pre-emptive action to prevent any pressure on the reserves. During April-November 1992 the value of exports in US dollar terms recorded a growth of 5.9 per cent over the corresponding months of the previous year. What is encouraging is that exports to the General Currency Area, which are important from the point of view of accretion to reserves, grew by 13.4 per cent. On the other hand, imports too recorded a substantial increase of 18.7 per cent during the period as compared with the corresponding months of 1991. This was the result of the release of the pent-up demand consequent to the relaxation of the import controls by both the Government and the Reserve Bank of India. As a consequence, trade deficit rose to $3,097 million from $1,431 million in the corresponding months of 1991. However, it was still lower than the deficit of $4,079 million observed in April-November 1990. The analysis of trade balance shows that while there was a deficit of $3,468 million in April-November 1992 on account of oil, the non-oil balance showed a surplus of $371 million. Our success on the external front will to a large extent be determined by our ability to manage the oil sector.

As of January 15, 1993, foreign exchange reserves amounted to $5.3 billion. Although this indicates a fall of $300 million compared with the position at the beginning of the year, that we have

been able to maintain more or less the level of foreign exchange reserves does indicate that on a current basis our inflows and outflows are matched. Our inflows do of course include exceptional financing.

There has been a distinct change in the climate for foreign investment. The approvals by the Reserve Bank of India and the Government do show a sharp rise. During the period from August 1991 through October 1992 foreign collaboration approvals were granted to 1,876 proposals (of which 740 were for equity participation), amounting to US$1,224 million. Of these, 808 proposals were approved by the Reserve Bank and the remaining by the SIA and the Foreign Investment Promotion Board. The approvals given by RBI include 38 proposals from existing companies for enhancing foreign equity up to 51 per cent. Most of the proposals approved both by the Government and the RBI have yet to result in the actual flow of investment. This does indicate that much more work needs to be done to translate the approvals into actuals.

Monetary and Credit Policy

Containment of inflationary pressures and supporting productive activities with adequate credit have remained the cornerstone of Reserve Bank's monetary and credit policies. The Reserve Bank came to bear more than its normal share of responsibility in mid-1990-91 when the balance of payments situation acquired crisis dimension. It had to respond swiftly through monetary and credit policy measures aimed at import compression and demand containment. While these strong measures helped to alleviate the balance of payments problem they inevitably had an adverse, impact on the general level of economic activity which in the circumstances could not be avoided. In formulating the monetary and credit policies in the current year 1992-93, while keeping in mind the primacy of the objective of inflation control, measures have been introduced to revive industrial and agricultural production.

There has been a distinct improvement in the price situation during the current financial year so far. The inflation rate as measured by the Wholesale Price Index on a point-to-point basis in the current financial year up to January 2, 1993 was 5.7 per cent as compared with 12.0 per cent recorded during the corresponding period of the previous year. Even after allowing for the difference between the provisional and final price index, which is about one to one and a half percentage points, there has been a distinct moderation in the price increase in the current year. For the year as a whole, the Wholesale Price Index may record an increase between 8 and 9 per cent.

The pace of monetary expansion during the current year up to December 11, 1992 has been 11.2 per cent as compared with a 14.2 per cent increase in the corresponding period of last year. Though there has been a moderation in the money supply growth, it has already exceeded the target set for the full financial year. There is a continuing need to keep a watch on money supply growth. The slower rate of growth in broad money during the current year as compared with last year has been made possible mainly on account of two factors. First, the foreign exchange assets adjusted for net drawals from the IMF declined this year as compared with a large increase last year. Second, there was a lower expansion of net RBI credit to the Central Government; during the current financial year so far (up to December 25, 1992) the fortnightly average level of net RBI credit to Central Government was Rs. 6,592 crore as compared with the average level of Rs. 9,425 crore during the corresponding period of last year. For the first time, the net RBI credit to Central Government is running at a level lower than the budgetary deficit. The reduction in the net RBI credit to the Centre this year has been in tandem with the Government's declared objective of reducing the gross fiscal deficit from 6.5 per cent of GDP during 1991-92 to 5 per cent of GDP in 1992-93.

If the reduction in fiscal deficit and more particularly the budget deficit is enduring, it provides greater manoeuvrability to monetary and credit policy, by enabling a reduction in pre-emptions under the cash reserve ratio and the statutory liquidity ratio. In relation to both these ratios, there have been substantial changes during

1992-93. Because of the modifications introduced in these two ratios, the pre-emption of incremental deposits which stood at 63.5 per cent in 1991-92 came down to 45 per cent in the first half of 1992-93 and further to 25 per cent in the second half of the year. This implies that in the second half of the year, almost 75 per cent of incremental deposits are available for expanding credit. In fact, there has been a sharp increase in non-food credit made available during 1992-93. During the current financial year (up to December 25, 1992) credit extended by scheduled commercial banks rose by 16,405 crore or 13.6 per cent as compared with the rise of Rs. 3,450 crore or 3.1 per cent during the comparable period of last year. To some extent the increase in net bank credit in the current year is also due to the adjustments which became necessary because of the changes introduced with respect to the bill discounting and rediscounting operations as well as higher receivable finance to be provided to some industries, such as fertilisers. Nevertheless, there has been a significant increase in the provision of bank credit which has been facilitated by significant reductions in reserve requirements.

In fact, recognising the need to provide additional stimulus to industry and agriculture certain measures were introduced on January 18, 1993. The Reserve Bank has enhanced the general line of credit for short-term agricultural operations to National Bank for Agriculture and Rural Development (NABARD), by Rs. 400 crores from Rs. 2,700 crores to Rs. 3,100 crore. This will enable NABARD to provide larger credit to finance short-term agricultural operations during the Rabi season.

To stimulate output of capital and intermediate goods industries, the RBI will provide accommodation to Industrial Development Bank of India (IDBI) to the tune of Rs. 400 crore by way of refinance limits. Another Rs. 200 crore will be made available out of IDBI's own resources. This additional financial assistance through bill discounting and other schemes will be available to manufacturers of commercial vehicles, machinery manufacturers, hire purchase and leasing companies and Road Transport Corporations.

Simultaneously, the RBI has also relaxed the norms for calculating maximum permissible bank finance. Banks have been advised to treat only two-thirds of the term loan instalments falling due for repayment during the next 12 months as current liabilities and to keep the remaining one-third outside the current liabilities for the purpose of calculating maximum permissible bank finance. This move will enhance the borrowers' eligibility for maximum permissible bank finance which would alleviate to some extent the liquidity problems faced by some borrowers because of changes relating to bill discounting/rediscounting.

Besides we have also announced relaxation of selective credit control measures by reducing the minimum margins on bank advances against oilseeds and vegetable oils (including vanaspati) and also against cotton and kapas across-the-board by 15 percentage points in view of the improved price-output situation. Thus, on the whole, despite compelling needs to moderate monetary growth to contain inflationary pressures, attempts have been made to ensure that the availability of credit to the productive sectors of the economy is adequate.

Finally, I come to the issue of interest rates. I can understand your concern about the high level of interest rates. A central feature of the Indian monetary and credit system is that the interest rates are administered. In the case of commercial banks, both the deposit rates and lending rates are regulated. Until recently the rate at which corporate entities can borrow in the form of debentures was also regulated. The rate of interest on the government securities can be maintained at lower levels because commercial banks and certain other institutions are required to invest a certain proportion of their liabilities in government securities. The purpose behind an administered structure of interest rates is to enable certain preferred or priority sectors to obtain funds at concessional rates of interest. An element of cross-subsidisation gets automatically built into the system if the concessional rates provided to some sectors are to be compensated by higher rates charged on other non-concessional borrowers. Regulation of lending rates leads to the regulation of the deposit rates. If the average lending rate is to be maintained at a certain level,

the deposit rate has to be accordingly adjusted. Over the years, the system of administered interest rate structure became complex as the number of sectors and segments to which concessional credit is to be provided proliferated.

The last few years have seen some important reforms in relation to administered structure of interest rates. These are: (a) considerable rationalisation has been effected in banks' lending rates with reduction in the number of concessional slabs and enhancement in some of the rates, thereby reducing the element of cross-subsidisation; (b) the regulated deposit rate structure has been replaced by a single prescription setting a maximum rate for maturities of 46 days and above; (c) rates of interest on government securities have been raised; and (d) for several instruments, such as Certificates of Deposits the interest rates are freely determined by individual banks. On the deposit side, there is need to give depositors a positive real rate of interest; otherwise funds may move out of the organised financial system into the unorganised system. There is considerable controversy whether rate of interest is an important variable in determining the overall savings. Notwithstanding this dispute, there is no doubt that transferable savings are influenced by interest rates. It is relevant to note that the rate of return earned by banks on their entire portfolio of lending including those to government is no higher than 13 per cent. It is the element of cross-subsidisation, which becomes essential to some extent, that keeps the rates of interest for the large borrowers at a relatively higher level. Moreover, these high interest rates were a part of crucial policy measures undertaken to achieve a turnaround of the balance of payment position. However, from the high level of 20 per cent which was prescribed as the minimum lending rate in October 1991, it has been brought down in two stages to 18 per cent. In fact, on the last occasion when the lending rate was lowered, the maximum deposit rate was also lowered. Any downward adjustment in the lending rate is possible only if the deposit rate is also lowered. Otherwise the viability of the banking system will be severely affected. In determining the deposit rate, one has to take into account the perceptions of depositors as well as the returns available on alternative financial assets. All that I can say, at this juncture, is that we will keep interest rates under continuous review. It is not the intention of policy to keep the real lending rate at a very high level over a long period.