

Address by Dr. C. Rangarajan Governor, Reserve Bank of India on "Current Economic Trends" at the All India Manufacturers' Organisation's Meet Mumbai on July 25, 1997

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1. In my address this evening I would like to focus on the current developments in the Indian economy in the context of the on-going macro-economic reform programme. The decade of the 90s has seen India rapidly transforming into a high growth economy. There has been an enormous change in the economic environment since 1991, with the introduction of reforms as part of a comprehensive stabilisation and structural adjustment programme. The basic objectives of the current reform programme have been to remove various structural constraints in the factor and product market activities, let competitive forces improve efficiency and productivity in the economy, and provide necessary outward orientation to the economy for bringing about higher degree of integration of the Indian economy with the rest of the world. Structural reforms in industrial and financial policies and trade regime have been combined with fiscal and monetary policy reforms to ensure macro-economic stability and enhance long-run growth potential.

Economic Indicators in 1996-97

2. During the past three years, the economy has done well in several spheres. While the growth conditions have improved significantly after the initial downturn in the early phases of stabilisation, this achievement is marked with two qualitative developments. First, the growth rate in real GDP exceeded 7 per cent successively for two years in 1994-95 and 1995-96. In view of the higher growth of 5.7 per cent estimated for agriculture and other allied activities, the rate of growth of real GDP is placed at 6.8 per cent in 1996-97. The trend over the last three years has brought about a significant shift in the perception relating to the long-term growth prospects of the economy. This has created a major impact on the long-term investment opportunities in the economy. Secondly, unlike the decade of 1980s, the achievement in the growth front in recent years has come about with notable improvements in some of the macro economic fundamentals in the economy. This has been reflected in a higher saving rate, a lower order of fiscal deficit, a sustainable external payments situation and a relatively stable exchange rate environment.
3. The industrial growth, after showing a speedy recovery in 1994-95, touched a high of 11.6 per cent in 1995-96. Industrial growth has decelerated during 1996-97: the overall Industrial Production Index grew by 6.7 per cent. Some correction has thus taken place in the industrial growth from the peak attained in 1995-96. A major deceleration has been noticed in the 'mining and quarrying' and 'electricity' sectors. Mining and quarrying activity increased by 1.2 per cent during 1996-97, well below 7.4 per cent level attained during the previous year. The rate of growth of electricity generation has come down to 3.8 per cent as against 8.1 per cent in 1995-96. It is somewhat puzzling how a growth rate of 3.8 per cent in electricity has been able to support a manufacturing growth rate of 8.0 per cent. The manufacturing sector after having done well in the first nine months decelerated thereafter. But, comparatively, the deceleration in the manufacturing growth (8.0 per cent during 1996-97 as against 13.0 per cent in 1995-96) is less pronounced than that of the infrastructure sectors. From the user side of industrial production,

consumer goods sector has decelerated significantly to 3.9 per cent in 1996-97 as compared with the growth of 12.9 per cent during 1995-96. What has accounted for this slow down is the sharp contraction in the growth of the consumer durables to 4.3 per cent as against 36.0 per cent in 1995-96 and a somewhat lower order of growth of 3.8 per cent in consumer non-durables than 7.2 per cent in the previous year. Both the basic goods and intermediate goods sector grew at a slower pace of 7.0 per cent and 7.1 per cent respectively in 1996-97; in the preceding year, these sectors recorded output increases respectively of 8.4 per cent and 10.7 per cent. Compared to the performance of these sectors, the capital goods sector did better by posting a growth of 8.5 per cent, but it was sharply low in relation to the 17.7 per cent growth recorded in the previous year. The deceleration in the capital goods sector has also coincided with the decline in the capital goods imports by 10.9 per cent 1996-97 in contrast to 35.3 per cent growth seen in 1995-96.

4. The deceleration in industrial growth in 1996-97 has caused considerable concern. This deceleration can be analysed in terms of supply and demand factors. While undoubtedly over the medium term infrastructure constraints can act as a break on growth, there is no reason to believe that supply constraints were more severe in 1996-97 than in 1995-96. The demand factors can be analysed in terms of (a) consumer demand, (b) private investment demand, (c) Government expenditure, and (d) exports.
5. The rural consumer demand in 1996-97 must have been weakened by the negligible growth in agriculture in the previous year and the consequent decline in rural incomes. The demand for consumer durables follows a cyclical pattern with high growth being followed by deceleration. The consumer durable goods industry rose sharply for three consecutive years with an average growth rate of 21 per cent. The deceleration in 1996-97 in that sense is explained by the very sharp increase in the previous years. Export growth was sluggish in 1996-97. Besides domestic factors, a major contributing factor must have been the decline in world trade which grew only by 5.6 per cent in 1996 as compared with 9.2 per cent in 1995. While overall government expenditure maintained the usual growth rate, there is evidence to indicate that the growth rate in public investment decelerated in 1996-97. As for private investment demand, the continued sluggishness noticed in the primary capital market must have moderated private investment expenditure. It may however be noted that some of the factors are self-reversing in character and the prospects for industrial growth in 1997-98 will depend on resurgence of demand, both domestic and external.
6. Agricultural growth, on the other hand, has shown a recovery in 1996-97 (5.2 per cent) from the negative rate of growth in 1995-96. The foodgrain production during 1996-97 is estimated at 198.2 million tonnes which is an all-time peak so far. The foodgrains production has in the process recorded a growth rate of 7.1 per cent during 1996-97, the highest in last five year period 1992-93 to 1996-97.
7. An important question which has been raised in the context of the current economic situation is : how far the economy would be able to maintain a growth rate of 7 per cent or more in future and what are the preconditions for achieving this target? I think the issue has to be addressed both from the resources side and from the angle of the physical structural constraints in the economy. On the resources side, improvement in the domestic saving rate would constitute the most critical factor for accelerating the growth momentum in the economy. In 1995-96, the domestic saving rate reached a new peak of 25.6 per cent, which with a net inflow of external resources of 1.8 per cent, increased the investment rate to 27.4 per cent. The estimates relating to the saving rate for 1996-97 are not yet available. However, if the saving rate achieved in 1995-96 is maintained in 1997-98, it is possible to realise an investment rate of around 27 per cent, assuming the current account deficit to be about 1.5 per cent of the GDP. It is also important to note that, with increased competitive pressure, the economy is slowly but gradually moving up on the productivity scale, which is reflected in the recent decline in the incremental capital-output ratio. During the period 1993-94 to 1995-96, the mean ICOR declined to 3.7 from over 4 in the 1980s. These trends would indicate that achieving a growth rate of about 7 per cent in the medium term may not pose a difficult challenge. But, the key

question is : what policy conditions will be required to maintain and perhaps enhance the saving rate to around 27 per cent? Clearly, public sector saving must show further improvement from the level of 1.9 per cent of GDP achieved in 1995-96. While the household saving responds to a host of factors, including the growth and distribution of income, from the policy point of view, maintaining an appropriate level of interest rate assumes a critical significance. What the appropriate interest rate should be to provide incentive for saving and at the same time encourage investment depends on the relative elasticity of saving and investment to interest rate. In the light of the current deceleration in some of the key industrial sectors, a major growth constraint may stem from the slower rate of expansion of infrastructure industries than what would be required to sustain a growth rate in excess of 7 per cent or so. Improving infrastructure position would not only require a large order of investment, both in the public and private sectors, over a medium to longer-time- horizon but also effective and efficient utilisation of the existing capacity. The latter consideration becomes relevant in the context of maintaining the growth momentum in the short run.

8. The monetary and financial developments in the economy during 1996-97 remained fairly satisfactory, highlighted by the containment of the broad money growth (M3) within the target range for the year, a considerable improvement in the price situation as measured by the movement in the Wholesale Price Index for the year as a whole, and a decline in the short-run interest rate. A slow rate of expansion in the reserve money helped to restrict M3 growth to 15.9 per cent in 1996-97, which was within the target range of 15.5 - 16.0 per cent envisaged for the year. The deceleration in the reserve money growth stemmed from the combined effect of a sharp reduction in the cash reserve ratio in the second half of the year, and a decline in the utilisation of export credit refinance by banks. The net RBI credit to the Government increased by about 2.3 per cent during 1996-97 as against 19.6 per cent in 1995-96. There was, however, a large order of increase (28.0 per cent) in the net foreign assets of the Reserve Bank during the year.
9. Despite the strong improvement in the lendable resources, following a large order of release of liquidity through reduction in cash reserve requirement, the credit demand remained sluggish, with the non-food bank credit showing a growth of 10.9 per cent in 1996-97 as against 22.5 per cent in 1995-96. This has happened despite the decline in the prime lending rate of most of the banks. The capital market developments show that resource mobilisation through primary issues came down from Rs.22,929 crore in 1995-96 to Rs.18,953 crore in 1996-97. The depressed capital market has also played its role in the deceleration of bank credit to commercial sector, in as much as there has to be a balance between debt and equity.
10. The inflation rate, as measured by the increase in the wholesale price index (on average basis) declined from 10.9 per cent in 1994-95 to 7.8 per cent in 1995-96 and further to 6.4 per cent in 1996-97. In an effort to sustain this improvement, monetary policy has continued to lay stress on modulating the monetary growth that would be, consistent with the expected growth rate in real GDP and a target rate of inflation during the year. During 1996-97, monetary policy has envisaged to contain the price rise to around 6 per cent. The actual inflation rate has stayed around that level. It must however, be noted that there have been substantial differences in the rate of inflation between the Wholesale Price Index and Consumer Price Index both in 1995-96 and 1996-97.
11. The external payment situation in the country has eased considerably since the crisis year of 1991. Merchandise exports in U.S.dollar terms maintained an average growth of about 20 per cent during 1993-94 to 1995-96. In 1996-97, according to the provisional trade statistics, exports are estimated to have risen by 4.0 per cent. The slowdown in the export growth (in US\$) can be attributed to deceleration in the export growth rates of both primary products and manufactured goods. The deceleration in export growth in part reflects a major slow down in the world exports in 1996. For the developing countries as a whole, exports grew by only 6.0 per cent in 1996 as against 11.7 per cent in 1995, while for the advanced countries export growth has fallen from 8.8 per cent to 5.1 per cent during the same period. The trends in the import growth in terms of US dollar has also revealed a sharp deceleration in 1996-97 from 28.7 per cent in 1995-96 to 6.0 per

cent in 1996-97, largely led by a 2.3 per cent decline in non-oil imports as against a large increase of 33.8 per cent in oil exports. The overall current account deficit is expected to be around a little over one per cent of GDP. The order of current account deficit seen in recent years is very much sustainable. The overall trend in the external payment situation in 1996-97, as revealed by the sizeable build-up of foreign currency assets of the Reserve Bank, remains comfortable. The stock of foreign currency assets has grown from US\$ 17.0 billion as at end March 1996 to US\$ 22.4 billion as at end March 1997 and further to US\$25.8 billion as of today, with the Reserve Bank intervening in the exchange market to avoid the appreciation of rupee on account of a steady inflow of capital from abroad. The exchange rate of the rupee remained fairly stable during 1996-97. With the increasing integration of the exchange and money markets in India, the focus of monetary policy has been on maintaining proper co-ordination between these two markets on a day-to-day basis for ensuring the objectives of inflation control and a competitive real exchange rate. Almost all the external sustainability indicators have remained very much favourable. Current receipts as a ratio of current payments is expected to be at 91.4 per cent in 1996-97 while the debt-service ratio is estimated at 25.7 per cent.

Monetary Policy for 1997-98

12. The monetary and credit policy for 1997-98, announced in April 1997, seeks to achieve the twin objectives of inflation control and promotion of growth. In pursuing these objectives, the accent has been placed on creating an environment that leads to augmentation of credit flow to the real sector for supporting the expected buoyancy in economic activity, consolidating and making further progress in the financial sector reform and maintaining a strong vigil on the price front. Broadly speaking there are four major areas which have been given focussed attention in the current monetary and credit policy. The first relates to maintaining a reasonable degree of price stability in the economy by regulating the money supply towards moderating the inflationary pressure. Based on the assumption of a real GDP growth of 6 to 7 per cent, the money supply growth has been targeted in the range of 15 to 15.5 per cent, for restricting the inflation rate to below 6 per cent during 1997-98. Such an inflation target should be viewed as reasonable for dampening the long-term inflation expectation in the economy, for reducing the impact of inflation related uncertainty on output, and for maintaining the external competitiveness of the economy.
13. The second important objective addressed by the monetary policy relates to improving the credit situation and bringing about a reduction in the interest rates. While the full impact of the 4 percentage point reduction in CRR effected in the last financial year will be seen in the current year, a number of measures have been announced to further improve the lendable resources of the banks. Introduction of a general refinance facility for banks equivalent to 1.0 per cent of the fortnightly average outstanding aggregate deposits during 1996-97 and exemption of inter-bank liabilities from maintenance of Cash Reserve Ratio of 10 per cent are the two important measures in this direction. These measures will augment the banking sector's liquidity to the extent of Rs.5,550 crore. Apart from its liquidity impact, the exemption of inter-bank liabilities from maintenance of CRR will help promote the term money market and facilitate the development of a realistic rupee yield curve.
14. An important step in the direction of improving the monetary management has been the operationalisation of the Bank Rate as an instrument to transmit signals of monetary policy and as a reference rate for influencing the direction of interest rate movement in the economy. Keeping this in view while the Bank Rate has been reduced from 12 per cent to 11 per cent, its linkage with the short-term deposit rate of banks has ensured one percentage point reduction in the interest rate on deposits of 30 days to one year maturity. Interest rate on NRE has also been linked to the Bank rate, while the banks will decide their own interest rates on FCNR(B) deposits. The reduction in the average cost

- of funds to banks due to these measures has fructified in bringing down the lending rates. Responding to the policy announcement, a number of banks have already brought down their Prime Lending Rates (PLR) by 50 to 100 basis points. On a four-year horizon, i.e., between 1993-94 and 1996-97, the lending rate has come down by nearly three percentage points from the high of 17 per cent in 1993-94. The Bank Rate has been further reduced by one percentage point from 11 per cent to 10 per cent in June 1997. Consequently, interest rates on domestic deposits of maturity of 30 days to one year and on NRE deposits of maturity of six months to one year were brought down from nine per cent to eight per cent per annum. Some public sector banks have reduced their Prime Lending Rates by 50 basis points to 13.5 per cent per annum. Interest rate on post-shipment export credit upto 90 days was reduced by one percentage point from 13.0 per cent to 12.0 per cent per annum and for export credit beyond 90 days and upto six months it was reduced from 15.0 per cent to 14.0 per cent per annum.
15. The third area of emphasis enunciated in the monetary policy is the revamping of the credit delivery system through the empowerment of the banking system in several spheres. The freedom given to banks to evolve their own methods of assessing the working capital requirements would result in quicker decision making and speedier flow of funds from banks to their borrowers.
 16. The fourth major objective relates to bringing about an improvement in the functioning of the various markets – the money market, the government securities market and the foreign exchange market. Some of the important measures in the areas of money and capital markets include the removal of CRR on inter-bank liabilities, the reduction in the minimum period of maturity for commercial paper to 30 days, the reduction in the minimum size of certificates of deposit, an improved access to cash surplus entities through primary dealers, an enlargement of eligible government debt instruments for Repo transactions, the entry of non-bank entities with SGL accounts to enter reverse Repo transactions and the introduction of Treasury Bills of varying maturity. These measures will carry forward the on-going institutional and policy reforms in the money and government security markets with a view to strengthening the role of interest rate in the economy and improving the conduct of monetary policy. Some major policy initiatives have been also announced to promote the foreign exchange market, such as the permission to book forward contracts on the basis of declaration of exposure, the permission given to the authorised dealers to borrow from and invest upto US\$ 10 million abroad and to engage in Forex-Rupee current swap without the prior approval of the Reserve Bank. The basic objectives of these measures are to widen and deepen the foreign exchange markets and integrate them with the other markets, so that a unified financial system would lead to the achievement of higher level of efficiency in resource allocation in the economy. Integration of various segments of financial markets has also become an absolute necessity for improving the transmission channel of monetary policy and achieving a greater degree of openness in the economy.
 17. The monetary policy for 1997-98 has therefore, adopted a package approach to improving the functioning of the financial system, to augmenting the flow of credit from the banking system to various segments of the economy, and to keeping the inflationary pressure under control.
 18. During the period March 28 to July 4, 1997, non-food credit by scheduled commercial banks declined by Rs.2,242 crore as against a decline of Rs.2,753 crore during the corresponding period in the previous year. However, banks investment in commercial paper, PSU bonds and shares and debentures of the private sector increased by Rs.2,169 crore as against an increase of Rs.1,108 crore last year. Thus, looking at the total flow of funds from scheduled commercial banks to commercial sector, it will be seen that there has been a turn-around of Rs.1,700 crore in the current year as compared with the previous year. In this context, it must also be noted that normally, during this period, bank credit declines from the peak reached at the end of March. The decline in non-food credit during the first quarter was particularly sharp in 1993-94 and 1994-95 when the fall was as high as Rs.5478 crores and Rs.6665 crores respectively.

19. The interest rates have started declining. The Prime Lending Rate (PLR) has been brought down to 13.5 per cent by some public sector banks and to 14.0 per cent by other public sector banks. Private sector banks and foreign banks have also brought down their PLRs, though not to the levels of public sector banks. The rate on the 91 days Treasury bills has declined from 9.88 per cent as on July 13, 1996 to 6.83 per cent as on July 12, 1997. In the case of 364 days Treasury bills, the rate has come down from 12.87 per cent as on July 5, 1996 to 8.83 per cent as on July 4, 1997. The inter-corporate rates have also come down. The decline in the rate of interest is seen in terms of the long-term rates as well. The 10-year Bond rate has come down from 13.85 per cent in 1996 to 13.05 per cent in April 1997. The yield on 3-year Government Bond has declined to 12.14 per cent in May 1997 as compared with a rate of 13.70 per cent that prevailed in June 1996. In July 1997, the rate on 6-year Bonds came down to 11.83 per cent as compared with 13.82 per cent in September 1996. The outstanding amount of Commercial Paper (CP) witnessed a pronounced increase from Rs.646 crore as on March 31, 1997 to Rs.1,515 crore as on June 30, 1997. The typical discount rate offered on Commercial Paper witnessed a steady decline from the range of 11.25 - 12.25 per cent to 9.50 - 11.00 per cent during the above period.
20. Questions have been raised about the appropriate level of interest rates in the Indian context. As I mentioned earlier, the interest rate should be such as to provide incentive for saving and at the same time, to encourage investment. In the developing countries, this dilemma continues to pose policy challenges. The interest rates in India have come down from the very high level reached in 1990 and 1991. The PLR of five major scheduled banks in October 1994 had come down to 14 per cent from 15 per cent in September 1993. There was a rise in interest rates in 1995-96. Since then, once again, there has been a decline in interest rates over the entire maturity spectrum.
21. Critics had pointed to the high levels of real interest rates in India. There are difficulties in computing the real rates of interest. The real rate of interest computed on the basis of the Consumer Price Index will not be as high as the one that uses the Wholesale Price Index because of the substantial differences between the WPI and CPI in the last two years. Strictly speaking, the real rate of interest is the nominal rate of interest less the expected inflation rate.
22. Monetary policy will be generally supportive in bringing down interest rates. As the inflation rate remains at a reasonably low level and inflationary expectations are broken, it should be possible to bring down the nominal interest rate. It is also hoped that as the operational efficiency of the banks improves, they would pass on some part of the gains in the form of lower interest rates to the borrowers by reducing the spread.

Prospects for 1997-98

23. To sum up, despite some deceleration in growth in 1996-97, the current economic scene reveals several positive trends, which would accelerate the growth momentum in the economy in 1997-98. On the monetary and credit side, there has been a substantial expansion in deposits in the recent period. Interest rates both short term and long term have shown a steady decline. These coupled with some of the major tax incentives announced in the Union Budget for 1997-98 and a better prospect for export growth should help accelerate the industrial growth during the current fiscal year. World trade is expected to grow at 7.3 per cent in 1997 as against 5.4 per cent in 1996. The business outlook surveys carried out by the Confederation of Indian Industry and the Federation of Indian Chambers of Commerce have indicated the prospects of an improved growth performance in 1997-98. The industry according to these surveys is optimistic in achieving a higher order of growth in 1997-98, even though these surveys do indicate that several sectors in the first quarter of the current year have shown growth rates lower than previous year. A study on the forecast of corporate investment for 1997-98 made in the Reserve Bank of India indicates that the capital expenditure of the corporate sector in 1997-98 will be 9 per cent higher than in the previous year. The favourable monsoon this

year has also brightened the prospects of a higher agricultural growth. Overall, the economy is poised for a much better growth performance in 1997-98 than in 1996-97. Over the past five years of reform, the internal and external balance of the Indian economy has undergone a fundamental positive change, contributing to the sustainability of the macro-economic system and realisation of the objectives of higher growth and stability. Accelerating the growth momentum on a continuous basis, will depend on how quickly and effectively the business community responds to the various policy initiatives and the emerging investment opportunities in the economy.