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RESERVE BANK OF INDIA

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RBI Annual Report 2003-04: Highlights

The Reserve Bank of India released its Annual Report for 2003-04. Some highlights:

Assessment of 2003-04

Overall Performance

The Indian economy recorded a strong performance during 2003-04. While the main driver of growth was the resurgence of agricultural production from the drought of the preceding year, the other factors included buoyant external demand and continued industrial recovery. The performance of agriculture in 2003-04 was typical of a normal monsoon year following a drought year as has been observed on previous occasions. The notable feature this time was the simultaneous and well distributed firming up of activity in industry and services. Exports contributed significantly to higher growth in a wide range of manufacturing industries – machinery and transport equipment, automobiles, iron and steel, chemicals and chemical products – attesting to the rising international competitiveness of Indian industry. Capacity utilisation improved in several manufacturing industries as well as in electricity generation and mining and quarrying. A robust expansion of activity in trade, hotels, transport and communication paved the way for strong growth of the services sector, well above the average for the period 1993-2003. Yet another heartening feature was the resilience of the information technology enabled services and business process outsourcing activities despite some evidence of increasing protectionist postures in major international markets.

Significant gains were posted in the external sector, indicative of a growing resilience of the economy to cushion domestic activity against external and internal shocks. The run of current account surpluses that began in 2001-02 was extended into 2003-04 – a steady rise from 0.2 per cent of GDP to 1.4 per cent. The foreign exchange reserves rose to US $ 113 billion by end-March 2004 and further to US$ 119.3 billion as on August 13, 2004.

Monetary Developments

Monetary policy assigned priority to the revival of investment demand in the economy in 2003-04 in an environment of macroeconomic and financial stability. The expansionary effects of large capital inflows posed a challenge to monetary policy, especially since the absorption of liquidity through non-food credit remained lacklustre except in the last quarter of the year. This necessitated policy intervention almost continuously throughout the year to sterilise the capital flows and prevent undue monetary expansion. The institution of the Market Stabilisation Scheme in April 2004, which provides for issuance of Government securities exclusively for sterilisation operations, enhances the capacity of the Reserve Bank to deal with capital flows in future. Another noteworthy feature of macroeconomic management in 2003-04 was the reining in of inflationary pressures. Inflation receded in the first half of the year, reaching a trough in August 2003, before being driven up almost continuously up to January 2004 by a combination of international and domestic factors. By the end of the year, however, inflation had retreated to the levels anticipated by the Reserve Bank.

During 2003-04, domestic financial markets experienced orderly and stable activity in general, under conditions of ample liquidity. The yield curve steepened in the latter part of the year, driven by market expectations relating to inflationary pressures and the raising of some major international interest rates. The foreign exchange market witnessed orderly conditions during the year. The exchange rate of the rupee appreciated against the US dollar, but depreciated against Euro, Pound Sterling and Japanese Yen during the period.

Financial Stability

Efficient functioning of the financial system and an environment of financial stability were concurrent pursuits of the Reserve Bank. In 2003-04 heightened sensitivity to these objectives was reflected in the stance of financial policies. Issues relating to corporate governance and appropriate disclosures were the focus of the conduct of financial regulation. At the same time, prudential norms and supervision continued to be tightened and benchmarked to international best practices and the emphasis also continued to shift from micro regulation to risk-based supervision. A significant development during the year was a successful pilot run for risk-based supervision (RBS), aimed at allocating supervisory resources in accordance with the risk profile of banks. The initiatives taken in recent years were reflected in the significant improvement in profitability, asset quality and capital across the financial system.

OUTLOOK FOR 2004-05

GDP Growth Rate

Early developments in 2004-05 present several continuing strengths in the economy though accompanied by some uncertainties. A clearer assessment of rainfall, as the monsoon progresses into central India and northern plains, will enable a firmer prognosis of the prospects for agriculture. The industrial climate reflects a revival of investment demand and building up of capacity. In particular, the capital goods and the intermediate goods sectors have recorded robust growth signifying the quickening of investment activity. This has been supported by improved corporate profitability, expansion in non-food credit and continuing optimism regarding production and export growth. On the other hand, production of consumer goods has slowed down considerably with the sustained growth in consumer durables providing a silver lining. The growth of the services sector is expected to build upon the momentum achieved in the preceding year and be sustained above trend levels. In view of the above, on current indications, while the prospects for GDP growth continue to be bright, in particular, due to a possible acceleration in growth of world output and enhanced domestic investment activity, there are also downside risks emanating from uncertain monsoon as well as the possible persistence of high and uncertain oil prices. These risks impart an element of downward bias to the estimates of GDP growth made at the beginning of the year but evolving strengths during the rest of the year may restore the position and in any case India will continue to be among the top performers globally.

Price Situation

Inflation, measured by year-on-year changes in the wholesale price index (WPI), has been edging up since May 15, 2004 driven up by prices of iron and steel, iron ore, mineral oils, coal and vegetables. The CPI inflation, however, continues to be at moderate levels. Over the rest of the year, pressures from international prices on domestic inflation are expected to moderate although considerable uncertainty surrounds the short-term movements in international crude oil prices, which would influence the domestic inflation outlook. Another important factor which would determine the inflation outlook in India is the progress of the monsoon, after taking into account the shortfalls and uneven spread of rainfall in July which is the sowing month of the *kharif* season. The overhang of liquidity would also need to be carefully monitored in view of its potential to pose demand pressures on prices. The outlook for headline inflation is, on current indications, less optimistic than what was envisaged at the beginning of the year. Price pressures could be a cause of some concern though it remains to be seen how the imported price shocks would evolve globally and be absorbed domestically. The comfortable level of foreign exchange reserves, however, provides the wherewithal for ensuring adequate supplies and for moderating inflationary pressures on the common man. The inflation environment needs to be monitored closely on a continuous basis for any unforeseen developments either in the global or in the domestic environment, with a view to considering prompt as well as measured responses, as appropriate.

Monetary Management

The stance of monetary policy for 2004-05 continues to be guided by the objectives of provision of adequate liquidity for meeting credit growth and to support investment and export demand while keeping a very close watch on the movements in the price level. Consistent with the above, while continuing with the *status quo,* monetary policy would pursue an interest rate environment that is conducive to maintaining the momentum of growth as well as ensuring macroeconomic and price stability. The confluence of global factors - in particular, the rise in international interest rates - and domestic developments with respect to capital flows, liquidity management and the unforeseen impact of supply shocks have necessitated close and careful monitoring of price trends, keeping in view the policy preference for stability. In this background, the need, the extent and the timing of review of the policy stance would depend not only on these unfolding circumstances but also on the adjustments that take place in the financial markets, given their sensitivity to the global and domestic conditions. Finally, monetary policy would continue to enhance the integration of various segments of the financial market, upgrade credit delivery systems, nurture a conducive credit culture and improve the quality of financial services.

The pursuit of price stability remains a key objective of monetary policy, especially in a country like India where a large majority of the population have no insurance against inflation. There is, thus, a need to consolidate the gains from reining in inflationary expectations especially as cross-country experiences suggest that public confidence can dissipate very quickly in the case of adverse movements in prices. An added dimension is the increasing sensitivity of domestic inflation to the movements in international commodity prices, with the opening up of the economy. The pursuit of price stability in future will call for a carefully crafted strategy in which monetary policy will not only need to address the demand side of the economy but also strike a fine balance in assessing the supply side of inflation, while enhancing prospects for growth.

Real Sector

Agriculture

It is an imperative that the agricultural growth rate is enhanced to around 4 per cent per annum as the critical minimum in order to sustain an overall growth trajectory of the economy at 7 per cent and more. If agricultural growth were to continue at its long-term average of 2.5 to 3.5 per cent, it would be difficult for industry and services to grow in the range of 9-10 per cent that would be necessary to attain the overall growth rate of 7 to 8 per cent. To attain higher growth in agriculture, the major areas requiring attention in the financial sector are, inter *alia,* spread of insurance against crop losses, development of commodity-derivatives market to minimise the impact of price uncertainties and facilities for meeting the entire - not merely the credit - needs of the rural economy.

Industry

The recovery of the industrial sector which began in the first quarter of 2002-03 has been steadily gaining momentum. Indian industry is engaged in a process of transformation due to competitive pressures, rapid technological progress, deregulation of product and financial markets and organisational change. An issue of concern has been the fluctuations in industrial output in the second half of 1990s with adverse consequences for the competitiveness of manufactured products. While export demand imparts a competitive dynamism to industry, there is a need to broad-base competitiveness over a wider spectrum of products. Moreover, while strong export demand tends to support overall industrial demand, there is a need to generate domestic demand on a more enduring basis to sustain the growth momentum.

Services

The services sector has emerged as the engine of growth of the Indian economy. The strength of the services sector needs to be leveraged in view of its enormous growth potential and positive externalities for the commodity producing sectors. While the rising share of services in the GDP is an encouraging sign of greater degree of diversification of the Indian economy, the corresponding decline in the shares of commodity producing sectors implies that overall productivity gains in the economy would depend increasingly on the degree of efficiency attained by the services sector. The sustainability of high growth of services would hinge upon high quality of production and delivery, continuous improvement in productivity and pro-active supply responses in markets where tastes and patterns change rapidly.

Fiscal Policy

An important goal of fiscal consolidation through the implementation of FRBM Rules, 2004 is to eliminate the revenue deficit by 2008-09. This is sought to be achieved by raising the tax-GDP ratio through augmentation of tax receipts from sustained growth and better compliance. Moreover, emphasis needs to be on withdrawing exemptions and rationalising the tax structure so as to eliminate subjectivity in the tax system. In this context, it is also worthwhile to explore the applicability of a uniform tariff rate on imports. Given the downward rigidities characterising revenue expenditure, the attainment of the goals set out in the FRBM Rules would be contingent upon the realisation of the assumed revenue buoyancies.

External Sector

The growing strength of India’s external sector has provided the enabling conditions to accelerate the pace of external liberalisation. This has considerably mitigated the inward-looking bias of past regimes and has brought forth a healthy response in terms of export earnings and the inflow of remittances. Liberalisation of foreign exchange transactions has to be backed up by price alignments in the form of reduction in tariff rates. The experience of most emerging markets suggests that internationally competitive tariff rates contribute towards export performance on a sustained basis.

Financial Sector

The Reserve Bank has been focusing on developing a competitive operating environment in the financial sector in terms of markets, institutions, products and practices. The litmus test of regulatory design in a competitive environment is to strengthen financial stability while at the same time minimising the costs of financial regulation. This, in turn, implies that as the process of deregulation deepens, regulatory initiatives have to be reoriented towards more pro-active supervision of the financial system. It is in this context that the Reserve Bank’s supervisory strategy has been to move away from micro-prescription oriented on-site supervision to risk-based supervision. A key element of a market-oriented risk-based supervisory strategy is to develop sound corporate governance practices, which would minimise the need for process-focussed supervision. The Reserve Bank, therefore, has been emphasising corporate governance and better risk assessment within banks and financial institutions, both public and private.

The Reserve Bank favours a process of gradual convergence with international standards and best practices with suitable country-specific adaptations. This has also been the guiding principle in the approach to the New Basel Accord. Having decided, in principle, in April 2003 to adopt the Basel Accord, the Reserve Bank is overseeing a road map for migration to Basel II with reviews of the progress made at quarterly intervals.

Considerable progress has been made in preparing the ground for realising the full potential of the Indian economy. The drag imposed by high levels of unemployment, poverty and inequity has brought to the fore the urgency attached to actualising this potential. This is consistent with the renewed emphasis on equity in the reorientation of growth strategy that is underway. The process of structural reforms has imparted a resilience and a momentum to the economy even as the pursuit of macroeconomic and financial stability has produced gains in terms of low and stable inflation relative to several emerging economies and a vibrant and well-functioning financial system equipped with the wherewithal of intermediating the financing requirements of high and sustained growth. The regulatory and supervisory function is getting increasingly tuned to the fast changing financial environment. Issues in governance and transparency are at the forefront of this change even as efforts are being intensified to put in place the appropriate legislative framework for the smooth functioning of the financial sector.

Alpana Killawala
Chief General Manager

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