*For the Year July 1, 2013 to June 30, 2014**

PART ONE: THE ECONOMY - REVIEW AND PROSPECTS

I ASSESSMENT AND PROSPECTS

During 2013-14, amid slow growth and high inflation, the Indian economy had to contend with serious challenges to external stability emanating from an unsustainably high current account deficit (CAD), capital outflows and consequent exchange rate pressures. Several measures taken by the Reserve Bank and the government helped stabilise the economy. With greater political stability, commitment to fiscal consolidation, strengthening of the monetary policy framework and better policy implementation, GDP growth is expected to be around 5.5 per cent in 2014-15 from the sub-5 per cent growth in the preceding two years. The disinflationary momentum that set in since December 2013 has taken inflation to a lower trajectory, broadly in line with the Reserve Bank's projections. However, downside risks to growth and upside risks to inflation arise from the sub-normal monsoon and the geopolitical situation in the Middle East. To secure a sustainable growth of at least 7 per cent over the medium term, microeconomic policies that improve activity levels and productivity will be needed so that they can work in tandem with a supportive macroeconomic regime with a reasonably positive real interest rate, low inflation, moderate CAD and low fiscal deficit.

I.1 The Indian economy stands at crossroads that could take it from a slow bumpy lane to a faster highway. Some acceleration is likely in 2014-15 that could take the growth to around 5.5 per cent. Deficiency in rainfall during the 2014 monsoon season so far poses some downside risks, but overall growth in 2014-15 is likely to be better than previous year with likely revival in industrial and construction activities. The improvement in the monsoon since mid-July will also help contain crop output losses. With greater political stability and a supportive policy framework, investment could turn around. The economy is poised to make a shift to a higher growth trajectory.

I.2 Enabling this shift in gear requires policies in support of sustainable growth. The economy had to face serious challenges to stability in 2013-14 emanating from exchange rate pressures amid capital outflows, persistence of near double digit inflation, fiscal imbalances and a decline in investment. This prompted the Reserve Bank and the government to take several measures to stabilise the economy. Monetary and fiscal policies, therefore, need to maintain caution during 2014-15 so that the gains in macro-stability are preserved and the disinflationary momentum gathers traction. In the near term, the objective of macroeconomic policies should be to secure a sustainable recovery.

* While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated beyond March 2014. For the purpose of analysis and for providing proper perspective on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

Meanwhile, microeconomic policies covering reforms in the areas of industry, services, international trade, labour markets, public sector management, financial markets and competition are needed to work towards improving activity levels and productivity, thus shaping improved supply responses that can help enhance the growth potential. This approach can deliver a sustainable growth of at least 7 per cent in a non-inflationary manner once global growth normalise.

ASSESSMENT OF 2013-14

I.3 The year 2013-14 was marked by continued slow growth, modest gains in containing inflation, reduction of fiscal deficits, correction in the current account gap and further deterioration in the asset quality of banks. The economy coped with challenges on growth, inflation and financial stability front through several government policy initiatives and the Reserve Bank's role in this is documented in the rest of the chapters of this Report that cover the review of economic policies (Part I) and Reserve Bank operations (Part II). As the year progressed, it became clear that the macroeconomic fragilities were getting under control and the outlook for 2014-15 appeared to be better.

Growth continues to be slow with contraction in mining and manufacturing

I.4 After two consecutive years of moderation, GDP growth improved marginally in 2013-14 due to a rebound in the growth of 'agriculture and allied activities' and electricity, besides buoyant activity in 'financing, insurance, real estate and business services'. While the value added in mining and manufacturing contracted, services sector growth remained unchanged. The low overall growth reflected contracting fixed investment and slowing consumption, though there was an improvement in export growth aided by rupee depreciation and contraction in imports due to subdued demand conditions and policies to dissuade gold imports.

I.5 The weak business sentiment, infrastructure bottlenecks, low public investment, domestic political uncertainty and an uneven global recovery led private fixed investment to contract. The uncertainty in the legal and regulatory framework in key areas such as environmental clearances, land acquisition and use of natural resources, especially mining activity, added to the low business confidence and affected investments in the economy. Private final consumption expenditure moderated on account of low income growth and high inflation. Macro instability, however, diminished considerably with the narrowing of the twin deficits- both current account and fiscal- and the gradual reduction in inflation.

Inflation declined during latter months of 2013-14, but remains above the level that could secure sustainable growth

I.6 Headline consumer price index (CPI) inflation generally increased during June-November 2013 driven largely by food price increases. The spike in vegetable prices, especially of onions, led to CPI inflation peaking at 11.2 per cent in November 2013. Food price corrections, largely on account of seasonal moderation in vegetable prices drove a subsequent fall in CPI inflation to 8.3 per cent in March 2014. Apart from the pressure from rising food prices, the sharp depreciation of the rupee in the H1 of 2013-14 led to pass-through effects, especially in the case of freely priced fuel products. Staggered revisions in administered prices of diesel also added to inflationary impulses. Even more worryingly, CPI excluding food and fuel segment inflation remained sticky at around 8 per cent for most of 2013-14. Double digit inflation in housing and 'others' sub-category, which largely includes services, were the major drivers of inflation in this segment.

I.7 Food price pressures witnessed in 2013-14 despite a normal monsoon raised concerns over supply chain inefficiencies as well as the need for

improving the agro-marketing infrastructure in the country. Sharp swings in vegetable prices often have a destabilising impact on inflation expectations and concomitantly raise the general level of prices. Increased input costs, driven by sticky nominal wages in rural areas partly fuelled by high food inflation and full indexation of Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) wages, also pointed to the role of wage-price spiral in keeping inflation elevated and persistent. Administered price revisions in fuel, have pushed up inflation in the short run, but have also reduced fiscal pressure and thereby medium-term inflation risks.

Twin deficit risks tamed in 2013-14

I.8 Twin deficit concerns that were the source of macro-economic fragilities during 2011-12 and 2012-13 moderated during 2013-14. Central government finances continued to improve in 2013-14 with the gross fiscal deficit (GFD) at 4.5 per cent of GDP lower than 4.8 per cent budgeted for the year and also realised for 2012-13. Containing GFD at this level helped in demand management and in providing credibility to the fiscal consolidation commitment in a year when risks of contagion came to the fore.

I.9 However, notwithstanding the headline numbers, some concerns about the quality of fiscal adjustment remain. Achievement of budgetary targets was made possible by a sharp cutback in expenditures and higher non-tax revenues, aided in a large part by higher dividend receipts from various public sector enterprises (PSEs) and public sector banks (PSBs). While many PSEs were already cash rich with inadequate investment plans, it is important to ensure that this practice does not affect the internal financing or reserves of the public enterprises that could hamper their investments in the future.

I.10 Non-plan expenditure remained broadly at the budgeted level, although expenditure on major subsidies exceeded budgetary targets. Capital expenditure was lower than budget estimates by 18 per cent. Cuts in capital outlays have potential adverse implications for growth in the medium-term, as public investment is critical to crowd-in private investment against the backdrop of two years of subdued private sector activity.

I.11 The external sector adjustment over the year was even more remarkable. Though the current account deficit was large in Q1 of 2013-14 at 4.9 per cent of GDP, a correction in CAD subsequently helped compress full year CAD to 1.7 per cent of GDP. This transformation after two years of wide CAD was brought about by a confluence of domestic policy efforts and better global conditions, with a resultant steep fall in imports and some improvement in exports. Imports declined mainly due to a fall in gold imports induced by a significant decline in international gold prices and policy curbs on its imports. Similarly, softening of international commodity prices such as oil, fertilisers and coal along with a slowdown in the domestic economy contributed to a fall in imports. The improvement in exports was supported by improvements in partner countries' growth and a more depreciated rupee.

PROSPECTS FOR 2014-15

I.12 The year 2014-15 has begun on a promising note. Index of Industrial Production (IIP) growth is beginning to look up, while inflation on an average, so far, has been lower than in the corresponding period of the previous year. Monetary policy is providing a more stable environment in terms of interest rates, liquidity and credit conditions, with tangible efforts to improve resource flow to productive sectors. The latter includes cuts in statutory liquidity ratio (SLR) and exemptions from regulatory pre-emptions such as cash reserve ratio (CRR), SLR and priority sector lending (PSL) for issuing long-term bonds to finance loans to infrastructure and affordable housing.

I.13 The Union Budget aims to keep the economy on the path of fiscal consolidation. However, strict adherence to fiscal discipline to avoid overshooting of expenditures and concerted efforts to mobilise tax and non-tax revenues, as also strong efforts on non-debt capital receipts will be necessary to attain these fiscal targets.

I.14 Export growth has improved, while capital inflows remain adequate. Further, there has been a healthy accretion to foreign exchange reserves that helps insulate the economy against prospective shocks that may be transmitted onshore. The spike in global oil price following the civil war in Iraq was transitory. Upside risks to the oil prices, however, remain in the event of underlying geopolitical tensions resurfacing more strongly in the Gulf region. Overall, the exchange rate has been stable so far in 2014-15.

Growth outlook for 2014-15

I.15 The Indian economy could grow in the range of 5 to 6 per cent in 2014-15 with risks broadly in balance around the central estimate of 5.5 per cent. This is broadly in line with the projections made by the Reserve Bank at the start of 2014-15, though risks to the central estimate were more on the downside at that point. Signs of improvement in mining and manufacturing activity, expected pickup in investment, improved availability of financial resources to private sector with lower draft of government on financial savings of the households amid fiscal consolidation, improved external demand and stabilising global commodity prices are expected to support recovery. However, downside risks could play out if global recovery slows, geopolitical tensions intensify or monsoon weakens again in the rest of the season.

I.16 All-India cumulative rainfall deficiency in the current monsoon season till August 13, 2014 was placed at 18 per cent of the long period average (LPA), as against an excess of 12 per cent in the corresponding period last year. There has been a marked improvement in the monsoon since mid-July when the deficiency was 43 per cent.

I.17 Area sown under *kharif* crops (till August 14) was 2.3 per cent lower than the normal and was 8.9 per cent higher than the 2009 drought year. Based on the sowing data, it appears that the drop in output may now be restricted mainly to coarse cereals and pulses. The reservoir water levels provide comfort. As on August 13, the level in the 85 major reservoirs was 14 per cent higher than the average over the last 10 years, though it was 12 per cent lower than last year's level on the comparable date.

I.18 Even if the rainfall is normal in the rest of the monsoon season, some rainfall deficiency will stay. However, its adverse impact on growth, inflation, fiscal and trade deficits is expected to be small as on the current reckoning, the deficiency in quantitative and qualitative terms is likely to be much less than that in 2009 (Box I.1). Moreover any shortfall in *kharif* could be substantially made good by the *rabi* crop. On an average basis for the last five years, *rabi* crop accounted for 50.7 per cent of total foodgrains output. As such, the odds are that agriculture and allied sector could make a positive contribution to overall growth as was the case even in 2009-10.

I.19 In case the monsoon weakens again in the rest of the season, there is risk of modest adverse impact on electricity production. This is because reservoir levels could fall short of their full capacities. However, overall prospects for electricity generation remains encouraging despite the likelihood of hydro-power generation decelerating from 18.6 per cent growth registered in the previous year. Hydro-power accounts for about 14 per cent of the total power supply. In the thermal segment that accounts for nearly 82 per cent of power generation, new capacities planned for the year are expected to add 8.9 per cent to overall installed thermal capacity. Similarly, installed nuclear power

Box I.1
Low Rainfall and Its Consequences

The India Meteorological Department (IMD) in August 2014 updated its forecast of southwest monsoon rainfall to 87 per cent of the long period average (LPA), from 93 per cent given in June 2014. The probability of monsoon to be deficient (< 90 per cent) is now less at 68 per cent. Till August 13, 2014 cumulative rainfall was 82 per cent of LPA. Prospects of drought in some parts of the country exist.

There is no unique definition of a drought. However, droughts are classified as meteorological droughts, hydrological droughts and agricultural droughts. IMD focuses on meteorological droughts and classifies all-India drought years as those with overall rainfall deficiency of 10 per cent or more and drought area exceeding 20 per cent of the total plain areas.

While, Indian agriculture has become more resilient in recent years, rainfall deficiency and its uneven distribution over time and space continues to have a significant bearing on crop production. Historically, whenever rainfall was deficient by 10 per cent or more, *kharif* foodgrains production, mainly rice and coarse cereals, declined. Major *rabi* crops being well irrigated were less impacted (Table 1).

Since 1980, there have been four all-India drought years as per the IMD's definition (Table 2). In all these years, foodgrains production declined, but the extent of decline ranged between 2 to 18 per cent (6 to 23 per cent in the case of rice). WPI food inflation was above 9 per cent, except for 2002-03 when off-take jumped by 59.2 per cent. Low rainfall can also have adverse consequences for rural demand, overall growth and, fiscal and trade balance. Agro imports constituted only 2.6 per cent of total imports in 2013-14, but an additional impact can come from lower agro exports that constituted 13.6 per cent of India's total exports.

The marked improvement in monsoon since mid-July 2014 has reduced the likelihood of 2014-15 being a drought year but the final outcome would depend on the spatial distribution of rainfall in the rest of the season.

Table 1: IMD Rainfall Index and Crop Production

Year	IMD Rainfall Index (Per cent of LPA)	Production Growth (Per cent)									
		Rice	Wheat	Coarse Cereals	Pulses	Foodgrains (FG)	*Kharif* FG	*Rabi* FG	Oilseeds	Cotton	Sugarcane
1982-83	86	-11.5	**14.3**	-10.7	3.0	-2.8	-11.9	10.6	-17.2	-4.4	1.7
1986-87	87	-5.1	-5.8	2.4	-12.4	-4.7	-5.9	-3.0	4.1	-20.8	9.0
1987-88	81	-6.1	4.2	-1.8	-6.4	-2.1	-7.0	4.1	**12.2**	-7.7	5.7
2002-03	81	-23.1	-9.6	-21.9	-16.8	-17.9	-22.2	-13.1	-28.2	-13.8	-3.3
2004-05	86	-6.1	-4.9	-11.0	-11.9	-7.0	-11.7	-1.2	-3.3	19.7	1.4
2009-10	78	-10.2	0.1	-16.2	0.6	-7.0	-12.0	-1.9	-10.2	7.8	2.6

Note: shaded cells show high growth in certain crops in certain years as the *rabi* crop could substantially offset *kharif* crop losses.

Table 2: Rainfall, foodgrains and food inflation in drought years

Drought Year	Per cent of LPA					(Y-o-Y change in per cent)					
	IMD Rainfall Index					Foodgrains Production	Foodgrains (PDS)			Food Inflation	
	June	July	August	September	Jun-Sep		Procurement	Off-take	Stocks	WPI	CPI-IW
1982-83	83	77	109	68	86	-2.8	9.1	16.1	0.3	11.1	6.7
1987-88	78	71	96	75	81	-2.1	-25.0	18.1	-51.7	9.0	7.8
2002-03	109	46	98	87	81	-17.9	-8.9	59.2	-35.7	1.8	2.4
2009-10	53	96	74	80	78	-7.0	4.4	23.7	21.9	15.3	15.2
Memo item											
2014-15	57	90	96#		87#						

#: IMD Forecast.

capacity is expected to go up by 41.8 per cent during the year. Thus, any losses in hydro-power are expected to be more than fully compensated by increased thermal and nuclear power and electricity production could register reasonably good growth.

I.20 Overall, the economy may grow faster than in the previous year, with acceleration in mining, manufacturing, construction and trade, hotels, transport and communication sectors. These four segments account for 50 per cent of GDP compared with about 15 per cent in case of agriculture, forestry and fishing, and electricity.

I.21 The business and investment climate in the economy is improving with the formation of a stable government at the Centre, a comparatively lower inflation and an improvement in global growth. Coincident indicators such as automobile sales, railway freight traffic, cargo handled at ports and foreign tourist arrivals are pointing towards some recovery in the services sector and automobile sales have shown signs of a turnaround.

I.22 The Union Budget 2014-15 is supportive of both investment and savings. Measures taken include an increase in the personal income tax exemption limit that will increase disposable income and increase in investment limit under section 80C of the Income Tax Act as well as the annual ceiling limit in the Public Provident Fund that will encourage savings and improve financing of investment. The proposal to increase the deduction limit on account of interest on loan with respect to self-occupied house property is also expected to increase households' physical savings. The Reserve Bank has complemented these measures by providing incentives for encouraging the flow of bank credit to infrastructure and affordable housing.

Inflation outlook for 2014-15

I.23 After remaining above 8 per cent during April-May 2014, CPI inflation (y-o-y) moderated to 7.5 per cent in June 2014 largely driven by the favourable base effect. However, inflation increased to 8.0 per cent in July 2014 as prices of vegetables increased substantially on the back of deficient monsoon rainfall. The sequential changes in food prices also indicated a significant inflation build-up in select components such as fruits, protein-rich items like eggs, fish, meat, milk and pulses during Q1 of 2014-15. CPI excluding food and fuel inflation, however, eased to 7.4 per cent in July 2014 from close to 8 per cent in April and May 2014.

I.24 Some stability in the exchange rate, has, mitigated the risk to inflation from exchange rate pass-through during 2014-15 so far. Global crude oil prices (Indian basket) declined from above US$ 110 per barrel, witnessed in June 2014 on account of geopolitical tensions in the Middle East, Ukraine, and supply outages in Libya to about US$ 105 per barrel in the latter half of July 2014. However, given the tight demand-supply balance, any risk to crude oil supply could have a large impact on prices and as such remains an upside risk going forward.

I.25 The revisions in administered prices during 2014-15, which include railway fare and freight fares apart from the staggered increases in diesel prices, could exert some pressure on generalised price levels. However, much of this will reflect the release of suppressed inflation in the past and, therefore, is desirable to keep medium term inflation under control. Moreover, the smaller increases in the minimum support prices (MSPs) will help somewhat in restraining food price pressures.

I.26 Overall, there are no significant departures in the inflation outlook from the baseline inflation trajectory indicated by the Reserve Bank at the start of 2014-15, when it committed to a disinflationary glide path of taking CPI inflation to 8 per cent by January 2015 and 6 per cent by January 2016. The Reserve Bank, in its Third Bi-Monthly Monetary Policy Statement, 2014-15 in August 2014 indicated that inflation at 8 per cent in early 2015 seems likely. Subsequent data release in terms of a higher CPI inflation driven by vegetable price spike indicate that the upside risks to this assessment persist. However, some of the increase in food prices could

be temporary and there are early indications that the price corrections are underway in select items like tomato. Also, recent decline in oil prices could partly offset the pressure from food prices. While inflation trends during the rest of 2014-15 will also be conditional on several risk factors and the timing and extent of further revisions in administered prices, the inflation projections for 2014-15 remain in reach. Though the balance of risks around the medium-term inflation path, and especially the target of 6 per cent by January 2016 are still to the upside, the Reserve Bank remains committed to supporting the disinflationary process.

Fiscal and current account gaps likely to remain contained in 2014-15

I.27 Going forward, the fiscal deficit is likely to reduce further in 2014-15. The budgetary targets are realisable, though concerted efforts will be necessary to achieve these targets. The CAD though is likely to widen from the levels in 2013-14, is expected to remain within the sustainable level. As such, the risks associated with twin deficit risks are expected to stay moderate.

I.28 The economy is well set on the course of fiscal correction since H2 of 2012-13. The intent to lower the GFD ratio to 3.6 per cent in 2015-16 and further to 3.0 per cent in 2016-17 is both feasible and reasonable. Lowering the revenue deficit, however, is proving to be difficult and will require further expenditure cuts and better targeting of subsidies. In this regard, much is expected from the Expenditure Reforms Commission announced in the budget. Expenditure restraints will be necessary during 2014-15, in particular, concerted attention is necessary during the course of year to ensure quick pass-through of global crude oil price changes to domestic prices of petroleum products so that oil subsidies are kept at the budgeted level of ₹634 billion. As such, early measures for more flexible domestic prices of diesel, liquified petroleum gas (LPG) and fertilisers are warranted.

I.29 Budgetary projections critically hinge on mobilisation efforts on the receipts side of the budget. In view of the assumed growth of 19.8 per cent growth in gross tax revenues during 2014-15 over the provisional accounts figures for 2013-14 and implied tax buoyancy of 1.5, the actual outcome of the budget will depend on efforts for widening the tax base and improving tax compliance. An early implementation of the recommendation of the Tax Administration Reforms Commission (TARC) will facilitate the process. Given that a revenue loss of ₹147 billion is estimated as the net effect of the tax proposals, achieving the estimated tax buoyancy will require concerted efforts. Achieving excise and customs duty projections will hinge upon a significant pick-up in economic growth during the year. More importantly, while the increased disinvestment target of ₹634 billion compared with ₹569 billion in the Interim Budget is realisable, it will require quick and timely action, while market conditions stay encouraging.

I.30 On the external sector side, with upside risks to oil prices due to geopolitical developments and improvements in domestic demand, a rise in imports can be expected. Therefore, the policy shift towards full pass-through of international oil prices to retail prices of diesel and other products will help limit demand and imports. Similarly, though the restrictions on import of gold for genuine trade purposes may merit a gradual withdrawal, the process for which has already begun, steps to channel investment demand for gold into financial assets need to be strengthened.

I.31 Admittedly, higher exports will also be critically important for avoiding undue expansion of the trade deficit. While the exchange rate of the rupee should remain competitive, sector-specific issues that hamper exports should be brought under sharper policy focus. In this context, the proposal to set up an Export Promotion Mission is a right step, envisaging better coordination among different stakeholders responsible for facilitating

exports. Though, the external sector now appears to be far more resilient than before, particularly with moderation of CAD and the stabilisation of rupee, one needs to be vigilant against market turbulence in the event of quicker monetary tightening by advanced economies than has been priced in by global investors. The rebuilding of foreign exchange reserves in recent months will help India buffer the economy against potential shocks.

SOME CHALLENGES FOR THE INDIAN ECONOMY IN THE SHORT AND MEDIUM TERM

I.32 The Union Budget on July 10, 2014 provided for several incentives to boost investment and growth that could help in reviving the economy over the medium term. As these supply-side policy changes seep through the economy, macro-stability and sustainable growth hinge on several medium term issues. A selected few are covered below:

Lowering high food inflation through supply-side management

I.33 High food price inflation has emerged as a major challenge for macroeconomic policy in recent years. The phenomenon of rising food prices in India has been attributed to a number of factors both from the supply and demand side. For medium-term management of food inflation, following measures could be considered:

i) The long-term elasticity of market prices to MSP is close to unity for most food crops implying that increases in MSPs eventually get passed on to market prices. While MSPs are usually fixed on a cost plus approach, this spiral calls for a relook at the agricultural price policy in the wake of persistent food price increases.

ii) Against this backdrop, increases in wage costs have been a major factor pushing up the cost of production in agriculture in recent years. A host of factors such as movement of labour into construction, implementation of the MGNREGA and its indexation to the CPI for Agricultural Labourers (AL) and, falling labour force participation rates in particular for women could explain the increase in rural wages in the recent period. While the increase in wages could be desirable from a social welfare point of view, wage increases in excess of productivity growth lead to a wage-price spiral and make food inflation a self-perpetuating cycle. The impact is not confined to food prices alone. Such a cycle, in turn, raises the prices of non-food commodities and services as well. Inflationary expectations go up and, in general, get built into wage and other contracts. In this context, the Union Budget proposal to focus MGNREGA on works that are more productive, asset creating and substantially linked to agriculture and allied activities will help. For wage increases under rural employment programmes to be non-inflationary, they cannot exceed the enhancements in labour productivity.

iii) Amid inefficiencies in the supply chain, short-term supply disturbances often driven by weather related issues, usually lead to spiralling prices in the case of select food articles. This volatility is a major issue as these price movements often impact inflationary expectations, feeding further into generalised inflation. This requires supply-side responses such as increasing storage and warehousing facilities, as also cold storage facilities for perishable food, besides more competitive marketing structures.

iv) The Union Budget has emphasised the need to set up a national market to bring in competition and integration across markets for the benefit of both farmers and consumers. State governments will also be encouraged

to develop farmers' markets in towns to enable farmers to sell their produce directly. The Agricultural Produce Marketing Committee (APMC) Acts will need to be suitably re-oriented for the purpose.

v) Trade should play an important and predictable role. The export window should be shut only in extremis so as to give farmers to gain from international trade and get a fair chance of higher realisation in an open economy. Imports should also be used liberally in anticipation of scarcity, and should not be delayed until scarcity hits the market (where it is typically too late to import). This will also improve consumer welfare.

Strengthening the monetary policy framework and transmission

I.34 A strong, transparent, predictable and effective monetary policy framework is needed to deliver low inflation. Greater central bank credibility on inflation allows it to use monetary policy in a counter-cyclical fashion. With the annual average consumer price inflation touching double digits or near for the last six years, establishing a credible nominal anchor to rein in inflation and anchor inflation expectations assumes importance. Against this backdrop, the Reserve Bank of India constituted the Expert Committee to revise and strengthen the Monetary Policy Framework (Chairman: Dr. Urjit Patel) (henceforth, the Expert Committee). The monetary policy framework had not received comprehensive attention since the change to the monetary targeting framework in the mid-1980s and to a more eclectic multiple indicator approach in 1998. Meanwhile, several countries have adopted inflation targeting with instrument independence for their central banks. In many cases, this has helped deliver low inflation. While some of these countries neglected financial stability with attendant costs that came to fore during the global financial crisis, flexible inflation targeting and financial stability are not mutually exclusive goals. In fact, low inflation helps secure monetary as well as financial stability.

I.35 Considering the above, the Reserve Bank and the government will need to work towards a new framework. Several committees including the High Powered Expert Committee on Making Mumbai an International Financial Centre, Committee on Financial Sector Reforms, the Financial Sector Legislative Reforms Commission (FSLRC) and the Expert Committee have made recommendations for a new framework. In this backdrop, the changes that need to be considered, *inter alia* are:

i) The objectives of monetary policy.

ii) The operating framework including the possible setting up of a Monetary Policy Committee.

iii) The methods of establishing accountability of the central bank for targets and ensuring its operational independence to meet the targets.

I.36 Following the Expert Committee's recommendation, the Reserve Bank in January 2014 adopted a glide path for disinflation based on a CPI inflation which is representative for all India (CPI-Combined). The index is of recent vintage in terms of its base and is available with minimal lag for policy purposes. The Reserve Bank has also been changing the monetary policy operating framework keeping in view the recommendation of the Expert Committee. While the new monetary policy framework is expected to work towards better inflation management, the eventual outcome will also depend on the efforts to remove impediments in monetary transmission (Box III.3).

Fiscal adjustment through revenue augmentation

I.37 Fiscal consolidation since H2 of 2012-13 has essentially focused on expenditure cutting

backed by one offs in revenue. While there is significant scope for further pruning and better targeting of subsidies, the fiscal consolidation ahead could be additionally supported by higher revenue mobilisation. The major gains so far have been made on the expenditure side, with revenue expenditure getting reduced by 2.0 percentage points of GDP over 2009-10 to 2013-14 (Provisional Accounts). Gross tax revenue showed a relatively moderate improvement of 0.6 percentage points of GDP over the same period.

I.38 Revenue to GDP ratio for India is lower than that of advanced countries and major emerging market and developing economies (EMDEs). For instance, general government revenues were just over 20 per cent of GDP in 2013-14, about half the average for advanced economies at 37 per cent. However, this essentially reflects the low per capita income and level of development in the economy. As such, raising tax rates to increase tax buoyancy may not result in dynamic optimisation of revenues as it could disincentivise savings, investment and growth. However, there is scope to increase the tax base and improve tax compliance, for example, through reform of the indirect tax regime. In this context, the most important tax reform that is on the anvil is the Goods and Services Tax (GST). It would transform the indirect tax regime to a more efficient one and help raise additional revenues over a period of time by improving tax compliance.

I.39 Improving tax administration will help as general government tax receipts accounts for over 80 per cent of revenue receipts in India. For increasing tax collections, it is important to improve tax efficiency and tax buoyancy. Tax efficiency can be improved through minimisation of distortions by broadening the tax base, targeting negative externalities and strengthening tax compliance. The recently constituted Tax Administration Reform Commission can play an important role in improving transparency and efficiency in tax administration. The list of services exempted from service tax has been shortened over the years, but scope for further reduction exists. Further reforms in direct taxes are needed keep in view the principles are efficiency, equity and effectiveness. However, it is important that these changes do not adversely affect saving and investment behaviour.

I.40 Low returns on government investments in public sector undertakings, insufficient returns on the use of natural resources and inadequate disinvestment receipts also contribute to low revenue mobilisation. These should be addressed to put India's public finances on a firmer footing. Revamping the process of disinvestment to enable quicker decisions and engaging professional expertise available in the market will help. Engagement of professional merchant bankers with proven track records and measurable performance yardsticks with market-related fees and incentives is needed in this context. These merchant bankers could quickly handle the process of road shows and putting together the prospectus so as to complete the entire process of budgeted disinvestment as quickly as possible. This nimble-footed approach will benefit from favourable market conditions, and also help in unlocking the true value for PSEs. Further, the government also needs to give a thought to privatising some PSEs which are not yielding due returns. This is typically the case where the PSEs suffer from capital misallocations and corporate governance issues. More broadly, improvements in corporate governance and a greater management focus on improving firm values will increase government realisation from disinvestment.

Strengthening infrastructure by improving contractual arrangements for private sector

I.41 Despite concerted efforts by the government, the revival of interest in infrastructure investment has been rather modest. Therefore, further initiatives have been taken in the Union Budget 2014-15 in consultation with the Reserve

Bank. The Reserve Bank has followed up on the budgetary announcements and, as stated earlier, allowed banks to raise funds for lending to infrastructure sector without regulatory requirements such as CRR, SLR and priority sector lending targets. The Union Budget has also sought to improve infrastructure through measures related to public private partnership (PPP) and setting up of a National Industrial Corridor Authority in order to coordinate the development of industrial corridors with smart cities linked to transport connectivity. The Budget aims at providing incentives for Real Estate Investment Trusts (REITs) as well as announced the setting up of Infrastructure Investment Trust (a modified REITs type structure) in order to attract long term finance from foreign and domestic sources for PPP and infrastructure projects. The budgetary provision for the Pooled Municipal Debt Obligation (PMDO) was enhanced from ₹50 billion to ₹500 billion with the extension of the facility by five years to March 31, 2019.

I.42 However, the PPP model in India has come under strain during the cyclical downturn, partly due to aggressive bidding by private sector firms facing competitive pressures. Their unrealistic assumptions that the economy will keep growing at a high rate have been belied. Cyclical downturns had not been adequately built in the project mathematics. At the same time, contractual arrangements with the private sector provided little flexibility and have worked to dampen private sector interest in infrastructure investments during difficult macroeconomic conditions. Some firms have also exacerbated the problems of liquidity and leverage by showing inflexibility in asset sales by sitting on large land banks or other assets. These problems need to be quickly resolved by a flexible approach, both from the government and the private sector. In this context, a more focussed initiative to revive the infrastructure sector, *inter alia*, by improving contractual arrangements with private sector is needed (Box I.2).

I.43 Given the infrastructure deficit, a large opportunity awaits the private sector for participation in the growth of the infrastructure sector. These opportunities exist in road, railways, ports and power sectors. Improved contractual arrangements can rekindle interest in this space and help the investment cycle to turn around soon.

Box I.2
Rethinking Contractual Arrangements with Private Sector in Infrastructure

While infrastructure expenditure is vital for growth, it is a challenge to balance it with fiscal restraint, which remains a policy imperative. This could be partly addressed by the private sector, but many such existing investments are facing problems.

The banking system, which has largely financed private involvement in infrastructure, is showing the resultant strain. While stressed advances of the scheduled commercial banks (SCBs) have declined marginally to 10.0 per cent of the total advances in March 2014 from 10.2 per cent in September 2013, they remain high. Five sub-sectors, *viz.*, infrastructure, iron and steel, textiles, mining (including coal) and aviation services, that account for about 24 per cent of total advances, comprise over half of stressed assets. Of these, asset quality in iron & steel and infrastructure has worsened most sharply. While share of advances to infrastructure continued growing, *albeit* slowly (the share of the other four sub-sectors have declined), from 13.5 per cent in March 2011 to 14.4 per cent, in March 2014; infrastructure as a share of stressed assets, has risen sharply, from 8.4 per cent to 29.2 per cent. This implies that the stress rate of infrastructure, which was much less than the average, is now over twice that of the overall portfolio. Over a fifth of all infrastructure advances are stressed and in stress tests of credit risk exposure to sectors, infrastructure impacts banks most severely on account of potential losses on future assumed impairments.

It is important to avoid a repeat of the past, where a push for infrastructure projects, many of which later stalled, resulted in accelerated growth in gross NPAs. Furthermore,

(Contd...)

while early detection and prompt corrective action (PCA), concerted recovery efforts, and a more supportive legal infrastructure, *etc*. can help to address issues of asset quality, it is necessary to also revamp the contractual relationship between private firms and the government in the infrastructure sector.

The nature of contracts with the government determines the risk allocation to the private sector in infrastructure. The broad principle is to allocate such risks as can be controlled or managed by the private sector to them, but many current contracts do not fully reflect this principle. In power generation, the bids allowed bidders to assume exchange rate and fuel cost risks, without enforcing suitable hedging. This led to large scale renegotiation. In roads, the transfer of traffic risk, known as unpredictable, highly variable and outside the control of the private sector, could have been avoided. Given that the high leverage of construction firms in the road sector amid environmental and land acquisition issues has tempered the private sector's interest in PPP bidding, measures such as premium rescheduling, cancelling and rebidding of contracts and recourse to engineering, procurement and construction (EPC) contracting has become necessary. The perception is that Port concessions are designed to charge users more than needed; a number of them have been challenged in courts. Similarly structured airport concessions have had to be renegotiated.

Pension and insurance companies have consequently been reluctant to lend to infrastructure projects, which their regulators, prudently, given the experience so far, perceive as excessively risky. Total lending by them is thus limited, even as there is substantial growth in assets under management (AUM). A better distribution of risk will allow them to increase their participation and could bring in substantial additional funding into the sector.

A wholesale reversion to works contracts may be undesirable, not only fiscally, but because infrastructure PPPs are needed to increase accountability and leverage private management and implementation capacity. Based on learning from existing projects, revamped contract arrangements that limit risk transfer to project costs and controllable revenue items and use of innovations like Least Present Value of Revenue (LPVR) bids, *e.g.* for electronically tolled roads, may be examined.

Revamped infrastructure contracts also need to factor in the possibility of renegotiation and include mechanisms that clearly lay out the process to be followed in such an event. This will reduce the advantages of those who bid unreasonably in the expectation of being able to renegotiate better terms subsequently. Also, a more level playing field will help to attract foreign direct investment (FDI) into the sector.

Removing obstacles and improving access to finance

I.44 It is not enough for the banking system to support growth by channelling the household financial surplus to meet the investment needs of corporations. While financial deepening in itself is important, the distribution of finance is also important. Access to finance for those who are ignored or crowded out of the credit markets but can make use of it for productive purposes is an equally important element in supporting growth and more inclusive development. Obstacles to finance for small businesses due to information asymmetry and other frictions in the credit market and to individuals due to poverty, lack of collateral, geographical reach or education have been major policy challenges.

I.45 A number of studies have shown that financing is a greater obstacle for small and medium enterprises (SMEs) than it is for large firms, particularly in the developing world, and that access to finance adversely affects the growth of the SME sector more than that of large companies. Cross-country surveys appear to suggest that external finance and external financing premium constitutes a significant impediment for their operations and growth. These financing constraints vary across firm size with empirical evidence suggesting that financing constraints lower firm growth by a much higher percentage for small firms as compared with large firms, and these magnitudes are, by no means, non-negligible.

I.46 In the Indian case, there is overdependence of SMEs on trade credit. Lowering information

asymmetry through improved credit reporting, and greater competition and productivity enhancements in banks to lower intermediation costs, are necessary to improve credit flow to SMEs.

I.47 The financial inclusion programme of the Reserve Bank is detailed in Chapter IV. However, while improving access to finance is no doubt an important public policy goal, the prerequisite for sustaining any public policy programme lies in its financial viability. Microfinance institutions and small regional rural banks can certainly help in furthering access to finance. However, they cannot on their own bridge the gaps. We need sound and well capitalised financial institutions to take up the agenda. Therefore, we need mainstreaming of financial inclusion. Banks will not lend to the unbanked unless they find such lending financially viable. This cannot happen unless transaction costs come down. Surveys suggest that transaction costs for small sized loans are considerably higher than that for larger loans. One possible solution lies in harnessing technology to lower transaction costs and thus facilitating inclusion. Competition will also help, not just through more bank licensing but also by encouraging NBFCs and other businesses with the necessary capabilities and reach.

I.48 India is a knowledge economy that has a large and expanding pool of engineers and software professionals. However, we have not fully reaped technology for financial inclusion in relation to the potential. It is true that financial illiteracy, low incomes, volatile incomes, availability of collateral and lack of credit history come in the way of financial inclusion in a meaningful way, but lack of product innovation and appropriate technology use constitute the most important hurdle in promoting financial inclusion. Greater use of technology and increased competition could help as has been seen in the case of the telecom industry earlier. The Industry grew exponentially in just 10 years taking the mobile phone user base to nearly 1 billion and paving the way in sharp reduction in long distance call rates.

Managing the NPA cycle to improve soundness of the banking system

I.49 The credit quality of banks has deteriorated notably over the last three years. Gross NPAs increased from 2.4 per cent of gross advances in March 2011 to 4.4 per cent in December 2013, before declining somewhat to 4.1 per cent in March 2014. Net NPAs to net advances showed similar trends and stood at 2.2 per cent in March 2014. The capital adequacy ratio (CRAR) also declined from 15.0 per cent in December 2009 to 13.0 per cent in March 2014.

I.50 This deterioration in NPAs occurred for both Public Sector Banks and Foreign Banks. In March 2014, PSBs' gross and net NPA ratio stood at 4.7 per cent and 2.7 per cent, respectively. Private sector banks' gross NPA ratio declined despite economic downturn to 1.9 per cent in March 2014 from 2.5 per cent in March 2011. Their net NPA ratio has marginally increased from 0.6 per cent in March 2011 to 0.7 per cent in March 2014.

I.51 Compared over time and across countries, India's NPAs are not high. Historically, the gross NPA ratio was at 12.0 per cent in March 2001. It had declined sharply to 2.4 per cent in June 2008 on the back of stringent prudential regulations and high growth in the economy. The global financial crisis started the cycle of deterioration. This was compounded by the growth slowdown and emergence of sector specific problems, especially in power, road and airlines industries. Exposure to certain group firms that became excessively leveraged has also contributed to weakening asset quality. Further, it would be imprudent to focus only on the NPA ratio since restructured loans are also significant.

I.52 The experience with the current NPA cycle has several lessons. First, there is need for

countercyclical capital buffers and dynamic provisioning to deal with cyclical economic movements. The Reserve Bank asked banks to make floating provisions in 2006 and 2007 that could be set off in bad times. However, a comprehensive move in the direction of dynamic provisioning emerged only in 2012 when it released a discussion paper. Given that the banks were already in the low phase of the NPA cycle, building new buffers required more time. However, following extensive discussions with stakeholders, the Reserve Bank in February 2014 asked banks to develop necessary capabilities to compute their long term average annual expected loss for different asset classes, for switching over to the dynamic provisioning framework as asset quality improves.

I.53 Second, there is need to focus more closely on the restructuring of standard loans. Restructured standard advances for all scheduled commercial banks increased from 2.5 per cent of gross advances in June 2011 to 5.9 per cent in March 2014. In response, the Reserve Bank made debt restructuring norms more stringent and loans recast after April 1, 2015 will need to be classified as NPAs. Also, from June 2013, the provisioning requirement for fresh standard restructured advances has been increased to 5 per cent from 2.75 per cent, for the interim period. It has also been decided that promoters of firms will have to bring in 20 per cent of the erosion of the net present value, compared with 15 per cent earlier.

I.54 Similarly, while encouraging the process of recovery of distressed assets through asset reconstruction firms (ARCs), the Reserve Bank is taking steps to ensure that distressed asset sales to ARCs genuinely transfer risks from the banks. This is especially important as there has been a sharp rise in asset sales to ARCs during 2013-14 (Table VI.3). In order to tone up the regulatory framework for the securitisation companies and reconstruction companies, the Reserve Bank in August 2014 increased the mandatory minimum holding in securities receipts from 5 per cent of the securities receipts issued by them to 15 per cent of the securities receipts of each class in each scheme, while granting them more time for due diligence. The regulatory amendments made are expected to improve recovery prospects of ARCs, support price discovery and enhance transparency. Overall, functionally efficient ARCs are needed, especially as recovery through the SARFAESI and debt recovery tribunals has been weak.

I.55 The Reserve Bank remains committed to improving the ability of financial and non-financial firms to cope with distress in a manner that is consistent with the financial stability over the medium and long run. Taking into account cyclical considerations, it will continue its efforts to improve the asset quality.