*For the Year July 1, 2014 to June 30, 2015**

PART ONE: THE ECONOMY - REVIEW AND PROSPECTS

I ASSESSMENT AND PROSPECTS

I.1 Over the year gone by, the Indian economy remained resilient in a global environment characterised by falling macroeconomic risks but rising financial stability risks. While a modest recovery is tentatively gaining foothold in advanced economies, activity slowed across a broad swathe of emerging economies as commodity prices fell, financing conditions tightened and structural constraints started building. India is a notable exception. Globally, financial risks increased as investors reached for yields, expecting US monetary policy to normalise more slowly. Incipient threats to financial stability were also evident in rising corporate indebtedness in both advanced and emerging economies, stretched asset valuations in some sectors, marked increase in exchange rate volatility and the debt crisis in Greece in the closing months of 2014-15. Spillovers from these external shocks impacted various segments of the financial markets in India, asset prices and capital flows, although the latter remained by and large buoyant.

I.2 Even as banking sector risks remained elevated domestically, the macroeconomic fundamentals of the Indian economy improved gradually over the year, anchored by some easing of inflation and continuing fiscal consolidation. Notwithstanding deterioration in export performance brought on, *inter alia*, by weak external market conditions, the current account deficit narrowed in 2014-15 from its level a year ago on terms of trade gains and weak import demand. With fiscal consolidation firmly underway and with buoyant business optimism, the stage is now set for unshackling stalled investments and for boosting new capital spending in order to accelerate the pace of growth. Drawing on the experience of 2014-15, it is now time to implement an agenda to take the economy to higher growth in 2015-16 and over the medium-term. Concomitantly, recent gains in reducing inflation pressures need to be built upon so that disinflation continues along with higher growth. Importantly, resolute actions are needed to ease stress in financial assets, mitigate/resolve debt burdens so that stranded assets are put back to work quickly wherever feasible and capital buffers are built to enable financial intermediaries to provide adequate flow of credit to productive sectors.

ASSESSMENT: 2014-15

I.3 While the pick-up in the growth of GDP at market prices in 2014-15 was largely sustained by private consumption, the decline in the

* 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 2015. 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.

rates of saving and investment for the second consecutive year to 2013-14 emerged as a matter of concern. The improvement in the financial saving of households and the expected decline in government dissaving in 2014-15 should work towards releasing the financing constraints on investment, especially when seen in conjunction with the step-up in capital goods production in the latter half of 2014-15.

I.4 On the production side, the weather-induced slowdown in agriculture impacted rural demand and also necessitated policy interventions to manage food price pressures. In the industrial sector, a turnaround in manufacturing in the latter half of the year was essentially driven by upbeat business sentiment, some unclogging of stalled projects and a robust improvement in electricity generation and coal production in the closing months. A durable upturn in new capex, capacity utilisation and new orders – both domestic and foreign – holds the key to a sustained revival of industrial activity. In the services sector, only a few sub-sectors, such as finance, real estate and construction, grew at a higher pace.

I.5 From June 2014, inflation declined faster than initially anticipated. A combination of favourable factors such as the collapse of international commodity prices, particularly of crude, and loss of pricing power among corporates due to weakening demand as well as pro-active supply management and deregulation of key fuel prices worked in alignment with a disinflationary monetary policy stance that was set from September 2013. Accordingly, inflation expectations eased to single digit for the first time since September 2009 and wage pressures moderated.

I.6 A significant factor influencing the evolution of monetary conditions during 2014-15 was the large surge in capital inflows, which necessitated active and nimble liquidity management operations to sterilise flows in accord with the stance of monetary policy. Still sluggish demand, receding inflation and risk aversion stemming from stress in financial assets restrained bank credit growth and also incentivised substitution of bank lending to take advantage of competitive pricing conditions.

I.7 The revised liquidity management framework introduced in September 2014, and in particular intra-day fine-tuning operations, improved, over time, the alignment of money market rates with the policy repo rate. Notably, large spikes in rates hitherto associated with advance tax payments and balance sheet closure were muted. Gilt yields declined, reflecting the improvement in macro-fundamentals. In the foreign exchange market, two-way movements were associated with lower volatility. Stock markets rallied strongly throughout the year on buoyant investor optimism, both foreign and domestic, stretching valuations before some correction in the closing months of the year.

I.8 While the committed path of fiscal consolidation was adhered to by the central government for the third year in succession, slack revenue mobilisation – particularly through disinvestment – necessitated cutbacks in productive capital expenditure towards the end of the year. This highlights the need for more realistic assessment of revenue targets and expenditure allocations. Furthermore, states need to remain committed to fiscal consolidation.

I.9 The contraction in merchandise exports since December 2014 emerged as an area of concern, sapping aggregate demand and increasing external vulnerability, notwithstanding terms of trade gains and a large saving on POL imports helped contain the current account deficit. Buoyant capital inflows in excess of the external financing requirement raised international reserves to an all-time high by the end of the year.

PROSPECTS: 2015-16

I.10 Turning to 2015-16, the outlook for the global economy has been adversely impacted by the contraction in output in North America in the first quarter of 2015. In the second and third quarters, there are indications of demand picking up in advanced economies; however, the continuing slowdown in emerging economies holds back a fuller global recovery. At the same time, with hardening bond yields and risk premia, emerging economies are contending with volatile currency movements and capital flows. Going forward, these factors could pose risks to the global recovery. Accordingly, the IMF has pared its forecast for global growth in 2015 to 3.3 per cent in its July update, marginally lower than in 2014.

I.11 For the Indian economy, the outlook for growth is improving gradually. Business confidence remains robust, and as the initiatives announced in the Union Budget to boost investment in infrastructure roll out, they should crowd in private investment and revive consumer sentiment, especially as inflation ebbs. While the progress of the monsoon has allayed initial fears of moisture shortfall, uncertainty surrounding the progress and distribution of the monsoon remains a risk to the outlook for both growth and inflation. Comprehensive and pre-emptive food management strategies need to be put in place to contain these spillovers. In the first four months of 2015-16, indicators of real activity have broadly tracked the Reserve Bank's baseline projection of output growth (at basic prices) at 7.6 per cent for the year as a whole, up from 7.2 per cent in 2014-15.

I.12 Taking into account initial conditions, including the prospects for the monsoon and for international crude prices, the Reserve Bank projected in April 2015 a baseline path for inflation in 2015-16 in which it would be pulled down from current levels by base effects till August but is expected to start rising thereafter to below 6.0 per cent by January 2016. So far, inflation outcomes have closely tracked these projections. The risks to this trajectory are balanced as the weather-related uncertainties are offset by falling crude prices. Inflation developments will warrant close and continuous monitoring as part of the overall disinflation strategy that requires inflation to be brought down to 5 per cent by January 2017.

I.13 As regards fiscal policy, the Government's resolve on fiscal consolidation should propel efforts to reach the target for the gross fiscal deficit for 2015-16 at 3.9 per cent of GDP. In the early months of the year, indirect tax collections have been robust and set to achieve budget estimates, though contingent upon a recovery in manufacturing and services. Furthermore, plans for disinvestment need to be front-loaded to take advantage of supportive market conditions, and also to forestall cutbacks in capital expenditure to meet deficit targets. Such cut backs compromise the quality of fiscal consolidation. States need to take advantage of the greater fiscal autonomy stemming from higher devolutions and prioritise capital and developmental expenditure so that the quality of sub-national fiscal correction is maintained.

I.14 In the external sector, merchandise exports have contracted through the first four months of 2015-16, rendering the economy vulnerable to external shocks. Imports have remained subdued, primarily reflecting softening of crude and gold prices. Non-oil non-gold imports have also moderated due to muted domestic activity. Over the rest of the year, some savings may accrue on account of POL and bullion imports; on the other hand, the gradual pick-up in activity anticipated over the rest of the year may revive non-oil non-gold import demand. Remittances from Indians working abroad have weathered the slowdown in global growth and should continue to lend support to the balance of payments. Along with a surplus expected on trade in services as in the past, from software exports and travel earnings, the current account deficit for the year as a whole should be contained below 1.5 per cent of GDP. The outlook for capital flows is highly uncertain, with the widely anticipated normalisation of US monetary policy later in 2015 expected to generate capital outflows from emerging markets and also to harden financing conditions as bond yields rise. In this context, the level of reserves at over US$ 350 billion and equivalent of about nine months of imports should provide a buffer and smooth out normal import and debt servicing requirements over the year.

I.15 Key to the realisation of these expectations is a durable pick up in investment, supported by sustained efforts to alleviate supply constraints. The proposal to introduce a Comprehensive Bankruptcy Code of global standards by 2015-16 and replacement of the existing multiple prior permission procedure for investments by a pre-existing regulatory mechanism is expected to improve the business environment in India. Easing the doing of business has now become a widely cited constraint on the revitalisation of manufacturing. Areas that require significant changes include legal and regulatory environment, labour market reforms, tax regime and administrative environment.

I.16 Gaps in distribution networks and deteriorating financials of power discoms need to be addressed expeditiously for demand to keep pace with the ongoing easing of supply constraints. Focusing on renewable and clean sources of energy should be accompanied by conservation of energy as a medium-term strategy.

I.17 Expansion of the avenues for gainful employment opportunities is vital for efforts to harness the demographic dividend. This calls for careful identification of skill gaps, providing vocational and technical training, and building of new skills. The National Mission for Skill Development which aims at consolidating skill building initiatives spread across several ministries, is relevant in this context. As self-employment holds out greater employment opportunities, the SETU (Self Employment and Talent Utilisation) initiative for supporting all aspects of start-up business and other self-employment activities is crucial. Other initiatives like Digital India and Make in India will also help to enhance the employment potential.