*For the Year July 1, 2018 to June 30, 2019**

PART ONE: THE ECONOMY - REVIEW AND PROSPECTS

I ASSESSMENT AND PROSPECTS

I.1 Half way through the financial year 2019-20, several uncertainties weigh on the near-term outlook for the global economy and India. After growing strongly in January-March 2018, the global economy began to slow in subsequent months. The loss of speed spread to different parts as political developments purveyed heightened uncertainty, world trade froze, investment slumped, while manufacturing weakened worldwide. From the early months of 2018, a combination of global spillovers - from attempted monetary policy normalisation by systemic central banks; elevated and volatile crude oil prices; geopolitical tensions; trade tensions; and Brexit - triggered safe haven flights that swept capital flows out of emerging market economies (EMEs) as an asset class. Bouts of turbulence unsettled financial markets, leaving in their wake currency depreciations, asset price volatility, reserve depletions and macroeconomic losses which impacted EMEs almost continuously till early October, 2018. It was only with some ebbing of the vortex of global spillovers that calm returned in the ensuing months. India was not immune to these negative externalities.

I.2 India's real GDP growth clocked an average of 7.7 per cent during 2014-18 and 8 per cent in Q1 of 2018-19, but it began to shed momentum through the rest of 2018-19. The year 2018-19 began on a robust note, but it was to be marked by unanticipated swings and turning points that would take their toll on India's macroeconomic performance. The drivers of growth were hit by downturns at different points of time. Gross fixed capital formation slowed in Q2, which further deepened during subsequent quarters, with knock-on effects on manufacturing and net exports in Q2 and Q3. As in the rest of the world, private consumption remained resilient, supporting services. From the second half of the year, however, and right up to the time of writing, this mainstay of aggregate demand in India has weakened more than initially anticipated. Meanwhile, the growth of value added in agriculture and allied activities decelerated from Q3. This, in turn, pulled down rural demand.

I.3 India's macroeconomic stability provided a silver lining, with inflation remaining below target of 4 per cent for the second financial year in succession under the monetary policy committee (MPC); the current account deficit (CAD) settled below 1 per cent of GDP in Q4 (2018-19); and the fiscal deficit for the year as a whole was contained at 3.4 per cent of GDP. External sector faced headwinds during 2018-19 as CAD exceeded net capital inflows, though reserve losses were partially recouped toward the close of the year. Yet, it is unclear now whether this stability mitigated a deeper loss

* 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 2019. 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.

of activity or whether it reflected the symptoms of the slowdown itself. This dilemma becomes all the more acute when juxtaposed with issues relating to financial stability. The ongoing repair of banks' balance sheets and rebuilding of capital buffers brought about a plateauing of stressed assets and a rekindling of credit flows in anticipation of the reinvigoration of growth impulses. With aggregate demand slowing in a broad-based manner, the gains in restoring financial stability may be at risk, exacerbated by credit and liquidity stress in the non-banking space, which are, however, being addressed by the Reserve Bank.

I.4 The key question that confronts the Indian economy as it looks ahead to the rest of 2019-20 is: are we dealing with a soft patch, or a cyclical downswing, or a structural slowdown? This will determine the policy responses - illustratively, a soft patch can be looked through, while a cyclical downswing will warrant counter-cyclical actions in terms of monetary and fiscal policies, but a structural slowdown will need deep-seated reforms. The diagnosis is difficult; these conditions are hard to disentangle cleanly, at least in the formative state. Proximate answers could perhaps be found in the lessons of the experience of 2018-19, with which it could be feasible to assess the outlook for 2019-20 and the challenges that lie ahead.

Lessons from the 2018-19 Experience

I.5 As mentioned earlier, 2018-19 turned out to be a high-wire year in terms of the unanticipated nature of shifts in macroeconomic and financial conditions, and their sheer magnitude. Sifting through these eventful developments for underlying drivers could provide insights into the current state of the economy and policy perspectives in that context.

I.6 Throughout the year, protectionist policy pronouncements and actions in the form of labelling, bilateral tariff escalations, sanctions and retaliations dominated the global political arena. They dealt a body blow to world trade, roiled financial markets and posed risks to macroeconomic prospects of several economies, advanced and emerging alike, that have sought to employ the engine of trade to integrate into the global economy. They also fuelled an animated debate on the end of globalisation. Yet, the unfolding of events during the year demonstrated that the world remains coupled, or at least uniformly vulnerable to global shocks.

I.7 Macroeconomic outcomes in the first quarter of calendar year 2018 seemed to indicate that the global economy was on an extended expansionary phase. Crude oil prices rose to confirm expectations of robust demand. Normalisation of ultra-accommodative monetary policy gathered advocacy and even some traction in the form of interest rate increases and some balance sheet contraction by the Fed and tapering down of quantitative easing (QE) by the ECB. The consequent stampede of capital flows out of emerging markets did not distinguish between jurisdictions, including between economies that were on high growth trajectories and those emerging tentatively out of recessionary conditions. Fundamentals did not seem to be the main determinant of capital flows. Moving forward, when growth expectations turned out to be illusory towards the close of the year and a slowdown became pervasive in subsequent months, most EMEs irrespective of the level of development or underlying state of macroeconomic conditions, got affected.

I.8 These developments suggest that individual economies have to build strong buffers for themselves against forces that have cross-border effects, especially as neither global collective action nor global financial safety nets are assured. In this context, there is a need for greater sensitivity all around about the deleterious effects of global spillovers while adhering to the extant rules of the game in dealing with them. Spill-backs from emerging markets have become a real danger to global economic prospects. Multilateral solutions are preferable to short-sighted actions that reduce global welfare. Given the high degree of global interconnectedness, the Integrated Policy Framework (IPF) taken up by the IMF in its global policy agenda this year (April 2019) could offer a way forward by jointly considering monetary, exchange rate, macro-prudential and capital flow management policies and their interactions. Its efficacy will hinge around a spirit of cooperation and buy-in by all stakeholders.

I.9 The global slowdown has several channels of contagion. For India, export volumes moderated in spite of a modest real depreciation, showing that it is external demand that is the key determinant of export performance. Moreover, exchange rate pass through has been low due to the spread of global supply chains and 'pricing to market' strategies. Terms of trade became another channel: international crude oil prices rose and were volatile for the greater part of the year in the crossfire of OPEC plus production cuts, ramped up shale supplies and social media statements. Meanwhile, slowing domestic demand led to moderation in non-oil non-bullion imports. The growing incidence of unilateral trade actions warrants an opportunistic export strategy that (i) seizes upon the space opened up by trade diversion and the vacation of niches by large players; (ii) intensifies diversification of products and markets; and (iii) builds on innate strengths and competitive advantages. At the same time, efforts need to be redoubled to move countries towards cooperative multilateral arrangements under the existing institutional architecture, eschewing national self-interest and promoting an open multilateral trading order that includes all.

I.10 Yet another conduit through which trade wars and other sources of global spillovers impacted India during 2018-19 is the intertwining of the finance and confidence channels. The sensitivity of portfolio capital to global spillovers is estimated to have increased several-fold relative to the taper tantrum period. This has been ascribed to the increasing prominence of 'passive investment' strategies in which fund managers employ vehicles such as exchange traded funds that track returns on a particular index or benchmark. Consequently, risk-on risk-off swings in sentiment have amplified the mobility and volatility of capital flows, with spillovers to financial markets and eventually to economic activity. For countries like India which traditionally run current account deficit, viable external financing can become an additional consideration for holding adequate precautionary buffers. It is prudent to bear in mind the experience of 2018-19 when a crude oil price induced expansion in the current account deficit through the first three quarters of the year was coincident with risk-averse portfolio outflows, warranting the use of reserves for meeting financing requirements.

I.11 The trade channel has itself become the mode of transmission of global impulses to domestic manufacturing and investment. This is evident in the close synchronisation across borders of sluggishness in industrial production and of the 'reluctance to invest'. In India, the deceleration in industrial output and its main component – manufacturing – to below 4 per cent during 2012-19 has larger consequences in terms of employment and income generation in both rural and urban areas. While the persisting weakness in capital goods production has evoked concerns about the investment slowdown, a source of worry is the subdued performance of consumer non-durables as well. In coincident movements, sales of leading consumer goods companies have slumped, and volume growth of FMCG products has fallen to single digit rates. Clearly, rural demand has been sapped by weaker harvests in 2018-19 relative to preceding years, and depressed crop prices. This has brought forward concerns about consumption joining investment in the overall slowdown, which is worrisome as consumption accounts for 57 per cent of GDP. This challenge naturally ascends the hierarchy of policy priorities.

I.12 Although consumption is the bedrock of domestic demand in India, it is investment that provides the turning points in the growth trajectory – phases of sustained high growth in the economy are usually triggered by investment upturns and *vice versa*. The investment rate – measured by the ratio of gross capital formation to GDP – had fallen to 32.3 per cent in 2017-18. It was staging a tenuous recovery from the second half of 2017-18 when in a span of barely 12 months, it is losing that momentum. Survey-based measures are reporting higher than trend levels of capacity utilisation, typically a trigger for investment in new capacity addition. Currently, however, the capex cycle remains muted – firms are preferring to intensely utilise existing capacity to meet demand rather than expand it. The downslide in sales growth of manufacturing companies is impacting sentiments. What ails the animal spirits? At the core is the issue of domestic demand. And what should be the policy focus? Continuing focus on improving ease of doing business; reforms in factors of production, *viz.*, land and labour; capitalising on opportunities opened up by the heightened trade tensions (as alluded to earlier in para I.9); and faster implementation of capital expenditures by public authorities, and similar other measures have the potential to inject growth impulses into the economy.

I.13 In the farm sector, excess supply conditions relative to demand, brought about by successive record harvests during 2016-17 and 2017-18, has confronted policy authorities with the *deja vu* of surplus food management - large buffer stocks; less viable opportunities for international trade in view of excess supply conditions in agricultural products worldwide; structurally low food prices in India; and low farm incomes, all in a self-reinforcing spiral. At the core is the fact that 44 per cent of the total labour force is absorbed by the agriculture sector which generates only about 17 per cent of gross value added with an annual average growth of about 3.1 per cent (2011-12 to 2017-18).

I.14 Enhancing the income levels of farmers while sustaining the benefits of low food inflation for price stability emerged as a formidable challenge during 2018-19. Effective income transfers under the PM-KISAN scheme at the central government level and under a variety of schemes at the sub-national level have emerged as the preferred policy response, alongside the usual supports in the form of MSPs, rural employment programmes, supply side infrastructure such as irrigation, availability of inputs, and interlinking APMCs through e-NAM. The time has come to rethink the whole approach to the farm sector and the quality of policy interventions. The amendment of APMC rules by states remains far from complete, hindering agricultural marketing reforms that could enable direct purchase of agricultural produce from farmers by bulk buyers, retailers and exporters. This would help farmers get assured prices and market access. If accomplished, this would be a game changing reform in agricultural marketing which can unleash fresh investment across the value chain. Development of the food processing industry can push up demand and reduce losses associated with wastage. While the number of cold storages has increased over time, India faces an acute shortage of aggregation points at the back-end where agricultural produce can be stored, packaged by grade, pre-cooled and despatched to final destinations. Investment in cold supply chain network holds the key to the future of seamless delivery of fresh products. Supply chain networks can be fortified by investing in rural roads and transportation infrastructure, the goal being to fetch higher prices for farmers in markets that are integrated and free of localised frictions[1].

I.15 Turning to the financial sector, steadfastly pursued recognition, repair and resolution resulted in gross non-performing assets (GNPA) ratio of the banking system declining to 9.1 per cent as at end-March 2019 from 11.2 per cent in the previous year. Fresh slippages declined and the system-level provision coverage ratio jumped to 60.9 per cent, after hovering around 50 per cent until recently. Capital buffers have been strengthened by recapitalisation of the order of ₹2.7 trillion, including the budgetary allocations for 2019-20. The abatement of stress has rekindled bank credit flows, which are getting broad-based.

I.16 After initial teething difficulties, the insolvency and bankruptcy code is proving to be a game changer: recoveries have gradually improved and as a result, deadlocks in the potential path of the investment cycle are easing. New norms for resolution of stressed assets framed in June 2019 by the Reserve Bank provide incentives for early resolution, with discretion to lenders on resolution processes. The objective is to ring-fence future build-ups of NPA stress and protect the banking sector. The Large Exposure Framework was revised in order to capture exposures and concentration risks more accurately and to align the framework with the international best practices. The minimum leverage ratio has been revised for domestic systemically important banks and other banks for greater harmonisation with Basel III standards.

I.17 While the mounting overhang of impaired assets inhibited lending by the banking system, non-banking financial companies (NBFCs) stepped in to intermediate resources to various sectors of the economy. As the events of 2018-19 showed, there was irrational exuberance and considerable overleveraging, with asset-liability mismatches. Even though NBFCs constitute around 12 per cent of the total assets of banking and non-banking space, the emergence of stress following isolated but large credit events and a wider perception of liquidity shortages revealed the degree of interconnectedness in the financial system and the systemic ramifications. The ongoing strengthening of the liquidity and regulatory framework for NBFCs will be informed by this experience, especially in efforts to remove regulatory arbitrage.

[1] The Agricultural Produce Market Regulation Act authorised the states governments to set up and regulate marketing practices in wholesale markets. Over time, an increased number of middlemen formed a virtual barrier between the farmer and the consumer. The licensing of commission agents in the state regulated markets led to the monopoly of the licensed traders acting as a major entry barrier for new entrepreneurs. Consequently, the inter-ministerial task force on agricultural marketing reforms (2002) recommended the Agriculture Produce Marketing Committee (APMC) Act be amended to allow for direct marketing and the establishment of agricultural markets by the private and cooperative sector to provide more efficient marketing and creating an environment conducive to private investment. In response, the Union Ministry of Agriculture proposed a model act on agricultural marketing in consultation with state governments for adoption by the states. A total of 19 states have amended their APMC rules to effect direct purchase of agricultural produce from farmers by bulk buyer, retailer and exporter. States like Odisha, Nagaland, Sikkim, Maharashtra, Jharkhand and Uttarakhand have established private market yards/private markets. Most of these states have also granted direct marketing license to commodity exchanges registered under the commodity market regulator - the Forward Markets Commission to promote e-trading in agricultural produce. Proper implementation of amended APMC Act will allow the businesses get in touch with farmer producer organisations and self-help groups to procure farm products directly from them. This would help farmers to get assured prices and market access and create backward linkages as well as assurance of quality control for the corporates.

I.18 Significant progress was achieved during the year in promoting the usage of electronic modes of payments on the path towards a less cash economy. During the financial year 2018-19, the retail electronic payment transactions increased by 59 per cent to 23.3 billion from 14.6 billion in the previous year, resulting in an increase in the share of electronic transactions in the total volume of retail payments to 95.4 per cent during the year from 92.6 per cent in the previous year. FinTech and digitalisation emerged as new growth drivers. The policy challenge, though, is to balance the expansion of the digital economy with the minimisation of risks associated with data and technology misuse so that public confidence and trust is sustained, and the efficiency and soundness of the payment and settlement system is ensured. The comprehensive exercise to evaluate India's payment systems, which was reflected in the Report on Benchmarking India's Payment Systems (June 2019), shows India's leading/ strong position *vis-à-vis* peer countries in terms of several parameters pertaining to digital transactions, technology infrastructure, and payment and settlement laws and regulations. Yet, as the experience during the year gone by has demonstrated, these are areas in which regulators have to constantly innovate and adapt to keep pace with the advances taking place in retail payment and settlement processes and choice of payment instruments. Although considerable progress has been made, a vast potential exists.

I.19 Against the backdrop of these developments, it is apposite to circle back to the question posed earlier in this chapter. A decomposition of various seasonally adjusted indicators of economic activity, aggregate and sectoral, into trend and cyclical components suggests that the recent deceleration could be in the nature of a soft patch mutating into a cyclical downswing, rather than a deep structural slowdown. Nonetheless, there are still structural issues in land, labour, agricultural marketing and the like, which need to be addressed. The disaggregated analysis confirms that a broad-based cyclical downturn is underway in several sectors – manufacturing; trade, hotels, transport, communication and broadcasting; construction; and agriculture. It is important to note, however, that trend growth has witnessed slight moderation since 2016-17, contributed mainly by the services sector, especially trade, hotels, transport, communication and broadcasting, and financial, real estate and professional services. Issues and challenges in these sectors need to be addressed for achieving broad-based upturn.

I.20 These stylised facts and empirical findings conditioned the setting of monetary and fiscal policies during 2018-19. They warrant a careful evaluation, at least from the point of view of ascertaining the headroom available for counter-cyclical policy responses, if the slowdown gets prolonged.

I.21 Beginning with fiscal policy, the central government's gross fiscal deficit is broadly in line with the budget target of 2018-19 despite shortfalls in collections under GST and other indirect taxes, and also in income tax, which pulled down overall tax buoyancy. On the expenditure front, the improvement in 2015-16 and 2016-17 in the quality of expenditure, measured by the ratio of revenue expenditure to capital expenditure could not be sustained in 2017-18 and 2018-19. Furthermore, a primary surplus (gross fiscal deficit *minus* interest payments) has not been achieved since 2007-08.

I.22 For States, the actual fiscal outcome for 2018-19 may continue to be influenced by farm loan waivers, implementation of the 7th Pay Commission recommendations and financing of income support schemes. Consequently, the space available for delivering a fiscal stimulus to the economy, if warranted, is constrained. Nonetheless, a modest fiscal stimulus was delivered on the back of the implementation of House Rent Allowance (HRA) and staggered arrear payments relating to the 7^{th} Pay Commission awards by the centre and few states. Excluding government final consumption expenditure (GFCE), real GDP growth would have been 0.8 percentage points less in 2017-18 and by 0.3 percentage points in 2018-19.

I.23 The conduct of monetary policy had to be two-sided to contend with opposite shifts in evolving inflation and growth dynamics. During the first half of 2018-19, monetary policy was tightened in response to rising inflationary pressures from higher international crude oil prices, volatility in financial markets and firm underlying inflation. A cumulative increase in the policy rate by 50 basis points (bps) was backed up by a change in the policy stance from neutral to calibrated tightening in October 2018. In the following months, however, macroeconomic and financial conditions altered dramatically. Inflation moderated with the softening of global crude oil prices and food prices sank into deflation. Consumer price inflation averaged 3.4 per cent in 2018-19, remaining below the target of 4 per cent for the second financial year in succession under the period of reference of the current monetary policy committee (MPC). Although inflation risks ebbed, domestic activity lost pace amidst a deteriorating global economic outlook. Accordingly, the policy repo rate was cut in February 2019 and the stance of monetary policy was changed to neutral. As the next section will elaborate, this has been followed up with further accommodation and liquidity operations to keep the system flush with liquidity.

I.24 Through 2018-19, the Reserve Bank actively managed liquidity with a variety of instruments, including repo/reverse repo of various maturities, outright open market operations (OMOs) and foreign exchange swaps. Banks' deposit and lending rates had moved up in response to the 50 bps increase in the policy rate during June-August 2018. Transmission was, however, uneven across sectors, with the maximum pass-through recorded in the weighted average lending rate (WALR) on fresh rupee loans, which increased by 57 bps during June 2018-January 2019. In the wake of the February 2019 monetary policy action, reinforced by those in April and June this year, interest rates in the banking system and in financial markets have modestly softened, as will be discussed in the following section.

Prospects for 2019-20

I.25 The macroeconomic environment remains unsettled and financial markets are experiencing considerable flux as the financial year 2019-20 progresses. Global economic activity appeared to rebound in January-March 2019 especially in advanced economies as monetary stances were eased in response to the slowdown. Crude oil prices remained soft and financial market recouped some lost ground. In the ensuing months, however, these expectations have been belied by incoming data. Purchasing managers indices (PMI) have moderated, even pointing to contraction in some large economies. Risk appetite has diminished and the universe of negative yielding bonds has expanded in advanced economies. Several downside risks seem to be materialising in the form of escalation of trade tensions, geopolitical strife and renewed financial volatility in EMEs as portfolio flows have shown signs of weakening. Financial markets have remained edgy and volatile amidst these uncertainties, which are being reflected in repeated downgrades of forecasts of global growth. Notably, the IMF expects global growth to slow down to 3.2 per cent in 2019 from 3.6 per cent in the previous year, its fourth successive downward revision since October 2018. Central banks are gearing up to become increasingly accommodative, with reductions in policy rates. This has stoked apprehensions that the global economy may be weakening more than what the headline numbers suggest.

I.26 Turning to India, the MPC projected real GDP growth for 2019-20 at 6.9 per cent in its August 2019 meeting, with risks somewhat tilted to the downside. Effectively, the MPC marked down its projection by 50 basis points since its first projection of real GDP growth for 2019-20 was placed in the public domain in February 2019. It is useful to review how recent data arrivals stack up against this baseline forecast.

I.27 Starting with the production sectors, the south-west monsoon which impacts the performance of agriculture (14.4 per cent of overall economic activity), made landfall a week late on June 8 and was stalled by cyclone *Vayu*. The south-west monsoon gained pace since mid-July and as on August 19, 2019, the country-wide rainfall was 2 per cent above the long period average (LPA). Spatially, rainfall was above LPA in Central India and South Peninsula while it was below LPA in other two meteorological regions *viz.*, North West India (2 per cent), and East and North East India (14 per cent). Despite some catch-up in the last few weeks, *kharif* sowing was lower by 4.2 per cent on August 16, 2019 than a year ago. Buffer stock of cereals were 1.9 times above the norm on August 1, 2019, but for other crops, supply-demand imbalances may warrant imports if food prices are to remain contained. On July 4, hikes in MSPs for 2019 *kharif* crops were announced in the range of 1.1 - 9.2 per cent.

I.28 In pursuance of the objective of doubling farmer incomes, the Union Budget has outlined a strategy of forming new Farmer Producer Organisations (FPO), expansion of benefits of e-NAM to larger number of farmers and introduction of Zero Budget Farming. As regards the allied activities sector, the Budget proposes the *Pradhan Mantri Matsya Sampada Yojana* (PMMSY) to establish a robust fisheries management framework. Apart from income support measures, the Budget envisages an integrated approach towards farming, including rural infrastructure, irrigation and marketing.

I.29 The index of industrial production decelerated in April-June, pulled down by manufacturing and mining. On the other hand, strong growth in electricity generation propelled by rising demand mitigated the slowdown. In terms of uses, capital goods production remained sluggish, awaiting a turnaround in the investment cycle. The slowing down of infrastructure goods output on account of cement products could be pointing to a soft patch in construction activity: steel consumption, another indicator for the construction sector, sustained its momentum through Q1:2019-20. A recent positive development was the acceleration in consumer non-durables by 7.3 per cent during April-June, 2019, *albeit* heavily reliant on sunflower oil production and anti-malarial drugs. Consumer durables production, on the other hand, remained weak and contracted in Q1: 2019-20, with a slump in auto (including two-wheelers) and white goods sales. The output of eight core industries moderated in June 2019 largely on account of petroleum products which were affected by temporary maintenance shutdowns in major refineries. After remaining muted during Q1:2019-20, the purchasing managers index (PMI) for manufacturing expanded in July 2019 driven by acceleration in output, new domestic orders and employment.

I.30 As regards services sector activity, signals from coincident indicators for Q1:2019-20 were mixed. In the transport sub-sector, commercial vehicle sales contracted by 9.5 per cent in Q1:2019-20 continuing through July 2019, partly due to unfavourable base effects. Sales of passenger vehicles contracted by 18.4 per cent in Q1:2019-20, reflecting flagging urban demand. Growth of cargo handled at major ports remained subdued in Q1:2019-20 at 1.5 per cent, essentially mirroring the downturn in exports and imports in response to the slowdown in world trade. While domestic and international air passenger and cargo traffic contracted in April-May 2019, this was mainly on account of the drag from the closure of the services of a major domestic airline. In June, however, both domestic and international air passenger traffic recovered and posted growth rates of 4.6 per cent and 2.7 per cent, respectively, as the vacation season picked up. In the hospitality sub-sector, foreign tourist arrivals in April-June 2019 increased by 3.3 per cent, up from 1.2 per cent a year ago. In the communications sub-sector, the base of telephone subscribers continued to expand, and robust growth in broadband services was sustained in April-May 2019. Financial services maintained the recent acceleration in growth, with coincident indicators - bank credit and aggregate deposits of SCBs - rising on a y-o-y basis by 12.2 per cent and 10.1 per cent, respectively, as on August 2, 2019. Life insurance first year premium during April-June 2019 also accelerated to register a vigorous y-o-y growth of 65.1 per cent, while non-life gross direct premium also maintained momentum, growing at 9.8 per cent during Q1:2019-20 over Q1:2018-19.

I.31 Turning to indicators of aggregate demand, private final consumption expenditure (PFCE), appears to have moderated in Q1:2019-20 across both urban and rural constituents. The delayed onset and skewed distribution of the south-west monsoon rainfall may pose downside risks to crop production and to rural consumption demand. This is already evident in a sharp contraction in sales of motorcycles and tractors by 8.8 per cent and 14.1 per cent, respectively, during Q1:2019-20. The recent acceleration in the production of consumer non-durables, if sustained, could provide a buffer. As regards urban demand, both passenger car sales and domestic air passenger traffic registered contraction in recent months. Production of consumer durables contracted in June 2019 (-5.5 per cent) due to a fall in output of TV sets, hand tools, passenger vehicles, electrical apparatus and two-wheelers.

I.32 In Q1:2019-20, government final consumption expenditure (GFCE) as reflected in revenue expenditure by Union government less interest payments and subsidies was lower at 1.7 per cent compared to 14.5 per cent a year ago. The slowdown is sharper in the case of state governments.

I.33 Indicators of gross fixed capital formation (GFCF) registered either moderation or contraction in Q1:2019-20. Investment in dwellings, other buildings and structures proxied by construction gross value added (GVA) moderated as the growth in cement production fell to 1.2 per cent in April-June, 2019 from 16.3 per cent a year ago. Steel consumption has also slowed down to 6.6 per cent in Q1:2019-20 from 8.8 per cent a year ago. Production of capital goods contracted at about 2.4 per cent in April-June 2019 (8.6 per cent a year ago) and imports of capital goods registered a contraction in Q1:2019-20.

I.34 Several measures have been adopted to boost infrastructure in order to revive demand. They include a comprehensive restructuring of the National Highway Programme to ensure that a national highway grid of desirable length and capacity is created; public-private partnership (PPP) for developing railway infrastructure like development and completion of tracks, rolling stock manufacturing and delivery of passenger freight services; and making India a hub for aircraft financing, leasing, and maintenance, repair and overhaul (MRO). The 'scheme of fund for upgradation and regeneration of traditional industries' (SFURTI) is expected to give impetus to employment generation by emphasising traditional labour intensive industries. Streamlining of labour regulations for ease of doing business in the economy is also underway.

I.35 The inflation outlook remains benign and the recent catch-up in the progress of monsoon and *kharif* sowing has eased earlier concerns from the delayed onset of monsoon. Food inflation has picked up in the typical summer hardening of vegetables and fruits prices. Prices of pulses and protein-rich items have also risen in the early months of 2019-20 although it remains to be seen as to how long these pressures are likely to last. In the fuel and light group, a recovery in LPG prices in line with international prices imparted some upside pressures in Q1:2019-20, which has since eased in July. In contrast, inflation excluding food and fuel eased significantly and in a broad-based manner reflecting the weakening of demand, *albeit* with some recovery in July. Headline CPI inflation was 3.1 per cent in Q1 and in July 2019. In the third bi-monthly monetary policy statement of August 2019, inflation was projected at 3.1 per cent for Q2:2019-20 and 3.5-3.7 per cent for H2:2019-20, with risks evenly balanced. CPI inflation for Q1:2020-21 was projected at 3.6 per cent.

I.36 Domestic financial markets have been volatile against this backdrop. Equity markets registered losses up to August 20, 2019. In the recent months, the BSE Sensex has traded below its all-time peak on June 3, 2019. After trade tensions eased in May, the Indian rupee had started reflecting an appreciating bias, helped by softness in global crude oil prices. However, rupee came under pressure in August 2019 after China allowed its currency to depreciate to a decade low level. Money and G-Sec markets have remained broadly stable during the first quarter of 2019-20, with surplus liquidity conditions since June 2019 following sharp drawdown in government cash balances and decline in currency in circulation helping to moderate interest rates in both segments. Nonetheless, global spillovers may portend downside risks going forward.

I.37 India's external sector outlook is vulnerable to downside risks from global developments, especially the possibility of the global downturn deepening, the uncertainty surrounding international crude oil prices and the volatility of capital flows. During the first four months of 2019-20, India's exports as well as imports have dipped into contraction. Net FDI inflows were robust at US$ 14.5 billion in Q1:2019-20 as compared with US$ 9.6 billion a year ago. Foreign portfolio investment recorded net inflow of US$ 2.4 billion in 2019-20 so far (up to August 16) as against net outflow of US$ 8.2 billion in the corresponding period of 2018-19. India's foreign exchange reserves at US$ 430.5 billion as on August 16, 2019 increased by US$ 17.6 billion since end-March 2019.

I.38 Against this backdrop, and particularly taking note of the slowdown in investment activity and headline inflation trajectory remaining below target, the MPC reduced the policy rate by 85 bps during April-August 2019 (in addition to the 25 bps reduction in February 2019), along with a change in the stance from neutral to accommodative in June 2019. The conduct of monetary policy would continue to be guided by the objective of achieving the medium-term target for CPI inflation of 4 per cent within a tolerance band of +/- 2 per cent, while supporting growth.

I.39 The Union Budget 2019-20 has projected the gross fiscal deficit at 3.3 per cent in 2019-20 (3.4 per cent in 2018-19). During April-June 2019-20, the gross fiscal deficit at 61 per cent of Budget Estimates (BE) was lower than a year ago. On the receipts side, gross tax collections were lower under indirect taxes though direct taxes remained buoyant, while total expenditure was marginally higher. With regard to the fiscal position of states in 2019-20, budget estimates envisage revenue neutrality and a lower fiscal deficit, though the quality of expenditure is budgeted to deteriorate, with lower growth in capital spending *vis-à-vis* revenue heads. Accordingly, the combined gross fiscal deficit of the centre and states is budgeted at 5.7 per cent in 2019-20, down from 5.9 per cent in the revised estimates for 2018-19[2]. Going forward, fiscal readjustments to boost growth without accumulating public debt warrant improvement in spending for infrastructure and the social sector, given the high capital expenditure multiplier. On the revenue side, tapping the full potential of GST and digitisation, coupled with renewed efforts towards improving ease of compliance may help open up room for reduction of tax rates where possible, while maintaining revenue neutrality.

I.40 During 2019-20, the banking sector is poised to build upon the consolidation achieved in the year gone by. Stress tests for credit risk conducted by the Reserve Bank[3] indicate that under the baseline scenario, SCBs' gross NPA ratio may decline further to 9.0 per cent by end-March 2020 (9.1 per cent as at end-March 2019). This would release headroom for provisioning efforts, a turnaround in financial performance and for energising and broadening the flow of credit to the productive sectors of the economy. Concomitantly, several regulatory and supervisory measures are underway to strengthen the soundness of the banking system. The Reserve Bank will issue draft guidelines on (a) corporate governance in banks; and (b) revised standardised approach for calculating minimum capital requirement for operational risk in order to align the current regulatory framework with global best practices. Further, draft revised guidelines will be issued on capital charge for credit risk as well as on securitisation. The regulatory framework for Interest Rate Risk in Banking Book will be finalised. These measures will work in conjunction with the revised prudential framework for resolution of stressed assets framed in June 2019 and the large exposures framework, effective April 1, 2019 to incentivise a prudent credit culture.

I.41 A Discussion Paper followed by final guidelines will be issued for the purpose of transition to a non-operative financial holding company structure for banks. In the emerging FinTech landscape, a Regulatory Sandbox framework will be operationalised. Subject to legislative amendments, the Reserve Bank will align Indian Accounting Standards for banks and AIFIs with international norms to converge with International Financial Reporting Standards (IFRS). A Discussion Paper will be released on implementation of macro-prudential policies for banks for addressing incipient credit risks in the system. Data from banks/Central Repository of Information on Large Credits (CRILC) will be examined for re-assessing the implementation of the framework for credit supply to large borrowers through market mechanism. Digital on-boarding of bank customers would be facilitated, enabling video-based KYC for individuals within the framework of the extant Prevention of Money Laundering (PML) Rules.

[2] Data pertains to 27 states.
[3] Financial Stability Report, June 2019.

I.42 The Reserve Bank has constituted a Committee on the development of housing finance securitisation market (Chairman: Dr. Harsh Vardhan) and a Task Force on the development of secondary market for corporate loans (Chairman: Shri T. N. Manoharan) for the development and deepening of securitisation and corporate bond markets. Towards fine tuning the supervisory process to adequately capture the health of the banks in cooperative sector, an improved rating framework is being introduced from the ensuing inspection cycle. Occurrences of frauds in the UCB sector are proposed to be captured through reporting to a Centralised Fraud Registry which can be accessed by all UCBs.

I.43 The Reserve Bank proposes to strengthen the asset-liability management (ALM) framework for NBFCs. In pursuance of the announcement made in the Union Budget 2019-20, the Government of India has rolled out a scheme offering to provide a one-time partial credit guarantee for first loss up to 10 per cent to public sector banks (PSBs) for purchase of high-rated pooled assets amounting to ₹1 trillion from financially sound NBFCs/Housing Finance Companies (HFCs). This policy measure will support NBFCs' access to funding from the PSBs. On its part, the Reserve Bank will provide required liquidity backstop to the banks against their excess G-sec holdings. The Reserve Bank has also front-loaded increase in the facility to avail liquidity for liquidity coverage ratio (FALLCR) of 0.5 per cent each of banks' NDTL scheduled for August 1 and December 1, 2019, respectively, for incremental credit given to NBFCs and HFCs, over and above credit outstanding to NBFCs and HFCs as on July 5, 2019. Dispensing with the Debenture Redemption Reserve (DRR) will also facilitate the issuance of bonds by NBFCs.

I.44 With regard to payment and settlement, the Reserve Bank proposes to empower every Indian with a bouquet of safe, secure, convenient, quick and affordable e-payment options as envisaged in the Payment System Vision 2019-21. The Reserve Bank, on its part, has abolished charges levied by it for transactions processed in the RTGS and NEFT systems. It is reviewing actions in respect of the entire gamut of ATM charges and fees. The recommendations of the High-Level Committee on Deepening of Digital Payments (Chairman: Mr. Nandan Nilekani) aim to strengthen safety and security of digital payments and to evolve a medium-term strategy for expanding digital payments. Efforts are also underway for strengthening credit information infrastructure by providing a 360-degree view of all borrowers on near real time basis, facilitating quick and efficient credit decision-making by the credit institutions.

I.45 With the implementation of the Centralised Information Management System (CIMS) during the year, a state-of-the-art big-data based information management ecosystem for processing high volume structured and unstructured data with machine learning (ML) and artificial intelligence (AI) will become available. The CIMS will provide a Data Science Lab platform, a Granular Data Access Lab (GDAL), a centralised analytical layer and automation of data flow from the regulated entities.

I.46 Reviving consumption demand and private investment has assumed the highest priority in 2019-20. This may involve strengthening the banking and non-banking sectors, a big push for spending on infrastructure and implementation of much needed structural reforms in the areas of labour laws, taxation, and other legal reforms, which will also enhance ease of doing business in pursuit of fulfilling the vision of India becoming a US$ 5 trillion economy by 2024-25.