*For the Year July 1, 2017 to June 30, 2018**

## PART ONE: THE ECONOMY - REVIEW AND PROSPECTS

# I ASSESSMENT AND PROSPECTS

I.1 In a milieu of a strengthening global economy, a cyclical rebound in world trade and generally buoyant financial markets, the Indian economy in 2017-18 turned in a resilient performance that was also entrenched in macroeconomic stability. Although real GDP growth was somewhat slower than in the preceding year, the turnaround in capital formation and construction activity, together with record agricultural production, considerably brightens the near-term outlook. The combination of (i) a steady easing of inflation for the fifth year in succession to undershoot the target in 2017-18, (ii) a modest current account deficit of 1.9 per cent of GDP, and (iii) public finances having sturdily weathered the implementation of a major structural reform – the Goods and Services Tax (GST), reinforces the prospects for 2018-19. On the downside, the firming profile of international commodity prices – especially of crude oil, spillovers from tightening global financial conditions, geo-political tensions, trade wars stirring up across borders, financial turbulence, and the overhang of impairment in domestic banking and corporate balance sheets, emerge as the key downside risks.

I.2 The year 2018-19 has commenced on an eventful note, with several of these risks materialising. Bouts of financial market turmoil associated with persisting foreign portfolio outflows have unsettled emerging market economies as an asset class, and India has not been immune to these global developments. Yet, there are country-specific factors that could distinguish the Indian experience going forward. In the real sector, a normal monsoon for the third consecutive year should lift agricultural output. Manufacturing activity is gathering momentum on the back of new business, both domestic and export orders, rising capacity utilisation and drawdown of inventories. In the services sector, the impulses of growth are broadening and expansion in employment conditions is generating anticipations of improvement in demand conditions. Early indicators suggest that consumption demand remains robust. Aggregate domestic demand is also being supported by steadily strengthening investment – with a renewal of the capex cycle underway – and a strong pick-up in exports in Q1. India remains a preferred destination for foreign direct investment (FDI).

I.3 The stage is set for the intensification of structural reforms that will unlock new growth energies and place the Indian economy on a sustainable trajectory of higher growth. Resolute progress in repairing and resolving the acute stress in the banking system and in shoring

* 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 2018. 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.

up corporate debt will re-intermediate financial flows for productive purposes, which are essential for sustaining an acceleration in growth with macroeconomic and financial stability.

I.4 Against this backdrop, the rest of the chapter drills down into noteworthy developments that characterised the year gone by. Drawing insights therefrom, a realisable outlook is etched out for 2018-19 and the near term.

**ASSESSMENT: 2017-18**

I.5 The year 2017-18 turned out to be a year of inflexions in the growth path of the Indian economy, despite the lingering after-effects of demonetisation and the GST implementation. Green shoots of recovery sprung up from Q2, finding expression in a sequential rise in real GDP growth from a 13-quarter low of 5.6 per cent in Q1 to 7.7 per cent in Q4. A significant accelerator was gross fixed capital formation (GFCF) which snapped out of a four-quarter soft patch and posted expansion right through Q2 and until Q4. Private final consumption expenditure (PFCE) was supported by rural demand on the back of a bumper harvest and the government's thrust on rural housing and infrastructure. In contrast, support from government final consumption expenditure ebbed in relation to the preceding year and there was a leakage of domestic demand through net exports, in contrast to a slender contribution a year ago. Given these diverse pull factors, the fact that the loss of speed in real GDP growth was contained at only 0.4 percentage points on a year-on-year basis reflects innate resilience, and possibly, the onset of a new phase, in the life of the economy.

I.6 On the supply side, agriculture posted an all-time high production of foodgrains and horticulture. On top of this supply response, imports resulted in excess supply conditions in key crops such as rice, wheat, pulses and oil seeds, leading to prolonged deflation in the prices of pulses and oilseeds, and record buffer stock levels of rice and wheat – the highest in five years. The sizable erosion in the terms of trade of the farm sector under the weight of this supply glut emerged as an area of concern, however. In the second half of the year, manufacturing started recovering from its sluggishness, driven by capital goods, infrastructure/construction goods and intermediate goods. Breaking the sequence of two years of deceleration, the pace of services sector activity registered a broad-based recovery. In this context, the turnaround in the construction sector after a prolonged period of stagnation is heartening in view of positive externalities in the form of employment generation and downstream linkages.

I.7 Infrastructure activity, which could be the force multiplier for India in the take-off to the middle income group of countries, gained pace in terms of projects under implementation, but new project announcements remained subdued across public and private sectors. There were several noteworthy achievements, though. In the road sector, the sustained growth in construction of national highways and the length of roads awarded was a silver lining. The foundation for the Mumbai-Ahmedabad bullet train project was laid and work on eastern and western dedicated freight corridors progressed. In the area of air transport, flight routes to various underserved and unserved airports were awarded along with viability gap funding. Smart cities started implementing various projects like smart command and control centre, smart metering, smart buildings, intelligent transport systems and smart parks. Furthermore, the *Pradhan Mantri*

*Sahaj Bijli Har Ghar Yojana (SAUBHAGYA)* was launched with universal household electrification by March 2019 as its mission.

I.8 As regards the price situation, inflation eased to its lowest level in the new consumer price index (CPI) series in June 2017, with food prices going into deflation. Thereafter, a confluence of domestic and global developments pushed inflation up – an unseasonal spike in the prices of vegetables during October-November 2017, disbursement of house rent allowance (HRA) for central government employees under the 7$^{th}$ Central Pay Commission's award and firming up of global commodity prices. The delayed softening of food prices in Q4 brought relief as it got prolonged and in the event, the year ended with the lowest annual average inflation of 3.6 per cent since 2012-13.

I.9 Turning to the setting of monetary policy, the significant fall in inflation excluding food and fuel during Q1:2017-18 and the dynamics of the output gap opened up space for the Monetary Policy Committee (MPC) to reduce the policy repo rate by 25 basis points (bps) in August 2017. In the ensuing months, however, the rising inflation trajectory accentuated growth-inflation trade-offs. In response, the MPC kept the policy rate on hold for the rest of the year, while continuing with a neutral stance.

I.10 Consistent with the monetary policy stance, liquidity management operations sought to modulate systemic liquidity from persisting surplus conditions to a position closer to neutrality. Multiple instruments were deployed, including repo/reverse repo operations of various tenors under the liquidity adjustment facility, and outright open market operations. Eventually, the liquidity situation turned into a deficit during February-March 2018 on account of moderation of government spending and large tax collections, resulting in the Reserve Bank briefly switching to an injection mode.

I.11 Monetary transmission from the policy rate to banks' deposit and lending rates improved during 2017-18, facilitated by the demonetisation-induced slosh of liquidity, but it remained uneven across sectors and bank groups. In particular, the pace of reduction in lending rates for fresh rupee loans was impeded by asset quality concerns and risk-averse behaviour in lending activity.

I.12 As regards fiscal policy, the combined fiscal position of the centre and states deteriorated somewhat in relation to budgeted levels due to subdued growth in revenues and elevated revenue expenditure. For the centre, revenues were affected by lower collections from indirect taxes due to late implementation of GST; shortfall in non-tax revenue due to deferment of spectrum auctions; and, lower dividend receipts. In the event, cutbacks in capital expenditure were necessitated, with implication for the quality of fiscal adjustment. While state finances were budgeted to improve in 2017-18, revised estimates have been impacted by a shortfall in revenue receipts – mainly lower own tax revenue – and higher revenue expenditure due to implementation of farm loan waivers and the pay commission recommendations on salaries and pensions. These developments, together with global bond sell-offs, fuelled a persistent hardening of 10-year bond yield in the government securities market from 7.40 per cent on January 30, 2018 to a high of 7.78 per cent on March 5, 2018 with spillover to the corporate bond market.

I.13 India's external sector remained resilient in 2017-18 despite a challenging global environment. Higher non-oil import volume along with erosion in terms of trade, especially on account of the sharp increase in crude oil prices, widened the trade deficit to a five-year high. Services exports and remittances, however, offset this increase and kept the current account deficit (CAD) within sustainable limits. Net capital inflows – predominantly in the form of FDI and portfolio investment – exceeded the CAD and led to an increase in foreign exchange reserves during the year. Reflecting these movements in underlying fundamentals, the exchange rate of the Indian rupee (INR) appreciated by 3.1 per cent during the year on a nominal effective basis. In real terms, the INR appreciated by 4.5 per cent.

I.14 In contrast to developments in money, foreign exchange and fixed income markets, the bull run in the Indian equity market that commenced in the preceding year propelled the benchmark equity indices up by more than 10 per cent during 2017-18. After touching a peak in January 2018, the market underwent significant correction during February-March 2018 on release of strong US jobs and inflation data, the consequent surge in US bond yields, and worries about trade war.

I.15 In the financial sector, dynamic changes in the Reserve Bank's balance sheet took place shaping monetary and financial conditions during the year. Underlying them, reserve money growth was driven primarily by the expansion of currency in circulation (CiC) as the pace of remonetisation quickened and eventually, the pre-demonetisation level of CiC was exceeded in March 2018. Consequently, the velocity of CiC declined gradually, converging to its long-term trend. Driven largely by private sector banks, credit growth revived from a historic low in 2016-17 and crossed double digits from December 2017, re-emerging as a significant source of financing for the commercial sector. The off-take of credit was noteworthy; even credit to industry picked up, and personal loans and credit to services surged above the overall growth of bank credit. Credit flows from public sector banks (PSBs) were subdued, constrained by the capital requirements as also the elevated levels of loan delinquency.

I.16 Stressed assets [gross non-performing assets (GNPAs) *plus* restructured standard advances] in the banking system remained elevated at 12.1 per cent of gross advances at end-March 2018. The combined impact of the increase in provisioning against NPAs and mark-to-market (MTM) treasury losses on account of the hardening of yields eroded the profitability of banks, resulting in net losses. In a pre-emptive response, the Reserve Bank allowed banks to spread their MTM losses over four quarters – starting from Q3. Going forward, the stress tests carried out by the Reserve Bank suggest that under the baseline assumption of the current economic situation prevailing, the GNPA ratio of scheduled commercial banks may increase further in 2018-19.

I.17 With the deterioration in asset quality and the progressive implementation of Basel III warranting higher buffers, troubled PSBs received capital infusions *via* the issuance of recapitalisation bonds and budgetary support. The Reserve Bank's revised prompt corrective action (PCA) framework became effective in April 2017. Eleven PSBs placed under this framework so far have been restricted in their operations and subjected to remedial action plan so as to prevent further capital erosion. The Reserve Bank also put in place revised/harmonised guidelines for resolution of stressed assets during the year, replacing earlier schemes like Sustainable Structuring of Stressed Assets (S4A scheme), Strategic Debt Restructuring scheme (SDR), Corporate Debt Restructuring (CDR) scheme and Joint Lenders' Forum (JLF). Final guidelines relating to the net stable funding ratio (NSFR) were also issued in May 2018 to prepare the ground for banks to build durable buffers against potential liquidity disruptions. Banks were also advised to encourage large borrowers to obtain Legal Entity Identifiers (LEI) including for their parent entity as well as all subsidiaries and associates. This is expected to improve the quality and accuracy of financial data for better risk management. With financial stability concerns at the fore, regulated entities were prohibited, starting from April 06, 2018, from dealing in virtual currencies and from providing services for the dealing with or settling in virtual currencies to any person or entity.

I.18 Looking beyond the banking sector, non-banking financial companies (NBFCs) continued to post double-digit growth in 2017-18, with improvement in profitability indicators, asset quality and even capital positions *vis-a-vis* the regulatory prescription of 15 per cent and minimum Tier 1 capital of 10 per cent from April 1, 2017 onwards that NBFCs-ND-SI (Non-Deposit taking systematically important NBFCs) and all deposit-taking NBFCs are required to maintain. The Reserve Bank also decided to withdraw the exemption from regulatory and statutory provisions granted to government-owned NBFCs, bringing them on par with other NBFCs. This should contribute to establishing a level-playing field in the sector.

## PROSPECTS: 2018-19

I.19 The global economy expanded at a strong pace in the first half of 2018. In advanced economies (AEs), activity was accompanied by tightening labour markets, firm commodity prices and resilient trade dynamics. Emerging market economies (EMEs) front-ran the AEs in Q1 but fell back somewhat in Q2 as capital flows exited on risk aversion generated by a cocktail of trade wars, rising interest rates in the US, geo-political tensions and the unrelenting hardening of crude oil prices. As per the International Monetary Fund's (IMF's) estimate, global growth is expected to pick up by 0.2 percentage points to 3.9 per cent in 2018 and is projected to sustain at the same level in 2019. The domestic and international repercussions of expansionary fiscal policy in the US and terms of trade gains for commodity exporters are expected to be impulses of propulsion. Headwinds could nonetheless rise from further tightening of financial conditions, escalation of trade tensions and intensification of geo-political risks. Increasingly, financial markets are emerging as the main conduit for transmission of global spillovers to financial, and eventually, macroeconomic conditions in EMEs, including India.

I.20 In this unsettled international environment, incoming data configure favourable conditions for an acceleration of activity in the Indian economy. The initial lull in the progress of the southwest monsoon got reversed, including in the spatial dispersion, and in response, cropping gaps are closing. Overall, agricultural production is likely to remain strong for the third consecutive year. Meanwhile, growth impulses in industry are strengthening, propelled by a sustained pick-up in manufacturing and mining activity, especially coal. Corporates are reporting robust sales growth and improvement in profitability as pricing power returns. Services sector activity is also set to gather pace, as high frequency indicators suggest. Revenue-earning freight traffic of railways has picked up, driven by stepped-up movement in coal, fertiliser and cement. The uptrend in construction is expected to continue going forward, given the government's push for infrastructure – affordable housing, roads, and ports – and the robust expansion in the production of cement. Underlying this reinvigoration is the steady expansion in aggregate demand, fuelled by consumption (both urban and rural), investment and exports. Over the rest of 2018-19, the acceleration of growth that commenced in 2017-18:H2 is expected to be consolidated and built upon. Keeping in view the evolving economic conditions, real GDP growth for 2018-19 is expected to increase to 7.4 per cent from 6.7 per cent in the previous year, with risks evenly balanced.

I.21 Going forward, the up-tick in credit growth is likely to be supported by the progress being made under the aegis of the Insolvency and Bankruptcy Code, 2016 (IBC) in addressing stress on balance sheets of both corporates and banks, recapitalisation of PSBs, and a positive outlook on the economy. The prevailing negative credit-to-GDP gap indicates that there is sufficient scope for credit absorption and expansion in bank lending on a sustained basis.

I.22 Headline inflation which averaged 4.8 per cent during Q1:2018-19, is likely to face upside risks over the rest of the year from a number of sources, warranting continuous vigil and a readiness to head off those pressures from getting generalised. Rising global commodity prices, especially of crude oil, and recent global financial market developments are firming up input cost pressures. The staggered impact of HRA revisions by various state governments could also pose an upside risk through second-round effects. Much will depend on how food prices play out and how effective are the supply management strategies.

I.23 A further rise in households' inflation expectations in the June 2018 round of the Reserve Bank's survey warrants caution, especially to prevent wage-cost spirals from developing. On the whole, headline inflation is projected at 4.6 per cent in Q2:2018-19; 4.8 per cent in H2 and 5.0 per cent in Q1:2019-20, including the HRA impact for central government employees, with risks evenly balanced. Excluding the impact of HRA revisions, headline inflation is projected at 4.4 per cent in Q2:2018-19; 4.7-4.8 per cent in H2 and 5.0 per cent in Q1:2019-20. The MPC raised the policy repo rate by 25 bps in June 2018 and again in August, keeping in view the hardening of inflation and inflation expectations, while continuing with the neutral stance. The conduct of monetary policy will 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.24 The Union Budget for 2018-19 is confronted with an Occam's razor. The surge in the number of tax assessees, especially new ones, augurs well for raising the tax-GDP ratio to at least the levels of peers. While the GST may gradually expand revenues as it stabilises and gains traction, terms of trade losses associated with the hardening of international crude prices could restrict fiscal space. Meanwhile, sizable outlays on agriculture and infrastructure could impose a financing constraint. In this milieu, aggressively pursuing disinvestment targets contingent upon market conditions and investor appetite holds scope for fiscal metrics in line with the Fiscal Responsibility and Budget Management (FRBM) targets.

I.25 With regard to the fiscal position of states, budget estimates for 2018-19 have envisaged a revenue surplus and a lower fiscal deficit. During the year, however, fiscal risks may emanate from many states going for elections, the additional burden of farm loan waivers announced outside budgeted outlays, and the implementation of pay/pension/allowances revisions. Revenue mobilisation remains the key to attaining the budgeted targets. The cushion provided by compensation cess by the centre for any interim shortfall in GST revenue could help smooth state finances on the revenue front. Against this backdrop, the combined gross fiscal deficit of the centre and states is budgeted to be brought down to 5.9 per cent of GDP in 2018-19 from 6.6 per cent in the revised estimates for 2017-18.

I.26 Global headwinds are likely to confront India's external sector in 2018-19. Even though exports have gathered momentum in Q1 of 2018-19, the worsening global trade environment as a result of protectionist policies may impinge upon external demand. Elevated crude oil prices and the strengthening of domestic demand may push up the import bill. With India being a net energy importer, the changing demand-supply dynamics in the international crude oil market may impact heavily on India's trade deficit. With domestic information technology (IT) companies gradually adapting to the global business environment, software exports are expected to remain strong. The increase in limits for foreign portfolio investment in both government and corporate bonds augurs well for the prospects for external financial flows adjusted for downside risks. The current account deficit is expected to be largely financed by FDI flows.

I.27 Several initiatives set in motion to secure the soundness of the banking system are expected to reach critical mass during 2018-19. First, keeping in view the IBC process and the need to put in place a harmonised and simplified generic framework for resolution of stressed assets, the Reserve Bank has introduced a new framework for resolution of stressed assets, which is more outcome-oriented and provides considerable flexibility for banks to determine the minutiae of the restructuring process. The recent amendments to the IBC are expected to improve the efficiencies in decision making under it. The voting threshold for the committee of creditors has been brought down to 66 per cent from 75 per cent for all major decisions, including approval of resolution plans and recommendation for extension of the period of the corporate insolvency resolution process (CIRP). Furthermore, a special dispensation has been provided to micro, small and medium enterprises (MSMEs), recognising their importance in employment generation and exports.

I.28 Second, institutional reforms in India's financial system and credit information availability are poised for a transformation. Drawing on the recommendations of the task force (Chairman : Shri Yeshwant M. Deosthalee), the Reserve Bank has decided to set up a pubic credit registry (PCR) with an Implementation Task Force (ITF) assigned to design the logistics.

I.29 Third, the Reserve Bank has put in place a graded enforcement action framework for any lapses observed in conducting a bank's statutory audit to address large divergences in asset classification and provisioning in the credit portfolio of banks as well as rein in the rising incidence of frauds in the Indian banking system. As pointed out in the Detailed Assessment Report of the Financial Sector Assessment Program (FSAP) of the IMF-World Bank, legal reforms facilitating ownership-neutral regulation and supervision of the banking system would empower the Reserve Bank further in supervisory enforcement.

I.30 The impact of international financial reporting standards on quantitative and qualitative reporting by banks would be reviewed, aligned and integrated with the supervisory framework, in view of its impending implementation. An Audit Management Application portal to handle various supervisory functions of the cyber security and information technology examination cell in the Reserve Bank and to fully automate monitoring of returns has been envisaged in order to facilitate consistency and efficiency of the offsite monitoring mechanism.

I.31 Efficiency and security of the payment and settlement architecture is paramount for the Reserve Bank in the context of its mandate of oversight over the system. With the increased focus on adoption of digital payments, the availability and accessibility of quality infrastructure at a pan-India level continues to be the critical factor for sustained usage. In this regard, the Reserve Bank will intensify its focus on robustness, safety and security of the payments infrastructure in 2018-19. An important objective will be to manage safe and secure innovations in payment systems that provide wider payment options to users. Robust customer grievance redressal mechanisms will continue to be developed further to increase trust and confidence in payment systems.

I.32 The Reserve Bank has been playing a catalytic role in permeation of FinTech into the economy, propelled by its Payment and Settlement System Vision – 2018. The report of the Reserve Bank's Working Group on FinTech and Digital Banking covers granular aspects and envisages a reorientation of the regulatory framework so that it can respond to the dynamics of a rapidly evolving scenario. These issues will engage policy attention in 2018-19.

I.33 This year will also see the gaining of traction of initiatives for consumer protection in the area of financial transactions, especially by leveraging on technology. Among them, the ombudsman scheme for redressal of complaints related to NBFCs aims to provide a cost-free and expeditious complaint redressal mechanism. The ombudsman scheme for NBFCs will be reviewed during the year, and its scope will be widened to encompass other eligible NBFCs. Furthermore, efforts will be made to raise customer awareness on safe banking habits and access to grievance redressal. Considering the increasing number of complaints relating to transactions conducted digitally, the Reserve Bank will also formulate an ombudsman scheme for digital transactions.

I.34 Looking ahead, the Indian economy is set to step up its growth trajectory. Two aspects warrant priority if this aspiration is to be realisable and sustainable. First, infrastructure holds the key to unleashing the impulses of faster growth. In particular, the reasonable success achieved in the transportation space is worthy of emulation in other areas. During 2018-19, this aspect of the infrastructure mission is set to accelerate. In the road sector, the key targets are awarding works for around 20,000 km length of national highways; construction of 45 km per day *vis-à-vis* 27 km per day last year; and developing ring roads around

28 major cities under the *Bharatmala* project. In railways, upgradation of Bengaluru and Mumbai suburban systems, Mumbai-Ahmedabad high-speed rail construction, installing modern facilities in railway stations as part of station redevelopment, and opening India's First National Rail and Transportation University in Vadodara will be the priorities. In the port sector, more than 576 projects with an estimated cost of ₹8,700 billion have been identified for implementation under the *Sagarmala* project.

I.35 Second, even as infrastructure development provides the thrust, sustaining the momentum of growth will hinge around its inclusiveness and, in particular, its employment intensity. The Government is designing a comprehensive strategy to bring employment to the core of the development strategy: (i) promoting industrial activity through the Make in India drive; (ii) enhancing employability through Skill India including Skills Acquisition and Knowledge Awareness for Livelihood Promotion (SANKALP) and Skill Strengthening for Industrial Value Enhancement (STRIVE); and (iii) encouraging innovation and entrepreneurship through Start up India. With regard to reforms in labour laws, codification is in progress and the Code on Wages Bill has been introduced in the *Lok Sabha*.

I.36 Over the medium-term, the pace and quality of growth will be anchored by progress on the unfinished agenda of structural reforms in, *inter alia,* resolution of banking and corporate financial stress; taxation; agriculture; liberalisation of the economy's external interface, especially with FDI; and galvanising the business environment. The hard-earned gains of macroeconomic stability that have defined the recent period as its greatest achievement need to be preserved as an imperative within this endeavour.