*For the Year July 1, 2015 to June 30, 2016**

PART ONE: THE ECONOMY - REVIEW AND PROSPECTS

I ASSESSMENT AND PROSPECTS

I.1 Against the backdrop of a global environment characterised by anaemic growth and heightened financial market volatility, the Indian economy posted gains in 2015-16. Economic activity picked up pace and the trajectory of growth was underpinned by macroeconomic stability embodied in narrowing fiscal and current account deficits and ebbing inflation. Domestic financial markets exhibited differential responses to episodic shifts in risk sentiment on global spillovers, with money and bond markets remaining relatively sheltered. In the first quarter of 2016-17, global risks intensified after remaining dormant in the aftermath of the turbulence that roiled global financial markets in January. The Brexit referendum initially shocked financial markets, producing overshoots and misalignments of asset prices and frantic churns of capital, but gave way to a reach for returns as an uneasy calm returned. These financial perturbations are increasingly taking a knock-on toll on real activity in advanced and emerging economies and present the biggest risk to their near-term outlook.

I.2 In this turbulent setting, underlying conditions have been firming up in India for scaling up the growth momentum. Progress of the southwest monsoon augurs well for agriculture and the rural economy. The seventh pay commission award may provide a stimulus to consumption spending within the targeted fiscal deficit through the multiplier effects of government consumption expenditure. On the external front, India became a preferred destination for foreign direct investment (FDI), receiving the highest annual net inflow in 2015-16. Indicators of external sustainability recorded a distinct improvement during the year. Elsewhere, however, particularly in the industrial sector, considerable slack and sluggishness continues to weigh upon the outlook. The capex cycle remains weak and private investment activity is listless. Even as the banking sector deals with high stress emanating from deterioration in corporate balance sheets and, therefore, loan quality, efforts have to be redoubled to free up credit flows to the productive sectors of the economy so that growth is supported. Alongside, perseverance with disinflation towards the medium-term CPI inflation goal of 4 per cent under a new monetary policy framework, anchoring states to high quality fiscal consolidation and concerted efforts to reverse the erosion of productivity and competitiveness will assume importance as the ambit of structural reforms widens.

* 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 2016. 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.

ASSESSMENT: 2015-16

I.3 Looking back at the year gone by, private consumption remained the mainstay of the modest acceleration in real GDP growth, as in 2014-15. Fixed investment and exports were the missing drivers. Nonetheless, the sustained improvement in households' financial saving since 2013-14 has been a noteworthy development. The ongoing disinflation is freeing up real incomes, and interest rates – especially on small savings – turned positive in real terms. The significant improvement in corporate profitability, essentially on account of saving on input costs and more recently on sales growth, is expected to boost corporate saving and translate into investment spending going forward. Record inflows of foreign direct investment and the surge of initial public offerings after a four-year lull seem to be providing lead indications of this tipping point.

I.4 On the production side, agriculture weathered two consecutive years of drought conditions and posted modest growth in contrast to the contraction a year ago. This resilience, aided by astute supply management, smoothed breaks in availability of farm output and restrained food price pressures. Industrial output slowed down in relation to a year ago, despite a turnaround in consumer durables. Consumer non-durables posted a decline after six years of expansion, mainly on account of contraction/deceleration in fast moving consumer goods which, in turn, reflected the subdued state of rural demand. Going forward, the improvement expected in agricultural activity could reverse this deterioration and boost rural incomes. A sustained turnaround in capital goods output would, however, await a revival of investment demand. In the services sector, a deceleration was evident across all constituents as new business orders slowed and exports were impacted by weak external demand.

I.5 In the infrastructure space, electricity generation reached 98 per cent of the annual target, with the highest ever annual capacity addition in the solar and wind energy segments. Seventeen states have given in-principle approval/joined the Ujwal DISCOM Assurance Yojana (UDAY). The hope is that as the DISCOMs become debt-lite, their financial and operating efficiency will improve and the slack in demand will progressively decline. However, continuing efforts in these directions, including on enhancing collections and reducing line losses, are needed. In the road sector, there was significant improvement in terms of new constructions, especially in the national highway network. While this progress has been mainly public investment-driven, policy measures such as ease of exit, injection of funds into languishing projects at a pre-determined rate of return and the innovative hybrid annuity model will likely enhance private interest in the sector. Notable progress was also achieved in railways in terms of capital investment, commissioning of broad gauged lines and electrification of railway tracks. Major ports in India, especially private ports, also recorded the highest ever capacity addition in a single year.

I.6 Benign inflation conditions prevailing until August 2015 were dispelled by the sustained elevation in prices of pulses. Consequently, inflation picked up from September and rose month after month till January 2016, *albeit* remaining below the target of 6 per cent set for that month. In the ensuing three months, inflation eased on the back of the seasonal decline in prices of fruits and vegetables but picked up again from May 2016 as food prices firmed up ahead of the onset of the monsoon.

I.7 Monetary conditions reflected an interplay of diverse factors. An unusually high and protracted

demand for currency drove up the expansion of reserve money and muted the money multiplier which, in turn, moderated the rate of money supply. Anecdotal evidence suggests several forces at work – the simultaneous conduct of elections in various states; a possible response to increases in the rate of service tax; the jewellers' strike protesting excise duty increases in the Union Budget, which effectively impeded the return flow of currency. Bank credit was generally sluggish in the first half of the year, reflecting lacklustre demand in the economy, asset quality concerns, the ongoing deleveraging through write-offs, recoveries and upgradations, and some amount of disintermediation in favour of relatively cheaper source of funds outside the banking system. In the second half of the year, however, bank credit growth picked up in the retail segment and also to industry and agriculture. Timely recognition of the deterioration in banks' balance sheets through the Reserve Bank's asset quality review resulted in the overall stressed assets ratio rising marginally by end-March 2016 from its level a year ago, with a rise in the gross NPA ratio but a fall in the restructured assets ratio. Banks' profitability was affected by provisioning requirements. Going forward, the stage is set for continued efforts to declog the banking system and enable credit to flow to productive sectors.

I.8 With the fiscal deficit declining to 3.9 per cent of GDP, central finances were revenue-driven in 2015-16 – additional revenue mobilisation through cesses; duty revisions in respect of petrol and diesel; higher dividend and profits; and earnings from spectrum auctions. Significantly, there were no cutbacks to budgeted capital expenditure. By contrast, states overshot the budgeted deficit, mainly on account of shortfall in revenues.

I.9 In the external sector, a faster pace of contraction in imports relative to exports and large terms of trade gains narrowed the current account deficit to 1.1 per cent of GDP, which was comfortably financed along with sizable accretion to reserves. In terms of financing, a noteworthy feature of 2015-16 was the highest ever inflows of foreign direct investment, impervious to the bouts of turbulence in the international financial markets. By the end of the year, the level of reserves was equivalent of 11 months of imports. Other indicators of external sustainability also recorded improvement.

PROSPECTS: 2016-17

I.10 In the aftermath of the Brexit referendum, the outlook for the global economy has weakened, as reflected in downgrades of projections by multilateral agencies. Although the extreme financial market reactions to its announcement have subsided and financial asset prices have regained lost ground, high uncertainty regarding its evolution may shadow the course of a fragile and slowing global recovery in the year ahead and possibly even beyond.

I.11 So far, the effects of Brexit on the Indian economy have been relatively muted, including the immediate impact on equity and foreign exchange markets. Yet, in view of the linkages to the UK and the euro area, spillovers through trade, finance and expectations channels cannot be ruled out as events unfold. Abstracting from these external shocks, the near-term domestic outlook appears somewhat brighter than the outcome for 2015-16. While a durable pick-up in investment activity remains elusive, consumption will continue to provide the main support to aggregate demand and may receive a boost from the revival of rural demand in response to the above-normal and spatially well-distributed southwest monsoon as

well as from the seventh pay commission's award. Notably, the impact of the fifth and sixth pay commissions' awards on growth was also positive. Agricultural and allied activities are expected to benefit substantially from the distinct improvement in moisture conditions.

I.12 Industrial activity has been in contraction mode in the early months of 2016-17, pulled down by manufacturing. Looking ahead, no strong drivers are discernible at this juncture that could engineer a turnaround. Export demand also remains anaemic. Successive downgrades of global growth projections by multilateral agencies and the continuing sluggishness in world trade points to further slackening of external demand going forward. Some support to industrial activity may, however, stem from the recent measures taken by the Government such as 100 per cent FDI in defence, civil aviation, pharmaceuticals and broadcasting.

I.13 Service sector activity is likely to receive a stimulus especially under the category of public administration, defence and other services as public expenditure on wages, salaries and pensions translates into disposable incomes. Overall GVA growth is, therefore, projected at 7.6 per cent in 2016-17, up from 7.2 per cent last year. A better than anticipated agricultural performance and the possibility of allowances under the seventh pay commission's award being paid out in Q4 of 2016-17 provide upsides to this projection. On the other hand, a rise in the implicit GVA deflator as WPI inflation hardens will operate as a statistical downside.

I.14 Headline CPI inflation has ranged above target in the first quarter of 2016-17, driven up by the seasonal surge in prices of fruits and vegetables and protein-rich items on top of still elevated prices of pulses and sugar. With the steady progress of the southwest monsoon, however, these prices are likely to moderate over the ensuing months. A heartening development is the recent softening of inflation excluding food and fuel, which could sustain if international crude prices remain soft and, in turn, hold down prices of petrol and diesel embedded in transport and communication services. Further, pulses production may likely increase with a softening impact on food inflation. Thus, headline inflation is expected to trend towards the target of 5 per cent by the last quarter of the year, although at the current juncture, upside risks are prominent. If the current softness in crude prices proves to be transient and as the output gap continues to close, inflation excluding food and fuel may likely trend upwards and counterbalance the benefit of the expected easing of food inflation. It is also important to take note of the impact of the implementation of the seventh pay commission's award on the future trajectory of headline inflation. The largest effects are expected to emanate from increased house rent allowance in the CPI, which may raise headline inflation in a purely statistical manner. In addition, indirect effects through demand and expectations channels could add to the headline CPI's path. In aggregate, the impact of the pay commission is expected to peak by September 2017. Separating statistical effects from those that impart a durable upside to inflation will complicate the setting of monetary policy going forward, especially in the management of inflation expectations.

I.15 The commitment of the central government to the path of fiscal consolidation in 2016-17 has enhanced the credibility of fiscal policy, which will, in turn, help in anchoring inflation expectations and in improving the business environment, including by

fostering credibility among international investors. A conducive environment has also been created through appropriate incentives/penalties for states to renew their fiscal consolidation. The passage of the Goods and Services Tax (GST) Bill marks a new era in co-operative fiscal federalism and a growing political consensus for economic reforms. The implementation of the GST would boost trade, investment and growth by reducing supply chain rigidities, encouraging scale economies, cutting down transportation and transaction costs, as also promoting efficiency gains. By eliminating the cascading impact of taxes on production and distribution costs, the GST would also improve the overall competitiveness of the economy. The impact of GST on CPI inflation would largely depend on the standard rate that would be decided by the GST council; however, the impact is likely to be low, with around 54 per cent of the CPI basket exempt from the GST. As regards public finances, the GST is expected to widen the tax base, result in better tax compliance and reduce the cost of tax collection.

I.16 As regards implementation of the recommendations of the pay commission, it is noteworthy that nearly 90 per cent of the estimated payout on account of pay, pension and arrears in 2016-17 has already been provided for in the Union Budget. However, states tend to mimic central pay and pension implementation. To the extent that states have provided for these outgoes, no deviations from the budgeted targets are envisaged at this juncture. For states that have not made such provisions in their respective 2016-17 budgets, the implementation of the pay commission's recommendations may impose a deviation from fiscal targets in the absence of off-setting fiscal measures, entailing a risk to general government finances, with spillovers to aggregate demand.

I.17 India's external position is viable and well-buffered to sustain a pick-up in non-oil non-gold imports as growth gathers momentum. Nevertheless, the external environment continues to pose challenges stemming from large currency movements, a rising incidence of protectionist measures, swift and massive movements of capital and the amplification of uncertainty by the Brexit vote. Furthermore, the sustenance of terms of trade gains would be predicated upon movements in international commodity prices. Even as the outlook for capital inflows is optimistic with the recent liberalisation of FDI policy, the repayment of FCNR(B) deposits under the special swap scheme due in September to November 2016 will need to be managed carefully. In this context, the level of reserves and covering through forward assets provide ample resources.

I.18 Turning to the agenda of structural reforms to reap efficiency and productivity gains, several important steps that are underway need to be persevered with and taken to their logical conclusion. The UDAY scheme has provided a one-time opportunity to DISCOMs to regain financial viability. Going forward, it is important to avoid the recurrence of loss building processes for DISCOMs. In this regard, the MoUs signed by the state governments with the Government of India need to be monitored closely and clauses with regard to user charges and administrative reforms need to be enforced. Another important area of ongoing reforms is the banking sector for which stressed assets need to be unlocked and put back to work. The enactment of the Insolvency and Bankruptcy Code will make it easier for sick companies to either wind up or turn around, and for investors to exit. The Parliament has also passed

amendments to strengthen the Debt Recovery Tribunals for speedier resolution of stressed assets. Efforts need to be made to re-energise asset reconstruction companies (ARCs) – which have played a critical role in managing NPAs in many countries – by resolving issues relating to their capital requirements and enabling price discovery for NPAs/security receipts so that they can be traded in open, competitive markets that ensure liquidity. In all these issues, harnessing asset management expertise of foreign investors could offer synergies with their business models. The financial landscape is poised to undergo a significant transformation with the setting up of new institutions and enabling niche strategies. On-tap licensing of banks will facilitate expanding the universal banking network. Furthermore, the arrival of peer-to-peer lending and other Fin Tech-leveraged financial entities is expected to expand the reach of finance through innovative technological platforms.

I.19 Finally, the need for intensifying structural reforms in factor markets, particularly land and labour, is now widely seen as necessary for realising the potential of the economy and for avoiding jobless growth. In this context, various levels of government need to act together for the best results. First, labour regulations are often cited to be a significant barrier to growth, particularly with regard to large and medium scale manufacturing firms. Initiatives taken by some state governments to amend labour laws are a good starting point. Second, land acquisition processes are another critical factor affecting the pace of investment. State governments may consider putting in place a transparent and viable framework, de-bottlenecking land constraints, *e.g.*, as in Andhra Pradesh, to drive the capex cycle. Third, marketing infrastructure is critical. The National Agriculture Market (NAM) – a pan-India electronic trading platform – is an important example towards setting up a common agriculture market.