Annual Report 2000-01 Summary

*For the Year July 1, 2000 to June 30, 2001**

PART ONE : THE ECONOMY : REVIEW AND PROSPECTS

MACROECONOMIC POLICY ENVIRONMENT

1.1 Macroeconomic policy settings in 2000-01 were predominantly influenced by the underlying conditions in the domestic economy. Among the positive developments were an easing of the inflation rate towards the close of the year, and considerable strengthening of the balance of payments as reflected in a smaller than anticipated current account deficit and rising level of foreign exchange reserves. However, during the year, there was a deceleration in the rate of real growth, spread over agriculture, industry and even services, which dominated policy concerns. The social and economic consequences of the Gujarat earthquake engaged policy attention towards the close of the year. Moreover, the slowdown revealed several weaknesses in the growth process in terms of declining rates of capital accumulation, infrastructural and ecological constraints, gaps in social and economic opportunities available to various sections of society and continuing unemployment and poverty. Efforts to arrest the deceleration and revitalise the momentum of growth gathered importance in view of the need to prepare for launching medium-term strategies for the Indian economy hinging around a higher growth trajectory.

1.2 The framing of macroeconomic policies for revitalising growth was, to some extent, constrained by the uncertainties surrounding the international economic environment. Apprehensions of a global slowdown, the possibilities of international capital flows receding and the inflationary effects of high international oil prices emerged as external constraints on the growth prospects of developing countries, including India.

1.3 It is in the context of these developments that the macroeconomic policies in 2000-01 were framed. The Union Budget, 2000-01 accorded priority to curbing expenditure growth and bringing about structural changes in the composition of expenditure. Tax measures emphasised stability, growth, rationalisation and simplification. The Budget adopted a seven-fold strategy of strengthening the rural economy, developing knowledge-based industries and modernising traditional industries, removing infrastructural bottlenecks, human resource development, rapid export growth and higher foreign investment, prudent debt management and a credible framework for fiscal correction. Trade policies focused on liberalisation of the trade regime by removal of quantitative restrictions and streamlining of procedures. Policies for capital flows carried forward the progressive liberalisation of foreign direct investment, foreign institutional investment, external commercial borrowing and outward investment from India. Monetary policy continued to ensure that all legitimate requirements for bank credit were met while guarding against the emergence of inflationary pressures. It also continued to pursue the active management of liquidity to ensure stability in the financial markets. The Reserve Bank intensified the process of financial sector reforms through the development and regulation of financial markets, strengthening of the financial system as well as the regulatory and supervisory framework, improvement in credit delivery mechanisms and the monitoring of international developments with a view to considering the application of international best practices to the Indian situation. In regard to the real sectors, the National Agriculture Policy emphasised

efficient use of soil, water, bio-resources and inputs, a regional approach to agricultural and allied activities and stronger linkages with research. Policy initiatives in the industrial sector included extension of tax holidays for small-scale industries (SSIs) set up in industrially backward States and districts and incentives for knowledge-based, information technology (IT) and telecommunication industries.

1.4 The policy initiatives undertaken for 2001-02 continue to reflect the overall macroeconomic priorities. The Union Budget, 2001-02 has focused on extending reforms to the agricultural sector, investment in infrastructure, deepening of financial sector reforms and stronger fiscal correction through expenditure control, widening the tax base, rationalising subsidies and speeding up the process of disinvestment of public sector enterprises (PSEs). The Budget has also provided further momentum to the liberalisation of capital flows. The modified Export Import (EXIM) policy announced on March 31, 2001 has accorded primacy to agricultural exports and provided incentives for the special economic zones (SEZs). Furthermore, the phasing out of remaining quantitative restrictions was completed with safeguards to protect the domestic industry. Procedural improvements and easing of residual quantitative restrictions in respect of foreign direct investment have been undertaken under policies for external capital flows along with substantial liberalisation for Indian companies issuing American Depository Receipts (ADRs)/Global Depository Receipts (GDRs). The Monetary and Credit Policy for 2001-02 announced in April 2001 continues to emphasise the need for adequate availability of bank credit to meet all genuine requirements while ensuring that inflationary pressures are contained. Within this overall framework, the conduct of monetary policy would explore the possibility of softening of interest rates to the extent the evolving situation warrants. A flexible approach is adopted to counter the emergence of any adverse and unexpected developments either in the domestic or external sectors.

1.5 An important objective of monetary policy is to improve its operational effectiveness. Accordingly, the liquidity adjustment facility (LAF) has been further refined in terms of liquidity support facilities and operating procedures. A strategy has been put in place for the smooth transition of the call money market to a pure inter-bank market. Complementary measures have been undertaken to improve the functioning of money and government securities markets. Financial sector reforms undertaken within the ambit of monetary and credit policy for 2001-02 encompass the rationalisation of the interest rate regime, tightening of prudential measures including exposure norms, progress towards consolidated supervision, improvement in mechanisms for dealing with non-performing assets, moving towards risk based supervision, establishment of credit information bureau, the Clearing Corporation and Negotiated Dealing System, improving credit delivery mechanisms and monitoring of international standards and codes for the financial sector.

REAL SECTOR POLICIES : AGRICULTURE AND INDUSTRY

1.6 The performance of the agricultural sector has been receiving considerable policy attention in the recent years, especially in the context of reaching the benefits of reforms to the widest sections of society. Low and variable growth of output, poor and declining yields, inadequacy of capital formation and infrastructure and degradation of natural resources due to inefficient cropping patterns have emerged as the major obstacles to rapid and sustained agricultural growth. Furthermore, in recognition of the need to coordinate a national strategy covering land use pattern consistent with the conservation and optimal use of natural resources,

the Union Budget for 2000-01 proposed the setting up of a National Commission on Land Use Policy. It is against the backdrop of these concerns that the National Agriculture Policy was announced on July 28, 2000 with the objective of achieving a growth rate of over 4 per cent per annum in the sector. It emphasised sustainable growth by efficient use of soil, water, bio-resources, fertilisers and pesticides. A regional approach to the development of horticulture, floriculture, poultry, fishing and animal husbandry was mooted. Location specific and economically viable varieties of crops, use of bio-technology, strengthening of the linkage between research and extension activities, improved input management, protection to plant varieties through *sui generis* legislation and breeding of new varieties are other elements of the policy framework which would guide the direction of endogenous technological transformation in agriculture. The National Agricultural Policy also emphasised micro-credit through the promotion of farmers' Self-Help Groups with linkages with the banking system. A Micro-finance Development Fund was set up in the NABARD with a contribution of Rs. 40 crore each from the Reseve Bank and the NABARD. Over the medium-term, reforms in rural credit delivery will need to focus on a thorough restructuring of cooperatives including changes in cooperative law.

1.7 The New Agriculture Policy emphasised a conducive policy regime which would require the reforms to bring about improvements in the terms of trade for agriculture, a favourable price regime, removal of infrastructural bottlenecks and institutional reforms taking the form of land reforms, risk management and management changes emphasising the quality aspects of all stages of farm operations.

1.8 A National Policy on Handling and Storage of Foodgrains was announced on June 20, 2000 to deal with storage issues, mechanisation of harvesting and transportation, construction of chain silos and private sector participation in integrated bulk handling, storage and transportation.

1.9 In October 2000, a multi-pronged strategy for foodstock control was announced for (i) supplying foodgrains at below poverty line (BPL) rates to States, (ii) exporting surplus stock at realistic prices, and (iii) promotion of Food for Work Programmes.

1.10 Several initiatives in industrial policy were undertaken. Under the National Textile Policy 2000, the garment sector was de-reserved from the purview of SSI reservation and a venture capital fund was proposed with a view to facilitating knowledge-based entrepreneurship in the industry. Tax holidays for SSIs and industrial units in backward states were extended by another two years. Knowledge-based industries were provided incentives in the form of reduction in customs duties on several items of the information technology (IT) and telecommunications sectors. The domestic long-distance services industry was opened up without any restrictions on the number of operators. An Expert Group was constituted with a mandate to work towards the replacement of the Industries Development and Regulation Act, 1951 by an Industry Act, which would focus on development and promotion of the industrial sector instead of regulation.

THE UNION BUDGET, 2001-02

1.11 The Union Budget, 2001-02 reviewed the gains in terms of growth and resilience of the Indian economy posted over ten years of structural reforms. Budgetary initiatives for accelerating the spread of reforms in agriculture and rural development emphasised the provision of adequate credit for agriculture through the Rural Infrastructure Development Fund (RIDF)

VII, Kisan Credit Cards (KCC), the National Bank for Agriculture and Rural Development (NABARD) and the Small Industries Development Bank of India (SIDBI), particularly in the context of linking self-help groups (SHGs) and the disbursal of credit-linked subsidy for funding storage capacity building, development of rural roads and rural electrification, and setting up a technology mission for the development of horticulture in the North Eastern States. The Union Budget also envisaged an enlarged role for State Governments in the procurement and distribution of foodgrains to BPL families and a thorough review of the restrictive provisions of the Essential Commodities Act in so far as they impede the inter-State movement of foodgrains.

1.12 In the context of raising investment in infrastructure, the Union Budget, 2001-02 focused on the issue of the imposition of appropriate user charges in the power sector through reforms of State Electricity Boards (SEBs) for the restoration of financial viability, enhancement of Plan outlay for central sector power utilities, roads and telecommunications, legislative reforms in the areas of electricity distribution, telecommunication, information technology (IT) and broadcasting and rationalisation of tariffs for ports.

1.13 Financial sector reforms were provided momentum through comprehensive legislation envisaged alongside measures taken by the Reserve Bank for developing a transparent and active debt market, which are reported in Part Two of this Report. Furthermore, legislation to facilitate foreclosure and enforcement of securities in the event of default has been contemplated together with expanding the number of Debt Recovery Tribunals (DRTs). Greater autonomy is envisaged for banks in the area of recruitment.

1.14 Progressive liberalisation of the capital account was continued through greater freedom for Indian companies to invest abroad, and in the utilisation of American Depository Receipt (ADR)/Global Depository Receipt (GDR) proceeds including two-way fungibility *vis-a-vis* domestic shares. Overseas investment by partnership firms and companies providing professional services is allowed. Complementary measures undertaken by the Reserve Bank to liberalise capital account transactions are reviewed in Part Two of the Report. Foreign Institutional Investors (FIIs) are allowed to invest up to 49 per cent of the paid-up capital of Indian companies. Foreign direct investment in non-banking financial companies (NBFCs) is allowed up to 100 per cent without any domestic divestment stipulation, provided the foreign investors bring in a minimum of US $ 50 million under the automatic route.

1.15 Intensification of structural reforms through the Union Budget included a time-bound action programme for the dismantling of the administered pricing mechanism in the petroleum sector, rationalisation of fertiliser pricing with the objective of phasing out the retention price scheme in the medium term, decontrol of sugar and the introduction of futures/forward trading, reduction in the span of price control relating to drugs and pharmaceuticals, legislation to repeal the Sick Industrial Companies (Special Provisions) Act (SICA) and the Companies Act in order to set up a National Company Law Tribunal and amendments to the Industrial Disputes Act relating to lay-offs, retrenchment and closure. Similar legislation was proposed in the case of contract labour. A new scheme of group insurance *i.e.*, the Ashraya Bima Yojana was introduced to provide compensation for one year for workers who lose their jobs. Several measures were undertaken in respect of the small-scale sector, health and family welfare, social security, education and other aspects of human development including the welfare of women, scheduled castes and tribes and journalists.

1.16 The strategy of fiscal consolidation proposed in the Union Budget rests on the plank of prudent expenditure management. Important initiatives to economise public expenditure and also improve its quality relate to revision in user charges, scrutiny and limits to recruitment, downsizing, redeployment and retraining of staff, trimming of perquisites provided to Government employees, zero-based budgeting for all schemes at the Central and State levels, pension reform and reduction of administered interest rates. Involvement of States in the reform process is sought to be fostered through an Incentive Fund.

1.17 Tax measures in the Union Budget, 2001-02 are guided by the principles of growth in revenues, simplification and rationalisation of the tax regime and effective tax compliance. On direct taxes, no changes in existing tax rates were proposed and all surcharges, except the 2 per cent surcharge for Gujarat earthquake relief, were withdrawn. The one-by-six scheme was extended to all urban areas and the scope of deduction at source was enlarged. Tax on distributed dividend was reduced to promote growth. Tax holidays were granted for infrastructural areas and special economic zones. Under indirect taxes, the Union Budget reduced the three rates of special excise duty to a single rate of 16 per cent and abolished 8 per cent special excise duty on certain items. Special surcharge on cigarettes and tobacco products was introduced to replenish the National Calamity Contingency Fund. Several services were brought under the ambit of taxation to widen the tax base. The peak level of customs duty was reduced from 38.5 per cent to 35 per cent by discontinuing the surcharge of 10 per cent. The four-rate import duty structure (of 5 per cent, 15 per cent, 25 per cent and 35 per cent) has been left unchanged. With a view to aligning the customs tariff to the levels prevailing in the Asian countries, the number of rates would be progressively reduced to the minimum within three years with the peak rate at 20 per cent. The customs duty on certain items was reduced in accordance with the World Trade Organisation (WTO) bound rate.

1.18 The Budget proposed to strengthen disinvestment programme through the strategic sales of blocks of shares. Disinvestmen t proceeds would be used for restructuring PSEs, safety nets for workers, reduction of debt burden and additional budgetary support for plan, particularly in the area of social and infrastructure sectors.

EXTERNAL SECTOR POLICIES

Trade Policies

1.19 The modified EXIM policy for 1997-2002, announced on March 31, 2001 was framed in the context of the goal of accelerating export growth to achieve at least 1 per cent share of global trade (which translates to an export level of US $ 75 billion or roughly 18 per cent in terms of growth rate) by 2004-05.

1.20 In the context of the on-going negotiations on agriculture in the World Trade Organisation (WTO) and in order to take advantage of the expected liberalisation of agricultural trade, primacy was given to agricultural exports. Measures include proposals to formulate a specific agricultural export policy and set up Agricultural Export Zones, extension of benefits of export promotion schemes such as the Duty Exemption Scheme and the Export Promotion Capital Goods (EPCG) Scheme to the agricultural sector, and the recognition as Export House/Trading House/Star Trading House/Super Star Trading House for exporters achieving one-third of the threshold limit prescribed for exporters of goods. State Governments were assigned an important role in identifying such zones for end-to-end development for exports of specific products from

specific geographical areas. The Agricultural and Processed Food Products Exports Development Authority (APEDA) would supplement the efforts of State Governments for facilitating agricultural exports.

1.21 Assistance is to be extended in research and development, market research, specific market and product studies, warehousing and retail marketing infrastructure in select countries and direct market promotion activities through media advertising and buyer-seller meets through the newly instituted Market Access Initiative scheme. In respect of Special Economic Zones (SEZs), measures include permission for foreign direct investment (FDI) under the automatic route for all manufacturing sectors, except a small negative list, doing away with licences for setting up units for items reserved under SSI, allowing units to bring back proceeds in 365 days (instead of normal period of 180 days) and retaining 100 per cent of the same in Exchange Earners' Foreign Currency (EEFC) accounts, duty free import/ procurement from Domestic Tariff Area (DTA) of goods for setting up factories in SEZs, permission to sell goods in the DTA in accordance with the import policy in force, permission to sub-contract part of the production process abroad and to allow amortisation of value to be spread over 8 years instead of the present 5 years to attract capital intensive units into the SEZs and to give infrastructure status to SEZs under Income Tax Act. The Union Budget, 2001-02 had earlier announced a 10-year tax holiday for the developers of SEZs on the same lines as the developers of industrial parks.

1.22 In continuation of the process begun in the EXIM policy announcement of March 2000, the phasing out of balance of payments related quantitative restrictions (QRs) on imports on the remaining 715 items was completed in the policy announcement of March 2001. The freed items include 342 textile products, 147 agricultural products including alcoholic beverages and 226 other manufactured products (including automobiles). Along with removal of QRs, measures were simultaneously taken to safeguard against a surge in imports. These include restricting the import of agricultural products like wheat, rice, maize as also petrol, diesel, Aviation Turbine Fuel (ATF) and urea only through designated State Trading Enterprises, instituting import permits issued by Ministry of Agriculture after an import risk analysis based on scientific principles and in accordance with the WTO Agreement on Sanitary and Phyto-sanitary Measures for the import of all primary products of plant and animal origin and the prescription of certain conditions for importing new and second hand cars for ensuring road safety as also environment concerns. In addition, an Early Warning System for monitoring of imports by streamlining and reducing the time lag for gathering data was put in place with a high-powered Standing Group functioning as a "War-room" for tracking, collating and analysing data on 300 sensitive items of importance to the public which is being published on a monthly basis.

1.23 Several measures were also taken to simplify and streamline procedures like providing automatic customs clearance to status and green card holders, reduction in percentage of physical verification and random drawing of shipping bills, expeditious verification of Duty Entitlement Passbook (DEPB) and Duty Free Replenishment Certificate (DFRC), redemption of advance/EPCG licence on the basis of No Bond issued by Directorate General of Foreign Trade (DGFT) and issuance of receipt by the Customs for ensuring accountability.

1.24 In the light of the complete removal of quantitative restrictions on imports, the Government announced several safeguard measures in order to protect the domestic industry. There was a substantial hike in the customs duties on agricultural commodities like tea, coffee and coconut (35 per cent to 70 per cent), crude edible oils (a uniform rate of 75 per cent from 35-55 per cent) and refined oils (85 per cent from 45/65 per cent), completely built units of cars and two-

wheelers (60 per cent from 35 per cent) and imported liquor. In case of second-hand cars, the total duty would work out to more than 180 per cent, with the rate of basic customs duty raised to 105 per cent.

1.25 In consonance with the New Textile Policy announced to prepare the domestic industry to meet the challenges of global competition, the Union Budget, 2001-02 announced several measures including exemption from *ad valorem* excise structure for independent textile processors and abolition of the 16 per cent countervailing duty on 12 textile machinery items.

Policies for External Capital Flows

1.26 The approach to international capital flows has been conditioned by the specific institutional and legislative framework characterising the current state of development of the domestic economy with a preference for a gradualistic approach and an implicit hierarchy of various types of flows based on stability considerations. During 2000-01, policy initiatives were undertaken to further facilitate the access of industry to external capital flows so as to improve the climate for new investment.

1.27 Periodic adjustments have been made in the policy regime for foreign direct investment (FDI) to create a congenial environment for these flows. All FDI would henceforth be permitted under the automatic approval route, except for a small negative list. New foreign investment proposals in the information technology (IT) sector are entitled to automatic approval irrespective of whether the investor has an existing joint venture or technical collaboration in the country. FDI up to 100 per cent is allowed for business-to-business e-commerce subject to certain conditions. The dividend balancing condition for FDI in the remaining 22 consumer goods industries was removed. The upper limit of Rs.1,500 crores for FDI in projects relating to electricity generation, transmission and distribution (other than atomic reactor power plants) was also removed. The limit of FDI in oil refining sector under automatic route was raised from the existing 49 per cent to 100 per cent. FDI under the automatic route is permitted up to 100 per cent for all manufacturing activities (with certain exceptions) in Special Economic Zones (SEZs). Foreign equity participation up to 26 per cent was allowed in the insurance sector subject to the issue of necessary license by the Insurance Regulatory and Development Authority (IRDA). 100 per cent FDI was allowed in the telecommunications sector for Internet Service Providers (ISPs) [not providing gateways (both for satellite and submarine cables), infrastructure providers providing dark fibre (IP category I), electronic mail and voice mail]. In principle or prior approval of the Reserve Bank is no longer required for any proposal for issue of shares as long as it is in conformity with Government guidelines.

1.28 As mentioned earlier, the Union Budget substantially liberalised the procedures for FDI in non-bank financial companies. The list of NBFC activities eligible for foreign equity investment was increased to 18 with the addition of micro-credit/rural credit. Foreign investment guidelines for NBFCs were amended to provide a minimum capitalisation norm of US $ 0.5 million for activities which are consultative in nature or are not fund-based, irrespective of the foreign equity participation level. The provision applies to investment advisory services, credit reference and rating agencies, financial consultancy, foreign exchange broking and money changing. Permission was granted to holding companies in NBFC activities with a minimum capital of US $ 50 million to set up 100 per cent downstream subsidiaries.

1.29 In May 2001, the Government significantly liberalised the FDI policy for crucial sectors including banks, drugs and pharmaceuticals and some areas of telecommunication. The defence

equipment industry was opened to the private sector with FDI limit of 26 per cent. FDI to the extent of 100 per cent was permitted in pharmaceuticals, hotels, airports, tourism, courier services, township development and mass rapid transport system (MRTS) in all metropolitan cities.

1.30 Policies for international offerings through American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) by Indian companies were liberalised. Overseas business acquisitions through the ADR/GDR route were permitted under the automatic/simplified approval mechanism for Indian companies engaged in (i) information technology and entertainment software, (ii) pharmaceuticals, (iii) biotechnology and (iv) any other sector notified by the Government from time to time. The automatic approval is subject to conditions of previous listing, conformation to FDI policy and limiting of transactions to US $ 100 million or ten times the export earnings during the preceding financial year. Indian companies engaged in information technology (IT) software and IT services were permitted to issue ADR/GDR – linked stock options to permanent employees (including Indian and overseas working directors) of the subsidiary companies incorporated in India or outside and engaged in IT software and IT services (subject to eligibility criteria and other conditions). Indian companies engaged in information technology and entertainment software, pharmaceuticals, biotechnology and any other activities within the knowledge-based sector (as notified by the Government from time to time) were permitted to issue employees' stock options (ESOPs) to their permanent employees. The liberalised norms for ESOPs were extended to multi-product diversified companies subject to specific conditions.

1.31 The Union Budget, 2001-02 proposed several measures towards further liberalising the policies towards ADRs/GDRs. Indian companies wishing to invest abroad were permitted to invest up to US $ 50 million on an annual basis through the automatic route without being subject to the three year profitability condition. Companies with proven track record wishing to invest larger amounts were allowed to get a block allocation in advance from the Reserve Bank for investments overseas. Companies which have issued ADRs/GDRs were permitted to make foreign investments up to 100 per cent of these proceeds, up from the ceiling of 50 per cent. A scheme has been announced whereby local shares can now be re-converted to ADRs/GDRs while being subject to sectoral caps, wherever applicable. Indian companies were permitted to list in foreign stock exchanges by sponsoring ADR/GDR issues against block share holding. This facility has to be offered to all categories of shareholders. Restrictions on overseas investments by registered partnership firms and companies providing professional services were removed. Indian employees who have the benefit of ESOP schemes in foreign owned companies can now make investments abroad up to US $ 20,000 annually instead of in a block of five years.

1.32 The access of Indian corporate entities to use of external commercial borrowings (ECBs) as a window for resource mobilisation was considerably improved and procedures streamlined. The Government delegated ECB sanctioning powers up to US $ 100 million under all schemes to the Reserve Bank. Furthermore, prepayment approvals can now be given by the Reserve Bank, as per prevailing guidelines, even in cases where ECBs were approved earlier by the Union Ministry of Finance. The existing all-in-cost ceilings for normal projects, infrastructure projects and long term ECBs were fixed at 300, 400 and 450 basis points over 6 months London Inter-Bank Offer Rate (LIBOR) for the respective currency in which the loan was to be raised or applicable bench marks as the case may be. The average maturity for the purpose of ECB guidelines was declared to be the weighted average of all disbursements, taking each

disbursement individually and its period of retention by borrowers. Corporates having underlying exposure in respect of crude and petroleum products were permitted to hedge the commodity price risk subject to detailed guidelines of the Reserve Bank. With effect from September 1, 2000, it was decided to operationalise the automatic route for fresh ECB approvals up to US $ 50 million (with average maturity of not less than 3 years) and for refinancing of existing ECBs. Corporates are not required to obtain prior approval from the Ministry of Finance/Reserve Bank.

MONETARY POLICY FRAMEWORK

1.33 During 2000-01, the emphasis of monetary and credit policy was to provide sufficient credit for growth while ensuring that there is no emergence of inflationary pressures on this account. Towards this end, the Reserve Bank continued its policy of active management of liquidity through open market operations (OMO), including repo and reverse repo operations as part of the Liquidity Adjustment Facility (LAF), and changes in the cash reserve ratio (CRR) and the Bank Rate, as and when required. The policy stance took into account the sharp increase in oil prices in an otherwise reasonably benign international inflationary environment, a freer trade regime, the high levels of food stocks and foreign exchange reserves, the budget stance of reining in the overall fiscal deficit and the delay in the adjustment of important administered prices, including prices of petroleum products. At the beginning of the year on April 1, 2000, the Reserve Bank announced a one percentage point reduction in the Bank Rate, the CRR (in two stages) and the repo rate, and 0.5 percentage point reduction in the saving deposit rate of scheduled commercial banks from 4.5 to 4.0 per cent. Following these measures, most public sector banks reduced their lending and deposit rates. The monetary policy stance also took note of unfavourable events such as rising inflation, droughts and emphasised the need for continuous vigilance and caution in the event of unanticipated domestic and international developments. Accordingly, a flexible approach was adopted with allowance for tightening monetary policy when necessary and unavoidable.

1.34 The year-on-year expansion of scheduled commercial banks' non-food credit was high during a greater part of the year, reflecting the increases in stocks in some industries, consumer credit demand and an augmented credit flow to the infrastructure sector. In the last quarter of 2000-01 and also in the first quarter of 2001-02, non-food credit growth decelerated as industrial activity slowed down.

1.35 The day-to-day liquidity management function of monetary policy is performed through the Liquidity Adjustment Facility (LAF) with a view to ensuring reasonable stability in financial markets and orderly market conditions. The introduction of the LAF in June 2000 facilitated the management of volatility in the foreign exchange market segment and tight liquidity conditions.

1.36 By mid-July 2000, the improvement in market liquidity enabled an easing of the reverse repo rate. Thereafter, with renewal of pressures in the foreign exchange market, the Bank Rate and the CRR were raised, standing facilities were temporarily halved and repo operations were employed to absorb liquidity and to signal the monetary stance. The cut-off repo rates gradually rose in August 2000 and were around 10 per cent for most part of September 2000. Additional repo auctions with maturity ranging from 3 to 7 days were also undertaken during this period. By mid-September 2000, market conditions began to improve. Market sentiment was rejuvenated by inflows in the form of India Millennium Deposits (IMDs) and other capital flows. Interest rate measures undertaken earlier in the context of market turbulence were withdrawn.

The CRR was reduced in two stages to the April 2000 level of 8 per cent by March 2001. The Bank Rate was also reduced, in successive cuts of 50 basis points each from mid-February 2001 to the April 2000 level of 7 per cent, effective March 2, 2001. On the other hand, reverse repos were used in December 2000-January 2001 to assuage the temporary spiking of call rates and again towards the end of March 2001 in view of the usual balance sheet date adjustments. In view of easy money market conditions, repos under the LAF were used to absorb liquidity, with the rates easing to 7.0 per cent and further to 6.75 per cent on April 27, 2001 and to 6.5 per cent on May 28, 2001. The Reserve Bank conducted reverse repos during May 8-23, 2001 to tide over a spell of tight liquidity caused by Government securities auctions, reduced lending by non-bank participants under the new regulations on lending in the call money market and rationalisation of liquidity support at the Bank Rate as per the revised LAF scheme. Furthermore, the CRR was reduced by 50 basis points to 7.5 per cent effective May 19, 2001, injecting Rs.4,500 crore in terms of lendable resources to the banking system.

1.37 Against the background of macroeconomic developments in India, the budgeted levels of the government borrowing programme, expectations of lower world GDP growth and a reasonably benign international inflationary environment, the overall stance of monetary policy for 2001-02 is to provide adequate liquidity to meet credit growth and support revival of investment demand while continuing a vigil on movements in the price level. Within the overall framework of imparting greater flexibility to the interest rate regime in the medium-term, the policy would be to maintain a stable interest rate environment with a preference for softening to the extent the evolving situation warrants. While this policy stance would characterise normal circumstances, a flexible approach would be adopted in the event of emergence of any adverse and unexpected developments in domestic or external sectors. The active management of liquidity through OMO, including the two-way sale/purchase of Treasury Bills, would also continue with reductions in CRR as and when required. Assuming a revival of the industrial sector from the second half of 2001-02, a reasonable monsoon and good performance of exports, monetary policy was formulated taking into account a growth rate of real GDP at 6.0 to 6.5 per cent, a rate of inflation within 5.0 per cent, *i.e.*, close to that in the previous year, the projected expansion in broad money (M_3) and aggregate deposits of scheduled commercial banks of about 14.5 per cent and non-food commercial bank credit (adjusted for investments in commercial paper, shares/debentures/bonds of PSUs and private corporate sector) growth of 16.0 to 17.0 per cent.

1.38 The Liquidity Adjustment Facility (LAF) has emerged as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a flexible manner as well as transmitting short-term interest rate signals and, in the process, providing an informal corridor for the call money market. Given the satisfactory experience with the LAF, the endeavour of monetary policy has been to make it more efficient, by removing some of the existing institutional, procedural and technological constraints. The experience has also shown that the LAF can be made fully effective only when it becomes the primary instrument of liquidity adjustment, and the other forms of liquidity support to the system *viz*., the collateralised lending facility and export credit refinance to banks and liquidity support to Primary Dealers (PDs) are gradually phased out. Yet another requirement for the LAF to become fully effective is the need to move towards a pure inter-bank call/notice money market and the need to create opportunities for activating the repo market and other alternative short-term investment options with adequate safeguards for non-bank participants which are at present allowed to lend in the call/notice

money market. Considering all these issues, the Reserve Bank initiated a package of measures covering the LAF, call money market and standing liquidity facilities with a view to enhancing the smooth flow of funds across instruments and participants, resulting in further integration of the money market, thereby rendering it a more effective channel of monetary policy.

1.39 Changes in operating procedures were implemented to improve the efficiency of LAF and increase operational flexibility of the scheme to enable small level operators to participate. With a view to stabilising market expectations and arresting volatility in call rates, the Reserve Bank reserved the discretion to switchover to fixed rate repos on overnight basis and to introduce longer-term repos up to a 14-day period as and when required. The multiple price auction introduced on an experimental basis in May 2001 has been extended. Information on the scheduled commercial banks' aggregate cash balances maintained with the Reserve Bank and the weighted average cut-off yield in case of the multiple price auction is being released to the public.

1.40 The export credit refinance facility was also rationalised so that the facility reflects more closely the extent of total credit support being provided by banks to exporters. The limits are now fixed on the basis of total outstanding export credit eligible instead of the incremental export credit eligible for refinance over a base date. As a matter of further comfort to all banks, the existing refinance limit as on May 4, 2001 was kept as the minimum limit available up to March 31, 2002.

1.41 The minimum maturity period for term deposits was reduced to 7 days from 15 days for wholesale deposits of Rs.15 lakh and above. With a view to enabling banks to have further flexibility in holding reserves depending upon their intra-period cash flows and to reduce volatility in the call money market, the minimum daily cash reserve requirement was reduced from 65 per cent to 50 per cent for the first seven days of the reporting fortnight from August 11, 2001. For the rest of the fortnight, the minimum requirement of 65 per cent is applicable including on the last day of the fortnight. This would enable banks to have flexibility in the management of bank reserves.

1.42 The interest rate structure on export credit was rationalised. In respect of pre-shipment credit up to 180 days, the ceiling rate applicable was set at 1.5 percentage points below the relevant PLR; banks are free to charge interest rate below the ceiling rate so prescribed. This is expected to introduce healthy competition and provide exporters a greater choice to avail of banking services in terms of interest rate, quality of service and transaction costs. The ceiling rate on FCNR (B) deposits was set at LIBOR (instead of LIBOR plus 0.5 percentage point). The ceiling rate on foreign currency loans for exports by banks was also revised to LIBOR plus 1.0 percentage point.

FINANCIAL SECTOR REFORMS

1.43 The Reserve Bank continued to carry forward the process of financial sector reforms, focusing on the development and regulation of financial markets, strengthening the financial system in the context of fundamental changes occurring in the environment in which financial institutions and markets operate and refining the regulatory and supervisory function in the light of these changes.

Development and Regulation of Financial Markets

1.44 A crucial element of the ongoing financial sector reforms is the development of various segments of financial markets, strengthening the inter-linkages among various segments, introducing sophistication in market practices and products and building the technological infrastructure for the efficient functioning of markets. In the recent period, the focus of policy measures has been on enhancing the stability of financial markets by developing internal rules for healthy market activity, strengthening prudential and supervisory norms and redefining the regulatory role of the Reserve Bank in the context of financial markets. The amendments to the Securities Contract (Regulation) Act, 1956, which were brought into effect in March 2000, represent an important milestone in the appropriate assignment of regulatory authority over the financial markets. These amendments establish the jurisdiction of the Reserve Bank over transactions in Government securities, money market securities, gold related securities, derivatives based on these securities as also ready forward contracts in debt securities, in conjunction with the Reserve Bank's regulation of foreign exchange transactions under the Foreign Exchange Regulation Act, 1973 and later by the Foreign Exchange Management Act, 1999.

1.45 During 2000-01, the Reserve Bank adopted a flexible stance in the regulation of financial markets, involving quick responses to unanticipated market pressures and return to the normal stance as pressures eased. Liquidity management enabled the setting of informal corridors for the evolution of call rates. Consistent with measures for operational improvement of the LAF, efforts were also made to develop the call money market into a pure inter-bank market. Corporates were allowed to route their call money transactions through primary dealers up to June 2001. A phased exit of non-bank participants from the call money market through a graded reduction in their call money lending linked to the commencement of operations by the Clearing Corporation was set in motion. At the same time, other segments of the money market are being developed to allow non-bank entities to participate. The minimum maturity of CDs was reduced to 15 days. Restriction on their transferability was also withdrawn. Guidelines for commercial paper (CPs) issuance were modified to provide flexibility to issuers and to widen the market. The repo market was expanded to cover non-bank entities holding current and SGL accounts with the Bank.

1.46 The development of the Government securities market has been an important component of the financial sector reforms. During 2000-01, the Reserve Bank continued to manage market conditions by a combination of private placements/devolvement, open market operations and reissuance of existing securities. This strategy enabled the smooth absorption of the Government borrowing programme and imparted efficiency to monetary policy operations. A scheme for automatic invocation of undrawn refinance/liquidity support from the Reserve Bank by an SGL account holder was introduced to resolve gridlock during settlement in the Government securities market. Sale of Government securities allotted in primary issues were allowed on the same day. An electronic Negotiated Dealing System (NDS) is expected to be introduced shortly with a view to moving towards transparent electronic bidding in auctions and secondary market transactions on a real-time basis.

1.47 In the foreign exchange market, the primary objective continued to be the maintenance of orderly conditions without any specific target for the exchange rate. The Reserve Bank met temporary mismatches in demand and supply through direct operations in the market and/or through banks. During the period May to August 2000, when the foreign exchange market experienced turbulence, market operations were combined with monetary measures. These

measures included imposition of interest rate surcharge of 50 per cent on import finance, interest of 25 per cent per annum (minimum) in respect of overdue export bills from the date the bill falls due for payment, close monitoring of banks' foreign exchange transactions and upward adjustment of the Bank Rate and the CRR, along with reduction in all standing liquidity facilities. EEFC entitlements were temporarily reduced. The combination of these measures enabled orderly corrections in the exchange rate. These measures were reversed as soon as normal conditions were restored.

Banking Sector Reforms

1.48 Banking sector reforms, during 2000-01, emphasised building the health of banks and financial institutions, improving their asset quality, strengthening prudential norms and supervision and monitoring developments with a view to securing the soundness and stability of the Indian banking system comparable to international standards.

Capital Adequacy and Provisioning

1.49 In a move towards consolidated supervision, banks were required to voluntarily build in the risk-weighted components of their subsidiaries into their own balance sheets on a notional basis. They were required to assign additional capital in phases from 2000-01 onwards. A risk weight of 100 per cent was assigned for State Government guaranteed securities issued by defaulting entities and to deposits placed with the NABARD/SIDBI in *lieu* of shortfall in advances to priority sector. The general provision of 0.25 per cent on standard assets which was required to be made on a global portfolio basis, was allowed to be included in Tier II capital along with general provision and loss reserves up to a maximum of 1.25 per cent of the total risk weighted assets. In general, banks were encouraged to make provisions in excess of the stipulations, taking into account their own risk perceptions.

Prudential Accounting Norms

1.50 Valuation norms applicable for banks' investment portfolios were modified to reflect market movements. Commercial banks were required to classify their entire investment portfolio under three categories, *viz*., "held to maturity", "available for sale" and "held for trading". Investments available for sale or held for trading were required to be marked to market periodically. Guidelines were also issued regarding classification and provisioning norms for restructured accounts in the standard and substandard categories.

1.51 The concept of past due in the identification of non-performing assets was dispensed with and banks were advised to draw action plans for moving over to international practice of classifying loans as non-performing when the interest and/or principal remains overdue for a period more than 90 days as against the existing 180 days from the year ending March 31, 2004. In July 2000, guidelines were issued for recovery of dues relating to non-performing assets (NPAs) of public sector banks with outstandings up to Rs.5 crore. The guidelines provide a simple, non-discretionary and non-discriminatory mechanism for recovery of NPAs in all sectors through compromise settlements.

Exposure Norms

1.52 The Reserve Bank announced fresh norms on the concept of 'capital funds', measurement of credit exposures and level of exposure limits to individuals/group borrowers. The exposure ceiling for commercial banks in respect of individual borrowers is scheduled to be reduced from 20 per cent to 15 per cent of capital funds in March 31, 2002. With effect from

April 1, 2003, the non-fund based exposure is to be reckoned at 100 per cent and banks are required to include forward contracts and other derivatives in determining individual/group exposure. Within the overall exposure, a bank's exposure to the capital market in all forms was set at 5 per cent of its outstanding advances (including commercial paper) as on March 31 of the previous year. Banks making investments in equity shares/debentures, financing of equities and issue of guarantees were encouraged to develop expertise in equity research and to formulate a transparent policy and procedure for investment in shares, *etc*. Equity shares in a bank's portfolio should be marked to market preferably on a daily basis, but at least on a weekly basis. Banks are required to disclose the total investments made in equity shares, convertible bonds and debentures, units of equity oriented mutual funds, aggregate advances against shares in the 'Notes on Account' to their balance sheets. Revised guidelines in this respect were issued on May 11, 2001.

Entry Norms for New Private Sector Banks

1.53 The entry norms for new banks in the private sector were revised in January 2001, and guidelines for conversion of non-banking financial companies (NBFCs) to scheduled banks were also issued. The minimum capital for entry was set at Rs.200 crore, to be raised to Rs.300 crore within three years from commencement of business. A minimum of 40 per cent of the paid-up capital was required to be contributed by promoters. Participation by NRIs was restricted to 40 per cent. A minimum CRAR of 10 per cent was prescribed for new private sector banks.

Norms for Banks and NBFCs Entering Insurance

1.54 Banks and registered NBFCs have been permitted to enter the insurance business under the Insurance Regulatory and Development Authority (IRDA) Act, 1999. The Reserve Bank issued guidelines in this regard for banks and NBFCs to enter into insurance business (i) on risk participation basis; (ii) for strategic investment in an insurance company without any risk participation and (iii) for agency business on behalf of insurance companies on fee basis without any risk participation. Certain eligibility criteria have been prescribed for entry of banks and NBFCs into insurance business through the above routes.

Supervision of Urban Co-operative Banks (UCBs)

1.55 Existing supervisory systems for UCBs allow for regulatory arbitrage and potential for contagion effects. Furthermore, the existence of overlapping jurisdictions between the Central Government/State Government and the Reserve Bank hinders the speed of response to unforeseen developments. In the light of the recent experience, the Reserve Bank undertook several interim measures, pending formal legislative changes, relating to lending against shares, borrowings in the call market, composition of SLR investments and term deposits placed with other UCBs.

1.56 In the April 2001 Monetary and Credit policy statement, the Reserve Bank has mooted a proposal for setting up of a new apex supervisory body, which can take over the entire inspection/supervisory functions in relation to scheduled and non-scheduled UCBs. This apex body could be under the control of a separate high-level supervisory board consisting of representatives of the Central Government, State Governments, the Reserve Bank as well as experts and may be given the responsibility of inspection and supervision of UCBs and ensuring their conformity with prudential, capital adequacy and risk-management norms as laid down by the Reserve Bank.

International Standards

1.57 The Reserve Bank has been conducting self-assessments of the Indian banking system *vis-a-vis* the Core Principles of Effective Banking Supervision. These assessments, supported by an external assessment by the IMF in November 1999, indicate that systems in India are largely compliant with the Core Principles. As a member of the Working Group on Capital of the Core Principles Liaison Group (CPLG), the Reserve Bank has provided the perspectives of the non G-10 countries in the drafting of the New Capital Accord. With regard to the New Capital Accord, it has expressed the view that where banks are of simple structure and have subsidiaries, the Accord could be adopted on stand-alone basis with the full deduction of equity contribution made to subsidiaries from the total capital. Secondly, for assigning preferential risk weights for banking book assets (excluding claims on the sovereign), preference has been expressed for assessments made by the domestic rating agencies as opposed to external rating agencies. The Reserve Bank is also of the view that risk weighting of banks should be de-linked from that of the sovereign in which they are incorporated and instead, preferential risk weights in the range of 20-50 per cent on a graded scale could be assigned on the basis of risk assessments by domestic agencies. The feedback received from a few banks indicates the need for substantial upgrading of existing Management Information Systems (MIS), risk management practices and procedures and technical skills of the staff. The Reserve Bank has forwarded its comments on the New Capital Accord to the Basel Committee. It has also sought public opinion in India on the New Capital Accord.

1.58 The Standing Committee on International Financial Standards and Codes (Chairman: Dr.Y.V. Reddy) was constituted by the Reserve Bank and Government of India for identifying the developments in global standards and codes with a view to considering the applicability of these standards and codes to the Indian financial system. The reports of the ten advisory groups, constituted by the Standing Committee, in the areas of accounting and auditing, banking supervision, bankruptcy law, corporate governance, data dissemination, fiscal transparency, insurance regulation, transparency in monetary and financial policies, payment and settlement systems and securities market regulation assessed the appropriateness of international standards and codes in these areas to the Indian context and recommended, where necessary, measures to improve existing standards. All the Advisory Groups have submitted their Reports which have been posted at the Reserve Bank's website in order to elicit public opinion.

Technological Developments in Banking

1.59 The approach to the modernisation of the payments and settlement system over the medium-term is three-pronged: (i) consolidation, (ii) development and (iii) integration. The process of finalising the Real Time Gross Settlement (RTGS) design specifications covering the entire gamut of policy, operational and implementation issues was completed during the year. A key component of the RTGS system is the sub-system of queuing of RTGS messages pending settlement. While the general principle of 'first-in-first-out' (FIFO) would be the base for the queuing mechanism for the Indian RTGS system, there would be enhancements in the form of priority assignment and potential grid lock identification by the software on the basis of pending queues. The INdian FInancial NETwork (INFINET) which initially comprised only the public sector banks was opened up for participation by other categories of members. 26 public sector banks achieved the level of 70 per cent of business captured through computerisation by June 2001.

1.60 The Information Technology Act, 2000 has given legal recognition to creation, transmission and retention of an electronic (or magnetic) data to be treated as valid proof in a court of law, except in those areas, which continue to be governed by the provisions of the Negotiable Instruments Act, 1881. Payment System Legislation in the form of amendments to various Acts as also the need for framing new legislation for the regulation of multiple electronic payments is under consideration. Several measures to ensure the authenticity of the message across the Internet have been suggested by the Working Group on Internet Banking.

Credit Delivery

1.61 During 2000-01, channels for the flow of bank credit to certain sectors such as agriculture, exports, small-scale industry, infrastructure, housing, micro-credit institutions and self-help groups were strengthened. Bank finance to agriculture through NBFCs and finance for distribution of inputs for activities allied to agriculture up to Rs.15 lakh (raised from Rs.5 lakh) were included under priority sector lending. Domestic commercial banks are required to lend a minimum of 18 per cent of net bank credit (NBC) to agriculture of which indirect lending to agriculture should not exceed 4.5 per cent of NBC. Pursuant to the announcement in the Union Budget, 2001-02, Rural Infrastructure Development Fund-VII (RIDF-VII) has been established in National Bank for Agriculture and Rural Development (NABARD) with a corpus of Rs.5,000 crore. The interest rate charged by NABARD to State Governments under RIDF-VII will be 10.50 per cent. A sum of at least Rs.750 crore will be earmarked out of RIDF-VII for rural electrification work. The rate of interest on RIDF deposits is linked to the banks' performance in lending to agriculture. Accordingly, banks will receive interest from NABARD on contribution to RIDF-VII at rates of interest inversely proportional to the shortfall in agricultural lending, the maximum being 10 percent.

1.62 Public sector banks were set annual targets for issue of Kisan Credit Cards (KCC) during 2001-02 to achieve overall target of 33 lakh set for commercial banks. All eligible agriculture farmers are to be covered under the Scheme within the next three years. Cumulatively, 43.77 lakh KCCs involving a sum of Rs.10,626 crore have been issued by public sector banks from the inception of the Scheme up to March 2001. Banks have also been advised to provide a personal insurance package to the KCC holders to cover them against accidental death or permanent disability, up to maximum amount of Rs.50,000 and Rs.25,000, respectively. As per the model Scheme, the premium burden will be shared by banks and the KCC holders in 2:1 ratio.

1.63 Removal of procedural hurdles facing exporters has been a priority with the Reserve Bank. Exporters' suggestions were invited by the Reserve Bank, including on its website. Based on these suggestions, guidelines were issued for a flexible approach by banks to negotiating bills drawn against LCs over and above limits, delegation of discretionary powers at bank branch level for sanction of export credit, flexibility in disbursing enhanced/*ad hoc* limits pending sanction, waivers of LCs/export orders, *etc*. Exporters whose suggestions could not be implemented have been informed of the reason for non-acceptance.

1.64 The limit for investment in plant and machinery for considering a unit as small scale industry (SSI), which stood at Rs.3 crore earlier, was brought down to Rs.1 crore in order to give a fillip to small units with low investment. The investment limit for tiny units continues to be Rs.25 lakh. Investment in plant and machinery in respect of industry-related Small Scale Service/Business Enterprises was increased to Rs.10 lakh from Rs.5 lakh. Commercial banks were advised to dispense with collateral requirements for the tiny sector for loans up to Rs.5

lakh. Similarly, to promote credit flow to small borrowers, the composite loan limit for providing working capital and term loan through single window was increased from Rs.10 lakh to Rs.25 lakh. Under the Credit Linked Capital Subsidy Scheme for technology upgradation of SSIs introduced in October 2000, 12 per cent back-ended capital subsidy was made admissible on the loans granted to the SSIs by scheduled commercial banks/designated State Financial Corporations (SFCs) for technology upgradation in certain selected sectors.

1.65 A Credit Guarantee Fund Scheme for small scale industries was introduced with effect from August 2000 for the purpose of providing guarantees to a substantial extent in respect of credit facilities up to Rs.25 lakh to borrowers in the SSI sector, without any collateral security and/or third party guarantee. The scheme covers eligible credit facility extended by the lending institutions effective June 1, 2000.

1.66 Efforts to augment and rationalise micro-credit were carried forward with guidelines being issued to banks in February 2000. A Micro Finance Development Fund with a start-up contribution of Rs.100 crore from the Reserve Bank, NABARD and select public sector banks was set up in NABARD to, *inter alia*, promote research, management information systems and dissemination of best practices in micro finance. During 2001-02, linkages with SHGs would be extended across the country so as to expand the access to credit.

Non-Banking Financial Companies

1.67 The regulatory framework of NBFCs is subject to continuous review. Money received by NBFCs by issue of CPs was exempted from the purview of public deposits. The maximum rate of interest that NBFCs and Miscellaneous Non-Banking Companies (chit fund companies) and *Nidhi* companies can pay on their public deposits was reduced, effective April 1, 2001, from 16 per cent to 14 per cent per annum. In respect of Residuary Non-Banking Companies (RNBCs), effective July 1, 2000, the floor on interest rates payable was lowered by two percentage points to 6 per cent per annum (to be compounded annually) on amounts deposited in lump sum or at monthly or longer intervals and 4 per cent per annum (to be compounded annually) on the amount deposited under daily deposit schemes.

1.68 The Supreme Court upheld the constitutional validity and reasonableness of the provisions of Section 45-S of the RBI Act which prohibits unincorporated bodies engaged in the business of a financial institution from accepting public deposits, except from certain specified relatives and specified financial institutions.

Financial Institutions

1.69 Changes in the regulatory framework for select all India Financial Institutions (FIs) were put in place during 2000-01 in the context of the move towards universal banking and consolidated supervision. The risk weight of 100 per cent to be assigned by banks for State Government guaranteed securities issued by defaulting entities was extended to FIs as well. The netting of provision against standard assets from gross advances was discontinued in respect of FIs. These provisions are to be shown separately in their balance sheets and would be eligible for inclusion in Tier II capital. The provision on standard assets together with ‘other general provisions and loss reserves’ should not exceed 1.25 per cent of the total risk weighted assets.

1.70 FIs were required to value the investments in mutual fund units at the market rates, as per stock exchange quotations, if available, or the latest net asset value (NAV) declared by the mutual fund in respect of each particular scheme. The guidelines for classification and valuation

of investments by FIs were revised with effect from March 31, 2001, so as to bring the norms at par with the international best practices. Parity in the non-performing assets (NPA) norms for banks and FIs in respect of the overdue concept was sought to be effected from the year 2001-02 (for FIs, overdue for more than 180 days with effect from the year ended March 31, 2002, as against the present norm of an overdue period of 365 days or more in respect of principal and more than 180 days in respect of interest). FIs were required to issue notices to eligible defaulting borrowers to avail of the opportunity for one time settlement of their outstanding dues and the period for giving notice was extended up to September 30, 2000. The operation of guidelines for settlement of the outstanding dues were later extended up to June 30, 2001.

1.71 Guidelines on raising of resources by FIs were modified on June 21, 2000. FIs are not required to seek the Reserve Bank's prior approval/registration for raising of resources by way of issue of bonds (both public issue and private placement) subject to the fulfilment of certain conditions relating to the minimum maturity of the bond, call/put options, the yield-to-maturity (YTM) offered and 'exit' option on the bonds. The outstanding total resources mobilised by an individual FI, including funds mobilised under the 'umbrella limit' prescribed by the Reserve Bank, should not exceed 10 times its net owned funds (NoF) as per the latest audited balance sheet. The limit fixed for raising resources by FIs would be only an enabling provision. Resource requirements along with maturity structure and the interest rate offered thereon need to be arrived on a realistic basis and derived, *inter alia,* from a sound system of Asset Liability /risk management. In the case of floating rate bonds, FIs are required to seek prior approval from the Reserve Bank with regard to the reference rate selected and the methods of floating rate determination. In order to improve functional efficiency, rating of term deposits by all-India FIs was made mandatory. They were, however, allowed flexibility in fixing interest rates on their term deposits.

1.72 A system of monthly reporting to the Reserve Bank on raising resources by way of bonds/debentures was introduced in respect of select all-India FIs since July 2000. The format of consolidated returns on raising of resources by all-India FIs was revised to facilitate inclusion of information on short-term borrowings, which has been included under the one time 'umbrella limit'.

1.73 The existing norms relating to restructuring/rescheduling/re-negotiation of terms of the standard and sub-standard loan assets were reviewed in the light of international best practice and the BIS guidelines. For determining the exposure ceiling for FIs, the Reserve Bank proposes to adopt the concept of 'capital fund' as defined under capital adequacy standards, effective March 31, 2002. The exposure ceilings for 'single borrower' and 'group borrower' were brought down and FIs were advised to disclose certain important financial ratios/data in their published Annual Reports as part of the 'Notes to Accounts' to enable the auditors to authenticate the information. Changes in the practices and procedure of conducting financial inspection by Reserve Bank in respect of FIs were introduced.

POLICIES FOR CAPITAL MARKETS

1.74 During 2000-01, policy initiatives in respect of the capital market consisted of the tightening of prudential norms, the introduction of new products and strengthening of the existing risk management system.

Primary Market

1.75 The Securities and Exchange Board of India (SEBI) tightened entry norms relating to primary issues. Debenture Trustees Regulations were modified to ensure an arm's length relationship between the issuer and the trustee, besides laying down of responsibilities for different intermediaries. The SEBI (Disclosure and Investor Protection) Guidelines were modified to allow initial public offerings (IPOs) of sizes up to five times the pre-issue net worth only if the company has a record of profitability and net worth as specified in the guidelines. Companies not having such a track record or IPOs (or public issues) of more than five times the size of net worth were allowed to raise resources only through the book-building route where 60 per cent of the issue size is required to be allocated to 'Qualified Institutional Buyers'. In order to strengthen the book-building process, 100 per cent one-stage book-building was permitted with Bidding Centres at all cities with stock exchanges. Stipulations were also prescribed relating to allocations, on-line information, uniformity of margin, price band, etc. The SEBI notified that companies in the IT, telecom, media and entertainment sectors are allowed to tap the market with a minimum of 10 per cent of their equity, subject to fulfillment of certain criteria.

1.76 Banks were advised on November 10, 2000 that their exposure to the capital market by way of investments in shares, convertible debentures and units of equity oriented mutual funds, within the overall exposure to sensitive sectors, should not exceed 5 per cent of the outstanding domestic credit (excluding inter-bank lendings and advances outside India) as on March 31 of the previous year. These guidelines were revised on May 11, 2001 specifying the types of capital market exposure that could be undertaken by banks. Furthermore, the 5 per cent ceiling will be computed in relation to the total advances (including commercial paper) as on March 31 of the previous year.

Secondary Market

1.77 The SEBI undertook several measures to improve the functioning of the stock market. Besides granting approval for trading in futures contracts based on Bombay Stock Exchange Sensitive Index (BSE Sensex) and the Standard and Poor (S&P) CNX Nifty, the SEBI permitted introduction of new products in the form of Continuous Net Settlement (CNS), carry forward in the rolling settlement segment, Automated Lending and Borrowing Mechanism (ALBM), and Automated Lending and Borrowing Mechanism under Rolling Settlement (ALBRS). Disclosure norms relating to material information and market surveillance system covering such aspects as maintenance of records, code of ethics for elected directors, empowerment of stock exchanges, stock watch system, *etc.* were tightened.

1.78 After the presentation of the Union Budget, 2001-02, the BSE Sensex gained 4.4 per cent on February 28, 2001. This increase in the BSE Sensex was the highest on a single day in the last 11 months. During the first week of March 2001, however, the equity markets experienced some turbulence and uncertainty leading to problems in certain stock exchanges as well as liquidity/insolvency problems in some co-operative banks, which, in turn, affected some commercial banks also. The SEBI undertook several measures to stabilise conditions in the stock exchanges including banning of naked short sales, imposition of additional deposit margins on net outstanding sales of all shares and restraining broker-directors from acting as directors on the Governing Board of the BSE. Settlements on various stock exchanges were completed smoothly with shortfalls of some brokers being met by drawing down the Trade/Settlement Guarantee Funds set up by the exchanges. An important priority of the Reserve Bank during this period was to try and minimise the "contagion" spreading from the equity market to the money and the

government securities markets or to the banking system as a whole. In order to achieve this objective, it was necessary to provide assurance of sufficient collateralised liquidity to banks and to take early action to prevent the problem affecting particular co-operative banks in one region from spreading to other financial institutions. As a result, by and large, the money market as well as government securities market continued to function normally. Further, there was no reduction in market liquidity in spite of some cases of payment delays/defaults. There was also no immediate adverse impact of stock market turbulence on interest rates.

1.79 Subsequently, in May 2001, SEBI announced significant changes in the capital market in keeping with the international practices and operations in the securities markets. These measures include: (i) banning of all deferral products in the cash segment including badla; (ii) bringing in 414 scrips accounting for 95 per cent of trading volumes within the ambit of rolling settlements system from July 2, 2001; (iii) allowing index based and individual stock based options; (iv) introduction of uniform Monday-to-Friday settlement cycle across all stock exchanges for all scrips not in the rolling mode; (v) a code of conduct and a preventive framework against insider trading; (vi) removal of price bands for all stocks in the rolling mode from July 2, 2001 and for the entire market from January 2, 2002; (vii) introduction of a market wide circuit breaker system to be applicable at three stages of the index movements; (viii) shifting the margining system from net to gross basis (sales and purchases) with effect from September 3, 2001; and (ix) introduction of 99 per cent value at risk (VaR)-based margin system for all scrips in the compulsory rolling settlement with effect from July 2, 2001. These measures are expected to play an important role in the long-term growth of the capital market.

1.80 The recent experience in equity markets and its aftermath have thrown up new challenges for the regulatory system as well as for the conduct of monetary policy. It is necessary to develop firewalls against contagion stemming from non-adherence to prudential norms and regulatory guidelines in certain segments of the banking system. In the interest of financial stability, it is important to take measures to strengthen the regulatory frame-work for the co-operative sector by removing “dual” control, by laying down clear-cut guidelines for their management structure and by enforcing further prudential standards in respect of access to uncollateralised funds and their lending against volatile assets. In the light of recent experience, it is also necessary for commercial banks to take some corrective measures to reduce undue risks in their portfolio management.

Mutual Funds

1.81 Investment norms relating to Mutual Funds (MFs) were liberalised by allowing them to invest in mortgage backed securities of investment grade and above. Furthermore, the open-ended schemes were allowed to invest up to 5 per cent of their net asset value in unlisted equity shares. The above two measures are expected to increase the funds to the housing sector and venture capital industry. Eligibility criteria for overseas investment were changed by allowing apportionment of US $ 500 million limit of overseas investments among Indian MFs. Norms relating to code of conduct, classification of NPAs and their disclosure, period for initial offer of a scheme and dispatch of certificates, standardisation of format, treatment of unclaimed deposits and standards for trading by the employees were tightened. Disclosure and transparency standards relating to Asset Management Companies (AMCs) were also tightened.

MEASURES FOR NATURAL CALAMITIES

1.82 The earthquake which struck Gujarat on January 26, 2001 is widely regarded as unprecedented in its intensity measuring 7.7 on the Richter scale as per the US Geological Survey. It caused loss of life, extensive damage to both private property and public property such as roads, railways, ports and telecommunications networks and disruption in economic activity. To enable the Government of Gujarat to deal with the situation, the Government of India and the Reserve Bank undertook a number of measures. These measures included: (i) an advance of Rs.500 crore to Gujarat immediately from the National Calamity Contingency Fund; (ii) augmentation of the National Calamity Contingency Fund, set up with initial corpus of Rs.500 crore as a result of the Eleventh Finance Commission recommendations, by the imposition of a 2 per cent surcharge on personal income tax and corporate tax; (iii) assistance to State Government under various Centrally Sponsored Schemes for reconstruction of roads, bridges, power installations, school buildings, public utilities and other public infrastructure; (iv) arrangements for obtaining a combined line of credit of US $ 800 million from World Bank and Asian Development Bank; (v) setting apart of adequate funds for housing reconstruction by the Union Budget by allocating a special quota of tax-free bonds of the order of Rs.2,000 crore between the Housing and Urban Development Corporation (HUDCO) and the National Housing Bank (NHB); (vi) exemption of cement and steel used for construction in the Indira Awas Yojana, by HUDCO and by agencies identified by the State Government, from excise duty as was done after the Orissa cyclone; (vii) permission to Government of Gujarat to raise funds by floating tax-free earthquake relief bonds, which will be open to subscription in Rupees to individuals and others including Non-Resident Indians through the Reserve Bank; and (viii) exemption of all goods intended for relief from excise and customs duties and direct tax assessees were given extension of time for filing their returns. More recent measures have been announced for rehabilitation of the earthquake-affected region in Gujarat *viz.*, (i) a five-year excise duty holiday for the goods produced in the Kutch district, (ii) an additional amount of Rs.70 crore has been earmarked for the three hundred drought-affected villages, and (iii) Rs.160 crore to be utilised for rebuilding primary schools.

1.83 The Reserve Bank announced a package of relief measures for Gujarat and also instructed the banks to make special arrangements for freezing of loan classification status and extension of new loans on liberal terms for borrowers in the affected areas. The package of special relief measures included sanction of special limits up to Rs.1 lakh for restoration/rehabilitation of businesses of small traders, self-employed and small road transporters, *etc*.; grant of loans up to Rs.2 lakh for repairs/reconstruction of houses/shops; additional limits/ rescheduling of existing limits for loans for small scale industry (SSI), business, trade and industry; relaxation in interest rates; allowing loans up to Rs.10 lakh at PLR of State Bank of India and interest rates for loans exceeding Rs.10 lakh to be determined at the discretion of the financing bank; reckoning credit extended for repairs/construction of houses/shops and to small traders, small business, self-employed and small road transporters *etc.* under the relief package as a part of priority sector lending; delaying recovery of principal and interest for a period of two years in case of agricultural loans, and rescheduling of the amounts not collected during two years, for a period up to 7 years; and allowing consumption loan up to Rs.2,000 per eligible beneficiary. Banks were also advised to adhere to the time schedule of one month for sanction of new loans and reschedulement of existing loan accounts from the date of request from the affected borrower.

1.84 With a view to assisting exporters affected by the earthquake in Gujarat, banks were advised by the Reserve Bank to: (i) extend the period of packing credit at concessional rate even beyond 360 days in deserving cases where the goods are likely to be exported (the concessional rate ranges between 10-13 per cent); (ii) convert the overdue packing credit into term loans after taking into account the availability of ECGC claim, repayable in suitable instalments; and (iii) not to classify the overdue loans as non-performing assets (NPA) in respect of i) and ii) above, but to treat as NPA if interest and instalment of principal remains unpaid for 180 days, after it has become overdue, taking into account the revised due date fixed by the banks. Instructions are already in place for rescheduling/rephasing of existing loans and for extending fresh loans to agricultural borrowers affected by natural calamities. The rescheduled loans and the fresh facilities granted to such borrowers will be treated as current dues and need not be classified as NPA as per the Reserve Bank's income recognition, asset classification and provisioning norms. A special remittance of funds was arranged for the Ahmedabad office of the Reserve Bank whose fresh note stock position is being constantly monitored.

1.85 Gujarat's limits for ways and means advances (WMA) were completely relaxed and the terms of overdraft regulations for Gujarat were eased for three months till end-April 2001. The normal WMA limit of Gujarat was revised upwards to Rs.393 crore from the earlier limit of Rs.243 crore. The Reserve Bank sanctioned soft loans of Rs.1,000 crore to the National Housing Bank (NHB) to provide financial assistance for construction of houses damaged in the Gujarat earthquake. These loans were granted at 6 per cent rate of interest per annum and are repayable over a period of 18 years, inclusive of a moratorium period of 3 years.

1.86 In July 2001, Orissa still recouping from the ravages of the super cyclone of October 1999 followed by drought in the next year, was severely hit by floods, affecting 24 out of 30 districts in the State. The Central Government disbursed Rs.100 crore from the National Calamity Contingency Fund to the State, besides other material help. Commercial banks were advised by the Reserve Bank to be in readiness to take up necessary relief measures. A Steering Committee consisting of some major banks was formed for co-ordination of such activities. Heavy rains throughout Kerala during the first three weeks of July 2001 caused considerable damage leading to crop losses, flooded lands, collapsed houses, torn roads and landslides in many places. On a representation from the State Government, the Central Government had announced a relief of Rs. 26 crore from the National Calamity Contingency Fund. As an immediate relief measure, the State Government provided free ration and medical assistance. The State of Bihar was also affected by recent floods causing damages to standing crops and property. The Central Government has sanctioned Rs. 30 crore from the National Calamity Contingency Fund and also released one lakh tonne of foodgrains. The frequent incidence of potential calamities has resulted in economic and social losses, eroding the recent gains in macroeconomic performance. In this context, a consensus for integrated and pre-emptive disaster management strategies is approaching critical mass.

THE APPROACH TO THE TENTH FIVE YEAR PLAN

1.87 The approach to the Tenth Five Year Plan (2002-07) is being formulated against the background of a distinct step-up in the growth path during the preceding two Plan periods, and concerns arising of the recent deceleration and some evidence of erosion in the quality of growth. The Draft Approach Paper of the Planning Commission reflects the growing concern about the deterioration in the social conditions of development, despite the acceleration of GDP growth from 5.8 per cent in the 1980s to 6.4 per cent during 1992-93 to 1999-2000. It envisages an

indicative target of 8.0 per cent average real GDP growth for the plan period with a view to accelerating it further in the succeeding Plan period so that per capita income doubles over the decade. Recognising that the envisaged growth target would require a 6 percentage points increase in the investment rate and up to 5 percentage points increase in the domestic saving rate, given the incremental capital output ratio (ICOR) of 4.0, the Tenth Plan would seek to maximise efficiency gains through radical departure from existing practices and institutional arrangements

1.88 The strategy for the Tenth Plan would include redefining the role of Government, a State-wise breakdown of growth and social development targets, extending reforms into the agricultural sector, emphasis on employment-generating sectors and poverty alleviation. Simultaneously, the Tenth Plan would have a specific focus on key indicators of human development. Accordingly, the Draft Approach Paper seeks to establish, in addition to the target rate of real growth of 8 per cent, "specific and monitorable targets" measuring human well being, in terms of: (i) reduction of the poverty ratio to 20 per cent by 2007 and to 10 per cent by 2012; (ii) providing employment to the addition to the labour force over the period 2002-07; (iii) universal access to primary education by 2007; (iv) reduction in the decadal rate of population growth to 16.2 per cent between 2001 and 2011; (v) increase in literacy rate to 72 per cent by 2007 and to 80 per cent by 2012; (vi) reduction of infant mortality rate to 45 per 1000 live births by 2007 and to 28 by 2012; (vii) reduction of maternal mortality ratio to 20 per 1000 live births by 2007 and to 10 by 2012; (viii) increase in forest and tree cover to 25 per cent by 2007 and 33 per cent by 2012; (ix) provision of drinking water to all villages by 2012; and (x) cleaning of all major polluted rivers by 2007 and other notified stretches by 2012.

1.89 The approach to the Tenth Plan takes note of the growing importance of financial intermediation in the process of growth. In this regard, it underscores the need to expand the ambit of the financial sector reforms to encompass sectors such as agriculture, unorganised manufacturing and infrastructure which have been the focus of recent policy measures. It also emphasises the need to address the shortage of long-term risk capital. Widening and deepening of financial markets combined with adequate regulatory oversight would enable a judicious mix between interest income and capital gains. This, in turn, would create the conditions for sustained increases in gross domestic saving and investment rates.

THE REAL ECONOMY

2.1 India's real GDP growth is estimated at 5.2 per cent in 2000-01 as against 6.4 per cent in 1999-2000 and 6.6 per cent in 1998-99. Compared with other developing countries, excluding China, as well as industrial countries, India's growth performance, despite the deceleration, has been quite favourable. The gross domestic saving rate improved moderately to 22.3 per cent in 1999-2000 from 22.0 per cent in 1998-99. The gross domestic investment rate mirrored the improvement in the saving rate. The net inflow of resources from abroad was 1.0 per cent of GDP as in the preceding year. On the supply side, real GDP growth emanating from agriculture and allied activities recorded a deceleration to 0.2 per cent in 2000-01 from 0.7 per cent during the previous year. Agricultural production, in terms of the index of agricultural production, in fact, declined by 6.5 per cent in 2000-01. Real GDP growth originating from industry slowed down to 5.3 per cent from the preceding year's level of 6.1 per cent. Industrial production, measured in terms of the index of industrial production (IIP), also decelerated to 5.1 per cent during 2000-01 from 6.7 per cent in 1999-2000 on account of pronounced slowdown in manufacturing and electricity. Although GDP growth in the services sector slackened during the

year by almost 2 percentage points to 7.5 per cent, it remained close to the average of 8.5 per cent for the period 1994-2000.

2.2 The deceleration in real GDP growth during the past two years has engaged policy attention. Filtering the data on real GDP growth to eliminate irregular year-to-year fluctuations indicates the presence of a growth cycle in the Indian economy and a discernible downturn in the second half of the 1990s. Although the economy is currently poised above the long-term average growth rate of 4.4 per cent covering the full period of the growth cycle, there is clearly a need to arrest the downswing and revive the momentum of growth achieved in the high growth phase of 1994-97.

2.3 Quarterly real GDP growth moved up marginally to 6.1 per cent in the first quarter of 2000-01 from 6.0 per cent in the fourth quarter of 1999-2000. Although the second quarter GDP growth improved moderately to 6.2 per cent, this could not be sustained in the third and fourth quarters when the growth rate slowed to 5.0 per cent and 3.8 per cent, respectively. The behaviour of quarterly real GDP growth during 2000-01 mainly reflected the downward movement in the growth rate of the services sector from 8.6 per cent in the first quarter to 6.3 per cent in the fourth quarter. Real GDP growth from agriculture and allied activities at 0.6 per cent in the first quarter and at 0.5 per cent in the second quarter of 2000-01 reversed the absolute declines recorded in the second half of 1999-2000. The moderate acceleration to 1.0 per cent in the third quarter could not be maintained and the real GDP from this sector registered an absolute decline of 1.4 per cent in the fourth quarter of 2000-01. Real GDP growth in industry improved to 6.1 per cent in the third quarter, after dipping to 5.4 per cent in the second quarter from 6.6 per cent in the first quarter of 2000-01. In the fourth quarter, however, it decelerated to 3.2 per cent.

2.4 Agricultural production declined sharply during 2000-01. The index of agricultural production registered a steep fall of 6.5 per cent in 2000-01 on top of a decline of 0.7 per cent in the previous year. The fall in crop production in 2000-01 was the result of the sharp decline in foodgrains (6.3 per cent) as well as non-foodgrain crops - mainly oilseeds and cotton. The country received 92 per cent of the Long Period Average (LPA) rainfall during South-West monsoon 2000, with highly skewed spatio-temporal distribution of rainfall coupled with inadequate precipitation resulting in drought conditions in the States of Chattisgarh, Gujarat, Madhya Pradesh, Rajasthan and Western Orissa. The drought conditions also had an adverse impact on the production of non-foodgrains and *rabi* agricultural production - mainly wheat - as it resulted in shrinking of productive area and consequent production losses. Indian agri-culture continues to suffer from natural shocks, technology-gaps, low investment, and inadequate availability of quality inputs. During the second half of 1990s the volatility in the growth of agricultural production has increased. The combination of these factors has led to a deceleration in the average growth of all crop index to 2.3 per cent during the 1990s from 5.2 per cent during the 1980s.

2.5 The production of total foodgrains declined to 196.1 million tonnes in 2000-01 from the peak of 208.9 million tonnes attained in 1999-2000. The fall was on account of rice (3.2 million tonnes), wheat (7.1 million tonnes), coarse cereals (0.3 million tonnes) and pulses (2.3 million tonnes). Production of rice and wheat declined to 86.3 million tonnes and 68.5 million tonnes in 2000-01 from their respective peak levels of 89.5 million tonnes and 75.6 million tonnes achieved in the previous year. The decline in rice production was mainly due to a decline in the area coverage in West Bengal, which had experienced severe moisture stress at the time of

sowing. The decline in wheat output may be attributed to a reduction in area under the crop in Madhya Pradesh, Maharashtra and Rajasthan. Lower production of pulses was due to a decline in production in the major pulses producing States of Madhya Pradesh and Rajasthan. These States also reported substantial fall in their output of coarse cereals.

2.6 The index of non-foodgrains (base: triennium ending 1981-82=100) registered a fall of 6.6 per cent in 2000-01 as compared with a fall of 4.8 per cent in the previous year. The decline in non-foodgrains output was mainly due to fall in the production of oilseeds, cotton and jute and mesta. Oilseeds output declined in the past two years and the level of 18.2 million tonnes recorded in 2000-01 was the lowest in the past eleven years. The production of soyabean, rapeseed and mustard recorded substantial declines because of widespread drought in the oilseeds growing States of Chhattisgarh, Madhya Pradesh and Rajasthan. The production of groundnut at 6.4 million tonnes, however, recovered to some extent from the 14-year low of 5.3 million tonnes recorded in the previous year - despite the drought conditions experienced in Gujarat. Cotton registered a sharp decline over its output level in the previous year, while sugarcane, tea and coffee recorded increases in production. Sugarcane output, which has been increasing continuously since 1996-97, scaled yet another peak in 2000-01 at 300.3 million tonnes

2.7 Despite the lower output of rice and wheat during 2000-01, total procurement of foodgrains reached a new peak at 36.5 million tonnes, recording an increase of 16.0 per cent over that of 31.4 million tonnes in 1999-2000. On the other hand, the total off-take of rice and wheat during 2000-01 at 18.0 million tonnes was lower by 22.1 per cent than that of 23.1 million tonnes during the corresponding period of the previous year. This decline may be attributed to lower off-take under the Targeted Public Distribution System (TPDS) coupled with Open Market Sales Scheme (OMS), even as there was increased off-take under Other Welfare Schemes (OWS). The sharp decline in the total off-take during 2000-01 was largely reflected under the TPDS category. While the off-take under OWS picked up significantly by 3.55 million tonnes, the OMS during 2000-01 was very low at 1.25 million tonnes as compared with 4.55 million tonnes in 1999-2000. Hence, even a two-and-a-half times increase in the off-take under OWS to 5.0 million tonnes in 2000-01 could not off-set the decline in total off-take under the TPDS category. The sharp rise in procurement and lower off-take resulted in a growth of 55.6 per cent in the stocks of foodgrains to 45.0 million tonnes at end-March 2001 from 28.9 million tonnes at the end-March 2000. The addition of 16.1 million tonnes of foodgrains in 2000-01 has expanded the buffer stock to almost treble its normative level. However, the per capita net availability of foodgrains per day declined from a high of 505.5 grams in 1997 to 470.4 grams in 1999 and further to 458.6 grams in 2000. Concerted efforts are necessary to bring down the quantum of foodgrains through encouraging off-take from the PDS, promoting open market sales including exports and increasing distribution through other welfare schemes.

INDUSTRY

2.8 In terms of the index of industrial production (IIP), the growth of industrial output slowed down to 5.1 per cent during 2000-01 from 6.7 per cent during 1999-2000 reflecting, *inter alia*, low agricultural production, subdued performance of infra-structure (especially power), low investment activity and the presence of excess capacity in many industries. The slowdown in IIP growth was persistent throughout the year, with brief upturns in October and November 2000. The monthly profile of the IIP during 2000-01 and 2001-02 (up to June) exhibited the general

seasonal production behaviour. The sharp deceleration in production to 3.3 per cent during the last quarter of 2000-01 from 5.9 per cent during the third quarter, however, drove down the growth in IIP for the year as a whole. The sectoral profile showed a pronounced deceleration in manufacturing to 5.4 per cent during 2000-01 from 7.1 per cent during 1999-2000 as well as in electricity to 4.0 per cent from 7.3 per cent in the preceding year. The mining and quarrying sector, on the other hand, improved its growth to 3.7 per cent from 1.0 per cent during 1999-2000.

SERVICES

2.9 A notable feature in the structural transformation of the Indian economy has been the rapidly expanding role of services in the overall growth process. Besides emerging as a leading sector of the economy with both backward and forward linkages with the primary and secondary sectors, the rising contribution of services to GDP has imparted resilience to economic activity, particularly in the face of adverse agricultural shocks and industrial slowdown. The growth in the services sector has averaged 8.5 per cent during the period 1994-2000, reaching a peak of 10.0 per cent during 1995-96. Service sector growth decelerated to 7.5 per cent during 2000-01 mainly due to lowering of the growth rates witnessed in 'community, social and personal services' on account of some evening out of the effect of wage revisions of government employees as well as in 'construction' in the preceding year. The share of services in GDP moved up to 54.2 per cent in 2000-01 from 51.5 per cent in 1998-99 and its relative contribution to overall growth increased even more sharply to 76.8 per cent in 2000-01 from 61.8 per cent in 1998-99. The growth rate of services sector recorded a steady deceleration from 8.6 per cent in the first quarter to 6.3 per cent in the fourth quarter of 2000-01. The quarterly growth of services sector has remained fairly robust, averaging at 8.8 per cent in the past four years.

MONEY, CREDIT AND PRICES

3.1 Reserve money expansion during 2000-01 was broadly in alignment with that recorded in the preceding year. Broad money (M_3) growth, net of inflows under the India Millennium Deposits (IMDs), worked out to 14.4 per cent in 2000-01 as against 14.6 per cent in 1999-2000. The growth of aggregate deposits of scheduled commercial banks accelerated to 18.4 per cent (15.2 per cent excluding IMDs) in 2000-01 from 13.9 per cent in 1999-2000. The growth of non-food credit (adjusted for non-SLR investments) of scheduled commercial banks was significantly high at 20.9 per cent in the first three quarters of 2000-01 but decelerated towards the end of the year, reflecting the slowdown in overall economic activity. These movements were reflected in the behaviour of assets and liabilities of scheduled commercial banks. Inflation moderated to 4.9 per cent by the end of the year after the adjustments to upward revision in the administered prices of petroleum products were completed.

RESERVE MONEY

3.2 During 2000-01, reserve money grew by 8.1 per cent as compared with 8.2 per cent during 1999-2000. Primary liquidity flows during the past two years need to be viewed in the context of changes in reserve requirements. The approximate cumulative net first round release of resources on account of CRR changes, at Rs.7,500 crore, during the year was much lower than that of Rs.13,000 crore during 1999-2000. Adjusted for the impact of CRR changes, reserve

money growth worked out to about 11.0 per cent in 2000-01 as against about 13.0 per cent in 1999-2000.

3.3 The increase in reserve money during 2000-01 essentially emanated from an accretion to the Reserve Bank's foreign currency assets (Rs.27,463 crore, adjusted for revaluation, as against an increase of Rs.27,382 crore adjusted for revaluation during 1999-2000), which occurred mainly in the period November 2000-March 2001. The net domestic assets (NDA) of the Reserve Bank underwent a compensating decline of Rs.4,444 crore (adjusted for revaluation) in 2000-01 as compared with a decline of Rs.6,528 crore (adjusted for revaluation) in 1999-2000.

3.4 In recent years, reserve money has exhibited considerable oscillations from week to week, often of sizeable amplitudes, reflecting the growing market orientation of monetary policy and, in particular, the active man-agement of liquidity in the money, government securities and foreign exchange segments of the financial markets. Progressively market determined interest rates, financial innovations and the frequent adjustments of reserve require-ments as part of the flexible deployment of monetary policy in the context of market developments, have imparted volatility to the money multiplier. Accordingly, the conventional role of reserve money in the determination of money supply has become blurred under the impact of the Reserve Bank's liquidity operations. In the process, reserve money changes have emerged as the principal operating target of monetary policy, with liquidity adjustments setting up corridors for the money market rates, enabling a gradual softening of yields in the gilt markets and ensuring orderly conditions in the foreign exchange market.

3.5 In view of the growing market orientation of base money changes, an accurate assessment of market liquidity and shifts therein assumes critical importance. Financial sector reforms have brought about a freeing of interest rates from administrative setting. Accordingly, movements in key market interest rates have emerged as the principal gauge of liquidity conditions. Fundamental changes in the financial system have necessitated the monitoring of a panel of indicators in conjunction with interest rate movements to obtain a 'fix' on market liquidity

3.6 The conduct of monetary policy is being increasingly characterised by constrained discretion. Typically monetary authorities operating in the short run are faced with the dilemma of the growth-inflation trade-off despite a conviction in the neutrality of money in the long run. Accordingly, they are confronted with the need to take a position on the growth-inflation curve which maximises welfare, thereby setting the overarching objectives of dis-cretionary monetary policy in terms of the appropriate combination of growth and inflation. Within this assignment, central banks react to immediate concerns arising out of their responsibility for financial stability by modulating liquidity in tune with or counter to financial market developments.

MONETARY SURVEY

3.7 Broad money (M_3) increased by 16.7 per cent during 2000-01 as compared with an expansion of 14.6 per cent during the previous year. The M_3 growth rate, net of India Millennium Deposits (IMDs), at 14.4 per cent, however, remained broadly within the 15.0 per cent projection announced in the April 2000 monetary and credit policy statement. On a monthly average basis, the M_3 growth rate (net of RIBs/IMDs) decelerated to 15.0 per cent during 2000-01 from 16.7 per cent during 1999-2000 and 18.2 per cent during 1998-99.

3.8 Aggregate deposits of scheduled commercial banks accelerated to 18.4 per cent in 2000-01 from 13.9 per cent in 1999-2000. The total deposit mobilisation during 2000-01, at Rs.1,49,273 crore, stood much higher than the projected increase of Rs.1,25,000 crore, mainly on account of IMDs (Rs.25,662 crore). The monthly growth profile of commercial bank deposits, excluding the amounts raised through Resurgent India Bonds (RIBs) for 1999-2000 and IMDs for 2000-01, was, however, stable at around 15.5 per cent.

Credit Aggregates

3.9 Domestic credit (adjusted for scheduled commercial banks' investments in non-SLR securities) decelerated to 15.8 per cent during 2000-01 from 17.0 per cent during 1999-2000. The share of the Government in adjusted domestic credit declined to 40.6 per cent at end-March 2001 but continues to remain substantial. As at end-March 2001, commercial banks held SLR securities amounting to 35.1 per cent of their net demand and time liabilities as compared with the statutory SLR requirement of 25.0 per cent. Banks' holding of SLR paper, amounting to about Rs.1,06,000 crore over and above the SLR requirement, was substantially higher than the net annual borrowings of the Central Government. The ratio of incremental non-food credit (adjusted) in incremental domestic credit (adjusted), at 43.8 per cent during 2000-01, was comparable with 45.0 per cent during 1999-2000.

3.10 Commercial bank credit decelerated to 17.3 per cent during 2000-01 from 18.2 per cent recorded during 1999-2000. The food credit extended by scheduled commercial banks showed a substantial increase of Rs.14,300 crore (55.7 per cent) during 2000-01 as compared with a rise of Rs.8,875 crore (52.8 per cent) during 1999-2000, reflecting a peaking of food procurement and a decrease in food off-take during 2000-01.

3.11 Non-food credit decelerated to 14.9 per cent during 2000-01 from 16.5 per cent registered during 1999-2000. However, the monthly dynamics of non-food credit showed that the above-average growth rates were sustained for around three quarters of 2000-01 in a *contra*-seasonal pattern. The *contra*-seasonal pick-up was, *inter alia*, on account of accumulation of stocks of fertilisers, sugar, petroleum and automobiles. The deceleration, thereafter, seemed to reflect an unwinding of oil credit off-take, repayment of working capital and subdued industrial activity.

Aggregate Resource Flow to Commercial Sector

3.12 The resource flow from bank and non-bank sources, inclusive of capital issues, GDRs/ADRs/FCCBs, CPs subscribed by non-banks and borrowings as well as bills rediscounted with FIs, to the commercial sector increased by Rs.1,65,056 crore during 2000-01 as compared with Rs.1,60,381 crore during the preceding year. The share of the banking system in resource flows to the commercial sector, at 53.5 per cent during 2000-01, was comparable to the average during the previous three years. The resource flow to the commercial sector, at Rs.16,263 crore during the first quarter of 2001-02, was much lower than that of Rs. 38,031 crore in the corresponding period of 2000-01, mainly on account of the decline in non-food credit off-take.

3.13 Banks continue to remain 'special' in the financial system as the primary financial intermediary, especially in view of the wide branch network. Bank finance continues to account for more than half the resources raised by the commercial sector. Small-scale industries accounted for as much as 40.0 per cent of industrial output and around 14.1 per cent of non-food gross bank credit as at end-March 2000. The correlation between the deviation from trend in

respect of aggregate non-food credit and credit to small-scale industries was higher than that for large-scale industries over the period 1990-2000. This is borne out by data in respect of public limited companies for 1997-98 through 1999-2000 in which there is no systematic relationship between the size of the paid-up capital and the ratio of short-term bank borrowing to inventories. Thirdly, the velocity of credit in the Indian economy has remained reasonably stable, implying a close link between domestic (and commercial) credit and output.

PRICE SITUATION

3.14 The annual rate of inflation, measured by the year-on-year variations in the wholesale price index (WPI), was predominantly influenced by revisions of administered fuel prices in February, March and September 2000. The year began with an inflation at 6.8 per cent. The impact of the February and March 2000 adjustments in administered prices persisted over the first half of the year, with inflation easing below 6.0 per cent only in the third week of August 2000. As a result of continuous hardening of international crude oil prices, the administered prices of petroleum products were revised upward again in September 2000. The consequent upward drift imparted to inflation took it to a peak of 8.8 per cent by January 13, 2001 (the highest in 2000-01). The pressures from administered price changes ebbed in March 2001 resulting in a significant drop in the inflation rate to 4.9 per cent at the end of the year (the lowest level in 2000-01). This sudden fall in inflation in the last week of March 2001 was mainly on account of the base effect correction. The inflation outcome was characterised by an absence of demand induced pressures. Excluding the price increases of the administered items, the inflation rate worked out to 2.6 per cent during 2000-01.

GOVERNMENT FINANCES

4.1 As per revised estimates for 2000-01, the Central Government's gross fiscal deficit (GFD) is placed at 5.1 per cent of the GDP at current market prices and the revenue deficit at 3.5 per cent. The information available in respect of State finances indicates that the consolidated gross fiscal deficit of States in 2000-01 narrowed to 4.3 per cent of GDP in the revised estimates from 4.6 per cent in 1999-2000, due to relatively high growth in receipts than in expenditure. Accordingly, as per the revised estimates, the combined revenue and fiscal deficits of the Centre and States taken together narrowed to 5.9 per cent and 9.1 per cent, respectively, from 6.2 per cent and 9.4 per cent, respectively in 1999-2000. Market borrowings continued to be the most important source of financing for the Centre, accounting for 69.6 per cent of the gross fiscal deficit. For the States, market borrowings financed 13.3 per cent of the gross fiscal deficit. Although the recourse of States to Ways and Means Advances (WMA) from the Reserve Bank was generally higher in 2000-01 than in the preceding year, the outstanding WMA and overdrafts declined to Rs.6,811 crore at end-March 2001 from Rs.7,519 crore at end-March 2000. The combined debt of the Centre and States rose to 63.7 per cent of GDP at the end of March 2001 as against 61.5 per cent at the end of March 2000. Contingent liabilities of the Centre and States rose to 10.7 per cent of GDP at end-March 2000 from 9.8 per cent at end-March 1999.

4.2 For 2001-02, the gross fiscal deficit and the revenue deficit of the Centre are placed at 4.7 per cent and 3.2 per cent of GDP lower than 5.1 per cent and 3.5 per cent, respectively, in the revised estimates for 2000-01. The improvement in the fiscal outcome would be based on maintaining higher growth in revenue and continued focus on expenditure management. The

finances of States are also expected to improve during 2001-02. The combined gross fiscal deficit of States is expected to decline to 3.8 per cent of GDP from 4.3 per cent in the revised estimates for 2000-01.

FINANCIAL MARKETS

5.1 During 2000-01, financial markets in India were characterised by orderly and liquid conditions except for a brief period of uncertainty from mid-May to August 2000. A growing integration between money, gilt and foreign exchange market segments was visible in the convergence of financial prices, within and among various segments, and co-movement in turnovers. The call money market was broadly stable except for some pressures in June and August 2000 emanating from the foreign exchange market on account of unfavourable international developments. Apart from this brief period, the foreign exchange market experienced generally comfortable supply conditions. The Government securities market experienced a perceptible downward shift in yields in the primary as well as secondary segments during the second half of the year. The credit market tracked the movements in the other segments with a lag. The capital market exhibited isolated behaviour from the other segments of domestic financial markets with a clear indication of cross-border integration, particularly reflecting the large decline in international technology stock driven exchanges. Liquidity operations of the Reserve Bank were conducted keeping in view the market conditions.

5.2 In view ofthe easy liquidity conditions at the beginning of 2000-01, the financial markets witnessed a softening of interest rates across segments up to mid-May 2000.

5.3 Excess demand conditions surfaced sporadically in the foreign exchange market during May-August, 2000. Monetary, regulatory and other measures were combined with repo auctions to break circuits of arbitrage running from money to foreign exchange segments. The tightening of market was reflected in the hardening of the PLRs of the PSBs, particularly in August 2000. The stock prices also went down in August 2000 with the BSE Sensex declining by 3.87 per cent as compared with April 2000.

5.4 As the foreign exchange market stabilised from November 2000 onwards, monetary measures were phased out during the last quarter of 2000-01 to return to the April 2000 position. Comfortable liquidity fuelled price rallies in the secondary market for Government paper and the PSBs also reduced PLRs during this period. The BSE Sensex also gained by 7.73 per cent in November 2000 as compared with the previous month.

5.5 Liquidity conditions eased in April-July 2001 in line with seasonal trends coupled with slackening in credit demand. As the ways and means advances of the Central Government crossed the limit of Rs.10,000 crore for the first half of the fiscal year, it privately placed three securities of Rs.4,000 crore each with the Reserve Bank on April 20, 2001. In the secondary gilt segment, the yields came down more prominently at the extreme ends of the maturity spectrum with the yields for the 10-year maturity paper not witnessing any significant change. The foreign exchange market was broadly stable during April 2001 with the increased supply of foreign exchange on account of foreign institutional investment inflows.

5.6 During May 2001, the call money rates moved above the repo-reverse repo corridor reflecting rationalisation of standing facilities available to the commercial banks and primary dealers at the Bank Rate, and call money lendings by non-bank financial institutions. The Reserve Bank injected liquidity through the reverse repos which nudged the call money rates

back to the corridor. The yields of Treasury Bills and Government securities came down. The foreign exchange market was generally stable with orderly movements in the exchange rate. The PLR of PSBs declined.

5.7 The stock prices tended to move generally downward between April-July 2001. The Sensex declined by 5.40 per cent between April 2001 and July 2001. The slowdown in the industrial sector and profit warnings issued by various software companies for the coming quarters had a negative impact on the market sentiment. In May 2001, the SEBI announced significant changes in the capital market in keeping with the international practices. The ban on deferral products in the cash segment by SEBI and the ban by UTI on sales and repurchases of US-64 units affected the market sentiment adversely in July 2001. The subdued market sentiment continued in August 2001. The Sensex declined by 6.6 per cent between April 21 and August 14, 2001 in sharp contrast to gains of 10.2 per cent by the Nasdaq and 6.5 per cent by the Dow Jones.

5.8 Recent empirical analyses of financial market behaviour in India have yielded evidence of growing integration between money, debt and foreign exchange markets with relatively weak convergence of capital markets. The experience of 2000-01 suggests that market integration has tended to strengthen during episodes of volatility, pointing to a swifter transmission of market pressures from one segment to another than in earlier years. An indication of this integration during periods of market pressures is the existence of excess returns contemporaneously in various segments. This imposes additional constraints on the management of market conditions requiring simultaneous action across the spectrum.

EXTERNAL SECTOR

6.1 The external sector recorded a distinct improvement in 2000-01. There was an accretion to the foreign exchange reserves of the order of US $ 4.2 billion with the level of the reserves crossing US $ 42 billion by end-March 2001, equivalent of around 9 months of imports. The current account deficit (CAD) narrowed over the year, reflecting robust merchandise export performance and subdued import demand. Another noteworthy aspect was the decline in the external debt in terms of its ratio to GDP and also in terms of the ratio of short-term debt to the level of foreign exchange reserves. The pressures on the balance of payments (BoP) in the first half of 2000-01 on account of the hardening of international oil prices, the massive downturn in inter-national equity prices and successive increases in interest rates in the US economy and Europe eased with the mobilisation of funds under the India Millennium Deposits (IMDs) which brought about a turnaround in the BoP in the second half of the year. The exchange rate of the rupee remained broadly stable, except for a brief period during May-August 2000. During 2000-01, it depreciated by about 5.1 per cent against the US dollar but strengthened against other major currencies.

BALANCE OF PAYMENTS

6.2 The overall balance recorded a surplus for the fifth year in succession taking the level of foreign exchange reserves to US $ 42.3 billion by end-March 2001. The merchandise trade deficit, on BoP basis, declined to US $ 14.4 billion during 2000-01 from US $ 17.8 billion in the previous year. Export growth was higher at 19.6 per cent as against 9.5 per cent in 1999-2000 with buoyancy in all major categories of exports. Import growth, however, decelerated to 7.0 per cent from 16.5 per cent in 1999-2000, despite the increase in imports of petroleum, oil and

lubricants (POL) by 24.1 per cent. The invisible account continued to provide support to the balance of payments with a net surplus of US $ 11.8 billion in 2000-01. Reflecting the improvement in the performance of exports, the CAD declined to 0.5 per cent of GDP in 2000-01 from 1.0 per cent in 1999-2000. Net capital flows were lower at US $ 9.0 billion as against US $ 10.4 billion recorded in 1999-2000.

6.3 Key monitoring indicators of the BoP point to a combination of improvement in fundamentals and the impact of cyclical factors. Notwithstanding a difficult international environment characterised by a sharp slowdown of the US economy, the growth in current receipts was robust, spread across both merchandise and invisibles. This was reflected in upward movements in the export/GDP ratio, the invisible receipts/GDP ratio and the current receipts/GDP ratio. The ratio of invisible payments to GDP increased moderately while that of imports to GDP remained almost unchanged. As a result, current receipts financed around 96 per cent of current payments in 2000-01, recording an improvement over the previous year. The decline in the CAD/GDP ratio was thus primarily achieved on the strength of current receipts which grew by 17.1 per cent during 2000-01. Information on exports in terms of physical performance is not yet available; however, the decline in international prices of commodities and manufactures, excluding POL, as well as erosion in the terms of trade (ToT) facing developing countries in Asia reported in the World Economic Outlook (May 2001) of the International Monetary Fund (IMF) imply that the merchandise export growth recorded during 2000-01 might have been mainly driven by higher volume.

6.4 Net capital flows were lower with inflows under IMDs making up for the decline in external assistance and normal external commercial borrowings. The share of equity flows in net capital flows increased to 56.6 per cent in 2000-01 as compared with 49.7 in 1999-2000. The debt/GDP ratio declined to 21.4 per cent which is well below the conventional threshold of moderate indebtedness. The adequacy of reserves in terms of current and contractual obligations improved to around 9 months of imports/38 months of debt service payments/12 times the level of short-term debt.

FOREIGN EXCHANGE RESERVES

6.5 India's foreign exchange reserves comprising foreign currency assets, gold held by the Reserve Bank and Special Drawing Rights (SDRs) held by the Government increased by US $ 4,245 million (including valuation changes) during 2000-01 to US $ 42,281 million by end-March 2001 as against an increase of US $ 5,546 million during 1999-2000. The Reserve Bank's forward liabilities remained low, declining from US $ 2,225 million in August 2000 to US $ 1,259 million at end-March 2001. Net of outstanding forward liabilities and use of IMF credit, foreign exchange reserves increased by US $ 3,687 million to US $ 41,022 million as at end-March 2001.

EXTERNAL DEBT

6.6 During the 1990s, there has been a consolidation of external debt. The sustainability of external debt improved with robust growth in current receipts, containment of the CAD, capping of short-term debt flows and predominance of equity flows in the capital account. Moreover, capital flows were used to build up the foreign exchange reserves instead of financing current import requirements.

6.7 India's external debt increased by 2.1 per cent from US $ 98,158 million as at end-March 2000 to US $ 100,255 million as at end-March 2001. The increase in external debt during the

year was mainly on account of the accretion of US $ 5.5 billion under IMDs. However, the overall increase in external debt during the year could be contained at US $ 2.1 billion in view of sluggishness in normal commercial borrowings and valuation factors. While the proportion of multilateral (excepting IMF) and bilateral debt in the total debt declined to 47.6 per cent as at end-March 2001 from 50.5 per cent as at end-March 2000, that of rupee debt fell to 3.7 per cent from 4.5 per cent over the same period. The share of commercial borrowings (including long-term trade credits) in total external debt at 29.9 per cent as at end-March 2001 was higher than that of 27.1 per cent at end-March 2000 reflecting accretions on account of IMDs. The proportion of long-term non-resident deposits also increased to 15.4 per cent from 13.8 per cent over the same period.

6.8 The key indicators of external debt sustainability point towards further consolidation. Notwithstanding the increase in the absolute level of external debt, the external debt-GDP ratio declined from 21.9 per cent as at end-March 2000 to 21.4 per cent as at end-March 2001. The ratio of debt to current receipts fell from 145.5 per cent at end-March 2000 to 126.9 per cent at end-March 2001. The proportion of short-term debt to total external debt declined from 4.0 per cent at end-March 2000 to 3.5 per cent at end-March 2001. As a result, the ratio of short-term debt to foreign exchange reserves declined from 10.3 per cent as at end-March 2000 to 8.2 per cent at end-March 2001. The interest service ratio continued its downward trajectory, declining from 7.3 per cent during 1999-2000 to 6.4 per cent during 2000-01. The debt service and liability service ratios at 17.1 per cent and 18.3 per cent, respectively, during 2000-01 were marginally higher than that of 16.2 per cent and 17.0 per cent during 1999-2000. The increase in the debt service and liability service ratios during the year was essentially on account of prepayments of external assistance and refinancing of commercial debt.

6.9 The orderly conditions witnessed in the foreign exchange market since November 2000 have continued in 2001-02 so far. The spot exchange rate of the rupee *visa-vis* the US dollar moved in a range of Rs. 46.56-47.18 per US dollar during the period April 2001 to August 10, 2001. The exchange rate was Rs. 47.12 per US dollar as on August 10, 2001. Excess supply conditions resulted in net purchases from the market amounting to US $ 487 million during April-June 2001. The 6-month forward premia were broadly stable during the period and averaged 4.7 per cent during July 2001 as against 4.6 per cent during March 2001. The 6-month forward premia was 4.8 per cent as on August 10, 2001.

ASSESSMENT AND PROSPECTS

7.1 During the year 2000-01, the GDP growth at 5.2 per cent reflected the impact of two consecutive years of below-average monsoons, a downturn in industrial growth after promising signs of revival in 1999-2000, the strains imposed by droughts and floods in various parts of the country and the unprecedented severity of the Gujarat earthquake. Despite the fall in foodgrains production, foodstocks reached an all-time high, improving food security and insulating the economy from transient agricultural shocks. The lower growth performance of 2000-01 was associated with signs of stability as inflation turned relatively benign towards the close of the year, the combined fiscal deficit of the Centre and States was manageable, the external current account deficit moved to near-balance, the external debt/GDP ratio declined and the foreign exchange reserves touched a level equivalent to around nine months of imports.

7.2 Apart from a brief period of volatility during the year, financial market segments generally remained stable and liquid. Reforms in the broad areas of money and finance were carried forward as originally contemplated. There was, however, substantial turbulence in equity markets in March 2001. This was followed by considerable stress in certain segments of the financial markets affecting a few banks, some co-operative institutions and the largest mutual fund. This has posed some challenges for the management and development of financial markets as a whole.

7.3 The outlook for the global economy suffered a downturn with the release of first quarter growth figures for 2001 for most of the developed countries. In the second quarter, the growth of the US economy slowed down to 0.7 per cent from 1.2 per cent in the first quarter. In the domestic economy, the onset of the monsoon has been, on the whole, fairly satisfactory in spite of initial spatial aberrations reflected in drought conditions in the southern States and Maharashtra and floods in Orissa, Bihar and Kerala. Although full information on agricultural production is not yet available, procurement of foodgrains at 23.2 million tonnes up to June 2001 was higher by 28.2 per cent over April-June. As a result, despite some increase in off-take, stocks of foodgrains soared to 62.0 million tonnes at the end-June 2001. The growth of industrial production fell sharply to 2.1 per cent in the first three months of 2001-02 from 6.1 per cent in April-June, 2001. This mirrored the slowdown in manufacturing and electricity generation. Capital goods production index recorded an absolute decline while basic and intermediate goods production indices decelerated. The slowdown spread to the consumer goods segment in which the growth rate of 4.3 per cent almost halved from that of 8.6 per cent in April-June, 2000.

7.4 Reserve money increased by 0.1 per cent during the current financial year up to August 10 as against a decline of 1.2 per cent during the corresponding period of the previous year. Net Reserve Bank credit to the Centre decelerated to 9.9 per cent (Rs.14,497 crore) from 15.7 per cent (Rs.21,934 crore) during the corresponding period of 2000-01. Private placements/devolvements in Government securities of Rs.21,679 crore were partly offset by open market operations of Rs.16,050 crore. The Reserve Bank's net foreign currency assets (adjusted for revaluation) recorded an increase of Rs.7,544 crore in contrast to a decline of Rs.7,047 crore in the corresponding period of the previous year. The year-on-year M_3 expansion at 15.4 per cent (net of IMDs) as on July 27, 2001 was a little above the indicative target of about 14.5 per cent set for the year as a whole. Aggregate deposit growth of 16.2 per cent (net of IMDs) was buoyant in relation to the growth of 15.6 per cent recorded a year ago. Growth in currency with the public at 12.0 per cent remained strong as compared with 10.3 per cent in the previous year. Net bank credit to the Government accelerated to 8.9 per cent during 2001-02 (up to July 27) from 8.6 per cent in the comparable period of the previous year, reflecting the absorption of the market borrowing programme of the Centre. Bank credit to the commercial sector decelerated to 1.9 per cent from 2.6 per cent during the same period on account of significantly lower off-take of non-food credit of scheduled commercial banks at Rs.1,714 crore from Rs.14,482 crore during April-July, 2000. Scheduled commercial banks' investments in non-SLR securities increased by only Rs.495 crore during April to mid-July, 2001 as against an increase of Rs.4,307 crore in the corresponding period of the preceding year. Accordingly, scheduled commercial banks' non-food credit adjusted for their non-SLR investments increased by Rs.2,209 crore up to end-July, 2001; in April-July of the preceding year, the increase in the adjusted non-food credit extended by scheduled commercial banks had been of the order of

Rs.18,967 crore. Food credit extended by scheduled commercial banks for procurement operations rose to Rs.11,036 crore from Rs.7,117 crore in April-July, 2000. Inflation, measured by the year-on-year change in wholesale prices, declined to 5.2 per cent by August 4, 2001 from 6.3 per cent a year ago. The easing of inflationary pressures was also reflected in the movement of the average wholesale prices as well as consumer prices during the current financial year.

7.5 The Centre's gross fiscal deficit at Rs.42,198 crore during April-June, 2001 was higher by 68.3 per cent over the level in April-June, 2000. The revenue deficit was almost double the level in the first quarter of 2000-01, reflecting the continuing slowdown in revenue collections, both tax and non-tax. On the other hand, growth in expenditure was higher in the revenue account as well as in the capital account during April-June 2001 over the level in April-June 2000.

7.6 Stock prices tended to decline from April to mid-August, 2001. The Sensex which stood at 3566.26 on April 2, 2001, declined by 234.37 points or 6.6 per cent to close at 3331.89 on August 14, 2001. The decline was in contrast to the trends in the international capital markets with the Nasdaq gaining by 10.2 per cent and the Dow Jones by 6.5 per cent in the same period. Domestic factors such as the general sluggishness in industrial activity, profit warnings issued by various software companies for the coming quarters and the uncertainty characterising stock markets had a bearing on the market behaviour. Mutual funds remained net sellers in equities during this period. The decision by the Unit Trust of India (UTI) to suspend temporarily sales and repurchases of US-64 units also dampened the market sentiment.

7.7 Financial markets were otherwise generally characterised by conditions of stability and ample liquidity, supported by the relatively higher deposit mobilisation, lower non-food credit demand and releases of resources through CRR cuts. The call money rates remained broadly within the corridors set by the repo and reverse repo rates except in mid-May, 2001 reflecting adjustment of the market with revised guidelines under the second stage of LAF. The Government securities market was driven by strong rallies in the secondary market. The yield curve shifted downwards with yields on 10-year paper reaching 9.3 per cent, the lowest in the recent past. Prime lending rates of the public sector banks declined by 25 basis points each at the higher end of the range in May and July, 2001 and remained stable in the first part of August, 2001. The foreign exchange market was active, with occasional bunching of demand setting off movements in the spot exchange rate. Forward premia eased across all maturities in June, 2001 after a temporary hardening in May, 2001 tracking the rise in the call rates.

7.8 Export growth decelerated sharply to 1.7 per cent in April-June, 2001 from 26.6 per cent in the first three months of 2000-01 reflecting the slowdown in global economic activity. Imports declined as the sluggishness in the domestic economy held down import demand and the sharp rise in PoL imports witnessed during the preceding year lost momentum. Capital flows remained stable. Foreign direct investment inflows at US $ 608 million in April-June, 2001 were marginally lower than those in the corresponding period of the preceding year. On the other hand, net inflows on account of FIIs at US $ 632 million in the first three months of 2001-02 were higher than in the corresponding period of 2000-01. The level of the foreign exchange reserves increased by US $ 1,854 million to US $ 44,135 million as on August 10, 2001 reflecting the improvement in the merchandise trade account and the stability in net capital flows.

Prospects for Growth

7.9 The deceleration of economic activity for the second year in succession has raised some concerns about the feasibility of rapidly moving the economy to a higher growth path in the medium term. The recent growth experience has undoubtedly revealed some areas of concern which could impede the path to sustained high growth. The rate of capital formation has been declining over the second half of the 1990s, mainly reflecting the inadequate response of private investment to the current state of structural reforms and deceleration in public investment. Given the unsatisfactory capital accumulation, infrastructural requirements are emerging as binding constraints on growth. The size and quality of fiscal adjustment have also remained insufficient, resulting not only in shifts in the pattern of aggregate demand from investment to consumption in the Government sector but also undermining the output and the quality of delivery of public services. The large and growing financing requirements of the Centre and the States have occasionally strained the financial markets, rendering the conduct of both monetary policy and debt management more complex.

7.10 Over the period of planned development, the Indian economy has undergone contrasting phases in the pace and variability of the growth process. Up to the 1970s, low rates of real growth were associated with considerable fluctuations, mainly emanating from the behaviour of the monsoon. Since the late 1980s and particularly in the 1990s, the reform process has increased the susceptibility of the economy to the reality of the cycle in economic activity and the swings of alternating phases of the cycle. The experience of the late 1990s suggests that India is not immune to the slowdown phase of the global business cycle. Cyclical turns of economic activity have imposed some constraints on the operation of macroeconomic policies for achieving developmental goals. Against this background, the conduct of monetary policy, in particular, has been complicated by the uncertainties characterising an environment of slowing output and low inflation.

7.11 The recent slowdown in economic activity seems to reflect a combination of cyclical and structural factors with different weights assignable to either, depending on the changing conditions in the growth process. The general deficiency in aggregate demand, and in particular, the faltering pace of investment demand, relatively low requirements of bank credit, the slowdown in currency expansion, decline in import demand and some evidence of high carrying costs of inventories being incurred by some industries are indicators of cyclical influences on the growth process. On the other hand, growing evidence on the gaps in agricultural development and the absolute deficiencies in physical and social infrastructure, which are already operating as a drag on the speed and quality of growth, are being identified as structural impediments. In the recent period, the structural constraints have necessitated a revision in the assessment of the potential output growth path of the economy generated from the robust optimism in the wake of the high growth phase in the mid-1990s. In respect of agriculture, the increase in the variability of production, falling capital formation and the loss of pace in technological upgradation seem to be indicative of long-term deceleration in agricultural development. As regards infrastructure, the demand for infrastructure services continues to outpace supply, warranting urgent new capacities in power, tele-communications, transport and the social infrastructure. Apart from expansion in supply, upgradation of quality is also crucial.

7.12 A major concern arising out of the performance of the economy during 2000-01 is the relative role of global and domestic factors in determining the duration of the current phase of activity. Given the relatively low degree of openness of the economy, the recent slowdown is predominantly ascribed to domestic conditions – demand slowdown, sluggishness in supply

responses and supply side constraints. There is also the view that the economy is part of the global developments and irrespective of the degree of openness, India cannot be immune to the global economy. While there is still considerable uncertainty, it is widely expected that the world GDP growth would be substantially lower in 2001 as compared with a high growth of 4.8 per cent in the previous year, due to the slowdown of the US economy. A favourable factor this year is that the international inflationary environment is reasonably benign. Low inflationary expectations have facilitated substantial reduction in international interest rates in order to revive economic activity in major industrial countries. India cannot but reckon the impact of these global developments though for several reasons, including its relatively small share of trade, GDP growth in India is unlikely to be as seriously affected by these developments, as in many other countries. While merchandise exports growth may moderate, software exports with more diversified destinations and private remittances may still be maintained.

7.13 It is also necessary to recognise the limits up to which strategic combinations of policies can overcome the operation of the institutional constraints on growth. So far, a degree of deftness in the design of macroeconomic policy framework has been successful in stemming contagion from global financial crises, the impact of the global slowdown as well as temporary influences that have tended to slow down domestic activity. These interventions in terms of policy mixes are getting increasingly circumscribed by the inadequate legal and institutional structure which, in several ways, is inhibiting the response of policies to rapidly changing circumstances in a transitional phase. In the development and regulation of the financial markets and in improving the financial soundness of financial institutions, the legal and institutional constraints are being acutely felt. The current monetary policy has signalled important reforms which require changes in existing legislation or introduction of new laws to provide, *inter alia,* flexibility to undertake transactions in Government securities and facilitate retailing, to bring about greater flexibility in monetary policy operations, to enable separation of debt management functions, to bring reasonable control over fiscal management, to redesign the ownership function of the Reserve Bank, to restructure deposit insurance consistent with financial sector liberalisation, to provide enhanced protection to depositors of NBFCs, to encompass areas of security laws within the regulatory framework of banking and to create an enabling environment for markets for asset securitisation.

7.14 In the present stage of the development process, policy formulation is also faced with the dilemma posed by the need to address simultaneously the macroeconomic concerns (the slowdown of growth and capital formation, the stagnation in saving, the vitiation of the macro-balances, distributional issues, the consolidation of the fiscal accounts, the viability of the BoP and the reining in of inflationary pressures) and the microeconomic considerations (regulation of financial markets, soundness of financial institutions, extending reforms into particular sectors and availability of bank credit). In certain periods and the exigencies attached to micro-developments have required a temporary abandonment of the macro stance or even a temporary sacrifice of macro objectives. The functions of financial supervision and the conduct of monetary policy, for instance, involve significant trade-offs. Rapid movement toward strong supervision could lead inadvertently to a dampening in economic activity. Excessive monetary easing to relieve financial stress could, on the other hand, lead to higher inflationary expectations, exchange rate volatility and asset bubbles.

7.15 The balancing of the relative emphasis on financial versus non-financial sectors in the process of reform is also engaging policy attention in the context of the medium term. For

example, considerable anxiety is being expressed that the poor performance of agriculture indicates that the process of reforms has by-passed the agricultural sector while there has been considerable progress in the financial sector. It is argued that in countries where agricultural reforms were started in the early stage of the overall reform process, the potential output of the economy as a whole has moved upwards. Thus, there is a need to clearly spell out the reform objectives and destinations while carefully accelerating the pace of reforms in several of the non-financial sectors. The legal and institutional changes to enable policy reform would no doubt command attention.

7.16 Growth prospects for 2001-02 are associated with some favourable objective conditions. The Meteoro-logical Department has forecast a normal South-West monsoon during 2001. The target fixed for foodgrains production in 2001-02 is 212 million tonnes, an increase of 8.1 per cent over the preceding year. More recent estimates of the performance of the monsoon and the area coverage under major crops indicate that foodgrains output could be around 209 million tonnes in 2001-02. Leading indicators of industrial activity and business confidence suggest the prospects of a modest revival of the industrial sector only in the second half of the year, in alignment with the usual seasonal upturn in industrial activity. A critical consideration would be the performance of the services sector and a return to the average growth rate of 8.4 per cent achieved in the 1990s. As regards the likely growth rate of real GDP, in April 2001, the Statement on Monetary and Credit Policy had projected a growth rate of 6.0 to 6.5 per cent for 2001-02 on certain favourable assumptions regarding the state of the monsoon and possibility of industrial recovery in the second half of the year. On the whole, the monsoon conditions so far have turned out to be not unfavourable. However, the industrial outlook continues to be uncertain and a cause for considerable concern. The realisation of the growth rate projected in April 2001 is dependent on a sharp reversal in current industrial trends during the post-monsoon period. Inflationary conditions are expected to remain supportive with headline inflation around 5 per cent. Money supply expansion is expected to be about 14.5 per cent, amply supporting an expansion of non-food credit of the order of 16-17 per cent, assuming that there would be a pick-up in industrial activity. A major objective guiding the conduct of monetary policy is the close monitoring of financial market conditions with a view to flexibly shifting policy operations towards managing excess liquidity, should circumstances warrant. The current account deficit is expected to be well below 2 per cent of GDP even if non-oil imports show considerable increase in the event of a pick-up in economic activity. The fiscal deficit of the Centre is budgeted at 4.7 per cent of GDP and over three-fourth of the Centre's net borrowing requirement has already been completed. The Centre is also closely monitoring the fiscal developments in various States. The growth prospects for 2001-02 will also depend to a certain extent on the global developments and the bottoming out of the current slowdown in world output, trade and international capital flows. The availability of more recent information on the performance of the real economy will no doubt entail a conditional adjustment to these initial expectations.

Issues in Agriculture

7.17 In the second half of the 1990s, real GDP growth originating in agriculture and allied activities slowed down significantly to 3.2 per cent from 4.5 per cent in the 1980s, exhibiting considerable variability and recording absolute declines in the third and fourth quarters of 1999-2000 and again in the last quarter of 2000-01. The annual trend growth rate of agricultural production decelerated to 2.2 per cent in the 1990s from 3.1 per cent in the 1980s. The share of capital formation in agriculture as a proportion to gross capital formation has declined from 9.9

per cent in 1990-91 to 8.0 per cent in 1999-2000. The decline in capital formation has been more pronounced in the public sector, reflecting the persistent and large revenue deficits. The share of agriculture and allied activities in total Plan outlay declined from 6.1 per cent in the Sixth Plan Period to an estimated 4.9 per cent in the Ninth Plan Period. The share of irrigation and flood control in total outlay also shrunk from 10.0 per cent to an estimated 6.5 per cent over the Plan periods.

7.18 Agricultural development represents the convergence of the main objectives of economic policy in India: growth, stability and poverty alleviation. Agriculture continues to provide productive employment opportunities for over two-thirds of the population. The agricultural sector also makes a significant contribution to India's exports, accounting for a little less than a fifth of total merchandise exports. Despite some degree of resilience acquired by the economy in recent years, agriculture continues to play a critical role in determining the macroeconomic balances, especially in generating private consumption demand.

7.19 While public investment in agriculture is declining, subsidies for agriculture are increasing. The increase is concentrated on input subsidies, though food subsidies are also being incurred to maintain high levels of food stocks. In this context, a conscious choice needs to be made, given the overall resource constraint, between subsidies and investment. The question that has to be raised in the context of the overall balance is whether it would be worthwhile shifting spending on subsidies to investment, especially in terms of contribution to agricultural employment and poverty alleviation as well as to spread the benefits to backward and dry land tracts. This leads to the issue of the ideal instruments for agricultural credit delivery and the appropriate institutional changes that are required to ensure necessary credit flow to agriculture. The supply chain arrangements in agriculture encompassing storage, processing and trading, also need to be reviewed taking into account the role of the middlemen and the appropriate legal as well as regulatory structures. Genuine self-regulatory organisations including co-operatives need to be founded and nurtured, tailoring international experience to the country-specific requirements and cultural milieu. A major challenge is to devise nationwide networks that can cater to nationally integrated markets while allowing for local variations and initiatives particularly at the State level. It is necessary to move to a situation where an efficient system of market intermediaries is created in the agriculture sector. In fact, the pace of progress in liberalisation of external trade in agriculture warrants a sense of urgency and priority to institutional reform in agriculture.

7.20 The issue of terms of trade facing Indian agriculture also assumes importance. India is a large producer of several agricultural products. If the focus is on global agriculture, it is important to consider both quality and quantity of production. Certification of quality requires institutional arrangements within the country that carry credibility in both domestic and foreign markets. In this context, the institutional mechanisms such as commodity exchanges and futures trading for hedging risks as well as insurance mechanisms to alleviate the effects of weather uncertainties assume importance. The concept of a nationwide multi-commodity exchange has been mooted in this regard. Commercialisation of agriculture can progress only when institutional arrangements such as insurance penetrate deep within the agricultural sector.

Industrial Revival: Problems and Prospects

7.21 Industrial production slowed to an annual average growth rate of 6.6 per cent in the post-reform period from 7.8 per cent in 1980s. In the first four years of the Ninth Plan period, *i.e.*, up

to 2000-01, industrial production grew at 5.6 per cent per annum. Given the continuing slowdown in the first quarter of the current financial year, it is likely to clearly remain well below the target growth of 8.2 per cent per annum set for the Plan period 1997-2002. Subdued investment demand reflected in the low growth of capital goods output, decline in power generation, the deceleration in the production of basic and intermediate goods and inventory accumulation in some industries are factors which reflect the phase of the cycle through which the industrial sector is transiting.

7.22 Despite some stress, the industrial sector has successfully stood up to the pressures of competition from imports and the entry of multinational companies into the domestic market. The growth and spread of structural transformation exemplified in corporate restructuring, mergers and acquisitions is also noteworthy. This suggests that Indian industry has the inherent capability, resilience and skills to cope with the exacting pressures of a transforming, globally competitive environment. Thus, a central task in the revival of the industrial sector is the re-building of confidence in the growth impulses by a conducive policy environment.

7.23 In the context of reinvigorating industrial growth, public sector enterprises (PSEs) also have an important role to play. On the one hand, the PSEs face a tightening of the budget constraint as budgetary support has dried up. On the other hand, considerable uncertainty characterises the future especially in an outcome dominated by uncertain prospects for disinvestment, restructuring and privatisation. Setting out a clear path would help to dispel uncertain expectations and provide the PSEs with the confidence to design strategies to raise resources, plan growth trajectories and cope with the pressures for change. Appropriate changes in legislation as well as in the institutional infrastructure enabling flexibility in policies will facilitate the critical public sector component of Indian industry to compete effectively, domestically and globally.

7.24 The course of future industrial development in India would need to reinforce the strong complementarities between the public and private sectors. In the investment mixes for the medium term, the guiding consideration should be to focus energies of PSEs in areas that 'crowd in' the private sector and those with the minimal 'crowding out' effects. A conscious policy of flexibility and promoting greater competition is needed so that public investment takes place where needed and vacates where it is superfluous or inefficient.

7.25 Preparing for the Tenth Plan would pose testing challenges for Indian industry. As per the projections of the approach to the Tenth Plan, in order to attain the target of 8 per cent growth of GDP per annum envisaged for the Plan period, industry is required to grow at over 10 per cent, especially in an environment of heightened competition from imports following the removal of quantitative restrictions. A conducive environment for the industrial revival would hinge upon reforms in the labour market to bring about the necessary flexibility and supply response, changes in exit procedures through appropriate legislation relating to industrial sickness, the Companies Act and industrial disputes and bankruptcy laws. The impetus for accelerated industrial growth could be released by substantially raising investment in infrastructure, hastening of the disinvestment process and restructuring of public sector enterprises.

7.26 The new economy sectors continue to enjoy a competitive edge, despite the underlying domestic industrial conditions and the global slowdown. The fast growing sectors, *i.e.*, software, knowledge-based industries, information technology (IT) enabled services, pharmacology, biotechnology and entertainment services carry the potential of generating increasing returns to

scale and sustaining the step-up in the growth path of the economy. These industries have the inherent confidence and the capabilities to expand rapidly and command global leadership. A critical enabling requirement for accelerated growth of these sectors is the expeditious removal of procedural and institutional constraints on production, marketing and international trade.

External Sector

7.27 The prospects for an early recovery in the global economy turned uncertain with the US economy slowing down in the second quarter, with real growth falling below 2 per cent for three consecutive quarters. Business investments in equipment and software also recorded consecutive declines over the same period. In the Euro area, the moderation in growth since the third quarter of 2000 continued with domestic demand remaining weak and investment demand registering a negative growth in the first quarter of 2001. The recovery in the Japanese economy continues to be hesitant. For the global economy, downside risks, particularly, the impact of falling asset prices on demand and business confidence, weaker corporate earnings and corporate restructuring, growing external imbalances and the potential misalignment of key currencies have made the prospects for the global economy less promising in 2001 than assessments based on currently available information. The growth in world trade volume is projected to decelerate steeply with projections by multilateral institutions placed between 5.5-6.7 per cent in 2001 as against 12.4 per cent in 2000. The decline in export growth is expected to be more pronounced for non-fuel exporting developing countries.

7.28 An assessment of the leading information on industrial production, employment, inventories, new investments and exports suggests that the speed and the period over which the global recovery could occur remains uncertain. It is now expected that the recovery of the US economy may be visible only towards the beginning of 2002 with the turnaround starting possibly towards the close of 2001.With all the major regions of the global economy experiencing downturn, prospects for the emerging market economies remain uncertain, depending on the level of global inter-dependence. Net private capital flows to the emerging markets are projected to decline from US $ 168 billion in 2000 to US $ 140 billion in 2001.

7.29 Risks to emerging market economies emanating from both external and domestic developments have intensified in 2001. The slowdown in the US economy and sharp fall in the global electronics demand have weakened the prospects of most of the export-dependent East Asian economies. Amidst financial crisis in two of the leading emerging market economies – Argentina and Turkey- average emerging market credit quality deteriorated in the first quarter of 2001 with Argentina, Turkey, Ecuador and Malaysia facing rating downgrades in a sequence. Spillover to other emerging markets from Argentina and Turkey was, however, limited in terms of elongation of spreads on the Emerging Market Bond Index (EMBI), reflecting the limited impact of devaluation in Turkey and the large sell offs of Argentinean bonds in March 2001. Syndicated lending to emerging markets fell sharply in the first quarter of 2001 and the rally in the equity markets following the Federal Reserve’s January 2001 cut in interest rates was reversed by the end of the quarter. In June 2001, both Argentinean and Turkish government completed major debt swap arrangements to lengthen debt maturities. Yield spreads on sovereign bonds of emerging markets generally declined in the second quarter of 2001, with the maximum improvement for countries with superior ratings. Equity markets in general also recovered to end-2000 levels.

7.30 Unlike many emerging markets, the impact of the US slowdown on India's exports of merchandise and software is expected to be moderate with export diversification providing a degree of insulation. While foreign direct investment flows are expected to be relatively unaffected, the outlook for portfolio flows remains mixed. On one hand, they could recede, affected by a degree of home bias. On the other hand, readjustment of portfolios among fund managers could result in additional flows into India. The prospects for raising external commercial borrowings may, however, require constant monitoring.

7.31 Recent developments in India's external current account indicate that exports hold the key to a sustainable balance of payments. Ensuring adequate credit flows to the export sector and removal of procedural bottlenecks in the access to the trade and payments regime will continue to dominate the formulation of monetary and exchange management policies. Sustained efforts to create a conducive export performance by effecting enduring improvements in productivity at the specific export industry level, efforts to diversify export markets through appropriate marketing plans, and state level export efforts would need to be pursued. Maintaining and building upon the recent export performance is critical for ensuring viability to the envisaged expansion in the CAD in the Tenth Plan period.

7.32 While the CAD is expected to remain low in 2001-02, preliminary projections for the Approach to the Tenth Five Year Plan incorporate an average CAD of 2.8 per cent per annum during the Plan period. This would imply that net capital flows would have to increase from US $ 10 billion in the initial year of the Tenth Plan to about US $ 40 billion in the terminal year or an average of US $ 20 billion per annum during the Tenth Plan period. This would depend on a four-fold increase in FDI, FII and ECB flows from current levels. Policies for capital flows would need to be suitably adjusted to ensure a preferred hierarchy in flows so that the capital account is stable and not subject to sudden reversals. In India, the pace of liberalisation of the capital account would critically depend on both domestic factors, especially progress in the financial sector reform as well as fiscal adjustment, and the evolving international financial architecture. It is considered prudent for many developing countries to have the legal framework for taking appropriate action to manage unwarranted swings and volatility in external markets. Such options for domestic actions are warranted as long as the international financial system imposes an unequal burden of adjustment between the domestic economy and market participants in the event of volatility.

7.33 The overall approach to the management of India's foreign exchange reserves in recent years has reflected the changing composition of balance of payments, and has endeavoured to reflect the "liquidity risks" associated with different types of flows. The policy for reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Such factors, *inter alia*, include the size of the current account deficit, the size of short-term liabilities (including current repayment obligations on long-term loans), the possible variability in portfolio investments and other types of capital flows, the unanticipated pressures on the balance of payments arising out of external shocks, and movements in the repatriable foreign currency deposits of non-resident Indians. Taking these factors into account, India's foreign exchange reserves are at present comfortable. It is, however, necessary to ensure that, leaving aside short-term variations in reserve levels, the quantum of reserves in the long run is in line with the growth of the economy and the size of risk-adjusted capital flows. This will provide greater security against unfavourable or unanticipated developments.

Fiscal Policy Issues

7.34 Fiscal policies announced by the Central and State Governments for 2001-02 have renewed a commitment to stronger fiscal consolidation through expenditure management, revenue augmentation, and restructuring of PSEs. Fiscal stability is crucial for achieving the targets being envisaged for the Tenth Five Year Plan (2002-07). Public sector saving of 4.6 per cent of GDP and reduction of the combined fiscal deficit to 3.3 per cent of GDP during the Plan period are key fiscal indicators consistent with Plan targets. Gross budgetary support for the Plan would need to be raised to 5 per cent of GDP by the terminal year of the Plan. The Plan's fiscal strategy would envisage reduction in the number of Government employees with all additional requirements met through redeployment and rationalisation. It is obvious that fiscal corrections at the Centre and States are critical to reach the targets for growth indicated in the Approach Paper to the Tenth Plan.

7.35 The Fiscal Responsibility and Budget Management Bill 2000 proposes the legal and institutional framework for initiating the consolidation. In this context, it is important for fiscal reforms to percolate to the States where the quality rather than the quantity of adjustment is under evaluation.

7.36 The path to durable fiscal consolidation is through fiscal empowerment *i.e.*, by expanding the scope and size of revenue flows into the budget. A fiscal strategy based on revenue maximisation would also provide the necessary flexibility to shift the pattern of expenditures and redirect them productively; on the other hand, fiscal adjustments based predominantly on expenditure reduction involve welfare losses and risk the danger of triggering a downturn of overall economic activity. There has been some progress in restructuring the tax system; however, the leakages in the tax base through exemptions continue to pose problems. A major medium-term challenge would be to arrest the declining trend in the tax-GDP ratio – from 16 per cent in the late 1980s to 14 per cent in 1999-2000 – and raise to the level of about 18 per cent by the terminal year of the Tenth Plan Period, as suggested by the Planning Commission. Higher tax revenue should be achieved mainly through buoyancy and expansion of the tax base. A central issue remains the co-ordination of central excises (CENVAT) with a State-level VAT, with the objective of structuring a national VAT. In this context, the issue of a State-level VAT that includes inter-State trade assumes critical significance. It is also imperative to introduce comprehensive taxation of services at the central level with appropriate assignment to States and local bodies.

7.37 Revenue maximisation covers not only taxes but also non-tax revenues, especially cost recovery in respect of all commercial services directly (*i.e.*, water) or indirectly (*i.e.*, power) in which investments have been made. The non-tax revenue/GDP ratio has stagnated at around 2.5 per cent in the 1990s. Improvement in setting and collection of user charges, extension of user charges to non-merit goods and improvement in cost recoveries are essential to raise the contribution of non-tax revenues and the elimination of the revenue deficit which emerges as the medium term objective. The issue in regard to PSEs is not merely their profit or loss, but also return on investments made by Government to cover the cost of capital after meeting the maintenance cost. Adequacy of returns on investments already made by the Government is the key to fiscal empowerment. This is also needed to overcome overhang issues relating to accumulated burden of expenditure commitments in the power sector, public enterprises, the financial sector and the carrying costs of food stocks. Therefore, the problems associated with 'flow' of return would need policy changes and that with 'overhang' would need structured solutions spread over a period.

7.38 In the area of expenditure management, the Union Budget, 2001-02 has effected some of the recommendations of the Expenditure Reforms Commission relating to financial assistance to States to procure foodgrains for Below Poverty Line (BPL) families, phased programme of complete decontrol of urea by April 1, 2006 and downsizing of staff. In any approach to containment of expenditures, it is necessary to recognise the constraints as well as the consequences. Since a predominant part of the budgets, especially at the State level, is committed in the form of interest, pensions and salaries, there is often a reduction in non-committed expenditure which may actually be essential in nature. It is, therefore, necessary to assess the impact of expenditure containment on the level and quality of delivery of public services. The primary responsibility of Government in terms of providing public goods and essential public services can be discharged effectively when tax as well as non-tax revenues are enhanced, non-merit subsidies are eliminated and tax expenditures are eschewed.

7.39 Debt management strategies of the public sector need to consider sustainability of budgetary operations at various levels. In this context, the size of Government borrowings is only one element in public debt management. It is necessary to monitor the behaviour of the components of public debt. In particular, it is important to track the growth in other liabilities. One of the structural weaknesses of the fiscal system is the ballooning of the pension liabilities of the public sector. The Union Budget for 2001-02 noted with concern that pension liabilities have reached unsustainable proportions and constituted a High-Level Expert Group to provide a roadmap for pension reforms. The Eleventh Finance Commission underscored the need for some viable scheme of pension funding. In this context, a new pension scheme based on defined contributions for central Government employees entering service after October 2001 has been announced. Contingent liabilities arising on account of formal guarantees extended by Central and State Governments need to be considered within strategies to ensure the sustainability of public debt. The quality of financial assets in terms of ownership in PSEs and Government-owned financial entities need to be assessed keeping in view the health of their balance sheets as a whole, since the Government is the owner. In addition, a holistic view of the assets and liabilities as well as incomes and expenditures of the public sector as a whole would add to the quality of fiscal adjustment and the health of public finances.

7.40 The growing interest burden in the budget has been a matter of considerable concern. Several options to address the problem are available. Some of these actions are aligning interest rates on small saving instruments with those on similar instruments offered by banks and financial institutions, gradual elimination of tax exemptions on small savings and harmonisation of tax exemptions for all saving instruments, repayment of interest and principal on the Special Deposit Scheme, and issue of callable loans, floating rate bonds and inflation-indexed bonds. An expert committee set up by the Government of India is currently reviewing the system of administered interest rates. The tax exemptions on small saving instruments have been under review. On the repayment of interest and principal on the Special Deposit Scheme, a gradual phasing is the preferred approach. Initiatives have recently been taken to establish an efficient and reliable benchmark rate for the issuance of floating rate bonds through the recent rationalisation of the treasury bill issuance structure.

7.41 The prohibition of direct borrowings by the Central Government from the Reserve Bank under the Fiscal Responsibility and Budget Management Bill, except by way of advances to meet temporary cash needs in certain circumstances, is of particular relevance to the flexibility in the conduct of monetary policy consistent with its objectives. The exit of the Reserve Bank from the

primary market does not prohibit participation of the Reserve Bank in the secondary market and does not eliminate monetisation; however, the scope for private placement of debt or devolvement of auctions of public debt on the Reserve Bank is eliminated. Thus, the extent of monetisation and terms of such monetisation would depend on the judgement of the Reserve Bank in regard to overall stability. Such operational freedom is essential to assure the system that conduct of monetary policy balances the three relevant elements, *viz.*, the fiscal needs of government, the compulsion of a deregulated interest rate regime and requirements of a more open external sector. In fact, separation of functions of a public debt manager from that of monetary authority needs to be viewed in this context.

7.42 The proposals in the Fiscal Responsibility and Budget Management Bill and the policy announcement made in regard to separation of public debt functions from the Reserve Bank should be viewed in this context as medium-term goals. Such separation is no doubt predicated on a manageable level of fiscal deficit and Government borrowings. In view of the complex nature of linkages, co-ordination between fiscal and monetary policies should be consistent with the overall macroeconomic objectives. Operating procedures of monetary and fiscal authorities, especially debt and cash management, have to be consistent and mutually reinforcing. Harmonious implementation of policies may require that one policy is not unduly burdening the other for too long and for this purpose, credibility of both monetary and fiscal policies is critical.

7.43 The strategy of fiscal empowerment is of special significance for States since the bedrocks of socio-economic welfare, *i.e.*, law and order and social services are in the State sector. There is considerable merit in emphasizing the quality aspects of fiscal adjustment in the process of reduction in the fiscal deficit and this means fiscal empowerment rather than fiscal enfeeblement as an appropriate strategy.

7.44 As regards the growing interest burden of States, the Group of State Finance Secretaries on Interest Burden of States is discussing draft recommendations which merit consideration. States would need to undertake reduction of fiscal deficits and the elimination of the revenue deficit. Another recommendation is renegotiation of existing loans from the Centre either by restructuring terms of existing loans on the basis of prevailing market rates or by repaying earlier loans through fresh borrowings from the market. With regard to future loans from the Centre, interest rates are sought to be related to weighted average costs of borrowings of the Centre with the minimum spread. The Group also envisaged flexibility in the selection of projects as well as deployment of existing staff in respect of Centrally Sponsored Schemes, issue of securities of different maturities and the development of a liquid and vibrant retail debt market.

7.45 The major focus of economic reform in India has to be at the level of States with the inter-State issues emerging as the major concern of Government. Extending fiscal reforms to States will require a focus on institutional infrastructure especially relating to law and order, provision and delivery of essential services such as drinking water, sanitation, primary education and dispensaries, not only to serve the needs of the poor and the underprivileged but also to attract resources from the financial sector for investments in physical infrastructure. Improving the delivery of services should be the priority warranting total cost recovery for commercial activities with self-balancing cross-subsidisation. State budgets may have to differentiate between bankable and non-bankable segments, enable, expand and hive off the former while focusing on efficient use of resources for non-bankable components such as anti-poverty programmes, and social services. The major thrust of reform is to expand what may be called social infrastructure which requires large public funding and where scope for private funding is

extremely limited in the short run, especially among poorer regions. The objectives of reform can be attained by fiscal reorientation towards larger responsibilities for States to provide public goods and social services, including anti-poverty programmes, with concomitant rollback of fiscal activism in commercial activities.

The Conduct of Monetary Policy

7.46 For 2001-02, the Reserve Bank proposes to continue to ensure that all legitimate requirements for credit are met consistent with price stability. Towards this objective, the Reserve Bank will continue its policy of active management of liquidity through OMO, including two-way sale/purchase of treasury Bills, and further reduction in CRR as and when required. Unless circumstances change unexpectedly, or current problems in some segments of the market are not resolved soon, on the present reckoning, it should also be possible to maintain the current interest rate environment, and explore the possibility of some further softening in medium and long-term rates over time, following the stance of interest rate flexibility announced in the Union Budget for 2001-02. The policy stance is flexible in case the underlying inflationary situation turns adverse or there are unfavourable and unexpected external developments.

7.47 There has been some easing of constraints on the flexibility of interest rates in the financial system as a whole. Assuming a continued positive outlook for inflationary expectations, further flexibility would be facilitated if consistent progress is made in the direction of credible fiscal adjustment combined with flexibility in administered interest rates, improvements in the operational efficiency of the financial system and reduction of the burden of non performing assets in the banking system. The Reserve Bank will continue with its effort to bring about orderly development and smooth functioning of financial markets and would take further steps in financial sector reforms.

7.48 In India, while inflation is not targeted, policy statements have been identifying a tolerable level of inflation taking into account the global trends and domestic compulsions. There has also been some sensitivity to issues relating to measurement of prices including in the growing services sector as also asset prices. An area of concern is the continuing hardness in international oil prices and the impact on inflation in India. In the coming years, the element of 'buying time' embodied in the pricing mechanism may not be available in view of emerging budgetary priorities relating to quasi-fiscal activities embodied in the oil pool account. The impact of movements in international oil prices on domestic inflation and the balance of payments may, therefore, be more direct and rapidly transmitted.

7.49 In a deregulated environment, the availability of adequate resources at appropriate costs, *i.e.*, interest rates assumes importance. Stable and preferably low interest rates are conditional upon enabling stable inflationary expectations which, in turn, depends on price stability. The monetary policy review of October 1999 had identified several structural and other constraints impeding the downward flexibility of interest rates in India, *i.e.*, high non-interest operating expenses of public sector banks, the relatively large overhang of NPAs, the practice of offering fixed interest rates on term deposits by banks, the large and persistent increase in the size of the market borrowing requirements of the Government, the floor set by administered interest rates on contractual savings and the high level of the CRR. The need to impart flexibility to interest rates has emerged as a focal point for policy action. Accordingly, priority is attached to removing these constraints. The recent reductions in administered interest rates on some saving instruments

enabled a general easing of the interest rate structure through monetary policy action in the beginning of the current financial year.

7.50 There is merit in devising a transparent system of determining administered interest rates, such as small savings rates, which would ensure a reasonable and assured real return to the small savers and at the same time make the small savings rates more flexible. As interest rates in the economy cover credit, money and securities markets, such a system has to reckon with linkages among these rates as well. Similarly, in considering returns to sources from a variety of instruments, the interest rate regime cannot ignore tax incidence and their contractual nature or otherwise. The Expert Committee appointed by the Government of India to review the system of administered interest rates and other related issues is currently examining various aspects of small savings rates.

7.51 The objective of monetary policy operations is to make the interest rate regime more flexible and responsive to the economic fundamentals. The interest rate policy is evolving and at the present stage of development, it may not be as effective as it could be in a more deregulated environment mainly because the financial markets lack depth and are far from being fully integrated. Moreover, the public sector dominates the financial sector; this has a tendency to impede responses based on either market considerations or regulatory incentives. In the context of the deceleration in industrial activity, the role of monetary policy in enabling the revival by marking down interest rates has been widely discussed. In this context, it is worth noting that the Reserve Bank has created a number of instruments, as a package, to ensure adequate liquidity and appropriate interest rates. Allowing for lending at below Prime Lending Rates (PLR), for instance, has resulted in a significant amount of lending at sub-PLR rates.

7.52 In recent years, the operating procedures of monetary policy have undergone significant changes. A major transformation has also taken place in the form of an expansion in the array of monetary instruments. The gradual switchover to indirect market-based instruments in the conduct of monetary policy was made possible because of simultaneous efforts at developing various segments of the financial market, particularly money, foreign exchange and government securities market. Reform in the call money market when fully implemented in the next two to three years would mean completion of the transition towards indirect instruments of monetary policy. The increasing responsibility of the Reserve Bank in undertaking reform in the financial markets has to be seen essentially in the context of improving the effectiveness of the transmission channels of monetary policy. Development of financial markets has, therefore, encompassed regulatory and legal changes, building up of institutional infrastructure, constant fine-tuning in market microstructure and massive upgradation of technological infrastructure. An important development in the evolution of monetary policy in India is the activation of the Bank Rate as instrument of monetary policy in 1997. This was followed up with a more active recourse to repo operations, leading to an orderly progress to a full-fledged LAF. With the emergence of financial markets with depth and sophistication, the Bank Rate would perform the critical function of the principal signaling variable and the LAF rates, setting a corridor for short-term money market, would be the operating instruments of monetary policy.

Financial Sector Reforms

7.53 The major thrust of financial sector reforms would continue to be on the development of financial markets, strengthening of the financial system and prudential and supervisory norms,

improvement in credit delivery and modernisation of the technological environment of the financial sector.

7.54 In India, the regulation of financial sector traditionally evolved as an instrument of planned development. In such a situation, the objectives are mobilisation of savings and allocation of investible resources mainly through public sector and/or administered prices of financial products. There has been an implicit sovereign guarantee of maintaining systemic stability giving in the process an impression of protecting interests of all financial intermediaries and market participants. The management of the financial sector, therefore, contained a variety of objectives and to this end, many financial institutions were nationalised or created to subserve ends of planned development, thus relegating the role of competition as an instrument of efficiency to a secondary position. Furthermore, co-ordination among the financial institutions took precedence over arm's length relationships or checks and balances, which underplays both the degree of transparency and the extent of accountability. In a deregulated environment, savers have a wide range of financial instruments and intermediaries to choose from with a spectrum of risks, rewards and liquidity. The expectations of savers, the options for investors to raise resources, the accountability of intermediaries and the focus of regulation need to be fully attuned to the reforms in the financial sector which emphasise competition and attendant risks as a package, leading to greater efficiency along with systemic stability.

7.55 Some progress has been made in the context of the recommendation of the Narasimham Committee (1991) that non-bank financial companies should be brought under the ambit of regulation and supervision of the Reserve Bank. In recent years, the Reserve Bank has taken a number of steps towards regulating the undertaking of financial business by NBFCs and the acceptance and safety of public deposits. Separate legislation has been proposed for enhanced protection to depositors of NBFCs. The Narasimham Committee II (1998) also recommended the conversion of Development Financial Institutions (DFIs) into either commercial banks or NBFCs so as to improve their regulation, especially in the context of the move towards universal banking. In the recent period, developments relating to the activities of DFIs have been drawing concern. The ratio of net NPAs to net advances has increased sharply for some of the major DFIs, with an accompanying deterioration in their capital adequacy ratios and the ratio of total outstanding borrowings to net owned funds. It is in the context of these developments that early implementation of recommendations of the Narasimham Committee and an unambiguous signal of strengthening of the regulatory framework for the DFIs assume critical importance.

7.56 In recent years, a view that has gained ground is that the Reserve Bank should be delinked from the ownership of financial institutions through transfer of ownership to the Government. In order to enhance competitive impulses as also in view of the regulatory and prudential considerations, the issues relating to the separation of ownership and regulation have been receiving increasing attention. Retaining the ownership structure of the regulated/supervised institutions engenders moral hazard with systemic implications. The Reserve Bank has accepted the recommendation of transfer of ownership in respect of the State Bank of India, the National Housing Bank, the National Bank for Agricultural and Rural Development, and plans to initiate the process of transfer of ownership of other financial institutions. The Reserve Bank's holdings in the Discount and Finance House of India and the Securities Trading Corporation would be completely divested during 2001-02.

7.57 Transparency and disclosure standards in regard to banks have been enhanced to meet international practices, with the range and extent of disclosures gradually increasing over the last couple of years. Recent policy announcements have expressed the intent of moving towards international best practice of 90-day norm for loan classification by end-March 2004. The NPA portion of banks due for reclassification needs to be closely monitored. The issue of transparency also leads to questions of corporate governance in banks. It needs to be recognised that the reform process is only an enabling mechanism; leveraging it fully is possible only if the institutional players in the system are receptive to good governance. The corporate governance practices in banks needs to be transparent and consistent, striking a balance between promoting safe and sound banking, on the one hand, and imparting to banks the necessary flexibility for effective competition, on the other. It is in this context that the need for good governance practices in banks, especially with regard to the constitution of bank boards and their accountability, is reiterated.

7.58 An important aspect of the future course of financial sector reforms relates to the supervisory framework. The regulatory regimes and supervisory systems in the changing environment face new challenges in safeguarding the integrity, efficiency, soundness and stability of the financial system. In India, the regulatory and supervisory arrangements have been rendered complex in view of the existence of various types of financial intermediaries with differing charters owing their origins to pre-reform strategies.

7.59 In the light of the recent experience, the Reserve Bank has proposed the setting up of a new apex supervisory body, which can take over the entire inspection/supervisory functions in relation to scheduled and non-scheduled urban co-operative banks (UCBs). This apex body could be under the control of a separate high-level supervisory board consisting of representatives of the Central Government, State Governments, the Reserve Bank as well as experts and may be given the responsibility of inspection and supervision of UCBs and ensuring their conformity with prudential, capital adequacy and risk-management norms as laid down by the Reserve Bank.

7.60 Notwithstanding a perceptible decline in the NPAs of the banking system in India, the levels of NPAs still remain high. Several initiatives have been undertaken for containing/minimising the stock of NPA overhang as well as its increment. The resolution of the NPA problem requires greater accountability, improved disclosures and an efficient credit information system. Concomitantly, there is a need to initiate legislative framework that will make the recovery process smoother and legal action more prompt and efficient. It is necessary to recognise that insolvency laws in India and their operating mechanisms are out of alignment with the pace of reforms in the financial sector and are emerging as the most critical impediment to debt recovery with mounting defaults perpetuated under relevant legal provisions.

7.61 Considering the complexities of banking business and emerging product innovations with complex risk profiles, there is a growing acceptance that a risk-based supervision (RBS) approach would be more efficient than the traditional transactions-based approach. Accordingly, the focus has shifted towards evaluating and monitoring risk management systems, internal controls, corporate governance, and information systems, as opposed to merely examining the balance sheets of individual banks. To meet with the requirements of RBS, banks would have to take immediate measures to improve the reliability and robustness of their risk management strategies, management information and supervisory reporting systems.

7.62 The credit needs of small and medium enterprises which typically come under pressure during a period of structural change require special attention warranting changes in internal procedures and incentive mechanisms among financial intermediaries, especially banks. An important task of the banking system in the coming years will be the management of the rural credit delivery systems and processes as also channels of credit flow to small and medium scale industries. Harnessing the widely dispersed skills of artisans in rural areas through micro-credit schemes would, to some extent, augment both the income and employment generation potential. It needs to be recognised that for the rural borrower also, it is not costs *per se* but an appropriate credit delivery mechanism characterised by adequacy, timeliness and certainty of credit availability based on simple norms that is of most relevance. Improving the credit delivery system of co-operatives is vital for reaping productivity and employment gains and to this end, strengthening of genuine co-operative credit structures is essential.

MONETARY AND CREDIT POLICY

8.1 The macroeconomic environ-ment since the second half of the 1990s has rendered the conduct of monetary policy complex and subject to conflicting pulls. While output considerations may warrant monetary easing, it has been necessary to guard against monetary expansion turning excessive in a situation of slowing down of output growth which could cause the emergence of inflationary pressures and expectations. Moreover, the policy setting has been complicated by the impact of brief, yet significant, supply shocks to the price level within the general ebbing of demand-pull factors, structural rigidities resulting in the downward inflexibility of interest rates, the continuous pressure of the Government's market borrowing programme and sporadic episodes of volatility in the financial markets. The on-going integration of financial markets across the world, the phenomenal increase in financial turnover, the liberalisation of the economy and the rapidity with which unanticipated domestic and international tremors get transmitted to financial markets across the world because of the new technology have added additional dimensions to the conduct of monetary policy.

8.2 A factor which further complicates the conduct of monetary policy during certain periods is the difficulty of an appropriate assess-ment of the potential inflationary pressures. While there is little disagreement that in the medium- to long-run, inflation is largely caused by monetary expansion, in the short-run, price fluctuations could be affected by non-monetary and supply side factors. Under these conditions, monetary and credit policies have been deployed in support of the overall macro-economic policy objectives, *albeit,* with a flexible approach under which tightening or easing of monetary conditions can be swiftly undertaken.

8.3 The conduct of monetary management has undergone significant changes in the 1990s in terms of objectives, framework and instruments, reflecting broadly the progressive liberalisation of the Indian economy. The Reserve Bank announced a multiple indicator approach in 1998-99, which accords the necessary flexibility to respond to changes in domestic and international economic and financial market conditions more effectively. While the growth in broad money (M_3) continues to be used as an important indicator of monetary policy, interest rates along with information on currency, credit extended by banks and financial institutions, the fiscal position, trade, capital flows, the inflation rate, the exchange rate and and transactions in foreign exchange available on high frequency basis are juxtaposed with output data for drawing policy

perspectives. This shift has been gradual and a logical outcome of measures taken over the period of structural reforms.

8.4 A major transformation has also taken place in the operating procedures of monetary policy. The reform of monetary and financial sectors has enabled the Reserve Bank to expand the array of instruments of indirect monetary control and at the same time reduce reliance on reserve requirements. The liquidity management in the system is carried out through open market (including repo) operations (OMO), supplemented by access to the Reserve Bank's standing facilities. The Liquidity Adjustment Facility (LAF) operations combined with strategic OMO have evolved as the principal operating procedure of monetary policy.

8.5 Against the background of easy liquidity conditions in the early part of the year, notwithstanding the turbulence in equity markets in March 2001, the monetary stance for 2001-02 is to ensure that all legitimate requirements for credit are adequately met consistent with price stability. Towards this objective, the Reserve Bank continues its policy of active management of liquidity through OMO, including two-way sale/purchase of treasury bills, and further reduction in CRR as and when required. Unless circumstances change unexpectedly, or current problems in some segments of the market are not resolved soon, on the present reckoning, it would also be possible to maintain the current interest rate environment and explore the possibility of some further softening in medium- and long-term rates over time, following the stance of interest rate flexibility announced in the Union Budget for 2001-02. The monetary policy stance takes note of the fiscal deficit of the Centre budgeted at 4.7 per cent of GDP and the consequent size of the borrowing programme and envisages a real GDP growth of 6.0-6.5 per cent and an inflation rate projected within 5 per cent. Consistent with this macroeconomic outlook, the growth rates projected for the key information variables are: about 14.5 per cent each for M_3 and commercial bank aggregate deposits and 16-17 per cent for adjusted non-food credit of commercial banks.

8.6 The exchange rate management, within this monetary stance, will continue to focus on managing volatility and ensuring orderly market conditions with no fixed "target" for the exchange rate. The approach would be one of watchfulness, caution and flexibility. The policy for building adequate levels of international reserves will continue with due consideration to the liquidity risks associated with various types of capital flows. The progressive liberalisation of the capital account would be carried forward while the pace and sequencing will be determined by evolving macroeconomic and external conditions.

8.7 The major thrust of financial sector reforms would continue to be on the development of financial markets, strengthening of the financial system and prudential and supervisory norms, improvement in credit delivery and modernisation of the technological environment of the financial sector.

DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

9.1 The development and regulation of money, foreign exchange and Government securities markets is a function of the Reserve Bank that emerges out of its role as monetary authority as well as debt manager to the Government and its responsibility for the stability of the financial system. In this context, the Reserve Bank has been emphasising a redefinition of its regulatory role *vis-ã-vis* financial markets, particularly in an environment characterised by multiple regulation. The amendments to the Securities Contract (Regulations) Act (SCRA), 1956 which

were brought into effect on March 1, 2000 assume critical significance. They establish the regulatory jurisdiction of the Reserve Bank over transactions in Government securities, money market securities, gold related securities, derivatives based on these securities and ready forward contracts in all debt securities, in conjunction with the Reserve Bank's regulation of foreign exchange transactions under the Foreign Exchange Regulation Act, 1973 and later by the Foreign Exchange Management Act, 1999.

9.2 The development of financial markets is regarded as a critical prerequisite for improving the operational effectiveness of the transmission of monetary policy. Accordingly, the first phase of financial sector reforms consisted of the easing of various structural rigidities – both price- and quantity-based, so as to increase participation in financial markets as well as to develop and strengthen inter-linkages between market segments, fostering competition, introduction of more sophisticated financial instruments and innovations in market practices, ensuring adequate liquidity in various segments of the market spectrum, and developing the regulatory, legal, institutional and technological infrastructure for orderly market activity.

9.3 In the second phase of reforms, issues relating to the stability of financial markets have received priority in the policy agenda. The liberalisation of financial markets has raised the vulnerability of financial institutions to volatility in financial asset prices and thereby increased the potential risks of impairment of their balance sheets, with implications for systemic stability. The international experience with market failures in 1997-98 and contagion effects have prioritised the regulatory function in the context of the development of financial markets in India. The need for regulation arises in the context of maintaining systemic stability given the strong complementarity between financial stability and price stability. In the country-specific situation, the challenge is to make the micro regulations consistent with macro objectives. In the recent period, policy initiatives have encompassed measures for market discipline, fine-tuning of the market microstructure in order to reflect the evolving sophistication and technological advancement in the functioning of markets, and specific changes in the legal and regulatory framework which would institute healthy market practices and also enable more effective supervision and oversight.

9.4 In regard to the money markets, a basic objective in the recent years has been to develop a proper short-term rupee yield curve with deep liquidity therein. A four-fold strategy is being adopted in this regard. First, LAF operations are being conducted with a view to keeping the short-term interest rates within a corridor. Secondly, the call money market is being developed into a pure inter-bank market with a phased withdrawal of non-bank participants who only lend in the market. Thirdly, the traditional sector-specific refinance support is being rationalised and the additional recourse to the standing liquidity facilities of the Reserve Bank is being made increasingly market-based. Finally, the other money market segments, especially the repo market, are being developed with lending as well as borrowing access to the non-banks in these markets.

9.5 In respect of Government securities market, the initiatives in the recent years have been to develop the market in terms of depth, liquidity, turnover and participants. Given the constraints imposed by conditions in the money and foreign exchange markets and the persistently large Government borrowing programme, the Reserve Bank has at times taken private placements in the primary issues or devolvement at the auctions and has subsequently undertaken open market operations at opportune points of time to assuage market pressures to contain the monetary impact of the fiscal operations and to allow for the emergence of a smooth

yield curve. The Reserve Bank has also been adopting a policy of passive consolidation in the number of outstanding loan issuances and facilitating creation of volumes in benchmark securities. Open market operations are undertaken to contain volatility and to provide liquidity to the Government securities market.

9.6 The foreign exchange market in India continues to be relatively thin, localised and expectation-driven with a tendency towards 'herding' and asymmetrical behaviour. The medium-term policy endeavour is to develop the foreign exchange market in terms of depth and liquidity, enable the introduction of new instruments and pricing strategies and greater integration with other segments of the financial market. In the day-to-day regulation of the foreign exchange market, the policy objective is to manage volatility with no fixed rate target and allow demand and supply conditions to determine exchange rate movements in an orderly manner. The Reserve Bank also enters periodically into foreign exchange transactions with the market to prevent undue fluctuations in the exchange rate.

9.7 The medium-term agenda would be to monitor smooth implementation of the various structural and technological measures which have already been announced. In the short-end of the financial market spectrum, the strategy of transforming the call money into a pure inter- bank market and development of the repo market to provide increased access to non-bank participants would be pursued with an emphasis on managing the transition. The integration of the various market segments would equilibrate short-term positions of banks as well as non-banks. Furthermore, efforts would be made to facilitate transparent electronic bidding in auctions and secondary market transactions in Government securities on a real-time basis and integration with EFT and RTGS. Institutional and technological arrangements for settling transactions through the delivery-versus-payment (DVP) system of the Reserve Bank on T + 1 basis will be strengthened in order to improve cash and liquidity management among money market participants and sensitise them to NDS. The operationalisation of Clearing Corporation would prepare the ground for reaping efficiency gains.

FINANCIAL REGULATION AND SUPERVISION

10.1 The Reserve Bank is entrusted with the supervision of the banking system in India under the provisions of the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. The Reserve Bank regulates select financial institutions (FIs) and non-banking financial companies (NBFCs) under Chapter IIIB of the Reserve Bank of India Act. Consequent upon amendments to Chapters IIIB, IIIC and V, through the Reserve Bank of India (Amendment) Act in 1997, the Reserve Bank introduced a comprehensive regulatory framework in respect of NBFCs, including compulsory registration in terms of the amended Section 45-IA.

10.2 Structural and organisational changes in the financial system since the early 1990s under the impact of financial sector reforms and globalisation have fundamentally transformed the regulatory function. The large macroeconomic and social costs of recent financial crises have lent urgency to the world-wide quest for institutional arrangements and processes which enable efficient and appropriate oversight of financial systems. Drawing from the recommendations of the Committee on the Financial System (Chairman: Shri M. Narasimham), 1991, and the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham), 1998, financial sector reforms have consisted of reduction of statutory pre-emptions by way of changes in the policy

environment, institutional strengthening, infusion of competition and establishment of a pro-active and comprehensive regulatory and supervisory framework.

10.3 The BFS, set up in November 1994 under the Reserve Bank of India (Board for Financial Supervision) Regulations, is entrusted with the supervision of commercial banks, select FIs and NBFCs. The directions of the BFS are implemented by the Reserve Bank's Department of Banking Supervision (DBS), which supervises scheduled commercial banks (except regional rural banks), the Financial Institutions Division (FID) of DBS, which supervises select FIs and the Department of Non-Banking Supervision (DNBS), which supervises the NBFCs. The BFS has approved a new strategy of supervision comprising, *inter alia*, (i) the setting up of an off-site surveillance system for in-house monitoring of banks and other credit institutions, building a 'Memory' on all supervised institutions and setting up of a Market Intelligence and Surveillance Unit (MISU); (ii) restructuring of the system of bank inspections in terms of focus, process, reporting and follow-up; (iii) strengthening the statutory audit of banks and enlarging the role of auditors in the supervisory process; and (iv) strengthening the internal defence of the supervised institutions as an extension of the task of supervision. While on-site inspections in the case of domestic banks are based on the CAMELS model (capital adequacy, asset quality, management, earnings, liquidity and systems and controls), foreign banks are inspected on the basis of the CACS model (capital adequacy, asset quality, compliance and systems). The off-site monitoring system for surveillance over banks, introduced in 1995, has since been extended to select FIs and NBFCs as well. In the case of NBFCs, the supervisory framework consists of a four-pronged mechanism comprising (i) on-site inspection on the CAMELS pattern, *viz.*, capital adequacy, assets, management, earnings, liquidity, systems and procedures; (ii) off-site monitoring through periodic control returns from NBFCs using state-of-the-art information technology; (iii) an effective market intelligence network; and (iv) a system of submission of exception reports by statutory auditors of NBFCs.

10.4 During 2000-01 (July-June), the BFS reviewed the annual financial inspection in respect of 27 public sector banks, a consolidated report of the local head offices of the State Bank of India, 26 private sector banks, 50 foreign banks and 6 all-India FIs. During the year, 877 urban co-operative banks were inspected as against 828 banks during 1999-2000. In case of NBFCs, out of the 36,683 applications for the certificate of registration (CoR), 13,618 applications were approved and only 771 were permitted to accept public deposits as at end-June 2001. Besides, 270 regular inspections (and 1,193 scrutinies) were completed during the year. The Board also reviewed the monitoring with regard to bank frauds and house-keeping in public sector banks including reconciliation of entries in inter-branch accounts, inter-bank accounts (including *nostro* accounts) and balancing of the books of accounts of select FIs and NBFCs. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the BFS also provided guidance on several regulatory and supervisory concerns.

10.5 Contemporaneous with the operational dispensation of the regulatory and supervisory functions, the Reserve Bank has been undertaking structural measures to strengthen the financial system and improve the efficiency of financial intermediation. In general, measures for institutional reform have emerged out of a consultative approach involving policy authorities, market participants, technical committees and advisory groups, as well as experts within the country and abroad. These structural measures have focused on improving the institutional infrastructure for a sound and resilient financial system, strengthening prudential and supervisory norms consistent with the organisational changes occurring in financial institutions, and

developing the appropriate technological architecture. During 2000-01, emphasis was placed on developing financial markets, improvement in risk management and internal control mechanisms, debt recovery and upgradation of the payment and settlement system.

International Standards and Codes: Indian Initiatives

10.6 The Reserve Bank appointed a Standing Committee on International Financial Standards and Codes (Chairman: Dr.Y.V. Reddy) in December 1999, in consultation with the Government, in order to (i) identify and monitor developments in global standards and codes being evolved in the context of international developments; (ii) consider the applicability of these standards and codes to the Indian financial system; and (iii) chalk out a road map for aligning India's standards and practices to the evolving international standards. The Financial Stability Forum (FSF), established in April 1999 in order to promote international financial stability by improving the functioning of markets and reducing systemic risk through information exchange and international co-operation in supervision and surveillance of financial markets, identified a dozen areas grouped into three areas, *viz.,* macroeconomic policy and data transparency (covering monetary and financial policy transparency, fiscal policy transparency, data dissemination and data compilation), institutional and market infrastructure (covering insolvency, corporate governance, accounting, auditing, payment and settlement and market integrity) and financial regulation and supervision (covering banking supervision, securities regulation and insurance supervision) for priority implementation. The Standing Committee has constituted ten advisory groups comprising of non-official experts, in the areas of banking supervision, bankruptcy laws, corporate governance, data dissemination, fiscal transparency, insurance regulation, international accounting and auditing, monetary and financial transparency, payment and settlement system and securities market regulation to examine the feasibility and time frame of compliance with international best practices.

10.7 The Indian approach follows an internationally acclaimed systematic three-step process of (i) identification of standards and codes in relevant areas; followed by (ii) an in-depth assessment of the issues pertaining to the present status of applicability, relevance and the existing degree of compliance, the feasibility of compliance and the earmarking of the possible time frame for transition given the prevailing legal and institutional practices by experts; and thereafter, (iii) mapping a comprehensive course of possible actions for achieving the best practices, with due prioritisation of some of the more important codes and standards. The reports of all the advisory groups have already been placed in the public domain. This would be buttressed by efforts for the widest possible dissemination including by means of seminars and workshops to foster a national debate and generate a consensus towards the necessity of change and sensitise the regulatory authorities, agencies and institutions about the priority areas of action.

Consolidated Supervision

10.8 In recent times, there has been a renewed focus on empowering supervisors to undertake consolidated supervision of bank groups. The Core Principles for Effective Banking Supervision issued by the BCBS have underscored this requirement as an independent principle, which requires that bank supervisors have the ability to supervise banking groups on a consolidated basis. Consolidated supervision is defined as "an overall evaluation (qualitative as well as quantitative) of the strength of a group to which a large bank belongs, in order to assess the potential impact of other group companies on the bank". A major element of this approach is the

production of financial reports on a consolidated basis which combine the assets and liabilities and off-balance sheet items of banks and their related companies, treating them in effect as if they were a single entity.

10.9 The Reserve Bank has taken several initiatives to move towards a system of consolidated supervision. In the second half of 2000-01, banks were advised to voluntarily build in the risk-weighted components of their subsidiaries into their own balance sheet on a notional basis, at par with the risk-weights applicable to the bank's own assets. Banks were directed to earmark additional capital in their books over a period of time so as to obviate the possibility of impairment of their net worth when the switchover to a unified balance sheet for the group as a whole is adopted. The additional capital required was to be provided in the banks' books in phases, beginning from the year ended March 2001. To further the aim of consolidated supervision, the Reserve Bank advised banks to annexe the balance sheet, profit and loss account, report of the board of directors and the report of the auditors in respect of each of their subsidiaries to their own balance sheets beginning from the year ended March 2001.

10.10 Recent developments in the capital market and in the co-operative banking system have thrown up new challenges for the conduct of the regulatory functions. The multiplicity of regulatory authorities in several segments of the financial system has often hindered the containment of systemic risk arising out of imprudent behaviour of a few small entities. It is in this context that the Reserve Bank has been seeking a clearer definition of its regulatory role. For this purpose, it has been involving public opinion as well as expert assessment of the need for enabling changes in the legislative framework for financial regulation

PUBLIC DEBT MANAGEMENT

11.1 The Reserve Bank manages the public debt of the Central and the State Governments and also acts as a banker to them under the provisions of the Reserve Bank of India Act, 1934. While these functions become obligatory in the case of the Central Government (under the Sections 20 and 21), the Reserve Bank undertakes similar functions for the State Governments by agreement with the Government of the respective State (under Section 21 A).

11.2 All State Governments, with the exception of Jammu and Kashmir and Sikkim, had entered into agreements with the Reserve Bank for the purpose of both the aforesaid functions. These two States have agreements only for the limited purpose of the management of their public debt. Consequent upon the reorganisation of three States, *viz*., Bihar, Madhya Pradesh and Uttar Pradesh, the new States, *viz*., Jharkhand, Chattisgarh and Uttaranchal have also entered into agreements with the Reserve Bank, entrusting it the twin functions of public debt management and banking. Simultaneously, the ways and means advances (WMA) limits, the minimum balances which the States are required to keep with the Reserve Bank and the outstanding debt have been apportioned amongst the reorganised States as per the provisions of the respective State Reorganisation Acts.

11.3 The Central Government entered into an agreement with the Reserve Bank in 1994 to phase out the system of automatic monetisation of budget deficit through creation of *ad hoc* Treasury Bills within a period of three years. Accordingly, the system of deficit financing through the creation of *ad hocs* was abolished with effect from April 1, 1997. Under a new arrangement, a WMA scheme was introduced to facilitate bridging of temporary mismatches in the Central Government's cash flows. The growing market orientation of debt management

policy has, in turn, placed increased emphasis on the timing, speed of response to market developments and in general, greater skills in active debt management. The objective of debt management policy is clearly emerging in terms of raising resources from the market at the minimum cost while containing the refinance risk and its consistency with the monetary policy objectives. The introduction of Primary Dealers (PDs) in 1996, with a view to developing the Government securities market is another important institutional development in the area of public debt management. Recognising the fact that liquidity in the Government securities market would narrow the bid-ask spreads and reduce the cost of borrowing, initiatives have been undertaken in recent years to consolidate loans and develop benchmark securities. Reissuance of existing loans has, over the past few years, facilitated the emergence of benchmark securities as also improved market liquidity for government paper. In order to reduce the refinancing risk, greater emphasis has been placed on managing the maturity structure of Government loans.

11.4 The WMA limits for the State governments, made effective from March 1, 1999 based on the recommendations of the Informal Advisory Committee on Ways and Means Advances constituted by the Reserve Bank (Chairman: Shri B.P.R. Vithal), were revised under the WMA Scheme 2001, effective February 1, 2001. The State Governments have adopted the auction system for raising a part of their market borrowings since January 1999.

11.5 Public debt management continues to be constrained by the large and growing borrowing programme of the Government, which exerts pressure on the absorptive capacity of the market. During 2000-01, the Reserve Bank continued its policy of combining auctions, private placements and open market operations with a view to minimising the cost of public debt, as also to contain volatility in interest rates, reducing the monetary impact of the Government borrowing programme and supporting the monetary policy stance for a softer interest rate environment. The Reserve Bank had to moderate the pressure of the Government borrowing programme as well as the impact of the brief reversal of the monetary stance warranted by foreign exchange market volatility on interest rates. This was achieved by combining devolvements/private placements when money market conditions were tight followed by net open market sales when liquidity conditions improved.

11.6 The separation of the functions of debt management and monetary management is regarded as a desirable medium-term objective, conditional upon development of the government securities market, durable fiscal correction and an enabling legislative framework. The separation of the two functions is expected to have significant effects on the functioning of the government securities market. The Working Group on Separation of Debt Management from Monetary Management, which submitted its report to the Reserve Bank in December 1997, recommended, *inter alia,* the separation of the two functions and establishment of a company under the Indian Companies Act to take over the debt management function. The Union Budget, 2000-01 expressed the need to accord greater operational flexibility to the Reserve Bank for the conduct of monetary policy and regulation of the financial system. The existing Public Debt Act is sought to be repealed and replaced by a new Government Securities Act. The new Act will simplify the procedures for tran-sactions in Government securities, allow lien marking/pledging of securities as also electronic transfer in a dematerialised form. The new Act has been passed by the Legislatures of most of the States. Attendant legislative changes are envisaged under the Fiscal Res-ponsibility Bill and the Reserve Bank of India Act to enable greater flexibility and operational effectiveness in the conduct of monetary policy in the new environment. The Reserve Bank has proposed amendments to the Reserve Bank of India Act, 1934 which would take away

the mandatory nature of management of public debt by the Reserve Bank and vest the discretion with the Central Government to undertake the management of the public debt either by itself or to assign it to some other independent body, if it so desires. The amendments to various legal acts are also expected to bring about greater compatibility with innovations taking place in banking operations.

11.7 During 2000-01, significant progress has been made in the development and integration of financial markets, introduction of new instruments and participants, strengthening of the institutional infrastructure and greater clarity in the regulatory structure. During 2000-01, amendments to the Securities Contracts (Regulation) Act, 1956 demarcated the regulatory roles of the Reserve Bank and the SEBI in the financial markets and established the regulatory jurisdiction of the Reserve Bank over money and government securities markets.

11.8 The recent monetary and credit policy statements of the Reserve Bank stressed that the major constraint in the evolution of an independent debt management function is the continuing fiscal dominance over financial markets. The durable solution for more efficient conduct of these policies is a substantial and enduring fiscal correction. The proposed Fiscal Responsibility Bill is expected to bring in reasonable control over the fiscal deficit. Apart from the elimination of the revenue deficit and the reduction of the fiscal deficit to 2.0 per cent of GDP by March 31, 2006, the proposed Bill envisages prohibition of direct borrowing by the Central Government from the Reserve Bank after three years except by way of advances to meet temporary cash needs.

11.9 The active stance of the debt management policy pursued in the recent years would be continued in 2001-02. The market borrowing programme of the Centre for the year has been placed at Rs.1,18,852 crore (net Rs.77,353 crore) and that of the States provisionally at Rs.12,648 crore (net, Rs.11,201 crore). Easy liquidity conditions have enabled the smooth issuance of the borrowing programmes of the Centre and States. While the ideal situation for the debt manager is one in which the market absorbs the entire debt issuances, the Reserve Bank subscribes to primary market loans in view of the large market borrowing requirements of the Government and the need to ensure orderly market conditions. The operational framework of debt management policy would, therefore, continue to combine private placement/devolvements with open market operations so as to ensure absorption of the public debt without undue pressure on the conduct of monetary policy or on the cost of the debt. Lengthening of the maturity structure would also be continued along with reissuances and price-based auctions to smoothen the yield curve. As in the recent past, the debt management operations will have to be carefully timed with market liquidity conditions and expectations so that there are no undue pressures on the monetary policy preference for a softer interest rate environment.

CURRENCY MANAGEMENT

12.1 The Reserve Bank is entrusted with the function of note issue and currency management by the preamble to the Reserve Bank of India Act, 1934 and by the specific provisions of Section 3 of the Act. It acts as the sole currency authority under Section 22 for the issue of bank notes. Section 38 requires the Government to put one rupee coins and one rupee notes into circulation only through the Reserve Bank. The function of note issue and currency management is discharged through 18 regional Issue offices/sub-offices and a wide network of currency chests maintained by banks and Government treasuries spread across the country. Consequent upon the formation of the new States of Chattisgarh, Jharkhand and Uttaranchal, the jurisdiction of

currency operations in the newly created States has been retained as hitherto with the Issue offices of Nagpur and Bhopal, Patna and Kanpur, respectively, and necessary arrangements have been made for currency distribution and accounting.

12.2 There has been a phenomenal growth both in the value and volume of currency in circulation over the years. The value of currency, including coins, rose from Rs.172 crore in March 1935 to Rs.2,18,205 crore as at end-March 2001. During the same period, the number of notes in circulation (Re.1 and above) increased from 124 million pieces to over 38,000 million pieces. Currency management has involved efforts to achieve self- sufficiency in the production of currency notes and coins with a judicious denomination-mix, improve-ment in the efficiency of distribution networks and withdrawal and destruction of notes, technology upgradation and enhancement in the security features of currency notes.

12.3 The medium-term agenda of the Reserve Bank would be to continue its effort to provide clean notes and even out supply-demand mismatches through self-sufficiency in production capacity and by improving the efficiency and network of distribution channels. The present system of arrangement of distribution of fresh notes and coins and withdrawal of soiled notes would be reviewed for establishing a more effective distribution network for currency management. The strategy would be to reap efficiency gains through the mechanisation of note processing in all the Issue offices in a phased manner to supplement the manual system for a quicker disposal of notes. The shredding and bri-quetting systems compatible with the CVP systems in the offices would be put in place in a phased manner for the eco-friendly disposal of soiled notes. Increasing emphasis would be placed on computerisation of cash operations in the Reserve Bank offices in a phased manner for effective and efficient handling of increasing volumes of cash demand across geographical areas. Necessary measures would be taken to improve the longevity of notes by obviating multiple stapling of bank note packets which along with other measures would help realise the objective of clean and efficient notes circulation.

PAYMENT AND SETTLEMENT SYSTEMS

13.1 The Reserve Bank has been playing a central role in the reform of the payment and settlement system in India, particularly since January 1995. While the apex-level National Payments Council, constituted by the Reserve Bank in May 1999, lays down the broad policy parameters, the design and development of a national state-of-the-art robust payment and settlement system is entrusted to a multi-disciplinary Payment Systems Group which is guided by the Payment Systems Advisory Committee.

13.2 Modernisation of the payment and settlement system has been accorded high priority in the agenda of financial sector reforms in India during the 1990s in view of its role as a key determinant of the efficiency of financial intermediation and financial system stability. Technology has been the driving force behind the payment and settlement system reforms. While computerisation has been at the base of the reform process, connectivity of branches of banks by means of networking of computers and inter-connectivity of banks has been a focus area of attention. The operatio-nalisation of the INdian FInancial NETwork (INFINET) in June 1999, by the Institute for Development and Research in Banking Technology (IDRBT), Hyderabad represents a major step forward in providing a communication network for the exclusive use of banks and financial institutions in the form of a Closed User Group.

13.3 Reforms in the payment and settlement systems have been driven by the three-pronged approach of consolidation, development and integration. The consolidation of the existing payment systems in the form of Computerised Cheque Clearing (CCC), Electronic Clearing Services (ECS) and Electronic Funds Transfer (EFT) was a thrust area during the year. Development included initiatives aimed at opening new clearing houses, designing multiple net settlement systems, technology upgradation relating to modes of payment and funds transfer and the implementation of systems aimed at better funds management by banks and their constituents. The integration of these strategies within the Reserve Bank and across the financial sector would ensure completion of the reform process. The ultimate objective is to set up a Real Time Gross Settlement (RTGS) system in an on-line environment in which various payment and settlement systems would be integrated. Several factors have impacted upon the pace and sequencing of payment system reform, *viz.,* (i) the different degrees of computerisation in the financial system; (ii) geographical spread of the banking sector; (iii) defining the regulatory role of the Reserve Bank in relation to the payment systems; (iv) systemic risks in payment and settlement systems; (v) legal infrastructure; and (vi) impact of payment and settlement system reforms on the conduct of monetary policy.

13.4 The Reserve Bank proposes to continue developmental efforts aimed at the setting up of an efficient state-of-the-art payment and settlement system. With a view to moving to the RTGS, the implementation of the initial modules and the development of an IAS have been planned in the immediate future. Pending a full-scale RTGS, the CFMS would be extended. Full imaging is proposed to be implemented at all the four National Clearing Cells (NCC) managed by the Reserve Bank. Besides, the Reserve Bank plans to put in place the NDS and to operationalise the Securities Settlement System by extending the INFINET services to all the banks and eligible financial institutions, with suitable PKI security features. The Reserve Bank would prepare a payment system 'Vision Document' to lay the road map for the adoption of the measures recommended for payment system reforms. The enactment of suitable electronic funds related acts including those for payment systems using electronic channels would also be necessary to develop an efficient payment and settlement system.

HUMAN RESOURCE DEVELOPMENT AND ORGANISATIONAL MATTERS

14.1 The content of human resource development (HRD) within the Reserve Bank has been undergoing significant changes along with the complexities characterising its role in the emerging economic and financial environment. Within the constraints of a relatively rigid organisational, pay and staff structure, the Reserve Bank has been following a strategy of meeting the evolving requirements through innovations in the approach to the development of a professional cadre and fortification of human skill formation through training, promotion, recruitment and transfers. There is an increasing emphasis, to the extent feasible, on the need for constant improvement and adaptation in strategies for placement, career development, performance management, incentive structures and organisational re-engineering.

THE RESERVE BANK’S ACCOUNTS FOR 2000-01

15.1 The key financial results of the Reserve Bank’s operations during the year are presented in this section.

INCOME

15.2 The total income of the Reserve Bank for the year 2000-01 (July-June), declined by Rs. 112.10 crore (0.5 per cent) from Rs. 21,960.97 crore to Rs. 21,848.87 crore. The decline in income was mainly due to decrease in earnings from domestic sources. However, the earnings from foreign sources increased substantially; its share in total income also increased from 29.7 per cent in 1999-2000 to 46.2 per cent in 2000-01.

Income from Foreign Sources

15.3 During the accounting year ended June 30, 2001, the Reserve Bank's net earnings from the deployment of foreign currency assets including gold increased by Rs. 3,571.35 crore (54.8 per cent) from Rs.6,514.73 crore in 1999-2000 to Rs.10,086.08 crore in 2000-01 due to the higher average level of foreign currency assets at Rs.1,68,577 crore in 2000-01 as against Rs.1,40,275 crore in 1999-2000 and also a higher return on these assets.

Income from Domestic Sources

15.4 Domestic income declined by Rs.3,683.45 crore (23.8 per cent) from Rs.15,446.24 crore in 1999-2000 to Rs.11,762.79 crore in 2000-01. This was mainly due to the decline of Rs.3,198.31 crore in the profits booked on sale of Rupee Securities *i.e.*, from Rs.3,280.54 crore in 1999-2000 to Rs.82.23 crore in 2000-01.

EXPENDITURE

15.5 Total expenditure of the Reserve Bank increased by Rs. 246.60 crore (4.6 per cent) from Rs. 5,340.92 crore in 1999-2000 to Rs. 5,587.52 crore in 2000-01. The increase was largely in respect of non-establishment expenses.

Interest Payment

15.6 Interest payment increased by Rs.22.92 crore (1.2 per cent) from Rs.1,971.88 crore in 1999-2000 to Rs.1,994.80 crore in 2000-01.

Establishment Expenditure

15.7 Establishment expenditure increased by Rs. 24.10 crore (2.8 per cent) from Rs.846.75 crore in 1999-2000 to Rs.870.85 crore in 2000-01.

Non-establishment Expenditure

15.8 Expenditure towards agency charges decreased by Rs.32.92 crore (2.8 per cent) from Rs.1,193.62 crore in 1999-2000 to Rs.1,160.70 crore in 2000-01. However, expenditure on security printing, comprising cost of printing of currency notes, cheque forms *etc.,* increased by Rs. 54.34 crore (5.1 per cent) from Rs.1,068.44 crore in 1999-2000 to Rs.1,122.78 crore in 2000-01 mainly due to the rise in supplies of note forms. Further, the expenditure under the head 'Printing and Stationery' which includes computer consumables and related software, has increased by Rs.75.83 crore from Rs. 12.93 crore during 1999-2000 to Rs. 88.76 crore during 2000-01 on account of the replacement of the cheque processing software for use in the mainframe computer systems in the National Clearing Cells (NCCs) of the Reserve Bank at the four metropolitan centres.

APPROPRIATION

Net Disposable Income

15.9 The net disposable income of the Reserve Bank for the year 2000-01 amounted to Rs.9,354.00 crore. Since 1991-92, transfers to statutory funds on a significant scale have been discontinued. However, pending amendment to the Reserve Bank of India Act, 1934 for vesting in the Reserve Bank the discretion in the matter of transfer to statutory funds from the profits of the Reserve Bank, a token contribution of Rupees one crore each, has been made to the four funds.

Surplus transferable to Government of India

15.10 The surplus transferable to the Central Government for the year 2000-01 amounted to Rs.9,350 crore, inclusive of Rs.1,479 crore towards interest differential on special securities converted into marketable securities. In the year 1997-98, special securities of the order of Rs.20,000 crore carrying interest at 4.6 per cent per annum held by the Reserve Bank were converted into marketable securities at market related rates to augment the stock of eligible securities in the Reserve Bank's investment portfolio for open market operations. The above transfer is intended to compensate the Government for the difference in interest expenditure, which the Government had to bear consequent upon the conversion.

BALANCE SHEET

Liabilities

National Industrial Credit (Long Term Operations) Fund

15.11 The National Industrial Credit (Long Term Operations) Fund was established by the Reserve Bank in July 1964 with an initial corpus of Rs.10 crore and annual contributions from the Reserve Bank's disposable surplus in terms of Section 46-C(1) of the Reserve Bank of India Act, 1934 for the purpose of making loans and advances to eligible financial institutions. Consequent upon the announcement in the Union Budget for 1992-93, the Reserve Bank decided to discontinue the practice of crediting large sums to the said Fund. Subsequently, no further disbursements from the Fund have been made. It was decided in 1997-98 to transfer the unutilised balance in the Fund arising from repayments to Contingency Reserve (CR) on a year-to-year basis. Accordingly, an amount of Rs.400 crore has been transferred to CR in 2000-01 as against Rs.350 crore transferred in the preceding year.

Exchange Fluctuation Reserve and Exchange Equalisation Account

15.12 Gains/losses on valuation of foreign currency assets and gold due to movements in the exchange rates and/or prices of gold are not booked in profit and loss account but in a separate account called Exchange Fluctuation Reserve (EFR), which represents accumulated net gain on valuation of foreign currency assets and gold. During 2000-01, there was an accretion of Rs.1,516.01 crore to the EFR raising the balance to Rs.29,124.44 crore as on June 30, 2001 from Rs.27,608.43 crore as on June 30, 2000. This was mainly on account of appreciation in the value of foreign currency assets. The EFR at the end of June 2001 was equivalent to 14.2 per cent of foreign currency assets and gold holdings of the Reserve Bank, as against 16.8 per cent at the end of June 2000. The balance in Exchange Equalisation Account (EEA) is utilised to meet

exchange losses on accrual basis in respect of liabilities under schemes involving exchange guarantees provided by the Reserve Bank in respect of funds parked by Indian Financial Institutions. After meeting the exchange difference on foreign currency funds parked by these institutions (since withdrawn fully on February 5, 2001), the balance in the EEA as on June 30, 2001 stood at Rs.49.46 crore.

Contingency Reserve and Asset Development Reserve

15.13 The Reserve Bank maintains a Contingency Reserve (CR) to enable it to absorb unexpected and unforeseen contingencies. The Reserve Bank has been pursuing a pro-active policy of strengthening the CR and has accordingly set an indicative target of 12 per cent of the Reserve Bank's total assets to be achieved in phases by the year 2005, subject to review, if considered essential. The balance in CR has gone up from Rs.29,911.56 crore as on June 30, 2000 to Rs.36,514.13 crore as on June 30, 2001 due to the transfer of Rs.6,202.57 crore from income and transfer of the unutilised balance of Rs.400 crore from National Industrial Credit (Long Term Operations) Fund in 2000-01. The balance in CR was sufficient to meet contingent liabilities as on June 30, 2001.

15.14 In order to meet the internal capital expenditure and make investments in its subsidiaries and associate institutions, the Reserve Bank had created, in 1997-98, a separate Asset Development Reserve (ADR) with the aim of reaching one per cent of the Reserve Bank's total assets within the overall target of 12 per cent set for CR. In the year 2000-01, an amount of Rs.704.78 crore was transferred from income to ADR raising its level from Rs.3,167.85 crore as on June 30, 2000 to Rs. 3,872.63 crore as on June 30, 2001. As a proportion of total assets, CR and ADR together constituted 9.9 per cent of total assets of the Reserve Bank as on June 30, 2001 as against 9.2 per cent as on June 30, 2000.

ASSETS

Foreign Currency Assets

15.15 The foreign currency assets comprise foreign securities held in Issue Department, balances held abroad and investments in foreign securities held in Banking Department. Such assets rose from Rs.1,50,901.13 crore as on June 30, 2000 to Rs.1,91,226.06 crore as on June 30, 2001. In US dollar terms, these assets rose from US $ 33.77 billion as on June 30, 2000 to US $ 40.65 billion as on June 30, 2001.

Investment in Government of India Rupee Securities

15.16 Investment in Government of India Rupee Securities which stood at Rs.1,48,908.36 crore as on June 30, 2000 increased by Rs.8,119.05 crore (5.5 per cent) to Rs. 1,57,027.41 crore as on June 30,2001.

Investments in Shares of Subsidiaries and Associate Institutions

15.17 The Reserve Bank's investments in the shares of its subsidiaries and associate institutions have increased by Rs.1,200 crore on account of conversion of advance contribution made towards capital of NABARD (during the period from 1996-97 to 1998-99) into its capital and transfer of the same amount to the Reserve Bank's investment account during the current accounting year

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* 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 up to June 2001, and in some areas, information beyond end-June 2001 is also discussed. For the purpose of analysis and for providing proper perspectives on policies, references to past years as also prospective periods, wherever necessary, have been made in this Report.