PART ONE : THE ECONOMY : REVIEW AND PROSPECTS

I - Macroeconomic Policy Environment

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Introduction

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 sevenfold 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 co-operatives including changes in co-operative 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. Disinvestment 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 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 (Box I.1).

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.

Box I.1

Liquidity Adjustment Facility : Stage II

- Standing Liquidity Facilities split into (i) normal facility at the Bank Rate, and (ii) back-stop facility at variable daily rate at 1 percentage point above reverse repo cut-off rate in LAF auctions or 2-3 percentage point above repo cut-off rate in the absence of emergence of rate at the reverse repo auctions, or 1-3 percentage point above NSE –MIBOR when no bids for repo or reverse repo auctions have been received/accepted as the case may be as decided by the Reserve Bank.
- Normal facility constitutes about 2/3 rd and back-stop facility about 1/3rd of total limits of standing liquidity support available to PDs and banks.
- Export credit refinance up to 15 per cent of outstanding export credit eligible for refinance as at the end of second preceding fortnight or existing limit as on May 4, 2001 as per the old formula whichever is higher applicable till March 31, 2002.
- Minimum bid size for LAF reduced from Rs.10 crore to Rs.5 crore.
- LAF timing advanced by 30 minutes to 10.30 a.m. for receipt of bids and 12 noon for announcement of results.
- Information on aggregate cash balances maintained by banks with the Reserve Bank to be made available to market on a cumulative basis during the reporting fortnight, with a lag of 2 days.
- Option to switchover to fixed rate repos on overnight basis.
- Option to introduce repos up to 14-day maturity.
- Multiple price auctions in place of uniform price auctions.

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 (details are given in Section IX). 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 (for details, see Section X).

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 (for details, see Section X). 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 (for details, see Section X).

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 (for details, see Section X).

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 (see Box X.4).

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 subsystem 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 (for details see Section X).

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 framework 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 coordination 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 (Box I.2).

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 (Table 1.1).

Box I.2
Disaster Management : Existing Arrangements

The country experienced a series of natural disasters in the 1990s such as earthquakes in Maharashtra (1993) and Gujarat (2001), floods in Andhra Pradesh (1996), Bihar, Kerala and Orissa (2001), the super-cyclone in Orissa (1999) and severe drought in Gujarat, Rajasthan and Madhya Pradesh in the last two years. These shocks have adversely affected both agricultural and industrial production, apart from resulting in loss of life and property.

Under the current institutional arrangements, the primary relief functions of the Central Government relate to forecasting and operation of a warning system and publicising the warnings on impending calamity, provision of transport with particular reference to evacuation and movement and ensuring supply of essential commodities and medicines, maintenance and restoration of physical communication links and mobilisation of financial resources. The secondary relief measures relate to flood/ inflow forecasts from the Central Water Commission, relief rehabilitation and restoration through various agencies, contingency plans for crops, cattle preservation, nutrition and health measures, technical and technological inputs for provision of drinking water, and assistance in water management for various uses and co-ordination of the activities of the State agencies and voluntary agencies.

The Eleventh Finance Commission (EFC) recommended the continuation of the provision of Calamity Relief Fund (CRF) with contribution from the Centre and the State in the ratio of 75:25. Natural calamities such as cyclones, droughts, earthquakes, fire, floods and hailstorms are eligible for relief under the CRF. A National Calamity Contingency Fund (NCCF) with an initial coupon of Rs.500 crore has been set up to assist the States in case of calamity of severe nature where States are not in a position to provide necessary relief.

An international Programme for Enhancement of Emergency Response (PEER) was established with external aid from the Office of United States Foreign Disaster Assistance in April 1999. The programme has the objective of improving the search and rescue capability and performance of first responders from Government and non-Government agencies and will be carried out in three phases. Phase I (1999-2001) of the programme concentrates on establishing a management unit within the Asian Disaster Preparedness Centre (ADPC) and identifying international partners. Phase II (2001-2003) of the Programme will concentrate on course of development and adaptation by conducting training courses. Phase III (2004-06) aims at expanding the Programme to other Asian countries while at the same time continuing to promote and support the integration of the program in all training institutions and their on-going programs. A United Nations Development Project (UNDP) for strengthening disaster management capacity is also in operation under which the National Centre for Disaster Management would be upgraded as the Indian Institute of Disaster Management and a National Disaster Management Plan has been formulated. India is actively participating in various international fora on disaster management.

Table 1.1 : Macroeconomic Parameters for the Tenth Plan

(Per cent)

	Item	Base-Line	Target
	1	2	3
1.	Average GDP growth rate	6.5	8.0
2.	Gross Investment Rate	27.8	32.6
3.	Implicit ICOR	4.28	4.08
4.	Current Account Deficit	1.5	2.8
5.	Gross Domestic Saving	26.3	29.8
	5.1 Government	-0.6	1.7

Source : Draft Approach Paper to the Tenth Five Year Plan (2002-2007), Planning Commission, Government of India, May 2001.

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.

* 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.