VII - Assessment and Prospects

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

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

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

7.4 Reserve money increased by 0.1 per cent during the current financial year up to August 10 as against a decline of 1.2 per cent during the corresponding period of the previous year. Net Reserve Bank credit to the Centre decelerated to 9.9 per cent (Rs.14,497 crore) from 15.7 per cent (Rs.21,934 crore) during the corresponding period of 2000-01. Private placements/devolvements in Government securities of Rs.21,679 crore were partly offset by open market operations of Rs.16,050 crore. The Reserve Bank's net foreign currency assets (adjusted for revaluation) recorded an increase of Rs.7,544 crore in contrast to a decline of Rs.7,047 crore in the corresponding period of the previous year. The year-on-year M_3 expansion at 15.4 per cent (net of IMDs) as on July 27, 2001 was a little above the indicative target of about

14.5 per cent set for the year as a whole. Aggregate deposit growth of 16.2 per cent (net of IMDs) was buoyant in relation to the growth of 15.6 per cent recorded a year ago. Growth in currency with the public at 12.0 per cent remained strong as compared with 10.3 per cent in the previous year. Net bank credit to the Government accelerated to 8.9 per cent during 2001-02 (up to July 27) from 8.6 per cent in the comparable period of the previous year, reflecting the absorption of the market borrowing programme of the Centre. Bank credit to the commercial sector decelerated to 1.9 per cent from 2.6 per cent during the same period on account of significantly lower off-take of non-food credit of scheduled commercial banks at Rs.1,714 crore from Rs.14,482 crore during April-July, 2000. Scheduled commercial banks' investments in non-SLR securities increased by only Rs.495 crore during April to mid-July, 2001 as against an increase of Rs.4,307 crore in the corresponding period of the preceding year. Accordingly, scheduled commercial banks' non-food credit adjusted for their non-SLR investments increased by Rs.2,209 crore up to end-July, 2001; in April-July of the preceding year, the increase in the adjusted non-food credit extended by scheduled commercial banks had been of the order of Rs.18,967 crore. Food credit extended by scheduled commercial banks for procurement operations rose to Rs.11,036 crore from Rs.7,117 crore in April-July, 2000. Inflation, measured by the year-on-year change in wholesale prices, declined to 5.2 per cent by August 4, 2001 from 6.3 per cent a year ago. The easing of inflationary pressures was also reflected in the movement of the average wholesale prices as well as consumer prices during the current financial year.

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

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

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

2001. The foreign exchange market was active, with occasional bunching of demand setting off movements in the spot exchange rate. Forward premia eased across all maturities in June, 2001 after a temporary hardening in May, 2001 tracking the rise in the call rates.

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

Prospects for Growth

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

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

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

7.12 A major concern arising out of the performance of the economy during 2000-01 is the relative role of global and domestic factors in determining the duration of the current phase of activity. Given the relatively low degree of openness of the economy, the recent slowdown is predominantly ascribed to domestic conditions –demand slowdown, sluggishness in supply responses and supply side constraints. There is also the view that the economy is part of the global developments and irrespective of the degree of openness, India cannot be immune to the global economy. While there is still considerable uncertainty, it is widely expected that the world GDP growth would be substantially lower in 2001 as compared with a high growth of 4.8 per cent in the previous year, due to the slowdown of the US economy. A favourable factor this year is that the international inflationary environment is reasonably benign. Low inflationary expectations have facilitated substantial reduction in international interest rates in order to revive economic activity in major industrial countries. India cannot but reckon the impact of these global developments though for several reasons, including its relatively small share of trade, GDP growth in India is unlikely to be as seriously affected by these developments, as in many other countries. While merchandise exports growth may moderate, software exports with more diversified destinations and private remittances may still be maintained.

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

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

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

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

Issues in Agriculture

7.17 In the second half of the 1990s, real GDP growth originating in agriculture and allied activities slowed down significantly to 3.2 per cent from 4.5 per cent in the 1980s, exhibiting considerable variability and recording absolute declines in the third and fourth quarters of 1999-2000 and again in the last quarter of 2000-01. The annual trend growth rate of agricultural production decelerated to 2.2 per cent in the 1990s from 3.1 per cent in the 1980s. The share of capital formation in agriculture as a proportion to gross capital formation has declined from 9.9 per cent in 1990-91 to 8.0 per cent in 1999-2000. The decline in capital formation has been more pronounced in the public sector, reflecting the persistent and large revenue deficits. The share of agriculture and allied activities in total Plan outlay declined from 6.1 per cent in the Sixth Plan Period to an estimated 4.9 per cent in the Ninth Plan Period. The share of irrigation and flood control in total outlay also shrunk from 10.0 per cent to an estimated 6.5 per cent over the Plan periods.

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

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

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

Industrial Revival: Problems and Prospects

7.21 Industrial production slowed to an annual average growth rate of 6.6 per cent in the post-reform period from 7.8 per cent in 1980s. In the first four years of the Ninth Plan period, *i.e.*, up to 2000-01, industrial production grew at 5.6 per cent per annum. Given the continuing slowdown in the first quarter of the current financial year, it is likely to clearly remain well below the target growth of 8.2 per cent per annum set for the Plan period 1997-2002. Subdued investment demand reflected in the low growth of capital goods output, decline in power generation, the deceleration in the production of basic and intermediate goods and inventory accumulation in some industries are factors which reflect the phase of the cycle through which the industrial sector is transiting.

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

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

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

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

7.26 The new economy sectors continue to enjoy a competitive edge, despite the underlying domestic industrial conditions and the global slowdown. The fast growing sectors, *i.e.*, software, knowledge-based industries, information technology (IT) enabled services, pharmacology, biotechnology and entertainment services carry the potential of generating increasing returns to scale and sustaining the step-up in the growth path of the economy. These industries have the inherent confidence and the capabilities to expand rapidly and command global leadership. A critical enabling requirement for accelerated growth of these sectors is the expeditious removal of procedural and institutional constraints on production, marketing and international trade.

External Sector

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

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

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

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

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

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

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

Fiscal Policy Issues

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

Paper to the Tenth Plan.

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

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

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

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

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

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

7.41 The prohibition of direct borrowings by the Central Government from the Reserve Bank under the Fiscal Responsibility and Budget Management Bill, except by way of advances to meet temporary cash needs in certain circumstances, is of particular relevance to the flexibility in the conduct of monetary policy consistent with its objectives. The exit of the Reserve Bank from the primary market does not prohibit participation of the Reserve Bank in the secondary market and does not eliminate monetisation; however, the scope for private placement of debt or devolvement of auctions of public debt on the Reserve Bank is eliminated. Thus, the extent of monetisation and terms of such monetisation would depend on the judgement of the Reserve Bank in regard to overall stability. Such operational freedom is essential to assure the system that conduct of monetary policy balances the three relevant elements, *viz.*, the fiscal needs of government, the compulsion of a deregulated interest rate regime and requirements of a more open external sector. In fact, separation of functions of a public debt manager from that of monetary authority needs to be viewed in this context.

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

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

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

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

The Conduct of Monetary Policy

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

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

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

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

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

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

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

Financial Sector Reforms

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

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

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

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

Securities Trading Corporation would be completely divested during 2001-02.

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

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

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

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

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

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