Summary of the Report of the Central Board of Directors on the Working of the Reserve Bank of India for the Year ended June 2002

*For the Year July 1, 2001 to June 30, 2002**

PART ONE : THE ECONOMY : REVIEW AND PROSPECTS

I MACROECONOMIC POLICY ENVIRONMENT

Introduction

1.1 Policies for macroeconomic management in 2001-02 were geared to initiate and nurture the recovery of industrial activity and exports against the backdrop of sluggishness in several industries and the deepening of the synchronised slowdown characterising the global economy. A robust recovery in agricultural performance, comfortable food stocks, record lows in inflation, and a strong improvement in the balance of payments reflected in a large accretion to the foreign exchange reserves provided the enabling environment for the macroeconomic policy stance.

1.2 Real sector policies were guided by the objective of boosting domestic investment demand by expanding the participation of private enterprise and by promoting foreign investment. Trade policies focussed on an aggressive medium-term export strategy, both product- and market-specific, within the overall goal of raising India's share in world exports over a five-year span. The process of removal of quantitative restrictions (QRs) and the reduction/ rationalisation of tariffs was carried forward. Foreign investment policy extended the liberalisation of extant ceilings on foreign direct investment (FDI) in various sectors. Liberalisation was also effected in respect of the participation of foreign institutional investors (FIIs) in Indian corporate entities. Norms for overseas issuances by Indian companies and Indian direct investment abroad were eased significantly along with procedural simplifications. Fiscal policies renewed the commitment to consolidation and rectitude alongside a six-pronged strategy to reinvigorate the economy and return to a growth path consistent with its potential. Monetary policy continued its stance of ensuring adequate liquidity to meet credit demand, and pursued the objective of softening of interest rates consistent with a vigil on price stability. Channels of credit delivery were refined and augmented and the operational effectiveness of monetary policy was improved as an integral part of building the institutional infrastructure of an efficient and vibrant financial system. Banking and financial sector reforms were intensified with continued emphasis on deregulating the policy environment to enhance the operational efficiency of financial intermediaries, strengthening these institutions by benchmarking prudential standards against international best practices, improving the regulatory and supervisory function, and enhanced transparency, accountability and market discipline.

REAL SECTOR POLICIES: AGRICULTURE AND INDUSTRY

Agriculture

1.3 A number of steps were undertaken to reduce foodgrain stocks that are posing problems of storage and disposal. QRs on export of several food items including wheat and wheat products, coarse grains and pulses were dismantled in March 2002. The 'First In First Out' (FIFO) condition for export of foodgrains from the Food Corporation of India (FCI) stocks – requiring disposal of old stocks before newer arrivals could be sold - was waived in

June 2001. The Central Issue Price (CIP) of wheat and rice was lowered by around 26 per cent in July 2001 for the Above Poverty Line (APL) consumers so as to increase the off-take under the Targeted Public Distribution System (TPDS). The quantum of foodgrains for the Below Poverty Line (BPL) consumers was increased to 35 kilograms per household. The Public Distribution System (PDS) was converted into a statutory entity in September 2001. The policy of dividing the country into five zones for selling subsidised wheat in the open market was removed in January 2002. Each State would be treated as a separate zone and the actual freight cost incurred by the FCI in transporting wheat to that State would be charged.

1.4 Several new initiatives under the "save grain campaign scheme" to reduce losses of foodgrains during the post-harvest period were initiated in 2001-02, including creation of additional storage capacities (estimated at 54 lakh tonnes), creation of additional capacity for bulk handling, storage and transportation facilities and creation of conventional godowns through private sector participation. Grain banks are proposed to be established in various locations of the country.

1.5 Forward trading was allowed in sugar in April 2001. A package of policy measures aimed at boosting sugar exports and forward trading was announced in November 2001. Three exchanges were given 'in-principle' approval to carry futures trading in sugar. A consortium was given an 'in-principle' approval to set up a multi-commodity exchange to undertake futures and spot trading in 30 commodities in July 2001.

1.6 A key objective of fiscal policy for 2002-03 is the acceleration of agricultural reforms, the removal of regulatory and procedural rigidities and an improved infrastructure in the agricultural sector. Assistance from Rural Infrastructure Development Fund (RIDF) is linked to reforms in the agriculture and rural sectors and funds for RIDF-VIII have been enhanced. The allocation for the Accelerated Irrigation Benefit Programme (AIBP) was also stepped up.

Manufacturing, Infrastructure and Services

1.7 FDI up to 100 per cent was permitted in a wide range of manufacturing activity and commerce, in special economic zones (SEZs) and in telecommunications, airports (including concessions for private sector participation in greenfield airports proposed in the Union Budget, 2002-03), courier services, drugs and pharmaceuticals, and hotel and tourism sectors. The defence sector was opened up for private participation. The Union Budget for 2002-03 put in place a tourism development package consisting of development of six tourism circuits to international standards during 2002-03 and permission for Special Purpose Vehicles (SPVs) to raise resources from both public and private sectors for infrastructure development in these circuits. Steps were also taken to address infrastructural constraints through the implementation of the National Highway Development Project, expansion in the ambit of National Telecommunication Policy (1999) through opening up of Domestic Long Distance telephony, and introduction of the Convergence Commission of India Bill (2001) in the Parliament. An Infrastructure Equity Fund of Rs.1000 crore was set up for providing equity investment for infrastructure projects.

1.8 The new policy for the automobile industry, announced in March 2002, allows foreign equity investment up to 100 per cent in this sector without any minimum capitalisation norms. It aims to promote the Indian automotive industry as globally competitive, with a balanced transition to open trade at minimal risk to the Indian economy and local industry. In the Union Budget, 2002-03 manufacturing of some auto components has been de-reserved. The Government is also planning to remove the outstanding export obligation of auto companies, given the imperatives of the Word Trade Organisation (WTO).

1.9 The Plan outlay on power, roads and national highways and railways was enhanced

substantially to step up public investment in infrastructure. Measures were taken to address the issue of appropriate user charges necessary to provide adequate returns on investment. In the power sector, the focus of reforms shifted from generation to transmission and distribution. The Accelerated Power Development Programme (APDP) is being redesigned as the Accelerated Power Development and Reform Programme (APDRP) with enhanced Plan allocation. Access of the States to the fund under the Programme will be on the basis of agreed reform programmes.

EXTERNAL SECTOR POLICIES

Trade Policies

1.10 The Medium Term Export Strategy 2002-07 (MTES) announced in January 2002 sets out a road map for the export sector which would be co-terminus with the Tenth Five-Year Plan period. The MTES aims at increasing India's share in world trade to one per cent by 2006-07 from the present level of 0.67 per cent. This implies doubling exports from the present level. The MTES includes product (220 commodities) and market identification for exports and indicative sector-wise strategies for identified potential sectors. Export market diversification is also a major objective of the Export and Import (EXIM) Policy with special focus on sub-Saharan Africa and the Commonwealth of Independent States (CIS).

Export and Import (EXIM) Policy (2002-2007)

1.11 The Five-Year EXIM policy for the period 2002-2007 announced on March 31, 2002 includes, *inter alia,* removal of all QRs on exports (except a few sensitive items reserved for exports through State Trading Enterprises), a farm-to-port approach for exports of agricultural products, special focus on cottage sector and handicrafts, and assistance to States for infrastructural development for exports (ASIDE).

1.12 28 Agri Export Zones (AEZs) were sanctioned in 14 states to promote the export of agro products and agro-based processed products. Export capabilities of the small scale sector, which accounts for about 50 per cent of India's exports, were strengthened through a programme for "Special Focus on Cottage Sector and Handicrafts" including promotion of cottage sector exports under Khadi and Village Industries Commission (KVIC), access to funds from Market Access Initiative (MAI) for units in the handicrafts sector, exemption from maintenance of average level of exports under Export Promotion Capital Goods (EPCG) Scheme, duty-free imports of specified items up to three per cent of the Free-on-Board (FoB) value of exports and benefit of export house status at a lower average export performance (Rs.5 crore). Similar incentives would be extended to industrial cluster-towns with export potential like Tirupur (hosiery), Panipat (woollen blankets) and Ludhiana (woollen knitwear).

1.13 Several measures including reduction in customs duty on imports of rough diamonds to zero and abolition of licensing regime for rough diamonds were undertaken to enable India to emerge as a major international centre for diamonds. Important measures were taken to give a fillip to jewellery exports, including reduction in value addition norms for export of plain jewellery from 10 per cent to 7 per cent and allowing mechanised unstudded jewellery exports at a value addition of only 3 per cent.

1.14 Facilities for SEZs under the EXIM policy include income tax concessions, exemption from Central Sales Tax (CST) on supplies from the Domestic Tariff Area (DTA), drawback/ Duty Entitlement PassBook (DEPB) to DTA suppliers, exemption from external commercial borrowing restrictions, freedom to make overseas investment and carry out commodity hedging. For the first time, Overseas Banking Units (OBUs) exempt, *inter alia,* from CRR

and SLR stipulations, would be set up in SEZs to provide access to external finance at international rates. In a post-budget announcement, 100 per cent deduction of export profits was allowed to all SEZ units commencing production on or after April 1, 2002 for a period of five years and thereafter at 50 per cent for the next two years. Supplies to SEZs from the DTA would be treated as physical exports instead of deemed exports for the purposes of duties, tariffs and central sales tax under the Income Tax Act and Customs Act.

1.15 In order to give a boost to the hardware industry, the Electronic Hardware Technology Park (EHTP) Scheme was modified to enable the sector to avail of the zero duty regime under the Information Technology Agreement (ITA-I). Net foreign exchange earning as a percentage of exports (NFEP) for these units has to be positive in five years instead of every year. There would be no other export obligation for EHTPs and supplies of ITA-I items with zero duty in the domestic market would be eligible for counting of export obligation.

1.16 Rationalisation and procedural simplification has been undertaken in respect of the Duty Free Replenishment Certificate (DFRC), DEPB, EPCG Scheme and Advance Licence Scheme (ALS). Various facilities would be extended to status holders like direct negotiation of export documents, 100 per cent retention in Exchange Earners' Foreign Currency (EEFC) accounts and extension of the repatriation period for realisation of export proceeds from 180 days to 360 days. With a view to further reducing transaction costs, various procedural simplifications are being introduced in the Directorate General of Foreign Trade (DGFT) and customs procedures.

1.17 Transport subsidy was extended to units located in North Eastern States, Sikkim and Jammu & Kashmir to offset the disadvantage of being far from ports. In order to encourage re-location of industries to India, import of plant and machineries was permitted without a licence where the depreciated value of such relocating plants exceeds Rs.50 crore.

Budget Proposals Relating to Customs Duties

1.18 Major changes relating to customs duties effected in the Union Budget for 2002-03 include reduction in the peak rate of customs duty from 35 per cent to 30 per cent, increase in the customs duties of tea and coffee (from 70 per cent to 100 per cent), spices, *i.e.,* pepper, cloves and cardamoms (from 35 per cent to 70 per cent), natural rubber and poppy seeds (from 35 per cent to 70 per cent), pulses (from 5 per cent to 10 per cent) and imposition of duty of 30 per cent on such non-edible oils that contain 20 per cent or more of free fatty acid.

1.19 The customs duty on dairy products was hiked to the WTO bound rate of 40 per cent from 30 per cent. The customs duty on imported liquors was reduced from 210 per cent to the bound rate of 182 per cent in accordance with WTO commitments; the rates of countervailing duty (CVD) applicable to liquors and wines were rationalised.

1.20 There was a reduction in customs duty on IT products. Customs duty on specified items of reeling, twisting, weaving and processing machinery for silk textile industry was reduced from 25 per cent to 10 per cent. These items were exempted from Central Value Added Tax (CENVAT) along with 28 items of processing machinery, automatic shuttle looms and specified jute machinery; these concessions would be available up to February 28, 2005.

Post-Doha Developments

1.21 The Doha Declaration of November 2001 comprising a main Declaration, a Declaration on Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement and Public Health and a decision on implementation related issues and concerns sets out the future Work Programme of the WTO. The negotiating mandate focuses on reducing or eliminating tariff peaks and escalations as well as non-tariff barriers. With regard to General Agreement on

Trade in Services (GATS), members are to make requests for market access by June 30, 2002 and initial offers of market access by March 31, 2003. India continues to focus on seeking enhanced market access for developing countries in future WTO negotiations. India has urged that that the work programe on implementation issues should be given the highest priority. Greater attention needs to be given to issues concerning Sanitary and Phyto-Sanitary Standards (SPS) and Technical Barriers to Trade (TBT) so as to fully realise gains in agriculture. India has also argued that the TRIPS agenda should reflect the concerns of developing countries. In the context of the Doha declaration, India has also called for a 'Development Coalition' of the bio-diversity rich countries of the world for the protection of traditional knowledge.

Policies for External Capital Flows

1.22 Various policy initiatives were undertaken to further liberalise the movement of cross-border capital flows especially in the area of outward foreign direct investment, inward direct and portfolio investment, non-resident deposits and external commercial borrowings.

Foreign Direct Investment

1.23 The policy framework governing inward foreign direct investment (FDI) was substantially liberalised under the automatic route. FDI up to 100 per cent was permitted under the automatic route for manufacture of drugs and pharmaceuticals, in the hotel and tourism sector and for mass rapid transport systems in all metropolitan cities (including associated commercial development of real estate). Similarly, airports, development of integrated townships, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, manufacture of building materials and courier services (subject to exclusion of activity relating to distribution of letters) were permitted 100 per cent FDI under the automatic route. FDI up to 49 per cent from all sources was permitted in the private sector banks under the automatic route.

Portfolio Investment

1.24 Indian companies were permitted in September 2001 to raise the 24 per cent limit on Foreign Institutional Investors' (FIIs) investment to the sectoral cap/statutory ceiling as applicable. As announced in the Union Budget for 2002-03, FIIs portfolio investment will not be subject to sectoral limits for FDI except in specified sectors. FIIs were allowed by the Reserve Bank on February 4, 2002 to trade in exchange traded derivative contracts subject to limits prescribed by the Securities and Exchange Board of India.

Non-Resident Deposits

1.25 Continuing with the policy of progressive liberalisation of the capital account, the non-resident non-repatriable (NRNR) account and nonresident special rupee (NRSR) account schemes were discontinued with effect from April 1, 2002. Existing accounts under the schemes would continue up to the date of maturity after which the amount would be credited to nonresident (external) accounts/nonresident (ordinary) accounts.

1.26 Ongoing liberalisation of current external transactions encompassed repatriation of current income like rent, dividend, interest and pension of nonresident Indians (NRIs) based on an appropriate certification. Indian corporates with proven track record were allowed to contribute funds from their foreign exchange earnings for setting up Chairs in educational institutions abroad, and for similar such purposes.

Indian Direct and Portfolio Investment Overseas

1.27 Existing limits for Indian direct investment outside India under the automatic route were raised to US $ 100 million. Two-way fungibility of American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) became operational with the issuing of guidelines by the Reserve Bank in February 2002. The transactions will be demand driven and the custodian will monitor the re-issuance of ADRs/GDRs. Foreign Currency Convertible Bonds (FCCB) up to US $ 50 million were brought under the automatic route.

External Commercial Borrowings and EEFC Accounts

1.28 The Reserve Bank allowed corporates on a case-by-case basis to credit even higher proportions of export proceeds to their EEFC accounts than 50/70 per cent allowed hitherto with a view to enabling them to take advantage of lower interest rates and prepay their external commercial borrowings.

FISCAL POLICY

1.29 The Union Budget for 2002-03 adopted a six-pronged strategy, *inter alia,* emphasising continuation of agricultural and food economy reforms, enhancement of public and private investment in infrastructure, strengthening the financial sector and capital markets, deepening structural reforms and regenerating industrial growth. The strategy for fiscal correction continues to rest on control of non-Plan expenditure, tax reforms, larger disinvestment proceeds and maintaining a higher growth in revenue relative to aggregate expenditure.

Expenditure Management

1.30 The prospects for expenditure management have been strengthened by the success achieved in containing non-Plan expenditure during 2001-02. The Union Budget 2002-03 envisages several measures for reinforcing the process of expenditure management. Various Ministries/Departments have identified around 17,200 posts for abolition, of which around 7,800 posts have been abolished so far. Fresh recruitments will be limited to one per cent of total civilian staff strength over the next four years. To contain the expenditure on subsidies, the Union Budget increased the issue price of urea and other fertilisers. Capital disbursements and the capital outlay have been enhanced in order to reverse the trend of fiscal adjustment occurring through reductions in public investment.

Tax Measures

1.31 The Union Budget aims at providing a modern tax regime with a view to reviving demand, promoting investment, accelerating economic growth and enhancing productivity. On the direct tax front, measures were aimed at further progress towards widening the tax base, rationalisation and simplification of tax structure and encouraging voluntary compliance. The two per cent surcharge for Gujarat earthquake relief was abolished and a surcharge of five per cent was imposed on all categories of tax payers except income up to Rs. 60,000. Tax on perquisites in case of employees with taxable salary (excluding perks) up to Rs.1,00,000 will be exempted from tax for 2002-03 and for the subsequent years the employer may opt to pay the tax on perquisites on behalf of the employees. Tax on distribution of dividend by domestic companies and mutual funds was abolished; however, the ultimate recipients of the income would be taxed as per the rate applicable to them. Corporation tax for foreign companies was reduced from 48 per cent to 40 per cent to correct the disparity between foreign companies and domestic companies.

1.32 Additional depreciation at the rate of 15 per cent was allowed on new plant and machinery acquired on or after April 1, 2002 for setting up of a new industrial unit or for expanding the installed capacity of existing units by at least 25 per cent to give stimulus to

the industrial sector. Banks were allowed to deduct up to 7.5 per cent (up from 5 per cent) of their total income against provisions made for bad and doubtful debts. Further, the optional deduction on account of non-performing assets (NPAs) falling in the category of loss or doubtful assets was enhanced from 5 per cent to 10 per cent and a similar option of deduction was allowed to public financial institutions.

1.33 Investment in bonds issued by Small Industries Development Bank of India (SIDBI) and National Housing Bank (NHB) were exempted from capital gains tax under 54EC. Tax concessions announced on July 31, 2002 include, *inter alia,* deductions from income derived from specified investments under Section 80L of the Income Tax Act raised from Rs. 9,000 to Rs. 12,000, no tax be deductible on dividend up to Rs. 2,500 received from each company or a mutual fund and exemption of life insurance premia from any service tax.

1.34 The indirect taxes were further simplified by reducing the number of items attracting special duty of 16 per cent. The tax base was expanded by including specified services provided by the corporate sector similar to services provided by banks and non-banking financial institutions. The peak rate of customs duty was reduced while rationalisation and simplification of the rate structure was carried further along with concessions for specified equipment for ports and airports and the civil aviation sector, the steel industry, IT hardware and units in Special Economic Zones.

Structural Reforms

1.35 The Union Budget, 2002-03 also provided momentum to the consolidation of structural reforms. A key policy change envisaged was the dismantling of the Administered Price Mechanism (APM) and Oil Pool Account from April 1, 2002. The outstanding balances in the Oil Pool Account would be liquidated by issue of oil bonds to the oil companies. The pricing of petroleum products would increasingly be determined by the market forces. Private companies will be permitted to undertake distribution, subject to specified guidelines to be overseen by a Petroleum Regulatory Board. The subsidy on Liquefied Petroleum Gas (LPG) and kerosene oil was reduced from April 1, 2002 and these subsidies are proposed to be phased out in the next 3 to 5 years.

1.36 Measures were outlined to enhance social security coverage. The Insurance Regulatory and Development Authority (IRDA) recommended a regulatory framework for setting up pension funds to enable individuals to subscribe on a defined contribution basis to obtain the benefit of pensions on their retirement. The public sector insurance companies will provide health insurance to the needy people in the rural areas under the scheme called “Janraksha”, which will enable a person to get treatment up to Rs.30,000 per year at selected and designated hospitals with a payment of Re. 1 per day as insurance premium. These initiatives are expected to accelerate the pace of pension reforms in India.

1.37 In order to encourage State-level fiscal reforms, the Union Budget provided additional allocations in respect of Centrally Sponsored Schemes –Accelerated Power Development and Reform Programme (APDRP), Accelerated Irrigation Benefit Programme (AIBP), Urban Reform Incentive Fund (URIF) and Rural Infrastructure Development Fund (RIDF).

1.38 Measures were taken to facilitate adequate credit flow to small scale industries and a new Laghu Udyami Credit Card (LUCC) Scheme was introduced for providing simplified and borrower friendly credit facilities to small businessmen, retail traders, artisans and small entrepreneurs, professionals and other self employed persons, including those in the tiny sector. A micro venture capital fund for small innovations is being set up by the Small Industries and Development Bank of India (SIDBI) in cooperation with the National Innovation Foundation to facilitate the transition of innovations into enterprises.

1.39 The Expert Committee to review the system of administered interest rate and other related issues (Chairman: Dr. Y.V. Reddy) provided a framework for reforms in the administered interest rate regime. In pursuance of the Committee's recommendations, the Union Budget, 2002-03 announced that interest rates on small savings would be linked to the average annual yield of government securities in the secondary market for the corresponding maturities. Such adjustments would be undertaken annually on automatic and non-discretionary basis, which would considerably reduce the rigidities of the interest rate structure in India.

MONETARY POLICY FRAMEWORK

1.40 During 2001-02, the Reserve Bank continued to ensure that all legitimate requirements for credit are met consistent with price stability. Towards this objective, the Reserve Bank continued its policy of active management of liquidity. The overall stance of monetary policy for 2001-02 was stated as: (i) provision of adequate liquidity to meet credit growth and support revival of investment demand while continuing a vigil on movements in the price level and (ii) within the overall framework of imparting greater flexibility to the interest rate regime in the medium-term, to continue the present stable interest rate environment with a preference for softening to the extent the evolving situation warrants. Banks and financial institutions were sensitised to the possibilities of a reversal or tightening of monetary policy in case the underlying inflationary situation turns adverse or there are unfavourable and unexpected external developments.

1.41 The measures undertaken in 2001-02 in pursuit of the monetary policy objective included, *inter alia,* a 50 basis point reduction in the Bank Rate effective October 23, 2001; a rationalisation of Cash Reserve Ratio (CRR) through a reduction of 200 basis points from 7.5 per cent to 5.5 per cent in two stages and withdrawal of exemptions from CRR on all liabilities other than inter-bank liabilities; freedom to banks to price loans at sub-PLR rates; rationalisation and reduction in ceiling rates on rupee export credit by one percentage point across the board effective September 24, 2001 up to September 2002; a 100 basis point reduction of the repo rate in three stages; and refinement of the Liquidity Adjustment Facility (LAF) and standing liquidity facilities.

1.42 The Bank Rate changes combined with CRR and repo rate changes have emerged as signaling devices for interest rate changes and important tools of liquidity and monetary management. The LAF has evolved as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a flexible manner and, in the process, providing a corridor for the call money market.

1.43 For the purpose of monetary policy formulation for 2002-03, the growth rate of real GDP in 2002-03 was placed at 6.0-6.5 per cent in the April 2002 Monetary and Credit Policy statement. The rate of inflation is assumed to be slightly lower than 4.0 per cent. The projected expansion in broad money (M3) and in aggregate deposits for 2002-03 is 14.0 per cent each and 15.0-15.5 per cent for non-food credit. Against this background, the Reserve Bank proposes to ensure that all legitimate requirements for credit are met during 2002-03 consistent with the objective of price stability. Towards this end, the Reserve Bank will continue its policy of active management of liquidity using the policy instruments at its disposal, whenever required. Unless circumstances change unexpectedly, the Reserve Bank will continue to maintain current interest rate environment with a bias towards softer interest rate regime in the medium-term. Furthermore, the long-term objective would be towards realignment of interest rates of all types of debt instruments, both the government and private sector, within a narrow band. The Reserve Bank will also continue its efforts to bring about development and smooth functioning of the financial market and pursue further financial

sector reforms towards achieving a greater degree of efficiency, transparency and financial stability.

1.44 In pursuit of the monetary and credit policy stance for 2002-03, the CRR was reduced by half a percentage point to 5.0 per cent which was to be effective from June 15, 2002 but was subsequently advanced to June 1, 2002. A flexible stance was indicated with respect to the Bank Rate with a reduction up to 50 basis points envisaged as and when necessary. Flexibility was sought to be imparted to interest rate policy by encouraging introduction of variable rate systems for deposits and transparency in disclosure of maximum spreads over Prime Lending Rates (PLRs) and various charges payable by borrowers. The ceiling rate on foreign currency export credit was reduced by 25 basis points.

FINANCIAL SECTOR REFORMS

1.45 Financial sector reforms in 2001-02 continued to focus on structural and regulatory measures with a view to strengthening the financial system and improving the functioning of the various segments of the financial markets. During 2002-03 so far, reforms in these directions have been accelerated with priority attached to developing the technological infrastructure of the financial system, a redefinition of the regulatory function of the Reserve Bank and a stronger vigil on asset-liability management in an environment characterised by the interaction of technology with deregulation.

Development and Regulation of Financial Markets

1.46 One of the main objectives of policy measures in the recent years has been to improve the functioning of financial markets by broadening and deepening the various segments and by equipping them with adequate infrastructure.

Money Market

1.47 Besides ensuring orderly conditions, the Reserve Bank took steps to develop the call/notice money market into a pure inter-bank market in a phased manner. Lending in call money market by non-bank participants was reduced to 85 per cent of their average lending in 2000-01. Corporates have been phased out of this market since July 1, 2001. Further scaling down of non-bank lending in the call/notice money market to 75 per cent would be considered once the Negotiated Dealing System (NDS) and Clearing Corporation of India Limited (CCIL) become fully operational and widely utilised. The standing liquidity support to the banks and primary dealers was also rationalised by apportioning two-thirds of the facility as a normal facility extended at the Bank Rate and the balance one-third as back-stop facility which could be availed at a variable rate with a spread over the reverse repo/repo rate under LAF/NSE-MIBOR. Operational modifications were also effected in the LAF in order to facilitate transactions. The daily minimum reserve maintenance requirement of banks was reduced from 65 per cent of CRR balances to 50 per cent for the first week while keeping it at 65 per cent for the second week, effective from the fortnight beginning August 11, 2001.

1.48 Repo auctions are generally conducted without any pre-announced rate; however, the Reserve Bank exercised its option and conducted a fixed rate repo at a cut-off rate of 6.0 per cent on March 5, 2002. Subsequently, the repo cut-off rate was reduced to 5.75 per cent on June 27, 2002. The Reserve Bank introduced longer term repos of 14 days on November 5, 2001. Prudential limits on exposure to call/notice money market including on call/notice money lending of PDs are slated to come into effect in October-December 2002.

Government Securities Market

1.49 Efforts to deepen and widen the government securities market continued during 2001-02. The maturity profile of Government debt was elongated with issuances of bonds up to 25-year maturity. There was "passive consolidation" by reissuing existing stocks through price-based auctions. In order to cater to diversified investor needs, Floating Rate Bonds (FRB) were reintroduced in 2001-02 and bonds with call/put options were issued in July 2002. An indicative advance calendar for issuance of dated securities of the Central Government for the first half of 2002-03 was announced in March 2002 to improve transparency in primary issuance of Central Government securities.

1.50 The NDS (Phase I) was operationalised from February 15, 2002 to provide online electronic bidding facility in the primary auctions of Central/ State Government securities and OMO/ LAF auctions, screen-based electronic dealing and reporting of transactions in money market and securities markets. Contemporaneously, the Clearing Corporation of India Limited (CCIL) also commenced its operations for clearing and settlement of transactions in Government securities (including repos). The envisaged replacement of the existing Public Debt Act, 1944 by a Government Securities Act, would simplify the procedures for transactions in Government securities, allow lien-marking/pledging of securities as also electronic transfer in dematerialised form.

Foreign Exchange Market

1.51 In the foreign exchange market, the prime objective of the Reserve Bank is to manage volatility with no fixed target for the exchange rate which is determined by market forces. During 2001-02, capital account transactions were further liberalised, as mentioned earlier. The existing limit on overseas borrowing as well as investment of 15 per cent of unimpaired Tier I capital by banks was increased to 25 per cent. Banks were permitted to invest their FCNR(B) deposits in longer term fixed income instruments. The ceiling interest rate on FCNR(B) deposits for a maturity period of 1-3 years was revised downward.

1.52 Importers and exporters were allowed to book forward contracts, subject to a cap of US $ 50 million or equivalent. The facility to cancel and rebook forward contracts which was available only in respect of export transactions was extended to all forward contracts effective April 1, 2002. The EEFC scheme was further liberalised for exporters with proven track record.

Banking Sector Reforms

1.53 Policy measures undertaken in the context of the banking sector during 2001-02 were guided by the objectives of strengthening the banking sector through rigorous operational, prudential and accounting norms set to gradually converge to international standards, improvement in the credit delivery system and gradual narrowing of the divergences in regulatory framework of different types of institutions. Prudential tightening covered exposure and disclosure norms, guidelines on investment, risk management, asset classification and provisioning. Banks were encouraged to prepare themselves to follow international practices in respect of assigning capital for market risk. Initiatives in the direction of redefining the regulatory oversight of the Reserve Bank included mitigating the potential conflict of interest regarding issues of ownership, risk-based supervision, consolidated accounting and supervision, off-site monitoring and inspection. Policy attention was also drawn to issues in management of non-performing assets (NPAs) and related supervisory initiatives, including the setting up of asset reconstruction company and the revival of weak public sector banks. New avenues of banking activity were created in insurance and the access of the banking sector to foreign direct investment was enhanced during 2001-02.

Prudential Norms

1.54 Exposure limits defined in terms of banks' capital funds were tightened effective March 2002 for both individual and group borrowers. Foreign banks were brought on par with Indian banks for the purpose of exposure ceilings. The financing of equities and investments by banks was eased to allow banks to extend finance to stockbrokers for margin trading within the overall ceiling prescribed for banks' exposure to capital market with adequate safeguards, including the requirement of dematerialised trading.

1.55 Banks were required to prepare for convergence with international standards on asset classification and provisioning norms. From the year ended March 2002, banks were required to make additional disclosures relating to movement of provisions held towards NPAs and depreciation of investments, the total amount of loan asset subjected to restructuring under Corporate Debt Restructuring (CDR) and amounts of sub-standard and standard assets subjected to CDR.

1.56 In order to ensure that banks follow a more prudent policy for utilising the gains realised on sale of investment in securities, they were advised to transfer the maximum amount of gains realised on sale of investment in securities to the Investment Fluctuation Reserve (IFR) Account which should reach a minimum of 5 per cent of their investment under "held for trading" and "available for sale" categories within 5 years, with the freedom to build up higher percentage of IFR up to 10 per cent of banks portfolios in the IFR.

Issues in Regulation and Supervision

1.57 The Board for Financial Supervision (BFS) evolved a country-specific approach to consolidated supervision through a multi-disciplinary Working Group which examined the introduction of consolidated accounting practices for consolidated supervision, in line with international best practices. The frequency of some of the off-site surveillance returns was increased to a monthly basis during 2001-02 and progress was made towards implementation of risk-based supervision.

1.58 The regulation of systemically important institutions performing payment and settlement services such as the Clearing Corporation of India Ltd., is to be performed by the Reserve Bank with oversight authority vested in the Board for Financial Supervision (BFS). Similarly, in view of the growing systemic implications of PDs operations for the stability of the financial systems, they have been brought in the purview of regulation of BFS.

1.59 In keeping with its approach to avoid the potential conflict of interest created by the ownership of regulated financial institutions, the Reserve Bank divested its entire holdings in the Securities Trading Corporation of India Ltd. and the Discount and Finance House of India. Similar disinvestment is proposed for its holding in the State Bank of India, the National Housing Bank and the National Bank for Agriculture and Rural Development. In pursuance of the objective of withdrawing from development financing functions, the Reserve Bank transferred assets on account of loans and advances to Development Financial Institutions out of National Industrial Credit (Long Term Operations) Fund to the Government, replacing them with long-term Government of India securities through private placement.

1.60 A Consultative Group of Directors of Banks/FIs (Chairman: Dr. A.S. Ganguly) was set up to strengthen the supervisory role of the Boards of banks. Banks have been requested to place the Report before their Board of Directors. Certain recommendations of the Group require the approval of the Government or legislative amendments.

Management of Non-Performing Assets

1.61 Several initiatives were undertaken to reduce the level of NPAs in the banking system and to manage them better. A special one-time settlement (OTS) scheme for small and marginal farmers was put in place. Banks were advised to formulate a policy for the recovery of loans from small borrowers in all sectors irrespective of the nature of business or purpose. The Union Budget for 2002-03 announced the establishment of a pilot Asset Reconstruction Company to take over the NPAs of the banking sector and to develop a market for securitised loans.

Institutional Issues

1.62 Policy efforts to deepen the banking sector and infuse competition into financial intermediation were accelerated. Banks were allowed to freely price and issue rights shares while bonus shares were delinked from the rights issues. Foreign direct investment (FDI) in banks in the private sector was allowed up to 49 per cent under the automatic route with transfer of existing shares from residents to non-residents requiring approval of the Foreign Investment Promotion Board and in-principle approval of the Reserve Bank. In order to provide a level playing field the maximum limit of share holding of Indian promoters in private sector banks was raised to 49 per cent of their paid up capital. In the case of public sector banks, FDI and foreign portfolio investment was allowed up to 20 per cent. Foreign banks were allowed to set up subsidiaries in India. The Union Budget for 2002-03 announced that the Deposit Insurance and Credit Guarantee Corporation would be converted into the Bank Deposit Insurance Corporation.

Urban Co-operative Banks

1.63 Withdrawal of the stipulation of the minimum lending rate (MLR) was announced in the Monetary and Credit Policy for 2002-03. Urban co-operative banks (UCBs) were allowed to determine their lending rates subject to appropriate disclosure norms. UCBs were advised to review their interest rate structure on term deposits of different maturities and to make them comparable with the rates offered by commercial banks.

1.64 Prudential guidelines were issued to UCBs in order to minimise their exposure to credit and market risk. They were also required to begin additional provisioning to achieve the international norms relating to asset classification and provisioning by March 2004. Criteria for classification of UCBs as weak and sick were revised with a view to sharpening the focus of efforts to implement revival plans. Guidelines were issued to the State Governments on one-time settlement of NPAs for UCBs under their jurisdiction. Registration and licensing procedures were subjected to critical review in the light of recent problems in the sector and the danger of contamination in other segments of the banking system. Recommendations of the Madhava Rao Committee such as inclusion of Directors with banking experience in their Boards and formation of Audit Committees were required to be implemented by all UCBs. An external screening committee was set up to assist the Reserve Bank in an advisory role for considering proposals for setting up UCBs. An off-site surveillance system on the lines of monitoring systems for commercial banks was introduced for scheduled UCBs and will be extended to all UCBs in a phased manner. Similarly, the system of Asset-Liability Management (ALM) has also been introduced for scheduled UCBs.

Financial Institutions

1.65 In August 2001, capital adequacy standards for financial institutions (FIs) were modified with a risk weight of 20 per cent on all loans and advances granted to their own employees, which are fully covered by superannuation benefits and mortgages of flats/houses and 100

per cent risk weights for all other loans and advances granted to employees. Refinancing institutions were advised in June 2001 that they need not classify the Government guaranteed accounts as NPAs, even if they are in arrears and not reckoned for income recognition purposes, unless the guarantees are repudiated. Exposure norms for refinancing institutions would be applicable in respect of their direct finance and not on their refinance portfolio for which FIs have to devise their own norms approved by their Board. Disclosure requirements for FIs were enhanced to include the movement in the provisions held towards non-performing assets and depreciation in investment portfolio. The treatment of 'time overrun' in respect of projects under implementation for the purpose of asset classification was redefined/ reclassified. Norms were prescribed for the FIs for entry into insurance business. The Reserve Bank also introduced CAMELS-based supervisory rating model for the FIs.

Corporate Debt Restructuring

1.66 A three-tier Corporate Debt Restructuring (CDR) System was introduced in August 2001 to provide a transparent mechanism for restructuring of debts of viable corporate entities affected by internal or external factors, outside the purview of Board for Industrial and Financial Reconstruction (BIFR), the debt recovery tribunals (DRT) and other legal proceedings. In pursuance of the proposal made in the Union Budget 2002-03, the Reserve Bank constituted a High Level Group (Chairman: Shri Vepa Kamesam, Deputy Governor) to review the operations of the CDR scheme, to identify the operational difficulties in its smooth implementation and to suggest measures to make the scheme even more effective. The Group has submitted its report which is under examination. As an interim measure, permission for debt restructuring would be given by the Reserve Bank on the basis of specific recommendations of the CDR Core Group, if a minimum of 75 per cent (by value) of the lenders constituting banks and FIs consent for the CDR, irrespective of differences in classification of the assets by banks/FIs.

Non-Banking Financial Companies

1.67 The major thrust of policy in respect of non-banking financial companies (NBFCs) during 2001-02 was on bringing about convergence in the operational, prudential and accounting norms and practices of NBFCs with those of the banking industry. With a view to further strengthening the regulatory/ supervisory framework for NBFCs, guidelines were issued on investment policy and classification of investments, identification of loss assets and the need for a credit policy in respect of call/ demand loans. Guidelines for the ALM system for NBFCs issued on June 27, 2001 became operational from the year ended March 31, 2002. The concept of 'past due' for the purpose of income recognition norms is to be dispensed with, effective from the balance sheet for the year ended March 31, 2003. The maximum rate of interest that NBFCs can pay on their public deposits was reduced.

1.68 In order to inculcate a sense of discipline among NBFCs, it has been decided to take serious action against NBFCs progressively for non-submission of returns to the Reserve Bank. Such action may include imposition of penalties as provided for in the Reserve Bank of India Act, 1934 and also launching court proceedings, besides considering rejection/cancellation of the certificate of registration (CoR). To start with, cases of NBFCs having public deposits of Rs. 50 crore and above, and defaulting in the submission of returns are being taken up.

1.69 The Reserve Bank continued its efforts towards educating the NBFC depositors about the regulatory framework, the role of the Reserve Bank in monitoring the functioning of NBFCs and the factors to be considered before investing money in NBFCs, *etc*., through both the print and electronic media.

Money Laundering and Financing of Terrorism

1.70 Sharing the increasing international concern on the use of the financial system for money laundering and financing of terrorism, the Reserve Bank and the Government initiated various steps to check misuse of the financial system for laundering proceeds of criminal activities. With a view to safeguarding banks from being unwittingly used for the transfer or deposit of funds from criminal activities, it was decided to reinforce the existing instructions on Know Your Customer (KYC) norms and cash transactions. The policy, procedures and controls required to be introduced by banks including strict adherence to KYC procedures have been issued in consultation with banks.

1.71 In the light of recent international developments and recognising the need for a critical assessment of India's position *vis-a-vis* international standards on market integrity, the Standing Committee on International Financial Standards and Codes commissioned an internal technical group on 'Market Integrity'. The Report of the Group provides an assessment of India's position with respect to G-7 principles on Market Integrity and recommendations of the Financial Action Task Force (FATF) on anti-money laundering and terrorist financing which serve as a benchmark in this regard. The Report also provides an overview of international efforts to combat money laundering, briefly reviews the existing laws and regulations for the purpose of detection and law enforcement against criminal activities in financial sector, and notes the recent initiatives taken for prevention of money laundering. The full text of the Report on 'Market Integrity' has been placed on the website of the Reserve Bank.

POLICIES FOR CAPITAL MARKETS

1.72 During 2001-02, several changes were introduced in the settlement practices in the capital markets, including extension of the rolling settlement on T+5 basis to all scrips. The risk management system for the stock exchanges was strengthened in the aftermath of the irregularities in the securities market. The year also witnessed major institutional changes for improving corporate governance practices. The norms for issuance of shares in the primary market were eased further in order to encourage companies to come out with public issues. In the derivatives segment, the range of products was extended further to include index options, stock options and stock futures.

Primary Market

1.73 The Securities and Exchange Board of India (SEBI) amended the SEBI (Disclosure and Investor Protection) Guidelines, 2000 to provide for the inclusion of Foreign Venture Capital Investors (FVCIs) and State Industrial Development Corporations (SIDCs) as Qualified Institutional Buyers (QIBs) for participating in the book-building process. It also abolished the lock-in period for the pre-issue share capital of an unlisted company held by Venture Capital Funds (VCFs) and FVCIs and removed the restriction of a minimum issue size of Rs.25 crore in case of an Initial Public Offer (IPO) through book-building. The option to allocate the unsubscribed portion of the fixed price portion in a book-building issue to any category or lapse altogether was allowed. Buyback norms were relaxed by the Government and the cooling-off period for a fresh issue of a security after buyback was reduced to six months from two years.

Secondary Market

1.74 The SEBI extended compulsory rolling settlement on T+5 basis to 414 scrips from July 2, 2001 and advised the stock exchanges to introduce uniform settlement cycle (Monday to Friday) in respect of remaining securities. Rolling settlement on T+5 basis was extended to

all scrips with effect from January 2, 2002. The settlement cycle was shortened to T+3 effective April 1, 2002. This brings the securities settlement system in India at par with international standards, in line with the recommendations of the Report of the joint task force of the Committee on Payments and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) on securities settlement systems.

1.75 Other reforms initiated by the SEBI included banning of all deferral products, including *badla*; introduction of a market-wide circuit breaker system applicable at three stages of the index movements and 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; and shifting of the margining system from net basis to gross basis (sales and purchases) with effect from September 3, 2001. In order to widen the equity derivatives market, the SEBI permitted introduction of new derivative products. The stock exchanges, accordingly, commenced trading in index options in June 2001, followed by options on select securities in July 2001 and futures on select securities in November 2001. The FIIs were also permitted to trade in all exchange-traded derivative contracts subject to position limits effective February 2002.

1.76 Major initiatives were also taken to improve standards of corporate governance, including amendment to listing agreements requiring the companies to furnish segment-wise details of revenues, results and capital employed along with quarterly unaudited results, *etc.* The SEBI issued norms for speedy redressal of investors' grievances and prescribed Model Rules for stock exchanges to be implemented in phases. The SEBI advised the stock exchanges to amend listing agreements requiring companies to furnish statements and reports on their Electronic Data Information Filing and Retrieval (EDIFAR) system.

Mutual Funds

1.77 The disclosure norms for mutual funds were tightened to help investors take more informed investment decisions. The SEBI decided that mutual funds should disclose the performance of benchmarks in case of various types of equity-oriented, debt-oriented and balanced fund schemes while publishing half-yearly results. Detailed investment and disclosure norms for employees of Asset Management Companies (AMCs) and Trustee Companies were laid down in order to avoid any actual or potential conflict of interests. The SEBI prescribed that all mutual funds should enter into transactions in Government securities only in dematerialised form. Mutual funds were allowed to invest in the listed or unlisted securities or units of VCFs within the overall ceiling for such investments. To bring about uniformity in calculation of the net asset value (NAV) of mutual fund schemes, the SEBI issued guidelines for valuation of unlisted equity shares. With a view to improving the professional standards, certification by the Association of Mutual Funds of India (AMFI) was made mandatory for the appointment of agents/distributors by all mutual funds.

II THE REAL ECONOMY

2.1 The Indian economy exhibited resilience in an uncertain global environment dominated by the worsening of the slowdown in economic activity in several parts of the world. Benefiting from an unusually strong rebound in agricultural production, India's real GDP growth accelerated to 5.4 per cent during 2001-02 as against a deceleration to 4.0 per cent in 2000-01 from 6.1 per cent in 1999-2000. Foodgrains output touched a record high of 211.3 million tonnes in 2001-02 while the production of non-foodgrains increased significantly, except for sugarcane. Stocks of foodgrains touched 51.02 million tonnes at the end of March 2002, well above thrice the prevailing norm. On the other hand, industrial production suffered a pronounced and fairly widespread deceleration, led by a marked slowdown in the

manufacturing sector. Capital goods and crude petroleum production recorded absolute declines. Real GDP originating in the services sector rose by 6.2 per cent in 2001-02, up from 5.0 per cent in 2000-01, reflecting an improved performance of financial services, particularly financing, insurance, real estate and business services

2.2 Coincident peaks - Q_2 of 2000-01 and Q_4 of 2001-02 - and troughs - Q_3 and Q_4 of 2000-01 - in real GDP and GDP from agriculture for 2000-01 and 2001-02 suggest that fluctuations in agricultural activity mainly influenced and set the pattern for the overall GDP growth path. The sharp slowdown in growth after the third quarter of 2000-01 in the industrial sector plateaued in 2001-02. Industrial growth increased marginally from 2.5 per cent in Q_1 of 2001-02 to 3.4 per cent in Q_4 of 2001-02. The quarterly growth rate of the services sector fluctuated between 2.9 per cent and 7.0 per cent during Q_4 of 2000-01 and Q_4 of 2001-02.

2.3 The rate of gross domestic capital formation (GDCF) at current prices decelerated from 24.3 per cent in 1999-2000 to 24.0 per cent in 2000-01 primarily on account of the rate of private corporate investment which decelerated from 6.5 per cent in 1999-2000 to 5.9 per cent in 2000-01. The public sector investment rate remained stable at 7.1 per cent for the years 1999-2000 and 2000-01. The rate of gross domestic saving (GDS as percentage of GDP at current market prices) edged up from 23.2 per cent in 1999-2000 to 23.4 per cent in 2000-01. All the constituent sectors registered improvement in saving rates except the public sector which increased its dissaving rate from 0.9 per cent in 1999-2000 to 1.7 per cent in 2000-01.

2.4 Tentative estimates of the Reserve Bank, based on latest available data, place the rate of household financial saving at 10.9 per cent in 2001-02 as against the revised estimate of 10.8 per cent in 2000-01. Instrument-wise, this marginal improvement in household financial saving is primarily attributable to currency and claims on government held by the household sector. In contrast, the rate of household financial saving in deposits is estimated to have shown a marginal decline from 5.0 per cent in 2000-01 to 4.9 per cent in 2001-02 on account of the non-bank deposits; household saving in the form of bank deposits increased from 4.5 per cent to 4.8 per cent. The household saving in the form of contractual instruments (life insurance fund and provident and pension funds) declined from 4.3 per cent in 2000-01 to 4.1 per cent in 2001-02 partly reflecting the lowering of the rate of return on these instruments.

Agriculture

2.5 Foodgrains production increased by 15.4 million tonnes during 2001-02, scaling a new peak at 211.3 million tonnes. The production of non-foodgrain crops such as oilseeds and cotton also showed improvement. The index of agricultural production (base : triennium ending 1981-82=100) increased sharply by 7.5 per cent in 2001-02 in contrast to a fall of 6.6 per cent in the previous year. In consonance, real GDP originating from agriculture and allied activities surged up by 5.7 per cent in contrast to a decline of 0.2 per cent in 2000-01. The rejuvenation of agricultural production in 2001-02 is attributable to better spatio-temporal distribution of rainfall. The South-West monsoon was normal for thirteen years in a row with precipitation at 90 per cent of the Long Period Average (LPA) in the 2001 season and 30 (highest in the last seven years) out of 35 meteorological sub-divisions reporting excess/normal rainfall. There was adequate rainfall in 71 districts of 11 states, *viz.*, Chhattisgarh, Gujarat, Haryana, Himachal Pradesh, Kerala, Madhya Pradesh, Orissa, Punjab, Rajasthan, Tamil Nadu and Uttar Pradesh, which had experienced drought conditions in 2000. The North-East monsoon season also turned out to be satisfactory in 2001-02 with excess/normal rainfall in 23 out of 35 sub-divisions as compared with only 4 sub-divisions in 2000-01

2.6 The index of non-foodgrains (base: triennium ending 1981-82=100) rose by 5.7 per

cent in 2001-02 in contrast to a fall of 5.7 per cent in the previous year. The improvement in non-foodgrains output was mainly due to the increased output of oilseeds, cotton and jute and mesta, even as sugarcane suffered a moderate decline mainly on account of moisture stress in the States of Maharashtra, Karnataka and Tamil Nadu and parts of Andhra Pradesh. The total off-take of rice and wheat during 2001-02 at 31.3 million tonnes was higher than 2000-01, reversing the decline in the previous year. Despite the higher off-take and large open market sales, the increased procurement resulted in stocks of foodgrains attaining a new peak of 51.0 million tonnes at end-March 2002. The Central issue concerning PDs is that of supply chain management and ensuring prompt delivery of foodgrains in scarcity areas. Procurement of rice and wheat at 22.1 million tonnes during the first quarter of 2002-03 was lower by 4.4 per cent than in the corresponding period of the previous year. Procurement of wheat at 18.9 million tonnes was lower than that of 20.5 million tonnes. Rice procurement was higher at 3.2 million tonnes than 2.7 million tonnes during the corresponding period of 2001-02. The total off-take of rice and wheat in the first quarter of 2002-03 (up to end-June 2002) was higher at 10.1 million tonnes than 5.2 million tonnes during the corresponding period in 2001-02. The total stock of foodgrains was higher at 63.1 million tonnes as at end-June 2002 than 62.0 million tonnes, a year ago.

Industry

2.7 The slowdown in industrial activity deepened during 2001-02, affecting all industry groups and symptomatically manifested itself in disinflation of manufacturing prices, low investment activity, persistence of excess capacity, an absolute decline in the production of capital goods sector and a listless performance of the infrastructure industries. Business sentiment was dampened by the uncertainties characterising the domestic and global environment including specific incidents purveying extreme instability such as the September 11, 2001 terrorist attacks in the US and the recent disturbances in an industrially advanced State like Gujarat. Infrastructural bottlenecks - power, communication, transport and labour laws - continued to be a binding constraint on industrial revival.

2.8 The Index of Industrial Production (IIP) showed lower growth in each month of 2001-02, except March 2002. During 2001-02, the IIP rose by only 2.8 per cent as compared with 4.9 per cent recorded during 2000-01 and 6.7 per cent during 1999-2000. The slowdown was visible across all constituent sub-sectors. In 2001-02, the slowdown in manufacturing became wide spread, affecting a broad spectrum of constituent industries.

2.9 During 2002-03 (up to June 2002), the IIP recorded a growth of 4.0 per cent as against 2.2 per cent in the corresponding period of the previous year. Manufacturing recorded a growth of 3.7 per cent as compared with 2.6 per cent in the corresponding period of the previous year. Electricity and mining also registered higher growth.

Use-based Classification

2.10 The performance of the capital goods sector deteriorated further during 2001-02 with the growth rate of 1.8 per cent during 2000-01 weakening into an absolute decline of 3.4 per cent during 2001-02. All other sectors, *viz.*, basic goods, intermediate goods and consumer goods recorded lower growth in comparison with the preceding year.

2.11 Basic and consumer goods sectors registered an accelerated growth of 5.1 per cent and 6.5 per cent, respectively, during April-June 2002-03 as against 1.4 per cent and 4.8 per cent in the corresponding period of the previous year. The capital goods sector too registered an increase by 1.6 per cent during April-June 2002-03 as against a decline of 6.0 per cent during April-June 2001-02. The intermediate goods sector, however, recorded a lower growth of 1.1

per cent during April-June 2002-03 as compared with 3.3 per cent during April-June 2001-02.

2.12 The performance of infrastructure industries deteriorated during 2001-02. The composite index of six key infrastructure industries, with a weight of 26.68 per cent in the IIP, rose by 2.9 per cent as compared with 5.1 per cent during 2000-01 on a year-on-year basis, however, the growth rate remained higher since December 2001.

2.13 The composite index of six infrastructure industries recorded a higher growth of 5.7 per cent during April-June 2002-03 as against 1.2 per cent in the corresponding period of the previous year reflecting improved growth performance in all infrastructure industries.

Services

2.14 The services sector has been facing a deceleration of growth in recent years in comparison with the annual average growth of 7.7 per cent attained during the period 1997-2002. As per the revised estimates, the growth of real GDP from the services sector rose to 6.2 per cent in 2001-02, up from 5.0 per cent during 2000-01 but well below that of 9.4 per cent during 1999-2000. The share of services was estimated to be 54.1 per cent of GDP in 2001-02 as against 53.7 per cent in 2000-01. Sectors like 'financing, insurance, real estate and business services' and 'trade, hotels, restaurants, transport, storage and communication' were the major contributors to growth in 2001-02.

2.15 A notable feature of the structural transformation of the Indian economy in recent years has been the rising contribution of skill intensive services with high value addition such as information technology, to the overall output in the economy. The services sector has emerged as the fastest expanding sector with implications for other sectors especially manufacturing in terms of productivity, employment and trade.

III MONEY, CREDIT AND PRICES

3.1 Monetary conditions remained easy for the most part of 2001-02, enabled by the stance of monetary policy in support of the revival of investment demand in the economy. Consistent with the policy preference for softer interest rates, market liquidity was modulated through reductions of cash reserve ratio (CRR), primary operations through private placements as well as secondary operations in the form of open market operations (OMOs) in government securities and through the Liquidity Adjustment Facility (LAF). Reserve money rose faster during 2001-02 mainly due to a strong accretion to net foreign assets (NFA) of the Reserve Bank. Accordingly, liquidity conditions were generally comfortable throughout the year. Interest rates generally moved southwards in various market segments with all-time lows being reached in the gilt markets. Broad money (M_3) expansion was almost the same as in the preceding year. Similar patterns were exhibited in the behaviour of the new broad money aggregate (NM_3, *i.e.,* broad money adjusted, *inter alia*, for nonresident foreign currency deposits) and the wider measures of liquidity, *viz.,* L_1, L_2 and L_3. Currency growth returned to trend levels. Time deposit growth was maintained as uncertainty in other segments of the financial markets fuelled a flight to safety. Credit off-take continued to remain weak in the absence of the much-awaited industrial recovery. Inflation began to dip after August 2001 as the impact of administered price revisions effected in the previous year wore off and by the end of the year it had fallen to 1.6 per cent.

Reserve Money

3.2 Reserve money expanded by 11.4 per cent (Rs.34,659 crore) during 2001-02 as

compared with 8.1 per cent (Rs.22,757 crore) in 2000-01, driven by the Reserve Bank's foreign currency assets. Consequently, the ratio of the Reserve Bank's NFA to currency, an important indicator of the quality of monetary management, rose to reach 105.2 per cent as on March 31, 2002. The rising profile of the NFA/currency ratio in a period characterised by capital inflows strengthens the prospective conduct of monetary policy as it empowers the monetary authority to deal with capital outflows, if they take place, without contraction in domestic economic activity or pressures on the balance of payments. Net domestic assets (NDA) of the Reserve Bank declined by Rs.23,335 crore (adjusted for revaluation) during 2001-02, partly off-setting the surge in the NFA and holding down the monetary impact of the foreign exchange inflows. The predominance of NFA in the sources of reserve money growth since the mid-1990s has reflected the growing openness of the economy to external capital inflows.

3.3 Devolvement/private placement of government securities on the Reserve Bank is a conscious strategy adopted by the Reserve Bank. In case liquidity conditions in the market are not appropriate for a market issue, or in the event of the market expecting unreasonably high yields from the primary offering as reflected in the bids received, the Reserve Bank may resort to private placement or devolvement. The Reserve Bank offloads such initial acquisitions when the liquidity conditions/ expectations stabilise, or, at its discretion through strategic open market sales depending upon capital flows, credit growth and requirements of monetary management. Devolvements/private placements, therefore, not only help contain volatility in the market, but also act as a monetary signal from the Reserve Bank.

3.4 Reserve money, on a year-on-year basis, registered an increase of 10.2 per cent (Rs. 31,007 crore) as on August 16, 2002 as compared with an increase of 9.5 per cent (Rs. 26,363 crore) as at mid-August last year. The major source of reserve money growth was the foreign currency assets which increased by Rs. 69,291 crore (adjusted for revalution) as compared with Rs. 42,917 crore during the corresponding period of the previous year. On the other hand, the Reserve Bank's net credit to the Centre declined by 12.1 per cent (Rs. 18,436 crore) as compared with a decline of 0.9 per cent (Rs. 1,309 crore) during the corressponding period of the previous year. The Reserve Bank's credit to commercial banks and PDs also declined by Rs.2,204 crore and Rs.884 crore, respectively.

Monetary Survey

3.5 Broad money (M_3) increased by 14.2 per cent (Rs. 1,86,782 crore) during 2001-02 as compared with 16.8 per cent (14.5 per cent, net of India Millennium Deposits (IMDs)) during 2000-01. Monetary expansion was in consonance with the projections set out in the Monetary and Credit Policy Statement for 2001-02. On a monthly average basis, the year-on-year M_3 (net of RIBs/IMDs) growth at 15.3 per cent during 2001-02 was almost the same as that of 15.1 per cent during 2000-01.

3.6 Currency with the public recorded a higher growth of 15.2 per cent during 2001-02 as compared with 10.8 per cent during the previous year. The increase in cash demand during 2001-02 reflected its typical co-movement with the performance of agriculture and rural demand for cash transactions.

3.7 Aggregate deposits increased by 14.2 per cent during 2001-02, which was lower than that of 15.3 per cent (net of IMDs) recorded during the previous year. The broadly steady accretion to time deposits against the backdrop of downward movement of interest rates reflected 'safe haven' sentiments and the decline in interest rates on alternative savings instruments.

3.8 Domestic credit (inclusive of commercial banks' non-SLR investments such as commercial paper, shares and debentures, which have assumed importance in recent years in

banks' portfolios) decelerated to 12.4 per cent during 2001-02 from 16.3 per cent during 2000-01 as demand conditions in the economy, particularly in industry, continued to remain weak.

3.9 There were shifts in ownership within the banking sector's credit extended to the Government sector. SCBs' investments in Government securities continued to record a strong growth although it decelerated to 20.9 per cent during the year from 22.1 per cent in the previous year; the net Reserve Bank credit to government, on the other hand, declined by 1.1 per cent. As a result, the share of the Reserve Bank in outstanding net bank credit to the Government sector declined from 32.1 per cent during 2000-01 to 27.9 per cent during 2001-02.

3.10 New monetary and liquidity aggregates were introduced in 1999 on the basis of the recommendations of the Working Group on Money Supply: Analytics and Methodology of Compilation (Chairman: Dr. Y.V. Reddy). The Reserve Bank has been disseminating the new aggregates alongside the existing monetary data with a view to sensitising the public to the analytical refinements in the new measures and thereby preparing the ground for replacing the existing broad money measure, *i.e.,* M_3. Considerable experience gained in the compilation of the new measures and feedback from reporting entities and analysts has been reflected in concurrent improvements in these aggregates. There is now a broader acceptance of the analytical and accounting superiority of the new monetary and liquidity aggregrates *visa-vis* M_3, including in terms of international best practices.

3.11 Industry-wise, credit off-take by the petroleum industry declined by 2.2 per cent during 2001-02 as against an increase of 29.0 per cent recorded during 2000-01. Credit demand also slowed down significantly in the case of cotton textiles and infrastructure. Amongst the principal industries, credit off-take improved only in the case of iron and steel (an increase of 3.3 per cent as compared with 3.2 per cent recorded in the preceding year), engineering (3.4 per cent *vis-a-vis* 1.4 per cent), chemicals, dyes, paints, (8.0 per cent *vis-a-vis* 2.7 per cent) and other textile industries (12.0 per cent as against a decline of 7.6 per cent).

3.12 The net resource flow from non-bank sources (inclusive of capital issues, GDRs/ADRs/FCCBs, CPs subscribed by non-banks and credit from financial institutions) to the commercial sector at Rs. 5,726 crore during 2001-02 was lower than that of Rs. 13,714 crore during the preceding year.

3.13 Broad money (M3) expansion at 13.7 per cent as on August 9, 2002 remained within the projection of 14.0 per cent announced in the April 2002 annual Monetary and Credit Policy Statement and in consonance with overall macroeconomic developments. Currency, on a year-on-year basis, grew by 13.6 per cent as compared with 11.8 per cent in the same period of the previous year. Aggregate deposits increased by 13.8 per cent as compared with 16.2 per cent (net of IMDs) in the comparable period of the previous year. Net bank credit to the Government increased by 14.4 per cent (Rs.81,043 crore) as compared with 16.3 per cent last year. Bank credit to commercial sector increased by 19.1 per cent (Rs.1,31,858 crore) as compared with 13.8 per cent during the corresponding period of the previous year. The sharp increase in bank credit to the commercial sector during the current financial year reflects the accounting effect of the impact of mergers since May 3, 2002 on the assets and liabilities of the banking system.

Price Situation

3.14 The annual rate of inflation in India, measured as point-to-point variations in the wholesale price index (WPI), fell from above 5.0 per cent during the first five months of 2001-02 (April-August) to touch 1.1 per cent as on February 2, 2002 (the lowest during the

year and in the last two decades). It was 1.6 per cent by end-March 2002 as compared with 4.9 per cent at the end of March 2001. The significant fall in inflation during the year represented a combination of factors: base effect correction (a higher base in 2000-01 due to administered price revisions), lower international crude oil prices, improved agricultural production, comfortable buffer stocks, absence of demand pressures due to sluggishness in investment demand, presence of excess capacities and inventory accumulation.

3.15 Inflation measured on the basis of variations in the WPI on an average of weeks basis, an indicator of underlying inflationary conditions, persistently trended downwards during 2001-02. The annual average WPI inflation fell to 3.6 per cent in 2001-02 from 7.2 per cent in 2000-01.

3.16 At the retail level, consumer prices diverged from headline inflation. The annual point-to-point variation in the consumer price index for industrial workers (CPI-IW) rose to 5.2 per cent in 2001-02 form 2.5 per cent in 2000-01 (Chart III.23). On an average basis, it was 4.3 per cent as compared with 3.8 per cent a year ago. The divergence between the WPI and CPI could be attributed to the order of change in primary articles inflation coupled with their larger weightage in the CPI. In addition, the movements of prices of some services which are included in the CPI could have contributed to the divergence.

3.17 The prevalence of different measures of inflation and the leads and lags in their relationship makes the assessment of inflationary pressures for monetary policy purposes a difficult task. In general, there is considerable co-movement between the WPI and CPI in India; the problem of assessment is complicated in periods when they move widely in opposing directions. Therefore, there is a need to observe a host of other factors and other indicators of inflation along with changes in the WPI and CPI for assessing future inflationary conditions with a view to providing guideposts for formulating forward-looking monetary policy.

3.18 The rate of inflation (year-on-year basis) during 2002-03 so far (up to August 3) has continued to remain low and stood at 2.7 per cent as compared with 5.5 per cent during the corresponding period of 2001-02. All major groups recorded deceleration in inflation. On an average basis too, the annual inflation rate consistently declined from 5.4 per cent to 2.0 per cent. The CPI-IW, on a point-to-point basis, showed an increase of 4.2 per cent as at end-June 2002 as compared with 3.4 per cent as at end-June 2001.

IV GOVERNMENT FINANCES

4.1 The finances of the Central Government came under pressure during 2001-02 from a shortfall in revenue collections, reflecting the continuing sluggishness in corporate activity and import demand. Consequently, despite some success achieved in the containment of non-Plan expenditure, deficit indicators recorded slippages from their budgeted levels. The gross fiscal deficit (GFD) during 2001-02 remained at 5.7 per cent of GDP [revised estimates (RE)] as in the preceding year, although higher than the budget estimates of 4.7 per cent. The information available in respect of State Governments indicates that the consolidated GFD of States at 4.5 per cent of GDP in 2001-02 (RE) was also higher than the budget estimates of 3.8 per cent[1]. Accordingly, the combined fiscal deficit of the Centre and States widened to 9.9 per cent in 2001-02 from 9.4 per cent in 2000-01. The deterioration in the fiscal deficit at all levels necessitated an increasing recourse to market borrowings which financed 69.4 per cent of the GFD of the Centre and 15.2 per cent of the GFD of the States. The recourse by States to Ways and Means Advances (WMA) from the Reserve Bank was generally higher in 2001-02 than in the preceding year. The combined debt of the Centre and States rose to 69.9 per cent of GDP at the end of March 2002 from 66.9 per cent at the end of March 2001.

Contingent liabilities of the Centre and States rose to 12.2 per cent of GDP at end-March 2001 from 11.2 per cent at end-March 2000.

CENTRAL GOVERNMENT FINANCES, 2001-02

4.2 The Union Budget 2001-02 aimed at fiscal consolidation through reduction in the fiscal deficit, the revenue deficit and the primary deficit to 4.7 per cent, 3.2 per cent and 0.2 per cent of GDP, respectively. In the actual outturn, according to the revised estimates for 2001-02, there were large gaps in revenues and disinvestment proceeds, whereas Plan expenditure registered an increase in relation to budgeted levels. As a result, the GFD overshot the budgeted level by 13.2 per cent in nominal terms. The revenue deficit in the revised estimates exceeded the budgeted level by 16.4 per cent and the primary deficit was more than six times the budget estimates. The revenue deficit accounted for 69.6 per cent of the GFD as against 67.8 per cent projected in the budget estimates.

Central Government Budget: 2002-03

4.3 The strategy of fiscal rectitude outlined in the Union Budget for 2002-03 is based on achieving a higher growth in revenue receipts at 15.3 per cent, while the aggregate expenditure is expected to grow at 12.6 per cent. In absolute terms, the GFD at Rs.1,35,524 crore is 2.9 per cent higher than that in the revised estimates for 2001-02. The revenue deficit, estimated at Rs.95,377 crore, is higher by 4.0 per cent but the primary deficit projected at Rs.18,134 crore is lower by 25.9 per cent than that in 2001-02. In terms of GDP, the key deficit indicators are budgeted to decline from 2001-02 levels

4.4 During the first quarter of 2002-03 (April-June), the Centre's GFD amounting to Rs.39,560 crore was lower by 6.3 per cent over the level in April-June 2001-02 (Rs.42,198 crore) and constituted 29.2 per cent of the budget estimates (Rs.1,35,524 crore) as compared with 37.9 per cent during the same period of the previous year. The revenue deficit at Rs.34,543 crore during April-June, 2002-03 was higher by 6.5 per cent and constituted 36.2 per cent of the budget estimates (41.1 per cent in the same period of the previous year). The gross primary deficit at Rs.15,671 crore was lower by 36.5 per cent over the same period of the previous year.

STATE GOVERNMENT FINANCES

4.5 Revised estimates for 2001-02 indicate deterioration in the fiscal position of States. The gross fiscal deficit of States in 2001-02 at Rs.1,04,557 crore or 4.5 per cent of GDP was higher by 20.3 per cent over the year 2000-01. The revenue deficit in 2001-02 was also higher by 15.7 per cent in absolute terms; however, in terms of GDP, it rose marginally from 2.5 per cent in 2000-01 to 2.6 per cent in 2001-02. The primary deficit as a percentage of GDP also increased, though marginally, from 1.7 per cent in 2000-01 to 1.8 per cent in 2001-02; in absolute terms, it showed an increase of 14.4 per cent over the previous year level.

4.6 The fiscal outcome for 2001-02 reveals continued imbalance between revenue receipts and expenditures of States which is overshadowing the modest efforts towards fiscal consolidation in recent years. While revenue receipts grew by 13.0 per cent over the previous year, mainly on account of a rise in States' own taxes (12.1 per cent) and grants from the Centre (32.6 per cent), these were outpaced by the growth of 13.5 per cent in revenue expenditure. Interest payments accounted for 32.3 per cent of the rise in revenue expenditure in 2001-02. The disaggregation of total expenditure reveals that developmental expenditure rose by 12.3 per cent in 2001-02, while non-developmental expenditure rose by 19.9 per cent over the previous year.

State Budgets: 2002-03

4.7 In the budget estimates for 2002-03, several States have proposed measures to intensify fiscal consolidation process by widening the resource base and containing expenditure. Accordingly, the GFD of States is budgeted to decline to 3.8 per cent of GDP in 2002-03 from 4.5 per cent in the revised estimates for 2001-02. The revenue deficit is also budgeted lower at 1.8 per cent of GDP in 2002-03 than 2.6 per cent in 2001-02. Revenue receipts of States are budgeted to rise by 13.2 per cent with about 70.0 per cent of this increase to be contributed by States' own revenue receipts comprising tax and non-tax receipts, while current transfers from the Centre comprising sharable taxes and grants would account for the rest. Total tax receipts comprising States' own taxes and States' share in Central taxes are estimated to show a higher growth of 13.8 per cent during 2002-03 than that of 11.1 per cent in the previous year. The tax-GDP ratio of the States, which remained stagnant at around 8.0 per cent during the 1990s, is budgeted to increase to 8.3 per cent during 2002-03 from 8.1 per cent in 2001-02. On the non-tax front, States' own non-tax revenue receipts are estimated to show a rise of 19.1 per cent in 2002-03 as against a marginal rise of 0.5 per cent in 2001-02. The grants from the Centre are budgeted to increase by 7.2 per cent. Thus, States' own revenue receipts are expected to finance 54.0 per cent of revenue expenditure and 44.7 per cent of the aggregate expenditure in 2002-03 as compared with 50.1 per cent and 41.4 per cent, respectively, in the revised estimates for 2001-02.

DOMESTIC PUBLIC DEBT

4.8 The outstanding domestic debt of the Central Government rose to 58.4 per cent of GDP at the end of March 2002 as compared with 56.4 per cent in the preceding year. During the earlier period of the economic reform process initiated in 1991, there was considerable progress in improving the debt position of the Government. This was reflected in significant improvement in the debt-GDP ratio which steadily declined from 54.3 per cent in 1991-92 to 49.4 per cent in 1996-97. Subsequently, as a result of the widening fiscal gap, higher Government borrowings became necessary and outstanding liabilities of the Central Government rose at an annual average rate of 14.4 per cent from Rs.6,75,676 crore in 1996-97 to Rs.15,12,768 crore in 2002-03. Similarly, high growth in outstanding debt also led to sharp increase in interest payments which rose at an annual average rate of 12.1 per cent from Rs.59,478 crore to Rs.1,17,390 crore over the same period.

4.9 The States' debt-GDP ratio, which had declined during the period 1991-97, has been edging up in subsequent years to reach 25.6 per cent at the end of March 2002. Fiscal consolidation and reforms at the State level have received considerable attention during recent years. The Eleventh Finance Commission has recommended that as a medium-term objective, State Governments should endeavor to keep interest payments as a ratio to revenue receipts to about 18 per cent. Many of the States in their budgets have proposed measures for fiscal reforms such as setting up of consolidated sinking fund, guarantee redemption fund, statutory limits on guarantees and restructuring of PSUs.

4.10 The combined outstanding debt of the Centre and the State Governments is estimated to be 69.9 per cent of the revised GDP for the year 2001-02 as against 66.9 per cent as at end-March 2001 and 61.7 per cent as at end-March 1991.

V FINANCIAL MARKETS

5.1 Financial markets remained liquid and stable during 2001-02. Money markets exhibited easy liquidity conditions which were modulated through the operation of Liquidity Adjustment Facility (LAF). Call money rates generally remained stable and within the repo-

reverse repo corridor. The government securities market experienced a softening in yields across the maturity spectrum with the 10-year yield declining by 287 basis points during the year to 7.36 per cent at end-March 2002. The foreign exchange market generally remained stable during the year with the exchange rate of the Indian rupee *vis-à-vis* the US dollar remaining range-bound within Rs.46.56-Rs.48.85 per US dollar. There were brief interruptions to the tranquil market conditions in some segments emanating from nervous reactions to the terrorist attack in the United States on September 11, 2001 and again in December 2001 in the wake of border tensions. The Reserve Bank's efforts to assuage market sentiment were, by and large, successful. Strong deposit accretions during the first half of the year coupled with reductions in CRR without any commensurate credit off-take created a situation of comfortable liquidity in the credit market for the greater part of the year. Equity markets remained subdued with the extraordinary events during 2001-02 dampening sentiment.

5.2 Strong deposit accretions, primary liquidity flows from a 50 basis point reduction in the CRR and low credit off-take generated conditions of surplus liquidity in the first quarter of 2001-02. Call money rates remained well within the repo-reverse repo corridor except for a temporary spike during May 2001 marking the transition to the next stage of the LAF. The range of prime lending rates of the public sector banks decreased by 25 basis points in May 2001. The foreign exchange market was flush with increased supply on account of foreign institutional investment inflows. The gilt market registered an increase in turnover and reduction in the yields across the maturity spectrum. The yield spread between AAA rated 5-year corporate bonds and government securities of equal residual maturity, however, widened.

5.3 Favourable interest rate expectations and comfortable liquidity revived the appetite for gilts before the September 11, 2001 incident affected market sentiment. A series of open market purchases through auctions without notified amounts by the Reserve Bank across the maturity spectrum stabilised the market and restored confidence. The foreign exchange market was affected by the events of September 11 and bid-ask spreads increased as nervous sentiments were amplified by the deceleration in FII inflows and the export slowdown. The Reserve Bank's market operations in this segment quickly restored stability. In the equity market, bearish sentiments ruled in the wake of the ban on the sale/ repurchase of the US-64 units of Unit Trust of India (UTI) in July 2001. In the aftermath of the terrorist attack in the United States, the BSE Sensex declined by 17.5 per cent between September 11-21, 2001 along with the widening of the high-low spreads.

5.4 In the third quarter, monetary conditions were further eased with a CRR cut of 200 basis points and a cut in the Bank Rate by 50 basis points. Call money rates remained mainly within the repo-reverse repo corridor, with minor episodes of pressure. The rally in the prices of gilts resumed and the yield on 10-year paper touched a low of 7.8 per cent on December 5, 2001. Open market sales checked the rally and kept gilt prices range-bound. In the wake of the December 13, 2001 terrorist attack on the Parliament House, bid-ask spreads widened in the gilt market and turnovers fell. The corporate bond yields hardened and their spread over the sovereign paper widened since December 2001. The foreign exchange market remained stable during the third quarter of 2001-02 on the back of the resumption of FII investments except for some downward pressure during December 11-28, 2001. The capital market showed signs of recovery with the BSE Sensex crossing the 3000 mark on October 17, 2001 but sentiments were adversely affected by border tensions in mid-December 2001, as reflected in the widening of the high-low spreads.

5.5 The return of comfortable liquidity conditions in the fourth quarter of 2001-02 was reflected in call rates stabilising around 6.5 per cent except for a temporary edging up

towards end-February 2002 and end-March 2002. Gilt prices rallied towards end-January 2002 on account of comfortable liquidity and a de-escalation in border tensions. The rally was halted on account of developments in Gujarat and market acclimatisation to the new electronic dealing and settlement system.

5.6 In February 2002, the yields continued to slide on budget expectations and touched a low of 7.18 per cent on February 18, 2002. Immediately after the budget, however, prices fell sharply due to the less than anticipated reduction in small savings rates and the yield on 10-year security temporarily hardened to 7.79 per cent on February 28, 2002. The repo rate reduction of 50 basis points to 6.0 per cent on March 5, 2002, improved sentiment before the usual end-of-the year profit booking drove down gilt prices. The foreign exchange market came under some pressure during January-February 2002 on account of increased corporate demand, inter-bank buying, increased purchases by foreign institutional investors (FIIs) as well as political uncertainties and tensions at the border. The market stabilised in March 2002 as supplies evenly matched demand, which kept the rupee range-bound. The equity market experienced a brief revival, especially following the announcement of disinvestment in public sector undertakings (PSUs).

5.7 The financial year 2002-03 commenced with easy liquidity conditions reflected in sizeable repo bids received under LAF auctions. This led to increased turnovers in money, foreign exchange and gilt markets during April 2002 (Table 5.1). Liquidity conditions tightened during mid-April 2002 to end-May 2002 leading to firming up of call rates. The gilt yields also moved up on account of the tensions at the border as also the irregular transactions of some co-operative banks. With the Reserve Bank taking a series of private placements/devolvements in government securities and following the CRR cut by 50 basis points on June 1, 2002, the market sentiment improved. The call rates eased and eventually led to a decline in the repo rate by 25 basis points to 5.75 per cent on June 27, 2002. This also restored the gilt market sentiment. The yield on AAA rated corporate bonds declined and its spread over gilt yields of comparable maturity narrowed during 2002-03 so far, particularly in July 2002. The foreign exchange market remained orderly with the depreciation in the exchange rate to Rs. 49.0 per US dollar during mid-May 2002 being recouped subsequently. The equity market was subdued following border tensions, weak trends in international stock markets and monsoon uncertainties.

VI EXTERNAL SECTOR

6.1 India's external sector posted significant gains during 2001-02, despite the deepening of the global slowdown and uncertainties owing to September 11, 2001 terrorist attacks. For the sixth year in succession, the balance of payments (BoP) recorded an overall surplus. The current account registered a surplus after a period of more than two decades. The buoyancy in capital flows bolstered the foreign exchange reserves which rose to US $ 54 billion by the end of March 2002, sufficient for financing about 11 months of imports. The increase of US $ 11.8 billion in reserves during the year was the largest accretion in a single year. Indicators of liquidity and sustainability of external debt improved further. The exchange rate of the rupee remained broadly stable during the year, except for an extremely brief period of uncertainty owing to the September 11 events.

6.2 The deceleration in global economic activity that began during the second half of 2000 intensified during 2001 with all the major regions of the world (excluding Africa) exhibiting a synchronised slowdown. According to the International Monetary Fund (IMF), world output growth is estimated at 2.5 per cent during 2001 as compared with 4.7 per cent during 2000. Capital flows to developing countries recovered in 2001 mainly on account of higher

official flows. For the year 2002, world output growth is projected at 2.8 per cent by the IMF (World Economic Outlook, April 2002). The IMF has also projected a modest recovery in world trade (goods and services) volumes to 2.5 per cent in 2002. Tradable prices (in US dollar terms) are, however, expected to decline further by 1.3 per cent in 2002 on the top of a decline of 3.3 per cent during 2001. The prospects of capital flows to emerging market economies (EMEs) remain uncertain. The IMF projects a modest increase in the net private capital flows to EMEs to US $ 58.0 billion in 2002 from US $ 31.3 billion in the previous year and US $ 7.7 billion in 2000; they would still be substantially lower than those of US $ 234.2 billion during 1996 and US $ 212.0 billion during 1995.

Balance of Payments

6.3 Weak external demand adversely affected India's export performance during 2001-02. This was counterbalanced by the listless domestic demand for imports and the softness in international oil prices for a greater part of the year. As a result, the trade deficit, on balance of payments basis, declined from US $ 14.4 billion during 2000-01 to US $ 12.7 billion during 2001-02.

6.4 Exports generally declined or decelerated across major commodity groups. In terms of destinations, exports to the OECD and Eastern Europe countries declined during 2001-02; on the other hand, exports to the OPEC and the developing countries in Asia and Africa posted increases.

6.5 Imports, at US $ 51.1 billion during 2001-02, recorded an increase of 1.1 per cent as compared with 1.7 per cent during 2000-01. Reflecting mainly subdued international prices, oil imports declined by 10.5 per cent during 2001-02 as against the sharp increase of 24.1 per cent during 2000-01. Non-oil imports increased by 6.3 per cent (US $ 2.2 billion) during 2001-02 to US $ 37.1 billion in contrast to the decline of 5.9 per cent (US $ 2.2 billion) recorded during 2000-01. The import of gold and silver declined by 2.2 per cent during 2001-02 as compared with a decline of 1.4 per cent during the previous year. Non-oil non-gold imports at US $ 32.6 billion during 2001-02 were higher by 7.6 per cent (US $ 2.3 billion) than that in the previous year.

6.6 During April-June 2002, exports amounted to US $ 11.5 billion recording a growth of 11.3 per cent over the corresponding period of the previous year. Imports increased by 3.2 per cent to US $ 13.2 billion; while oil imports recorded an increase of 11.4 per cent to US $ 4.3 billion, non-oil imports declined by 0.4 per cent to US $ 8.8 billion. The trade deficit, according to the DGCI&S, at US $ 1.7 billion during April-June 2002 was lower than that of US $ 2.4 billion during the corresponding period of the previous year.

6.7 The surplus in the invisibles account at US $ 14.1 billion during 2001-02 was higher by US $ 2.3 billion than that of the previous year mainly on account of higher net inflows in respect of non-factor services. The growth of invisible receipts has also outpaced that of merchandise exports during the 1990s, indicative of shifts in dynamic comparative advantage. India has emerged as among the fastest growing exporters of services in the world.

6.8 Earnings from export of services comprising mainly travel, transportation, insurance and private business and other miscellaneous services have emerged as the dominant category of invisible receipts since 1998-99, accounting for 57 per cent of the latter in 2001-02. Transfers, mainly private remittances from expatriate Indians, have traditionally been the major source of invisible receipts. In the recent years, however, their share in gross invisible receipts has declined from 53 per cent in 1997-98 to 35 per cent in 2001-02. The share of

factor income in gross invisible receipts rose steadily during the 1990s and formed around eight per cent of gross invisible receipts during 2001-02. Software exports recorded a growth of 13.1 per cent in 2001-02 on the top of an increase of 57.9 per cent in 2000-01, notwithstanding the marked slowdown witnessed by IT companies globally.

6.9 The current account recorded a surplus of US $ 1.4 billion during 2001-02 as against a deficit of US $ 2.6 billion during the previous year; the turnaround was due to a contraction in net payments on the merchandise account as well as a higher invisible surplus. As a proportion to GDP, the current account surplus was 0.3 per cent during 2001-02 as against a deficit of 0.5 per cent during 2000-01 and the average deficit of 1.3 per cent over the 1990s.

6.10 Net capital flows were higher at US $ 9.5 billion during 2001-02. Inflows under FDI touched a high of US $ 3.9 billion during 2001-02 surpassing the previous peak of US $ 3.6 billion achieved in 1997-98. On the other hand, there was a reduction in portfolio investment flows from US $ 2.8 billion during 2000-01 to US $ 2.0 billion during 2001-02 as both foreign institutional investment (FII) inflows and amounts raised through the GDR/ADR route were lower than in the previous year. Net accretions under various NRI deposit schemes were higher in 2001-02 than in the previous year, entirely on account of accretions under the NR(E)RA scheme. Deposits under other schemes (FCNR(B) and NR(NR)RD) were, however, lower than that in the previous year. The demand for external commercial borrowings (ECBs) continued to remain constrained by the weakness in domestic investment demand. Disbursements under short-term credits almost halved, mainly in consonance with the decline in oil imports, from US $ 10.8 billion during 2000-01 to US $ 5.5 billion during 2001-02.

Foreign Exchange Reserves

6.11 India's foreign exchange reserves, comprising foreign currency assets, gold held by the Reserve Bank and Special Drawing Rights (SDRs) held by the Government increased from US $ 42.3 billion as at end-March 2001 to US $ 54.1 billion as at end-March 2002. The accumulation of US $ 11.8 billion during the year 2001-02 (US $ 4.2 billion during 2000-01) has been the highest accretion in a single year so far. With the current level of reserves, India is among the top reserve holding emerging market countries.

6.12 The outstanding forward liabilities of the Reserve Bank, which have been maintained at relatively low levels as a part of prudent reserve management policy, declined even further during the year from US $ 1.3 billion as at end-March 2001 to US $ 0.4 billion as at end-March 2002. As a result, the ratio of outstanding forward liabilities to gross foreign exchange reserves declined sharply from 3.0 per cent as at end-March 2001 to only 0.7 per cent as at end-March 2002.

6.13 During 2002-03 so far (up to August 16, 2002), the foreign exchange reserves increased by US $ 6.5 billion to US $ 60.6 billion as foreign currency assets increased by US $ 6.4 billion to US $ 57.4 billion. The value of gold holdings also recorded an increase of US $ 0.2 billion to US $ 3.2 billion over the same period. The outstanding forward liabilities were US $ 0.4 billion at end-June 2002, the same level as at end-March 2002.

6.14 India's sustained efforts to build an adequate level of foreign exchange reserves have been vindicated by global uncertainties. It is now widely agreed that in judging the adequacy of reserves in emerging economies, it is not enough to relate the size of reserves to the quantum of merchandise imports or the size of the current account deficit. The overall approach to the management of India's foreign exchange reserves in recent years has, therefore, reflected the changing composition of balance of payments. In addition to the

likely developments in the current account, the reserve management has also endeavoured to reflect the risks associated with different types of flows and other requirements. A sufficiently high level of reserves is necessary to ensure that even if there is prolonged uncertainty, reserves can cover the "liquidity at risk" on all accounts over a fairly long period. The movement in foreign exchange reserves in recent years has kept pace with India's external financing requirements on current and capital accounts.

External Debt

6.15 India's external debt declined by US $ 1.6 billion (1.6 per cent) during 2001-02 to US $ 98.1 billion at end-March 2002 from US $ 99.7 billion at end-March 2001. Almost one-half of India's external debt was owed to multilateral and bilateral agencies, while around one-fourth was on account of external commercial borrowings. All components of external debt, except multilateral debt and long-term non-resident deposits, declined during 2001-02.

6.16 Key indicators of debt sustainability suggest continuing consolidation and improvement in solvency. The external debt-GDP ratio declined from 22.3 per cent as at end-March 2001 to 20.8 per cent as at end-March 2002. The size of short-term debt remained modest both in regard to total debt and reserves. While the proportion of short-term to total debt declined to 2.8 per cent at end-March 2002 from 3.5 per cent at end-March 2001, the ratio of short-term debt to foreign exchange reserves declined to 5.1 per cent from 8.2 per cent over the same period.

6.17 The debt service ratio and the liability service ratio, which had increased in 2000-01 due to prepayments, declined during 2001-02 to 14.1 per cent and 15.3 per cent from 17.3 per cent and 18.3 per cent, respectively. This reflected, in significant measure, the rising trend in current external receipts.

Exchange Rate Developments

6.18 The exchange rate of the Indian rupee *vis-à-vis* the US dollar moved within a range of Rs.46.56-Rs. 48.85 per US dollar during 2001-02. On the basis of monthly averages, the exchange rate depreciated by 4.3 per cent from Rs.46.62 per US dollar in March 2001 to Rs.48.74 per US dollar in March 2002.

6.19 In the swap segment, the forward premia for all the three maturities (one-month, three-month and the six-month) hovered around 4 per cent during the first five months (April-August) of 2001-02. In the days following September 11, the premia hardened to 5.5-5.6 per cent across all maturities and increased further to 6.3-6.4 per cent in December 2001. The forward premia averaged between 5.9-6.9 per cent during March 2002.

6.20 The Indian rupee remained broadly stable during the first four months of 2002-03 except for a brief period of uncertainty in May 2002. The rupee moved in a range of Rs.48.67-49.06 per US dollar during April-July 2002. The exchange rate was Rs.48.58 per US dollar as on August 16, 2002. The six-month forward premia moved in a range of 5.1-6.6 per cent during April-June 2002. Average six-month premia increased to 6.2 per cent in May 2002 before declining to 4.6 per cent in July 2002.

6.21 Recent international developments have underscored the need for careful monitoring of the exchange rate in order to maintain orderly conditions in the markets (without, however, targeting a specific level). India's exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way, has stood the test of time. Despite several unexpected external and domestic developments, India's external

situation continues to remain highly satisfactory. The Reserve Bank will continue to follow the same approach of watchfulness, caution and flexibility while dealing with the foreign exchange market. It is a matter of satisfaction that the recent international research on viable exchange rate strategies in emerging markets has lent considerable support to the exchange rate policy followed by India. A number of countries (including those in East Asia) are now following similar policies.

VII ASSESSMENT AND PROSPECTS

7.1 By August 2002, there is considerable uncertainty about the likely extent and spread of the drought conditions in the country, and their effect on agricultural output. Though a normal South-West monsoon had been forecast earlier, the progress of the monsoon has so far been unsatisfactory with 19 (out of 36) meteorological subdivisions receiving deficient/scanty rainfall up to mid-August, 2002 as compared with seven such subdivisions in the corresponding period of the previous year. While the uneven progress of the monsoon so far is a cause for concern, especially as regards localised availability of water, there is fortunately, no reason for undue alarm in respect of macro-economic stability, given the in-built resilience of the economy engendered by absence of inflationary pressures and substantial stocks of foodgrains and foreign exchange reserves.

7.2 In the year 2001-02, economic activity had recovered some momentum, benefiting from a robust performance of the agricultural sector. India was among the strongest growing economies in the world, notwithstanding an international environment bound down by the synchronised weakness affecting large parts of the global economy. Although India was not immune to the vicissitudes of the global weakening of export demand affecting merchandise exports in 2001-02, the buoyancy of software and private business and commercial services exports enabled the posting of a modest current account surplus after 24 years. With the continuing strength of the capital flows, including the largest net inflow of foreign direct investment recorded so far for any single year, the Indian economy is experiencing a relaxation of the balance of payments constraint on growth. The strength of the external accounts has greatly fortified the conduct of exchange rate policy and reserve management. There has also occurred a reduction of the external debt to 'least-indebted' levels alongside a marginal decline in the stock of external debt.

7.3 The favourable balance of payments conditions have vindicated and reinforced the policy objective of ensuring orderly market conditions with no fixed target for the exchange rate. Cross-country comparison indicates the relative stability of the Indian rupee *vis-à-vis* other emerging market currencies. In contrast to several other countries which have experienced considerable external difficulties in the 1990s, India's foreign exchange reserves (US $ 60.6 billion) have increased more than five-fold in the last ten years, and India is now among the top reserve holding emerging market economies. In the current year alone –up to August 16, 2002 – the reserves have increased by US $ 6.5 billion. The strategy of building up the foreign exchange reserves, not only in terms of import purchasing power and debt servicing, but also against liquidity risks associated with various types of capital flows, has helped in insulating domestic activity from external shocks.

7.4 Monetary and financial conditions also continued to remain stable in 2001-02 as well as in the first few months of the current fiscal year. Reserve money growth, on a year-on-year basis, at 10.2 per cent as on August 16, 2002 was broadly of the order of expansion up to mid-August last year, with net foreign currency assets continuing to be the main driver of base money growth. Net Reserve Bank credit to the Centre declined by 12.1 per cent; private placements/ devolvements in Government securities amounting to Rs.23,175 crore were

largely offset by open market operations of Rs.20,583 crore during 2002-03 so far. The year-on-year M_3 expansion was 16.8 per cent as on August 9, 2002. Adjusted for the impact of mergers since May 3, 2002, however, monetary expansion, at 13.7 per cent, has been close to its indicative trajectory of 14.0 per cent for the year. The growth in aggregate deposits, similarly adjusted, has been as per initial expectations. Currency expansion has been maintained. Although growth in bank credit to the commercial sector at 19.1 per cent shows a significant increase as against 13.8 per cent last year, this predominantly reflects the merger effects.

7.5 Scheduled commercial banks' non-food credit, inclusive of their non-SLR investments, increased by over Rs.64,000 crore during the current financial year so far (up to August 9). Excluding the impact of the mergers since May 3, 2002, non-food credit is estimated to have increased by nearly Rs.20,000 crore; on a comparable basis, non-food credit had increased by about Rs.6,000 crore last year. The expansion in non-food credit, which is widely regarded as a leading indicator of industrial activity, provides some confidence about revival of industrial growth.

7.6 Inflation, measured by the year-on-year change in wholesale prices, declined to 2.7 per cent as on August 3, 2002 from 5.5 per cent a year ago. The easing of inflationary pressures was also reflected in the movement of the average wholesale prices. The consumer prices, on the other hand, exhibited some upward movement over the year reflecting the pass-through of the April 2002 increases in administered prices of wheat and petroleum products to the retail level, and an upturn in housing prices. In view of the substantial stocks of foodgrains, comfortable foreign exchange reserves and the institutional mechanisms to absorb supply-side shocks, it is expected that uncertainties in monsoon conditions should not put any undue inflationary pressures on the economy.

7.7 During the first quarter of 2002-03, the provisional data on Central finances show some easing of the fiscal stress mainly due to buoyant collections under corporate and income taxes as well as indirect taxes under excise and customs. Gross tax revenues rose by 21.3 per cent during April-June 2002-03 as against a decline of 13.4 per cent during the same period of the previous year. Non-tax revenues also registered an increase of 19.3 per cent. On the other hand, there has been an increase of 16.3 per cent in aggregate expenditure during April-June 2002-03 constituting 18.5 per cent of the budget estimates. In particular, revenue expenditure registered an increase of 19.2 per cent. The Centre's gross fiscal deficit (GFD) was lower by 6.3 per cent over the level in April-June 2001-02 and constituted 29.2 per cent of the budget estimates. For the first quarter of 2002-03, while the revenue deficit was running higher than in the preceding year, the gross primary deficit was significantly lower.

7.8 In view of the drought conditions reported in some parts of the country, inevitably, affected State Governments would have to step up expenditures in identified areas, while the Central Government would also be required to provide the necessary support. Under these circumstances, the possibility of some unanticipated expenditures by the Central Government as well as in respect of several States would have to be reckoned with. However, on current indications, in view of comfortable liquidity conditions, such slippages can be accommodated by a combination of measures without seriously impacting the financial markets.

7.9 Financial market conditions have been orderly since the commencement of 2002-03 reflecting largely the cumulative impact of steady accretions to foreign currency assets of the Reserve Bank. Temporary episodes of tightening liquidity conditions engendered by the launching of the government borrowing programme, pick-up in currency demand and credit off-take were relieved from end-May 2002 with the Reserve Bank taking a series of private placements and the CRR cut being advanced to June 1, 2002. Softening of the call rates

below 6.0 per cent enabled a repo rate cut of 25 basis points on June 27, 2002. The call rates hovered generally around the repo rate in July 2002 and ruled even below 5.75 per cent in August 2002. With the easing of monetary conditions, market sentiments in the gilt market improved and yields softened particularly in July and August 2002. Prime lending rates of the public sector banks remained unchanged during 2002-03 so far. Contemporaneously, efforts towards developing the various financial market segments were carried forward with a view to ensuring financial stability and improving allocative efficiency.

7.10 The equity markets have been generally weak during 2002-03 so far, mainly reflecting co-movement with the behaviour of global equity markets as also uncertainties about the monsoon. The BSE Sensex declined by 11.6 per cent by August 16, 2002; however, the decrease in the BSE-500 (4.6 per cent) was moderated by buying interest in stable low priced mid-cap stocks. Interest in Public Sector Undertaking (PSU) scrips has also picked up following initiatives taken to speed up the disinvestment process.

7.11 On the whole, the macroeconomic prospects for the current year 2002-03 are mixed. On the one hand, financial, liquidity and inflationary conditions are highly favourable for higher growth. Similarly, the external sector is also strong with a high and growing level of foreign exchange reserves and competitive exchange rate. On the other hand, the agricultural outlook is sombre with the likelihood of widespread drought. This may also adversely affect the incipient industrial recovery unless countervailing and timely measures are put in place to accelerate the pace of industrial investment and economic reforms. On balance, there is a strong possibility that the growth rate of 6.0 to 6.5 per cent projected in the Annual Monetary and Credit Policy Statement (April 2002), which was based on the assumption of a normal monsoon, will not be realised. On the basis of current indications about the monsoon, the growth rate is likely to be lower than projected earlier. A re-assessment of the projected growth rate for the current year will be attempted in the mid-term review of the Monetary and Credit Policy in October 2002, by which time reliable information regarding the effects of drought on the agricultural and industrial output will be available.

Some Issues in Agriculture

7.12 Variability in agricultural production has emerged as a cause for serious concern. Much of this volatility seems to stem from poor performance of non-foodgrains, which is related to their excessive dependence on monsoon. Even among foodgrains, it is wheat and rice that are irrigated, while pulses and coarse cereals tend to be cultivated in dry land. Extending irrigation benefits to other crops and the induced crop diversification would enable the realisation of the objective of demand-driven agricultural growth envisaged in the National Agricultural Policy. The declining public investment in agriculture is resulting in reduced yields and slowdown in the growth of rural non-farm employment. There is an urgent need to increase public investment in irrigation and water management, given the high correlation between the growth of area under high yielding varieties of seeds and gross irrigated area. This can be achieved by restructuring the existing allocation of resources to agriculture on the one hand, and by increasing user charges (*e.g.,* in power, irrigation *etc.*) on the other, with due consideration to appropriate phasing. Moreover, investment needs to be directed towards watershed development in view of its salutary environmental implications.

7.13 The policy of declaring differential and exogenously determined Minimum Support Prices (MSPs) has emerged as a major factor inhibiting crop diversification. It is necessary to adopt a phased reduction of the implicit cross-subsidisation in administered farm prices. Simultaneously, the removal of the restrictions on inter-State movements of farm produce and greater exposure of the agricultural sector to international terms of trade will considerably improve the price sensitivity of cropping and land use. Market orientation of

cropping patterns will also be contingent upon a comprehensive overhaul of the legal infrastructure relating to ownership and transfer of land. Over the medium term, administered support prices should give way to vibrant spot and futures markets for both foodgrains and non-foodgrains which will enable farmers to obtain remunerative prices for their produce and to transfer various risks associated with their perishable stock. Introduction of futures trading brings to the fore the issues of financing trade and settlement mechanisms.

7.14 Despite India being the second largest producer of fruits and vegetables in the world, their production has been hampered due to the relatively low priority given to the food processing industry and inadequate market infrastructure. This has become increasingly important in view of the WTO bindings on tariffs. Concerted measures have to be taken to promote agro-based industries with export orientation as these are comparatively labour intensive and would exploit the comparative advantage India has in food processing. Diversification of agriculture needs to encompass subsidiary farm activities such as apiculture, dairying and poultry and appropriate marketing strategies need to be designed to make these products internationally competitive. In this regard, the vital function of efficient agricultural marketing should be recognised. This underscores the need to move to a situation where an efficient system of market intermediaries is created in agricultural marketing. The related issue of quality standards has several dimensions like adherence to global environmental and health standards, delivery schedules and proper certification. A thorough review of adequacy of institutional arrangements in quality control, certification and trading in the agriculture sector should be a national priority to take advantage of global opportunities.

7.15 The Government of India and the Reserve Bank have been taking a number of initiatives to ensure adequate credit to the agricultural sector. Besides augmenting the total flow of institutional credit, the major objective is to improve the distribution of credit in favour of the farm sector. There are broadly three categories of institutions which deliver credit to rural areas, *i.e.*, commercial banks, Regional Rural Banks (RRBs) and co-operative banks. Although public sector banks as a group have achieved the targets for lending to the priority sector, the flow of credit to rural areas by other segments of the banking system has not been buoyant. Efforts are underway to improve the recovery rate in respect of agricultural loans and advances as accumulated overdues have constrained capabilities of expanding credit to the agricultural sector. The non-performing assets of RRBs have been declining in recent years largely due to an increase in the share of assets in the standard category. This augurs well for the credit delivery mechanisms of the RRBs in the context of their specialised function. The rural co-operatives sector remains dependant on flow of finance from the National Bank for Agriculture and Rural Development (NABARD). There is a need to examine the issue of rural credit and its delivery systems in an objective as well as transparent manner and accord it priority in legislative actions and financial allocations. The scheme of micro-finance has made rapid strides in India, both in terms of Self-Help Groups (SHGs) linked with banks and the number of beneficiaries covered. The progress of micro-finance across the States has, however, been uneven.

Industrial Outlook

7.16 Restraining the strength of the industrial revival are the persistent gaps in the demand-supply of infrastructure. In the recent period, there have been some distinct signs of improvement, particularly, in the provision of telecommunication services with the narrowing of the demand-supply gap from 27.9 per cent in 1991-92 to 12.2 per cent in 2000-01. The phenomenal growth in the telecommunications sector continued in 2001-02. A net addition of 69.6 lakh lines (6.4 per cent growth) was made in switching capacity of the

telecommunication sector. The demand-supply gap in power sector which reached a peak of 11.5 per cent in 1996-97 has come down to 7.5 per cent in 2001-02. The situation, however, remains far from satisfactory. The Mid-Term Appraisal of the Ninth Five Year Plan identified a number of areas for further policy actions including replacement of the archaic Indian Post Office Act (1898) by a modern forward looking Act, an accelerated growth of the hardware sector, and a renewed thrust on science and technology in response to WTO requirements and standards. These policy initiatives could significantly ease the financing constraint on infrastructure. Steps to address infrastructural constraints with the implementation of the National Highway Development Project, expansion in the ambit of National Telecommunication Policy (1999) through the opening up of Domestic Long Distance telephony and the introduction of the Communication Convergence Bill 2001 are important developments in the infrastructure sector which augur well for the future.

7.17 The central sector projects form the core of the infrastructure initiatives undertaken by the Government. The central sector projects, which are primarily focused upon infrastructure development, however, continue to be plagued by delay relating to civil works, timing of award of contracts, land, funds and equipment supply. Delays in project completion, measured against the latest approved date of commissioning, affect nearly 62 per cent of the projects leading to substantial cost overrun. Such huge cost overrun primarily occur on account of inordinate delays in government clearances, lack of funds, absence of coordination, lack of supporting infrastructure facilities, problems with respect to industrial relations, contractual problems and technology. According to experts, nearly 75 per cent of the cost overrun could be checked if time overrun in the implementation of the projects could be controlled. A dynamic and focused approach to making central sector projects commercially viable and efficient needs to assume priority in the programme of public sector reforms.

7.18 The need of the hour is clearly an all round deepening of reforms in order to harness the full potential of the private initiatives for infrastructure, in addition to public investment. A carefully calibrated policy package with emphasis on contestability, enforceable contracts, development of markets for long-term debt instruments, proper pricing of infrastructure services, and above all, transparent and non-discriminatory rules of the game needs to be designed as part of the second generation reforms in infrastructure, guided by the relative strengths and weaknesses of the public sector and markets in infrastructure provision. Establishment of rational user charges and credible regulatory authorities are two critical features on which the success of infrastructure development will depend. An active promotion and creation of an institutional mechanism for community participation can also greatly improve the efficacy and efficiency of infrastructure services.

7.19 The prospects for industry and services are increasingly getting intertwined in the context of the former's extensive tertiarisation through outsourcing, advertising, publicity, infotainment and marketing. Infrastructure services especially transport, communication, storage, banking and finance enhance the efficiency of the secondary sector. The dominant share of producer services in tertiary GDP has intensified technological progress. The recent upsurge in services growth augurs well for industry. While the sectors like tourism and hotels might be adversely affected by the recent catastrophic events, the IT-related services could benefit from the growing demand for IT-outsourcing in the Asia-Pacific region, given the country's comparative advantage. This would act as a booster for the hardware segment of the industrial sector with a positive feedback for services. The services sector is undergoing shifts in its composition with a progressive erosion in the share of public administration. This trend is likely to get entrenched in the medium-term as efforts towards

rationalisation and reduction of manpower in various Ministries/ Departments of the Government and cutting various costs associated with public administration, including those associated with a large bureaucracy, are implemented over a wide area. Simultaneously, the focus would need to shift to improving the quality and delivery of public services. In view of the employment-intensity of the services sector, this will also enable a greater absorption of the workforce currently employed in the informal sector into the organised services sector. This improves the prospects of even higher growth of services sector GDP in the future.

7.20 As an outcome of the reform process, a more open trade and investment regime has forced a substantial restructuring in the Indian industry mainly through mergers and acquisitions (M&As), corporate repositioning, business refocus, competing globally and participating in overseas ventures. India has witnessed substantial rise in M&As during the first half of 2002 in sharp contrast to a decline worldwide. This indicates greater awareness in the Indian corporate sector of the need to compete globally through corporate restructuring. M&As enable companies to fructify synergy effects of economies of scale and scope through consolidating businesses and making them competitive in the area of their core competence. Non-core areas are phased out by de-merging and spinning-off activities.

7.21 In the Indian context, labour legislation and legal procedures pose challenges for restructuring of loss-making units. Another major obstacle is the law relating to reorganisation and bankruptcy of sick companies. The industrial restructuring would thus require fundamental changes in the bankruptcy and liquidation procedure currently governed by Sick Industrial Companies (Special Provisions) Act (SICA) and Board for Industrial and Financial Reconstruction (BIFR), strengthening of debt recovery tribunals and amendment to the Companies Act. The recent initiatives in regard to asset securitisation and improvements in the bankruptcy law as well as procedures augur well for the future, provided speedy implementation is ensured. Greater emphasis on corporate governance has also become necessary for successful industrial restructuring. In the public sector enterprises, the healthy process of combining restructuring with progressive reduction of government equity holding in such enterprises through the disinvestment route, needs to be pursued vigorously.

7.22 Indian industry has made efforts over the last few years to cut costs and improve the quality of its products through restructuring and modernisation. Measures aimed at providing a level playing field in terms of ready availability of capital at reasonable terms and enhancement in availability as well as quality of infrastructural facilities would improve competitiveness.

External Sector

7.23 Activity indicators of the advanced economics for the first quarter of 2002 suggested a higher growth forecast for the global economy, notwithstanding the presence of significant downside risks that may restrain a full-fledged recovery. Weak second quarter activity indicators for the US and the growing concerns about corporate earnings indicate that global recovery may be delayed further. The prospects of recovery in Japan also appear to be much weaker. Even though cyclical deflationary pressures are moderating, structural deflationary pressures continue to be deeply rooted in the economy. Sentiments regarding the recovery of growth in the Euro area remain uncertain. East Asia is expected to recover faster with the steady improvement in electronics exports. Domestic demand has also started strengthening and stock markets have rebounded strongly since the fourth quarter of 2001. Signs of correction in the perceived overvaluation of the US dollar also became clearly visible in 2002. Despite continued economic problems in Argentina, emerging market sovereign spreads have generally narrowed. Stock markets in some emerging economies have started looking up.

7.24 While these changes in the external environment augur well for India's external sector management, the developments in respect of India's exports require continuous vigilance. It is necessary to devise strategies to reverse the contraction in exports witnessed in 2001-02. The overall medium-term export strategy is to raise India's share in world exports to one per cent over a five-year horizon. This would require a vigorous drive, based on product-specific and market-specific export plans. Over the years, trade policy has undergone fundamental shifts to correct the earlier anti-export bias through the withdrawal of QRs, reduction and rationalisation of tariffs, liberalisation in the trade and payments regime and improved access to export incentives, besides a realistic and market-based exchange rate. Several measures have been introduced to ensure timely delivery of credit to exporters and to remove procedural hassles. The Reserve Bank has been arranging seminars at major exporting centres for the benefit of exporters and branch level bank officials for resolving the problems relating to export credit and meeting foreign currency requirements. A survey conducted by the National Council of Applied Economic Research (NCAER) in order to obtain a feedback on simplification of procedures, reflects a positive response to the initiatives in improving the credit delivery system to exporters. The recent experience suggests subtle shifts in international comparative advantage with software, business and commercial services eclipsing the performance of merchandise exports, and even providing support in phases of contraction in external demand. Accordingly, micro-strategies for export growth need to be designed to nurture the impulses for growth.

7.25 In recent years, the behaviour of the current account balance has reflected the underlying conditions of flagging aggregate demand. Accordingly, current account deficits (CADs) have been progressively narrowing in recent years, turning into a modest surplus in 2001-02. While these developments are noteworthy for reflecting the success of external sector management, they must be regarded as transient in the context of a developing country aspiring for higher rates of growth within the traditional resource constraints. The target growth path in the Tenth Five Year Plan would presage a greater recourse to higher imports and enlarged capital flows. At the same time, there remains considerable degree of concern regarding the sustainable level of the current account deficit for an economy of India's size and diversity. Clearly, exports hold the key to achieving a sustainable balance between the requirements of higher growth and the imperative of ensuring viability in the external sector. The projections of import growth underlying the growth rate of 8 per cent for the Tenth Plan have to be modulated and conditioned by the achievement of export targets along the course charted by the Medium-Term Export Strategy, 2002-07.

7.26 Against this background, financing of an average current account deficit (CAD) of about 2.8 per cent of GDP as projected in the approach paper to the Tenth Five Year Plan may require a two-fold increase in the size of annual capital flows from current levels. From a policy perspective, international investor confidence is critical to mobilise capital flows of this order. For this purpose, accumulation of reserves at a high level is an important prerequisite along with concerns relating to absorption of such flows and their associated monetary impact.

7.27 Foreign exchange reserves represent a critical defence against unpredictable flows. From this perspective, there are economies of scale to be gained by building reserves. A key issue in reserve management is measuring overall economic costs and benefits of holding reserves. In theory, the direct financial cost of holding reserves is the difference between interest paid on external liabilities of public and private sectors, and returns on external assets. At the same time, such costs, if any, have to be treated as insurance premium to assure and maintain confidence in the availability of liquidity. The benefits of such a premium are not merely in terms of warding off risks but also in terms of better credit rating and finer spreads while

contracting debt. Internationally, for emerging economies, large borrowings by some entities tend to increase country risk premia and thus raise the interest rate charged to all borrowers. Private sector external debt decisions have, in fact, impinged on fiscal management and balance sheets of the official sector in several ways. The recent crises have led to consideration of a broad concept of "national liquidity" which takes into account the maturity and currency mismatches of the private sector in structuring its own foreign assets and liabilities, apart from sovereign and publicly guaranteed external obligations. The dominant policy objectives in regard to foreign exchange reserves in India may be encapsulated as maintaining confidence in monetary and exchange rate policies, enhancing the capacity to intervene in foreign exchange markets, limiting external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis including national disasters or emergencies, and providing confidence and comfort to the external markets.

7.28 The gains of a prudent external debt management strategy pursued over the 1990s are being reflected in an appreciable decline in the debt-GDP ratio and the debt service ratio as well as the increase in the liquidity cover that the reserves provide for potentially volatile elements of the debt stock. Efforts are being made towards further consolidation of external debt and towards developing a more comprehensive framework of debt management by monitoring currency composition, interest and maturity mix.

Fiscal Policy Issues

7.29 It needs to be reiterated that fiscal empowerment by augmenting the volume and scale of the tax and non-tax revenue flows into the budget holds the key to fiscal consolidation in India. Revenue maximisation requires that the tax system be reformed through widening the tax base, simplification of tax rules, review of exemptions/incentives, and strict tax compliance along with extensive use of information technology and data warehousing. Moreover, it is also necessary to design a long-term tax policy. This would obviate the need for a large number of tax changes each year and would provide stability to the tax system. In the Indian context, lack of an effective and simple tax regime has been an important factor leading to a decline in the tax/GDP ratio. As regards indirect taxes, the successful implementation of the value added tax (VAT) at the national level is a major challenge in the drive for improvement in tax revenue.

7.30 Poor return on investments in public sector enterprises (PSEs) and statutory corporate entities are areas of concern. The issue of user charges and cost recoveries needs to be addressed in the context of fiscal correction and achieving a reasonable degree of flexibility in public finances. Improvement in fixing and collection of user charges, extension of the same to non-merit goods and progress in cost recoveries is also central to the issue of fiscal empowerment. As such, non-tax revenues, which include user charges and cost recoveries on the services rendered by the Government or their entities in areas such as transport, power and irrigation would reflect the cost of services provided. The PSEs which are making losses need to be restructured so that the profitability of the public enterprises could be a major source of resource generation and support to Government finances.

7.31 Fiscal consolidation also requires altering the pattern of expenditure. The level of expenditure of the Central Government is heavily loaded in favour of obligatory constituents – interest payments, defence and statutory grants to States – reducing thereby, the manoeuvrability of fiscal policy. Capital expenditure, which adds to the productive capacity in the economy, is being progressively pre-empted by growth in revenue expenditures. Although explicit subsidies provided by the Central Government have declined, there is a wide range of hidden subsidies which need to be contained. Proper targeting of subsidies is needed to reduce leakages and misappropriation. In this regard, the dismantling of the

administered price mechanism in the petroleum sector has been a welcome step as it would not only bring transparency to the fiscal operations, but would also improve the productivity, efficiency and international competitiveness of the domestic petroleum industry. In this regard, formulating a long-term energy policy, taking into account the future of public sector oil companies, is necessary to exploit the strong forward and backward linkages of the energy sector with other sectors of the economy.

7.32 A comprehensive approach to the management of public expenditure would require explicit recognition of macroeconomic linkages of Government expenditure policies, setting of expenditure priorities and ensuring that specified activities are undertaken efficiently and effectively. In this context, accumulated empirical evidence shows that public sector investment in the infrastructure sector 'crowds in' private investment. While the debate around ownership *versus* efficiency continues, it is necessary to recognise that there is no evidence for automatic reaping of efficiency gains merely from the transfer of ownership from public to private. On the other hand, there is some evidence suggesting that efficient public ownership in some selected sectors could bring with it external economies of scale and scope which provide a supportive environment for private enterprise especially when projects are lumpy, involve long gestation lags and where the critical minimum of infrastructure has to be created. However, an essential pre-requisite for such positive results to be realised is to make the management of public enterprises autonomous but accountable in terms of economic performance.

7.33 There has been a successful completion of the strategic sale process of some public sector undertakings since last year. The proceeds from disinvestments aggregated Rs.5,000 crore during 2001-02 which were significantly higher than Rs.2,125 crore raised during the preceding year. The real challenge, however, lies not merely in closing down non-viable public sector undertakings but in restructuring of potentially viable PSUs and significantly scaling down of government equity stakes in all non-strategic areas.

7.34 The fiscal position of the State Governments has remained under pressure throughout the 1990s. The large magnitude of committed expenditure, *viz.,* salaries, pensions and interest payments, has severely constrained the States' ability to undertake developmental activities. Recent policy initiatives by the States reflect the growing urgency for fiscal stabilisation and reforms. Each State has devised its own strategies; yet a common thread runs through them all - expenditure containment, revenue augmentation, reforms of public enterprises and reduction in subsidies.

7.35 A critical desideratum of the quality of fiscal reforms is the availability, quality and delivery of public services such as public health, education, water supply and sanitation. States have an important role in the development of social infrastructure. Therefore, it is important to ensure that the fiscal consolidation process does not lead to reduction in the States' support to these activities. Revenue maximisation including the States' own resources accordingly assumes critical importance. Improvement in tax administration/tax compliance and rationalisation of tax rates is crucial for enhancing the buoyancy in tax receipts.

7.36 The tendency of diverting funds raised by public enterprises, ostensibly for commercial purposes, to support budget operations of some States emerged as a serious problem in recent years. Such diversions lead to erosion of fiscal transparency, and as they grow in size, they have the tendency to distort both the fiscal and financial systems of the economy. This calls for close monitoring of the end-use of funds made available to State-level enterprises.

Monetary Policy Issues

7.37 The monetary policy framework has been undergoing change in the choice of

instruments and in terms of the transmission mechanism of monetary policy. The operationalisation of Negotiated Dealing System (NDS) and Clearing Corporation of India Ltd. (CCIL) coupled with the progress in establishing Real Time Gross Settlement (RTGS) provide valuable infrastructure for further refinements in monetary operations. The monetary and credit policy for 2002-03 has been reinforced by favourable developments in the form of low inflation, ample liquidity in financial markets, continuing capital inflows and a substantial build up of foreign exchange reserves. The policy stance continues to ensure that all legitimate requirements for credit are met consistent with price stability, with the outlook biased towards a soft and a more flexible interest rate structure in the medium term. The yields on government securities have fallen sharply; however, this situation may be subject to change in the context of the anticipated pick up in credit demand or unforeseen domestic and external developments. Accordingly, monetary policy has been imbued with a flexible approach and markets are being prepared for shifts in stance if a change in circumstances warrant a tightening.

7.38 Efforts to build the institutional infrastructure in terms of financial markets are being intensified. With the accomplishment of virtual Public Debt Office (PDO) and Deposit Accounts Department (DAD) coupled with the operationalisation of centralised funds management system (CFMS), transactions in government securities and foreign exchange are expected to become significantly more efficient and secure. While these developments could enhance the efficiency of financial markets, there is also the risk of faster transmission of contagion. Therefore, containment of systemic risk in the new environment would be a major challenge for the conduct of monetary policy in the future. The Reserve Bank will continue its efforts to ensure efficient functioning of the financial markets and would put in place further reforms in pursuit of financial stability and efficiency in financial intermediation, with concomitant benefits for improving the effectiveness of monetary policy transmission.

Financial Sector Reforms

7.39 Financial sector reforms have altered the organisational forms, ownership pattern and domain of operations of banks and financial institutions (FIs). Further intensification of the reform agenda includes divesting the Reserve Bank of its ownership functions. Steps have also been initiated to infuse competition into the financial system.

7.40 A major element of financial sector reforms in India has been a set of prudential measures aimed at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and public credibility. The supervisory strategy of the Board for Financial Supervision (BFS) consists of a four-pronged approach, including restructuring the system of inspection, setting up of off-site surveillance, enhancing the role of external auditors, and strengthening corporate governance, internal controls and audit procedures. While the objective has been to meet the international standards, fine-tuning has occurred in certain cases keeping in view the unique country-specific circumstances. While there is a degree of gradualism, there is also an intensification beyond the ‘best practices’ in several instances.

7.41 The development of financial markets has encompassed regulatory and legal changes, building up of institutional infrastructure, constant fine-tuning in market micro-structure and massive upgradation of technological infrastructure. Along with the steps taken to improve the functioning of these markets, there has been a concomitant strengthening of the regulatory framework. The price discovery in the primary market has progressively acquired greater credibility and secondary markets now have somewhat greater depth and liquidity. The number of instruments and participants has also increased in all markets. The presence of foreign institutional investors has also strengthened the process of convergence between the

domestic and international capital markets.

7.42 The Reserve Bank has been articulating the need for appropriate changes in the legal architecture. Several legislative measures affecting ownership of banks, debt recovery, regulation of non-banking financial companies, foreign exchange transactions and money market have been completed. Those on the anvil include measures relating to fiscal and budget management, public debt, deposit insurance, securitisation and foreclosure, and prevention of money laundering. The agenda for further legal reform has also been identified and articulated by the Reserve Bank in the Statements on Monetary and Credit Policy, and other fora. These relate, in particular, to ownership, regulatory focus, development of financial markets, and bankruptcy procedures. The legislative process is complex in a democratic set up and it will be inadvisable to rush into legislation through a "big bang" approach. Furthermore, many elements of economic reform and underlying legislative framework need to be harmonised. At the same time, it may not be necessary to wait for legislative framework to change to bring about some of the reforms or initiate processes to demonstrate usefulness of reform-orientation. In several cases, contracts with stipulated conditions have been framed in the absence of specific law governing such transactions. Similarly, it has been possible to invoke prudential regulations over financial institutions regulated by the Reserve Bank to anchor best practices in financial markets. Appropriate incentive structures have been put in place even where legal or formal regulation may be difficult. Some of the serious shortcomings in the anticipated benefits of reform such as in credit delivery need changes in legal and incentive systems. In particular, there is need to focus on reduction of transaction costs in economic activity, and on enhancing economic incentives.

7.43 An area of concern remains the absolute level of non-performing assets (NPAs), more so with the public sector banks (PSBs). Several initiatives have been taken towards NPA management and resolution, including compromise settlements, debt recovery tribunals and resort to court process, but the overhang of the past and the lack of necessary legislative empowerment in terms of foreclosure hampered recovery. Although loans were largely collateralised, timely execution of collateral remained a difficult problem in the absence of enabling legislation. The large difference between banks' gross and net NPAs reflected both obligatory provisions against NPAs and the limited write-offs of NPAs by the public sector banks. Write-offs were deterred by the public sector banks' modest profits and capital position and the risk of investigation, particularly in the case of large write-offs. Hence, NPAs tended to be carried on the books and provisions against them gradually built up. It is in this context that the role of the Asset Reconstruction Company (ARC) assumes significance in recovering bad loans and cleansing banks' balance sheets of NPAs, thus enhancing profitability through lower provisioning. It is to be hoped that the new "Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002" would help in speeding the recovery of NPAs.

7.44 In the ultimate reckoning, prudential regulations have helped to ensure systemic stability in the face of several external and internal uncertainties during the past few years. However, it needs to be recognised that prescription of norms alone does not necessarily ensure an improvement in the functioning of banks. Enhanced efficiency would necessitate institutional changes in the internal functioning of banks, especially improvements in the systems of credit evaluation, risk assessment and management, the quality of human resources as well as the quality of internal controls and corporate governance.

7.45 Recent policy measures have endeavoured to take into account the technological developments that have a major impact on the financial sector. Information technology allows sophisticated product development, better market infrastructure,

implementation of reliable techniques for control of risks and also help the financial intermediaries to reach distant and diversified markets. In view of this, technology has changed the contours of three major functions performed by banks, *viz.*, access to liquidity, transformation of assets and monitoring of risks. The interaction of technology with deregulation is also contributing to the emergence of a more open, competitive and globalised financial market which should improve efficiency in the economy, while at the same time calling for greater vigilance and prudence in asset-liability management. Banks have positively responded to policy initiatives by taking steps to adopt the necessary technology in their operations. Keeping in view the progress made in the implementation of measures taken so far, and their impact on the soundness of the Indian banking system, it is intended to speed up the process further to enable the Indian financial sector to be better equipped to meet the global competition.

7.46 Reforms of the payment and settlement systems would be carried forward with the implementation of the Real Time Gross Settlement (RTGS) System. Coupled with legal reforms in the form of the Payment Systems Act and regulations for electronic funds transfer (EFT) as also amendments to the Negotiable Instruments Act, 1881 to provide for e-cheque and cheque truncation, there would be a surge in usage of non conventional modes of funds movement through the banking system. The introduction of "Core Banking" or clustered solutions by banks – as part of their efforts towards technology upgradation – would herald the disappearance of local boundaries, and with the customer being identified as an entity of a bank as a whole, concepts such as clearing of cheques –whether local or inter-city – would reduce in significance. Usage of the Structured Financial Messaging Solution (SFMS) by banks would speed up inter-bank financial communication in a secure mode, paving the way for quick funds movement and flow of financial information across banks.

7.47 Considerable progress has been achieved in financial sector reforms in India in terms of setting out the objectives, the framework and the timetable. The agenda itself is forward-looking and sets a course for various constituents of the financial system over the medium-term. India's position on international standards and codes in respect of the financial sector has also been placed in the public domain. Expert assessment, both internal and external, of the applicability of these world's best practices to the specifics of the Indian situation has also been undertaken to enable an unbiased public assessment of the announced resolve to converge to international norms, with the speed and content modulated to the country-specific case. The focus of financial sector reforms is now on the implementation of the agenda of reforms over a wide area involving financial markets, financial intermediaries and the regulatory and supervisory function.

7.48 In sum, the Indian economy seems to have acquired a remarkable degree of resilience and is not only in a position to withstand supply shocks but also cope both domestic and external shocks with minimal adverse consequences for growth, inflation and financial stability. There are several significant achievements in terms of sustaining growth, containment of inflation and alleviation of poverty while providing resilience in the external sector. Moreover, a foundation has been laid, particularly in financial and external sectors, for acceleration of the growth rate. Medium-term growth prospects for the Indian economy, however, would be contingent upon a number of factors including legislative changes, in particular, those relating to ownership, regulatory focus, development of financial markets, and bankruptcy procedure; fiscal empowerment, especially in regard to finances of States; further reforms in the real sector, particularly in domestic trade; further liberalisation of the financial sector and of the external sector; and, solving 'overhang' problems in various areas, such as, cost recovery in the energy sector and management of foodgrains stocks while simultaneously ensuring that such pressures do not continue in the future.

VIII MONETARY AND CREDIT POLICY OPERATIONS

8.1 During 2001-02, monetary policy in India was committed to support the revival of investment demand in continuation of the stance adopted since 1997. The policy preference for softer interest rates and easier liquidity conditions was signaled through successive cuts in the Reserve Bank's key interest rates and in the CRR. Market responses to policy signals were facilitated by an environment of flexibility created by reductions in important administered interest rates in the system, particularly those on small savings. Given the importance of credit for industrial activity, augmenting the availability of credit and improving the channels of credit flows assumed policy priority. Sufficient and stable liquidity remained the operating target for policy. Liquidity Adjustment Facility (LAF) operations combined with strategic open market operations (OMO) have evolved into the principal operating procedure of monetary policy in the short run to ensure the adequate availability of liquidity consistent with the genuine credit requirements of the economy. Orderly development of financial markets including the technological and institutional infrastructure, and financial sector reforms were carried forward during the year. Even though inflation turned benign particularly in the second half of the year, price stability remained an abiding concern; in general, the stance of monetary policy was dominated by a sense of precaution in the context of unforeseen shifts in the inflationary outlook and the risk of external shocks in an uncertain international environment.

8.2 The stance of monetary policy was signaled in February and March 2001 with two successive cuts of 50 basis points each in the Bank Rate. With the further slowing down of industrial activity and exports, the Bank Rate was reduced by another 50 basis points to 6.50 per cent with effect from October 23, 2001, its lowest level since May 1973. A prospective cut of up to 50 basis points was indicated in the Policy Statement for 2002-03 if warranted by the overall credit and liquidity situation and if the inflation rate continued to remain low. In the recent period, a flexible interest rate environment has been created by reductions in key administered interest rates.

8.3 Comfortable liquidity conditions during April 2001 were reflected in daily average repo outstanding amount rising to Rs.10,968 crore from Rs.3,952 crore during March 2001. In response, the repo rate declined from 7 per cent to 6.75 per cent on April 27, 2001. As liquidity conditions eased during May 2001, the repo cut-off rate further decreased by 25 basis points to 6.50 per cent on May 28, 2001. Liquidity conditions remained easy thereafter for the rest of the year, except for brief spells in September, October and November 2001, when the Reserve Bank injected liquidity through reverse repos. The cut-off rate on repo remained at 6.5 per cent until March 5, 2002. Against the backdrop of downward revisions in the small saving interest rates, the Reserve Bank signaled a 50 basis cut in the repo rate on March 5, 2002 by conducting a fixed rate overnight repo auction at 6.0 per cent, which prevailed in subsequent LAF auctions till it declined further by 25 basis points to 5.75 per cent on June 27, 2002.

Monetary Policy Operations

8.4 Interest rate policy has been focusing on imparting greater flexibility to the rate structure so that interest rates evolve in alignment with the behaviour of domestic economic activity and international macroeconomic and financial conditions. Banks are advised to reduce the maximum spreads over their prime lending rates (PLR) so that credit may be available to the borrowers at reasonable interest rates. In the interests of customer protection as also to encourage competition, banks are required to announce the maximum spread over

PLR to the public along with the announcement of their PLR. Banks are also required to provide information on deposit rates for various maturities, effective annualised return to the depositor and maximum and minimum interest rates charged to their borrowers. Furthermore, banks have been urged to switch over to "all cost" concept for borrowers by explicitly declaring the processing charges, service charges, *etc*. to borrowers. As regards deposit rates, banks are encouraged to introduce flexible interest rate systems for all new deposits with resets at six-monthly intervals while a fixed rate option is also available to depositors. They are advised to consider paying the depositors at the contracted rate for the period of deposit already run and waive the penalty for premature withdrawal, if the same deposit is renewed at the variable rate. In order to provide greater flexibility to co-operative banks in a competitive environment, the stipulation of minimum lending rate (MLR) for all co-operative banks was withdrawn.

8.5 With progressive deregulation of interest rates, banks have considerable flexibility in setting their deposit and lending rate structures. Except for savings deposits on which the interest rate is fixed at 4 per cent, banks are free to offer fixed or floating rates linked to an anchor rate. In the April 2001 Policy Statement, they were allowed to offer fixed deposit schemes to senior citizens at fixed rates of interest relatively higher than normal deposits of any size. On the lending side, banks are free to prescribe their own PLRs across various tenors and also to lend at sub-PLR rates. In effect, the PLR ceased to be a floor rate for loans above Rs.2 lakh after the April 2001 policy announcement, although it continues to operate as a ceiling for loans up to Rs.2 lakh, taking on the role of a benchmark.

8.6 The Reserve Bank has been pursuing its medium-term objective of reducing the CRR to its statutory minimum level of 3.0 per cent by gradually reducing the CRR from 11.0 per cent in August 1998 to 7.5 per cent by May 2001. In the October 2001 mid-term review, the CRR of scheduled commercial banks [excluding Regional Rural Banks (RRBs)] was reduced by 200 basis points to 5.5 per cent of their net demand and time liabilities (NDTL). All exemptions were withdrawn, except on inter-bank liabilities, for the computation of NDTL (for requirement of maintenance of CRR) with effect from the fortnight beginning November 3, 2001. In the annual Policy Statement of April 2002, a 50 basis point reduction in the CRR was announced, bringing it to 5.0 per cent beginning June 15, 2002. On a review of the liquidity conditions the CRR reduction was advanced to June 1, 2002. The CRR would continue to be used in both directions for liquidity management in addition to other instruments.

8.7 From April 21, 2001, the interest rate paid on eligible balances under the CRR was increased to 6 per cent with a medium term objective of aligning it with the Bank Rate. Subsequently, in the mid-term review of October 2001, eligible cash balances of CRR are remunerated at the Bank Rate. From August 11, 2001, the inter-bank term liabilities of original maturity of 15 days and up to one year were exempted from the prescription of minimum CRR requirement of 3.0 per cent.

Liquidity Adjustment Facility

8.8 In the second stage of LAF starting from May 8, 2001, rationalisation in the operating procedures of LAF was effected. The minimum bid size was reduced from Rs.10 crore to Rs.5 crore to enable small level operators to participate in LAF auctions. The auction format for LAF was changed from the uniform price auction method to the multiple price auction method to ensure more responsible bidding. The timing for LAF auctions was advanced by 30 minutes with a view to providing additional time to the unsuccessful bidders in LAF auctions to cover up their positions in the short-term money market. A system of information dissemination on aggregate cash balances maintained by scheduled commercial banks with

Reserve Bank on a cumulative basis during the reporting fortnight was introduced with a view to stabilising market expectations and dampening volatility in call rates.

Open Market Operations

8.9 Outright open market sales were conducted to neutralise the monetary impact of private placement of government securities with the Reserve Bank as also to sterilise foreign capital inflows. The Reserve Bank's initial subscription amounted to Rs.21,000 crore during April-June 2001 as compared with Rs.6,961 crore during April-June 2000. The monetary impact could be partially offset with net open market sales of Rs.10,929 crore during April-June 2001 as compared with Rs.2,025 crore during April-June 2000. Open market sales were conducted thereafter to absorb excess liquidity in the system. The adverse reactions in the Indian financial markets in the wake of the terrorist attack on September 11, 2001 required the Reserve Bank to intervene more actively on the purchase side through a series of auctions - initially daily and subsequently weekly - from September 18, 2001 through October 3, 2001 in securities across the maturity spectrum to provide confidence and liquidity. Open market purchases of Rs. 5,084 crore were made during September 18 to October 3, 2001. A private placement of Rs.3,213 crore was effected in March 2002 which was essentially a swap of loans and advances to development financial institutions under the National Industrial Credit (Long-Term Operations) Fund with long-term government bonds, and hence was cash neutral.

Monetary Policy Stance for 2002-03

8.10 In April 2002, the monetary and credit policy for the year 2002-03 was announced conditional upon the real GDP growth placed at 6.0 - 6.5 per cent, the rate of inflation assumed slightly lower than 4.0 per cent and indicative projections of broad money growth and aggregate deposit growth of scheduled commercial banks at 14.0 per cent each. Non-food credit (inclusive of non-SLR investments) projected to increase by about 15.0 - 15.5 per cent which is expected to adequately meet the credit needs of the productive sectors of the economy. With the fiscal deficit of the Central Government for 2002-03 budgeted at 5.3 per cent of GDP and the consequent size of the borrowing programme, it is expected that debt management could be conducted without serious pressure on overall liquidity and interest rates. In recent months, however, the market borrowing programme in respect of some States has come under stress.

8.11 Easy liquidity conditions and softer interest rate environment make the present overall monetary conditions reasonably comfortable. However, as the experience of recent years confirms, monetary management has now become much more complex because of factors such as the on going integration of financial markets across the world, the phenomenal increase in financial turnover, liberalisation of the economy, and the rapidity with which unanticipated domestic and international tremors get transmitted to financial markets across the world because of the new technology. Changes in economic circumstances may make it necessary to take appropriate monetary measures, which may not be in consonance with the current easy liquidity conditions.

8.12 Accordingly the Reserve Bank will continue to maintain the current interest rate environment with a bias towards softer interest rate regime in the medium-term unless circumstances change unexpectedly. The long-term objective would be towards realignment of interest rates on all types of debt instruments, both the government and private sector, within a narrow band. The overall stance of monetary policy for 2002-03 would be focused on the following: (i) provision of adequate liquidity to meet credit growth and support

investment demand in the economy while continuing a vigil on movements in the price level; (ii) continuing the present stance on interest rates including preference for soft interest rates; and (iii) imparting greater flexibility to the interest rate structure in the medium-term.

8.13 A key element in the efficient conduct of monetary policy in the years ahead is balanced development of various constituents of the money market in an environment of greater transparency and market discipline. Phasing out non-bank participants from the call/notice money market and activating the repo market are the most significant policy initiatives for the future evolution of the money market. It is expected that these measures would, in turn, facilitate the development of other segments, *i.e.*, the corporate bond market, the swap market and the term-money market. Further refinement of the LAF would involved the existing standing liquidity facilities being subsumed within the LAF. Deregulation of interest rates on export credit in domestic currency will encourage competition among banks and facilitate the phasing out the export credit refinance.

8.14 The interest rate structure should become more flexible over the medium-term and increasingly reflect the underlying inflationary situation. In the emerging environment characterised by heightened competition and more rigorous standards of trasparency, it is critical for banks to improve productivity, reduce establishment costs and correct misalignment of interest rates.

8.15 In order to stabilise the short-term interest rates so that call money rate may move in a flexible corridor of repo - reverse repo rates, liquidity assessment on a daily basis becomes crucial. With a view to designing a formal framework for day to day liquidity assessment and for evaluation of the interactions between financial markets and monetary policy measures, the Reserve Bank, under the guidance of an advisory group of eminent economists, has developed a short-term operational model to guide monetary policy operations. The model has also been placed on the Bank's website for wider dissemination and public debate. The model is planned to provide likely scenarios and alternative intervention strategies aimed at stabilising short-term rates in money, securities and foreign exchange markets.

IX DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

9.1 Orderly conditions prevailed in financial markets during 2001-02 with brief periods of uncertainty associated with extraordinary events in September and December 2001. Barring these episodes, the call money market remained stable and generally range-bound within the informal repo-reverse repo corridor. The foreign exchange market experienced comfortable supply conditions. Yields fell across all maturities in the government securities market, accompanied by a significant rise in turnover. Orderly market conditions were engendered by the active management of liquidity in the money, foreign exchange and gilt markets. The Reserve Bank absorbed sizeable liquidity on a continuous basis through repos. Foreign exchange purchases were effected to offset strong capital inflows and open market sales of government securities were employed on some occasions to absorb excess liquidity Market reactions to the September 11, 2001 event were calmed by injections of liquidity through reverse repos, a series of open market purchases of government securities to support the gilt market and foreign exchange sales. The development of financial markets in terms of building up the institutional and technological infrastructure and fine-tuning of market microstructure was continued apace with the changing context of the regulatory function.

9.2 The Negotiated Dealing System (NDS) (Phase I) was operationalised with effect from February 15, 2002 with 41 participants. The NDS provides on-line electronic bidding facility in the primary auctions of Central/State Government securities and OMO/LAF auctions. It enables screen-based electronic dealing and reporting of transactions in money market

instruments, secondary market transactions in government securities and facilitates dissemination of information on trades with the minimal time lag. It also permits "paperless" settlement of transactions in government securities with electronic connectivity to the Clearing Corporation of India Limited (CCIL) and the delivery *versus* payment (DVP) settlement system at the Public Debt Office. As on August 5, 2002, 138 SGL account holders had joined the NDS.

9.3 The CCIL also commenced its operations from February 15, 2002 in clearing and settlement of transactions in government securities. Acting as a central counterparty through novation, the CCIL provides guaranteed settlement and has in place risk management systems to limit settlement risk. It operates a settlement guarantee fund (SGF) made up of contributions from its members and backed by lines of credit from commercial banks.

Money Markets

9.4 The thrust of monetary policy in recent years has been to develop an array of instruments to transmit liquidity and interest rate signals to the short-term money market in a flexible manner. The objective is to develop a liquid short-term rupee yield curve to enable efficient price discovery and to improve the operational effectiveness of monetary policy. Over the medium term, it is expected that the call/ notice money market would evolve into a pure inter-bank market where participants would meet short-term liquidity mismatches and not undertake regular financing operations. With the rationalisation of the standing liquidity facilities, the Liquidity Adjustment Facility (LAF) has emerged as the prime instrument for managing market liquidity and for setting a corridor for the movement of the short-term rates consistent with policy objectives. From May 2001, the Reserve Bank shifted to the system of multiple price auctions for repos and reverse repos conducted under LAF. Simultaneously, attempts are being made to develop the term money market, repo and other money market instruments for more balanced growth of various segments of money market.

Government Securities Market

9.5 The guiding objectives in the development of the government securities market have been to develop a smooth yield curve, to create a suitable benchmark for pricing of various debt instruments and to enable use of indirect instruments for the operation of monetary policy. The significant steps taken towards deepening and widening of the government securities market during 2001-02 include elongation of maturity profile of outstanding securities, development of benchmarks by consolidating new issuances in key maturities, enhancing fungibility and liquidity through consolidation by reissue of existing loans, promoting retailing of government securities and reintroduction of Floating Rate Bonds. The development of key benchmark securities in the Indian gilt market is in line with international best practices with the 10-year government security evolving as a benchmark, as in several developed countries.

Foreign Exchange Market

9.6 A number of steps were taken in continuation of the phased approach to capital account liberalisation during the year. Non-resident non-repatriable (NRNR) account and non-resident special rupee (NRSR) account schemes were discontinued with effect from April 1, 2002 in order to provide full convertibility on non-resident deposit schemes. While no new deposits would be accepted under these schemes, existing term deposit accounts under both the schemes have been allowed to continue up to the date of maturity. Existing NRSR accounts, other than term deposits, have been allowed to continue up to September 30, 2002. On maturity, the proceeds of NRNR scheme shall be credited to the account holders'

nonresident (external) (NRE)account, while those in the case of NRSR scheme shall be credited to the account holder's nonresident (ordinary) (NRO) account.

9.7 Amongst the facilities available to corporates, existing limits for Indian direct investment overseas under the automatic route were raised from US $ 50 million in a financial year to US $ 100 million. Indian investors can now purchase foreign exchange up to 50 per cent of their net worth as on the date of last audited balance sheet as against the existing limit of 25 per cent. At present, corporates are allowed to prepay external commercial borrowings (ECBs) to the extent of the balances in their EEFC accounts. Export-oriented units and others can credit up to 70 per cent and 50 per cent, respectively, of their foreign exchange earnings to their EEFC accounts. In order to enable the Indian companies more flexibility and to take advantage of lower interest rates and prepay their ECBs, the corporates were allowed to credit higher than the stipulated proportions of export proceeds to their EEFC accounts on a case-by-case basis.

Outlook

9.8 Development of financial markets is viewed as a continuum and an essential concomitant in the process of financial sector reform. The medium-term objective is to develop the call/notice money market into a pure inter-bank market while simultaneously broadening and activating other segments of the money market. Deliberations are also underway for extension of repos (outside Reserve Bank) to CSGL account holders. It is also expected that the CCIL would offer variants of repo products for facilitating liquidity and cash management and enlargement of repos to other participants. The phased evolution of the LAF towards becoming the primary instrument for liquidity management is consistent with this objective.

9.9 It is expected that the operationalisation of NDS and CCIL would give a fillip to secondary market activity. The next phase of operationalisation of PDO-NDS project will provide for centralised securities settlement system with distributed servicing to investors through regional PDOs. It will help in increased geographical participation in primary issuance of government securities from terminals located at regional PDOs and member terminals connected to the system.

9.10 A road map for developing Separate Trading for Registered Interest and Principal of Securities (STRIPS) has been prepared. The Reserve Bank is actively pursuing the creation and development of the STRIPS market which, in addition to providing more flexibility in managing interest rate risk, would help in addressing the asset-liability mismatch problem of banks/ institutions. Banks with typically short maturity funding can hold short duration STRIPS (*i.e.*, coupon STRIPS) while the longer duration STRIPS can be held by insurance companies and pension funds, *etc*. To facilitate the market for STRIPS (which are essentially zero coupon bonds (ZCBs), the tax anomaly that existed in respect of ZCBs has been removed by Central Board of Direct Taxes (CBDT) in a notification issued in February 2002. Accordingly, ZCBs are now to be taxed on a total return basis by treating the marked-to-market gains to the holder during the assessment year as taxable.

9.11 A proposal for replacement of the existing Public Debt Act, 1944 by Government Securities Act has been approved by the Central Government. The concurrence of almost all the State legislatures has also been obtained. The enactment of the Government Securities Bill would simplify the procedures for transactions in government securities and allow for lien-marking/pledging of securities and recognise the legal rights of benefical owners.

9.12 India's exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate

movements over a period in an orderly way, has stood the test of time. The Reserve Bank will continue to follow the same approach of watchfulness, caution and flexibility while dealing with the foreign exchange market.

X FINANCIAL REGULATION AND SUPERVISION

10.1 Financial sector reforms during 2001-02 continued to focus on strengthening the financial system and improving the functioning of the various segments. The broad parameters of the reforms undertaken during the year comprised ongoing deregulation of the operation of institutions within the Reserve Bank's regulatory ambit, tightening of the prudential norms and improvement in the supervisory oversight, expanding transparency and market disclosure, all with a view to improving overall efficiency and stability of the financial system.

10.2 The Board for Financial Supervision (BFS), which is entrusted with supervision of commercial banks, select all-India financial institutions (FIs), non-banking financial companies (NBFCs), the Clearing Corporation of India Ltd. (CCIL) and primary dealers (PDs), monitored and reviewed the performance of these institutions and provided guidance on regulatory and supervisory policy decisions.

10.3 During 2001-02 (July 2001 to June 2002), the BFS held 12 meetings. Annual financial inspections in respect of 27 PSBs, 14 local head offices (LHOs) of the State Bank of India, 31 private sector banks and 38 foreign banks, two local area banks and ten all-India FIs were completed. The BFS reviewed 126 Inspection Reports during 2001-02; of these, 77 related to the position as at end-March 2001.

Scheduled Commercial Banks

10.4 Scheduled commercial banks (SCBs) improved their performance in 2001-02 as reflected in key financial parameters. The ratio of operating profits to total assets of SCBs increased to 2.0 per cent during 2001-02 from 1.5 per cent during 2000-01 while that of net profits to total assets rose to 0.8 per cent from 0.5 per cent over the same period. During 2001-02, 69 banks recorded increase in the ratios of their operating as well as net profits to total assets. As at end-March 2002, all SCBs (except five) recorded capital to risk-weighted asset ratios (CRARs) in excess of the stipulated nine per cent with as many as 53 SCBs posting CRAR between 10 per cent and 15 per cent while for another 30 SCBs, CRARs were in excess of 15 per cent. The ratio of gross non-performing assets (NPAs) to gross advances of SCBs was 10.8 per cent as at end-March 2002, lower than that of 11.4 per cent as at end-March 2001. The ratio of net NPAs to net advances at 5.9 per cent as at end-March 2002 was also lower than that of 6.2 per cent as at end-March 2001. The majority of SCBs - 74 out of 97 banks - recorded net NPAs within 10 per cent of their net advances.

10.5 The thrust of the ongoing reforms in the banking sector was on increasing operational effectiveness, strengthening the prudential and supervisory norms, developing the technological and institutional infrastructure and redefining the regulatory role of the Reserve Bank.

10.6 Consistent with the recommendations of the Committee on Banking Sector Reforms (Narasimham Committee II) and with a view to moving closer to international best practices in regard to asset classification norms, banks were advised that with effect from March 31, 2005 an asset would be classified as doubtful if it remained in the sub-standard category for 12 months. Banks are permitted to phase the consequent additional provisioning over a four-year period, commencing from the year ending March 31, 2005 with a minimum of 20 per

cent each year.

10.7 Banks were advised to transfer the gains realised on sale of securities to the Investment Fluctuation Reserve (IFR) Account and to achieve a minimum IFR equivalent to five per cent of the specified investment categories within a period of five years. Banks are free to build up IFR up to 10 per cent of their portfolio depending on the size and composition of their portfolio, with the concurrence of their Board of Directors.

10.8 In January 2001, the Reserve Bank issued revised guidelines for entry of new banks in the private sector and stipulated a period for submission of applications. In all, 10 applications were received within the stipulated period and the same were scrutinised to ensure *prima facie* eligibility and were thereafter referred to a High Level Advisory Committee (Chairman: Dr. I.G. Patel). The Reserve Bank granted "in-principle" approvals for setting up two new banks to Kotak Mahindra Finance Ltd. and to three banking professionals with Rabobank in February 2002. These approvals are valid for one year.

10.9 Guidelines/clarifications relating to foreign direct investment (FDI) in the banking sector were issued. FDI up to 49 per cent from all sources is permitted in private sector banks under the automatic route, subject to conformity with the guidelines issued from time to time.

10.10 In relation to interest rates on advances, banks were required to move over to charging of interest at monthly rests by April 1, 2002 subject to certain conditions relating to applicability and timing. This was meant as a facilitating measure for adoption of the 90 days' norm for recognition of loan impairment from the year ending March 31, 2004.

10.11 In India, foreign banks were so far allowed to set up branches but not subsidiaries. The Union Budget 2002-03 announced the elimination of this restriction to allow foreign banks to set up subsidiaries in India. A foreign bank could choose either to set up a subsidiary or have branch presence. Such subsidiaries will have to adhere to all banking regulations, including priority sector lending norms, applicable to other domestic banks. Necessary amendments to the Banking Regulation Act, 1949 to relax the maximum ceiling of voting rights of 10 per cent for such subsidiaries would be brought about. Guidelines in this regard are being worked out by the Reserve Bank.

Co-operative Banking

10.12 Available information for 1,854 UCBs for 2001-02 indicates that 1,569 UCBs posted profits while the remaining 285 UCBs incurred losses. In the previous year, out of 1,868 UCBs for which information was available, 1,629 UCBs had posted profits and 239 UCBs had reported losses. The loss making banks either fall under the classification of 'weak' banks or are new banks which posted losses on account of initial operating expenses. Of the 52 scheduled UCBs, 10 banks reported losses during 2001-02 as compared with 11 banks during 2000-01.

10.13 The gross NPAs of 1,942 reporting UCBs stood at Rs.9,245 crore or 16.1 per cent of total advances as at end-March 2001 as compared with Rs.5,589 crore or 12.1 per cent of total advances for 1,866 reporting UCBs as at end-March 2000. For the year ending March 2002, gross NPAs, based on data available for 1,342 UCBs, stood at Rs.11,472 crore or 21.9 per cent of total advances. The increase in gross NPAs was primarily due to certain large UCBs.

10.14 With a view to moving towards international best practices, the norm for classification of an account as non-performing will be reduced from 180 days as at present to 90 days with effect from March 31, 2004 as for commercial banks. UCBs are to make additional provisions for NPAs starting from the year ended March 31, 2002 to facilitate smooth

transition to the 90 days norm by March 31, 2004.

10.15 As interest rates on deposits offered by a number of UCBs were much higher than those offered by commercial banks, UCBs were advised to review their interest rate structure on term deposits of different maturities and to make them comparable with the rates offered by commercial banks. On the lending side, as a step towards the self-discipline of prime lending rate and interest rate band, the stipulation of minimum lending rate (MLR) was withdrawn and the cooperative banks are now free to determine their lending rates. They are, however, required to publish their minimum and maximum lending rates for the information of customers.

Financial Institutions

10.16 All the FIs, except IFCI Ltd., had a CRAR much above the stipulated norm of 9 per cent as at end-March 2002. The ratio of net NPAs to net loans of select all-India FIs stood at 8.8 per cent as at end-March 2002 as compared with 8.6 per cent at end-March 2001.

Non-Banking Financial Institutions

10.17 Norms relating to capital adequacy issued in January 1998 were made applicable to NBFCs accepting or holding public deposits with effect from March 31, 1998. Accordingly, CRAR shall not be less than 12 per cent and for the purposes of CRAR, Tier II capital shall be reckoned up to 100 per cent of Tier I capital. A higher CRAR of not less than 15 per cent is stipulated for deposit-accepting equipment leasing and hire purchase finance companies without credit rating, and loan and investment companies. These requirements are to be complied with on an on-going basis and not on the reporting dates alone.

10.18 At end-March 2001, 667 out of 723 reporting NBFCs (92.3 per cent) had a CRAR of 12 per cent and above, with as many as 534 companies (73.9 per cent) registering a CRAR in excess of 30 per cent. At end-September 2001, 570 out of 615 reporting companies (92.7 per cent) reported a CRAR equal to or in excess of the stipulated minimum with as many as 448 companies (72.8 per cent) having a CRAR above 30 per cent.

Outlook

10.19 In keeping with the vision of an internationally competitive and sound banking system, strengthening the financial system to achieve the best internationally recognised standards has been the core of the Indian approach to financial sector reforms. Provisioning and exposure norms have been progressively tightened. India has made considerable progress in the identification of international standards and codes in relevant areas, expert assessment regarding their applicability, including comparative country evaluation and building up possible course of action for the future. The calibration of the convergence with international standards is conditioned by the specific realities of the Indian situation.

10.20 At the same time, there are a few areas regarding the efficiency of the Indian banking system - rather than its stability -that raise concerns, especially in an uncertain economic environment. The level of NPAs continues to be high. The process of debt recovery and asset restructuring initiatives undertaken as part of financial sector reforms has also been somewhat slow. In the cooperative banking sector, the present system of dual/triple regulatory and supervisory control needs to be replaced with a separate supervisory authority exclusively responsible for efficient functioning of the co-operative institutions and the safety of public deposits.

XI PUBLIC DEBT MANAGEMENT

11.1 Under the market borrowing programme for 2001-02, the Central Government mobilised a gross amount of Rs.1,33,801 crore as against the budget estimate of Rs.1,18,852 crore. Net of repayments, the borrowings amounted to Rs.92,302 crore as against the budget estimate of Rs.77,353 crore. The gross and net borrowings through dated securities amounted to Rs.1,14,213 crore and Rs.87,714 crore, respectively, while Rs.19,588 crore (gross) and Rs.4,588 crore (net) were raised through 364-day Treasury Bills. The gross and net market borrowings of the State Governments amounted to Rs.18,707 crore and Rs.17,261 crore in 2001-02 as compared with Rs.13,300 crore and Rs.12,880 crore in the previous year, respectively.

11.2 Comfortable liquidity conditions, low inflation rate and low credit off-take facilitated smooth completion of the market borrowing programme in an environment of falling yields. In case of States, the increase in the borrowing needs rendered the completion of the market borrowing programme difficult but it could be managed satisfactorily. Debt management continued to combine private placement of debt with the Reserve Bank and open market operation (OMO) sales to modulate the timing of new issues and market liquidity over the year. The weighted average cost of primary issuance of Government of India dated securities declined from 10.95 per cent in 2000-01 to 9.44 per cent during 2001-02.

11.3 Notable developments in the framework of debt management included the reintroduction of floating rate bonds after nearly 7 years, the introduction of a scheme of non-competitive bidding up to 5 per cent of the notified amount for retail and mid-segment investors, increasing the notified amount of 364-day Treasury Bills from Rs. 750 crore to Rs. 1,000 crore every fortnight and the announcement of a calendar for the core component of Government of India dated securities for the first half of fiscal 2002-03. Other important landmarks in the evolution of government securities market during the year were the operationalisation of the first phase of the Negotiated Dealing System (NDS) and the establishment of Clearing Corporation of India Limited (CCIL).

Central Government

11.4 The arrangements in respect of the WMA to the Central Government remained the same for the fiscal year 2002-03 as in the previous year. The limits have been continued at Rs.10,000 crore for the first half of the year (April-September) and Rs.6,000 crore for the second half (October-March). The daily average utilisation of WMA and overdraft by the Central Government was higher during 2001-02 when compared with the utilisation pattern in the preceding year. The Centre was in overdraft for 113 days (20 occasions) during the year 2001-02 as compared with 27 days (11 occasions) in the previous year

11.5 The gross amounts mobilised through 14-day and 182-day Treasury Bills before their discontinuance with effect from May 14, 2001 were Rs.1,100 crore (inclusive of Rs. 400 crore from non-competitve bidding) and Rs.300 crore, respectively. With the increase in the notified amount of the 91-day Treasury Bill from Rs.100 crore to Rs.250 crore from May 16, 2001, the gross amount mobilised stood higher at Rs.20,216 crore (inclusive of Rs. 8,016 crore from non-competitive bidding) during 2001-02 as against Rs.7,255 crore during the preceding year. The gross amount raised through 364-day Treasury Bills was also higher at Rs.19,588 crore as against Rs.15,000 crore during 2000-01. There was no devolvement on the Reserve Bank in any auction of the Treasury Bills during 2001-02. The dates of payment of 91-day and 364-day Treasury Bills was sychronised (See Sections V and IX for details). The notified amount of 364-day Treasury Bill was raised from Rs.750 crore to Rs.1,000 crore

from April 3, 2002 with a view to improving supply in the market.

11.6 The gross and net borrowings through dated securities amounted to Rs.1,14,213 crore and Rs.87,714 crore, respectively, while Rs.19,588 crore (gross) and Rs.4,588 crore (net) were raised through 364-day Treasury Bills. Favourable liquidity conditions engendered by continuous accretion to foreign exchange reserves, strong deposit growth, low credit off-take and the easing of monetary policy enabled the smooth absorption of the Centre's borrowing by the market. There was only one occasion of devolvement on the Reserve Bank of Rs.679 crore during the year. Large unanticipated funds requirement of the Central Government, however, necessitated private placements amounting to Rs. 28,213 crore with the Reserve Bank.

11.7 The consolidation of government stocks was carried forward in 2001-02. As large net market borrowing of the Government limits flexibility in active consolidation, the Reserve Bank has been attempting "passive consolidation" since April 1999 by reissuing the existing stocks through price-based auctions, thereby limiting the number of outstanding stocks. Thus, 23 securities, each with an outstanding amount of Rs.10,000 crore or more, accounted for more than half of the total outstanding amount of Rs.5,36,325 crore comprising 111 securities at the end of March 2002. The maximum maturity of primary issuances of fresh paper was raised from 10 years to 20 years in 1998-99 and then to 25 years in 2001-02; the weighted average maturity rose from 6.6 years in 1997-98 to 14.3 years in 2001-02. Since 1998-99, debt management policy has entailed a strategy of elongating the maturity of new issuances, reversing the phase of shortening of maturity during 1992-93 to 1997-98 which resulted in bunching of redemptions

11.8 In case liquidity conditions in the market are not appropriate for a market issue, or in the event of the market expecting unreasonably high yields from the primary offering as reflected in the bids received, private placement or devolvement are resorted to. The Reserve Bank offloads such initial acquisitions when the liquidity conditions/expectations stabilize, or, at its discretion through strategic open market sales depending upon capital flows, credit growth and requirements of monetary management.

11.9 In India, debt and monetary management functions are vested with the Reserve Bank. A decision to separate the two functions is considered desirable in principle. It was, however, felt that separation of the two functions would be dependent on the fulfilment of three pre-conditions, *i.e.*, development of financial markets, reasonable control over fiscal deficit and necessary legislative changes. Significant progress has been made in the development and integration of financial markets with the introduction of new instruments and participants, strengthening of the institutional infrastructure and greater clarity in the regulatory structure. The recent amendment to the Securities Contracts (Regulation) Act, 1956 demarcated the regulatory roles of the Reserve Bank and the SEBI with respect to the financial markets. In the Budget Speech of 2000-01, the Finance Minister expressed the need to accord greater operational flexibility to the Reserve Bank for conduct of monetary policy and regulation of the financial system. The Reserve Bank has already proposed amendment to the Reserve Bank of India Act, 1934 to take away the mandatory nature of management of public debt by the Reserve Bank and vest the discretion with the Central Government to undertake the management of the public debt either by itself or to assign it to some other independent body, if it so desires. The proposed Fiscal Responsibility and Budget Management Bill (FRBMB) envisages prohibition of direct borrowings by the Central Government from the Reserve Bank. With the setting up of the CCIL, the evolution of the full-fledged LAF and the other technological infrastructure being put in place, the Reserve Bank will be able to operate its instruments of monetary policy with greater flexibility and the proposed separation of debt management could greatly facilitate the performance of monetary management by the

Reserve Bank.

State Governments

11.10 The WMA/Overdraft position of States reflected continued pressure on the States' finances. The recourse to WMA in 2001-02 was generally higher than that in the previous year. During 2001-02, 20 States resorted to overdraft as against 19 States during 2000-01. In 2001-02, it was observed that there is a general tendency to resort to overdrafts as an extension of the normal WMA limits. Six States did not avail of overdraft at all. The WMA Scheme was reviewed in 2001 by a Group of State Finance Secretaries and a revised Scheme came into effect from February 1, 2001.

11.11 The gross and net market borrowings of the State Governments amounted to Rs.18,707 crore and Rs.17,261 crore in 2001-02 as compared with Rs.13,300 crore and Rs.12,880 crore, respectively, in 2000-01. The completion of the market borrowing programme of State Governments involved difficulties despite favourable conditions of comfortable liquidity and softening yields.

11.12 Some States responded to the decision taken in November 1997 to allow them the choice of raising between 5 to 35 per cent of their allocation through auctions. During 2001-02, 12 States resorted to the auction method. A decision was, therefore, taken through consensus in the Conference of State Finance Secretaries held in November 2001, to complete the remaining borrowing programmes through tap issuances without notifying amounts for individual States. Thus, different methods were used to raise the borrowings of the State Governments during the year 2001-02.

Outlook

11.13 Favourable market conditions augur well for the market borrowing programme for 2002-03. While the market borrowing programme in respect of some States has come under stress, it is expected that debt management would be conducted without serious pressure on overall liquidity and interest rates. Persistent overshooting of the market borrowings of the Central and State Governments has tended to impose constraints on the conduct of market borrowing programme putting pressure on yields. In turn, this often predicates the subservience of monetary policy operations to the goals and objectives of debt management. Accordingly, even as the debate on the separation of the two functions is intensifying, changes in the legal framework are being envisaged to improve the functional autonomy of the Reserve Bank in its operations. The Fiscal Responsibility and Budget Management Bill 2000 seeks to set an operational rule for fiscal policy which would considerably strengthen the redefinition of roles and responsibilities between the Government and the Reserve Bank in the management of public debt. In the interregnum, the Reserve Bank would persevere in its efforts to elongate the maturity profile of public debt, minimise costs, enhance fungibility and liquidity through consolidation of debt and the introduction of new instruments, improve the functioning of financial markets to enable the orderly absorption of market borrowings, and to develop the institutional wherewithal to minimise solvency and liquidity risks. At the same time, greater transparency is being imparted to debt operations as part of a conscious attempt to share with market participants a common set of expectations relating to the future sustainability of public debt management.

XII CURRENCY MANAGEMENT

12.1 During 2001-02, the demand for currency resumed trend rates of expansion after decelerating in the preceding year. The concomitant requirement for issue of currency was met through improved supply and distribution of fresh notes and coins in the economy. Major organisational initiatives in currency management have been taken towards improving the quality of notes in circulation through a variety of measures such as widening of the currency chest network, speeding up the process of handing over and taking over of remittances by the chests, directions to the banks for non-stapling of note packets, withdrawal of soiled notes from circulation and their disposal, mechanisation of note processing and eco-friendly destruction of soiled notes. Anti-counterfeit measures were continued in co-ordination with the Government of India and through public awareness campaigns.

12.2 Notes in circulation (Rs.2 and above) increased by 15.2 per cent during 2001-02 as compared with 10.7 per cent during 2000-01 reflecting the resurgence in agricultural activity. The supply of fresh notes improved during the year through better utilisation of capacity of the two printing presses of Bharatiya Reserve Bank Note Mudran Private Ltd., a wholly owned subsidiary of the Reserve Bank and augmentation of capacity of the two Government Presses.

12.3 In view of the growing volume of notes in circulation and the limitations of existing manual systems, the Reserve Bank embarked upon mechanisation of currency processing operations in the Issue Offices. In the first phase of mechanisation, 22 Currency Verification and Processing Systems (CVPS) have been commissioned in nine of the Issue Offices. Shredding and Briquetting Systems (SBS) have been put in place in all the Issue Offices except Bhubaneswar for destruction of soiled notes in an environment friendly manner.

Outlook

12.4 Ensuring availability of notes and coins for an economy of sub-continental dimensions with currency as the dominant medium of payment and settlement and maintaining the quality of notes in circulation are important elements in the mission of the Reserve Bank. Towards this objective, the institutional framework for currency management is placed under constant monitoring and review and on a progressive path of expansion commensurate with the economy's requirements for currency. Issue Departments of the Reserve Bank are being modernised and expanded. Computerised systems of issue accounting function are operational in 14 Issue Offices. It is envisaged that the CVPS would be installed at the remaining Issue Offices in the second phase of mechanisation. A computerised system for the work of exchange of mutilated notes is under implementation at the Issue Offices. The Reserve Bank has taken up a project for computerising the work of cash operations, planning and management information system (MIS) for currency management.

12.5 The BRBNMPL strives for continuous improvement in its operations through business process re-engineering and is now in the process of implementing the Enterprise Resource Planning (ERP) system encompassing the Finance, Manufacturing, Distribution and Human Resource Modules. The ERP system will enable continuous monitoring of the consumption of raw materials and consumables, analysis and improvement of machine uptime, elimination of in-fructuous and non-value adding activities. The ERP system is likely to be completed by end-October 2002. The BRBNMPL has also undertaken a project on the implementation of ISO 14001 in order to put in place a proper Environmental Management System. This is intended to take care of the environmental impact of the manufacturing process and evolve systems whereby there will be reduction in resource cost by reducing wastage of raw materials.

XIII PAYMENT AND SETTLEMENT SYSTEMS

13.1 The ongoing process of payment and settlement systems reform gained momentum during 2001-02. Significant milestones marking the year's developments were the introduction of the Negotiated Dealing System (NDS) for transactions in Government securities, the implementation of the Centralised Funds Management System (CFMS) and progress in the operationalisation of the Real Time Gross Settlement (RTGS) system. Given the predominant usage of cash as a means for settlement of payment transactions, the switch over to non-cash based modes like cheques, Electronic Clearing Service (ECS) and Electronic Funds Transfer (EFT) has been a gradual but definitive trend which strengthened during 2001-02.

13.2 The value of transactions settled through the clearing system increased by 12.3 per cent to Rs.1,20,69,577 crore during 2001-02. The ratio of cheque clearances to GDP stood at 5.2 during 2001-02 as compared with 5.1 per cent during 2000-01.

13.3 The facilities available under the various electronic payment systems of the Reserve Bank were further improved during the year. This included introduction of Centralised ECS, multiple daily settlements for EFT and increasing the per transaction limit of EFT transactions to Rs. 2 crore. Under the Centralised ECS, a user can submit ECS data at a single location for transfer amongst beneficiaries located at any of the other centres forming part of the ECS network. With the introduction of multiple daily settlements, EFT settlements are now available at 12:00 noon, 2:00 p.m. and 4:00 p.m. on weekdays and at 12:00 p.m. and 2:00 p.m. on Saturdays, thus providing for funds settlements on a same-day basis. The facility has been received well in the context of the introduction of the T+3 based rolling settlement at the stock exchanges. The value of ECS-Credit transactions increased by 56 per cent to Rs.4,818 crore during 2001-02 while that of ECS-Debit transactions more than doubled from Rs.498 crore during 2000-01 to Rs.1,102 crore during 2001-02.

Outlook

13.4 A forward-looking path for the consolidation, development and integration of payments systems in India has been set out in the Vision Document and the Reserve Bank would persevere with reforms in pursuance of this vision. For this purpose, infrastructural developments would encompass expansion of inter-branch networking and connectivity, at least among the commercially important centres of the country. With the INFINET becoming fully operational and widespread in usage, e-banking encompassing e-payments and Electronic Data Interchange would be easily facilitated. Software development for the RTGS is under way and this would enable real time fund settlement and an effective risk control strategy for preventing domino effects of individual defaults. Work relating to introduction of MICR based clearing at various centres important for their share in financial transactions is in progress. The second phase of the CFMS would provide for movement of funds between banks across the 17 locations of the Reserve Bank where Deposit Accounts Departments function.

13.5 The role of the Reserve Bank as prime mover of payment and settlement reform in the financial system in India has been engaging critical attention in the context of the clear demarcation of its responsibilities as regulator and supervisor. At the same time, increasing attention is being focussed on the risks in the payment systems, especially in the large value

and systemically important payment systems. Risk monitoring and risk reduction activities have become highly technical and analytical and are regarded as specialised functions. A movement towards segregation of the operation and regulation of payment systems with respect to most of the significantly important payment systems has been set in motion. To begin with, for the MICR cheque clearing systems in centres other than the four metropolitan centres, the management of operation has since been entrusted with a suitable commercial bank. Similarly, for the securities settlement system and the proposed inter-bank foreign exchange clearing system, a separate institution, *i.e.*, CCIL would be responsible. This strategy will continue till the identified significantly important payment systems are implemented and integrated and attain stability.

XIV HUMAN RESOURCE DEVELOPMENT AND ORGANISATIONAL MATTERS

14.1 Sweeping changes in the environment within which the Reserve Bank operates and the increasing public scrutiny of its policies and functions have placed a premium on the quality of human resources. Keeping pace with the forces of globalisation and the dramatic advances in information and communication technology has hinged around continuous upgradation of skill and technical expertise and a high degree of professionalism among employees so as to ensure convergence between the goals of the employees and those of the institution.

14.2 In recent years, there has been a growing recognition that capital and technology are replicable, but not human capital which needs to be viewed as a valuable resource for the achievement of dynamic competitive advantage. In the context of the changing economic and business environment, there is a realisation that a rigid and hierarchical structure, which gives preference to seniority over performance is not the best environment for attracting and retaining the best talent or the best output from professionals. Accordingly, there is a critical need to review and improve strategies for recruitment, placement, career development and performance management. These efforts are likely to enable the fulfilment of the mission of the Reserve Bank to build and reinforce a corporate vision and culture that fosters learning, creativity and adaptability in the context of fundamental changes in technology and exacting requirements of business performance and customer service. Within the constraints of the existing framework, the Reserve Bank persevered towards the attainment of its goals during 2001-02 through training and skill enhancement, strategic changes in placement and recruitment policy, promotion of Hindi, improving customer services, and industrial relations. Efforts were intensified towards creating public awareness through a continuous process of dissemination and feedback within the framework of a consistent communications policy. Important legal reforms were initiated to improve the functioning of the Reserve Bank in the context of its environment and to strengthen the technological and institutional infrastructure for the financial system.

XV THE RESERVE BANK’S ACCOUNTS FOR 2001-02

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

15.2 The total income of the Reserve Bank for the year 2001-02 (July-June) increased by Rs.2,841.47 crore (13.0 per cent) from Rs.21,848.87 crore to Rs.24,690.34 crore. The increase in income was mainly due to profits booked on sale of Rupee Securities. The share of domestic and foreign sources in total income was 59.6 per cent and 40.4 per cent respectively.

Income from Foreign Sources

15.3 During the accounting year ended June 30, 2002, the Reserve Bank's net earnings from the deployment of foreign currency assets including gold decreased by Rs.99.62 crore (1.0 per cent) from Rs.10,086.08 crore in 2000-01 to Rs.9,986.46 crore in 2001-02 due to a lower return on investment consequent upon decline in interest rates abroad although there was a higher average level of foreign currency assets at Rs.2,23,565 crore in 2001-02 as against Rs.1,68,577 crore in 2000-01. In percentage terms, the net earnings on foreign currency assets and gold decreased from 6.0 per cent in 2000-01 to 4.5 per cent in 2001-02 due to lower interest rates prevailing in the international markets. Excluding gains/ losses on account of securities transactions and depreciation, the net earnings on foreign currency assets and gold worked out to 4.1 per cent for 2001-02 as against 5.8 per cent for 2000-01. There was capital gain (net) on sale of securities at Rs.785.56 crore (realised capital gain of Rs.1,335.15 crore and depreciation of Rs.549.59 crore) during the year 2001-02 as compared to Rs.378.38 crore (realised capital gain of Rs.606.08 crore and depreciation of Rs.227.70 crore) during the year 2000-01. The foreign securities held in the Reserve Bank's portfolio are valued at the end of every month at the lower of book value or market rate. If the market rate is lower than the book value, depreciation to the same extent is provided for. Appreciation is neither taken to profit and loss account nor to the reserves. Such unrealised appreciation in the value of foreign securities held in the Reserve Bank's portfolio as at the end of June 2002 was Rs.781.81 crore as against Rs.703.29 crore as at the end of June 2001.

Income from Domestic Sources

15.4 Domestic income increased by Rs.2,941.09 crore (25.0 per cent) from Rs.11,762.79 crore in 2000-01 to Rs.14,703.88 crore in 2001-02. There was an increase of Rs.2,977.81 crore in the profits booked on sale of Rupee Securities, *i.e.*, from Rs.82.23 crore in 2000-01 to Rs.3,060.04 crore in 2001-02.

15.5 The interest income received on the Reserve Bank's investment in Government Securities also increased by an amount of Rs.335.15 crore from Rs.8,669.10 crore in 2000-01 to Rs.9,004.25 crore in 2001-02. The discount earned on Treasury Bills declined by Rs.200.67 crore from Rs.211.59 crore in 2000-01 to Rs.10.92 crore in 2001-02 as there was no acquisition of Treasury Bills at primary auctions by the Bank. Despite the reduction in the interest rates applicable to the Ways and Means advances, the interest income on these advances showed an increase of Rs.204.35 crore during 2001-02 from Rs.748.13 crore in 2000-01 to Rs.952.48 crore in 2001-02, reflecting increased recourse by the Central and State Governments to this facility. Interest earnings from loans and advances to banks/financial institutions declined by Rs.459.73 crore from Rs.1,630.17 crore in 2000-01 to Rs.1,170.44 crore in 2001-02, due to lower utilisation of refinance facility by Primary Dealers/Scheduled Commercial Banks combined with lower interest rates applicable on these advances.

EXPENDITURE

15.6 Total expenditure of the Reserve Bank increased by Rs.954.87 crore (17.1 per cent) from Rs.5,587.52 crore in 2000-01 to Rs.6,542.39 crore in 2001-02.

Interest Payment

15.7 Interest payment increased by Rs.340.19 crore (17.0 per cent) from Rs.1,994.80 crore in 2000-01 to Rs.2,334.99 crore in 2001-02.

Establishment Expenditure

15.8 Establishment expenditure increased by Rs.433.51 crore (49.8 per cent) from Rs.870.85

crore in 2000-01 to Rs.1,304.36 crore in 2001-02, due to provision of Rs.440.80 crore made for gratuity and pension funds as per the actuarial valuation.

Non-establishment Expenditure

15.9 Agency charges represent the compensation paid to agency banks for handling Government business on behalf of Reserve Bank. Expenditure towards agency charges increased by Rs.47.14 crore (4.1 per cent) from Rs.1,160.70 crore in 2000-01 to Rs.1,207.84 crore in 2001-02. Expenditure on security printing comprising cost of printing of currency notes, cheque forms *etc*., increased by Rs.181.71 crore (16.2 per cent) from Rs.1,122.78 crore in 2000-01 to Rs.1,304.49 crore in 2001-02 mainly due to upward revision in rates of printing currency notes and larger component of higher denomination notes.

APPROPRIATION

Net Disposable Income

15.10 The net disposable income of the Reserve Bank for the year 2001-02 amounted to Rs.10,324 crore. Since 1991-92, transfers to statutory funds on a significant scale have been discontinued. However, pending amendment to the Reserve Bank of India Act, 1934 for vesting in the Reserve Bank the discretion in the matter of transfer to statutory funds from the profits of the Reserve Bank, a token contribution of Rupees one crore each has been made to the four funds.

Surplus transferable to Government of India

15.11 The surplus transferable to the Central Government for the year 2001-02 amounted to Rs.10,320 crore, inclusive of Rs.1,479 crore towards interest differential on special securities converted into marketable securities. The transfer on account of interest differential is intended to compensate the Government for the difference in interest expenditure, which the Government had to bear consequent upon the conversion.

BALANCE SHEET

Liabilities

National Industrial Credit (Long Term Operations) Fund

15.12 The National Industrial Credit (Long Term Operations) Fund was established by the Reserve Bank in July 1964 with an initial corpus of Rs.10 crore and annual contributions from the Reserve Bank's disposable surplus in terms of Section 46-C(1) of the Reserve Bank of India Act, 1934 for the purpose of making loans and advances to eligible financial institutions. Consequent upon the announcement in the Union Budget for 1992-93, the Reserve Bank decided to discontinue the practice of crediting large sums to the said Fund. No further disbursements from the Fund have been made. It was decided in 1997-98 to transfer the unutilised balance in the Fund arising from repayments to Contingency Reserve (CR) on a year-to-year basis. Accordingly, an amount of Rs.4,224 crore has been transferred to CR in 2001-02 as against Rs.400 crore transferred in the preceding year.

National Housing Credit (Long Term Operations) Fund

15.13 The National Housing Credit (Long Term Operations) Fund was established by the Reserve Bank in terms of Section 46-D(1) of the Reserve Bank of India Act, 1934 in January 1989 with an initial corpus of Rs.50 crore with the intention of crediting to the Fund every year such sums of money as it may consider necessary. Annual contribution to the Fund is

being made from the profits of the Reserve Bank. The amount in the said Fund can be applied by RBI only for (i) making loans and advances to National Housing Bank (NHB) for its business and (ii) purchasing bonds and debentures issued by NHB. Consequent upon a decision of Government of India announced in the Union Budget for the year 1992-93, the Reserve Bank discontinued the practice of crediting large sums to the said Fund and since then only a token amount of Rupees one crore is being transferred to the Fund every year. A loan of Rs.700 crore was granted to NHB in the year 1997 out of NHC (LTO) Fund drawn from the Bank's Contingency Reserve for meeting the shortfall arising out of a dispute between NHB and Grindlays Bank. The amount of Rs.700 crore has been repaid by NHB in January 2002 consequent upon Court Settlement and the said sum has been transferred to Contingency Reserve of the Bank.

Deposits - Banks

15.14 'Deposits - Banks' represent balances maintained by the banks in current account with the Reserve Bank mainly for maintaining Cash Reserve Ratio (CRR) and as working funds for clearing adjustments. The aggregate deposits of scheduled commercial banks with the Reserve Bank decreased by Rs.19,095.76 crore (25.8 per cent) from Rs.74,107.98 crore as on June 30, 2001 to Rs.55,012.22 crore as on June 30, 2002 mainly due to the reduction in the rate of CRR requirement from 7.5 per cent to 5.0 per cent during the year 2001-02.

Deposits - Others

15.15 'Deposits - Others' include deposits from financial institutions, employees' provident fund deposits, surplus earmarked pending transfer to the Government and sundry deposits. Deposits under this head have increased by Rs.1,805.11 crore (11.0 per cent) from Rs.16,321.85 crore as on June 30, 2001 to Rs.18,126.96 crore as on June 30, 2002 due to increase in Provident Fund balances of employees and deposits by international financial institutions.

Other Liabilities

15.16 'Other Liabilities' include the internal reserves and provisions of the Reserve Bank and net credit balance in the RBI General Account. These liabilities have increased bY Rs.34,755.48 crore (46.6 per cent) from Rs.74,488.47 crore as on June 30, 2001 to Rs.1,09,243.95 crore as on June 30, 2002 mainly on account of increase in the levels of internal reserves.

15.17 The reserves, *viz.*, Contingency Reserve, Asset Development Reserve, Currency & Gold Revaluation Account and Exchange Equalisation Account, *etc.*, reflected in 'Other Liabilities' are in addition to the 'Reserve Fund' of Rs.6,500 crore held by the Reserve Bank as a distinct balance sheet head.

Currency and Gold Revaluation Account and Exchange Equalisation Account

15.18 Gains/losses on valuation of foreign currency assets due to movements in the exchange rates and/or prices of gold are not booked in profit and loss account but in a separate account called Currency and Gold Revaluation Account (CGRA), the balance in which represents accumulated net gain on valuation of foreign currency assets and gold. This account was earlier known as Exchange Fluctuation Reserve. During 2001-02, there was an accretion of Rs.21,886.33 crore to the CGRA, thus increasing the balance to Rs.51,010.77 crore as on June 30, 2002 from Rs.29,124.44 crore as on June 30, 2001. The CGRA at the end of June 2002 was equivalent to 18.0 per cent of foreign currency assets and gold holdings of the Reserve Bank, as against 14.2 per cent at the end of June 2001. This was mainly on account

of appreciation in the foreign currency assets.

Contingency Reserve and Asset Development Reserve

15.19 The Reserve Bank maintains a Contingency Reserve (CR) to enable it to absorb unexpected and unforeseen contingencies. The Reserve Bank has set an indicative target of 12 per cent of the Reserve Bank's total assets to be achieved in phases by the year 2005, subject to review, if considered necessary. The balance in CR has gone up from Rs.36,514.13 crore as on June 30, 2001 to Rs.48,434.17 crore as on June 30, 2002. A transfer of Rs.6,996.04 crore was made to CR during 2001-02 from income in addition to transfer of the unutilised balance of Rs.4,224 crore from National Industrial Credit (Long Term Operations) Fund, and Rs.700 crore from National Housing Credit (Long Term Operations) Fund.

15.20 In order to meet the internal capital expenditure and make investments in its subsidiaries and associate institutions, the Reserve Bank had created, in 1997-98, a separate Asset Development Reserve (ADR) with the aim of reaching one per cent of the Reserve Bank's total assets within the overall target of 12 per cent set for CR. In the year 2001-02, an amount of Rs.827.91 crore was transferred from income to ADR raising its level from Rs.3,872.63 crore as on June 30, 2001 to Rs.4,700.54 crore as on June 30, 2002. As a proportion of total assets, CR and ADR together constituted 11.7 per cent of total assets of the Reserve Bank as on June 30, 2002 as against 9.9 per cent as on June 30, 2001.

ASSETS

Foreign Currency Assets

15.21 The foreign currency assets comprise foreign securities held in Issue Department, balances held abroad and investments in foreign securities held in Banking Department. Such assets rose from Rs.1,91,226.06 crore as on June 30, 2001 to Rs.2,67,333.18 crore as on June 30, 2002.

Investment in Government of India Rupee Securities

15.22 Investment in Government of India Rupee Securities which stood at Rs.1,57,027.41 crore as on June 30, 2001 decreased by Rs.21,959.55 crore (14.0 per cent) to Rs.1,35,067.86 crore as on June 30, 2002.

Investments in Shares of Subsidiaries and Associate Institutions

15.23 The Reserve Bank's investments in the shares of its subsidiaries and associate institutions have decreased by Rs.93.05 crore on account of disinvestment of Reserve Bank's holding in Discount and Finance House of India (Rs.20.99 crore) and Securities Trading Corporation of India Ltd. (Rs.72.06 crore).

Other Assets

15.24 'Other Assets' comprise mainly dead stock, gold holdings in the Banking Department, amounts spent on projects pending completion and staff advances. The level of 'Other Assets' has decreased by Rs.666.18 crore (5.0 per cent) from Rs.13,381.52 crore as on June 30, 2001 to Rs.12,715.34 crore as on June 30, 2002.

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* While the Reserve Bank of India’s accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated up to June 2002, and in some areas, information beyond end-June 2002 is also discussed. For the purpose of analysis and for providing proper perspectives on policies, reference to past

years as also prospective periods, wherever necessary, has been made in this Report.