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 co-ordination, 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 inter-twined 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.