Summary of the Annual Report of RBI for the year ended June 2003

*For the Year July 1, 2002 to June 30, 2003**

Part One : The Economy : Review And Prospects

I - Macroeconomic Policy Environment

Introduction

1.1 Cautious optimism characterised the stance of macroeconomic policies during 2002-03, notwithstanding the continuing slowdown in global economic activity and an environment riddled with several external shocks. The shocks impacting the domestic economy included border tensions, severe drought and the hardening of international crude oil prices towards the year's close. The drought situation necessitated swift responses in supply management. Food supply was bolstered by a drawdown of foodstocks for a substantial increase in targeted public distribution programmes. Coupled with reduction in issue prices and ease in the access to imports, these strategies were effective in containing potential inflationary pressures. In the event, inflation remained weak for the greater part of the year, edging up only in the last quarter in the wake of the firming up of international prices of crude oil.

1.2 The counter-drought stance was reflected in fiscal policy as spending on food and input subsidies rose even as other expenditures were reined in. Revenue shortfalls on account of the continuing slack in economic activity and the reduction of tax/duty rates resulted in modest slippages in fiscal consolidation. Nevertheless, there was a renewal of the commitment to improve the quality of fiscal adjustment through monitorable reform programmes and appropriate incentive structures, especially at the sub-national level. Simultaneously, debt consolidation was carried forward and continued attention was given to measures designed to bring back buoyancy to the tax-GDP ratio.

1.3 Cuts in key policy rates and the cash reserve ratio (CRR) signaled the fine-tuning of monetary-fiscal coordination for stimulating the revival of aggregate demand. The conduct of monetary policy was dominated by the need to contend with large inflows of foreign exchange. The surplus in the current account of the balance of payments for the second year in succession and sizeable capital inflows engendered a record accretion to foreign exchange reserves. Financial markets with overhang of liquidity experienced a distinct easing of rates which, in turn, impacted on monetary policy, necessitating continuous operations to modulate and balance market conditions. Financial sector reforms were carried forward with the objective of rapid convergence with international best practices. The environment for deepening these reforms improved considerably with the enactment of appropriate changes in the institutional architecture, particularly in respect of the recovery of problem assets. The technological infrastructure for the financial system continued to be upgraded.

1.4 Against this backdrop, growth strategies were put in place to propel the economy towards its full potential over the medium-term with emphasis on the quality of growth. Resumption of industrial activity and a robust export performance in the face of the global downturn set the tone for a strategic trade policy centred around doubling of exports from the current level and thereby raising India's share in global exports to 1 per cent by 2007. The Union Budget for 2003-04 aims at stepping up revenue mobilisation and persevering with expenditure management with an overall shift in emphasis to qualitative aspects of fiscal reform. The Monetary and Credit Policy for 2003-04 provided a stimulus to aggregate demand through reductions in the Bank Rate and the CRR, even while indicating the need for a continued vigil on the inflation front. Several steps were taken to strengthen financial soundness and the content of regulatory supervision. The resurgence of positive expectations regarding the near-term was greatly facilitated by the passage of landmark reform legislations, setting the stage for intensifying structural reforms.

THE MEDIUM-TERM GROWTH STRATEGY

1.5 The year 2002-03 marked the launch of the Tenth Five Year Plan covering the period 2002-07. The Plan sets an ambitious growth target of 8 per cent per annum over the Plan period and envisages conditions for a further acceleration over the subsequent five-year period (2007-12) so that there is a doubling of per capita income over the decade. The Plan also adopts 'specific and monitorable' objectives in terms of crucial facets of human development – poverty, employment, education and demographic stability as well as ecological issues in sustainable development.

1.6 The Tenth Plan strategy accords to public expenditure the principal role in raising aggregate demand until private investment can be crowded in sufficiently so as to sustain the growth momentum. Accordingly, the gross investment rate is expected to be raised to about 28 per cent of GDP (from the current level of 24 per cent), primarily financed by a step-up in domestic saving and supplemented by a modest expansion in the inflow of external saving (to 1.6 per cent of GDP from less than 1 per cent during the Ninth Plan period). Other crucial elements in the Plan strategy are a reduction in the incremental capital-output ratio (ICOR) from 4.5 to 3.6, export volume growth of 12.4 per cent per annum, stabilising the variability of rural incomes and halting the dissaving of the public sector.

1.7 Fiscal correction and diverting more resources to productive purposes are keys to achieving the Plan objectives and ensuring fiscal sustainability. The Tenth Five-Year Plan aims at reduction in deficits at both the Central and State level. To achieve the expected level of fiscal consolidation and the growth target, the Tenth Plan envisages an increase in the Centre's gross tax revenue to 9.9 per cent of GDP by the terminal year of the Plan (2006-07) from 8.2 per cent in the base year (2001-02). The corresponding ratios for the States' own tax revenue are 6.6 per cent and 5.9 per cent of GDP, respectively. On the expenditure side, the Tenth Plan visualises higher budget support to the Plan (Plan expenditure) by the Centre – on an average, 4.9 per cent of GDP during the Plan period as against 4.4 per cent in the base year. On the other hand, the non-Plan expenditure is anticipated to decline to 9.9 per cent of GDP in the terminal year of the Plan from 11.3 per cent in the base year. Similarly for States, Plan expenditure is envisaged to increase to 4.2 per cent of GDP and non-Plan expenditure is anticipated to decline to 11.5 per cent of GDP by 2006-07 from their respective levels of 3.8 per cent and 13.3 per cent of GDP during 2001-02. These anticipated trends in the revenue and expenditure are expected to improve Government saving and public investment.

1.8 Critical to the Plan strategy are appropriate changes in policy and institutional settings which take due cognisance of the significant structural changes underway in the economy. Agriculture, construction, 'other transport' and 'other services' are specific sectors targeted for high growth in view of their potential for employment generation with relatively low capital intensity. Employment generation would be the driving factor in speeding up growth in segments within manufacturing. 'Agriculture and allied activities', 'mining and quarrying' and construction are likely to receive excess investment to meet the Plan objectives. Existing shortfalls in investment in 'electricity, gas and water supply', communication, financial services, public administration and community services are expected to be bridged by a significant improvement in private investment, and by removing fiscal constraints as well as generation of internal resources by the public sector. Balanced regional development, reduction in poverty across States, fiscal sustainability and further intensification of financial sector reforms are other notable elements of the Tenth Plan strategy.

REAL SECTOR POLICIES

Agriculture and Allied Activities

1.9 Mitigating the adverse impact of the drought emerged as an overriding priority in 2002-03 even as initiatives for ongoing institutional and structural reform in the agricultural sector were strengthened further.

1.10 The Central Government allotted 3.8 million metric tonnes of rice and wheat free of cost to the 14 drought affected States for various employment programmes. The Task Force on Drought approved a special package of drought assistance for Rajasthan under which people in the worst affected blocks in the State were provided relief employment for 10 days every month and received 8 kgs of foodgrains per day. Accordingly, Rajasthan was allocated 2.1 million tonnes of wheat free of cost from February to July 2003 for the purpose of providing employment to 6.6 million persons. Fodder of 30,000 tonnes was also allocated free of cost to Rajasthan, and 435 cattle camps were provided financial assistance amounting to about Rs.12 crore. The Task Force on Drought also approved allocation of 1,15,000 tonnes of foodgrains to Maharashtra for three months from February 2003 and 75,000 tonnes of rice to Himachal Pradesh for public distribution at Below Poverty Line (BPL) rates. Fodder and water were freely transported by the railways to the affected areas up to June 30, 2003. Onetime special drought relief prices were announced for various commodities ranging from Rs.20 per quintal for paddy, jowar, copra and sesamum, Rs.15 per quintal for sunflower seed, Rs.10 per quintal for bajra and soyabean and Rs.5 per quintal for various pulses. An increase of Rs.5 per quintal in the Statutory Minimum Price (SMP) was announced for sugarcane farmers in all States.

1.11 As part of drought relief measures, interest on *kharif* crop loans as well as on agricultural term loans during 2002-03 was deferred. The crop loans were rescheduled into term loans which would be recovered over the next five years in the case of small and marginal farmers and over three years in the case of other farmers. The first year's deferred liability of interest on *kharif* loans was waived completely as a one-time measure. The Government announced a grant of an input subsidy to small and marginal farmers amounting to Rs.1,490 crore. In view of the severity of the drought, the agricultural input subsidy was extended to cover all other farmers for both sown and unsown areas up to a ceiling of two hectares. All the 14 affected States received additional amounts of input subsidies, cumulatively in excess of Rs.555 crore, for tackling the drought. The Union Budget for 2003-04 expanded the *Antyodaya Anna Yojana* from April 2003 to cover an additional 50 lakh families, raising the total coverage to more than a quarter of all BPL families during the current year.

1.12 Futures trading is expected to help farmers and traders to hedge their risks and thereby lessen their dependence on Government procurement. Recently, all commodities were made eligible for futures trading. At present, there are 91 commodities under the purview of Section 15 of the Forward Contracts (Regulation) Act, 1952. Trading in these commodities would be conducted only in recognised exchanges regulated by the Forward Markets Commission. Notwithstanding the introduction of futures trading, Minimum Support Prices (MSPs) for these foodgrains and the procurement mechanism would continue to be in existence. The Food Corporation of India (FCI) was directed to open additional centres for procurement of paddy from non-traditional States like Madhya Pradesh, Bihar and Orissa.

1.13 The Agricultural Insurance Company of India Limited (AIC), which was proposed in the Union Budget, 2002-03, was constituted in December 2002 with the capital participation from General Insurance Corporation of India (GIC), National Insurance Company Limited, New India Assurance Company Limited, Oriental Insurance Company Limited, United India Insurance Company Limited and the NABARD. The National Agricultural Insurance Scheme will be transferred to AIC and would be the core business of the company. The new organisation will, in due course, cover other allied agricultural risks in addition to crop insurance.

Manufacturing and Infrastructure

1.14 In recent years, the objective of industrial policy in India has been to infuse competitive efficiency into Indian industry while promoting its restructuring with a focus on core competencies, organisational change and a growing exposure to the cutting edge of international competitiveness.

1.15 The Competition Act, 2002 was enacted in December 2002 to promote competition through prohibition of anticompetitive practices and abuse of dominance and through regulation of companies beyond a particular size. This Act will replace the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP).

1.16 A moderate rate structure and complete CENVAT chain to promote compliance and encourage modernisation in the textile sector is envisaged in the Union Budget, 2003-04. A special package for the power loom sector is likely to enlarge the Technology Upgradation Fund Scheme to cover the modernisation of the sector. The introduction of the revised Textile Sector Infrastructure Development Scheme is expected to improve working conditions, productivity and to provide insurance cover to weavers. A Centrally Sponsored Scheme ‘Apparel Parks for Exports Scheme’ was launched for setting up of apparel manufacturing units of international standards at potential growth centres. Under this scheme, nine Apparel Parks have been identified. A cluster-based approach to the implementation of schemes/programmes in handlooms, powerlooms, sericulture and other decentralised industries has been adopted.

1.17 The Export Import (EXIM) Policy, 2003-04 exempted domestic sales undertaken by the units located in Special Economic Zones (SEZs) from levy of the 4 per cent special additional customs duty. Special purpose vehicles (SPVs) are proposed to be set up to develop industrial clusters. The SPVs, which have no identifiable revenue stream, will be funded entirely by the Central Government and beneficiaries. The SPVs are expected to create a world class physical infrastructure in industrial clusters with a high growth potential and convert static local efficiency into dynamic competitiveness. Ten industrial clusters would be selected under the Industrial Infrastructure Upgradation Scheme announced in the Exim Policy 2002-07. The cap on the number of investment companies being floated by companies would no longer apply to SPVs set up to route funds into new ventures.

1.18 De-reservation of 51 items for the small scale industries (SSI) sector was effected in May 2002. For technology upgradation and quality improvement in the SSI sector, the scope of the on going ISO 9000 reimbursement scheme was enlarged to include reimbursement of expenses for ISO 14001 Environment Standard with effect from October 28, 2002. The Union Budget for 2003-04 announced de-reservation of 75 items for the SSI sector. The de-reserved items include laboratory chemicals and reagents, plastic, leather and paper products. The Government raised the SSI investment limit on 10 drugs and pharmaceutical items from Rs.1 crore to Rs.5 crore in June 2003. The composite bank loan limit for SSI was raised from Rs.25 lakh to Rs.50 lakh in June 2003 to meet their term loan as well as working capital requirements.

1.19 Noteworthy changes in the policy environment are expected to provide a strong impetus for the development of the physical infrastructure. The Union Budget, 2003-04 envisages innovative funding mechanisms principally in respect of roads, railways, airports and seaports. The objective is to leverage public money through private sector partnership, wherever possible. In February 2003, the Reserve Bank allowed banks to finance promoters' contribution to equity capital in infrastructure projects. Risk weight for the purpose of reckoning capital adequacy was halved to 50 per cent for core sector funding. This is applicable to banks' investments in securitised paper pertaining to an infrastructure facility. These measures are expected to give a boost to core sector funding.

1.20 The Electricity Bill, 2003 was approved by Parliament in 2003. The Bill seeks to delicense power generation and to permit captive power plants. It would help to facilitate private sector participation in the transmission sector and would provide open access to the grid sector. In April 2003, the Union Cabinet approved a six level intervention plan for the power sector involving a financial assistance of Rs.40,000 crore to State Electricity Boards (SEBs) in the next five years for power distribution reforms. The intervention strategy would encompass initiatives at the national level, State level, SEB and utility level, distribution circle level, feeder level and the consumer level to focus on accountability, deliverability and performance at all levels. The Ministry of Power, the Reserve Bank and States entered into a tripartite agreement in March 2003 for a one-time settlement plan of dues of Rs.42,000 crore payable by SEBs to central public sector undertakings.

1.21 In the telecommunications sector, the monopoly of Videsh Sanchar Nigam Ltd (VSNL) over long distance telephony ceased with its privatisation in 2002. Policies for opening up of international long-distance telephony, setting up of Universal Service Obligation, permitting a fourth operator in the cellular mobile segment and commissioning of internet backbone were put in place. In the Union Budget, 2003-04 the benefit of tax holiday to the telecom and domestic satellite service companies was extended till March 31, 2004. In June 2003, the Department of Telecommunication notified changes in the licence conditions of the cellular and basic service operators to enable greater consolidation in the telecom sector through merger, de-merger and acquisition.

1.22 In the road sector, private parties were allowed to apply for tenders either singly or through a consortium restricted to four members. The Ministry of Road and Surface Transport has short listed 23 build, operate and transfer (BOT) projects under this new bidding process. Airport handling was opened to foreign direct investment up to 49 per cent.

EXTERNAL SECTOR POLICIES

EXIM Policy (2002-07)

1.23 The ongoing strength and buoyancy in the external sector set the tone for an ambitious trade policy stance with continued emphasis on correction of the anti-export bias in the economy. Buoyed by a robust export performance in 2002-03 in the face of sluggish external demand and the burgeoning international reserves, the modified EXIM Policy for 2002-07 seeks a greater integration of international trade into the development strategy of the Tenth Plan.

1.24 The Policy intends to consolidate and accelerate India's export growth by capitalising on agricultural and allied products as areas of core competence and focusing on special economic zones (SEZs) and exports of services as engines of growth. Removal of export restrictions, modification of norms for fixing duty entitlement pass book (DEPB) rates, promotion of corporate participation in agri-export zones and export infrastructure are envisaged. Besides, agricultural extension, processing, packing, storage, R&D and other facilities in these zones, and transport assistance for exports of agricultural products are emphasised. The policy also contains a special focus on exports of cottage industries, handicrafts, gems and jewellery through market access initiative schemes, duty free imports and appropriate adjustments in value addition norms.

1.25 In recognition of the importance of SEZs, major steps were taken for simplification and codification of rules, regulations and procedures applicable to the SEZs and Export Oriented Units (EOUs). External Commercial Borrowings (ECBs) for tenure of less than three years are allowed to units in SEZs. Sales from the Domestic Tariff Area (DTA) to SEZs are treated as exports and entitle the DTA suppliers to Drawback/DEPB benefits. Special steps are drawn up to promote exports of gems and jewellery and electronic hardware from the SEZs.

1.26 In view of the growing importance of services, the EXIM policy has accorded a special thrust to these exports. Apart from software, a host of traditional (tourism) and non-traditional (health care, entertainment and professional services) services have been identified for promotion. For these sectors, import of consumables, office and professional equipments, spares and furniture up to 10 per cent of the average foreign exchange earning in the previous three years was allowed. The tourism sector was allowed to avail the benefits under the Export Promotion Credit Guarantee (EPCG) and advance licensing schemes. For entertainment and education services, sector-specific Working Groups are set up for framing action plans to achieve export potential within a specified time schedule.

Trade Policy Measures in the Union Budget for 2003-04

1.27 The Union Budget for 2003-04 contains several measures to facilitate foreign trade, such as, reduction/ rationalisation of customs duties, simplification and modernisation of customs clearance procedures, and strengthening export infrastructure. The peak rate of customs duty has been reduced from 30 per cent to 25 per cent, excluding agriculture and dairy products.

1.28 The report of the Task Force on Indirect Taxes (headed by Dr. Vijay Kelkar) submitted to the Ministry of Finance in December 2002 contained various recommendations relating to Drawbacks, SEZs, EOUs and Advance Licensing Scheme. Some of the recommendations of the Task Force have been accepted and implemented by the Government, subsequent to the Budget announcements. These include acceptance of self-declaration certificate of non-availment of CENVAT credit for grant of drawback, release of an amount equivalent to all industry drawback entitlement in cases of shipments under brand rate of drawback, acceptance of exporters' declaration regarding the weight of constituent material in case of composite item and payment of interest in cases of delayed sanction of drawback beyond one month.

Policies for External Capital Flows

1.29 Significant easing of payments restrictions were effected in respect of current and capital remittances abroad. Domestic entities were allowed to retain significant proportions of their earnings abroad to meet future foreign exchange requirements. Relaxations were effected in the movement of inward and outward capital flows in the form of foreign direct investment, foreign portfolio investment, NRI deposits and external commercial borrowings. Notable among them were:

- Norms on release of foreign exchange for purposes such as medical treatment abroad, private visits abroad, use of payment cards abroad, procurement of books and other items through internet liberalised including use of funds held in Non-Resident Ordinary (NRO) accounts for educational and medical purposes.

- Repatriation of proceeds from sale of immovable properties allowed after a minimum of 10 years lock in period and subject to annual limits and existing taxation. Repatriation of assets of foreign nationals and assets of nonresident Indians (NRIs)/persons of Indian origin (PIOs) by way of inheritance/legacy allowed up to a yearly limit.

- Up to 100 per cent of export earnings can be credited to Exchange Earners' Foreign Currency Account (EEFC).

- Norms for prepayment of external commercial borrowings (ECBs) simplified.

- Foreign institutional investors (FIIs) allowed to hedge the market value of their entire investment in equity.

- Rules for issue of ADRs/GDRs simplified to allow sponsoring, listing on overseas exchanges, retention of proceeds abroad and free conversions and repatriability.

- Listed Indian companies permitted to invest in companies abroad under conditions; ceiling for mutual funds' overseas investment raised to US $ 1 billion; banks' investment abroad enhanced to 50 per cent of Tier I capital; improvement in the automatic route for Indian joint ventures/wholly owned subsidiaries abroad.

- Resident individuals permitted to open domestic foreign currency accounts.

International Finance

Financial Transaction Plan

1.30 From September 2002 India became a member of the IMF's Financial Transaction Plan (FTP) in view of its strong balance of payments and comfortable reserves. Effective participation in FTP would amount to India becoming a creditor member of the IMF. Depending on the extent of its participation in the FTP, India's Reserve Tranche Position (RTP) in the Fund would increase on which the IMF would pay remuneration at market related rates. The IMF prepares a quarterly FTP indicating the expected total amount that all creditor countries may have to provide during any quarter. In the quarters September-November 2002 and December 2002-February 2003, planned transfers indicated in the FTPs were SDR 6.6 billion and SDR 6.0 billion. Actual transfers effected by all the creditors taken together were about SDR 1.8 billion and SDR 3.3 billion, respectively. In those two quarters, India was allocated SDR 156 million and SDR 128 million, respectively. Since actual transfers under the FTP were far less than the planned transfers, India was not required to effect any actual transfer during those two quarters. This situation changed in the subsequent quarters. India was allocated SDR 140 million under the FTP for March-May, 2003 quarter out of a total planned transfer of SDR 6.2 billion (by all creditor members) and was requested to effect an actual transfer to the IMF for the first time, amounting to SDR 5 million. For June-August 2003, India was allocated SDR 303 million out of a total planned allocation of 13 billion for all FTP members, and actual transfers effected by India during this period amounted to SDR 200 million.

G-20 Initiatives

1.31 In March 2002, India assumed the leadership of the Group of Twenty (G-20). During India's leadership, the G-20 Deputies deliberated on a range of issues of common concern to the G-20 members including measures for extending the benefits of globalisation, Sovereign Debt Restructuring Mechanism (SDRM), domestic policy requirements for regeneration of international capital flows, combating financing of terrorism, standards and codes, and enhancing the effectiveness of aid.

FISCAL POLICY

1.32 The stance of fiscal policy set out in the Union Budget for 2003-04 was indicated in a renewal of commitment to five basic objectives ("*Panch Priorities*"): poverty eradication, infrastructure development, fiscal consolidation, development of agriculture including irrigation and enhancing manufacturing sector efficiency. The process of fiscal consolidation is being carried forward through tax reforms and progressive elimination of budgetary drags, including reform of the additional excise duty and expansion of service tax. Debt restructuring and the cash management as part of expenditure management are envisaged as integral elements of fiscal consolidation.

Expenditure Management and Debt Consolidation

1.33 Cash management has been proposed to be initiated on a pilot basis in some major spending ministries so as to facilitate the release of budgetary allocations in a phased manner to permit convergence with the availability of resources within the year. Improvement in cash flow matching is expected to have salutary effects on expenditure management.

1.34 Debt restructuring would be undertaken on three fronts, *viz*., prepayment of external debt, buy-back of illiquid high interest rate loans from banks, and allowing State Governments to swap high cost Central Government debt with lower cost new borrowings. With regard to external debt repayment, the Union Budget expressed the intention to continue with the policy of prudently managing external liabilities and proactively liquidating relatively higher cost components of the external debt portfolio. As regards domestic debt, Government would offer to buy back high interest loans from banks on an entirely voluntary basis. The buy back scheme would enable the banks to improve their liquidity position. Furthermore, better NPA management is being encouraged through tax incentives if the banks make profits from the buy back for provisioning. Under the debt-swap scheme between the Central Government and the States, all State loans from Government of India bearing coupons in excess of 13 per cent would be swapped over a three-year period ending in 2004-05. The States are expected to save an estimated Rs.81,000 crore in interest and deferred loan repayments over the residual maturity period of the loans. The scheme would also help restrain the debt build-up in States through the small saving schemes.

Tax Reform

1.35 Tax reforms proposed in the Union Budget emphasise six important aspects: (i) Value Added Tax (VAT) for States; (ii) integration of services into the tax net; (iii) improvements in tax administration through greater application of information technology (IT); (iv) rationalisation of excise duties; (v) reduction in customs duty; and (vi) fiscal consolidation through expenditure reprioritisation and revenue augmentation.

1.36 Under direct taxes, measures taken to provide relief to taxpayers and to improve tax compliance include raising of standard deduction for salaried employees; relief to employees by exempting voluntary retirement scheme (VRS) payments from income tax up to Rs.5 lakh; rebate for education expenses up to Rs.12,000 per child for two children made eligible for rebate under Section 88 of the Income Tax Act; and tax rebate for senior citizens is increased to Rs.20,000, thereby making their income up to Rs.1.53 lakh fully exempt from income tax. For individuals, the surcharge is removed entirely; however, for incomes above Rs.8.5 lakhs, a 10 per cent surcharge on the tax has been imposed. On pension, the effective exemption limit becomes Rs.1.83 lakh per annum. The measures for simplification and rationalisation of tax regime include general deductions for individuals tax payers under section 80L on income from dividends, interest *etc*. up to Rs.15,000. In order in give a boost to investment, the corporate tax rate is left unchanged and the 5 per cent surcharge has been halved. The tax deductibility of interest on housing loans for construction or purchase of a self-occupied house property has been retained at Rs.1,50,000.

1.37 On the indirect tax front, rationalisation of excise rate structure and reduction of the multiplicity of rates are the main planks of tax reforms. In addition, more services have been put under the tax net and the general service tax rate has been enhanced from 5 per cent to 8 per cent. The peak rate of customs duty has been reduced to 25 per cent. In the case of excise duties, a three-tier excise duty structure - 8 per cent, 16 per cent and 24 per cent - has been implemented except for petroleum and tobacco products, *pan masala* and items attracting specific duty rates. The excise duty rate of 32 per cent, which applied to tyres, aerated soft drinks, polyester filament yarn, air-conditioners and motor cars has been reduced to 24 per cent.

1.38 With the objectives of minimising the cost of tax collection, encouraging voluntary compliance and to give better treatment to the existing taxpayers so as to encourage those outside the tax net to become taxpaying citizens, the budget announced certain measures to strengthen the tax administration, mainly drawing on the recommendations of the Kelkar Committee. Some of the principal measures announced in the budget are:

- outsourcing of non-core activities of the Income Tax Department;
- immediate abolition of present discretion-based system for selection of returns for scrutiny;
- expanding the scope of taxpayer services;
- direct crediting of all refunds to the bank account of the taxpayer through electronic clearance system,
- reduction in the compliance cost to the taxpayer - the Income Tax Act is being amended to enable electronic filing of returns; abolition of tax-clearance certificates for certain categories; and
- simplifying the procedures and methods employed during search and seizure, and during survey by the Income Tax department.

Social Security and Insurance

1.39 At present, primary health care, emergency life saving services, services under National Disease Control Programmes and National Family Welfare Programmes are being provided free of cost to all irrespective of their ability to pay. For a large majority of less advantaged citizens, however, access to good health services is still inadequate. In this regard, attempts are being made for utilisation of funds from Centrally Sponsored Schemes to improve functioning of primary health care institutions and minimise inter-State and inter-district differences.

1.40 A 100 per cent Centrally Sponsored Scheme called National Social Assistance Programme (NSAP) has been in existence since 1995 for providing social assistance benefit to poor households affected by old age, death of primary bread earner and maternity care. The programme has three components, *viz*., National Old Age Pension Scheme (NOAPS), National Family Benefit Scheme (NFBS) and National Maternity Benefit Scheme (NMBS). A scheme, *viz*., *Annapurna* was introduced on April 1, 2000, aimed at providing food security to meet the requirement of those senior citizens who though eligible for pensions under the National Old Age Pension Scheme, are not getting the same. Foodgrains are provided to the beneficiaries at subsidised rates of Rs.2 per kg of wheat and Rs.3 per kg of rice. The scheme is operational in 25 States and 5 Union Territories and more than 6.08 lakh families have been identified and are getting benefits of the scheme.

1.41 Public sector general insurance companies have been encouraged to design a community-based universal health insurance scheme during 2003-04. Under this scheme, a premium equivalent to Re.1 per day (or Rs.365 per year) for an individual, Rs.1.50 per day for a family of five, and Rs.2 per day for a family of seven will provide eligibility to get reimbursement of medical expenses up to Rs.30,000 towards hospitalisation, a cover for death due to accident for Rs.25,000 and compensation due to loss of earning at the rate of Rs.50 per day up to a maximum of 15 days. To make the scheme affordable to BPL families, the Government has decided to contribute Rs.100 per year towards their annual premium. In the first phase, at least an additional 50 lakh BPL families will be covered during 2003-04.

1.42 In order to provide relief to senior citizens and others, the Life Insurance Corporation of India (LIC) has introduced a special pension policy, following the announcement made in the budget, guaranteeing an annual return of 9 per cent in the form of a monthly pension scheme called *Varishtha Pension Bima Yojana*. Any citizen above the age of 55 years of age is eligible for the scheme which envisages a monthly return in the form of a pension for life. The difference between the actual yield earned by the LIC on the funds invested under the scheme and the assured return of 9 per cent, would be reimbursed to the LIC annually by the Government.

1.43 The 2001-02 budget had announced the restructuring of pensions for new Central Government employees and a scheme for the general public. The Union Budget, 2003-04 announced a new pension scheme, containing a basket of pension choices, which will be applicable to new entrants to Government service, except to the armed forces. The scheme will also be available, on voluntary basis, to all employers for their employees, as well as to the self-employed. The new scheme, when introduced, will be based on defined contributions and the contribution will be shared equally by the employees and the Government in case of Government employees. In case of individuals, who are not Government employees, there will be no contribution by the Government. The new pension scheme will allow transfer of benefits in case of change of employment, and will go into individual pension accounts with Pension Funds. The Ministry of Finance will oversee and supervise the Pension Funds through a new and independent Pension Fund Regulatory and Development Authority.

MONETARY POLICY FRAMEWORK

1.44 The monetary policy framework has undergone changes over the recent period in response to reforms in the financial sector and the growing external orientation of the economy. The endeavour of the policy has been to enhance the allocative efficiency of the financial sector, preserve financial stability and improve the transmission mechanism of monetary policy by moving from direct to indirect instruments. The stance of the monetary policy has been to ensure provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on the movements in the price level, to continue with the present stance on interest rates including preference for softer interest rates and to impart greater flexibility to the interest rate structure in the medium-term.

1.45 Bank Rate changes, combined with CRR and repo rate changes, have emerged as important tools of liquidity and monetary management. The liquidity adjustment facility (LAF) has evolved as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a more flexible manner and, in the process, providing a corridor for the call money market. In alignment with its accommodative stance in the context of stimulating industrial activity, a policy bias for soft interest rates and a flexible interest rate structure was indicated and in consonance, the CRR was reduced from 5.5 per cent to 5.0 per cent in June 2002, to 4.75 per cent in November 2002 and further to 4.5 per cent in June 2003, augmenting the lendable resources of banks by about Rs.13,500 crore. The Bank Rate and the LAF repo rate were reduced by 25 basis points each in October 2002 followed by a 50 basis point cut in the LAF repo rate on March 3, 2003. Comfortable liquidity conditions engendered by large capital inflows enabled a general reduction in market interest rates with varying sensitivity to policy signals across the maturity spectrum. Lending rates of banks exhibited, however, somewhat sluggish downward movements. The softening of interest rates was enabled by the benign inflation environment.

1.46 Monetary policy formulation for 2003-04 is based on conditional expectations of real GDP growth at about 6.0 per cent, inflation in the range of 5.0 to 5.5 per cent, projected expansion in broad money (M3) at 14.0 per cent and non-food bank credit (including investments in commerical papers, shares/ debentures/ bonds of PSUs and private corporate sector) at 15.5-16.0 per cent. The overall stance of monetary policy for 2003-04 re-affirmed preference for a soft and flexible interest rate environment within a framework of macroeconomic stability and centred on a close monitoring of inflation. In pursuit of its stance, the Reserve Bank would continue to modulate market liquidity to meet the economy’s requirements of bank credit. The stance of monetary policy was indicated through a 25 basis point cut each in the Bank Rate and the CRR. The policy preference in regard to the Bank Rate is to keep it stable in the near-term. Measures were taken to increase the efficacy of LAF operations. This was accompanied by gradual phasing out of sector-specific refinance facility and rationalisation of interest rate structure at which liquidity is available from the Reserve Bank. Strengthening of credit delivery mechanisms continued to be a concurrent priority.

FINANCIAL SECTOR REFORMS

1.47 Strengthening of the financial sector and improving the functioning of the financial markets are the core objectives of financial sector reforms in India. The central plank of financial sector reforms is a set of prudential norms aimed at imparting strength to banks and financial institutions as well as inculcating greater accountability and market discipline. These norms include not only capital adequacy, asset classification and provisioning but also accounting standards, exposure and disclosure norms, investment and risk management as well as asset-liability management guidelines. The approach has been to benchmark the norms against international best practices. Financial sector reforms were carried forward during 2002-03 with the announcement of measures for streamlining banking operations, upgradation of risk management systems, operationalisation of consolidated accounting practices and enactment of a new Act to improve the recovery of non-performing loans.

Prudential Norms

1.48 The Reserve Bank's approach to the institution of prudential norms has been one of incremental convergence with international standards and best practices. The internationally accepted 90-day norm for recognition of loan impairment would be applicable to commercial banks, co-operative banks and regional rural banks with convergence set for the year ending March 2004. For State Co-operative Banks and District Central Co-operative Banks, the convergence is set for the year ending March 2006. Beginning April 2002, banks began to move over to charging interest at monthly rests in order to achieve smooth convergence. The transition time for a sub-standard asset to be classified as a doubtful asset has been shortened from 18 months to 12 months with effect from March 31, 2005. The consequent additional provisioning is to be phased over a four-year period with a minimum of 20 per cent each year. The Reserve Bank participated in a Quantitative Impact Study (QIS) conducted by the Basel Committee to assess the impact of the new Capital Accord. A broader internal process of preparing banks for the complexity of the new Accord and the costs involved in adherence is also underway. The Reserve Bank forwarded its comments on the Third Consultative Paper of the New Basel Capital Accord to the Basel Committee of Banking Supervision in July 2003. The Reserve Bank has emphasised the need to take into account the structural characteristics of different economies as also preserving the spirit of simplicity and flexibility to ensure universal application of the New Accord. India has also shared the international concern on money laundering and financing of terrorism. "Know Your Customer" procedures have been put in place to prevent the misuse of the financial system.

1.49 In January 2002 banks were advised to build up Investment Fluctuation Reserve (IFR) of a minimum of 5 per cent of the investment portfolio within a period of 5 years. IFR should be computed with reference to investment in two categories, *viz.*, 'Held for Trading' and 'Available for Sale'. It is not necessary for banks to include the investment under 'Held to Maturity' category while computing IFR. IFR was treated as Tier II capital up to a maximum of 1.25 per cent of total risk-weighted assets. Effective from March 31, 2003 this ceiling was removed. For capital adequacy purposes, Tier II capital including IFR would be considered up to a maximum of 100 per cent of Tier I capital.

1.50 In adherence to the Core Principles of Banking Supervision, guidelines on country risk management and provisioning thereof were provided to banks to encourage internal assessment of country risk. These guidelines are applicable only in respect of countries where a bank has net funded exposure of two per cent or more of its total assets. Depending on the risk category of the country of exposure, banks were directed to make provisions, with effect from the year ended March 31, 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 per cent. Provisions held for country exposures are allowed to be treated on par with the ‘provisions held for standard assets’ for being reckoned for Tier II capital, subject to the ceiling of 1.25 per cent of the risk weighted assets.

1.51 Subordinated debt issued by banks in the nature of unsecured redeemable bonds currently qualify for inclusion in Tier II capital. Banks were able to utilise long-term resources raised from the market through subordinated debt to enable them to realign their portfolios for asset-liability management.

1.52 Several measures were taken to strengthen the financial position of the urban co-operative banking sector by extending the capital adequacy standards to urban co-operative banks (UCBs), prescribing an asset-liability management framework for the scheduled UCBs, enhancing the proportion of holding of Government and other approved securities by UCBs for the purpose of SLR, besides restriction on bank finance against the security of corporate shares and debentures.

1.53 Management and internal control systems are weak areas in the functioning of UCBs. New urban banks are required to have at least two Directors with requisite professional qualifications or adequate experience in banking. This requirement was extended to the existing UCBs as well. It has been proposed to impose a complete ban on advances by UCBs to Directors and their specified relatives and to concerns in which the Directors are interested effective October 1, 2003. UCBs which have fully/ partially computerised their operations are required to introduce an electronic data processing (EDP) audit system and set up audit committee of the Board for overseeing and providing directions to internal audit/inspection machinery of the UCB. The Audit Committees would examine and follow up observations and suggestions made in the Reserve Bank’s inspection report and Statutory Audit reports.

NPA Management

1.54 A broad framework has evolved for the management of NPAs under which a menu of options are provided for debt recovery and restructuring. Banks and financial institutions have the freedom to design and implement their own policies for recovery and write-off incorporating compromise and negotiated settlements The menu of options available to banks included : (a) reschedulement/restructuring done at bank level; (b) reschedulement/ restructuring done through the corporate debt restructuring (CDR) mechanism; (c) resolution/recovery through *Lok Adalats* civil courts and debt recovery tribunals (DRTs); (d) compromise settlement as per management’s own schemes and the Reserve Bank’s guidelines for public sector banks; (e) sale of assets to reconstruction companies/ securitisation companies and (f) recovery through powers available under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

1.55 The quality and performance of advances have a direct bearing on the profitability and viability of banks. While several measures have been undertaken towards preventing the accumulation of non-performing loans, in the absence of creditor rights, the problem has persisted, despite the credit appraisal and disbursement mechanism in place. To address this aspect, the final guidelines and directions on SARFAESI Act issued in April 23, 2003 cover all aspects relating to asset reconstruction and securitisation These include, *inter alia*, registration, owned funds, permissible business, operational structure for giving effect to the business of securitisation and asset reconstruction, deployment of surplus funds, internal control systems, prudential norms and disclosure requirements for asset reconstruction/ securitisation companies. The Act empowers secured creditors to enforce any security interest created in its favour without any intervention of court or tribunal. The secured creditor may require the borrower to discharge the liabilities within a stipulated time frame from the date of notice, failing which the secured creditor is entitled to take possession or management of the secured assets. In addition to the guidelines and mandatory directions, the Reserve Bank also issued guidance notes of recommendatory nature covering aspects including acquisition of assets and issue of security receipts. It is envisaged that banks would be able to sell their non-performing loans (NPLs) to securitisation/reconstruction companies at a considerable discount and the resultant shortfall, if any, in the net book value (total assets of banks *less* provisions held), would be required to be debited to the profit and loss account. Banks were accordingly advised to build up provisions, significantly above the minimum regulatory requirements for their NPAs, particularly for those assets which they propose to sell to securitisation/reconstruction companies.

1.56 Yet another opportunity was provided to borrowers for compromise settlement of chronic NPLs of public sector banks/ FIs up to Rs.10 crore. Fresh guidelines were issued which provide a simplified, non-discretionary and non-discriminatory mechanism for compromise settlement of chronic NPLs. Public sector banks were directed to uniformly implement these guidelines in order to achieve maximum realisation of dues from the stock of NPLs. The processing under the revised guidelines would have to be completed by December, 2003.

1.57 Banks were advised to consider introduction of a new asset category of “special mention accounts” in between “standard” and “sub-standard” accounts for their own internal monitoring and follow-up for assets with potential weaknesses which deserve close attention for resolution through timely remedial action.

Issues in Regulation and Supervision

1.58 The limitations of traditional supervisory practices in the swiftly changing financial environment has provoked supervisors the world over to continuously refine their approaches in consonance with advances in technology, innovations and globalisation. The Reserve Bank’s move towards risk-based supervision (RBS), which entails the allocation of supervisory resources and focus in accordance with risk profiles, is part of a forward-looking refinement of the supervisory function which will help in aligning supervised institutions with the New Basel Capital Accord when it is adopted. Drawing on assistance from international consultants and a study of the country-specific requirements as well as the cross-country experience, management processes were initiated in 2002-03 for a smooth switchover to RBS. They covered a discussion paper and analysis of responses thereon, risk profiling, preparation of manuals, training and other requirements. RBS was introduced during April-June 2003 for a few select banks on a pilot basis. Based on the experience gained, RBS would be extended to all banks in a phased manner.

1.59 The scheme of prompt corrective action (PCA), developed as a tool with trigger points for prompt supervisory response was put in place in December 2002 initially for a period of one year. The PCA framework includes structured action by the Reserve Bank when banks hit the trigger points (capital adequacy, NPAs, return on assets). It does not, however, preclude other discretionary corrective steps by the Reserve Bank.

1.60 As a step towards consolidated supervision, guidelines were issued to banks on consolidated accounting and quantitative methods for compliance from the year ended March 31, 2003. Initially, consolidated supervision would be mandated for all groups where the controlling entity is a bank. Over time, entities in mixed conglomerates would be brought under its purview. A critical requirement for supervised entities would be the setting up of appropriate management information systems (MIS) to support compliance with the consolidated accounting and reporting requirements.

1.61 The Reserve Bank, in its endeavor to ensure convergence of its supervisory norms and practices with the international best practices and to align standards adopted by Indian banks with the global standards, constituted a Working Group to eliminate/reduce gaps in compliance with the Accounting Standards issued by the Institute of Chartered Accountants of India. Based on the recommendations of the Working Group in respect of certain Accounting Standards where there were gaps in compliance, detailed guidelines were issued to banks.

1.62 To enable the regulated entities to manage their exposure to interest rate risk, scheduled commercial banks (excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs), Primary Dealers and specified All India Financial Institutions were allowed to deal in exchange traded interest rate derivatives. In the first phase, these entities are allowed to transact only in interest rate futures on notional bonds and Treasury Bills for the limited purpose of hedging the risk in their underlying investment portfolio.

1.63 Other supervisory initiatives during the year included development of macro-prudential indicators, managing the transition to risk-based internal audit, and computer and information systems audits for inspection in a computerised environment.

1.64 With a view to strengthening supervision of UCBs, the Reserve Bank introduced a system of off-site surveillance. A new system of grading UCBs based on their level of capital to risk weighted assets ratio (CRAR), level of net non perfroming loans (NPLs), record of losses and compliance with liquidity requirements was introduced. A system of supervisory rating for urban co-operative banks under the CAMELS (Capital, Assets, Management, Earnings, Liquidity and Systems) model is envisaged. In order to bring transparency in their balance sheets effective from the year ending March 31, 2003 all urban cooperative banks with deposits of Rs.100 crore and above are required to disclose in notes to their accounts additional specified information. They should also indicate the position of payment of deposit insurance premium to the Deposit Insurance and Credit Guarantee Corporation (DICGC) in their Directors' Report.

1.65 Considerable progress has been made in consolidating the existing payment systems and in upgrading technology with a view to establishing an efficient, integrated and secure system functioning in a real-time environment. Major projects under implementation are electronic clearing, centralised funds management, structured financial messaging solutions and the Indian Financial Network (INFINET). Facilities under Electronic Funds Transfer (EFT) have been upgraded and their spatial reach expanded with multiple settlements in a day. Foreign exchange clearing has been initiated through the Clearing Corporation of India Limited (CCIL).

Adequate security features are being incorporated into the EFT. Preparatory work for the real time gross settlement (RTGS) is complete. The live run of RTGS is scheduled towards the end of 2003.

Policies for Financial Markets

1.66 A number of steps were taken during 2002-03 to ensure balanced development of various segments of the financial market with a forward-looking perspective. The Reserve Bank's endeavour has been to develop a competitive and diversified financial market structure catering to various classes of instruments and participants of varying risk profiles, and with different market segments merging seamlessly into a continuum. A key priority is the development of the technological and institutional infrastructure for efficient financial intermediation. The operationalisation of the CCIL and the negotiated dealing system (NDS), introduction of collateralised borrowing and lending obligation (CBLO), collateralised repo transactions and interest rate options would increase the depth of the financial markets and prepare them for the operationalisation of RTGS.

Money Markets

1.67 A basic objective of money market reforms in the recent years has been to facilitate the introduction of new instruments and their appropriate pricing under orderly market conditions. A crucial prerequisite in this regard is the development of market segments which exclusively deal in specific assets and liabilities as well as participants. Accordingly, the call/notice money market is being transformed into a pure inter-bank market. Systemic stability is being ensured through prudential limits on exposures to the call money market. This was supported during 2002-03 through the rationalisation of standing liquidity support to banks from the Reserve Bank and facilities for exceptional liquidity support.

Government Securities Market

1.68 Initiatives for developing and deepening the government securities market were carried forward alongside a strengthening of regulation and surveillance. An enabling environment for proper investment planning by market participants was fostered by transparent dissemination of prospective issuances of government securities, introduction of new instruments to deal with risks associated with unanticipated market movements, and institution of anonymous screen-based order-driven trading in government securities on the stock exchanges.

Foreign Exchange Market

1.69 Orderly development of the foreign exchange market was pursued in the form of easing of entry restrictions, expanding the freedom of market participants and by creating greater space for the market in general by ongoing liberalisation of international current and capital transactions. Authorised dealers (ADs) in foreign exchange were allowed to offer foreign currency – rupee options and to undertake swaps with residents with unlimited hedging of exchange risk. Forward cover was allowed in respect of a number of capital transactions with greater freedom in the booking of forward contracts.

Capital Market

1.70 Policies for the capital market during 2002-03 were directed towards enhancing market efficiency and achieving better investor protection through greater transparency and improved trading and settlement systems. Important legislative changes with far reaching implications for the functioning of the capital market were initiated by the Government of India. The Securities and Exchange Board of India (SEBI) was vested with search and seizure powers in cases relating to insider trading and market manipulations. The penalties to be imposed by the Adjudicating Officer were enhanced so as to serve as effective deterrents. The Companies (Second Amendment) Act, 2002 was enacted to provide for a new, modern, efficient and time-bound insolvency law for both rehabilitation and winding up of sick companies within a maximum time frame of two years.

1.71 The SEBI introduced compulsory rolling settlement on a T+3 basis effective April 1, 2002. The settlement cycle was further shortened to T+2 basis effective April 1, 2003 with a view to reducing risks in the market and protecting the interest of investors, in line with the international best practices.

1.72 The SEBI accepted the recommendations of the Group on Corporatisation and Demutualisation of Stock Exchanges which recommended, *inter alia,* a uniform model of corporatisation and demutualisation to be adopted for all stock exchanges. With the issue of the SEBI (Central Listing Authority) Regulations, 2003 and formation of Central Listing Authority (CLA), companies are now required to obtain recommendation from the CLA prior to their listing in stock exchanges.

The existing list of stocks on which derivatives are traded was enlarged. With a view to developing the derivatives market further, interest rate derivatives were introduced on National Stock Exchange (NSE) with effect from June 24, 2003. Initially, the contracts have been introduced on a notional Government Security with a 10 year maturity and a Notional Treasury Bill with a maturity of 91 days or three months which would be cash settled. The SEBI put in place the risk containment measures to be adopted for such derivatives contracts. With a view to obviating the need for manual entry and re-entry of data on trade particulars which is time consuming and prone to errors, the Straight Through Processing (STP) for electronic trade processing with a common messaging standard was introduced. Based on the recommendations of the Bhagwati Committee, the SEBI made certain amendments to the Takeover Regulations which include *inter alia* removal of automatic exemption for acquisition through preferential allotment, increased frequency in disclosure of shareholding when it crosses 5 per cent, 10 per cent and 14 per cent. In order to enable the retail investors to participate in trading in government securities, the screen-based retail trading in government securities was launched on January 16, 2003. With this initiative, a major segment of the Indian fixed income securities market, which until recently was dominated by the wholesale investors like banks and insurance companies, was made accessible to the retail investors.

Corporate Governance

1.73 As part of the broader set of reforms aimed at improving the functioning of the securities market, the SEBI has initiated several measures to improve information flow from listed companies. It has also been the endeavour of SEBI to improve corporate governance practices for listed companies so as to infuse a sense of discipline and accountability in the Indian corporate sector.

1.74 During 2002-03, the SEBI amended the Listing Agreement to tighten disclosure norms for companies opting to publish audited results for the entire year within three months instead of publishing unaudited results for the last quarter within 30 days. Norms with regard to disclosure by listed companies in respect of loans/advances and investments, disclosure of audit qualifications and actions thereon, were strengthened. A clause was incorporated in the Listing Agreement requiring the companies to furnish statements and reports for the Electronic Data Information Filing and Retrieval (EDIFAR) system maintained by SEBI.

Mutual Funds

1.75 Various measures have been undertaken to improve the operations and governance of mutual funds. These include, *inter alia,* disclosure of performance of benchmarks, guidelines for valuation of unlisted equity shares, distribution of realisation from non-performing or illiquid assets to old investors after redemptions, emphasis on following the code of conduct and insider trading regulations, uniformity in calculation of sale and repurchase price, increasing the frequency of meeting of trustees, guidelines on risk management norms, increase in the investment limit on foreign securities and mandatory registration of intermediaries engaged in selling and marketing of mutual funds units.

Changes in the Legal Framework

1.76 In the recent period, the progress of financial sector reforms has encountered impediments in the form of the inadequacy of the existing legal infrastructure and its incompatibility with the evolving environment. Changes in financial markets, diffusion of financial innovations and the information technology revolution have sharpened the mismatch between the developments in the financial system and the ambit of regulatory authority of the Reserve Bank. A review of the laws relating to the regulatory responsibilities of the Reserve Bank suggests the way forward in the deepening of reforms in the legal architecture.

1.77 Macroeconomic policy settings for 2003-04 imbibe the positive expectations generated by the strengthening of the fundamentals and the resilience acquired by the economy despite being beset by significant shocks during the year gone by. The prospects for the economy are sanguine with real GDP growth expected to shrug off the loss of momentum and set the stage for a surge to full potential. In the wake of a reasonably good progress of monsoon till July, agricultural output is poised to register a recovery and join industry and services in resumption of trend growth. The smart rebound in exports of merchandise and invisibles in 2002-03 is expected to get entrenched during the year ahead. The experience of the early months of 2003-04 suggests that capital inflows would remain strong. The consequent accretion to international reserves would test the conduct of monetary policy, given its aggressive stance on holding wholesale price inflation. Nevertheless, financial markets would continue to experience ample liquidity conditions and a softening of interest rates. Ongoing fiscal consolidation would be supported by a renewed thrust to intensify and broaden the ambit of structural reforms in pursuit of the goals of the development strategy.

* 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 beyond March 2003. 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.

II - The Real Economy

MACROECONOMIC SCENE

2.1 A broad-based revival in industrial activity and a resurgence of growth in the services sector sustained economic activity in 2002-03. Real GDP originating in industry recovered steadily from the first quarter onwards, surging up towards trend levels on the strength of a rebound in manufacturing. The improvement in services sector GDP growth emanated from construction, 'financing, insurance, real estate and business services' and 'community, social and personal services'. While the return of growth momentum in industry and services augured well for the economy, severe drought conditions impacted on the farm sector in several States, producing a contraction in real GDP originating from 'agriculture and allied activities'. The loss of agricultural output was pronounced from the second quarter onwards, reflecting the full effects of the drought. Moisture stress was of a scale and intensity comparable to the severe drought of 1987 which had resulted in real GDP growth slowing down to 3.8 per cent in 1987-88. Despite the intensity of the supply shock to agriculture, the growth of real GDP at 4.3 per cent in 2002-03 was symptomatic of resilience and a degree of weather-proofing of the economy.

Agriculture

2.2 Indian agriculture experienced one of the worst droughts in 2002-03. A long, dry spell beginning in July 2002, a crucial month for sowing and plant growth, culminated in rainfall during the South-West monsoon season being at only 81 per cent of the Long Period Average (LPA).

2.3 The production of foodgrains and non-foodgrains was adversely affected almost across-the-board with the fall in *kharif* output sharper than that of *rabi*. Rice and coarse cereals were particularly affected by drought conditions. Oilseeds production declined mainly on account of dip in the production of groundnut, rapeseed/mustard and soyabean. The index of agricultural production (base: triennium ending 1981-82 = 100) recorded the steepest decline since 1979-80.

2.4 Foodgrain procurement was lower in 2002-03, reflecting the drought conditions. Off-take, on the other hand, was significantly higher, mainly on account of Open Market Sales (OMS) including exports, 'food for work' schemes and other welfare schemes (OWS). Higher off-take through the PDS and OWS was facilitated by lowering of issue prices under Targeted Public Distribution System (TPDS) for Above Poverty Line (APL) families, and by increasing the monthly allocation for APL, Below Poverty Line (BPL) families and Antyodaya families. As part of drought relief measures, the Central Government allocated 8.3 million tonnes of foodgrains to the drought affected States; of this 4.7 million tonnes were lifted during 2002-03.

Industry

2.5 A modest revival in industrial activity which set in by March, 2002 permeated all segments during 2002-03, with manufacturing contributing more than 80 per cent of the overall growth of industrial production. Strengthening signs of resumption of investment demand were evident in a sharp rise in the production and imports of capital goods. The industrial recovery enabled a robust expansion in exports of manufactures in spite of the slack in global demand, and triggered a coincident upswing in non-food credit from the banking system.

2.6 The Index of Industrial Production (IIP) rose through the first half of 2002-03 boosted by rural demand in the wake of the *rabi* harvest, before levelling off in the second half of the year. The growth of manufacturing peaked in September 2002, driven up by resumption of export demand in a wide range of industries. Leading the upsurge in manufacturing were five industry groups comprising 'beverages, tobacco and related products', 'basic chemicals and chemical products', 'food products', 'transport equipment and parts' and 'basic metal and alloy’ industries. The growth in mining and quarrying reached a high in July 2002. The growth of electricity remained broadly unchanged, despite the persistence of demand-supply gaps.

Use-based Classification

2.7 The demand composition of industrial production reveals that consumer non-durables production rose sharply and accounted for nearly half of the growth in the IIP, followed by basic goods. A positive development in 2002-03 was the significant turnaround in capital goods production after an absolute decline in the preceding year. Intermediate goods shared in this expansion *albeit* on a more moderate scale. Production in the consumer durables segment declined reflecting weak demand, particularly the slowdown of rural demand. Despite some shortfalls *vis-a-vis* the targets in key infrastructure industries, there was an overall improvement in production conditions in infrastructure during 2002-03.

Services Sector

2.8 Services regained their role as the principal driver of the Indian economy, accounting for 89.4 per cent of the real GDP growth in 2002-03. The resumption of near-trend growth in services was enabled by a pick up in activity in construction, 'financing, insurance, real estate and business services' and 'community, social and personal services'. This outweighed the deceleration in the growth of 'trade, hotels, transport and communication' services which constitute a little less than half of the services sector.

AGGREGATE DEMAND

2.9 The halting recovery of aggregate demand seems to have restrained a stronger acceleration of sectoral activity in 2002-03. The evolution of real effective demand up to 2001-02 indicates that it is consumption which has held up aggregate demand in the period of slower growth since 1998-99. The upsurge in real consumption expenditures in the recent period was shared between private final consumption expenditure and government final consumption expenditure, the latter including the counter-cyclical component of fiscal policy in the context of the slowdown. On the other hand, the growth of real gross fixed capital formation slowed down in both private and public sectors, reflecting the moderation of planned investment in the presence of idle capacity. Since 1995-98, there has been a precipitous decline in private fixed investment in real terms and considerable volatility in stocks/inventories.

2.10 The gross domestic saving (GDS) rate has been increasing in recent years, buoyed by the rise in both physical and financial saving of the household sector. A major factor contributing to this increase has been a steady improvement in personal disposable income. The improvement in the financial saving of the household sector has been mainly in the form of contractual instruments. A major area of concern is an unprecedented deterioration in the rate of public sector saving from a high of 2 per cent of GDP in 1991-92 to a dissaving which began in 1998-99 and touched (-)2.5 per cent in 2001-02, posing a constraint on growth. The rate of saving of the private corporate sector has decelerated since 1996-97 as a result of declining profitability in the downswing of the business cycle.

2.11 On the basis of the latest available data, financial saving (net) of the household sector, as a percentage of gross domestic product at current market prices, is estimated at 11.1 per cent in 2002-03 as compared with the revised estimate of 10.9 per cent in the previous year. The marginal increase in 2002-03 primarily reflected increases in the rates of contractual saving (life insurance, provident and pension funds) and shares and debentures. In contrast, the rate of household sector saving in the form of deposits is estimated to have shown a marginal deceleration in 2002-03 principally due to non-bank deposits and trade debt (net).

2.12 Despite the easing of the traditional constraints on the availability of domestic and external saving, rates of gross capital formation (GCF) at current prices and gross domestic capital formation (GDCF) (adjusted for errors and omissions) have decelerated.

2.13 The growth prospects for the current financial year hinge around the sustainability of the industrial upturn and a recovery in agricultural performance. The performance of agriculture would continue to depend upon the progress of monsoon, particularly its spatial distribution. Initial expectations support a strong rebound from the absolute decline in output recorded last year. The climate for industrial revival is showing a distinct improvement in an environment of higher overall growth prospects, low and stable inflation, rising international competitiveness and conducive monetary and fiscal policies. The buoyancy of the services sector would be contingent upon the strength of the symbiotic interface with the goods sector and the growth of 'new economy' activities.

2.14 The Tenth Five Year Plan (2002-07) has envisaged an average annual growth of 8 per cent. India's growth experience over the Eighth and Ninth Plan periods demonstrates that this growth target is feasible. The future growth strategy will have to rely on a combination of increased investment and improvement in efficiency. Rapid dismantling of policy constraints, procedural rigidities and price distortions will play a critical role in the drive to a higher growth path. It will also require that the appropriate changes in institutional architecture are put in place. In these efforts, achieving a growth rate of 6.0 per cent in 2003-04 becomes a critical minimum.

III - Money, Credit and Prices

3.1 Monetary conditions closely tracked the evolution of real activity during 2002-03. The growth of non-food bank credit, inclusive of banks' investments in non-Statutory Liquidity Ratio (non-SLR) instruments, was in consonance with the recovery of industrial output. Credit expansion was facilitated by conditions of ample liquidity in financial markets, engendered by massive capital inflows. Interest rates declined across the spectrum in response to the easy liquidity conditions, and to monetary policy signals for softening that were transmitted through cuts in the Bank Rate, the repo rate and the cash reserve ratio (CRR). The lowering of interest rates was made possible by a benign inflation environment except for a spurt in the last quarter due to the hardening of international oil prices and of some drought related price hike for items such as oilseeds and edible oils. On the other hand, currency and deposit growth slowed down moderately reflecting the adverse impact of the drought on rural incomes and the lowering of deposit rates by banks. Broad money growth reflected these diverse impulses from real activity. Reserve money growth was moderated by the deployment of policy instruments to counter the expansionary effects of large external flows.

RESERVE MONEY

3.2 The behaviour of reserve money in 2002-03 was predominantly influenced by the large inflows from abroad. Excess supply conditions in the foreign exchange market were reflected in continuous purchases of foreign exchange by the Reserve Bank and accretions to the Reserve Bank's foreign currency assets. The primary liquidity generated by this substantial accretion to the net foreign assets (NFA) was sterilised through active recourse to open market sales and repos under the liquidity adjustment facility (LAF). As a result, the net domestic assets (NDA) of the Reserve Bank declined to barely 2.9 per cent of reserve money at end-March 2003.

3.3 The decline in the NDA to near-zero levels as a proportion to reserve money focuses attention on the limits being approached to full sterilisation and, therefore, on the future conduct of monetary policy in the context of large and sustained capital inflows.

3.4 The Centre's comfortable liquidity position was reflected in lower recourse to loans and advances from the Reserve Bank during 2002-03.

3.5 Reserve money recorded a higher order of year-on-year expansion during 2003-04 so far (as on August 15, 2003). The growth in reserve money was entirely on account of sustained external flows driving up the NFA of the Reserve Bank. As a result, the NFA-currency ratio reached the level of 131.7 per cent as on August 15, 2003. The increase in NFA was partly offset by a further decline in the Reserve Bank's net credit to the Centre.

MONETARY SURVEY

3.6 Broad money (M_3) slowed down in consonance with real GDP growth during 2002-03, remaining within the indicative projection of the Monetary and Credit Policy announcement of April 2002. Slower growth of currency as well as aggregate deposits restrained monetary expansion, as deposits turned relatively unattractive at the margin in comparison with competing instruments of financial saving. This switch in preference away from bank deposits for alternative avenues of asset formation was also evident in a robust growth of postal deposits which drove up the principal liquidity measure *i.e.*, L_1 relative to M_3.

Sources of Money Supply

3.7 The pick-up in domestic credit during 2002-03 was absorbed by the government and the commercial sectors. Scheduled commercial banks' holding of Government securities was around 39.0 per cent of their net demand and time liabilities (NDTL); at end-March 2003, they were higher by Rs.1,95,974 crore than the statutory minimum requirement of 25.0 per cent required for the maintenance of the SLR. Since the 1990s, government securities have emerged as an attractive avenue for investments by banks, particularly in the context of prudential norms imposed under financial sector reforms.

3.8 Food credit declined in 2002-03 due to a significant fall in procurement operations. This added to liquidity in the system. Non-food credit extended by scheduled commercial banks accelerated to accommodate the revival of industrial activity.

3.9 The increase in non-food credit demand was well distributed across industries. Since 1997-98, the share of non-SLR investments in commercial sector credit has doubled, indicative of a shift in portfolio choice for tradable assets as against traditional loans and advances.

Developments during 2003-04

3.10 Year-on-year broad money (M_3) expansion decelerated during 2003-04 (as on August 8, 2003) mainly on account of slowdown in aggregate deposits. Deceleration in time deposits growth continued in response to lower interest rates and the continuing impact of last year's drought. Among the sources, growth in net bank credit to the Government decelerated. Bank credit to commercial sector slowed down primarily on account of decline in food credit which, in turn, was due to lower procurement and higher off-take. Commercial banks' non-food credit remained more or less steady in consonance with industrial growth. Non-SLR investments declined mainly on account of a decline in banks' investments in bonds/debentures.

3.11 The flow of resources from non-banks by way of capital issues, GDRs/ ADRs/FCCBs, CPs and credit from financial institutions (FIs) to the commercial sector continued to be subdued. Credit from FIs shrank for the second consecutive year due to slowdown in their new business while loans extended by them in the past were repaid. Capital issues dwindled under depressed conditions in the primary market and waning of corporates' interest due mainly to sluggish investment activity.

PRICE SITUATION

3.12 Inflation remained low in India over the first three quarters of 2002-03 in a benign international inflation environment. In the US and the Euro area, inflation was close to two per cent. Output gaps held down inflation in most of the industrial countries. Declining inflation raised the fears of deflation in several countries. The Japanese experience of prolonged decline in prices, bound in a spiral of weak activity and financial stress, is being examined afresh as several Asian countries (China, Hong Kong, Singapore, Taiwan and Thailand) joined Japan in deflation, either intermittently or persistently. Consumer prices are expected to increase by less than two per cent in 2003 in advanced economies and by just under six per cent in developing countries.

3.13 Headline inflation firmed up in June and July 2002 on the back of two rounds of increases in POL prices, and the impact of drought conditions which drove up prices of oilseeds and edible oils in the first half of the year. Inflation started easing in the second half of September 2002 as supply management strategies - step up in off-take, reduction in issue prices below economic cost, enhanced allocation for targeted employment programmes and imports - were put in place.

3.14 Reflecting the global situation, inflation in India firmed up in the last quarter of 2002-03, driven up by the hardening of international oil prices and supply side pressures on items like oil seeds, edible oils and oil cakes.

3.15 Within the overall variation in wholesale price inflation, disaggregated commodity price movements indicate that the inflation record of 2002-03 was dominated by the prices of non-food items; in contrast, it was primary food items which drove inflation in the preceding year.

Consumer Price Inflation

3.16 Consumer price inflation, measured by the annual variation in the average consumer price index for industrial workers (CPI-IW) eased during the year, reflecting lagged adjustments to agricultural supply disturbances.

Outlook

3.17 Upside risks from international oil prices for domestic inflation began to ebb with fortnightly downward revisions in domestic mineral oils (POL) prices beginning April 16, 2003. Point-to-point WPI inflation which had spurted to 6.9 per cent on May 3, 2003 caused by the one-time upward revision in electricity prices and the transporters' strike edged down below 4.0 per cent by August 2, 2003.

3.18 Based on the evolving international environment, the movement of key international prices and the underlying monetary conditions in India, inflation in India is expected to be in the range of 5.0 to 5.5 per cent as projected in the Monetary and Credit Policy for 2003-04.

3.19 Monetary conditions in 2003-04 are expected to be dominated by external capital flows. During 2003-04 so far (up to August 8), the net foreign assets of the banking sector rose by Rs.32,997 crore. The demand for non-food bank credit is likely to be maintained on the rising trajectory which began in early 2002, given the positive investment climate and the anticipation of a recovery in agricultural activity. Notwithstanding the projected expansion of non-food credit (15.5 to 16.0 per cent) and the size of borrowings of the Government sector, capital inflows, the release of resources through the CRR cut in June 2003 and lower order of food credit growth, monetary and liquidity conditions would facilitate a soft and flexible interest rate regime, consistent with the monetary policy stance.

IV - Government Finances

4.1 The slowing of economic activity due to the drought impacted on public finances in 2002-03. In the revised estimates, the combined gross fiscal deficit of the Centre and States overshot its budgeted level by more than one per cent of GDP on account of the shortfall in tax revenue and disinvestment from budget estimates. Furthermore, the imperatives for food supply management in the context of the drought necessitated fiscal support in the form of higher food subsidies, which surged back almost to 1991-92 level as a proportion to GDP. Despite these setbacks, there were distinct gains in expenditure management. The Centre reined in its expenditure by pruning non-plan spending. On the other hand, the States' expenditure exceeded budget estimates, but this was mainly in the form of a spurt in capital expenditure towards debt consolidation. Importantly, States were able to contain the revenue expenditure around the budgeted level. Notwithstanding these modest successes in expenditure containment, the slippages from the budgetary projections underscore the deterioration in the quality of fiscal adjustment.

4.2 The tax-GDP ratio has been losing buoyancy over the 1990s, falling by more than two per cent of GDP by the year 2001-02 from the level attained in the late 1980s. This imparts urgency to reforms in the tax regime in the form of simplification of rules, widening the tax base, reviewing exemptions and improving compliance. The surge in interest payments following reforms in budgetary financing has continued unabated, and it is only in 2002-03 that some moderation in pace has set in. The steady improvement in the primary deficit coupled with fall in capital outlay during the 1990s indicates that the burden of the unrelenting expansion in interest outgoes has devolved on productive elements of fiscal spending. The overarching priority attached to reduction of expenditure to meet deficit targets has accentuated the erosion of capital outlays with serious implications for expanding the productive capacity of the economy in the future. Expenditure on subsidies has remained impervious to fiscal adjustment, while spending on social infrastructure continues to remain low. Large gaps in disinvestment have intensified the fiscal stress. Reflecting these adverse developments, the debt-GDP ratio has been climbing since the second half of the 1990s and is expected to touch 77 per cent of GDP by the end of March 2004. Moreover, the monotonic rise in public debt has eroded the Government sector’s ability to generate savings and to service its internal debt. The "quality" of the fiscal deficit has worsened, with the revenue deficit having increased substantially indicating that a larger share of borrowed fund is pre-empted by consumption expenditure.

CENTRAL GOVERNMENT FINANCES, 2002-03

4.3 Expenditure management strategies put in place by the Centre since the second half of the 1990s have begun to yield room for fiscal manoeuvre, notwithstanding the slippages in terms of deficit indicators in the recent years. Despite additional expenditure on account of drought relief and Plan allocations, cuts in non-Plan expenditure enabled a reduction in overall spending (as per revised estimates *vis-à-vis* budget estimates) by the Centre in 2002-03. The expenditure on subsidies, however, increased significantly during 2002-03 reflecting the impact of dismantling of the Administered Price Mechanism (APM) for petroleum products as also the increase in food subsidy on account of drought conditions. The gap in revenue receipts *visa-vis* initial expectations was due to the fall in collections of direct taxes. Non-tax revenue remained broadly unchanged at 3 per cent of GDP in 2002-03, unresponsive to the impulses of fiscal reforms. The disinvestment programme made some progress during 2001-02 with the strategic sale process of some public sector undertakings gaining momentum; nevertheless the actual proceeds were lower than the targeted amount.

STATE GOVERNMENT FINANCES, 2002-03

4.4 The growth of revenue receipts of States during 2002-03 over the previous year was facilitated mainly by a rise in States' own taxes and grants from the Centre. There were shortfalls in the States' own revenue receipts (tax and non tax revenue) as well as in States' share in Central taxes in the revised estimates *visa-vis* budget estimates.

4.5 Total expenditure in the revised estimates exceeded budget projections in 2002-03 on account of higher capital expenditure. The increase in capital expenditure was mainly due to increases in the repayment of loans to the Centre and financial institutions reflecting the retirement of high cost debt owed to the Centre under the debt-swap scheme. Capital outlay in the revised estimates for 2002-03, however, fell short of budget estimates. The revised estimates for 2002-03 indicate deviations in all major deficit indicators of State finances, with significant slippages in the revenue deficit as well as the primary deficit. Gross fiscal deficit was also higher in the revised estimate as compared with the budget estimates.

DOMESTIC PUBLIC DEBT

4.6 The widening fiscal gap has led to a steep rise in the outstanding liabilities of the Government. Of the outstanding domestic debt of the Central Government, internal debt alone accounted for 66.4 per cent and 'other liabilities', accounted for 29.9 per cent at the end of March, 2003. The sharp increase in the debt-GDP ratio since the mid-1990s is reflected in burgeoning interest payments, despite a decline in interest rates.

4.7 The high level of gross fiscal deficit has aggravated the debt position of States in recent years. The total outstanding debt of States rose by 17.7 per cent in 2002-03. The debt-GDP ratio of States rose to 28.1 per cent by end-March 2003.

Union Budget, 2003-04

4.8 The Union Budget 2003-04 has accorded high priority to fiscal consolidation. All major deficit indicators are expected to be lower than during 2002-03.

4.9 The budget envisages improvement in the buoyancy of tax receipts. The increase in tax revenue is expected to emanate from Union excise duties, corporation tax, income tax, customs duties and service tax. Of the gross tax collection, the share of States works out to 25.3 per cent. The measures envisaged to increase the tax collections are anchored on broadening the tax base and improving the compliance. Capital receipts are budgeted to show a rise mainly due to sharp increase in projected proceeds from disinvestment.

State Budgets, 2003-04

4.10 The State Budgets for 2003-04 envisage continued efforts towards fiscal consolidation through revenue augmentation and containment of expenditure. The revenue deficit is budgeted to narrow from 2.5 per cent of GDP in 2002-03 to 1.8 per cent in 2003-04 and is expected to enable a decline in the gross fiscal deficit of the States from 4.7 per cent in 2002-03 to 4.0 per cent in 2003-04.

Outlook

4.11 A downward inflexibility in the fiscal deficit and the corrosion of public sector outlays on the social and physical infrastructure are the dominant concerns weighing upon the fiscal stance for 2003-04. There is a gathering urgency to halt the dissaving of the public sector, embodied in the rising preemption of resources through the revenue deficit. Fiscal authorities in States which have already moved in the direction of enacting legislation for fiscal responsibility are required to take a hard option *i.e.,* attacking the earmarking of funds for current consumption expenditures. In the current phase of the business cycle, the priority attached to augmenting revenues in the context of the steady deterioration of the tax-GDP ratio has to be tempered with the need to stimulate investment demand and maintain consumption expenditures. Consequently, the thrust of efforts towards revenue mobilisation would have to be on improvements in tax administration, rationalisation of tax structures, rapidly putting in place the IT-enabled environment widening the tax base by including services in a comprehensive manner in the tax net.

4.12 While expenditure management would be carried forward with renewed vigour, improvements envisaged on the revenue side are expected to halt the retrenchment of capital outlays forced by the process of fiscal consolidation. The composition of public expenditure is expected to change in favour of public investment at the cost of subsidies and transfers. Public investment is envisaged in a twin role of raising the level of aggregate demand, and expanding the productive capacity of the economy, as there is compelling evidence that it is public investment which has made the predominant contribution to building human and capital stock in India and that it has been the major facilitator of private investment. 'Crowding in' properties of public investment are particularly strong in the social and physical infrastructure. Accordingly, health, housing, education, employment, agriculture and export promotion are the guiding themes of the Centre's budget for 2003-04, indicative of a shift in focus to the quality of fiscal policy. This is extended to all aspects of the ongoing consolidation, and in particular, towards ensuring the sustainability of public debt, including through pension reforms and limits on contingent liabilities - the two major risks to the progress of fiscal reforms. Pension reforms would assume priority in the coming years with the availability of a menu of schemes, diversification of risk and independent regulatory oversight. Steps are being taken to identify and provide for the fiscal risk embodied in State Government guarantees with limits imposed to restrain their growth. These structural changes are expected to impart sustainability to public debt over the medium-term.

V - Financial Markets

5.1 Financial markets were flush with liquidity over the greater part of 2002-03, bolstered by sustained capital inflows and a liquidity overhang. There was a general easing of market conditions in terms of turnover and rates, the latter enabled by the accommodative monetary policy stance. In the money markets, key rates ruled close to the repo rate, except for a transient firming in mid-May 2002 and episodic spurts after October 2002. Market sentiment recovered quickly from border tensions in May 2002 and over the rest of the year, there was a modest appreciation of the spot exchange rate against the US dollar and a softening of forward premia. Repeated price rallies in the government securities market pushed down yields and flattened the yield curve, abating temporarily in February 2003 as fears of war in Iraq mounted. Yields on corporate bonds fell more sharply than those on gilts as risk perceptions improved. While bank deposit rates decreased in response to monetary policy impulses, this was not fully reflected in the lending rate reductions in the credit market. Activity in the credit market, however, picked up on the back of an upturn in demand from a range of industries. Equity markets remained subdued during the year, tracking developments in international markets. Uncertainty surrounding the disinvestment strategy and the lack of appetite among foreign institutional investors dampened market sentiment.

MONEY MARKET

5.2 Call/notice money market activity during 2002-03 was dominated by shifts in liquidity conditions. The usual beginning-of-the-year liquidity evinced considerable appetite for LAF repos. As the borrowing programme intensified, drawals of food credit began and border tensions surfaced in May, market liquidity tightened, driving up the average call rate to a high of 7.7 per cent on May 22, 2002. Easing of monetary conditions - reduction of CRR - and redemption inflows drove the call rates below the repo rate by the fourth week of June. The reduction in the repo rate on June 27 started a long phase of stability in the call money market with the call rates trailing just below the repo rate up to October 2002. Call/notice money market conditions remained relatively volatile in the remaining part of the year. The year 2003-04 began with softer call rates during April 2003. The call rates settled at sub-repo levels during May-August 2003 (up to August 13) reflecting ample liquidity conditions.

FOREIGN EXCHANGE MARKET

5.3 Tightness prevailed in the foreign exchange market during the first three months of 2002-03. The spot exchange rate firmed up from the third week of June as rising repatriation of export proceeds eased supply conditions and demand from corporates and importers moderated. Supplies continued to rise in the second quarter from export proceeds, unwinding of long dollar positions by banks and remittance inflows. In terms of monthly averages, the spot exchange rate appreciated by 1.0 per cent between April-September 2002 despite net purchases from the market by the Reserve Bank. The spot rate continued to gain strength as remittances from exporters, non-resident Indians and foreign direct investment continued while demand remained slack during October-November. Falling global crude oil prices and rising levels of foreign exchange reserves improved market sentiment and the spot exchange rate appreciated by 0.7 per cent in the third quarter with purchases by the Reserve Bank arresting further gains. Lingering weakness in the US dollar against major currencies owing to dismal US economic fundamentals contributed to the Rupee's gains. Purchases by the Reserve Bank checked the spot appreciation at 1.1 per cent at end-November 2002 over end-March 2002.

5.4 An increase in foreign investment flows from end-December 2002, despite mounting tensions in the Middle East, kept sentiments in the market upbeat and poised for further gains.

5.5 Soaring global crude oil prices resulting from war fears weighed heavily on market sentiment in the last quarter of the year, despite the significant liberalisation of banks' overseas investment and relaxation of restrictions in the forward market. Robust inflows of exports proceeds and inward remittances, however, continued to provide support to the spot exchange rate. On the basis of monthly averages, the Rupee appreciated against the US dollar by 2.3 per cent in 2002-03.

5.6 Activity in both the merchant and inter-bank segments of the foreign exchange market rose strongly. The inter-bank to merchant turnover ratio, however, declined, indicating the stability of market conditions and the narrowing of interest differentials.

5.7 Excess demand conditions prevailed in both merchant and inter-bank segments of the forward exchange market during the first quarter of 2002-03. One-month and the six-month forward premia hardened in May. As the spot market recovered in June, excess supply conditions characterised the forward market and continued to prevail during the rest of the year. The excess supply conditions in the forward segment necessitated a reversal in the strategy of intervention by the Reserve Bank. Outstanding net forward sales of the Reserve Bank remained negative up to August 2002. Forward premia in all maturities declined steadily reflecting heavy forward sales by exporters and easy liquidity conditions in the domestic money market.

GOVERNMENT SECURITIES MARKET

5.8 Yields declined in the secondary segment of government securities market during 2002-03 for the third year in succession reflecting ample liquidity and persistent expectations of interest rate cuts. Yields across residual maturity exceeding 14 years fell sharply relative to the benchmark 10-year security, flattening the yield curve. The aggregate volume of transactions in Central and State Government dated securities and Treasury Bills (outright as well as repos) rose during the year, although the share of outright transactions decreased.

CREDIT MARKETS

5.9 Easy liquidity conditions and monetary policy impulses for softening induced a reduction in deposit rates across all maturities. Comparable reductions were, however, not fully reflected in the prime lending rates (PLRs). Sub-PLR lending of the banking system (excluding exports, the bulk of which is at sub-PLR rates) constituted over one-third of total lending by December 2002. As many as 40 banks comprising 18 public sector banks (PSBs), 6 foreign banks and 16 private banks reduced their PLRs after the announcement of the mid-term Review of Monetary and Credit Policy in October 2002. The effective lending rates of commercial banks remained high due to wide spreads over the PLR which remained unchanged over 2002-03. The interest rate on home loans came down substantially over the year due to policy initiatives to boost the housing finance market.

EQUITY AND DEBT MARKETS

5.10 The capital market remained depressed during 2002-03. The primary market was subdued mainly due to lack of demand for funds by the corporates. Positive investor response to quality issues in the primary market, however, points to selectivity breaking through a generalised risk aversion. The secondary market was weighed down by a host of adverse domestic developments as well as the sell-offs in international equity markets in the first half of the year. Notwithstanding fall in prices of blue chip scrips, mid-cap scrips, PSU scrips and bank scrips experienced increased buying interest.

5.11 The stock market was affected significantly by some sector specific factors at different points of time during the year. In the first half of the year, the BSE Sensex was pulled down by the Fast Moving Consumer Goods (FMCG) sector, which remained subdued on account of drought fears and the depressed Information Technology (IT) sector, which posted lower than expected quarterly results. The BSE Sensex recovered to some extent during November and December 2002 as a result of the rally in PSU stocks on expectations of disinvestment initiatives. Bank scrips, in particular, witnessed a sharp increase almost throughout 2002-03, with improvement in profitability and relaxations on foreign direct investment (FDI) in private sector banks. The BSE Sensex was pulled down by the subdued FMCG and IT sector again in the last quarter of 2002-03.

5.12 Liquidity conditions in money, gilt and foreign exchange segments are expected to remain comfortable over 2003-04, with developments in the year so far providing early indications of market activity in the near term. In the money market segments, rates are expected to remain soft and clustered around the repo rate. The outlook for the Government securities market continues to be positive. The early signs suggest that the liquidity conditions are expected to remain adequate for supporting the government market borrowing programme as well as the off-take of credit for sustaining industrial recovery. The foreign exchange market is reflecting conditions of excess supply which have dominated the first few months of the year. The behaviour of the exchange rate is likely to depend considerably on the movements of the US dollar *vis-a-vis* other major currencies. The capital market has been experiencing heightened activity recently. Current valuations are attractive and FIIs' appetite for Indian paper is getting rekindled. The market is expected to further consolidate these gains in the near future. A sustained recovery in financial market activity is contingent upon the abiding strength of the macroeconomic fundamentals and a stronger and more durable recovery in international markets.

VI - External Sector

6.1 A vibrant and diversified export performance underpinned the growing vigour and resilience of India's external sector in 2002-03 notwithstanding an environment dominated by the weakness of the global recovery, declines in equity markets and geo-political uncertainties. Import demand was driven up by the pace of revival of industrial activity domestically relative to the rest of the world; however, with India emerging as the world's fastest growing exporter after China amongst leading exporting nations, the current account of the balance of payments was in surplus for the second successive year. A rising confidence in the macro-fundamentals created a distinct home bias. Readjustments of net financial claims of banks, corporates and exporters in favour of domestic assets resulted in net capital inflows becoming stronger, in spite of lower debt flows and foreign investment. The positive developments in current and capital account transactions were reflected in a modest appreciation of the exchange rate *vis-a-vis* the US dollar. There was an unprecedented order of accumulation of foreign exchange reserves, the third largest increase among emerging market economies in the year. At the end of March 2003, the reserves were equivalent of around 14 months of imports or about five years of debt servicing, amply satisfying the so-called 'Guidotti rule' (usable foreign exchange reserves should exceed scheduled amortisation of foreign currency debts, assuming no rollovers, during the following year). The burgeoning reserves enabled a further consolidation of external debt during the year through prepayment of multilateral and commercial debt as well as shifts in the composition and maturity of non-resident deposit liabilities.

6.2 Overall GDP growth in emerging market economies (EMEs), particularly in the Asia Pacific region, remained strong despite adverse external developments. Although private direct investment flows were lower, a moderation in outflows of other private capital flows helped to maintain the volume of net private capital flows to EMEs. These flows are expected to be marginally higher during 2003 on account of some improvement in FDI inflows.

6.3 According to the International Monetary Fund (IMF) projections, global GDP and trade volume growth may show some acceleration in 2003 to 3.2 per cent and 4.3 per cent, respectively. The large and growing global macroeconomic imbalances present the biggest risk to a sustained global recovery.

BALANCE OF PAYMENTS

6.4 India's balance of payments (BoP) improved significantly during 2002-03, with an overall surplus in each quarter. A surge in exports of merchandise and invisibles posted the current account into a surplus, in contrast to the previous year when a small current account surplus appeared due to lack of import demand. Growing openness in terms of the share of tradables in the economy is increasingly being driven by exports. The healthy rise in current receipts has had salutary effects on debt servicing capabilities and on import purchasing power. Banking capital movements supported by stable nonresident deposits brought in higher net capital flows, notwithstanding substantial pre-payments of multilateral debt.

6.5 Export growth during 2002-03 was broad-based, across commodity groups as well as destinations. Various policy initiatives taken by the Government in the recent years for export product and market diversification have helped in improving export competitiveness

6.6 In 2002-03, invisibles shared in the vigorous export expansion, rising to constitute 81 per cent of merchandise exports, *i.e.*, 45 per cent of gross current receipts. India's invisible earnings are dominated by private transfers (comprising mainly workers' remittances), followed by software and other business services. Remittances from Indians employed abroad have traditionally been the principal source of invisible earnings. India is the largest recipient of private transfers in the developing world and these amounted to US $ 14.8 billion in 2002-03. India's share in global flows of private transfers is placed at around 3 per cent. Software exports increased by around 27 per cent to US $ 9.6 billion during 2002-03 which is noteworthy in the context of the continuing 'technology slowdown' in the global economy and shedding of new economy stocks in world equity markets.

6.7 In 2002-03, as in the preceding year, it is the invisible account which emerged as the principal component, completely covering the trade deficit and driving the current account into surplus. The movement of the current account into surplus for the second consecutive year in 2002-03 is part of a broader trend emerging out of the crisis of 1990-91 – a conscious policy choice of a moderate current account deficit as an intermediate target for external sector policies.

6.8 Capital account developments dominated the balance of payments in 2002-03. Net capital flows were higher in 2002-03 than in any single year so far. Official assistance outflows increased in 2002-03 consequent upon the prepayment of multilateral debt - US $ 1.34 billion to Asian Development Bank and US $ 1.68 billion to the World Bank. Prepayments of high cost commercial debt were also put into effect by corporates. Thus, the long and medium term debt component of the capital account contracted in 2002-03, extending a phase of consolidation of external debt that has dominated external sector management since the adjustment to the crisis of 1990-91. Short-term debt flows increased to finance the higher order of POL imports.

6.9 Net inflows under non-resident deposits, another important element in debt flows, underwent compositional changes in 2002-03. There was a sharp increase in balances under the repatriable rupee-denominated external rupee accounts [NR(E)RA] as maturing balances of the discontinued non-repatriable rupee deposits [NR(NR)RD] poured into the repatriable scheme. Taken together, the net inflows into these rupee deposits were broadly stable during the year.

6.10 Key indicators of debt sustainability suggest continuing consolidation and improvement in solvency. The external debt-GDP ratio declined during the year to 20.0 per cent and proportion of short-term debt to total debt increased to 3.9 per cent at end-March 2003 from 2.8 per cent at end-March 2002. At 14.7 per cent, the debt service ratio continued to remain low in 2002-03. The marginal increase in debt service and liability service ratios during 2002-03 was due to pre-payments of official debt in the last quarter.

6.11 Weak stock markets pulled down foreign investment flows, both direct and portfolio, during 2002-03. Amounts raised through GDRs/ADRs were maintained.

International Investment Position

6.12 The International Investment Position (IIP) is a summary record of stocks of external financial assets and liabilities of the country and has a more comprehensive coverage than the external debt statistics which are restricted to only those external liabilities which have a contractual obligation to service. Information available up to March, 2002 indicate a distinct improvement in India's net international investment position over the period 1997-2002 on account of a decline of about US $ 13 billion in net foreign liabilities due to the build up of foreign exchange assets by the Reserve Bank.

FOREIGN EXCHANGE RESERVES

6.13 Overall surpluses have appeared in the balance of payments since 1993-94 (except in 1995-96). This has been reflected in growing accretions to the foreign exchange reserves. The accretion during 2002-03, the highest in any single year, was almost entirely in the form of foreign currency assets with small valuation gains booked under gold holdings. The major sources of accretion to foreign currency assets were the current account surplus and inflows in the form of foreign investment, banking capital and non-resident deposits. Valuation gains due to cross currency movement in exchange rates amounted to US $ 3.8 billion. On August 15, 2003 India held the sixth largest stock of international reserve assets among emerging market economies at US $ 85.4 billion.

6.14 Reserve management encompasses preservation of the long-term value of reserves and the need to minimise risk and volatility in returns consistent with the primary objectives of safety and liquidity. The overall approach to reserve deployment is one of high risk aversion with a preference for stable returns. Sound internal control systems are in place to identify, measure, monitor and control various types of risks encountered in the conduct of reserve management.

6.15 The substantial growth in reserves in the recent period has generated a debate regarding the costs and benefits of holding reserves. The accretion to reserves in the recent period has occurred without increasing the overall level of external debt and instead through higher workers' remittances, quicker repatriation of export proceeds and non-debt inflows. Even after taking into account foreign currency denominated non-resident deposit flows (where the interest rates are linked to LIBOR), the financial cost of additional reserve accretion in India in the recent period is quite low, and is likely to be more than offset by the return on additional reserves.

6.16 India was one of the 20 countries selected for a case study in a recent document published by the International Monetary Fund as a supplement to the IMF's "Guidelines for Foreign Exchange Reserve Management". The IMF has observed that India's management of foreign exchange reserves has generally been in accordance with IMF guidelines and is comparable to the global best practices in this area.

VII - Assessment And Prospects

Assessment of 2002-03

7.1 The Indian economy performed reasonably well in 2002-03, in spite of the simultaneous impact of several adverse developments. Border tensions in the early months of the year were followed by the worst drought in fifteen years. The estimated fall of 29 million tonnes in foodgrains production was the largest since Independence. Furthermore, the global economy was characterised by an environment of generalised uncertainty and low growth in the period leading up to the war in Iraq. During this period, there was also considerable hardening of international crude prices.

7.2 It is important to note that in the past, the occurrence of any one of the shocks experienced in

2002-03 in isolation had produced a sharp loss of growth, higher inflation, balance of payments difficulties, and even financial instability in the economy. Seen in this context, the performance of the economy during 2002-03 demonstrates the developing resilience of the Indian economy. This suggests that perseverance with structural reforms, despite the drag of slower growth in the second half of the 1990s, has helped to relatively shock-proof the economy and sustain a stable macro-economic environment.

7.3 The growth of the Indian economy in 2002-03, although significantly lower than expected, was still among the highest in the world. Timely and coordinated supply management strategies were effective in containing potential inflationary pressures, with headline inflation remaining benign over the greater part of the year. The strategy of accumulating food stocks and international reserves served the economy well by cushioning the impact of the shocks and by providing domestic and international confidence in the presence of considerable adversity. A heartening feature of the performance of the economy in 2002-03 was the revival of industrial activity, driven mainly by the strength of export demand that indicates the growing international competitiveness of Indian industry.

7.4 The comfortable state of India’s balance of payments reflected the high growth of merchandise exports at 19.2 per cent and buoyant invisibles. Consequently, the current account was in surplus for the second year in succession. International confidence in the fundamentals of the economy was further reflected in sustained capital inflows which in combination with the surplus in the current account led to an unprecedented accumulation of foreign exchange reserves in 2002-03. Recognition of the growing strength of the reserves has also led to the designation of India as a creditor country by the International Monetary Fund (IMF) under its Financial Transaction Plan (FTP). In recognition of the increasingly comfortable balance of payments situation, further progress was made during 2002-03 in liberalising external current and capital transactions covering overseas investments and remittances abroad by banks, corporates and resident individuals.

7.5 Monetary policy was effective in ensuring stability and orderliness in the domestic money, debt and foreign exchange markets. The expansionary impact of large capital flows was managed through timely action in the form of open market sales and LAF operations, supported by a sequenced liberalisation of outward international transactions. Interest rates declined in all segments of the market spectrum in response to the monetary policy stance of facilitating a softer interest rate regime that would support the revival of investment demand. The active management of liquidity conditions enabled the successful completion of the market borrowing programme of the Centre and States. Public debt management was strengthened through prepayment of external debt, debt swaps between the Centre and the States and a comprehensive restructuring of the scheme of ways and means advances and overdrafts for the States.

7.6 Ensuring financial stability continued to be a dominant objective underlying the intensification of financial sector reforms during 2002-03. Prudential norms were strengthened, consistent with the strategy to bring about greater convergence with international best practices. Significant initiatives were put in place to clean up and strengthen the balance sheets of banks. Management of non performing assets (NPA) was fortified by the operationalisation of the Corporate Debt Restructuring (CDR) mechanism and the enactment of the Securitisation and

Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, 2002 which provides statutory support for the enforcement of creditors' rights and, *inter alia*, paves the way for the establishment of Asset Reconstruction Companies (ARCs). The supervisory function was improved considerably through the institution of Prompt Corrective Action as an early warning tool. The development of financial markets was carried forward by putting in place the infrastructure for the retailing of government securities by order-driven, screen based trading in stock exchanges and the introduction of exchange traded interest rate derivatives. These developments will enable market participants to manage market risk better. The impact of financial sector reforms was reflected in an improvement in profitability of banks and in the overall efficiency of the financial sector.

7.7 The industrial recovery was well-diversified, particularly in manufacturing. The resurgence of industrial exports had a salutary effect across a wide spectrum of industry groups. In particular, exports of automobiles and components, chemicals, basic metals, food products, beverages and tobacco were robust. In terms of the demand composition, the revival of industrial activity in 2002-03 was led by consumer non-durables. The pick up in demand from the retail segment was also evident in the upturn in construction activity which was mirrored in the substantial increase in demand for bank credit from housing and cement industries. There was overall improvement in production conditions in the infrastructure industries, despite some shortfalls from targets. A significant development was the strong revival in the production of capital goods, heralding an improvement in the investment outlook. The financial performance of the corporate sector improved steadily in every quarter. A healthy expansion in sales and reduction in interest costs enabled a surge in post-tax profits, especially in the second half of the year.

7.8 There has been an active and continuous attempt at bringing about reforms in the infrastructure sector. The government is slowly moving away from its traditional role as a 'provider' of services to one of 'facilitator' by ensuring that infrastructure services are delivered in a desirable manner. The government has made rapid progress in the implementation of the National Highway Development Project (NHDP). There have been some efficiency gains in ports through the privatisation of ports services and berths. The telecom sector has perhaps seen the most significant development. Tariffs in the telecom sector have declined sharply in response to deregulation, competition and technology. Consequently, there has been a sharp increase in the growth of telephone lines, particularly in mobile services.

7.9 Although there have been some slippages in fiscal consolidation on account of the counter-drought stance of fiscal policy and the slack in economic activity, there was a renewal of the commitment to improve the quality of fiscal adjustment through monitorable reform programmes, debt consolidation and measures designed to bring back buoyancy to the tax-GDP ratio. With the passage of the revised Fiscal Responsibility and Budget Management (FRBM) Bill in the Parliament, the institutional architecture is being put in place for a much greater transparency in respect of the fiscal position and a phased decline in the Centre's borrowings to meet its capital and revenue expenditure. Some States have also enacted fiscal responsibility legislations.

7.10 The outlook for the global economy turned even more uncertain than a year ago. Despite positive developments such as the cessation of hostilities in Iraq, retreat of the Severe Acute Respiratory Syndrome (SARS) epidemic and reversal of persistent sell-offs in major equity markets, signs of recovery in major industrial economies are still not clear. Interest rate cuts by the Federal Reserve and the European Central Bank (ECB) in June 2003 have taken key international rates to all-time lows, reflecting a growing concern about possibility of deflationary trends emerging. The hesitant recovery of growth in the emerging market economies of Asia has been accompanied by the return of capital flows with falling bond spreads and a modest regaining of access to international capital markets. There are some concerns that higher capital flows reflect prospects of low returns in developed countries rather than strong fundamentals of emerging market economies. In spite of large cross-currency movements, misalignments continue to persist in the face of the continued global imbalances, particularly the high current account deficit in the US, which entail a downside risk for the prospects of recovery.

Outlook for 2003-04

7.11 The year 2003-04 has begun on a strong, positive note. Excess rainfall *vis-a-vis* the long period average in July 2003 - the sowing month for the *kharif* season - and revised projections of a normal monsoon have brightened the prospects for agriculture considerably. The satisfactory spread of the SouthWest monsoon so far is expected to compensate for the delay in sowing on account of the late arrival of the rains. A precise assessment of the anticipated levels of output under various crops would await more information on the intensity and distribution of the monsoon. Nevertheless, comfortable food stocks and the progressive improvement in reservoir levels provide sufficient protection against any unexpected developments.

7.12 The momentum of industrial growth has been sustained, with manufacturing output rising strongly in the first quarter. A heartening feature of the emerging industrial sector profile is the turnaround in the consumer durables sector after twelve successive months of decline. The outlook for the industrial sector is expected to be reinforced by the renewal of agricultural activity, the abiding strength of export demand and the improved environment for new investments indicated by a surge in the production of capital goods and non-oil imports, low interest rates and improved all round corporate profitability. Business confidence remains positive with expectations of increase in capacity utilisation, no major changes in employment and inventory levels and higher export orders.

7.13 Notwithstanding the unfavourable international environment, India’s external sector continues to post gain, with merchandise export growth in April-June, 2003 adhering to the target growth path set for the year. Capital flows continue to be buoyant with significant increase in non-resident rupee deposits and portfolio investment by foreign institutional investors in the first quarter of the fiscal year. Reflecting these developments, accretions to foreign exchange reserves have continued, taking their level to US $ 85.4 billion on August 15, 2003 – up by US $ 10.0 billion over the end-March level on top of an increase of US $ 21.3 billion in 2002-03.

7.14 The substantial expansion in net foreign assets of the Reserve Bank has engendered easy liquidity conditions so far. Net Reserve Bank credit to the Centre, on the other hand, declined sharply on account of Liquidity Adjustment Facility (LAF) repos and open market sales. Broad money expansion was also lower on account of slowing deposit growth, and a slack in currency demand. Lower procurement operations resulted in a weak off-take of food credit. Non-food credit expansion has been broadly maintained.

7.15 Financial markets exhibited stability and ample liquidity. Call rates softened to sub-repo levels since May 2003. Despite the launch of the Centre's borrowing programme for 2003-04, the gilt market has been range-bound by expectations of a further decline in yields. In the foreign exchange market, the Indian rupee appreciated against the US dollar on the back of strong supplies. Forward premia hovered between 1-3 per cent in April, 2003 before increasing mildly thereafter. The capital market experienced increased activity in the current year with significant buying interest in Public Sector Unit (PSU) and bank scrips.

7.16 Monetary policy for 2003-04 retains its stance of maintaining adequate liquidity in the system to meet credit growth and support investment demand in the economy while continuing a vigil on movements in the price level. Accordingly, the preference for a soft and flexible interest rate environment within the framework of macroeconomic stability is being continued. The endeavour of monetary policy would continue to be the development and smooth functioning of the financial markets, enhancing the allocative efficiency of the financial sector, preserving financial stability and improving the transmission mechanism of monetary policy.

7.17 By early-July, 2003, inflation retreated from a temporary spike during the last fortnight of June on account of spurts in prices of vegetables, processed tea and iron and steel. In the beginning of July, vegetable and fruits prices declined. Oilseeds prices have been ebbing since the beginning of June on the prospects of a good monsoon. The decline in the prices of mineral oil and man-made fibres continues to restrain overall inflation. By early August 2003, wholesale price inflation fell below 4 per cent. Internationally, inflation remains weak in the US, the UK and the Euro Area. The Fed and the Bank of England reduced their key policy rates by another 25 basis points each as the possibility of deflation continues to be a cause for concern. Although the international inflation scenario remains benign, a close watch will have to be kept on commodity prices of key items, such as, iron and steel, POL, edible oils and cotton, which exhibit some possibilities of firming up.

7.18 The fiscal deficit of the Centre was somewhat lower in April-June, 2003 than in the previous year. The revenue deficit and primary deficit were, however, higher during the first quarter of 2003-04 as a result of a substantial decline in proceeds from corporation tax, income tax and union excise duties. Custom duties, on the other hand, benefited from the surge in import growth and registered an increase. Aggregate expenditure during April-June 2003 registered a moderate growth. As the Tenth Plan document has noted, the key to sustaining growth of 8 per cent per annum is prudent fiscal management based on increased public investment financed by higher government saving and internal resource mobilisation by the public sector. States would have to play a predominant role in making investment decisions, particularly in infrastructure development. Priority needs to be accorded to arresting the declining trend in government saving. The revenue deficit must be contained and has to be reduced to 2.4 per cent of GDP by the end of the Tenth Plan period. This would also help in ensuring sustainability of public debt, inclusive of contingent liabilities. The large size of contingent liabilities has implications for the sustainability of Government finances. The contingent liabilities in case of State Governments essentially reflect the practice of setting up special purpose vehicles (SPVs) to borrow from the market. Given the low user charges and inefficient operations of PSUs, these contingent liabilities are a potential threat to the stability and sustainability of the financial system. In view of these systemic risks associated with any possible default of State Government guaranteed paper, there have been ongoing discussions between the Reserve Bank and the State Governments. States have now become sensitised to the risk inherent in committing support to unsustainable contingent liabilities and various mechanisms are being considered to limit them.

7.19 A number of initiatives have been taken to ensure adequate credit to the agricultural 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. 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-operative sector remains dependant on flow of finance from the National Bank for Agriculture and Rural Development (NABARD). The Government of India has introduced an amendment to the NABARD Act, 1981 to enable it to provide refinance facilities directly to District Central Co-operative Banks (DCCBs), in addition to State Cooperative Banks (StCBs) and Regional Rural Banks (RRBs) to which NABARD is already providing refinance. This would enable the system to reduce the rate of interest charged to the ultimate borrower. There is a continuing need to improve the delivery of rural credit so that farmers receive timely and adequate credit at a reasonable cost in an institutional manner.

7.20 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. Micro- finance forms an integral part of priority sector lending with banks allowed to classify their credit under the SHG-bank linkage programme as advances to weaker sections. Banks are being encouraged to mainstream micro-credit and enhance the outreach of micro-credit providers. The Reserve Bank has been placing emphasis on the flow of bank credit to micro-enterprises in rural and semi-urban areas. This programme is also of benefit to the banks by externalising the credit delivery process and ensuring more than 95 per cent recoveries, besides being cost effective.

7.21 Real GDP growth in 2003-04 was projected at about 6.0 per cent in the Statement on Monetary and Credit Policy for the year 2003-04, issued in April, 2003, based on the assumption of somewhat below normal rainfall forecast by the Meteorological Department at that time. As per the latest assessment of rainfall conditions, a strong recovery in agricultural output is likely during the year. Along with the continuance of the upturn in the industrial and the services sectors, the expected growth for 2003-04 may significantly exceed the earlier projection, if output growth in agriculture shows a sizeable increase over the low base of 2002-03. Based on current assessment, the inflation rate in 2003-04 on a point-to-point basis, is placed in the range of 5.0 to 5.5 per cent. Consistent with the expected GDP growth and inflation, the projected expansion in broad money (M_3) for 2003- 04 is placed at 14.0 per cent. As the projected expansion of money supply is on a higher base including the mergers that took place in the banking industry, the volume of liquidity would be adequate to meet the credit needs of the productive sectors of the economy. Consistent with this order of growth in M_3, an increase in aggregate deposits of scheduled commercial banks is set at Rs.1,79,000 crore. Non-food bank credit including investments in commercial paper, shares/ debentures/bonds of PSUs and private corporate sector is projected to increase by 15.5-16.0 per cent, which should be adequate to facilitate the sustenance of growth in industrial activity during 2003-04. 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 2003, by which time reliable information on the progress of the monsoon and the spread of the industrial upturn would be available.

7.22 Achieving the growth projections related to overall economic performance will be dependent on a significant increase in investment, both public and private. Such a change in expenditure composition towards higher investment could lead to the re-emergence of a current account deficit that would then enable better absorption of capital inflows for investment purposes.

MEDIUM-TERM ISSUES

Real Sector

7.23 The higher growth trajectory envisaged under the Tenth Five Year Plan would combine increased investment with improvement in efficiency. This would require shifts in the growth strategy to improve saving and investment rates, and reduce the high fiscal deficit. Raising the domestic saving rate to about 27 per cent per annum to finance the required investment effort is a daunting task at the current levels of income and this, in itself, underscores the imperatives for stepping up the growth rate of the economy. A key issue in this regard would be the intensification of reforms in social security, insurance and other conduits of long-term savings as well as the development of markets and instruments with a view to bringing about a convergence between the time preference of savers and the risk-return profiles of investors. At the same time, institutional mechanisms need to be put in place to draw the saving of the unorganised sector into formal channels.

7.24 Arresting the dissaving in the public sector and halting the preemption of private saving by burgeoning public sector revenue deficits is critical to the drive for mobilising finances for growth. As fiscal consolidation improves and the draft on domestic resources from the budget diminishes progressively, a larger volume of resources would be available for private investment also. This transformation would also stem the continuous erosion in public investment that has occurred in the new millennium, empowering it to anchor aggregate demand, build new productive capacities and create the enabling conditions for private investment. Reduction in the revenue deficit would also enable greater public investment for the provision of public goods that are necessary to catalyse a high rate of efficiency of private investment.

7.25 The Indian growth experience has been marked by a high correlation between domestic saving and investment. Globalisation and internationally mobile capital have tended to weaken this correlation elsewhere as developing countries have undertaken financial liberalisation to harness the growth-financing potential of foreign saving, especially when efforts to mobilise resources domestically have run up against hard constraints. The investment requirement of the

Tenth Plan strategy relies on external financing to the extent of about 1.6 per cent per annum, on average. Given the past experience and the evolving openness of the economy, the order of external saving envisaged in the Tenth Plan seems reasonable.

7.26 As the Tenth Plan document notes, the key to the growth strategy is efficiency "based on unlocking of hidden capacities in the economy, unleashing repressed productive forces and entrepreneurial energies and upgrading technology in all sectors". This will require acceleration of the process of dismantling policy constraints, procedural rigidities and price distortions. It will also require that the essential institutional structure necessary for the orderly operation of the economy is strengthened significantly.

7.27 An issue of concern as highlighted by the Tenth Five Year Plan is the decline in the employment growth rate from above 2 per cent per annum during the 1980s and the early part of 1990s to 1.1 per cent in the latter part of 1990s. With the growth rate of working age population exceeding the overall population growth rate, the unemployment rate could worsen further if the economic growth envisaged does not give rise to new activities that are appropriately labour intensive.

Agriculture

7.28 The drought of 2002-03 has renewed concerns relating to the high variability of agricultural output and the adverse ramifications for overall economic activity. The monsoon dependency of *kharif* production – the main agricultural season – and the indirect dependence of the *rabi* agricultural season on storage in reservoirs has become more pronounced in recent years. Furthermore, in a country of sub-continental proportions, there are always some regions which experience drought even though at the national level moisture stress is not there. Localised droughts have a severe region-specific impact, often repetitively, as in the case of Western India which suffered three droughts during 1999-2000 to 2002-03 leading to large losses of national oilseeds production. This underscores the urgent need for water harvesting and watershed development alongside water conservation. Classification of land capability in terms of inherent characteristics, external land features and environmental factors is a key issue from the point of view of preserving fertility and planning watershed development. Crop selection should be related to the availability of water. Programmes promoting greater afforestation in the uplands would help in better water management for increasing the availability of water in currently water scarce areas. Effective social and legal institutions for management of community resources are crucial for watershed development programmes including strategies to educate, encourage and operationalise the collective participation of watershed communities.

7.29 An area of vulnerability of Indian agriculture to weather shocks is the concentration in the cropping pattern, which constrains the flexibility of supply response. Agricultural pricing policies are at a crossroad. There is considerable debate in the country today assessing their benefits in terms of ensuring food security *versus* the distortions in cropping patterns and input usage that have stemmed from a skewed incentive structure. The Minimum Support Price (MSP) system has changed the cropping pattern in favour of rice and wheat at the cost of other important components of the average consumption basket such as other cereals, oilseeds and pulses, and other foodstuff such as fruits, vegetables, poultry and the like. Moreover, the irrigation intensive rice-wheat cropping pattern in North-Western India is increasingly being recognised as unsustainable environmentally. Water logging and the disproportionate application of fertilisers has led to decline in soil fertility and an alarming drop in the underground water table. Intensive input usage is causing salinity with adverse implications in terms of long-term desertification of soil.

7.30 As the Tenth Plan document has recorded, despite the declining share of agriculture in GDP, employment in agriculture has remained virtually unchanged at around 190 million people over the last decade. With growing incidence of fragmentation, the consequent decline in the average size of land holding and subdued growth in yields, any further improvement in agricultural incomes will have to come from value addition through agro-processing or agro-based industries rather than agricultural production *per se*. Demand based agricultural production may necessitate moving away from fiscal price supports in a phased manner towards greater exposure to international terms of trade and the development of alternatives such as futures trading which result in better price discovery and risk management. A crucial prerequisite is the removal of restrictions on the physical movement of major agricultural commodities and the integration of domestic agricultural markets.

7.31 The low growth of yields during the post-reform period highlights the need for upgradation of technology. Agricultural research and development must be geared to a re-prioritisation of investment on new technologies so as to balance or supplement the traditional technologies with new advances in biotechnology. Here, public investment in agricultural research is critical. The Indian agriculture research system performed well in supporting the green revolution. Now attention needs to be given to re-focussing the research system so that agricultural diversification can be accelerated for achieving new productivity levels. Effective adoption of new technologies also requires an efficient extension system for technology dissemination. The task of extension becomes more challenging with the signing of the Agreement of Agriculture under the World Trade Organisation (WTO). This requires a flexible approach allowing specific information to be customised for different farmer-groups.

7.32 If India is to approach the growth target of the Tenth Plan, it is essential to step up the growth of agriculture significantly. Higher agricultural growth will now have to come from a much more diversified agriculture as has been the experience in other fast growing Asian countries. Agricultural diversification and accelerated agricultural growth will require much greater investment in rural infrastructure such as roads, storage facilities, telecommunications, power, and the like. Diversified agriculture will need much more complex commercial linkages between the farm and market. A key challenge will be the financing of rural infrastructure. New approaches to public private partnerships, participation of local governments, funds sourced from dedicated levies such as the fuel cess will have to be explored.

7.33 Despite India being the second largest producer of fruits and vegetables in the world, the production of these commercial crops has been hampered by 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 should have in food processing. In this regard, the vital function of efficient agricultural marketing should be recognised. This underscores the need to move to a situation where an alternate system of market intermediaries is created in agricultural marketing along with the existing ones. A thorough review of adequacy of institutional arrangements in quality control, certification and trading in agriculture sector should be a national priority to take advantage of global opportunities. Under the Agricultural Produce Marketing Regulation Act, State Governments alone are empowered to initiate the process of setting up of markets for agricultural products within a defined area. In order to encourage private sector participation and investments required for development of alternative marketing infrastructure and supporting services, provisions of the corresponding State Acts would need modification.

Industry

7.34 Since the second half of the 1990s, the industrial sector has been undergoing deep-seated restructuring in order to cope with the rigours of the changing environment. There has been heightened activity in the form of mergers and acquisitions as also in the shedding of non-core operations. The significant acceleration of growth envisaged for industry in the Tenth Plan period - from 4.5 per cent in the Ninth Plan period to 10 per cent in 2002-07 - is a major challenge, given that this expansion would have to occur in a fiercely competitive environment created by the progressive removal of barriers to entry and exit, trade liberalisation, a congenial policy regime for foreign direct investment (FDI) and a progressive extension of the process of industrial liberalisation to the State level. Issues in corporate governance have assumed increasing significance with a view to avoiding/minimising corporate failures and financial irregularities as well as to strengthen management accountability. In consonance, amendments to the Companies Act, 1956, Chartered Accountants Act, 1949, Cost and Works Accountants Act, 1959 and Companies Secretaries Act, 1980 are currently underway. Indian corporate entities are increasingly faced with the need to benchmark their corporate governance practices with the best international practices.

7.35 In order to achieve the significant step-up in industrial growth, it is vital now to expand the ambit of reforms to the difficult areas concerning land laws, the labour market, bankruptcy and exit procedures. In this context, the recent amendment to the Companies Act in 2002 ushering in the National Company Law Tribunal as a single forum for winding up of companies is a noteworthy measure. The associated repeal of the Sick Industrial Companies Act (SICA) and consequent abolition of the Board for Industrial and Financial Reconstruction (BIFR) is yet to be passed. Furthermore, the Competition Act, 2002 which replaces the Monopolies and Restrictive Trade Practices (MRTP) Act recognises the need for businesses to grow and secure the advantages/economies of scale to compete with MNCs in the global market place. Another amendment to the Companies Act has allowed for primary producers/co-operatives to produce and market industrial products in a modern and professional manner at par with other companies. This is expected to enhance the competitiveness of co-operatives.

7.36 Inadequate project appraisal and persistent time and cost overruns have been identified as major impediments to improving the international competitiveness of Indian industry. While there has been some recent improvement in the implementation of Central Sector Projects (CSPs), the proportion of delayed projects has also increased. Delays in the completion of major

CSPs has led to the huge cost escalation, which currently accounts for 59 per cent (around Rs.26,000 crore) of the actual cost of delayed projects. According to the Ministry of Statistics and Programme Implementation, control on time overruns may reduce the cost overruns by 75 per cent. Time overruns in the completion of projects are mainly on account of problems relating to funds and land, apart from absence of feasibility studies before commencement of the projects, problems relating to award of contracts, equipment supply and civil works. Currently, the Railways have the largest number of projects that were delayed by more than five years. The power sector accounts for the predominant share (52 per cent) of cost overruns in respect of delayed projects. The implementation of projects in the road sector have started showing delays since February 2003, leading to the postponement of the scheduled date of completion of Golden Quadrilateral project to December 2005. The fiscal implications of delays in CSPs underscore the importance of the Tenth Plan strategy of placing full emphasis on the completion of partially completed or on-going projects as well as upgradation of existing capital assets before initiating new projects.

7.37 The significance of the Small Scale Industry (SSI) sector in terms of the objectives of nurturing new entrepreneurship, regional industrial growth and promotion of employment has been well recognised. In this regard, priority needs to be accorded to enhancement of investment limits, greater ancillarisation, and larger and quick credit flow to the SSI. There is a continuing need to undertake radical changes in the policy of reservation of certain products for the SSI sector which has impacted adversely upon growth and exports. Quantitative restrictions need to be replaced by an incentive structure which enables a greater market orientation of SSIs. The recent de-reservation of further 75 items for the SSI sector as well as the hike in investment limits for 51 items in the area of garments, hand tools, stationery items and drugs are steps in the right direction. The future of SSIs in India critically hinges on modernisation, technical up-gradation, and competitiveness in terms of quality and price. The flow of credit to SSIs has slowed down in the second half of the 1990s. Banks and other financial intermediaries need to support emerging SSIs more actively so that new entrepreneurship is encouraged to flourish.

7.38 Inflexibilities in the labour market have posed a serious problem for industrial restructuring and have also deterred new investment in labour using industries where India has a potential comparative advantage. There has been some progress in reforming the product markets; however, factor markets for labour and land have considerable structural rigidities. While Special Economic Zones (SEZs) may provide flexible labour markets, there is an urgent need to address the issue on a nation-wide scale so that employment intensive activities are encouraged. In the corporate sector, successful labour restructuring has brought modest successes and these initiatives are worthy of wider emulation.

Services

7.39 The services sector is emerging as the mainstay of the Indian growth process in recent years. The improvement in the performance in 'financing, insurance, real estate and business services' and 'community, social and personal services' has more than offset the deceleration recorded by 'trade, hotels, transport and communication' in 2002-03. The major contributory factors to services growth could be traced to the resurgence in financial services and housing finance, growing demand for transport and communication services and booming export demand particularly for software. An input-output analysis of the Indian economy reveals that 70 per cent of industrial activities (particularly, machinery, food processing, textiles, cement, leather, tobacco, steel, drugs, paper and rubber) are directly services-intensive. Thus, services are expected to continue leading the economy into the higher reaches of the growth potential of the economy, drawing from the strengthening linkages with manufacturing and the expansion of markets enabled by international commerce.

Fiscal Policy Issues

7.40 The progress of fiscal consolidation in the medium-term would need to hinge around a correction of the structural weaknesses in resource mobilisation as well as in expenditure management. Increasingly, the content of fiscal policy is being assessed by the quality of the adjustment. An improvement in the quality of fiscal adjustment would require cutting down consumption expenditure while maintaining or increasing the investment expenditure. At present, revenue expenditure accounts for nearly 85 per cent of Centre's aggregate expenditure and only 15 per cent goes for investment purposes. Further, of the total revenue expenditure nearly one third is accounted for by interest payments, other major items being defence and subsidies. Given the composition of Government expenditure with large proportion of committed expenditure, compression of expenditure is very difficult. Subsidies are perhaps one area where considerable scope for reduction exists. During the year 2002-03, however, expenditure on subsidies as a proportion to GDP has gone up to 1.8 per cent from 1.4 per cent in the preceding year. Thus, given such rigidities in the composition of expenditure, significant fiscal improvement will hinge increasingly on improvement in revenue collections. Deterioration in the tax-GDP ratio at the Central level that has occurred over the past decade has to be reversed. The improvement in tax administration and use of information technology should help greatly in curbing tax evasion, and hence in enhancement of revenues.

7.41 On the expenditure front, the deteriorating State finances have led to compression of social and economic overheads. This has severely limited the ability of the States to improve the physical and social infrastructure. Accordingly, developmental expenditure needs to be earmarked sector/area-wise and monitored through targets to judge the progress of reforms. This should form an integral part of the Medium-Term Fiscal Reforms Programme (MTFRP) which already encompasses fiscal consolidation, public sector enterprises reform, power sector reforms and fiscal transparency. While there is greater monitoring of the overall debt from all sources at the State level and increasing co-ordination between regulatory bodies, MTFRP should involve strict adherence to the monitorable targets.

7.42 Another important factor constraining the States' ability to undertake developmental activities is that of increasing pension payments, which rose from less than three per cent of revenue receipts in the early 1980s to about 10 per cent of the revenue receipts in 2001-02. Increasing pension liabilities of the State Governments have become an area of concern since they are not backed by any funding arrangements and have to be met through budgetary resources causing heavy drag on the State exchequer. There is a clear need for pension reform at the State-level.

7.43 Recognising that the mobilisation of adequate revenue is crucial to fiscal reforms, the Tenth

Plan document envisages a rise in the Centre's tax/GDP ratio from 9.0 per cent in 2002-03 to 10.3 per cent by 2007-08. Continuous efforts to improve tax administration, including IT enablement and expansion of the tax base to include the services sector are expected to enhance the buoyancy of both direct and indirect taxes. Indirect tax reforms would be based on rationalisation of rates and withdrawal of exemptions. States' own tax revenue collections would also need to rise from 5.8 per cent in 2002-03 to 6.6 per cent of GDP by the terminal year of the Tenth Plan. In this context, the move to a unified VAT covering all goods and services assumes importance. The objective is to create a single market space and a transparent and harmonious indirect tax system which eschews distortions such as tax cascades and tax exportation. The VAT requires integration of various stages of commodity taxation between the Centre and the States. It also involves managing the problems in transition from the existing structure, including the long run effects of State VAT on the economy and on public revenue. Consensus among all the States on the principle and rates is essential so that exemptions and escape clauses in VAT rate structures and anomalies in legislation are limited.

7.44 States also need to explore alternative taxes and the scope for improvement of the tax regime and administration in the areas of stamp duties, registration fees, and motor vehicle tax, particularly with a view to preventing interstate diversions. Certain States like Andhra Pradesh have in-built buoyancy in stamp duty by relating the duty to valuation of the property. With the increasing importance of urban infrastructure and efficiency of cities for overall economic efficiency, focussed attention has to be given by States to the improvement of city finances. This will need reforms to augment the urban tax base, particularly, through the levy and collection of property taxes and more efficient assessment procedures.

Infrastructure

7.45 The composition of expenditure as well as the stock of infrastructure assets has deteriorated with the neglect of cost recovery. The principal issue is the levy and collection of appropriate user charges on the array of social and economic services which the States provide (*e.g.*, water supply, sanitation, sewerage, transportation, education, and medical facilities). Provision for public goods has to be made from tax resources whereas private goods and services should be financed by the levy of appropriate user charges. User charges need to be indexed to input costs and the process of periodic revision should become automatic, along with appropriate provision for productivity improvements. At the same time acceptability of higher charges for such services will not be feasible unless there is greater efficiency in the delivery of these services. This requires widespread reform in the public sector - MOUs for 100 per cent metering to avoid transmission and distributional losses, setting up State Electricity Regulatory Commissions (SERC), unbundling of generation, transmission and distribution under deadlines. The issue of user charges may well be the most important in the canvas of fiscal reforms.

7.46 Key to the envisaged industrial expansion in the medium-term is the modernisation and deepening of the physical infrastructure. In the power sector, the Electricity Act, 2003 envisages liberalisation over a wide area providing for greater freedom for private investment. In the process, consumers would eventually be free to choose their suppliers of electricity in a competitive market. The Act also envisages phasing out of cross subsidies and outlines a strategy to address the poor financial health of the SEBs. The Tenth Plan also highlights the need to restore the balance between hydro (which presently accounts for only 25 per cent of total power generation) and thermal power as well as provide a thrust to nuclear power generation.

7.47 Financing the growth of infrastructure remains a major concern. Public sector resources can be effectively leveraged through greater reliance on the execution of infrastructure projects through public-private partnerships as has been recently proposed in the Union Budget. Although the demand for funds by the corporate sector reflects the dampened investment climate in the current phase of the business cycle, the supply and the tapping of these funds for infrastructure and industrial activity in general is likely to become critical as impulses of new investment gather strength. Cross-country experiences suggest that external sources play a predominant role in financing infrastructure, at least in the early and intermediate stages. The capital market, in particular, provides an efficient conduit, enabling the channelling of saving to investors of varied risk-return profiles.

7.48 The capital markets have witnessed a drastic slowdown over the last decade, mainly due to depressed primary market activity, low investor confidence and stringent norms for public issues. In the years ahead, strengthening of the role of the capital market is essential for maintaining the flow of funds through this channel. The role of the corporate bond market in this context can hardly be overemphasised. The corporate bond market in India is marked by a low investor base, lack of a variety of instruments and an illiquid secondary market. In the primary segment, corporates are innovating new arrangements to circumvent the barriers in access to markets. These off-market financing arrangements have, however, come in the way of market development, impeding price discovery and obscuring transparency, disclosure and market discipline.

7.49 The integral part of the process of market evolution is the tapping of new savings to meet the envisaged surge that is expected in investment demand over the medium-term. Contractual savings constitute the natural sources of funds that can be deployed productively in medium and long-term investments. Pension and provident funds, and insurance companies are the natural holders of such long-term funds along with the traditional instruments of small savings such as post office savings accounts. At present, such contractual savings are largely deployed in government securities for regulatory reasons or because of the perceived absence of productive opportunities for remunerative medium and long-term investments. A similar gilt bias is observed in the behaviour of banks, despite the change in regulatory environment that has blurred the boundaries between the banks and non-banks. There is need for greater innovation in risk management by all these institutions so that they can exploit better the emerging opportunities in both industrial and infrastructure financing. Financial intermediaries must also seek new arrangements to provide opportunities for the unorganised sector to deploy their savings for productive purposes. This would need improved marketing of new saving schemes along with innovative expansion of the distribution network, including the use of traditional outlets such as post offices and other retail outlets that offer synergies with other financial products. The proposed pension scheme that has been announced for the unorganised sector constitutes an appropriate step in this direction.

External Sector Issues

7.50 Over the years ahead, the progressive correction of the anti-export bias in India's trade policies would need to be carried forward with the complete elimination of quantitative restrictions and non-tariff barriers, accelerated reduction and rationalisation of tariffs, liberalisation in the trade and payments regime and improved access to export incentives. The attainment of a current account surplus would suggest that tariff reductions could be carried out faster than envisaged earlier, without posing any significant risk to the balance of payments. In the context of the strategic export promotion policies being designed to guide an aggressive export effort, it is necessary to broaden coverage to a large number of non-traditional items and markets which are expanding above the world average. Measures introduced to ensure timely delivery of credit to exporters and to remove procedural hassles should be strengthened. The Medium Term Export Strategy announced by the Government in January 2002 involves a comprehensive plan, taking into account the contemporary global scenario, to achieve a quantum increase in exports in the medium-term coinciding with the Tenth Plan period (2002-07). This would need to be buttressed with sector-specific strategies based on demonstrated or perceived export potential. The introduction of a comprehensive system to make tax rebates to exporters transparent and comprehensive, upgradation of export infrastructure, trading agreements (free trade agreements and preferential trade agreements), improved access to bank credit and marketing infrastructure are other elements of the strategic export policy of the medium-term.

7.51 The export led growth experience of South-East Asian countries provides valuable lessons for countries like India where export performance is regarded as the key to the health of the balance of payments. This experience suggests that it is technology intensive items that will provide momentum to the export drive. In particular, it is important to seize the opportunities afforded by the progressive vacation of technology exports by Japan, East Asia and China. So far India's export promotion policy has been broadly neutral in respect of technology upgradation, rather than focused on specific areas of technological advantage. Moreover, some elements of industrial policy such as emphasis on indigenisation, thrust on adaptation rather than innovation considerably restrict technology intensification in exports. In this context, a conscious choice between a 'leapfrog' from low technology to high technology exports or a more "gradualist" approach has to be made, given that India is a late entrant in the race for export markets.

7.52 Export promotion policy needs to utilise the natural complementarity of Foreign Direct Investment (FDI) with export activity. In the final analysis, it needs to be recognised that definitional issues notwithstanding, it is administrative and procedural hurdles which are the biggest impediments to larger flows of FDI into India. The time lag involved in converting investment intentions to actual flows of foreign exchange, technology and know-how must be reduced to compare favourably with investment destinations which have proven attractiveness on account of the ease in investing. The global reach and marketing abilities of FDI could be effectively utilised to provide a cutting edge to the export effort. The thrust on attracting higher FDI inflows in infrastructure sector should be dovetailed into the regulatory and pricing reforms in major infrastructure services such as power and transportation.

Financial Sector Issues

7.53 The monetary policy framework is changing in response to reforms in the financial sector.

The Reserve Bank's endeavour is to enhance the allocative efficiency of the financial sector and preserve price and financial stability. Striving for price stability and financial stability usually requires complementary and reinforcing policies; nevertheless the two objectives may occasionally be in conflict with each other. While internationally, economies have stabilised in terms of inflation and growth, financial cycles have become more pronounced. Besides the use of interest rates, the Reserve Bank is supporting financial stability by implementing policies to make the financial system more resilient. Through its monitoring mechanism, the Reserve Bank is not only striving to assess the potential problems but is also continuously monitoring risks at the macro level.

7.54 Recent domestic and international experience in the role of central banks as lenders of the last resort has highlighted some important issues. First, while the central bank's role in providing liquidity support instills confidence to the financial system, the actual action requires the central bank to distinguish between solvency and liquidity problems. For this, the regular availability of comprehensive information is a prerequisite. Secondly, in a deregulated financial system with progressive diversification of bank ownership, shocks tend to get transmitted more rapidly across financial institutions, especially if they do not have the comfort of the backing of sovereign ownership. While the contagion can adversely affect even strong institutions, the weaker and the more fragile institutions become relatively more vulnerable to shocks. It is, therefore, imperative that banks increase their intrinsic strengths. Thirdly, as the financial system opens up, it is vital for the central bank to be more proactive in monitoring macro risks arising out of any potential fragility in the financial system. Mechanisms that throw up early warning signals so that prompt corrective actions can be undertaken would help in preventing a crisis. Recent experience has also brought to the fore the possibility of a technology risk translating into a liquidity risk. This underscores the importance of appropriate liquidity management systems in banks that are attuned to providing enhanced services to customers through technological innovations.

7.55 In the recent period, there have been significant improvements in the financial health of the banking system as reflected in the performance of certain key parameters. Banks have shown improved profitability, reduction in the net NPA ratio and improvement in capital adequacy ratio. The balance sheets of banks are looking healthier and the institutional infrastructure mounted in the financial system, including the Negotiated Dealing System (NDS), Credit Corporation of India Ltd. (CCIL) and screen based trading system for interest rate derivatives is poised to enable banks to manage their risks more efficiently. These actions would get a further boost with the operationalisation of the real time gross settlement (RTGS) system.

7.56 The Reserve Bank is also committed to the implementation of the "Core Principles for Effective Banking Supervision" drawn up by the Basel Committee on Banking Supervision. In order to achieve full compliance with these principles, steps have been taken in a phased manner to move towards a system of consolidated supervision, for enhancing the role of external auditors, strengthening corporate governance and increasing transparency and disclosure in the balance sheets of banks. In this process, monitoring the financial system by the Reserve Bank in an increasingly deregulated financial system is better facilitated.

7.57 While the overall policy environment has fostered a significant degree of financial soundness and banks have recorded higher profitability, mainly due to large investments in gilts, this should not lull them into a state of complacency. Banks need to recognise the potential interest rate risks and resort to larger provisioning and build-up of reserves including investment fluctuation reserves. Globally, the best managed banks are proactive in building up reserves when the profits are on the upswing. Timely write off and provisioning in respect of problem assets characterise the operation of many of the banks.

7.58 In line with international best practices, the Reserve Bank announced a timetable to move to the 90-day norm for loan impairment, effective end-March 2004. Since banks were provided a sufficient time frame to graduate to these new norms, it is expected that they would have built-in adequate levels of provisioning. Nevertheless, banks need to be on guard against any upsurge in the measured NPAs consequent upon the movement to the 90-day norm.

7.59 Recent trends in exchange rate and interest rate movements have fuelled greater demand by corporates for foreign currency loans from Indian banks. Considerable flexibility has been given to the corporates over a period of years to hedge their foreign exchange exposure in the market. A significant portion of the corporate foreign currency commitments remain unhedged on the basis of perceptions of the market and these could potentially have an impact on their overall financial position in case of unexpected developments. Accordingly, banks need to exercise caution in "unhedged" lending in foreign currency since exchange risk could turn easily into credit risk if exchange rate movements turn adverse. Banks also need to put in place a system for monitoring such unhedged external liabilities.

7.60 While the financial sector reforms have focused on improving the efficiency of the banking system, as the Tenth Plan has observed, it is important to finance activities that are of crucial importance for growth. It has been the endeavour of the Reserve Bank to improve the credit delivery mechanism by simplifying procedures, encouraging decentralised decision making and enhancing competition. Improving the flow of bank credit to the agricultural sector is a dominant objective of monetary policy by removing procedural impediments, upgrading institutional mechanisms for delivery and creating an environment where small and marginal farmers reap the full benefits of softer interest rate regime. In this regard, the recent lowering of public sector banks lending rates for agriculture to a ceiling of 9.0 per cent is expected to improve the channeling of bank credit to the farm sector. The cooperative banking sector has been playing an important role in the delivery of rural credit. In order to further improve the credit delivery, co-operative banking is being sensitised to the changing context of the financial regulation through enhanced standards of disclosure and governance.

7.61 With the gradual liberalisation of the Indian financial system and the growing integration among markets, the risks associated with banks' operations have become increasingly complex, requiring strategic management. In keeping with the spirit of the guidelines on Asset-Liability Management (ALM) systems and on integrated risk management systems, banks need to design their risk management architecture, taking into consideration the size, complexity of business, risk philosophy, market perception and the level of capital. Banks are also being prepared for fine-tuning the risk management systems to deal with credit and market risk. Derivatives have been introduced in the Indian financial markets for management and hedging of market risk. The menu of derivative products has been recently expanded. Guidelines on credit derivatives for management and hedging of credit risk are being framed in consultation with banks. In pursuance of the Core Principles for Effective Banking Supervision guidelines on policies and procedures in banks for identifying/ monitoring/ controlling country risk exposures are already in place. The developments in the financial markets also emphasise the need for enhancing the scope and extent of disclosures by banks with a view to rationalising the existing disclosure requirements and make these instruments effective for ensuring market discipline.

7.62 The repeated bouts of international financial crises in the 1990s, including the recent spate of corporate accounting irregularities, have increasingly brought to the fore the multiple linkages between financial liberalisation, supervision and corporate governance. Prevention of financial fragility can come only through synergistic efforts of all stakeholders, *viz*., management, depositors, debtors and owners. Corporate governance assumes importance in this context in specifying the rights and responsibilities of various stakeholders and ensuring accountability within the decision making and implementation processes. Irrespective of the choice of the model for corporate governance, the key elements have to be timely and reliable public disclosures, independence of audit committees and obligations, strengthening of criminal penalties and addressing issues raising conflict of interest.

7.63 In consonance with the emerging financial environment, there is a conscious move away from micro-supervision towards off-site surveillance and risk-based supervision in India. The impetus for this has come from two sources: the need to infuse flexibility into the regime in the context of financial liberalisation, and to minimise the costs of the regulatory and supervisory function. Country experiences, including India's own, suggest that a mix of a risk-based supervisory framework (with effective prompt corrective action), detailed disclosure norms and conscious corporate governance could minimise the costs of supervision.

7.64 In recent years, there has been a significant transformation in the operating environment of development finance institutions (DFIs). Leading DFIs are in the process of getting converted into banks and in this context, a gap is emerging in the market continuum at the long end. DFIs have played a prominent role in providing industrial finance in India, particularly during the 1980s. Until the mid-1990s they complemented rather than competed with commercial banks in providing finance to Indian corporates. Commercial banks are now expected to play a greater role in bridging the gap in demand and supply of long-term funds faced by Indian corporates. In this context, the cross-country experience yields valuable lessons and banks are already in the process of introducing structured products, largely off-market, which adapt to the risk-return profiles of corporates. In this regard, banks have to contend with institutional, operational and regulatory issues such as (i) time consuming, costly and inadequate legal infrastructure for recovery of loans, especially long-term loans, (ii) difficulties in cash management for longer-term loans under a cash credit based system, (iii) significantly higher capital charges for providing funds to corporates as opposed to investment in government securities, (iv) lack of past expertise of banks in long-term lending and the lack of information base on term lending, (v) regulatory requirement for priority sector obligation linked to bank credit rather than total assets of banks, (vi) relatively higher liquidity of long-term investments in corporate securities compared to long-term loans to corporates and greater concern for credit risk as compared to market risk. Nevertheless, banks in India are poised to enhance their role into provision of long-term financing of corporates, including in the form of multi-agency approaches.

7.65 With the process of registration of NBFCs almost over, this sector is moving towards consolidation. The mushroom growth of NBFCs has been curtailed and with the weaker units weeded out, the NBFC sector is expected to become strong and vibrant and participate in the financing of higher growth. It is, therefore, important to preserve their integrity and financial soundness so that they emerge as viable financial intermediaries in India. Towards this goal, the Reserve Bank is refining its supervisory framework based on a four pronged mechanism consisting of on-site inspections based on the CAMELS rating system, a state-of-the art technology for effective scrutiny and monitoring of the returns (COSMOS) submitted electronically, market intelligence and exception reports from Statutory Auditors.

7.66 There is a progressive diffusion of computerisation and IT in the Indian financial system. Banks are increasingly integrating their own electronic funds transfer facilities with the Reserve Bank's Electronic Funds Transfer Scheme in order to offer innovative products to their customers. Major public sector banks are moving towards Core Banking Solutions, thus paving the way for 'anywhere banking' for a growing section of the banking public. Usage of the Structured Financial Messaging Solution (SFMS) by banks would help to speed up inter-bank financial communication in a secure mode, and result in quick flow of funds and financial information across branches and even amongst different banks. The payment systems in India are in the process of integration and technological upgradation, especially in large value payments. Currently foreign exchange transactions are being cleared domestically, resulting in a marked saving in terms of transaction costs. Retail payments are also being made faster and more efficient, including in debt and equity markets. The commencement of operations in the RTGS would have a positive impact on the efficiency and speed of the payment and settlement system.

Monetary Policy Issues

7.67 Since 1997, in addition to maintaining low inflation, the revival of investment demand has been an important concern in the setting of monetary policy in India. Accordingly, ensuring adequate liquidity and a preference for soft and flexible interest rates have characterised monetary policy formulation. This monetary policy stance has been signaled through cuts in the Bank Rate, LAF rates and the CRR. The pace and magnitude of easing has, however, been conditioned by the need to ensure macroeconomic and financial stability, particularly in the context of continuing large external capital flows. The full impact of the monetary policy stance on economic activity has been constrained by the structural rigidities in the financial system, especially on account of the downward inflexibility in the interest rate structure and operating costs of financial intermediaries. The conduct of monetary policy is faced with the dilemma of surplus liquidity in financial markets together with inadequate credit demand in the context of financing sustained growth in the real sector. Banks have improved their profitability by passively investing largely in government securities, reaping trading gains with the declining yields and rising prices. In this context, the improvement in banks' post-tax profits, while welcome, does not provide much room for comfort in the medium-term.

7.68 Further refinements in operating procedures have to be carried forward, both for day-to-day liquidity management and for equitable delivery of credit. This becomes necessary in the context of the soft interest rate stance and the need to maintain adequate liquidity in financial markets, while narrowing operating spreads in policy rates as well as market related rates. With the progressive integration of different segments in the financial market, it should be possible in the medium-term to fine-tune monetary policy operations to manage market conditions through a narrow interest rate corridor. With capital flows expected to remain strong, a key issue in the future would be greater innovation in the use of available instruments to deal with the expected strong capital flows. In this regard, it needs to be recognised that sterilisation is a first stage response for ongoing liquidity management until more durable policies can be put in place to absorb capital flows for the expansion of productive capacity. Furthermore, sterilisation has in-built costs and limitations. The growing internationalisation of monetary policy arising from the cross-border integration of financial markets also emerges as an important issue. In this context the exercise of discretion in the conduct of domestic monetary policy becomes challenging. There needs to be better clarity in the rules and responsibilities of monetary policy for ensuring effective macroeconomic policy co-ordination.

7.69 The Fiscal Responsibility and Budget Management Legislation provides a framework for the appropriate 'assignment' of fiscal and monetary policies. The Bill prohibits the Reserve Bank from subscribing to primary issues of Central Government securities, effective 2006-07. The Reserve Bank will continue, however, to purchase and sell government paper in the secondary market depending upon evolving liquidity and monetary conditions, consistent with the price situation. This would work towards strengthening the pursuit of growth in an environment of low and stable inflation. Recognising the possibility of unforeseen or special circumstances that could disturb financial stability, the Bill provides for some flexibility in these arrangements. Under well defined exceptional circumstances, the Reserve Bank will be enabled to subscribe to primary issues in consultation with the Government of India if considered necessary for providing stability.

7.70 In recent years, valuable lessons have been emerging for conducting monetary policy from the experience with managing the external sector during periods of external and domestic uncertainties - the need to keep a continuous vigil on market developments, the importance of building adequate safety nets that can withstand the effects of unexpected shocks and market uncertainties. In this context, India's exchange rate policy seems to have stood the test of time. It has focused on the management of volatility without a fixed rate target or a pre-announced target or a band and the underlying demand and supply conditions are allowed to determine the exchange rate movements over a period in an orderly way. The Reserve Bank will continue to follow the approach of watchfulness, caution and flexibility by closely monitoring the developments in the financial markets at home and abroad. It will co-ordinate its market operations carefully with appropriate monetary, regulatory and other measures as considered necessary from time to time.

Concluding Observations

7.71 To sum up, the macroeconomic fundamentals of the Indian economy are strong and have acquired a distinct resilience in the face of the periodic crises that characterised the previous decades. The overall policy environment has fostered macroeconomic stability, complementing financial stability, and this has generated optimism regarding the medium-term. As regards the financial sector, progress has been made in several areas, including enhancing accountability, improving management practices and corporate governance, and managing the pressures of structural changes. Considerable headway has been made in refining the regulatory and supervisory function, and fine-tuning it to the country-specific circumstances.

7.72 The main challenge that requires constant vigil in the macroeconomic management is that of reducing high fiscal deficits. Whereas expenditure containment must remain a continuing quest, particular attention must also be given to raising the tax/ GDP ratio along with concerted action to levy and collect appropriate charges for infrastructure and other services at both the Central and State levels. These actions are essential to correct and reverse the trend of increasing public sector dissavings that have emerged in recent years. Positive public sector savings are necessary to finance essential physical and social sector investments that will "crowd in" private sector investments for the achievement of self-sustaining, accelerated growth.

VIII - Monetary and Credit Policy

8.1 Monetary and Credit Policy for the year 2002-03 was formulated against the backdrop of comfortable liquidity conditions, a benign inflation environment and growing strength in the balance of payments and international reserves. The objective of revitalising investment demand dominated the conduct of monetary policy even while maintaining a continuous vigil on inflation. Accordingly, the policy stance remained accommodative with a commitment to ensure adequate liquidity to meet credit demand. A preference for softening of interest rates and greater flexibility in the interest rate structure in the medium-term was retained with changes in policy rates envisaged in response to the evolving liquidity and credit situation. Despite a modest recovery in industrial activity nurtured by the co-movement of non-food bank credit, the drastic shift in macroeconomic conditions due to the onset of the drought necessitated a preemptive easing in the monetary policy setting. Mitigating the deleterious effects of the drought on farm output and rural incomes emerged as a dominant concern. Amidst excess supply conditions in the financial markets, a decisive easing of monetary policy was signalled through cuts in the repo rate (June and October, 2002 and March 2003), in the Bank Rate (October, 2002) and in the CRR (June and November, 2002). Interest liabilities on farm loans were deferred and agricultural loans were rescheduled to provide a measure of financial relief to the drought affected areas. Improvements in the channels of bank credit flow to various sectors were facilitated by providing greater flexibility to banks in meeting allocations of lending to the priority sector, housing, the small scale sector, micro finance vehicles and rural infrastructure. Contending with large capital inflows engaged monetary policy throughout 2002-03. Efforts to sterilise the expansionary impact of the capital flows took the form of large open market sales and continuous repo operations under the LAF.

MONETARY POLICY OPERATIONS

8.2 The Bank Rate was reduced in stages to 6.25 per cent in October 2002, the lowest rate since May 1973, and by a further 25 basis points in April 2003. The Bank Rate has been reduced by 500 basis points in the last five years. This is the sharpest reduction in the Bank Rate since Independence. With the institution of the Liquidity Adjustment Facility (LAF), the repo rate has functioned as an informal floor for money market rates, providing a powerful signal to the market about the policy preference on interest rates. Ample liquidity conditions drove down money market rates frequently below the repo rate during 2002-03 prompting a 25 basis point reduction in the repo rate in June 2002, followed by another 25 basis point paring in October 2002 and a 50 basis point cut in March 2003. The repo rate has been adjusted downwards from 8.0 per cent in March 1999 to 5.0 per cent in March 2003. With a view to encouraging competition among banks and also to increase flow of credit to the export sector, interest rates on rupee denominated export credit were liberalised.

8.3 In April 2002, the ceiling rates on FCNR(B) deposits were revised downwards from LIBOR to LIBOR/SWAP rates of corresponding maturities minus 25 basis points. In April 2003, the minimum maturity period of fresh NRE deposits was raised from 6 months to 1 year in alignment with the maturity structure of FCNR(B) deposits. Effective July 17, 2003, the interest rates on fresh NRE deposits for one to three years should not exceed 250 basis points above the LIBOR/ SWAP rates for US dollar of corresponding maturity.

8.4 On a review of developments in the international and domestic financial markets, a 75 basis point reduction in the CRR during June to November, 2002 was followed by a further 25 basis points cut from June 14, 2003 taking the level of the CRR down to 4.5 per cent. The minimum daily maintenance of CRR was raised to 80 per cent of the average daily requirement for all the days of the reporting fortnight with effect from the fortnight beginning November 16, 2002. This was subsequently lowered to 70 per cent with effect from the fortnight beginning December 28, 2002. The payment of interest on eligible CRR balances maintained by banks was changed from quarterly basis to monthly basis from April 2003. The CRR has been almost halved since April 2000 resulting in cumulative release of first round resources of over Rs.33,500 crore.

8.5 From April 1, 2003, all scheduled UCBs have to maintain the entire SLR holdings of 25 per cent of NDTL in government and other approved securities only. Similarly, regional rural banks (RRBs) were required to maintain their entire SLR holdings in government and other approved securities by March 31, 2003 with SLR holdings of RRBs in the form of deposits with sponsor banks maturing beyond March 31, 2003 being reckoned for the SLR till maturity. The maturity proceeds of such deposits would have to be converted into government securities for RRBs not reaching the 25 per cent minimum level of SLR in Government securities by that time.

8.6 The medium-term objective of monetary policy is to move away from sector-specific refinance facility. Of the two standing facilities, *viz.*, export credit refinance (ECR) and collateralised lending facility (CLF) available to scheduled banks from the Reserve Bank, the latter was withdrawn with effect from October 5, 2002.

8.7 The LAF was actively used during 2002-03 to manage the injections of liquidity due to large capital inflows. Easy liquidity conditions in the market were reflected in the large repo bids received. The average daily repo bid amount received at overnight repo auctions was significantly higher at Rs.10,315 crore as against only Rs.162 crore for reverse repos. Net open market sales were higher during 2002-03 than in the previous year and in excess of the Reserve Bank's net subscription to primary issuance of government securities.

8.8 The conduct of monetary policy during 2002-03 was reasonably successful in the context of its objectives. There was a reduction in the deposit rates across all maturities. Longer-term deposit rates of commercial banks declined more sharply than the short-term rates. PLRs of public sector banks fell modestly to 9.0 - 12.25 per cent in March 2003. Sub-PLR lending of the banking system (excluding exports, the bulk of which is at sub-PLR rates) constituted over one-third of their total lending. Notwithstanding these reductions, the effective lending rates of commercial banks reflected high spreads.

Monetary Policy Stance for 2003-04

8.9 The increasing integration of the domestic markets and the sensitivity to impulses from the international financial markets pose new challenges for the conduct of monetary policy especially to the commitment to maintain adequate liquidity in the market with a preference for soft and flexible interest rates to the extent the evolving situation warrants.

8.10 Monetary policy for the year 2003-04 is set in conditions characterised by large accretion to foreign exchange reserves and improving prospects for agriculture with the revised expectations of a normal monsoon. Accordingly, considerable optimism characterises the prospects of real GDP growth, which was initially projected at 6.0 per cent. Inflation is expected to be in the range of 5.0 to 5.5 per cent. Non-food bank credit adjusted for investments in commercial paper, shares/ debentures/ bonds of public sector units (PSUs) and the private corporate sector is projected to increase by about 15.5-16.0 per cent in order to facilitate the sustenance of growth in industrial activity.

8.11 The overall monetary and macroeconomic conditions are, at present, satisfactory and in line with policy expectations. Nevertheless, the Reserve Bank would continue to keep a constant watch on the domestic and external situation. Monetary policy for 2003-04 is guided by the objective of provision of adequate liquidity to meet credit growth and support investment demand in the economy while monitoring carefully the movements in the price level. The policy stance continues to be one of preference for a soft and flexible interest rate environment within the framework of macroeconomic stability.

IX - Development and Regulation of Financial Markets

9.1 Adequate liquidity and orderly financial conditions facilitated the progress of reforms in the money, government securities and foreign exchange markets during 2002-03. In order to promote balanced development of the various segments of the money market, and to preserve its integrity and transparency, prudential limits on exposure of banks and primary dealers to call/notice money market were applied. This was accompanied by the infusion of vibrancy into the repo, commercial paper (CP), certificates of deposit (CD) and derivatives segments by easing entry conditions and providing flexibility in issuance. The deepening of the government securities market was carried forward with stricter regulation and surveillance. In the foreign exchange market, the prime objective has been to manage volatility, while there is no fixed target for the exchange rate which is determined by market forces. Liberalisation in current and capital account transactions was continued apace with a view to augment activity in the foreign exchange market, consistent with the growing openness of the economy, and to prepare market participants for greater sensitivity to volume-driven market movements. Priority was accorded during the year to modernising the technological infrastructure for markets in the form of automated screen-based trading under the Negotiated Dealing System (NDS) and risk minimising mechanism for efficient clearing and settlement under the Clearing Corporation of India Limited (CCIL).

MONEY MARKET

9.2 The basic objective of money market reforms continues to be the development of a proper short-term rupee yield curve with sufficient liquidity in all segments. The Reserve Bank has been following a four-fold strategy. First, with a view to transforming the call/notice money market into a pure inter-bank market, a phased exit of non-banks from the call/ notice money market was started in May 2001. As the implementation of Stage I did not cause any strain in the call/notice money market and in view of the encouraging progress in NDS/CCIL, the process of moving towards a pure inter-bank call money market was accelerated with the implementation of the Stage II in June 2003. Secondly, prudential limits were assigned on call exposure during 2002-03. The objective is to ensure that banks use the call/notice money market to finance only temporary mismatches. Thirdly, with the liquidity adjustment facility (LAF) emerging as a primary instrument for modulating day-to-day liquidity conditions and providing a corridor for market play, the sector-specific standing liquidity support to the banks and primary dealers was rationalised. Fourthly, measures (discussed below) were taken to make other money market instruments freely accessible to non-bank participants. These measures were intended to improve depth, efficiency and transparency in money market operations.

9.3 The limit on maximum daily call/ notice money borrowings at two per cent of aggregate deposits at the end of March of the previous financial year, that had been placed on Urban Co-operative Banks (UCBs) was extended to State Cooperative Banks (StCBs) and District Central Co-operative Banks (DCCBs) on April 29, 2002. Furthermore, prudential limits on borrowing and lending in call/ notice money market were stipulated for scheduled commercial banks (SCBs) with a view to preserving the integrity of the financial system and facilitating the development of the repo market. A two-fold strategy was adopted in order to ensure that these banks do not face any disruption in their asset-liability management (ALM). Borrowers and lenders were allowed to unwind their positions by October 4, 2002. Second, the application of caps on banks in the call/notice money market was undertaken in two stages, commencing from the fortnights beginning October 5, 2002 and December 14, 2002, respectively. Any bank facing mismatches was allowed to approach the Reserve Bank for temporary access to the call/notice money market in excess of the stipulated limit. An increased access over stipulated norms was also permitted for a longer period for banks with fully functional and satisfactory ALM systems.

9.4 In view of the encouraging results from the functioning of NDS and CCIL and to facilitate further deepening of repo/term money market, the Stage II of the transition was made effective from the fortnight beginning June 14, 2003. Non-bank participants were allowed to lend, on an average in a reporting fortnight, only up to 75 per cent of their average daily lending in the call/notice money market during 2000-01. The Reserve Bank may consider providing temporary permission to lend higher amounts in the call/notice money market for a specific period on a case-by-case basis.

9.5 In pursuance of the recommendations of the Working Group on Rupee Derivatives (Chairman : Shri Jaspal Bindra), banks and primary dealers were permitted to undertake transactions in exchange traded interest rate derivatives in June 2003. Trading in futures contracts in notional 10-year Government of India bonds, notional 91-day Treasury Bills and 10-year zero coupon bonds commenced at the National Stock Exchange on June 24, 2003.

9.6 Collateralised Borrowing and Lending Obligation (CBLO) was operationalised as a money market instrument through the Clearing Corporation of India Ltd. (CCIL) on January 20, 2003. The CBLO has original maturity between one day and up to one year. In order to develop CBLO as a money market instrument, it has been exempted from CRR subject to banks maintaining minimum CRR of three per cent. As on July 31, 2003, 52 members were admitted in CCIL's CBLO segment. The total turnover in CBLO during January 20, 2003 – July 31, 2003 stood at Rs.7,925 crore amounting to a daily average turnover of Rs.74 crore.

9.7 The eligibility to participate in the repo market was expanded with effect from March 3, 2003 to include non-SGL account holders like non-banking financial companies, mutual funds, housing finance companies and insurance companies. These entities were permitted to access the repo market through their "gilt accounts" maintained with the custodians. Since they do not maintain current and SGL accounts with the Reserve Bank, necessary precautions were built in to ensure "Delivery *versus* Payment" (DvP) and transparency while restricting the repos to government securities only. Repos between a custodian and its own clients as well as between clients of the same custodian are not permitted as DvP cannot be ensured for these transactions.

GOVERNMENT SECURITIES MARKET

9.8 Since the early 1990s, the Reserve Bank has been engaged in the deepening and widening of the primary and secondary segments of the government securities market in order to obviate the need for monetisation of fiscal deficits, as part of reforms in monetary-fiscal coordination. Significant steps taken by the Reserve Bank in the recent period include elongation of maturity, development of new benchmark government securities by consolidating new issuances in key maturities, enhancing fungibility and liquidity by reissuances of existing loans, promoting retailing of government securities, introduction of floating rate bonds, announcement of a core calendar and enhanced transparency of the Central Government's borrowing programme.

9.9 The Negotiated Dealing System (NDS) has stabilised since its inception on February 15, 2002. Almost all market participants have joined NDS and Subsidiary General Ledger (SGL) transactions at the Public Debt Office (PDO), Mumbai are now on electronic mode through NDS.

9.10 Clearing Corporation of India (CCIL) commenced operations with transactions in government securities as well as Rupee/US dollar foreign exchange spot and forward deals since November 12, 2002. Effective April 1, 2003 all transactions in government securities in the Public Debt Office (PDO), Mumbai are now being settled through CCIL which has resulted in significantly reduced funding requirement for every member and mitigation of liquidity risk.

9.11 Buying and selling of government securities through the stock exchanges (National Stock Exchange (NSE), Stock Exchange Mumbai (BSE) and Over the Counter Exchange of India (OTCEI) was allowed with effect from January 16, 2003 on an anonymous screen-based order-driven basis to facilitate countrywide access and wider participation in the government securities markets.

FOREIGN EXCHANGE MARKET

9.12 Reforms in the foreign exchange market were carried forward to deepen various segments of the market and impart sophistication to its functioning. Market participants were allowed greater flexibility of operations in both spot and forward segments, especially in managing risks. Alongside the introduction of new instruments, significant liberalisation was effected in international current and capital transactions. These efforts are intended to prepare the market for equilibrating significantly higher volumes, and for improving the process of price discovery, supported by the ongoing modernisation of the technological infrastructure. The development of the foreign exchange market in India has been facilitated by the stance of exchange rate policy – underlying demand and supply conditions are allowed to determine exchange rate movements in an orderly manner.

Outlook

9.13 The Reserve Bank has pursued a process of consultation with market participants in its endeavour to deepen and widen the financial markets so as to enhance allocative efficiency, preserve financial stability and improve the transmission of monetary policy. The objective is to ensure balanced development of various segments of the financial market as also to preserve integrity and transparency of market operations. The operationalisation of the CCIL, NDS and CFMS combined with the advanced stage of implementation of centralised PDO and the RTGS system would contribute to efficient functioning of the markets. Simultaneously, efforts are underway to reduce market overlap and to develop segments which cater exclusively to specific classes of instruments and participants. This will enhance efficiency and contain risk in a systemic sense.

9.14 The progress of money market reforms so far has been satisfactory and without undue strains on market conditions. The transformation of the call/notice money market into a pure inter-bank market is progressing and the accessibility of non-banks would be further reduced before being eventually phased out. The implementation of borrowing restrictions on primary dealers in call/notice money market is contingent on further developments in the repo market. A wider array of hedging instruments have been made available to the market as banks and PDs have been permitted to undertake exchange traded futures and foreign currency-rupee OTC options with suitable safeguards.

9.15 In the government securities market, various measures are being undertaken to widen the base of repo transactions by extending coverage to CSGL account holders, and to allow rollover of repo contracts using the same securities between the same counter-parties. Allowing sale of securities purchased under repo, widening of the repo market to all entities including corporates and extending the eligibility to all debt instruments including rated corporate bonds are some of the measures under active consideration. Furthermore, a “when issued” market for government securities would help efficient price discovery in the primary auctions. Widening of the instrument base through introduction of inflation indexed bonds and STRIPS in the government securities market is in progress. Measures to further develop the retail market for government securities using PDs and banks are being considered. The scheme of trading of government securities on stock exchanges through order-matching screen-based trading has been introduced and ways of enhancing investor interest are being examined. The implementation of the next phase of the PDO-NDS project involving integration with security settlement system and primary markets operations, automation and inter-connectivity of PDOs, electronic maintenance of record of ownership will represent a step forward in improving the government securities market.

9.16 With regard to the foreign exchange market, the Reserve Bank will continue to follow the approach of preparing the market for transacting rising volumes of international transactions. A key priority is to avoid disruptive shifts in volatility and market sentiment. Accordingly, the Reserve Bank will continue its stance of watchfulness, caution and flexibility by closely monitoring the developments in the markets at home and abroad, with appropriate monetary, regulatory and other measures as considered necessary from time to time.

X Financial Regulation and Supervision

10.1 In India, progressive strengthening of the regulatory and supervisory framework has been a key element of financial sector reforms. There has been significant progress in achieving international best practices in banking regulation and supervision. Within the process of convergence with best practices, fine-tuning is undertaken keeping in view the country-specific circumstances. The process of refining the crucial functions of regulation and supervision of the financial system in India gathered further momentum in 2002-03 in the context of dramatic shifts in the macroeconomic and financial environment. The focus of policy initiatives during the year was on streamlining banking operations, upgrading risk management systems, enhancing the level of compliance by banks with the Accounting Standards and operationalising consolidated accounting practices. A major development in the evolving institutional infrastructure for financial regulation was the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 which is expected to improve the recovery of non-performing loans. Policies for regulation and oversight of the financial system were guided by the objectives of increasing operational efficacy of monetary policy, redefining the regulatory role of the Reserve Bank, strengthening prudential norms and developing the technological and institutional infrastructure.

THE BOARD FOR FINANCIAL SUPERVISION (BFS)

10.2 The Board for Financial Supervision (BFS), formed in November 1994 under the aegis of the Reserve Bank, is responsible for an integrated system of supervision of banks, financial institutions (FIs) and non-banking financial companies (NBFCs) regulated by the Reserve Bank.

10.3 During 2002-03 (July-June), the BFS held 11 meetings. It reviewed the performance of regulated financial entities on the basis of 101 Inspection reports of banks/FIs. The Board also reviewed the monitoring of bank frauds, house-keeping in PSBs, including reconciliation of entries in inter-branch accounts, inter-bank accounts (including *Nostro* accounts) and balancing of the books of accounts. The performance of Primary Dealers (PDs) as a group was reviewed by the BFS. Besides delineating the course of action to be pursued in respect of institution-specific supervisory concerns, the BFS provided guidance on several regulatory and supervisory policy decisions.

10.4 At the initiative of the BFS, studies were also conducted on the impact on capital adequacy of converting excess SLR holdings into loan assets, capital market exposures of banks and the differences in the provisioning norms being followed by Indian banks and those applicable to banks in the US under their Generally Accepted Accounting Principles (GAAP). Another important study conducted under the direction of the BFS was the analysis of slippages of NPA accounts from sub-standard to doubtful/loss category.

10.5 Keeping in view the emerging supervisory concerns, six banks in the old private sector group and five banks in the new private sector group were placed under monthly monitoring. The scope of monthly monitoring is being expanded to include the progress in recovery of NPAs.

SCHEDULED COMMERCIAL BANKS

10.6 Subsequent to the introduction of the SARFAESI Act, 2002, the Reserve Bank issued fresh guidelines for onetime settlement scheme in January 2003 for compromise settlement of chronic NPAs up to Rs.10 crore in PSBs. These guidelines cover: (a) all NPAs in all sectors, irrespective of the nature of business, which have become doubtful or loss assets as on March 31, 2000 with outstanding balance of Rs.10 crore and below on the cut-off date; (b) NPAs classified as sub-standard as on March 31, 2000, which have subsequently become 'doubtful' or 'loss' assets; and (c) cases in which the banks have initiated action under the SARFAESI Act, 2002 and also cases pending before Courts/ Debt Recovery Tribunals (DRTs)/Board for Industrial and Financial Reconstruction (BIFR), subject to consent decree being obtained from the Courts/DRTs/BIFR. The last date for receipt of applications from borrowers under the scheme is September 30, 2003.

10.7 Guidelines for the special OneTime Settlement (OTS) scheme for loans up to Rs.50,000 to small and marginal farmers by PSBs were operative up to December 31, 2002. They were extended up to March 2003 in view of requests received from banks and the drought/ flood situation in various parts of the country.

10.8 The Reserve Bank issued guidelines to commercial banks and FIs to enable them to make increasing use of *Lok Adalats*. They were advised to participate in the *Lok Adalats* convened by various DRTs/DRATs for resolving cases involving Rs.10 lakh and above to reduce the stock of NPAs.

10.9 The Debt Recovery Tribunal (Procedure) Rules 2003 were amended substantially regarding application fee and plural remedies for better administration of the Recovery of Debts due to Banks and Financial Institutions Act, 2002. The passage of the SARFAESI Act, 2002 has provided the necessary impetus for banks and FIs to hasten the recovery of the dues.

10.10 Off-site monitoring and surveillance (OSMOS) function was established in 1995 with the primary objective of analysing the financial position of banks in between on-site inspections. A comprehensive OSMOS became fully operational in 1997. Since then, the scope and coverage of the off-site returns have been enhanced significantly. In view of the recent initiatives on consolidated supervision, country risk management and risk-based supervision, certain additional data needed to be collected through the off-site returns. Accordingly, an upgraded OSMOS system, including new returns as well as enhancing the coverage of the existing ones, has been implemented from the quarter ended June 2003.

10.11 Guidelines on consolidated supervision were issued to banks for implementation with effect from the year ended March 2003. Banks were advised to ensure strict compliance commencing from the year ended March 31, 2003. This would enable the Reserve Bank in adhering to the *Core Principles for Effective Banking Supervision.*

10.12 The scheme of prompt corrective action (PCA) was developed for preemptive adjustments by troubled banks to early signs of financial vulnerability. The scheme is in operation, initially for a period of one year from December 2002. Continuation or otherwise of the PCA framework as well as modification in the trigger levels or actions to be taken will be reviewed in December 2003.

10.13 To ensure a smooth transition to Risk Based Supervision (RBS) and to facilitate the requisite preparation, commercial banks were involved in a consultative process to identify the support required by them in this regard. The Risk Profile Template (RPT) has been tried by banks for undertaking self-assessment of risks and found suitable. Training of commercial bank officers as well as the Reserve Bank supervisory staff at the training colleges of the Reserve Bank has made considerable progress. On-location and dedicated programmes on risk based supervision and risk management have also been conducted for banks. The RBS Manual has been prepared for use by the Reserve Bank supervisory staff. The pilot run of risk-based supervision of select banks was initiated during the quarter April-June 2003.

10.14 Several countries, including India, have undertaken efforts towards developing macro-prudential indicators (MPIs) for monitoring the health of the financial system. Accordingly, a pilot review of MPIs was prepared for the half-year ended March 2000, followed by regular half-yearly reviews from September 2000 onwards for internal circulation. The scope and coverage of MPIs were enhanced in the review for the half-year ended March 2002.

10.15 The Government of India introduced Special Economic Zones (SEZs) with a view to providing an internationally competitive and a hassle-free environment for export production. For the first time, Offshore Banking Units (OBUs) were permitted to be set up in SEZs. These units would be virtually foreign branches of Indian banks but located in India. These OBUs, *inter alia*, would be exempted from cash reserve requirements and would be able to provide finance to SEZ units and SEZ developers at international rates of interest.

10.16 The Reserve Bank has been continuously making efforts to ensure convergence of its supervisory norms and practices with the international best practices. In regard to accounting standards issued by the Institute of Chartered Accountants of India (ICAI), banks in India are generally complying with most of these standards.

10.17 Scheduled commercial banks (SCBs) improved their profitability in 2002-03. Net profits (as a ratio of total assets) increased from 0.8 per cent during 2001-02 to 1.0 per cent during 2002-03, largely due to higher non-interest income and lower interest expenses. Non-interest income increased from 1.6 per cent of total assets in 2001-02 to 1.9 per cent in 2002-03 on account of treasury operations. Reflecting the soft interest rate environment, interest income as well as interest expenses (both as a ratio to total assets) moderated during the year to 8.4 per cent and 5.6 per cent, respectively. The reduction in the interest expenses ratio (around 22 basis points) was relatively sharper than that on the income side (around four basis points) suggesting that decline in lending rates was not commensurate with that in deposit rates. Banks were able to contain their operating expenses at 2.3 per cent of their total assets. At the end of March 2003, almost all SCBs (92 out of a total of 93) complied with the regulatory requirement of CRAR of nine per cent. There was a further improvement in the NPAs position of banks, both in relation to assets and advances. This reflected, *inter alia,* recent initiatives at improving recovery. The number of banks with net NPAs (as a proportion of net advances) above 10 per cent fell from 23 during 2001-02 to 12 during 2002-03.

CO-OPERATIVE BANKING

10.18 Since 2001-02, the Reserve Bank has undertaken a series of measures directed towards strengthening the financial position of the UCBs, such as applying capital adequacy standards, prescribing an asset-liability management framework, enhancing the proportion of holding of Government and other approved securities for the purpose of SLR, restriction on bank finance against the security of corporate shares and debentures. During 2002-03, these efforts were reinforced. Deposits and advances of scheduled UCBs increased marginally during the year, and their growth was significantly lower than that of the commercial banking system. A positive aspect of the performance of the UCBs was a reduction in net NPAs, both in absolute terms as well as a proportion to net advances, reflecting the recent supervisory initiatives.

FINANCIAL INSTITUTIONS

10.19 During 2002-03, the main focus of policy initiatives of the Reserve Bank for select all-India financial institutions[1] (FIs) was on imparting operational flexibility, strengthening the prudential regulatory and supervisory framework, and improving accounting and auditing standards. The Government undertook restructuring packages for some of the FIs, taking into account their financial performance, rising NPAs, adverse market conditions for raising resources, and challenges posed by commercial banks under a competitive environment. All FIs, except IFCI Ltd. and IIBI Ltd., had a CRAR much above the norm of nine per cent as at end-March 2003. The net NPAs of all-India FIs increased during 2002-03 due to slow economic recovery, sectoral bottlenecks and adverse domestic/international market conditions. IDFC Ltd., NHB and NABARD continued to maintain nil or negligible NPAs. The Corporate Debt Restructuring (CDR) mechanism became operational from March 2002 with the execution of the Inter-Creditor Agreement (ICA) on February 25, 2002 by 47 institutions/ banks. The CDR Empowered Group approved final schemes in respect of 41 cases in which aggregate assistance by financial system amounted to Rs.38,638 crore; 18 cases were rejected and the remaining 12 cases are being processed.

NON-BANKING FINANCIAL COMPANIES

10.20 At end-June 2003, a total of 37,859 applications were received by the Reserve Bank for grant of Certificate of Registration (CoR). Of these, approval was granted to 13,863 applications, including 725 applications of companies authorised to accept/hold public deposits. At the end of September 2002, almost 94 per cent of the NBFCs reported a CRAR equal to or in excess of the stipulated minimum of 12 per cent with as many as 74 per cent reporting a CRAR above 30 per cent. The gross and net NPAs of reporting companies have been showing a declining trend. The gross NPAs, which formed 12.0 per cent of the credit exposure in September 2001, came down to 9.7 per cent in September 2002. Over the same period, the net NPAs came down from 5.8 per cent to 4.3 per cent of credit exposure.

Outlook

10.21 Over the medium-term, the conduct of financial regulation and surveillance in India would progress from micro-regulation to macro-management, supported by a tightening of prudential norms and improvements in the functioning of the financial markets. A clearer definition of the regulatory role of the Reserve Bank is emerging within the broader debate on the conflict of interest between ownership and regulation. Co-operative banking is being sensitised to the changing context of financial regulation through enhanced standards of disclosure and governance, and a disentangling of the existing regulatory overlap.

10.22 The supervisory strategy of the Board for Financial Supervision would increasingly blend on-site inspection, off-site surveillance, enhanced role of external auditors and strengthening of corporate governance. Banks need to prepare for switching fully to risk-based supervision by 2003 by identifying information gaps in the compilation of risk profiles and training of personnel. The supervisory follow-up process will then involve a monitorable action plan including remedial actions and timely corrective steps.

10.23 Banks are being encouraged to improve the reliability and robustness of their risk management, management information and supervisory reporting systems. A scheme of prompt corrective action based on early warning triggers is evolving as a supervisory tool and would increasingly be adapted to country-specific circumstances. In addition to macro-prudential indicators of financial vulnerability being reviewed in India, financial soundness indicators have been proposed as early warning signals. The Reserve Bank and the Government have initiated a wide range of legal reforms to enable the regulatory and supervisory regime to keep pace with advancements in information and communication technology.

XI - Public Debt Management

11.1 Debt management in 2002-03 continued to be directed at minimising cost, keeping in view the rollover risk, within the overall objectives of monetary policy. The borrowing programmes of the Central and State Governments were completed successfully with gross market borrowings of Rs.1,81,979 crore. The Central Government mobilised market borrowings to the tune of Rs.1,51,126 crore (net Rs.1,04,118 crore) during 2002-03 as against Rs. 1,33,801 crore (net Rs.92,302 crore) in the preceding year. The gross and net borrowings through dated securities amounted to Rs.1,25,000 crore and Rs.97,580 crore, respectively while Rs.26,126 crore (gross) and Rs.6,538 crore (net) were raised through 364-day Treasury Bills. The gross and net market borrowings of the State Governments amounted to Rs.30,853 crore and Rs.29,064 crore in 2002-03 as compared with Rs.18,707 crore and Rs.17,261 crore in the preceding year, respectively. Comfortable liquidity conditions due to increased capital flows, absence of pressures on account of credit off-take, and reductions in CRR combined with appropriate private placements, facilitated the smooth completion of a large market borrowing programme. The weighted average cost of borrowings declined significantly during the year, benefiting from falling yields due to easy liquidity conditions and low inflation.

11.2 The Reserve Bank continued to combine private placements with open market operations to meet the twin objectives of managing liquidity in the system and containing volatility in the secondary market. New initiatives in debt management included pre-payment of external debt against issue of domestic debt, a debt-swap scheme for the State Governments and a debt buy-back scheme which involved buying back of high cost and illiquid securities issued in the past in exchange of new securities at the prevailing market yield. Comprehensive restructuring of the scheme of Ways and Means Advances (WMA) and overdraft (OD) for States was also undertaken during 2002-03.

CENTRAL GOVERNMENT

11.3 The Ways and Means Advance (WMA) limits of the Centre were maintained at Rs.10,000 crore for the first half (April-September) and Rs.6,000 crore for the second half (October-March) of 2002-03. The daily average utilisation of WMA and overdraft (OD) was, however, significantly lower.

11.4 The gross amounts raised through 91-day and 364-day Treasury Bills were higher during 2002-03. There was no devolvement on the Reserve Bank in any auction of the Treasury Bills during 2002-03. During the current year so far (up to August 6, 2003) the primary yield of 91-day and 364-day Treasury Bills declined by 97 and 94 basis points, respectively, from their March-end levels. Since April 23, 2003, the primary yields of both 91-day and 364-day Treasury Bills fell below the repo rate, mainly due to abundant liquidity. The notified amount of 91-day Treasury Bills was enhanced from Rs. 500 crore to Rs. 1,500 crore for eight auctions from August 6, 2003 to September 24, 2003 keeping in view the prevailing liquidity conditions in the system.

11.5 The Central Government raised a gross amount of Rs.1,25,000 crore and a net amount of Rs.97,580 crore during 2002-03 through issuance of dated securities. The gross and net market borrowings increased by 9 per cent and 11 per cent, respectively, over the preceding year. The ratio of net market borrowing through dated securities to the gross fiscal deficit moved up to 67.1 per cent in 2002-03 from 62.2 per cent in 2001-02. The policy of elongation of maturity of government securities was persevered with. The maximum maturity of securities issued was extended to 30 years in 2002-03 as compared with 25 years in 2001-02. There was a marginal fall in the weighted average maturity of securities issued during the year. This occurred mainly because of the issuance of securities for prepayment of foreign debt on maturity matched basis for an average tenor of 9.3 years. The scheme of non-competitive bidding, which was introduced in January 2002 to facilitate investment by retail and mid-segment investors in Central

Government securities, was made an integral part of the borrowing programme since October 2002. During 2002-03, out of a total reserved amount of Rs.4,050 crore, the non-competitive bidders were allotted Rs.1,302 crore, amounting to 32.2 per cent of the reserved amount. In the individual auctions, the response of non-competitive bidders varied from 8 per cent to 88 per cent of the reserved amount.

11.6 In line with the policy of ensuring sufficient securities in the portfolio of the Reserve Bank to conduct open market operations (OMO), the Government of India converted Rs.40,000 crore of 4.6 per cent Special Securities held in the Reserve Bank's portfolio into marketable securities of various maturities (3 to 18 years) at the prevailing yields in 2002-03. The outstanding balance of the Special Securities has accordingly diminished.

11.7 The budget estimate of the net market borrowing of the Central Government through dated securities for the year 2003-04 is placed at Rs.1,07,320 crore. Including repayments of Rs.32,910 crore, the gross market borrowing through dated securities amounts to Rs.1,40,230 crore, an increase of 12.2 per cent over the previous year's level. The calendar for the first half covering 50.6 per cent of the market borrowing programme was announced on March 31, 2003.

11.8 During the current year so far (up to August 7, 2003), the Central Government raised gross amount of Rs.88,434 crore (net Rs.61,316 crore), including Rs.14,434 crore raised on account of buy-back of Government securities; and Rs.5,000 crore was through private placement. On May 19, 2003, a Floating Rate Bond 2014 was issued for the notified amount of Rs.5,000 crore. The maximum amount for non-competitive bidding was raised from Rs. 1 crore to Rs. 2 crore from this auction onwards. The cut-off yield was at 5.09 per cent, 14 basis points above the variable base rate. Under the modified design of floating rate bonds, the variable base rate is determined on the basis of average cut-off yield emerging in the preceding three auctions of 364-day Treasury Bills instead of preceding six auctions earlier. It also provides for annual reset of variable base rate for fixation of coupon as against half yearly reset earlier. The coupon payment, however, continue to remain semi-annual.

STATE GOVERNMENTS

11.9 The Reserve Bank provides WMA to States with a view to help them tide over temporary mismatches in cash flow. The WMA limits are fixed by the Reserve Bank from time to time. Drawing from the recommendations of the Ramachandran Committee (2002) and consultations with the State Governments, the Reserve Bank revised the Scheme of Ways and Means Advances for the States, effective March 3, 2003 to give them the benefit of higher limits in the last month of the fiscal year. The revised normal WMA limits have been computed by taking into account the average of revenue receipts for the three fiscal years 1999-2000, 2000-01 and 2001-02 and then applying a multiplication factor of 3.19 for the non-special category States and 3.84 for the special category States. The total normal WMA limits effective from March 3, 2003 at Rs.7,170 crore was 18.8 per cent higher than the earlier limit of Rs.6,035 crore.

11.10 States resorted to large volumes of market borrowings in 2002-03. States raised Rs.30,853 crore (Rs.27,880 crore through tap issuances and Rs.2,973 crore through auctions), an increase of 65 per cent over Rs.18,707 crore (Rs.15,942 crore through tap issuances and Rs.2,765 crore through auctions) during 2001-02. The interest rates on tap issues ranged between 6.60-7.80 per cent with a spread fixed in the range between 38-52 basis points over the corresponding secondary market yield of Government of India dated securities. The cut-off yields on auctions ranged between 6.67-8.00 per cent with a spread ranging between 20-76 basis points over the corresponding secondary market yield of Government of India dated securities. Of the States that used the auction method, some were able to mobilise loans at competitive rates (Punjab and Andhra Pradesh) while others had to pay higher rates (Kerala and Jammu and Kashmir).

11.11 The Union Budget for 2003-04 has envisaged measures for debt restructuring as a part of fiscal consolidation. They encompass pre-payment of external debt, buy-back of loans by the Government from the banks on voluntary basis and restructuring of State Governments' debt to the Centre through a debt swap scheme. The Central Government prepaid foreign currency loans to these institutions amounting to US $ 3.0 billion. The possibility of further repayments of external debt is being explored.

11.12 The buy-back of high coupon loans by the Central Government from banks and debt-swap by the State Governments are the two schemes aimed at restructuring the domestic debt.

Outlook

11.13 The conduct of debt management continues to be driven by the objectives of reducing costs and elongating maturities while ensuring the smooth completion of the Centre's and States' borrowing programmes. The process of debt consolidation and efforts at enhancing the benchmarking of securities would be persevered with. Undue elongation of the maturity profile could increase interest rate risks. Accordingly, the issue of capital indexed and more floating rate bonds are under active consideration. It is expected that stripping of government securities will be operationalised after the Government Securities Act is passed in the Parliament. In the case of Treasury Bills, as in the past, the amounts offered in the auctions would be modulated keeping in view the liquidity conditions. In the secondary market, measures like rollover of repo and operationalisation of DVP III settlement system, measures to further develop the retail market for government securities using the PD network and banks would be accelerated. The Reserve Bank would develop the debt markets further through over the counter (OTC) as well as exchange traded interest rate derivatives (interest rate futures trading has commenced since June 24, 2003). Efforts are underway to introduce interest rate options on exchanges, broaden the eligible underlying to other items in the balance sheet for hedging through derivatives and permit market making to those banks that have the required risk management capabilities. Initiatives are being taken to harmonise regulations in respect of OTC derivatives with exchange traded interest rate derivatives.

XII - Currency Management

12.1 The core central banking function of note issue and management of currency in circulation is performed by the Reserve Bank with the objectives of ensuring adequate availability of notes and coins in the economy and maintaining the quality of notes in circulation. This is done through its 18 regional Issue Offices/sub-offices and a wide network of currency chests, repositories and small coin depots spread across the country. In 2002-03, the sub-offices of the

Issue Department at Bhopal and Chandigarh and the currency chest at Jammu were converted into full-fledged Issue Offices. Sixty-four additional currency chests and 46 additional small coin depots were opened during the year. The demand for notes and coins was addressed by sending remittances to currency chests and by issue of notes and coins over the counters of Issue Offices. With improvements in the supply position of fresh notes and coins, efforts were directed towards improving the quality of notes in circulation through a number of measures. Adequate supply of fresh notes to bank branches during episode of liquidity stress was ensured by keeping the vaults of Issue Offices open beyond office hours and also on sundays/public holidays.

Clean Note Policy - Quality of Notes in Circulation

12.2 In pursuance of the Clean Note Policy, efforts for improving the quality of notes in circulation were directed towards replacing soiled notes in circulation by fresh or reasonably good quality notes. Key measures in this regard included mechanisation of note processing-cum-verification and eco-friendly destruction of soiled notes, widening of the currency chest network, non-stapling of note packets, speeding up handing over and taking over of remittances by the chests, and continuation of anti-counterfeit steps.

12.3 Tracking of new type of forgeries and scrutiny in association with the Security Paper Mill and Note Printing Presses is an important step. The Reserve Bank's main thrust continues to be on dissemination of security features of bank notes to the public and other agencies like banks, Government departments, police and intelligence agencies. Enhanced security features in the form of improved public features and machine-readable features in bank notes are being incorporated in consultation with the Government of India. The notes in the Ashoka Pillar Series, *i.e.*, Ashoka Pillar in watermark window, are being phased out from circulation as they do not contain adequate anti-counterfeit security features as compared with the Mahatma Gandhi series notes which were introduced in 1996.

12.4 The Reserve Bank would pursue its objective of meeting the currency demand of the economy and improving the quality of notes. Installation of additional Currency Verification and Processing Systems would be undertaken to ease the accumulation of soiled notes in the Issue Circles. Constant surveillance over the system of distribution of notes and coins would be strengthened with a view to enlarging/improving the distribution of fresh notes and coins. Innovative measures like distribution of coins through post offices would be expanded. Customer service would be upgraded through mobile issue of coins and introduction of Rs.10 coins. Enhanced security features in the form of improved public features in bank notes are being devised to prevent counterfeiting. These features will be complementary to the process of mechanisation of currency operations.

XIII - Payment and Settlement Systems

13.1 The information technology revolution has thrown up powerful synergies with banking and finance. In particular, there are four key areas in which the financial system has experienced the benefits of the technology revolution: product development, market infrastructure, risk control and market reach. In the process, technology has changed the contours of three major functions of financial intermediaries: access to liquidity, transformation of assets and monitoring of risks.

13.2 In recent years, the Reserve Bank has assigned priority to upgrading the technological infrastructure of the Indian financial system. Efforts have been made to modernise clearing and payment through Magnetic Ink Character Recognition (MICR) based cheque clearing, Electronic Clearing Services and Electronic Funds Transfer (ECS and EFT) and the Centralised Funds Management System (CFMS). A key prerequisite for the development of the financial system is a modern, efficient, integrated and secure payment and settlement system. The goal is to put in place systems which conform to international standards and best practices.

13.3 At present, key large value payment systems such as the Negotiated Dealing System (NDS) and foreign exchange clearing adhere fully to the Core Principles for Systemically Important Systems of the Bank for International Settlements (BIS). Retail payment systems comply partially with the Core Principles. Efforts are on to make these systems also fully compliant to the Core Principles by providing a legal basis for netting and provision of risk reduction measures for netting systems.

13.4 The Reserve Bank is in the process of implementing the National Electronic Funds Transfer (NEFT) System - a nation-wide electronic funds transfer system - to provide for transfer of funds electronically across a large number of bank branches in the country. As a first step, a Special Electronic Funds Transfer (SEFT) System was implemented with effect from April 1, 2003. The System is designed to provide for same day inter-bank transfer of funds between accounts maintained in any of the designated participating branches which are networked so that SEFT messages could be transmitted electronically. SEFT provides for multiple daily settlements, with three settlement cycles on weekdays (at 12:00 noon, 2:00 p.m. and 4:00 p.m.) and two settlements on Saturday (at 12:00 noon and 2:00 p.m.). The System also facilitates timely funds settlement for the T+2 based rolling settlement introduced for settlement of securities at the stock exchanges.

Settlement Systems

13.5 The imperative for ensuring the integrity of settlement systems stems from the need to minimise risks inherent in payments. The settlement of foreign exchange clearing operations, which commenced from November 2002, is guaranteed by the Clearing Corporation of India Ltd. (CCIL). Effective May 1, 2003, all inter-institutional over-the-counter (OTC) transactions in Government securities, whether outright or repo, are traded through the NDS only.

Information Technology (IT) in the Reserve Bank

13.6 All activities of the Reserve Bank are getting increasingly IT-enabled. The implementation of IT in the Reserve Bank is based on the mission "IT for Overall Efficiency and Excellence". The Reserve Bank aims to bring in transaction processing and analytical capabilities at the desk top of each official in order to equip the functionaries to complete transactions in a timely and accurate manner and to make informed decisions. This will also usher in a Less-Paper Office. Furthermore, the Reserve Bank is committed to providing efficient customer service to the Governments, banks, financial institutions and general public, using the tools and solutions offered by information and communication technology.

13.7 In order to address each constituent of the INFINET/SFMS system uniquely, a system of Indian Financial System Codes (IFSC) was designed during 2002-03, similar in approach to that of SWIFT.

Outlook

13.8 The Reserve Bank will continue with its efforts to establish a modern, robust, efficient, secure, and integrated payment and settlement system for the country. Significant milestones in this path are the Negotiated Dealing System for transactions in Government securities and the Clearing Corporation of India. The INFINET would emerge as the communication backbone of the financial system. The operationalisation of RTGS System would enable real time funds transfers across different banks and thereby provide for optimal utilisation of funds.

13.9 The future of banking and finance hinges around the exploitation of opportunities thrown up by the technology explosion. This requires the combined efforts of all participants in the financial system. In December 2001 the Reserve Bank set out its vision of the road ahead in the document entitled "Payments System in India", to share this vision with all participants and the nature and direction of reforms needed to achieve it. The collective goal should be to make use of synergies between technology and finance to maximise the benefits to society.

XIV - Human Resource Development and Organisational Matters

14.1 The response of the Reserve Bank to the challenges imposed by the changing economic and business environment has been reflected in its approach to human resource management, notwithstanding the rigidities confronting it. The traditional institutional structure and culture has sometimes operated as a drag on human resource development, particularly in skill development, management change and career planning. This has been counteracted by recruiting skilled manpower from the open market to a certain extent, including some lateral induction of experts and redeployment of existing staff in new activities after suitable training. A major challenge is to develop the special competencies and skills for an environment of deregulation and openness driven by growing sophistication of operations and ever-expanding frontiers of information technology. In this milieu, building and reinforcing a corporate vision and culture that fosters creativity and recognises talent and merit is critical.

XV - The Reserve Bank’s Accounts For 2002-03

Appropriation of Net Disposable Income

15.1 The net disposable income of the Reserve Bank for the year 2002-03 amounted to Rs.8,838.00 crore.

15.2 The surplus transferable to the Central Government for the year 2002-03 amounted to Rs.8,834.00 crore, inclusive of Rs.1,717.00 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 on the conversion.

INCOME

15.3 The gross income of the Reserve Bank for the year 2002-03 (July-June), was Rs.23,185.64 crore which was lower by Rs.1,504.70 crore (6.1 per cent) as compared to the previous year's total income of Rs.24,690.34 crore. The fall in income from domestic sources was due to fall in domestic assets and lower interest rates. The fall in income from foreign sources was due to reduction in international interest rates.

15.4 During the year 2002-03, the return on foreign currency assets excluding capital gains less depreciation decreased to 2.8 per cent from 4.1 per cent during 2001-02 because of lower interest rates abroad. However, taking into account the capital gain on securities, the net earnings went up from 2.8 per cent to 3.1 per cent during 2002-03. 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.

15.5 Domestic income decreased by Rs.1,344.89 crore (9.1 per cent) from Rs.14,703.88 crore in 2001-02 to Rs.13,358.99 crore in 2002-03.

15.6 Profits booked on sale of securities amounted to Rs. 4,798.03 crore in 2002-03 representing an increase of Rs. 1,737.99 crore over the previous year. The net open market operations sales amounted to Rs.53,780 crore in 2002-03 as compared to Rs.30,335 crore in 2001-02. The interest income on ways and means advances showed decrease of Rs.339.98 crore during 2002-03 from Rs.952.48 crore in 2001-02 to Rs.612.50 crore in 2002-03, reflecting decreased recourse by the Central Government to this facility and also lower bank rate. Interest earnings from loans and advances to banks/financial institutions declined by Rs.769.31 crore from Rs.1,170.44 crore in 2001-02 to Rs.401.13 crore in 2002-03, due to lower utilisation of refinance facility by Primary Dealers/Scheduled Commercial Banks combined with lower interest rates applicable on these advances.

EXPENDITURE

15.7 Total expenditure of the Reserve Bank increased by Rs.181.02 crore (2.8 per cent) from Rs.6,542.39 crore in 2001-02 to Rs.6,723.41 crore in 2002-03.

Interest Payment

15.8 Interest payment decreased by Rs.344.90 crore (14.8 per cent) from Rs.2,334.99 crore in 2001-02 to Rs.1,990.09 crore in 2002-03 due to reduction in rate of CRR and lower interest rates payable on eligible CRR balances.

Establishment Expenditure

15.9 Establishment expenditure increased by Rs.184.50 crore (14.1 per cent) from Rs.1,304.36

crore in 2001-02 to Rs.1,488.86 crore in 2002-03 as a result of increased provisioning with respect to gratuity and pension funds. As per the actuarial valuation the provisioning in this regard was to the extent of Rs.616.67 crore during 2002-03 as against Rs.440.80 crore during the previous year.

Non-Establishment Expenditure

15.10 Expenditure on security printing, comprising cost of printing of currency notes, cheque forms *etc.*, increased by Rs.128.60 crore (9.9 per cent) from Rs.1,304.49 crore in 2001-02 to Rs.1,433.09 crore in 2002-03, mainly due to upward revision in rates of printing currency notes, increase in quantum of notes printed and larger component of higher denomination notes of Rs.100 and above consistent with the clean note policy.

BALANCE SHEET

Liabilities

National Industrial Credit (Long Term Operations) Fund

15.11 There were no operations in the National Industrial Credit (Long Term Operations) Fund (established under Section 46-C of the RBI Act, 1934) during 2002-03 except the credit of Rs.1.0 crore to the Fund out of Reserve Bank's income.

National Housing Credit (Long Term Operations) Fund

15.12 The National Housing Credit (Long Term Operations) Fund was established by the Reserve Bank in terms of Section 46D(1) of the Reserve Bank of India Act, 1934 in January 1989. A token contribution of Rs.1.0 crore was made to the Fund out of Reserve Bank's income during 2002-03.

Other Liabilities

15.13 '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.9,112.06 crore (8.3 per cent) from Rs.1,09,243.95 crore as on June 30, 2002 to Rs.1,18,356.01 crore as on June 30, 2003 mainly on account of increase in the levels of internal reserves.

15.14 The reserves, *viz.*, Contingency Reserve, Asset Development Reserve, Currency & Gold Revaluation Account and Exchange Equalisation Account 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

15.15 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. During 2002-03, there was an accretion of Rs.265.64 crore to the CGRA, thus increasing the balance to Rs.51,276.41 crore as on June 30, 2003 from Rs.51,010.77 crore as on June 30, 2002. The CGRA at the end of June 2003 was equivalent to 13.4 per cent of foreign currency assets and gold holdings of the Reserve Bank, as against 18.0 per cent at the end of June 2002. This was mainly on account of increase in the foreign currency assets and also appreciation of the rupee against the US dollar. The balances in Exchange Equalisation Account (EEA) represents provision made for exchange losses arising out of forward commitments. The balance in the EEA as on June 30, 2003 stood at Rs.567.25 crore.

Contingency Reserve and Asset Development Reserve

15.16 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.48,434.17 crore as on June 30, 2002 to Rs.55,249.29 crore as on June 30, 2003. A sum of Rs.81.20 crore representing unresolved items of credit, which was included under Other Liabilities - Miscellaneous was credited to CR during 2002-03. A transfer of Rs.6733.92 crore was made to CR during 2002-03 from Reserve Bank's income. The balance in CR was sufficient to meet the contingent liabilities.

15.17 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 2002-03, an amount of Rs.890.31 crore was transferred from income to ADR raising its level from Rs.4,700.54 crore as on June 30, 2002 to Rs.5,590.85 crore as on June 30, 2003. CR and ADR together constituted 11.7 per cent of total assets of the Reserve Bank as on June 30, 2003.

ASSETS

Foreign Currency Assets

15.18 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.2,67,333.18 crore as on June 30, 2002 to Rs.3,65,000.98 crore as on June 30, 2003. The increase in the level of foreign currency assets was mainly on account of market purchases, interest & discount and revaluation gains.

Investment in Government of India Rupee Securities

15.19 Investment in Government of India Rupee Securities which stood at Rs.1,35,067.86 crore as on June 30, 2002 decreased by Rs.29,923.82 crore (22.2 per cent) to Rs.1,05,144.04 crore as on June 30, 2003 mainly on account of substantial open market operations sales during the year.

Investments in Shares of Subsidiaries and Associate Institutions

15.20 The Reserve Bank's investments in the shares of its subsidiaries and associate institutions have increased by Rs.100.00 crore during 2002-03 on account of an additional investment in capital of the National Housing Bank.