*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-

* 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.

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 (Table 1.1).

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.

Table 1.1 : Macro Parameters for the Tenth Plan

Item	Ninth Plan	Tenth Plan	Post Plan
1	2	3	4
ICOR	4.53	3.58	3.84
Per cent of GDPMP			
Domestic Saving Rate	23.31	26.84	33.01
Private Saving Rate	24.13	26.40	*
Public Saving Rate	-0.82	0.44	*
Current Account Deficit	0.91	1.57	3.13
Investment Rate	24.23	28.41	36.14
Private Investment Rate	17.08	19.97	*
Public Investment Rate	7.15	8.44	*
Per cent per annum			
GDP Growth	5.35	7.93	9.40
Export Growth	6.91	12.38	*
Import Growth	9.80	17.13	*

* Not Projected. GDPMP : GDP at current market prices.
Source : Tenth Five Year Plan (2002-2007), Government of India.

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 (Box I.1).

Box I.1

Growth Strategy for Tenth Five Year Plan (2002-2007)

At the heart of the Tenth Plan strategy is a view of the development process in terms of efficiency. Considerable emphasis has been placed on policy and procedural reform and improved governance to achieve a significant improvement in overall efficiency. It is increased efficiency that is expected to make the acceleration in growth envisaged in the Plan feasible.

Typical of Plan models, the arithmetic of the Tenth Plan strategy is set in the standard neo-classical growth accounting framework, driven by a combination of capital accumulation and efficiency of resource use. In the tradition of the new innovation in growth theories in the 1980s, technological progress, productivity and efficiency are

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regarded as endogenous to the process of growth. An important difference, thus, lies in the Tenth Plan's approach *vis-à-vis* its predecessors in the emphasis on efficiency, expressed in a 'faith in the latent potentialities of the economy'. Accordingly, high priority has been accorded to policies that will unfetter growth impulses from existing practices and institutional arrangements.

The Tenth Plan adopts a seven pronged approach in its policy framework: (i) enhancing the efficiency of capital use; (ii) greater openness; (iii) widening and deepening of capital markets; (iv) stepping up agriculture and rural development; (v) competitive industrial policy environment; (vi) building the social and economic infrastructure; and (vii) reforms in governance. In each of these areas, there is a conscious emphasis on policy changes which could involve reprioritisation and even a radical break from the past:

- Full productive use of the existing capital stock, energising idle capacity in the public sector through a moratorium on new infrastructure projects and privatisation of non-strategic public sector enterprises; legal and procedural changes covering bankruptcy and foreclosure for quick transfer of capital assets in the private sector.
- Lowering of tariffs on imports, creation of capacities specifically for export markets, rationalisation of the domestic tax structure and simplified access to export promotion incentives to correct for the anti-export bias in policies and to enable a greater integration with the international economy.
- In the financial sector, the Plan envisages regime changes to allow for the flow of long-term risk capital. Reforms in the debt and equity markets are regarded as central to the convergence of long-term saving and investment horizons in the economy.
- The Plan identifies the need to raise productivity of land and water resources for agricultural development. Accordingly, it aims for a major revival of public investment in irrigation and water management, rural infrastructure, research and development (R&D), product diversification and freer trade.
- Indian industry will shoulder a large share of the drive to accelerate overall growth by expanding at above-trend rates of 10 per cent per annum during the Plan period, extending external liberalisation to State-level industrial enterprises to make them internationally competitive.
- Human development through three critical dimensions, *i.e.*, longevity, education and command over resources – education for all, improvement in the health status of the population, 'shelter for all' by 2012, building the economic infrastructure by intensifying power sector reforms in States and empowering them with adequate legislation and financial support, expansion of hydro-electric and atomic power capacity, tariff fixation on commercial and technical grounds by an independent authority in order to improve the financial constraints on the performance of railways, upgradation of the road network to international standards, reform of State road transport operations, rural road connectivity, expansion in civil aviation and a telecommunication policy.
- Reform of governance is a 'cornerstone' of the Tenth Plan. Reform of the civil service, corporate governance and consumer protection are regarded as essential for increasing efficiency and accountability.

The tone of cautious optimism running through the Tenth Five Year Plan captures the mood of the nation. The imperatives for poverty reduction and employment generation impart an urgency to achieving an annual growth of the economy at 8 per cent as a necessary minimum. Available empirical evidence and independent assessment of the growth experience so far place India's potential growth rate in the range of 6-10 per cent. Thus, the goal of the Tenth Plan is ambitious but not infeasible. In this endeavour, a vision of transformation of the Indian economy driven by efficiency becomes increasingly credible.

References

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2. Government of India (2002), *Tenth Five Year Plan*, Planning Commission, New Delhi.

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. One-time 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 anti-competitive 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 non-resident 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 (Box I.2).

Box I.2

G-20 during the Leadership of India

The creation of G-20 on September 25, 1999 in Washington D.C. was the result of the commitment made by the G-7 leaders at the June 1999 summit at Koln " to establish an informal mechanism for dialogue among systemically important countries within the framework of the Bretton Woods institutional system". The G-20 aims at promoting international financial stability through informal discussions, preparation of case studies and reviews of policy issues of relevance to the members. The forum comprises 19 member countries (Argentine Republic, Australia, Brazil, Canada, France, Germany, Italy, Japan, Kingdom of Saudi Arabia, Mexico, People's Republic of China, Republic of India, Republic of Indonesia, Republic of Korea, Republic of South Africa, Republic of Turkey, Russian Federation, United Kingdom and United States of America) and the European Union. The Managing director of the IMF and the President of the World Bank as well the Chairpersons of the International Monetary and Financial Committee (IMFC) and the Development Committee (DC) also participate in the discussions.

In the meeting of Deputies held in July, 2002 in New Delhi, Australia presented the key findings of the G-20 workshop held in Sydney on "Globalisation, Inequality and Living Standards". In the Ministerial Meeting held on November 23, 2002, discussions essentially focused on domestic and international crisis prevention and resolution initiatives, globalisation, combating financing of terrorism and strengthening the link between aid and development. In the Ministerial *Communiqué*, the Ministers recognised that inter-dependence among national economies and increased integration of financial markets have brought significant advantages and enormous opportunities for enhanced growth in many countries. Countries have, however, have become more exposed to external shocks and susceptible to the consequences of inappropriate domestic policies. The *Communiqué* emphasised the need to strengthen capacity to prevent financial crises and to develop efficient, expeditious, and socially and economically effective responses to a financial crisis when it occurs.

The Ministers noted that effective and accountable International Financial Institutions (IFIs) and worldwide surveillance are essential for a healthy global financial system. Sustainable exchange rate regimes, prudent asset-liability management, and implementation of agreed standards and codes are important components of an effective strategy for crisis prevention. The Ministers emphasised the importance of sound national financial systems, effective supervision, and corporate governance in line with global best practices and also agreed that capital account liberalisation should proceed in an appropriately sequenced manner.

It was noted that globalisation has generally been delivering rising living standards including to many of the world's poor. The benefits of globalisation can be maximised, and associated risks mitigated, through the

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pursuit of appropriate domestic policies and a healthy external environment. The experience of G-20 members as presented in the country case studies on globalisation as well as the findings of the Globalisation Workshop in Sydney were highlighted to suggest that strong institutions, a climate that fosters savings and investment, transparency, and the rule of law, coupled with increased investments in infrastructure and human capital in developing countries are essential ingredients for promoting growth and reducing poverty. The Ministers recognised that the process of globalisation has not yet delivered in reducing poverty in some of the world's poorest countries. In that context they felt that reduction in the remaining trade related barriers and phasing-out of trade-distorting subsidies would contribute to spreading further the benefits of globalisation, including to the poorest developing countries. They also recognised that development assistance can enable poorer nations to build capabilities for exploiting the benefits of more integrated markets.

At the end of the Ministerial Meeting, the leadership was transferred to Mexico.

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.*, pre-payment 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 (M_3) 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 co-operative 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 (Box I.3).

Box I.3

Progress in Legislative Reforms

Acts Enacted by the Parliament

- The Negotiable Instruments (Amendments and Miscellaneous Provisions) Act, 2002 effective February 6, 2003 introduces the concepts of 'Electronic Cheque' and 'Cheque Truncation' by expanding the definition of 'Cheque', enhances the punishment for dishonour of cheques, *etc.*
- The SARFAESI Act, 2002 effective June 21, 2002 regulates, *inter alia,* securitisation and reconstruction of financial assets and enforcement of security interest. The Act has also been extended to co-operative banks.
- The Prevention of Money Laundering Act, 2002 effective from January 17, 2003 provides for the legal framework and machinery for combating the menace of proceeds of crime, its circulation, use, attachment, adjudication and confiscation.
- The Multi-State Cooperative Societies Act, 2002 effective from August 19, 2002 in replacement of the Act of 1984 gives more functional autonomy to the Multi-State Co-operative Societies.
- The Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002 provides for transfer to and vesting of the undertaking of the Unit Trust of India into a specified company to be formed and registered under the Companies Act, 1956.

Legal Initiatives at Different Stages

- The Fiscal Responsibility and Budget Management Bill, 2000 introduced in the Parliament in December

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2000 was passed by both the houses of the Parliament. It includes provisions for legal and institutional framework, to bring down the fiscal deficit, contain the growth of public debt, and stabilise the debt-GDP ratio, *etc.*

- The Financial Companies Regulations Bill, 2000 introduced in Lok Sabha on December 13, 2000 includes provisions for regulation of financial institutions, protecting the interests of the depositors, ensuring monetary stability and economic growth and rationalising credit system. The Bill was referred to the Standing Committee on Finance which has submitted its report in June 2003.
- The Banking Companies (Acquisition and Transfer of Undertakings) and Financial Institutions Laws (Amendment) Bill, 2000 was introduced in the Lok Sabha on December 13, 2000 and is pending consideration of the Standing Committee on Finance. The Bill amongst others includes provisions for enabling the Government to supercede the Board of Directors and to appoint Financial Restructuring Authority for the weak banks, reduction of the Government stakes to 33 per cent, introduction of the principles of corporate governance *etc.*
- The draft Payment and Settlement Systems Bill, 2002 for regulation and supervision of the payment and settlement system in the country has been forwarded by the Reserve Bank to the Government.
- The Banking Regulation (Amendment) and Miscellaneous Provisions Bill, 2003 suggesting comprehensive amendments to the Banking Regulation Act, 1949 has been introduced in the Parliament.
- The draft Bill suggesting amendments to the Reserve Bank of India Act, 1934 was forwarded by the Reserve Bank to the Government. The Bill suggests among others, separation of the debt management of the Government from the monetary management, streamlining the CRR, empowering the Bank for electronic transfer of fund and multiple payment system.
- The proposed draft Bill on 'Credit Information Bureau Regulation' envisages that all banks and financial institutions and other institutions as specified by the Reserve Bank or Government, shall become member of at least one Credit Information Bureau.
- The Bank Deposit Insurance Corporation' Bill based on the decision taken by the Bank in the light of recommendations of the joint team of the Government, the Reserve Bank and the DICGC has been forwarded to the Government for their consideration.
- A Bill on Factoring of Debts Due to Industrial and Commercial Undertakings forwarded in April 2002 is under consideration of the Government.

Working Groups on Legislative Reforms

- A Working Group was constituted in the Reserve Bank to examine the provisions of the Negotiable Instruments Act and propose amendment for enabling the banks to make the payment of the cheque to the extent of balance available in the drawers' account. The Group has submitted its report in July 2003.
- A Working Group was formed by the Reserve Bank to examine the existing models of cheque truncation, e-cheques in other countries and to recommend the models for India to lay down the standards and procedures and provide broad rules and regulations for issue of e-cheques, processing, clearing and settlements and other related issues. The Group has submitted its report in July 2003.
- A Working Group was set up to examine the modalities for encouraging bank's investments in Mortgage Backed Securities (MBS) of Housing Finance Companies and widening the investor base, improving the quality of assets and creating liquidity for trading in assets. The Group has submitted its report in December 2002.

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.