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 South-West 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 Co-operative 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 pre-emption 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 inter-state 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, up-gradation 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 co-operative 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.