GOVERNOR'S FOREWORD TO ANNUAL REPORT

1. The Reserve Bank's Annual Report informs the public both on the past year – our narrative of economic events as well as what we intended to accomplish during the past year – as well as what we propose to do in the coming year.

Challenges in the Current Macroeconomic Environment

2. Both the Government and RBI have been engaged in the last few years in restoring macroeconomic stability to the economy. While the policy actions have had positive effects, there are a number of areas which should be considered "work in progress". From RBI's perspective, three such areas continue to be of importance. First, economic growth, while showing signs of picking up, is still below levels that the country is capable of. The key weakness is in investment, with private corporate investment subdued because of low capacity utilisation, and public investment slow in rolling out in some sectors. Second, inflation projections are still at the upper limits of RBI's inflation objective. With the Reserve Bank needing to balance savers' desire for positive real interest rates with corporate investors' and retail borrowers' need for low nominal borrowing rates, the room to cut policy rates can emerge only if inflation is projected to fall further. Third, the willingness of banks to cut lending rates is muted; not only does weak corporate investment reduce the volume of new profitable loans, their stressed assets have tightened capital positions, which may prevent them from lending freely. Certainly, the reluctance to lend to industry and small businesses is more visible among the more stressed public sector banks compared to the private sector banks.

3. While these areas of concern have not changed significantly over the year, there have been some developments that bode well. Expectations of a good monsoon (corroborated thus far) coupled with more money in the hands of government servants (as a result of the implementation of the 7th Pay Commission recommendations) should boost consumer demand. With final demand picking up, capacity utilisation is likely to increase, and so will investment. A virtuous cycle of growth is possible, reinforced by anticipation of the coming benefits from reforms like the recently passed Goods and Services Tax legislation in Parliament.

4. The short term macroeconomic priorities of the Reserve Bank continue to be to focus on bringing down inflation towards the government-set target of 4 per cent – thus far the RBI has followed a gentle glide path, aiming at 5 per cent by March 2017 after having coming below 6 per cent in January 2016; work with the Government and banks on speeding up the resolution of distressed projects and completing the clean-up of bank balance sheets; ensure banks have the capital to make provisions, support new lending, and thus pass on future possible rate cuts. I elaborate briefly on these priorities.

Inflation Target and MPC

5. The Government has notified the inflation target for the RBI, and has outlined the structure and functions of a Monetary Policy Committee. Once the MPC is constituted, it will be entrusted with making future policy decisions. This will be a welcome step forward in strengthening the transparency, continuity, and independence of monetary policy.

Liquidity Framework

6. An important aspect of the new monetary framework is liquidity management. RBI has moved to a new liquidity framework in April 2016, after a detailed review. There is now a clearer differentiation between the durable liquidity needs of the system and its short term liquidity needs, with the RBI intending to move closer to neutrality over the medium term on supplying overall durable liquidity needs. When the RBI gets to neutrality, periods of temporary liquidity surplus should be broadly equalled by periods of temporary liquidity deficit over the course of the year. While net permanent liquidity needs will be addressed through open market operations in government bonds, taking into account any net foreign exchange purchases, temporary liquidity needs will be addressed through liquidity windows and overnight/term repos/reverse repos.

Stressed Assets and Speedy Resolution

7. A third area of short term focus with macroeconomic relevance is stressed asset resolution. The Asset Quality Review initiated in early 2015-16 has improved recognition of NPAs and provisioning in banks enormously. Some banks have taken significant steps in recognising incipient stress early.

8. Now more focus should move to improving the operational efficiency of stressed assets, and creating the right capital structure so that all stakeholders can benefit. This implies simultaneous action on two fronts. Where necessary, new management teams have to be brought in, sometimes as owners, and where not possible, as managers. Creative search for new management teams, including the possible use of public sector firms or private sector agents, is necessary, as are well-structured performance incentives such as bonuses for meeting cash flow/profit benchmarks and stock options. Of course, if the existing promoter is capable and reliable, they should be retained. Equally important, the capital structure should be tailored to what is reasonable, given the project's situation. If the loan is already an NPA, there is no limit to the kind of restructuring that is possible. If standard but the project is struggling, we have a variety of schemes by which a more sensible capital structure can be crafted for the project. These schemes include the 5/25, the SDR, and the S4A. A caveat is in order: some of the current difficulties comes from an unrealistic application by banks of a scheme so as to postpone recognition of a loan turning NPA rather than because of a carefully analysed move to effect management or capital structure change. RBI will continue monitoring to see that schemes are used as warranted.

Medium Term Reforms

9. Moving to the medium term, in the financial sector we need to increase efficiency through greater entry and competition. The most appropriate institutions will prevail when the competitive arena is level, so we have to remove regulatory privileges as well as impediments wherever possible, especially those that are biased towards some form of ownership or some particular institutional form. A critical component of the medium term strategy in the financial sector will be to strengthen our public sector banks in all aspects, including governance, cost structure, and balance sheets. Another intent, applicable to all financial institutions, is to strengthen risk management, including cyber risk. RBI's supervision will look into all these aspects, and also strictly enforce penalties for non-compliance with regulations or remedial action plans.

10. We need more participation in our financial markets to increase their size, depth, and liquidity. Participation is best enhanced not through subventions and subsidies but by creating supporting frameworks and new institutions that improve transparency, contract enforcement, and protections for market participants against abusive practices. Technology can be very helpful in reducing the costs of the supportive frameworks, and can bring hitherto excluded populations into the financial fold.

11. Finally, as more institutions and technologies bring more people into the financial system, we have to make sure they are adequately informed and protected. In 2015, RBI came out with 5 principles that banks had to follow in dealing with customers. We asked banks to implement this Charter of Customer Rights, and asked them to appoint an internal ombudsman to monitor the grievance redressal process. We now will examine how banks are faring, and whether further regulations are needed to strengthen consumer protection. In particular, we will focus this year on the issue of mis-selling, especially of insurance products. We will also focus on enhancing our communication with the broader public, with a view to informing them on what they need to do to take best advantage of financial opportunities, as well as protecting themselves. Finally, we will work to enhance grievance redressal procedures, both within the financial institutions, and if the customer is still unsatisfied, subsequently through the RBI's ombudsman scheme. Particularly important will be to strengthen redressal in rural areas, as well as to the weaker sections of society.

12. Internally, the RBI will continue to increase the specialisation of our staff, while strengthening the performance evaluation system so as to identify weaknesses, and the skilling system so as to provide remedial action. For senior staff, the accent will be on building leadership and general management skills, while exposing them to diverse opportunities. The broader effort will be to enhance the incentives for continuous self-improvement for each employee in the Bank, even while promotions take their natural course.

13. Of course, there is far more that the RBI is working on. I do not want to pre-empt the rest of this report, in what is meant to be a brief introduction to a very rich document. Thank you for your interest in it, and more generally, in the working of our central bank.