*For the Year July 1, 2003 to June 30, 2004**

PART ONE : THE ECONOMY : REVIEW AND PROSPECTS

I MACROECONOMIC POLICY ENVIRONMENT

INTRODUCTION

1.1 Global recovery, which was somewhat hesitant earlier, firmed up and spread across various parts of the world in 2003 and continued through the first quarter of 2004 in an environment marked by heightened uncertainty. World merchandise trade accelerated in the second half of 2003 and financial flows to developing countries rebounded from subdued levels witnessed in the post-Asian crisis years. Persisting excess capacity and unemployment moderated potential inflationary pressures emanating from rising commodity prices. Consequently, inflation remained largely benign worldwide. Given the virtual absence of inflationary fears and prevalence of abundant liquidity conditions, an accommodative monetary policy stance was generally pursued in support of the recovery except in a few countries where rising asset prices prompted pre-emptive tightening. Financial markets experienced a broad-based strengthening, aided by the orderly depreciation of the US dollar. Improvements in corporate profitability and credit quality balanced the appetite for risk, enabling some consolidation of gains towards the close of 2003. These developments markedly improved the near-term outlook for the global economy, despite the risks from persistent US macro imbalances and rising oil prices weighing upon the transition to a higher interest rate regime in the emerging phase of the global business cycle.

1.2 India surged ahead of the global recovery on the back of a sharp turnaround in agriculture in 2003-04, aided by a normal monsoon. Industrial and services sector activities strengthened significantly, reinforced by higher rural consumption demand and a robust growth in merchandise exports for the second consecutive year. Consequently, India's real GDP grew at an impressive 8.2 per cent during 2003-04. In the post-Independence history, India's real GDP grew by over 8.0 per cent only on three occasions [*i.e.,* 1967-68 (8.1 per cent), 1975-76 (9.0 per cent) and 1988-89 (10.5 per cent)]. On these three occasions, however, the share of agriculture in GDP was much higher than in 2003-04. In 2003-04, while the rebound in agriculture was a significant driving force, the overall growth acceleration was widespread, drawing from industry, services and exports.

* 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, data in this Report are analysed on the basis of the financial year. Where available, data have been updated beyond March 2004. 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.

1.3 Growth prospects during the year were aided by a generally stable inflation situation. With orderly and easy conditions in the financial markets engendered by domestic and international sources of liquidity, interest rates continued to rule at low levels. This favourable environment, combined with restructuring by the industrial sector under competitive pressures, provided a significant boost to the profitability of the corporate sector. Unprecedented portfolio flows led to a strong rally in the stock markets with share prices touching new highs.

1.4 A resurgent industrial sector, improved corporate sector profitability and record resource mobilisation by way of divestment helped in fiscal consolidation with the revised fiscal deficit for the year turning out to be lower by 0.8 per cent of GDP than the budget estimates. Buoyant software exports and record workers' remittances led to a current account surplus for the third year in succession even as the merchandise trade deficit expanded due to the strong industrial recovery underway. The sustained buoyancy in merchandise exports was led by manufactures, reflecting structural changes and the growing competitiveness of the industrial sector. The overall strengthening of the balance of payments was reflected in an unprecedented accretion to India's foreign exchange reserves, which by March 2004, touched US $ 113 billion, the sixth highest in the world.

1.5 Achieving high growth rates on a sustainable basis requires further improvements in productivity and a step-up in investment as envisaged in the Tenth Five Year Plan. Key policy initiatives, thus, need to focus on augmenting the flow of resources to the productive sectors of the economy. In this regard, a number of initiatives have been undertaken recently by the Reserve Bank.

1.6 This Section reviews macroeconomic policy settings in 2003-04 against the backdrop of the foregoing developments. The assessment indicates that in the context of the significant turnaround in agricultural production, building the rural infrastructure and credit delivery conduits emerge as the key priorities in the formulation of real sector policies. In the external sector, capital account and foreign exchange transactions were further liberalised in view of the strong balance of payments position. Access to imported inputs was significantly liberalised for accelerating the growth of exports. The review of fiscal policy underscores the need for fiscal consolidation to be carried forward to preserve the benefits in terms of macroeconomic stability and sustained growth. The evaluation of monetary policy reveals the dominant concern associated with managing capital flows, *i.e.*, the recourse to large-scale sterilisation operations in the pursuit of price stability even while ensuring adequate resources for supporting credit demand for investment activity. Going forward, the dilemma posed by these conflicting pulls would become sharper. The Section concludes with a review of financial sector policies and the progress in building the appropriate legal architecture.

REAL SECTOR POLICIES

1.7 Policy initiatives for nurturing growth impulses were framed in the context of the strong recovery in agricultural production and the brightening of the investment climate in manufacturing and services. Several measures were initiated for improving agricultural productivity. Industrial policy initiatives were designed in the context of the multi-faceted globalisation of production systems, especially in terms of technology transfers and development of the physical infrastructure for higher growth.

Agriculture and Allied Activities

1.8 The Government stepped up efforts to improve agricultural productivity through regionally differentiated strategies under the macro management mode of planning and implementation, introduced in October 2000, subsuming all earlier Centrally Sponsored Schemes. In order to mitigate both the yield and price risks, a Farm Insurance Income Scheme (FIIS) was launched on a pilot basis during the *rabi* season 2003-04 in 19 districts across 12 States for wheat and rice, which was subsequently extended to 100 districts during *kharif* 2004. The scheme envisages a minimum guaranteed income computed on the basis of (i) average yield over the last seven years, indemnity level and minimum support price (MSP) of the current year; (ii) premium subsidy of 75 per cent to small and marginal farmers and 50 per cent for others; and (iii) withdrawal of MSP in select crops and districts in which the scheme is launched. The scheme is being implemented by the Agricultural Insurance Company of India Limited (AICL). In order to develop integrated agricultural markets nationwide, facilitate emergence of competitive agricultural markets in the private and the co-operative sectors and to create an environment conducive to massive investments in marketing-related infrastructure, a draft model Act, *viz.,* the State Agricultural Produce Marketing (Development and Regulation) Act, 2003 was framed in September 2003. It provides for establishment of private markets/yards, direct purchase centres, consumer/farmers' markets for direct sale and promotion of public-private partnership in the management and development of agricultural markets. Ten States have initiated legal or administrative action for 'direct marketing' and 'contract farming' arrangements in line with the Model Act. There is a need for all other States and Union Territories to bring the necessary amendments in their legislation on the lines of the Model Act. The establishment of *Kisan* Call Centres and Mass Media Support for Agriculture Extension were taken up in January 2004 with a view to overcoming information asymmetry through information technology. The Ministry of Agriculture is preparing a National Action Plan focusing on measures to be undertaken for increasing agricultural productivity and doubling food production by 2011-12.

Manufacturing and Infrastructure

1.9 Construction of quality infrastructure, initially in 20-25 functional clusters/industrial locations, was announced in January 2004. Implementation of the scheme would be through a Special Purpose Vehicle (SPV) formed by the cluster/industry association, which would carry out the business of developing, operating and maintaining the infrastructure facility created in industrial locations.

1.10 The Union Budget, 2004-05 proposed measures to encourage universal access to telecommunication facilities, facilitate research and development in bio-technology and promote investment in the industrial sector through setting up of an Investment Commission. The National Manufacturing Competitiveness Council proposed in the Union Budget, 2004-05 would help in energising and sustaining the growth of manufacturing industries. The reduction in the peak customs tariff on non-agricultural goods to 20 per cent in the *interim* Budget announced in February 2004 was maintained in the Union Budget 2004-05. Besides, the countervailing duty (CVD) exemption enjoyed by some imported goods where there is no corresponding exemption from excise duty on Indian made goods was removed. Specified raw materials for certain manufacturing items were exempted from excise duty. The customs duty on non-alloy steel was reduced from 15 per cent to 10 per cent, while the excise duty on steel was increased from eight per cent to 12 per cent so that the countervailing duty would also be applicable to imports. The peak customs duty on alloy steel, copper, lead, zinc and base metals was reduced to 15 per cent. The Central Value Added Tax (CENVAT) duty on textiles was abolished and there will be no mandatory excise duty on pure cotton, wool and silk, whether it is fibre, yarn, fabric or garment. There will be a mandatory excise duty on man-made staple fibre and other man-made filament yarn (16 per cent) and polyester filament yarn (24 per cent). The Union Budget, 2004-05 laid emphasis on technology upgradation of small scale industry (SSI) units to enable them to conduct business in a competitive environment and identified 85 items for de-listing from the reserved list of the SSI sector. An Inter-Institutional Group (IIG) will be formed to pool resources on a callable basis towards further development of infrastructure. A sum of Rs.40,000 crore will be made available to ensure speedy conclusion of loan agreements and implementation of infrastructure projects relating to airports, seaports and tourism.

1.11 Efforts were made to sustain the expansion of information technology and telecommunication sectors. The draft report of the Task Force on Power Sector Investments and Reforms (Chairman: Shri N.K. Singh) recommended liberalisation of generation, transmission and distribution. It also made recommendations to facilitate resource mobilisation by various measures such as according priority sector status to the power sector, SLR status to power sector bonds, access to the capital market for central utilities and also proposed wide-ranging fiscal incentives. The Information Technology Taskforce (Chairman: Shri Nandan Nilekani), set up by the Ministry of Power to develop a synergy between IT and the power sector, emphasised the need to adopt a holistic approach towards the standardisation of IT architecture, applications, network, hardware and management which could be customised to the specific requirements of individual utilities. In keeping with the objective of making telecommunication services available in the most efficient and affordable manner, it was decided by the Central Government that merger of licences would be restricted to the same service area.

EXTERNAL SECTOR POLICIES

1.12 External trade and payments policies were framed in the backdrop of the optimism generated by the strengthening of the balance of payments in 2003-04. The EXIM Policy 2002-07 was fine-tuned in January 2004 with a series of trade facilitation measures aimed at consolidation and acceleration of export growth so as to make India a manufacturing hub for producing quality goods and services. These measures focused on simplifying operational procedures and imparting greater transparency with the objective of reducing transaction costs for exporters. The Reserve Bank undertook a measured dismantling of restrictions on foreign exchange transactions with a view to providing an enabling environment for all entities engaged in external transactions. In conformity with this stance, the Exchange Control Department of the Reserve Bank was renamed as the Foreign Exchange Department.

1.13 Under the trade policy measures announced in January 2004, some of the restrictions for import of gold and silver, global positioning system receivers, electrical energy and air guns were removed. Under the Duty Free Replenishment Certificate (DFRC) Scheme, duty free import of fuel was allowed with actual user conditionality to offset the high power costs faced by the manufacturing industry. The procedure for fixation of the "nexus" between import of capital goods and export products under the Export Promotion Capital Goods (EPCG) Scheme was simplified. Imports are allowed on the basis of a Chartered Engineer's certificate as against the earlier system of examination by an expert committee. Rupee payments received for port handling services were allowed to be reckoned for the discharge of export obligation under the EPCG Scheme. Deemed export benefits were granted for items attracting zero per cent basic customs duty as well as fertiliser and refinery projects spilling over from Eighth and Ninth Plan periods. Measures to boost project exports included (i) enhancement of the equity base of the Export Credit Guarantee Corporation (ECGC) from Rs.500 crore to Rs.800 crore; (ii) creation of a National Export Insurance Account to enable the ECGC to underwrite high value projects being implemented by Indian companies abroad; and (iii) introduction of a Gold Card Scheme for creditworthy exporters with good track record to enable them to obtain export credit without difficulty. Import of all kinds of capital goods, including office and professional equipment, was allowed under the Duty Free Entitlement Scheme for the benefit of the services sector (including tourism).

1.14 India has played a crucial role in forming important alliances in the World Trade Organization (WTO) negotiations - G-20 on agriculture and G-16 on Singapore Issues. Suggestions made by India to address the developmental concerns of developing countries formed part of the revised framework for negotiations that was adopted by the General Council of the WTO on August 1, 2004.

Management of Foreign Exchange Transactions

1.15 The Reserve Bank continued to move away from micro management of foreign exchange transactions to macro management of flows. At the same time, greater emphasis was laid on transparency, data monitoring, information dissemination and stronger Know Your Customer (KYC) guidelines.

1.16 The Reserve Bank continued to liberalise foreign exchange transactions. Steps were also taken to strengthen risk management systems in banks. Firms engaged in export and import of commodities were allowed to hedge the price risk in international commodity exchanges/markets. Exporters were allowed greater flexibility in seeking regulatory compliance, self write-off and self extension of the due date for export realisation. The threshold limit for GR declaration was revised upwards and procedures for import remittances were simplified.

1.17 The process of liberalisation of the capital account was carried forward during 2003-04 with an accent on facilitating outflows by residents. Resident individuals were permitted to remit an amount of up to US $ 25,000 per calendar year for any current and capital account transaction or a combination of both and to borrow up to US $ 2,50,000 or equivalent from close relatives residing outside India free of interest with a minimum maturity period of one year. Authorised dealers were permitted to allow remittances up to US $ one million per calendar year, out of balances held in Non-Resident Ordinary (NRO) accounts/sale proceeds of assets, subject to the payment of applicable taxes. The limit of US $ one million per calendar year includes sale proceeds of assets. Sale proceeds of immovable properties which are not acquired through inheritance are eligible for remittances provided the same were held by non-resident Indians (NRIs)/ persons of Indian origin (PIOs) for a period of not less than 10 years. In case a property is sold after being held for less than 10 years, remittances could be made if the sale proceeds were held in NRO accounts or eligible investment for the balance period.

1.18 Resident corporates and registered partnership firms were permitted to invest up to 100 per cent of their net worth in overseas Joint Ventures (JV)/Wholly Owned Subsidiaries (WOS) and undertake agricultural activities abroad. Resident entities with overseas direct investments were permitted to hedge the exchange risk.

1.19 Deposit schemes for NRIs underwent major policy-induced changes. Policy measures undertaken in the broader context of managing capital flows included raising of the minimum maturity to one year for Non-Resident External (NRE) rupee deposits, progressive rationalisation of interest rates to close differentials *vis-a-vis* the London Inter-Bank Offered Rate (LIBOR)/SWAP rates and disallowing of non-bank entities from accepting deposits by NRIs.

1.20 Norms for external commercial borrowings (ECBs) were further liberalised in respect of eligibility, end-use restrictions and spreads. The limit for the automatic route was raised to US $ 500 million and the approval process in respect of loans above US $ 500 million was shifted from the Government to the Reserve Bank. Resident corporates were allowed to raise ECBs for overseas direct investment in JV/ WOS.

1.21 Foreign institutional investors (FIIs) and NRIs were permitted to trade in exchange traded derivative contracts. Multilateral development banks such as International Finance Corporation (IFC) and the Asian Development Bank, which are specifically permitted by the Government to float rupee bonds in India, were permitted to purchase dated Government securities.

1.22 In order to carry forward the process of liberalisation of the external sector, the Union Budget for 2004-05 proposed to i) raise the sectoral caps for FDI in telecommunications (from 49 per cent to 74 per cent), civil aviation (from 40 per cent to 49 per cent) and insurance (from 26 per cent to 49 per cent); ii) make the procedures for registration and operations simpler and quicker for FIIs; and iii) raise the investment ceiling for FIIs in debt funds from US $ one billion to US $ 1.75 billion. Other proposals included withdrawal of the exemptions on interest earned from a Non-Resident (External) Account and interest paid by banks to a Non-Resident or to a Not-Ordinarily Resident on deposits in foreign currency from tax. These exemptions would cease prospectively from September 1, 2004.

FISCAL POLICY

Central Government

1.23 The fiscal stance for 2003-04 was set by a firm commitment to prudence as reflected in the enactment of the Fiscal Responsibility and Budget Management (FRBM) Act in August 2003. A combination of measures to enhance revenue buoyancy, contain revenue expenditure, cut back capital expenditure and secure higher realisation of disinvestment proceeds resulted in all the key deficit indicators being lower than the budget estimates in 2003-04 for the first time since the initiation of structural reforms.

1.24 Tax reforms were reinforced by modifications to tax proposals announced in January 2004 covering reduction in customs duties and reduction in excise duties on computers and aviation fuel. Modifications in direct taxes included phasing out of filing of income-tax returns for employees drawing salary income up to Rs.1.5 lakh, exemption of pensioners from the purview of the 'one-by-six' scheme and expanding computerisation for tax administration.

1.25 The notification of the FRBM Act, 2003 and the FRBM Rules framed under it in July 2004 streamlined the process of the presentation of the Union Budget. The Union Budget, 2004-05 sought to achieve the following objectives, *viz*., sustained growth rate of 7-8 per cent per annum; universal access to quality basic education and health; gainful employment and investment promotion; minimum assured employment; agriculture and infrastructure development; fiscal consolidation and reform; and higher and more efficient fiscal devolution.

1.26 The Union Budget, 2004-05 proposed to utilise the current favourable conditions to undertake tax reforms for widening the tax base and for reducing the revenue deficit from 3.6 per cent of GDP in 2003-04 to 2.5 per cent of GDP in 2004-05 - more than the annual minimum target of 0.5 per cent set in the FRBM Rules. It also proposed to assist the Reserve Bank in restraining the growth in money supply without damaging the medium/long-term prospects of savings in the economy and without hurting the interests of the poor, the senior citizens and other fixed-income earners. Plan expenditure priorities are proposed to be reoriented and subsidies restructured. An integrated development perspective is proposed to be adopted in areas that are vital to national well-being such as food, water, energy, transport and communication.

Tax Reform

1.27 The Union Budget 2004-05 seeks to expand tax reforms to encompass taxation of services and to facilitate the introduction of the Value Added Tax (VAT). The guiding principles of tax policy, as spelt out in the Fiscal Policy Strategy Statement 2004, aim at widening the tax base by reducing exemptions, incentives and concessions; reducing multiplicity of rates; lowering tax rates; shifting the incidence of tax burden from production to consumption; moving away from excessive reliance on taxes on manufacturing and taxing all value additions including from services; securing neutrality between present and future consumption; securing the neutrality of the tax system to forms of business organisations and sources of finance; and reengineering business processes of tax administration to reduce compliance cost and overcome the culture of tax avoidance and evasion.

1.28 Under direct taxes, measures proposed to provide relief to tax payers include tax rebate for individuals with total income up to Rs.1 lakh; tax exemption to certain sections of tax payers such as widows, children and nominated heirs of personnel of armed forces killed in the course of operational duties; and exemption of contributions to the new 'defined contribution' pension scheme. Measures aimed at rationalisation and simplification of the tax regime include tax exemption for all long-term capital gains arising from securities transactions and a flat tax rate of 10 per cent for short-term capital gains from securities transactions; enhancement of withholding tax from 12.5 per cent to 20 per cent for debt-oriented mutual funds on the income distributed to corporate unit holders; dematerialisation of Tax Deducted at Source (TDS) and Tax Collected at Source (TCS) certificates; mandatory filing of TDS/TCS returns in computer media for Government deductors; and subjecting infrastructure capital companies to the Minimum Alternate Tax (MAT). The Union Budget also seeks to plug revenue leakages through a series of measures which include not allowing set-off of business loss against salary income and preventing bonus and dividend stripping. Two new taxes are proposed to be introduced, *viz*., a transaction tax in equities and a tonnage tax for shipping companies which would allow them to be taxed on notional income, based on the tonnage of the ship.

1.29 On the indirect tax front, the thrust of tax policy is on (i) moderation and stability in tax rates; (ii) increasing revenues from excise duties; (iii) aligning the tariff structure to that of the ASEAN countries; (iv) progressing towards a uniform rate of tax on goods and services; (v) progressing towards integration of tax on goods and services; and (vi) expanding the service tax net. The peak rate of customs duty is sought to be maintained at 20 per cent, while duties for specific industries are proposed to be reduced. Exemptions from excise duties are proposed to be granted for farm equipment, computers, telecom grade optical fibres and cables, raw materials for manufacture of parts of cathode ray tubes, specified capital goods for manufacture of mobile handsets and plasma display panels. Furthermore, measures are proposed to widen the tax base and rationalise rates towards the mean CENVAT rate. The service tax rate is proposed to be raised from eight per cent to 10 per cent along with the addition of 13 new services under the tax net as well as by expanding the scope of existing taxed services and removal of certain exemptions. The Union Budget proposed an education cess of 2 per cent on all taxes, *viz*., income tax, corporation tax, excise duties, customs duties and service tax. Tax proposals on direct taxes are expected to yield a gain of Rs.2,000 crore. On the indirect taxes side, they are broadly revenue neutral. Tax deduction at source (TDS) and tax collection at source (TCS) are proposed to be extended to more activities. The Union Budget expects to recover arrears both in direct taxes and indirect taxes through a special multi-pronged drive.

Expenditure Policy

1.30 The public expenditure policy inherent in the Union Budget seeks to reorient expenditure allocation towards two major areas - defence and the thrust areas in governance relating to infrastructure and social development. An additional provision of Rs.11, 000 crore has been made for defence capital expenditure. The Union

Budget has also made a lump sum provision of Rs.10,000 crore for programmes on Food for Work, *Sarva Shiksha Abhiyan*, mid-day meal scheme, basic health care, railway modernisation and safety, accelerated irrigation benefit programme, drinking water, public investment in agriculture, provision of urban amenities in rural areas (PURA), science and technology and road development. An intensive review of operational aspects of subsidies is proposed to be taken up so as to restructure and target them at the needy sections of the society. A blueprint on subsidies is proposed to be prepared for accomplishing these objectives.

State Governments

1.31 A number of States including Kerala, Punjab, Tamil Nadu and Uttar Pradesh enacted enabling legislation during the year to provide a statutory backing to fiscal reforms. A bill has also been introduced in Maharashtra. A Group comprising State Finance Secretaries of Kerala, Karnataka, Maharashtra, Punjab and Tamil Nadu and a representative from the Central Government was constituted in October 2003 to frame a model bill to facilitate faster adoption of the fiscal rule framework by the remaining State Governments.

1.32 The States have laid emphasis on fiscal rectitude and institutional reforms. On the revenue front, policy initiatives included strengthening of tax efforts and rationalisation of user charges relating to power, water and transport. On the expenditure side, the focus was on containment of revenue expenditure through restrictions on fresh recruitment/ creation of new posts and cutbacks in administrative expenditure. Some States initiated measures to introduce a contributory pension scheme for their newly recruited staff. Public Sector Undertaking (PSU) reforms, particularly in the power sector, also assumed critical importance.

1.33 The Central Government supported the States' fiscal reforms by the States' Fiscal Reforms Facility (2000-01 to 2004-05) through which the States draw up a Medium-Term Fiscal Reforms Programme (MTFRP) by setting targets for broad fiscal indicators in the medium-term covering fiscal consolidation, PSU reforms, power sector reforms and budgetary reforms. The process of sub-national reform is, thus, being driven by a unique twin-track strategy blending a co-ordination approach (MTFRP) and an autonomous approach in the form of fiscal responsibility legislation.

1.34 The debt swap scheme (DSS) for the State Governments, put in place in the Union Budget 2003-04, would enable them to prepay their high cost debt to the Centre. All loans from the Centre to the State Governments bearing coupons in excess of 13 per cent are to be swapped with market borrowings and small saving proceeds at prevailing interest rates over a period of three years ending 2004-05. The debt swap scheme would, over a period of time, reduce the pressure on the States' revenue account by way of lower interest payments and thereby on their overall borrowing requirements.

1.35 The Union Budget, 2004-05 proposes to prepare for a partnership between the Centre and the States in moving towards a single national market through the introduction of VAT and dismantling of controls, especially in agriculture. The Centre-State partnership would also seek to reform and restructure the fiscal institutions, which will get a further boost on the basis of the recommendations of the Twelfth Finance Commission. The focus will also be on increasing fiscal discipline, curbing wasteful expenditure and enforcing tax compliance.

MONETARY POLICY FRAMEWORK

1.36 The conduct of monetary policy in 2003-04 was in conformity with the objectives of ensuring adequate liquidity to meet credit growth for investment demand and price stability. The policy stance was reinforced by a 25 basis point cut in the Bank Rate in end-April 2003 and in the cash reserve ratio (CRR) in mid-June, followed by a 50 basis point reduction in the LAF repo rate towards the end of August. Banks took advantage of easy liquidity conditions to cut deposit rates and lending rates. Responding to the Reserve Bank's initiative, banks switched over from tenor-linked prime lending rates (PLRs) to benchmark PLRs (BPLRs). As at end-March 2004, BPLRs were lower by 25-200 basis points than the PLRs which prevailed a year ago.

1.37 Monetary policy had to contend with challenges posed by large capital flows almost throughout the year. Beginning in the second quarter, massive sterilisation operations were conducted through open market sales and LAF repos. The large scale sterilisation necessitated by the relentless expansion in the net foreign assets of the Reserve Bank resulted in repos outstanding under the LAF soaring to over Rs.50,000 crore by March 2004 and large scale open market sales from the stock of Government securities in the Reserve Bank's portfolio. Accordingly, a Market Stabilisation Scheme (MSS) was introduced in April 2004 to strengthen the Reserve Bank's ability to conduct monetary and exchange rate management.

1.38 Against the backdrop of developments in 2003-04, the stance of monetary policy for 2004-05 reflects the priority attached to realising a structural acceleration in the growth of the economy and to consolidating the recent gains from reining in inflationary expectations. Barring the emergence of any adverse and unexpected developments, the May 2004 Annual Policy Statement sets out the overall stance of monetary policy as:

- Provision of adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level.
- Consistent with the above, while continuing with the *status quo*, to pursue an interest rate environment that is conducive to maintaining the momentum of growth and macroeconomic and price stability.

Credit Delivery System

1.39 Several policy initiatives were undertaken to improve the process of credit delivery to agriculture and small and medium enterprises and strengthen the process of micro finance. Public sector banks were advised by the Government in July 2003 to charge interest rates not exceeding 9 per cent per annum on crop loans up to Rs.50,000 with a view to passing on the benefits of declining interest rates to the agricultural sector. Refinance from the National Bank for Agriculture and Rural Development (NABARD) to the district central co-operative banks directly was enabled by amending the NABARD Act, 1981 in September 2003 in order to reduce the transaction costs involved in extending credit facilities to the co-operative sector. Initiatives were also taken for franchising agricultural credit through post offices on a pilot basis in Tamil Nadu.

1.40 Steps were taken by the Government to liberalise the *Laghu Udyami* Credit Card scheme for providing small and medium enterprises easier access to bank credit. The Reserve Bank advised banks regarding enhancement of investment limits in plant and machinery for certain specified SSI units from Rs. one crore to Rs. five crore. Banks were allowed to increase the limit of dispensation of collateral requirement for loans to SSI units.

1.41 In order to increase the quantity and quality of credit flow to the agricultural sector, the Central Government announced a package of measures on June 18, 2004. Incremental agricultural credit by all financial institutions is slated to increase by 30 per cent to about Rs.1,05,000 crore in 2004-05. This would be reinforced by efforts to enhance coverage of institutional credit, with targets in terms of farmers, projects and agri-clinics in each rural and semi-urban branch.

FINANCIAL SECTOR POLICIES

1.42 The Reserve Bank intensified financial sector reforms during 2003-04 with an emphasis on deregulation, technological upgradation, strengthening of prudential standards and pro-active refinement of regulatory and supervisory oversight of the financial system.

1.43 Banks were sensitised to the need to put in place risk management systems and to draw up road maps by end-December 2004 for migration to Basel II. In recognition of the interest rate risks in a rising interest rate scenario, banks were advised to build up the minimum levels of the Investment Fluctuation Reserve (IFR) (5 per cent of investments in “Held for Trading” (HFT) and “Available for Sale” (AFS) categories) by March 2006 instead of the target date of March 2007 set earlier. Foreign currency exposure on account of foreign currency loans above US $ 10 million were required to be governed by a well laid down policy of their boards with regard to hedging of such currency loans. Guidelines on country risk management were expanded to include countries where a bank has an exposure of one per cent or more of its assets effective March 31, 2005.

1.44 The environment for non-performing assets (NPA) management through the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002 was considerably strengthened in April 2004 by the Supreme Court, which upheld the right of banks and financial institutions to attach and sell assets of the defaulting companies. The Court also upheld the borrowers’ right to appeal and struck down provisions requiring the defaulting borrower to pre-deposit 75 per cent of the liability.

1.45 Risk-based supervision (RBS) was introduced on a pilot basis for eight banks during 2003-04. The quality of compliance with the guidelines on Know Your Customer (KYC) was inspected in order to assess the adequacy of systems for anti-money laundering/combating financing of terrorism. The Reserve Bank proposes to issue fresh licenses for urban co-operative banks after a comprehensive policy is put in place, including an appropriate legal and regulatory framework for the sector.

Policies for Financial Markets

1.46 The Reserve Bank persevered with the development of domestic financial markets through introduction of new instruments, tightening of prudential norms for market makers, improvements in payment systems and strengthening of corporate governance practices.

1.47 Prudential limits were stipulated on borrowing/lending by banks and primary dealers in the call money market. The exposure limit of non-bank entities in the call money market was sharply curtailed with a view to converting the call money market into a pure inter-bank market and to foster the development of the repo market. In the Government securities market, there was a switch to the Delivery *versus* Payment (D*v*P) III mode in which transactions in Government securities could be settled on a net basis. An important development in 2003-04 was the operationalisation of real time gross settlement (RTGS) system which is expected to reduce the settlement risks and cost of financial intermediation significantly. Inter-bank transactions are being put through RTGS by 71 banks. A scheme of Special Electronic Funds Transfer (SEFT) was introduced for the electronic transfer of funds for retail transactions.

1.48 The Securities and Exchange Board of India (SEBI) initiated several policy measures to carry forward the process of development of the capital market and to ensure investor protection. The eligibility norms for unlisted companies to make initial public offers (IPOs) were revised to allow book building. A new clause on the Green Shoe Option (GSO) was added whereby any issuer company making an IPO of equity shares through the book building mechanism could avail of this facility for stabilising the post-listing price of its shares.

1.49 Guidelines prescribed by the SEBI for issue of debt securities on a private placement basis by listed companies require full disclosure, investment grade credit ratings and also issuance and trading in dematerialised form. Norms regarding issuances of derivative instruments such as participatory notes, equity-linked notes or similar instruments against the underlying securities by FIIs or sub-account holders were tightened. Interest rate futures were allowed to be traded on stock exchanges. The SEBI also specified risk containment measures and exposure limits in interest rate derivatives for FIIs and NRIs at US $ 100 million. In order to improve the liquidity in the market, the SEBI allowed corporate brokers with a net worth of at least Rs.3 crore to provide margin trading facility to their clients in the cash segment. A Central Listing Authority (CLA) was established in order to bring about uniformity in the due diligence process in scrutinising listing applications across the stock exchanges. The SEBI shortened the settlement cycle to T+2 with effect from April 1, 2003 with a view to reducing risks in the market and protecting the interest of investors. Straight Through Processing (STP) was made compulsory for all institutional trades with a view to making the trading system efficient and time saving.

1.50 The SEBI took several measures to strengthen corporate governance practices during 2003-04. All compensation paid to non-executive directors is now required to be fixed by the board of directors, subject to approval in a shareholders' general meeting. Company boards are required to lay down the code of conduct for all board members and senior management of a company. Audit committees would review, *inter alia*, the financial statement and draft audit report, with the company management required to justify departures from the accounting standards. The company's Chief

Executive Officer (either Executive Chairman or Managing Director) and the Chief Finance Officer (whole-time Finance Director or other person discharging this function) would have to certify, *inter alia*, the balance sheet and profit and loss account and all its schedules and notes on accounts as well as the cash flow statements and the Directors' Report.

1.51 Various measures were initiated by the SEBI to improve the operations and governance of mutual funds. These included setting investment limits in respect of all debt securities, prescribing minimum number of investors in each mutual fund, issuing guidelines for the participation of mutual funds in derivatives trading, determining a uniform cut-off time for applying net asset values (NAVs) and permitting mutual funds to invest in foreign securities up to 10 per cent of the mutual fund's net assets as on January 31 of each year, subject to a maximum exposure of US$ 50 million by each mutual fund.

1.52 The Union Budget, 2004-05 made some important policy announcements relating to the capital market. A Securities Transaction Tax (STT) of 0.15 per cent was proposed on all transactions made on recognised stock exchanges. The short-term capital gains tax was proposed to be reduced to 10 per cent from 30 per cent earlier. The long-term capital gains tax was proposed to be abolished.

1.53 The proposal relating to the STT was revised by the Finance Minister through a statement made in the Parliament on July 21, 2004. The STT of 0.15 per cent was made applicable only to the delivery-based transactions to be shared equally between the buyer and the seller. While the STT on non-delivery based transactions by day traders and arbitrageurs was proposed to be reduced from 0.15 per cent to 0.015 per cent, the same for derivative transactions was reduced to 0.01 per cent. The debt market was fully exempted from the STT.

Changes in the Legal Framework

1.54 Several significant changes/ modifications were effected in the legal infrastructure. In December 2003, the *Lok Sabha* passed the Industrial Development Bank (Transfer of Undertaking and Repeal) Bill, 2003 allowing IDBI to take up banking business. The Sick Industrial Companies (Special Provisions) Repeal Bill, 2001 enabling dissolution of (a) the Board for Industrial and Financial Reconstruction (BIFR) and (b) the Appellate Authority for Industrial and Financial Reconstruction (AAIFR) was also passed in December 2003 by the *Lok Sabha*. Some other legislations passed during the year were (i) the Fiscal Responsibility and Budget Management Act; (ii) NABARD (Amendment) Act, 2003 which allows NABARD to finance district central co-operative banks (DCCBs) directly; and (iii) the Electricity Act, 2003.

Outlook

1.55 The year 2003-04 was marked by an acceleration of growth and all round macroeconomic consolidation. Although a fuller assessment of the impact of the monsoon on the growth prospects for 2004-05 is difficult at the current juncture, the medium-term outlook remains favourable. With the deepening of the industrial recovery and sustained growth of the services sector, the Indian economy is set to build upon the robust performance recorded in 2003-04. Adequate stocks of foodgrains and foreign exchange reserves would provide a sufficient cushion to the economy against possible adverse developments.

II THE REAL ECONOMY

MACROECONOMIC SCENE

2.1 India recorded one of the highest growth rates in the world in 2003-04, second only to China among the emerging market economies. This robust economic performance was particularly noteworthy in an environment marked by hesitant global recovery, heightening of geo-political tensions during the year, volatility in international crude oil prices and large asset price movements in international financial markets engendered by abundant liquidity. Domestic developments – largely immune to the global business cycle – powered a surge in real GDP growth to 8.2 per cent – the highest in 15 years. An agricultural rebound, typical of a post-drought supply response of the Indian economy, played a key role in the resurgence of growth. Activity also firmed up in a wide range of manufacturing and services sectors. Trade, hotels, restaurants, transport, storage and communication surpassed trend growth. Capital goods production also continued to surge. Merchandise exports weathered pressures of the rupee's appreciation against the US dollar, posting a growth of above 20 per cent in US dollar terms. Despite the widening trade deficit, symbiotic of the growth resurgence, buoyant software exports and remittances enabled a current account surplus in the balance of payments for the third consecutive year. This was accompanied by a surge in capital inflows. In spite of substantial policy-driven outflows, foreign exchange reserves rose to an unprecedented level.

Agriculture

2.2 Real GDP originating in 'agriculture and allied activities' is estimated to have recorded a growth of 9.1 per cent in 2003-04 - the highest in seven years. This resurgence was distinctly similar to the post-drought rebound in 1988-89. With rainfall above the Long Period Average (LPA) in July 2003, the main sowing month of the *kharif* season, real GDP growth in 'agriculture and allied activities' surged in the second quarter and gathered further momentum over the rest of the year as *rabi* output also turned out to be satisfactory. The index of agricultural production rose by 19.6 per cent, a 14-year record. Foodgrains production recouped lost ground and returned closer to the pre-drought (2001-02) level. In the case of pulses, the production level reached an all-time high. Rice production rose by over 19 per cent, compensating for the loss of output in 2002-03 and supporting a vigorous export thrust, particularly in the non-basmati category. Oilseeds production scaled a new peak (over 25 million tonnes), led by groundnut and soyabean.

2.3 Notwithstanding the progress made since the 1980s, Indian agriculture continues to depend significantly on the monsoon. This is evident, yet again, from the alternating experiences of poor monsoon and drought in 2002-03 and normal monsoon and strong recovery of production in 2003-04. Rainfall was also spatially well distributed during 2003-04. The cumulative rainfall during the South-West monsoon (June 1 to September 30, 2003) was two per cent above the Long

Period Average (LPA) with 33 out of 36 meteorological sub-divisions receiving normal/excess rainfall. Only north and south interior Karnataka and Kerala received deficient rains. Rainfall in the sowing months of June and July 2003 was eight per cent and six per cent above the LPA, respectively. The North-East monsoon was also normal with the cumulative rainfall at nine per cent above the LPA. The total live water storage in the major reservoirs at the end of the monsoon season (as on December 26, 2003) was about 47 per cent of the Full Reservoir Level (FRL) and 122 per cent of the preceding year's level.

2.4 The stock of foodgrains with the Food Corporation of India (FCI) and the State agencies declined sharply from the peak level of 64.8 million tonnes on June 1, 2002 to 39.8 million tonnes on June 1, 2003 partly due to drought relief measures and partly due to policy initiatives to liquidate the surplus food stocks. As 2002-03 was a drought year, procurement of foodgrains declined by 3.3 million tonnes, while offtake increased by 18.3 million tonnes. The Central Government allocated 8.3 million tonnes of foodgrains to drought affected States. Of this, 4.7 million tonnes were lifted during 2002-03. Lower procurement and continued offtake during 2003-04 brought down the stocks of foodgrains further by March 1, 2004. The offtake during 2003-04, a normal monsoon year, remained closer to the offtake during the drought year of 2002-03, thereby reflecting continued policy initiatives to economise on wastage cost, storage cost and interest cost on food credit. Wheat procurement declined by 8 per cent during the *rabi* marketing season of 2002-03 and further by 17 per cent during the *rabi* marketing season of 2003-04. Paddy procurement declined by 26 per cent during the *kharif* marketing season of 2002-03. The offtake of foodgrains during 2003-04 was higher by 13 per cent in the Targeted Public Distribution System (TPDS) and 18 per cent in Other Welfare Schemes (OWS), while it was lower by 36 per cent under Open Market Sales (OMS). The procurement of paddy during the current *kharif* marketing season so far (October 1, 2003 to July 26, 2004) was higher by 39.8 per cent over 2002-03. The procurement of wheat during the *rabi* marketing season so far (April 1 to July 26, 2004) was also higher by more than 6 per cent over the corresponding period of the previous year. The offtake of foodgrains during the current year so far (April 1 to June 31, 2004) was, however, lower by around 40 per cent than the comparable period of the previous year. The foodgrains stocks at 30.6 million tonnes on July 1, 2004 are still above the stipulated quarterly norm of 24.3 million tonnes as on July 1.

Industry

2.5 Real GDP growth originating in industry gathered strength in every successive quarter of 2003-04. Industrial production steadily accelerated to reach a peak of 8.3 per cent in February 2004 (the highest since April 2000) before tapering off to 8.1 per cent in March 2004. The rise in the index of industrial production (IIP) in 2003-04 was the highest after 1995-96. The improvement in industrial performance was enabled by a rebound in rural demand, rising exports across a spectrum of industries, increased consumer durables demand fuelled by low interest rates and reduction in excise duties on a host of intermediate inputs.

2.6 The industrial revival became broad-based towards the latter part of 2003-04, driven primarily by manufacturing which contributed 86.5 per cent to overall growth in industrial production. This was supported by a strong expansion in electricity generation, especially in the last quarter of the year when plants, which had remained closed for repair and maintenance during the early part of the year, started functioning. The mining and quarrying sector also staged a recovery in the last quarter of 2003-04, which helped to maintain strong growth in the industrial sector.

2.7 A heartening feature of the industrial recovery has been the sustained growth in the production of capital goods and intermediate goods with the former registering a double-digit growth during 2003-04. The concomitant surge in imports of these items is indicative of capital deepening associated with a more intensive utilisation of capacity. Production in the basic goods sector increased marginally during the year due to slowdown in the growth of mining, cement and steel sectors. There was a sharp turnaround in the consumer durables production.

2.8 The composite index of six infrastructure industries recorded marginally lower growth during 2003-04 mainly on account of the subdued performance of crude petroleum, finished steel and cement sectors. The production of crude petroleum suffered on account of high water-oil ratio in some of the oil fields. The production of cement and steel decelerated from high growth during 2002-03 due to less than expected demand from the construction sector.

Services

2.9 The services sector continued to be the mainstay of the expansion during 2003-04, contributing 57.6 per cent to real GDP growth. Leading the upsurge was 'trade, hotels, transport and communication'. This was in consonance with the improved performance of the commodity producing sectors. The strong expansion in cargo handled at major ports as well as the rise in freight and passenger traffic of the railways boosted the performance of the transport sector. According to the CSO, net tonne kilometres and passenger kilometres in respect of railways grew by 5.5 per cent and 3.7 per cent, respectively, during the first three quarters (April-December) of 2003-04. Production of commercial vehicles and cargo handled at major ports showed a growth of 35.7 per cent and 7.5 per cent, respectively during the same period. A record increase in tourist inflows and higher occupancy provided an impetus to the growth of the hotel industry during the year. Lower tariffs in the cellular phone segment due to intense competition among cellular operators and increased penetration into rural areas led to substantial growth of the telecommunication sector. Other categories of services registered somewhat lower growth than in the preceding year.

AGGREGATE DEMAND

2.10 The deceleration in economic growth in 2002-03 reflected the slowdown in real private consumption demand on account of a sharp decline in rural incomes. Investment demand, however, continued to accelerate even in the drought year. Increased Government demand - consumption as well as investment - acted as counter cyclical stabilisers in 2002-03.

2.11 Information on saving and capital formation is available up to 2002-03. According to the CSO, the gross domestic saving (GDS) rate moved up to 24.2 per cent of GDP in 2002-03 from 23.5 per cent of GDP in the preceding year. The improved aggregate saving was entirely due to reduced public sector dis-saving, which contracted to 1.9 per cent of GDP in 2002-03 from 2.7 per cent in 2001-02, reflecting improved Government finances. Saving by the household sector - the principal saver - declined marginally to 22.6 per cent of GDP from 22.7 per cent over the same period. There was a switch in household savings in favour of physical assets from financial assets. The buoyancy of private corporate savings noticed from 1999-2000 continued in 2002-03 on the back of increased profits. As a ratio to GDP, however, private corporate sector saving declined marginally from 3.5 per cent in 2001-02 to 3.4 per cent in 2002-03.

2.12 In recent years, the investment rate has been lower than the saving rate. While the rate of gross domestic capital formation (GDCF) improved marginally in 2002-03, the improvement was sharper in the case of the GDS rate. As a result, the ratio of GDS-GDCF to GDP increased significantly to 0.9 per cent in 2002-03 from 0.3 per cent in the preceding year. The rate of capital formation of public and private corporate sectors declined marginally.

2.13 Preliminary estimates, based on the latest available information, placed the rate of financial saving (net) of the household sector higher at 11.8 per cent of GDP at current market prices in 2003-04 as compared with the revised estimate of 10.7 per cent in 2002-03. The increase in household financial saving (net) in 2003-04 reflected a greater propensity for saving in the form of deposits, claims on Government, currency and contractual schemes (life insurance, provident and pension funds).

Outlook

2.14 The India Meteorological Department (IMD) had made a forecast of normal South-West monsoon season at end-June, 2004, *i.e.*, 100 per cent of Long Period Average (LPA) with a model error of +/-4 per cent. The cumulative rainfall during June 1 to August 11, 2004 was, however, 7 per cent below normal (LPA) as compared with 3 per cent above LPA during the comparable period of 2003. The area sown as on July 30, 2004 indicates that production of major crops such as rice, coarse cereals, cotton, jute and mesta may be adversely affected, although a clearer assessment will depend on the progress of the South-West monsoon. The industrial recovery currently underway has been broad-based and qualitatively robust. Strong growth in key industries especially transport equipment and parts, paper and paper products, machinery and equipments and basic chemicals and chemical products has industrial growth in 2004-05. An encouraging feature of infrastructure performance has been a revival of the electricity sector. Various indicators suggest an improved investment climate. In particular, sustained expansion of the capital goods sector combined with increased capital goods imports augur well for investment climate. The services sector is also expected to gain further momentum from the commodity producing sectors, particularly in the trade, transport and communication segments and in the 'new economy' activities. Construction activity, in particular, is expected to pick up due to the impetus received from the growth in housing. Also, as the global economy picks up, export demand across a spectrum of industrial products and services is expected to increase. Uncertainties surrounding the progress of the monsoon, the impact on domestic real activity of elevated international crude price levels and the breadth of the global recovery contain some risks for the macroeconomic outlook for India.

III MONEY, CREDIT AND PRICES

3.1 Monetary conditions continued to remain easy during 2003-04, driven by persistent capital inflows. Despite sterilisation operations, the sheer volume of accumulation of the Reserve Bank's net foreign assets (NFA) expanded reserve money at the rate of 18.3 per cent – the highest since 1994-95. Broad money (M_3) expansion was also the highest since the late 1990s. As a consequence, financial markets operated in conditions of ample liquidity. Interest rates at the short end of the market continuum persistently ruled below the Reserve Bank's Liquidity Adjustment Facility (LAF) repo rate and generally softened across the maturity spectrum. Beginning in June 2002, the exchange rate appreciated through the year in nominal terms against the US dollar. Credit offtake remained weak in relation to initial expectations as bank finance was substituted by internally generated funds and cheaper funds raised overseas. The demand for bank credit picked up only in the latter half of the year. With the virtual absence of pressures from aggregate demand, inflation eased during the year, *albeit* haltingly in the second half of the year on account of transient supply pressures emanating from localised drought and the pass-through of hardening international crude prices into domestic prices of petroleum, oil and lubricant (POL) products.

RESERVE MONEY

3.2 Reserve money growth nearly doubled during 2003-04, led by strong capital inflows. The ratio of NFA to reserve money consequently rose to 120.7 per cent by February 2004 – the highest level since the mid-1950s. The Reserve Bank's NFA/currency ratio reached 150.8 per cent in February 2004, and remained well above the benchmark of 70 per cent which was recommended by the Committee on Capital Account Convertibility (Chairman: Shri S. S. Tarapore) to ensure that the Reserve Bank possessed the wherewithal to meet reversals in the external sector. In response, the Reserve Bank's net domestic assets (NDA) registered an unprecedented contraction.

3.3 The net Reserve Bank credit to the Central Government (Centre) contracted by 67.3 per cent during 2003-04, pulling its share in reserve money down to 8.5 per cent at end-March 2004 from over 90 per cent in the late 1980s. Private placements with the Reserve Bank during 2003-04 were mainly to enable prepayment of US $ 3.8 billion of multilateral and bilateral debt. This was counterbalanced by a large build-up of cash balances by the Centre on account of disinvestment proceeds, revenue buoyancy, proceeds under the State Debt Swap Scheme and the higher mobilisation on account of saving bonds. Sustained OMO, including repo operations under the LAF, reduced the stock of marketable Government paper with the Reserve Bank to Rs.40,750 crore at end-March 2004 from Rs.52,546 crore at end-March 2003. This was despite the conversion of the available stock of non-marketable special securities (of Rs.61,818 crore) created out of the past *ad hoc* and tap Treasury Bills into tradable securities during the year.

Developments during 2004-05

3.4 Reserve money expansion during 2004-05 (up to August 13, 2004) was broadly of the order recorded in the corresponding period of 2003-04 and was largely driven by the accretion to the Reserve Bank's NFA. Reflective of the Reserve Bank's sterilisation operations, the Reserve Bank's net credit to the Centre recorded a sharp decline. The Reserve Bank's net credit to the Centre, in fact, occasionally turned negative in the first quarter of 2004-05 due to the build-up in the Centre's cash balances, including proceeds under the Market Stabilisation Scheme (MSS).

MONETARY SURVEY

3.5 Broad money (M_3) growth was higher than projected in the Monetary and Credit Policy for 2003-04. A distinctive feature of the intra-year development of monetary conditions during 2003-04 was the sharp acceleration in M_3 growth towards the end of the year. The large monetary expansion occurred in spite of a bullet redemption of the RIBs in October 2003. During the first half of the year, a revival in cash demand coupled with weak credit demand resulted in a slowdown of the annual M_3 growth rate to a 28-year trough of 11.5 per cent in May 2003. Monetary expansion resumed in September, driven by the abundant liquidity emanating from capital flows, the cut in CRR in June 2003 and the strengthening of the credit offtake.

3.6 The strong recovery in agricultural activity during 2003-04 led to increased currency demand, especially because cash continues to dominate rural transactions. Aggregate deposits picked up in the last quarter of the year. A sudden spurt in scheduled commercial banks' non-food credit during the latter half of the year was reflected in a sharp increase in demand deposits. Increased activity in the capital market, including disinvestment and increased FII funds, also contributed to the expansion in demand deposits. Time deposits grew at a marginally higher rate despite a continuing migration of household saving to postal deposits, a shift in household preferences towards mutual funds from banks' fixed deposits and a slowdown in non-resident deposit inflows emanating from the rationalisation of interest rates on NRE deposits.

Sources of Money Supply

3.7 Changes in asset portfolios of commercial banks reflected the impact of rallies in the Government securities market, the appreciation of the exchange rate *vis-á-vis* the US dollar and the dynamics of credit demand. Domestic credit (including banks' non-SLR investments) decelerated to 11.0 per cent during 2003-04 from 13.5 per cent (adjusted for mergers) during the previous year.

3.8 Net bank credit to the Government grew at 10.2 per cent during 2003-04 – the lowest order of growth since 1994-95 – due mainly to a build-up of large cash balances by the Central Government with the Reserve Bank. Large sterilisation operations led to the share of the Reserve Bank in net bank credit to the Government dipping to a low of 5.1 per cent by February 2004 from 65.6 per cent at end-March 1990. Commercial banks continued to park surplus liquidity in gilts in response to attractive risk-free yields. This buoyed up their holdings of statutory liquidity ratio

(SLR) securities to as much as 41.3 per cent of their net demand and time liabilities by end-March 2004, far in excess of the statutory requirement of 25 per cent.

3.9 The growth of bank credit to the commercial sector during 2003-04 was comparable to that of the previous year. Food credit declined due to lower food stocks and sustained higher offtake. Commercial banks' non-food credit decelerated marginally for the year as a whole, although there was a significant pick-up in the latter half. Besides conventional credit, commercial banks' non-SLR investments recorded a marginal increase as higher exposures to mutual funds were largely offset by divestment of private sector corporate bonds.

3.10 In the deployment pattern of commercial bank credit, the priority sector continued to be the largest recipient, as in earlier years. This was essentially on account of substantially higher offtake by the 'other priority' segment, representing primarily small housing loans up to Rs.10 lakh.

3.11 An industry-wise distribution of credit shows that the lower expansion of credit was due to a decline in offtake by industries such as mining, iron and steel, other metal and metal products, chemicals, petroleum, fertilisers, cement, and rubber. This was reinforced by a deceleration in credit to cotton textiles, drugs and pharmaceuticals and computer software. On the other hand, credit to infrastructure industries, especially roads and ports, power and telecommunications, increased substantially. Some industries such as electricity, food processing, jute textiles, sugar, tea, tobacco, leather, gems and jewellery and construction also recorded higher bank credit offtake.

Developments during 2004-05

3.12 The expansion of money supply during 2004-05 (up to August 6, 2004) continued to be driven by a sustained increase in the monetary base. Currency expansion remained strong, reflecting a pick-up in activity across the economy. Demand deposits, in particular, recorded a strong growth, reflecting a sustained pick-up in scheduled commercial banks' non-food credit. Food credit expanded by Rs. 6,481 crore during 2004-05 (up to August 6, 2004) in sharp contrast to the decline of Rs. 6,228 crore in the corresponding period of the previous year. Net bank credit to the Government decelerated sharply following the significant slowdown in the Centre's market borrowing programme.

PRICE SITUATION

3.13 Inflation in India generally remained stable during 2003-04, although rising commodity prices led to episodes of pressures. Agricultural commodity prices were subdued due to favourable supply conditions in the market following the normal monsoon. The pick-up in domestic economic activity and exports led to an imbalance between domestic demand and supply of key commodities such as metals, cotton and fuel. This contributed to the hardening of their prices in line with international price movements. Owing to competitive pressures, however, a part of the higher input costs resulting from the rise in commodity prices seems to have been absorbed by corporates in their margins. Consequently, the rising commodity prices were not reflected fully in overall inflation. Accordingly, consumer price inflation remained benign in 2003-04, facilitated in addition, by stable housing and services prices.

Wholesale Price Inflation

3.14 Headline inflation, measured by year-on-year (y-o-y) changes in the wholesale price index (WPI), peaked at 6.9 per cent in the first week of May 2003, as transport disruptions and upward revisions in electricity prices offset the effect of cuts in petroleum product prices. Inflation receded thereafter to a trough of 3.8 per cent by August 23, 2003 due to declines in the prices of minerals oil, fruits, oilseeds, oil cakes and chemicals. Incipient inflationary pressures began to emerge when prices of iron and steel, cotton and fuel started firming up in line with international price movements. Prices of vegetables and sugar also rose during this period due to supply-side pressures from persistent localised drought conditions as well as upward revisions in the statutory minimum prices of sugarcane. By January 10, 2004 inflation had reached 6.6 per cent. About a fifth of this rise in inflation was caused by successive hikes in domestic petrol and diesel prices between December 16, 2003 and January 1, 2004. With the delayed seasonal fall in fruits and vegetable prices, a decline in prices of eggs and poultry chicken on fears of *avian influenza* and base effects of oil price hikes in February and March 2003, inflation retreated to 4.6 per cent by the end of the year.

Consumer Price Inflation

3.15 Consumer price Inflation, measured by year-on-year variation in the consumer price index for industrial workers (CPI-IW), eased during the year to 3.5 per cent, reflecting the effects of the bumper agricultural production and negligible/lower weightage of the key movers of WPI inflation - iron and steel and fuel items - in the CPI basket. Disaggregated commodity price movements within the CPI-IW basket indicate that lower prices of oil and fats, housing and services (proxied by the broad miscellaneous group) led to the ebbing of inflation. As against booming housing prices in developed countries, domestic housing prices remained moderate. Services prices remained flat. On an annual average basis, CPI inflation in 2003-04 remained below its level in the previous year.

Monitoring Inflation in India

3.16 The Reserve Bank continuously monitors the price situation by taking lead information from indicators for the conduct of monetary policy. Multiple indicators such as money, interest rates or rates of return in different markets (money, capital and government securities markets) along with such data as on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, exchange rate, refinancing and transactions in foreign exchange available on high frequency are juxtaposed with output trends for drawing policy perspectives. Evolving global inflation and monetary policy responses elsewhere form an integral part of monitoring inflation conditions by the Reserve Bank. With increasing globalisation of the Indian economy, the pass-through of international prices to domestic inflation is becoming increasingly evident. Accordingly, international commodity price movements as well as the demand-supply situation in key commodities are constantly monitored to gauge their impact on the domestic inflation process.

Outlook

3.17 Monetary conditions in 2004-05 are expected to remain stable. Non-food bank credit is likely to maintain its momentum, drawing from increased investment activity and improved business confidence. In this context, the Annual Policy Statement of May 2004 had projected money supply (M_3) expansion at 14.0 per cent during 2004-05. This order of monetary expansion should facilitate the financing of productive activity without placing undue pressure on aggregate demand.

3.18 The outlook on inflation during 2004-05 will, *inter alia*, depend on the progress of the South-West monsoon. The distribution of rainfall in various parts of the country up to July 2004 has raised some concern about the possible impact on primary agricultural commodity prices. The revival and spread of the monsoon since the beginning of August, however, could dampen the adverse impact on agricultural commodity prices to an extent. Food stocks and foreign exchange reserves should provide a cushion against any pressures on food prices. Fuel prices hold the key to the overall inflation outlook. Non-fuel commodity prices in the international market would have a critical bearing on the domestic inflationary situation during the year. Under the assumption of no significant supply shocks, and appropriate management of liquidity, the Annual Policy Statement had placed the inflation rate for 2004-05, on a point-to-point basis, at around 5.0 per cent. While the international non-fuel commodity prices could ease by the year end, further information, especially on the monsoon, would be needed to reassess the inflation scenario.

IV GOVERNMENT FINANCES

4.1 Government finances witnessed some improvement in 2003-04, reflecting the robust macroeconomic performance and the commitment towards sustainable fiscal consolidation. All the key deficit indicators, *viz.,* gross fiscal deficit (GFD), revenue deficit (RD) and primary deficit (PD) of the Centre in the revised estimates as well as in the provisional accounts for 2003-04 turned out to be lower than their budgeted levels, facilitated by higher revenue realisation and containment of non-Plan expenditure. In particular, the spectacular growth in corporation tax collections on the back of the rising profitability of the corporate sector enabled a rise in the tax-GDP ratio after seven years. Furthermore, proceeds from disinvestments exceeded the budgeted target after a gap of four years. On the other hand, there was an erosion in the health of State finances with all the key deficit indicators rising in the revised estimates for 2003-04 on account of the large increase in expenditure.

CENTRAL GOVERNMENT FINANCES – 2003-04

4.2 During 2003-04, finances of the Central Government revealed an improvement in the revised estimates *vis-á-vis* the budget estimates. This paved the way for the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. The key deficit indicators, *viz.,* gross fiscal deficit, revenue deficit and primary deficit in 2003-04 were lower in comparison with the budget estimates as well as their levels in 2002-03. In 2003-04, the GFD and the PD were at their lowest level since 1990-91 in relation to GDP. More than half of the reduction in the gross fiscal deficit was due to the improvement in the revenue account.

4.3 The improved fiscal performance during 2003-04 was also attributable to a successful strategy for containing non-Plan expenditure. The decline in interest rates on fresh borrowings in recent years facilitated a reduction in the ratio of interest payments to revenue receipts. In addition, higher disinvestment proceeds also enabled fiscal consolidation. The Centre built up a cash surplus with the Reserve Bank from August 2003, which was generally invested in its own paper. The trend in cut back in capital outlay, however, persisted in 2003-04.

4.4 Buoyant economic activity led to an improvement in the ratio of revenue receipts to GDP. The increase in gross tax revenue was on account of increased collections under corporation tax and service tax, which mitigated the shortfall in receipts under personal income tax and union excise duty. The considerable growth in service tax realisation resulted from measures aimed at bringing more services under the tax net.

4.5 Capital receipts of the Central Government were also higher than the budget estimates on account of higher receipts under the DSS and proceeds from disinvestment. Disinvestment proceeds exceeded the budgetary target after a gap of four years.

4.6 The financing pattern of the GFD in the revised estimates *vis-á-vis* the budget estimates underwent a compositional shift on account of the DSS. The surplus cash balances emanating therefrom economised on the requirement of financing the GFD. While the share of market borrowings was lower than the budget estimates, securities issued to the NSSF accounted for 45.7 per cent of the GFD.

Debt Position of the Central Government

4.7 The outstanding domestic liabilities of the Central Government declined marginally to 60.5 per cent of GDP at end-March 2004 from 60.7 per cent at the end of the preceding fiscal year. Internal debt alone accounted for 65.8 per cent of the total outstanding debt of the Central Government, while 'other liabilities' which comprise, *inter alia*, small savings and provident funds accounted for 31.5 per cent.

Interest Rate Structure of Central Government Debt

4.8 The soft interest rate regime has facilitated the raising of resources at relatively low cost. In recent years, the weighted average interest rate on the Centre's market borrowings by way of dated securities has declined steadily . The cost of resources mobilised through small savings and provident funds has also declined as a consequence of the efforts to align interest rates on various small saving instruments with the market interest rates. For instance, interest rates on Public Provident Funds and National Saving Certificates were reduced from 12.0 per cent in 1999 to eight per cent in 2003. The effective cost to the Government in respect of non-marketable borrowings such as small savings and provident funds would, however, be higher if various tax exemptions available on these instruments are taken into account.

STATE GOVERNMENT FINANCES – 2003-04

4.9 In recent years, the stress on the finances of the State Governments has intensified, as reflected in persistent and growing fiscal imbalances. The secular deterioration in State finances has impacted their current and prospective developmental and welfare-oriented functions. In this *milieu*, a positive development has been the growing recognition of the urgent need for fiscal consolidation. A number of State Governments initiated a wide spectrum of reforms in the late 1990s in order to arrest the deterioration in their financial position.

4.10 Notwithstanding such initiatives, the emerging fiscal scenario as reflected in the revised estimates for 2003-04, indicates the persistence of structural infirmities in State finances, *albeit* with some improvement in the orientation of expenditure. This underscores the need to carry forward and reinvigorate the multi-pronged reform process at the State level.

4.11 All the major deficit indicators recorded substantial slippages from the budget estimates of 2003-04 and were placed higher than their respective levels in the past. The widening of the revenue deficit in 2003-04 mainly reflected the increased outgo on economic services and interest payments, offset to some extent by a rise in shareable tax revenue from the Centre.

4.12 The financing pattern of the GFD shows that small savings continue to account for the predominant share. The share of market borrowings in GFD, however, shows a sharp increase reflecting, *inter alia*, additional allocations under the DSS. As a consequence, repayments of loans to the Centre exceeded gross loans from the Centre during 2003-04.

4.13 The large and increasing GFD of the States has led to a steady accumulation of debt over the years. The debt-GDP ratio of the States increased further to 29.1 per cent at end-March 2004 from 27.8 per cent at end-March 2003.

COMBINED BUDGETARY POSITION OF THE CENTRE AND THE STATES – 2003-04

4.14 The combined revenue receipts of the Centre and the States in 2003-04 (RE) exceeded their budgeted levels. While both the tax and non-tax revenues increased over the previous year, the rise was more pronounced in respect of non-tax revenue. The increase in combined revenue expenditure, however, outpaced the rise in revenue receipts, resulting in a higher revenue deficit. The combined aggregate expenditure exceeded the budget estimates on account of higher than anticipated revenue expenditure and loans and advances, while capital outlay was marginally lower than in the budget estimates. Relatively higher growth in aggregate expenditure *vis-á-vis* revenue receipts led to an increase in the GFD over the budgeted level. While in terms of GDP, the revenue deficit was higher by 0.3 percentage points over the budget estimates, the gross fiscal deficit remained unchanged at the budgeted level.

UNION BUDGET – 2004-05

4.15 The Union Budget, 2004-05 was presented against the backdrop of sound macroeconomic fundamentals. The Fiscal Responsibility and Budget Management (FRBM) Act, 2003 has further streamlined the budget presentation process. The commitment to prudent financial policies has been demonstrated by notifying the FRBM Act, 2003 and FRBM Rules, 2004 with effect from July 5, 2004.

4.16 The Union Budget for 2004-05 has endeavoured to carry forward the process of fiscal consolidation, essentially based on a projected upsurge in revenue mobilisation coupled with some deceleration in expenditure. A notable feature of the budget estimates is the reduction of nearly 24 per cent in the revenue deficit in 2004-05 on top of the decline of about 7 per cent in the previous year. As a consequence, the revenue deficit is placed lower in 2004-05 than the revised estimates of the previous year and the average during the second half of the 1990s. The GFD-GDP ratio is also budgeted to decline in 2004-05 in comparison with recent trends.

4.17 The Union Government constituted a Task Force on Implementation of the Fiscal Responsibility and Budget Management Act, 2003 (Chairman: Dr. Vijay L. Kelkar) to suggest ways of achieving the fiscal targets prescribed by the FRBM Act, 2003. The Task Force submitted its Report to the Government in July 2004, providing the road map for attaining the fiscal targets set in the FRBM Act.

STATE BUDGETS – 2004-05

4.18 A significant correction of fiscal imbalances is to be effected in the finances of the States in 2004-05 through a compression of developmental and investment-oriented expenditures. All the major deficit indicators of the State Governments are expected to be placed substantially lower than their levels in the previous year.

4.19 Total revenue receipts as well as States' own revenue constituents would, however, remain broadly unchanged in 2004-05 as ratios to GDP from their levels in the previous year.

COMBINED BUDGETS FOR 2004-05

4.20 The continued efforts towards fiscal consolidation were reflected in the lower projections for the combined gross fiscal deficit, the revenue deficit and the primary deficit in 2004-05 as compared with the revised estimates for 2003-04. This reduction is sought to be achieved through an acceleration in tax collections and a moderation in the growth of aggregate expenditure.

4.21 Combined revenue receipts are budgeted to register a substantial growth during 2004-05, solely on account of a rise in tax collections. The combined tax-GDP ratio of the Centre and the States is, accordingly, anticipated to register an improvement of 0.8 percentage points of GDP during 2004-05. The non-tax revenue, on the other hand, is budgeted to decline over the revised estimates for 2003-04. On the expenditure side, the share of non-developmental expenditure is budgeted to be higher than in the revised estimates for 2003-04.

4.22 Of the combined gross fiscal deficit, 47.2 per cent is budgeted to be financed through market borrowings. The share of small savings is budgeted to decline. The share of external financing will be relatively insignificant.

Outlook

4.23 The policy objectives for 2004-05 are to build upon the fiscal consolidation, *albeit* modest, achieved in 2003-04. The deepening of tax reforms, reorienting expenditure towards thrust areas and enhancing investment should help in attaining the goals set under the FRBM Act, 2003. The commitment to eliminate the revenue deficit as stipulated by the FRBM Act, 2003 and generation of revenue surplus for further investment is consistent with the envisaged improvement in the tax-GDP ratio. In this context, the focus is on expanding scope of the services tax by bringing newer services within the purview of taxation. On the expenditure front, non-plan expenditure is sought to be pruned by plugging leakages and by targeting subsidies at the needy. Public investments in infrastructure, both economic and social, are to be stepped up with an improved mechanism for delivery of infrastructural services. The Centre may be able to continue with the policy of managing the debt prudently through the debt-swap scheme and refinancing to reduce the interest burden. The FRBM Rules, 2004 would facilitate the reduction of total liabilities of the Centre.

4.24 At the States' level, the emerging fiscal scenario, as reflected in the revised estimates for 2003-04, indicates the persistence of structural infirmities, *albeit* with some improvement in the orientation of expenditure. A renewed emphasis on fiscal empowerment is reflected in the major policy initiatives contained in the State Budgets for 2004-05. These include perseverance with fiscal reforms, revenue augmentation and expenditure containment, reforms in tax administration, improvement in recovery of user charges, restructuring of SPSUs, enhancing transparency in budgetary operations, emphasis on infrastructure development and reduction and management of States' debt. The debt swap scheme and availing of loans from external agencies on the same terms and conditions as the Centre would reduce the debt burden of the States.

V FINANCIAL MARKETS

5.1 A broad based rally in global financial markets in 2003-04 was characterised by rising equity prices, decline in bond spreads, a rebound in financial flows to emerging markets, improved corporate finances and increased appetite for risks by investors. The Morgan Stanley Capital International (MSCI) World index gained 23 per cent in 2003 and a further 3 per cent during the first two months of 2004. The pattern of investment flows generally implied an allocation of funds away from relatively low-yielding assets in favour of riskier investments. Equity and debt prices in emerging markets outperformed most other markets. A combination of abundant liquidity and improved fundamentals buoyed global asset prices. Net issuances in international debt securities markets were distinctly higher at US $ 1,467 billion in 2003, as compared with US $ 1,011 billion in 2002, and were made largely by emerging market economies.

5.2 Against this background, financial markets in India were also characterised by ample liquidity during 2003-04 mainly due to persistent external capital flows. A steady appreciation of the rupee against the US dollar in the spot segment of the foreign exchange market generated unidirectional upside expectations which dominated the forward segment. In the Government securities market, there was a persistent rally in prices, interrupted by open market operations (OMO) and a hardening of inflation expectations in the last quarter of the year. In the market for bank credit, falling deposit rates nudged the stickier lending rates down. Equity markets regained vibrancy with intermittent corrections.

MONEY MARKET

5.3 Activity in the call/notice money market ebbed during 2003-04 with call rates ruling persistently below the LAF repo rate, except in isolated episodes. The surplus liquidity at the beginning of the year drew heavy bidding at the LAF repo auctions. Call rates inched up in June 2003, with the outflows on account of the usual end-of-the-quarter advance tax payments by corporates and market borrowings by the Centre and the State Governments. Consequent upon a reduction in the cash reserve ratio (CRR) by 25 basis points in June 2003 and continuing external capital inflows, call rates eased and settled below the repo rate in July 2003. Call rates turned somewhat volatile for a brief period in August 2003. With the 50 basis points cut in the LAF repo rate on August 25, 2003 stability returned to the market, accompanied by a softening of call rates. Advance tax outflows, unsettled expectations surrounding the RIB redemptions and a build up of surplus cash balances of the Government with the Reserve Bank led to some edging up of call rates towards the last week of September 2003, prompting the Reserve Bank to reduce the notified amount of 91-day Treasury Bills. Contrary to initial apprehensions, redemption of RIBs on October 1, 2003 did not strain the money market with liquidity conditions remaining comfortable. OMO sales and a series of

28-day repo auctions conducted by the Reserve Bank in the second half of October caused call rates to spike above 6.0 per cent towards the end of the month. Liquidity generated by large capital inflows brought down call rates to sub-repo levels for the remaining part of the year with some isolated dips in February 2004 due to unsterilised capital flows. Over the year, volatility in the call/notice money market declined and was accompanied by a reduction in turnover on account of abundant liquidity.

5.4 Recent money market reforms encompassing development of the repo market, introduction of exposure limits for banks in the call/notice money market segment and the calibrated phase out of non-banks from the call market have begun to infuse vibrancy into various money market segments. The significant increase in the outstanding amount of certificates of deposit (CDs) in 2003-04 essentially reflected issuances by some banks with low deposit bases, exemption of investments in CDs by banks from the restrictions on non-SLR investments below one year, reduction in stamp duty on CDs, effective March 1, 2004 and withdrawal of the facility of premature closure of deposits in respect of CDs. The outstanding amount of CP increased by about 59 per cent during 2003-04. The issuance of CP picked up from mid-November 2003 on account of increased interest by mutual funds and banks in the wake of the guidelines by the SEBI and the Reserve Bank barring investments in non-SLR debt securities with original maturity up to one year except in CP and CDs. Furthermore, reduction in stamp duty on CP also buoyed up the market.

5.5 During 2003-04, the monthly average volume of repo transactions [outside the liquidity adjustment facility(LAF)] increased by 69.6 per cent to Rs.79,628 crore over the previous year. The share of repo in total transactions (outright and repos) increased to 36.8 per cent in 2003-04 from 30.6 per cent in 2002-03.

FOREIGN EXCHANGE MARKET

5.6 Excess supply conditions dominated the foreign exchange market during the major part of 2003-04, reflecting a sustained expansion of the current account surplus in the balance of payments and a surge in capital inflows. Despite large scale purchases by the Reserve Bank to absorb excess supplies in the foreign exchange market, the Indian rupee appreciated by 9.3 per cent against the US dollar during 2003-04. This was counter balanced by the weakening of the rupee against other major currencies in tandem with the US dollar. Consequently, the depreciation of the rupee in terms of the nominal effective exchange rate was relatively muted. In cross-currency trade, the rupee weakened against both the Euro and the Pound sterling, reflecting the movements of the rupee against the US dollar and movement of the US dollar *vis-á-vis* other major international currencies. While the US dollar depreciated against the Euro, Pound sterling and Japanese yen by 11.4 per cent, 14.3 per cent and 11.7 per cent, respectively, the Indian rupee depreciated against these three currencies by 3.2 per cent, 6.0 per cent and 4.3 per cent, respectively, over the year.

5.7 Market sentiment remained buoyant during the first quarter of 2003-04 against the backdrop of rising foreign exchange reserves, stable international crude oil prices and the US dollar's weakness against other major currencies. The rupee gained against the US dollar, appreciating by 2.2 per cent in spite of net purchases of US $ 4.7 billion by the

Reserve Bank during the first quarter. The rupee ranged between Rs.45.71 and Rs.46.49 per US dollar and appreciated by 1.4 per cent against the US dollar during the second quarter of 2003-04. Although steady inflows from foreign funds and other sources continued, uncertainties in the foreign exchange market and the Reserve Bank's net market purchases of US $ 7.8 billion kept the rupee range-bound.

5.8 The smooth redemption of the RIBs, followed by the return flow of some part of the redemption proceeds, strengthened the rupee considerably in the first week of October 2003, aided by the continuing weakness of the US dollar against most major currencies. Sustained US dollar demand from corporates and importers amidst fears of slowdown in inflows on account of tightening of the external commercial borrowing (ECB) guidelines drove the rupee down by 59 paise or 1.3 per cent against the US dollar between November 14 and end-November 2003. It, however, bounced back against the US dollar in early December 2003 and the undertone in foreign exchange trading remained firm throughout the month on sustained investment flows from FIIs, steady inward remittances and a positive sovereign rating assigned by Standard & Poor's. The rupee moved in a narrow range of Rs.45.26-45.94 per US dollar and appreciated by 0.5 per cent during the third quarter of 2003-04, restrained by purchases of US $ 7.9 billion by the Reserve Bank.

GOVERNMENT SECURITIES MARKET

5.9 Activity in the Government securities market was characterised by a sustained softening of yields during 2003-04. The benchmark 10-year yield declined by 106 basis points as compared with 115 basis points in 2002-03. The decline in yields was more pronounced for Government securities with maturity up to 14 years. During 2003-04, the aggregate volume of transactions in the Central and the State Government dated securities and Treasury Bills (outright as well as repos) increased by 36.0 per cent to Rs.26,39,897 crore, of which outright transactions constituted 63.8 per cent.

5.10 The yield curve flattened during the first half of 2003-04. Easy liquidity and benign inflationary expectations fuelled persistent rallies in prices of Government securities which was halted in August 2003 when the notified amount of 91-day Treasury Bills was raised to Rs.1,500 crore from Rs.500 crore and open market sales were conducted to absorb excess liquidity. The repo rate reduction on August 25, 2003 boosted market sentiment with the 10-year yield declining to 5.23 per cent on August 26 from 5.6 per cent on August 23, 2003.

5.11 In the second half of 2003-04, inflationary expectations hardened the yields at the long end of the maturity spectrum. The lowering of the cut-off yields in the auction of 364-day Treasury Bills drove down the 10-year yield of the Government securities to a low of 4.95 per cent on October 16, 2003. OMO sales and a series of 28-day repos under the LAF in the second fortnight of October checked possible rallies. Spreads widened and the yield curve steepened by December 2003. Uncertainty about policy responses for managing capital flows and the edging up of inflation rates during January-February 2004 prompted a switch in portfolios. This, in turn, led to a decline in turnover and an upward shift of the yield curve. Turnover recovered in March 2004 as fuller information on the MSS became available to market participants.

EQUITY AND DEBT MARKETS

5.12 The capital market experienced generally buoyant conditions during 2003-04. Resource mobilisation from the public issues market increased, though this could not compensate for the decline in activity in the private placement market. Resource mobilisation by mutual funds witnessed a substantial increase. Assistance sanctioned and disbursed by financial institutions rose sharply after a gap of two years. The secondary market witnessed a strong rally led by a large institutional support, particularly from the FIIs due to attractive valuations *vis-á-vis* other emerging market economies. The stock market turned somewhat volatile during 2004-05 with turbulent conditions on May 17, 2004.

Primary Market

5.13 A long period of lacklustre activity and waning investor interest was dispelled in 2003-04 by signs of revival in the public issues segment. The bulk of resource mobilisation (71.4 per cent) from the public issues market in 2003-04 was by banks and financial institutions. Four public sector banks floated equity issues aggregating Rs.950 crore during 2003-04. In addition, there were six bond issues aggregating Rs.4,181 crore by the IDBI (Rs.2,930 crore from three issues) and the ICICI Bank (Rs.1,251 crore from three issues). The share of equity issues in total resource mobilisation increased sharply in 2003-04 in comparison with the previous year.

5.14 Resource mobilisation from the private placement market declined during 2003-04. This decline needs to be placed in the context of stringent disclosure norms prescribed by the SEBI on September 30, 2003 for this segment, which had remained almost unregulated until then. Public sector entities (mainly financial intermediaries) continued to dominate the private placement market in 2003-04, accounting for 75.0 per cent of the total resource mobilisation. Resource mobilisation by financial intermediaries (both public and private sector) increased by 17.4 per cent to Rs.35,057 crore, while that by non-financial companies declined sharply by 34.9 per cent to Rs.24,158 crore.

5.15 Resources raised by Indian corporates from the international capital market by way of Foreign Currency Convertible Bonds (FCCBs), Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) declined marginally during 2003-04. With a view to integrating the Indian capital market with the international capital markets and to enable Indian investors to diversify risk, foreign companies were allowed to access the Indian capital market by way of Indian Depository Receipts (IDR).

Secondary Market

5.16 The stock market turned buoyant in 2003-04, ending a long subdued spell of over three years which began shortly after the BSE Sensex crossed the historical 6000-mark in intra-day trading in February 2000. The rally in equity prices, which began from end-May 2003, continued almost uninterrupted till January 2004. It was sustained by large investments by FIIs against the background of improving fundamentals, strong corporate results and initiatives on the disinvestment front. The BSE Sensex crossed the 6000-mark again in January 2004. The uptrend was interspersed by several corrections from February 2004 in an environment of high uncertainty. Despite some downtrend in February 2004 and March 2004 due to political uncertainty, the BSE Sensex ended the year with net significant gains of over 83 per cent over the previous year.

5.17 The stock market remained somewhat volatile during April-June 2004. The downtrend witnessed in February 2004 continued during March and April 2004. On May 17, 2004 the stock market in India witnessed turbulent conditions. The market opened the day on an extremely weak note and plunged by 16.6 per cent during intra-day trading before recovering partly. The market ended the day with a net loss of 11.1 per cent as compared with the previous day's close. The trading was halted twice during the day due to the application of the index-based circuit filters.

5.18 The turbulence in the market on May 17, 2004 was caused mainly by uncertainty relating to the formation of the new Government after the general elections. External factors such as rising oil prices and apprehensions of rise in international interest rates also contributed to the sudden reversal of market sentiment. The sharp decline in the Indian stock market on May 17, 2004 was, however, a temporary phenomenon and not due to change in fundamentals which continued to be strong. On May 17, 2004 a sharp decline was also observed in several other emerging markets in Asia such as South Korea (-5.14 per cent), Taiwan (-5.10 per cent) and Thailand (-4.61 per cent).

5.19 Orderly conditions in the Indian stock market were quickly restored. Appropriate risk management systems were in place to tide over the period without any recourse to exceptional financing. Also, market participants were assured by the Reserve Bank of liquidity to meet payment obligations in stock exchanges.

Outlook

5.20 The financial markets are expected to remain stable and orderly, although they would evolve with the overall macroeconomic conditions. Developments in international financial markets as they prepare for the reversal in the interest rate cycle in major countries will have a strong bearing on the behaviour of domestic financial markets. Markets have experienced comfortable liquidity conditions during the first quarter of 2004-05, notwithstanding signs of a slow down in external inflows. With call rates generally remaining at sub-repo levels, the turnover in this segment is expected to decline as the participants increase their presence in the other money market segments. There has been a modest depreciation of the exchange rate against the US dollar in the first quarter but expectations relating to the near-term continue to be indicative of stable conditions in the foreign exchange market. The domestic price situation and global interest rate movements would have implications for yields in the Government securities market in 2004-05. The equity market, which remained subdued since February 2004, displayed signs of revival since end-July 2004. It is important to note, however, that with the return of inflation worldwide and the raising of policy rates by several central banks, reversal of the existing ample international liquidity conditions would impact domestic financial markets. As interest rates transit to a more neutral level, market participants could face the need for re-balancing of portfolios.

VI EXTERNAL SECTOR

6.1 The most significant feature of macroeconomic performance in 2003-04 was the developments in the external sector. Aided by a favourable external environment, India's balance of payments was characterised by robust exports of both merchandise and invisibles, a current account surplus of the order of 1.4 per cent of GDP, massive capital inflows brought in by sustained investor optimism about the resurgence of growth in India and an unprecedented accretion to the foreign exchange reserves which surpassed the level of external debt by the end of the year. This was also reflected in a marked improvement in India's international investment position. Under the circumstances, managing the surges in capital flows turned out to be an important objective of macroeconomic management during 2003-04. Strategic shifts in the policy stance were reflected in aggressive prepayment of external debt by official and private sectors to benefit from softer international interest rates, significant liberalisation of the exchange and payments system extended to freeing outward capital flows, fine tuning of interest rates on non-resident deposits to align them more closely with international interest rates and a tighter linkage between funds raised abroad and end-use domestically.

6.2 World real GDP is estimated to have risen by 3.9 per cent in 2003 from 3.0 per cent in 2002 as the global recovery took root and extended its reach to all regions of the world, *albeit* with variations in the pace and spread. The strength of the upturn was strongest in emerging Asia - led by China and India - and the US. Global growth surged to six per cent in the second half of 2003 on an annualised basis, regaining the momentum achieved before the onset of the synchronised downturn in 2000. More recent data indicate that the strong growth of 2003 has continued into early 2004. According to the IMF, the 'solid' improvement in global activity was associated with an acceleration in world trade, a sharp pick-up in industrial production and a resumption of business and consumer confidence. World trade shed the sluggishness characterising the first half of 2003 and expanded by 4.5 per cent during 2003, although it remained well below the average of 6.4 per cent recorded in the 1990s. Nominal trade flows were much more buoyant than real trade volumes with world exports in US dollar terms rising by 16.5 per cent due to weakening of the US dollar. China turned out to be the key driver of world trade, with imports rising by 41 per cent in US dollar terms. Accordingly, Asia recorded the strongest expansion in trade, followed by North America and Africa. Higher commodity prices, partly reflecting the depreciation of the US dollar, translated into gains in terms of trade for fuel and non-fuel exporters.

BALANCE OF PAYMENTS

6.3 The evolution of India's balance of payments (BoP) during 2003-04 reflected robust improvements on several fronts. Merchandise exports surged ahead of the growth of world trade, drawing strength from a distinct firming up of activity in the domestic economy and sustained external demand. Software exports remained resilient and vigorous in the face of the IT slowdown worldwide and a protectionist reaction against outsourcing in some industrial countries. Remittances from expatriate Indians rose strongly, making India one of the largest recipients of such flows. Accordingly, even as burgeoning import demand expanded the merchandise trade deficit to about 2.8 per cent of GDP, the current account recorded a surplus for the third year in succession on a steadily expanding scale. A noteworthy aspect of the strength of the current account is that the rising degree of openness - merchandise and invisibles transactions taken together - estimated at close to 37 per cent of GDP in 2003-04 was driven by a robust export performance. This augurs well for the rising international competitiveness of the Indian economy and the sustainability of the external sector.

6.4 Significant two-way movements in capital flows dominated the BoP outcome in 2003-04. The strong improvement in India's macroeconomic performance created a preferred habitat for private capital flows, led by unprecedented flows of portfolio investment. This was also reflected in an upgradation of the sovereign rating to investment grade during 2003-04 for the first time since 1997-98. Notwithstanding large outflows in the form of policy-induced prepayments of multilateral and bilateral loans as well as the one-shot redemption of Resurgent India Bonds (RIBs), the capital account recorded sustained inflows. Consequently, net capital inflows in 2003-04 were the highest ever. By March 2004, India had accumulated the sixth largest stock of international reserves in the world, sufficient to finance 17 months of imports and over five years of debt servicing. The level of reserves exceeded the level of external debt for the first time in India's history. In 2003-04, India also turned creditor to the IMF.

Merchandise Trade

6.5 According to the Directorate General of Commercial Intelligence and Statistics (DGCI&S), merchandise exports grew by 20.4 per cent in US dollar terms during 2003-04 on top of 20.3 per cent recorded in the preceding year. Export performance surpassed, by a significant measure, the target set for the year *(i.e.,* 12 per cent) and reflected the growing competitiveness of the Indian manufacturing sector. Certain traditional items in the primary products category did suffer erosion in competitiveness.

6.6 India's imports increased by 25.4 per cent during 2003-04 reflecting a pick-up in domestic industrial activity. Oil imports recorded a moderate growth of 16.6 per cent mainly on account of increased volumes driven by the growing demand (consumption *plus* exports) and the stagnant domestic production of crude oil (*viz.,* 33 million tonnes in 2002-03).

6.7 Non-oil imports recorded an increase of nearly 29.0 per cent, led by a sharp increase of 26.9 per cent in the imports of capital goods during 2003-04 on top of the large increase in the preceding year. Non-oil imports excluding gold and silver increased by 25.7 per cent. The co-incident expansion of imports of capital goods and domestic production during 2003-04 is strengthening the environment for a revival of investment demand.

6.8 The pick-up in domestic industrial activity fuelled a surge in imports of several intermediate manufactures and raw materials such as iron and steel, nonferrous metals, paper, paper board and manufactures (including newsprint), artificial resins and plastic materials, chemical materials and products and metalliferous ores and metal scraps. Imports of gold and silver, which had declined in 2002-03, increased by as much as 59.0 per cent during 2003-04, mainly due to revival in rural demand on the back of the rebound in agricultural output. Imports of edible oil increased mainly on account of refined palm oil and palmolein.

Invisibles

6.9 The surplus in the invisibles account rose steadily throughout the year, peaking in the fourth quarter. It reached an all-time high at US $ 25.4 billion in 2003-04. Spearheading the progressive improvement in the invisibles balance have been the heterogeneous category of professional and business services including software (which is recorded under ‘services’) and remittances from nationals employed overseas (recorded under ‘transfers’). Exports of services rose by 10.6 per cent in 2003-04. India ranked 20th in the world with a share of 1.4 per cent in global exports of services in 2003. An upward shift in the trend growth of services exports from 7.9 per cent in the first half of the 1990s to 15.3 per cent in the period from 2000-01 to 2003-04 reflected a distinct strengthening along with greater stability.

6.10 Inward remittances from Indians working abroad continued to surge, reaching US $ 19.2 billion in 2003-04 and maintaining India's position as the leading recipient of remittances in the world.

Current Account

6.11 India's current account surplus rose to 1.4 per cent of GDP in 2003-04, extending a phase of surpluses which began in 2001-02. India's current receipts grew at an average rate of 19 per cent during 2002-03 and 2003-04. Consequently, the ratio of current receipts to current payments rose to 107.7 per cent in 2003-04.

Capital Account

6.12 Large shifts characterised the capital account which dominated the BoP in 2003-04. Massive movements of financial flows occurred in both directions. Debt creating flows ebbed in response to policy changes such as prepayment of high cost official debt and rationalisation of interest rates on NRI deposits. The bullet redemption of RIBs also dampened the net debt flows. Non-debt creating flows, particularly portfolio investments, surged ahead of the resumption of private financial flows to the EMEs. India attracted the highest portfolio investment inflows to Asia in 2003, second only to Korea. With this resurgence, total foreign investment inflows accounted for 65.5 per cent of net capital inflows in 2003-04.

6.13 Foreign investment - both direct and portfolio - rose to an all-time high in 2003-04, amounting to 3.0 per cent of GDP and 25.5 per cent of merchandise exports. Net investment by foreign institutional investors (FIIs) rebounded from depressed levels in the preceding year to record an unprecedented surge during 2003-04. FDI flows remained subdued during 2003-04 in line with the slowing down of FDI flows to the developing countries in general.

6.14 Net inflows into deposit schemes for non-resident Indians (NRIs) were strong in the first half of 2003-04. These flows shared the overall investor optimism generated by the improvement in India's macroeconomic performance and responded to positive interest rate differentials in India *vis-à-vis* international interest rates, rendered attractive by a stable exchange rate. As a consequence of rationalisation of interest rates, the inflows moderated in the second half of 2003-04, particularly in respect of the non-resident external rupee accounts [NR(E)RA] scheme.

EXTERNAL DEBT

6.15 Critical indicators of debt sustainability exhibited significant improvement during the year. The ratio of external debt to GDP showed a steady improvement, dropping to 17.6 per cent as at end-March 2004 from 30.8 per cent as at end-March 1995. The debt-service ratio increased during the year mainly on account of redemption of RIBs and prepayments. Excluding these special transactions, the debt-service ratio would decline to 10.4 per cent. India improved its rank among the top 15 debtor countries from third in 1991 to eighth in 2002. Importantly, among the top 15 debtor countries, India's short-term debt to total debt ratio and short-term debt to foreign exchange reserve ratio are the lowest. India's foreign exchange reserves provided a cover of a little over 100 per cent of total external debt outstanding as on March 31, 2004.

FOREIGN EXCHANGE RESERVES

6.16 India's foreign exchange reserves increased by US $ 36.9 billion (including valuation gains) during the year, the largest increase ever recorded in a single year. The large accumulation occurred despite the depletion of reserves on account of redemption of RIBs and prepayment of official debt. At around US $ 113.0 billion on March 31, 2004, India held the fifth largest stock of international reserve assets among EMEs and ranked sixth in the world. As on August 13, 2004, the foreign exchange reserves amounted to US $ 119.3 billion. In February 2003, the International Monetary Fund (IMF) designated India as a creditor country under its Financial Transaction Plan (FTP). India, therefore, participated in the IMF's financial support to Burundi in March-May 2003, to Brazil in June-September 2003 and to Indonesia in December 2003. The total lending under FTP to the IMF amounted to US $ 561.3 million during 2003-04.

6.17 The Reserve Bank has been pursuing a policy of maintaining an adequate level of foreign exchange reserves to meet import requirements, unforeseen contingencies and liquidity risks associated with different types of capital flows. Adequacy of reserves has emerged as an important parameter in gauging its ability to cushion external shocks. At end-March 2004, the import cover of reserves was about 17 months. The ratio of short-term debt to foreign exchange reserves declined from 146.5 per cent at end-March 1991 to 4.2 per cent at end-March 2004. The ratio of volatile capital flows (defined to include cumulative portfolio inflows and short-term debt) to reserves declined from 146.6 per cent at end-March 1991 to 36.0 per cent at end-March 2004.

INTERNATIONAL INVESTMENT POSITION

6.18 India's net international investment position (IIP) recorded a marked improvement during 2002-03 with net foreign liabilities declining by 12.7 per cent. India's international assets grew by 28.6 per cent, largely on account of reserve assets. Consequently, the share of reserve assets in total foreign assets improved significantly in March 2003. The share of 'other investments' comprising mainly deposits, currency holding and other international assets declined sharply. This was attributable to the appreciation of the rupee *vis-à-vis* the US dollar as also a sharp decline in returns on investments in the form of bank deposits and fixed income securities in international markets. Indian banks liquidated a sizeable portion of their short-term investments in foreign assets and converted them into rupee assets. Reflecting the impact of the liberalisation of norms relating to Indian joint ventures/wholly owned subsidiaries abroad and the growing international competitiveness of Indian corporates, direct investment abroad by the Indian entities turned out to be another high growth component of international assets during 2002-03.

Outlook

6.19 Favourable global growth prospects are being signalled by the IMF, which revised its 2004 growth forecast upwards to 4.6 per cent in its *World Economic Outlook,* April 2004. Recent data show considerable uncertainty surrounding the strengthening of global economic recovery on account of the outlook on international crude oil prices. Global imbalances and possibility of disruptive currency movements, firming up of commodity prices, transition to high interest rates and the uncertain prospects of soft landing of the China's economy continue to be some of the major uncertainties and risks facing the global economy.

6.20 India's external sector would benefit from the prospects of strengthening of world output and trade in 2004. Merchandise exports have started the year on a high note, rising by 28 per cent during April-June 2004. The optimistic industrial outlook augurs well for consolidating and building upon the gains in international competitiveness. The key engines - software and remittances - are likely to be sustained, given the intensity of skill and specialised competency in labour outflows. By current reckoning, India has entered a phase of durable current account surpluses in the BoP, even after accounting for any acceleration in imports resulting from the positive macroeconomic outlook. The level of reserves is comfortable at present. Globalisation and the interface with new types of external transactions, particularly those impacting the overall international investment position, however, warrant a careful and continuous re-assessment of the adequacy of reserves.

VII ASSESSMENT AND PROSPECTS

ASSESSMENT OF 2003-04

7.1 The Indian economy recorded a strong performance during 2003-04. While the main driver of growth was the resurgence of agricultural production from the drought of the preceding year, the other factors included buoyant external demand and continued industrial recovery. The performance of agriculture in 2003-04 was typical of a normal monsoon year following a drought year as has been observed on previous occasions. The notable feature this time was the simultaneous and well distributed firming up of activity in industry and services. Exports contributed significantly to higher growth in a wide range of manufacturing industries – machinery and transport equipment, automobiles, iron and steel, chemicals and chemical products – attesting to the rising international competitiveness of Indian industry. Capacity utilisation improved in several manufacturing industries as well as in electricity generation and mining and quarrying. A robust expansion of activity in trade, hotels, transport and communication paved the way for strong growth of the services sector, well above the average for the period 1993-2003. Yet another heartening feature was the resilience of the information technology enabled services and business process outsourcing activities despite some evidence of increasing protectionist postures in major international markets.

7.2 The return to high growth in 2003-04 brought with it renewed business optimism and consumer confidence in the near-term outlook for the economy and a wider appreciation regarding India's potential for growth. It also underscored the need for consolidation of these gains and reorientation of the strategies for macroeconomic management so that a high growth trajectory is sustainable over the medium-term. At the same time, concerns have emerged about the need to ensure that all sections of society share in the gains from higher growth and participate in the realisation of India's potential in the years ahead. This reappraisal of the overall approach and strategy is leading to some rebalancing of macroeconomic priorities and tasks. Increasingly, the focus of ongoing structural reforms is turning to the quality of growth embodied in development, particularly of the rural economy.

7.3 Significant gains were posted in the external sector, indicative of a growing resilience of the economy to cushion domestic activity against external and internal shocks. The run of current account surpluses that began in 2001-02 was extended into 2003-04 – a steady rise from 0.2 per cent of GDP to 1.4 per cent. The foreign exchange reserves rose to US $ 113 billion by end-March 2004 and further to US$ 119.3 billion as on August 13, 2004. Reflecting the rising technology and knowledge content in the output of industry and services, the exports of manufactured goods as also travel-related and private business services grew robustly. The growth rate of merchandise export crossed 20 per cent in US dollar terms for the second consecutive year. With import growth at 25.4 per cent, the trade deficit increased from US $ 8.7 billion in 2002-03 to US $ 13.6 billion in 2003-04. Remittances from Indians abroad, which form a significant share of global remittance flows, continued to be a key component of India's balance of payments. The role of invisible earnings in underpinning the strength of the current account is perhaps the most noteworthy feature of balance of payments developments over 2001-04, especially since they enabled meeting a sizeable expansion in import demand without recourse to additional external liabilities. Rising international confidence in India's macroeconomic performance in an era of abundant international liquidity spurred large inflows of private capital in 2003-04 in the form of portfolio investments in domestic capital market. There was a reduction in debt owed to multilateral agencies by way of prepayments, besides the redemption of Resurgent India Bonds (RIBs). Consequently, indicators of external debt sustainability such as debt to GDP and debt service ratios continued to record a healthy improvement. These developments, coupled with the rising surplus in the current account, facilitated a step-up in the pace and spread of the liberalisation of the exchange regime.

7.4 The year 2003-04 witnessed a consolidation of gains achieved in respect of finances of the Central Government. The key indicators – revenue deficit, gross fiscal deficit and primary deficit – were better in the provisional accounts released by the Controller General of Accounts than those projected in the budget estimates as well as in the revised estimates. The improvement in Central finances was brought about by a reduction in the revenue deficit by 0.5 per cent of GDP in the revised estimates *vis-á-vis* the budget estimates. On the revenue side, there was an increase in tax receipts, mainly under corporate tax and service tax, as also in receipts from disinvestments, dividends and profits. On the expenditure side, there was a reduction in food and petroleum subsidies and non-Plan grants to States, along with some curtailment in capital outlay. These developments enabled an improvement in cash management by the Central Government. This progress in fiscal consolidation was accompanied by debt restructuring in the form of debt buybacks with the banking system, debt swaps with the States and prepayment of external debt. It also paved the way for the enactment of the Fiscal Responsibility and Budget Management Act, 2003. Although a fuller picture of the finances of the State Governments for 2004-05 is still emerging, the lower recourse to ways and means advance (WMA) - a leading indicator - reflects a slightly better financial discipline.

7.5 Another noteworthy feature of macroeconomic management in 2003-04 was the reining in of inflationary pressures. While in the early part of the year, global factors aided a benign inflationary situation, the latter part of the year was characterised by periodic episodes of hardening of international prices of metals, cotton, industrial intermediates and raw materials and a soaring of international crude oil prices in the closing months of the year. Transport disruptions in the beginning of the year, upward revisions in electricity prices and localised drought conditions in vegetable growing regions of the country also resulted in transient supply side pressures. Inflation receded in the first half of the year, reaching a trough in August 2003, before being driven up almost continuously up to January 2004 by a combination of international and domestic factors. By the end of the year, however, inflation had retreated to the levels anticipated by the Reserve Bank.

7.6 Monetary policy assigned priority to the revival of investment demand in the economy in 2003-04 in an environment of macroeconomic and financial stability. Cuts in key policy instruments – the CRR and the repo rate – were accompanied by active management of liquidity and refinements of the modes of delivery of bank credit, particularly to the priority sector, housing and infrastructure. The stance of monetary policy enabled a general reduction in the spectrum of market interest rates, although commercial bank lending rates did not decline commensurately. The expansionary effects of large capital inflows posed a challenge to monetary policy, especially since the absorption of liquidity through non-food credit remained lacklustre except in the last quarter of the year. This necessitated policy intervention almost continuously throughout the year to sterilise the capital flows and prevent undue monetary expansion. Open market operations, supplemented by repos, prepayment of external debt and liberalisation of outflows of foreign exchange were helpful in staving off the full impact of the capital inflows. Despite these actions, money supply expanded by 16.6 per cent – above the indicative rate of 14.0 per cent envisaged in the Monetary and Credit Policy Statement of April 2003. The institution of the Market Stabilisation Scheme in April 2004, which provides for issuance of Government securities exclusively for sterilisation operations, enhances the capacity of the Reserve Bank to deal with capital flows in future.

7.7 During 2003-04, domestic financial markets experienced orderly and stable activity in general, under conditions of ample liquidity. In the money market segments, interest rates displayed close co-movement and remained below the LAF repo rate over the year except for a few brief spikes. Turnover in the call money market declined in the second half of the year with activity shifting to other segments of the money market, particularly, the repo market outside the LAF, a segment which gained vibrancy and depth. The Government securities market was characterised by declining yields, reflecting the stance of monetary policy. The yield curve steepened in the latter part of the year, driven by market expectations relating to inflationary pressures and the raising of some major international interest rates. The foreign exchange market witnessed orderly conditions during the year. The exchange rate of the rupee appreciated against the US dollar, but depreciated against Euro, Pound Sterling and Japanese Yen during the period.

7.8 Efficient functioning of the financial system and an environment of financial stability were concurrent pursuits of the Reserve Bank. In 2003-04 heightened sensitivity to these objectives was reflected in the stance of financial policies. Issues relating to corporate governance and appropriate disclosures were the focus of the conduct of financial regulation. At the same time, prudential norms and supervision continued to be tightened and benchmarked to international best practices and the emphasis also continued to shift from micro regulation to risk-based supervision. A significant development during the year was a successful pilot run for risk-based supervision (RBS), aimed at allocating supervisory resources in accordance with the risk profile of banks. The initiatives taken in recent years were reflected in the significant improvement in profitability, asset quality and capital across the financial system.

7.9 The technological infrastructure for the smooth and secure functioning of the payment system was strengthened with the implementation of Real Time Gross Settlement (RTGS) system, the Special Electronic Funds Transfer system and the Online Tax Accounting System. The Negotiated Dealing System(NDS)-Clearing Corporation of India Ltd.(CCIL) system enabled an improvement in LAF auctions by providing in a timely fashion, all the parameters such as issue duration, type of auctions and opening and closing time. The CCIL, which also offers a multilateral netting mechanism for inter-bank spot and forward dollar-rupee transactions, has provided time and cost benefits to banks. Introduction of exchange traded interest rate derivatives in the National Stock Exchange and allowing sale of Government security against existing purchase contract provided depth to the Government securities market which switched to the Delivery *versus* Payment (D*v*P III) mode with effect from April 2, 2004.

7.10 International developments continued to have a bearing on domestic growth and inflation in 2003-04. The global economic recovery broadened and strengthened in 2003 led by the US and emerging Asia – most notably China and India. The recovery was underpinned by an acceleration in world trade, a pick-up in industrial activity, strong corporate performance and revival of consumer confidence. Economic activity in the UK and Japan strengthened although deflation haunted the stronger-than-expected growth in the latter. In the Euro area, recovery remained subdued and incipient. Inflation was benign in various parts of the world in spite of the rise in commodity prices, particularly oil prices. In recent months, while overall global growth prospects have improved markedly, monetary authorities all over the world are gearing up to contend with the return of inflation, the imminent reversal of the interest rate cycle, the persistence of large macro imbalances, and possible dangers of disruptive global currency adjustments.

OUTLOOK FOR 2004-05

7.11 Early developments in 2004-05 present several continuing strengths in the economy though accompanied by some uncertainties. The pre-monsoon assessment by the Meteorological Department was optimistic with the forecast of a normal monsoon. The monsoon set in almost ten days before time and the rainfall was normal in June 2004. The rainfall outlook became uncertain in July with the cumulative rainfall received till July 28, 2004 amounting to 15 per cent below the Long Period Average (LPA). In terms of spatial distribution, only 12 out of 36 meteorological sub-divisions had received excess/normal rainfall (as against 32 in the corresponding period of 2003). The monsoon, however, revived in August and the cumulative rainfall deficiency declined to seven per cent below the LPA by August 11, 2004. The spatial distribution of rainfall also improved significantly. Although the progress so far has not been as satisfactory as in the corresponding period of the South-West monsoon season of 2003, the earlier apprehensions of drought have distinctly receded. Indeed, 27 sub-divisions have received normal/excess rainfall in contrast to only 17 sub-divisions receiving normal/excess rainfall in the corresponding period of the drought year 2002. A clearer assessment of rainfall, as the monsoon progresses into central India and northern plains, will enable a firmer prognosis of the prospects for agriculture.

7.12 Industrial activity has gathered strength, rising by 7.6 per cent in April-June, 2004. All constituents – manufacturing, electricity and mining – have shared in this expansion *albeit* with some slowdown in electricity generation in the months of May and June. Seven manufacturing groups – wool, silk and man-made fibre textiles, basic chemicals and chemical products, machinery and equipment, leather and fur products, cotton textiles and textile products and metal products and parts – are leading the acceleration of activity. The industrial climate reflects a revival of investment demand and building up of capacity. In particular, the capital goods and the intermediate goods sectors have recorded robust growth signifying the quickening of investment activity. This has been supported by improved corporate profitability, expansion in non-food credit and continuing optimism regarding production and export growth. On the other hand, production of consumer goods has slowed down considerably with the sustained growth in consumer durables providing a silver lining.

7.13 The growth of the services sector is expected to build upon the momentum achieved in the preceding year and be sustained above trend levels. The principal drivers of service sector growth would be trade, hotels, transport and particularly communication which has registered robust expansion in the recent past. Community, social and personal services are also expected to record significantly higher growth. Overseas markets would increasingly provide the impetus for growth for a wide range of industrial products and services. In this context, the growing international competitiveness of India's business services augurs well for domestic producers. The prospects of certain categories of services such as trade and transport would depend significantly upon the performance of the agricultural sector. Similarly, the prospects for construction activity are linked to the production performance of electricity, coal and cement sectors.

7.14 In view of the above, on current indications, while the prospects for GDP growth continue to be bright, in particular, due to a possible acceleration in growth of world output and enhanced domestic investment activity, there are also downside risks emanating from uncertain monsoon as well as the possible persistence of high and uncertain oil prices. These risks impart an element of downward bias to the estimates of GDP growth made at the beginning of the year but evolving strengths during the rest of the year may restore the position and in any case India will continue to be among the top performers globally.

7.15 In the external sector, the robust performance characterising the preceding two years has extended into 2004-05. Merchandise export growth surged to 28 per cent in April-June, 2004 reflecting the sustained momentum of manufacturing activity and the conducive international environment. The firming up of aggregate demand in the economy is mirrored in import growth of 31 per cent in April-June 2004, with non-oil imports rising by 26 per cent and a trade deficit higher than in April-June last year. Capital flows have moderated with net outflows of US $ 0.8 billion under non-resident deposit schemes in the first quarter of 2004-05. Portfolio investment by FIIs recorded net outflows in May-July in tune with the observed pattern in other emerging markets as US interest rates are rising. On the other hand, net inflows in the form of FDI and ADRs/GDRs have gathered momentum. For the first quarter of 2004-05, the balance of payments recorded an overall surplus of US $ 7.5 billion. Reflecting these developments, the foreign exchange reserves crossed US $ 120 billion on July 2, 2004 before declining marginally to US $ 119.3 billion on August 13, 2004. Over the rest of the year, the outlook for the balance of payments appears reasonably strong and resilient. While the hardening of international crude prices is likely to increase the value of POL imports, sustenance of the robust growth of exports of merchandise and services recorded in the early months of the year would enable absorption of the additional import financing requirements. Accordingly, the current account is expected to remain in surplus *albeit* at a more moderate level than in 2003-04. Net capital flows are likely to remain positive, reflecting the underlying strength of the macroeconomic fundamentals and sustained international investor confidence in India. While the Indian economy may not have to deal with surges in capital inflows of the order of the preceding year, especially in the context of churning of portfolio investment flows in Asia, domestic financial markets must nonetheless be prepared for significant capital flows for the year as a whole.

7.16 Inflation, measured by year-on-year changes in the wholesale price index (WPI), has been edging up since May 15, 2004 driven up by prices of iron and steel, mineral oils, coal and vegetables. The CPI inflation, however, continues to be at moderate levels. The WPI inflation rate touched 8.0 per cent on August 7, 2004 following the increases in the prices of petroleum products, iron ore, iron and steel and coal. The hardening of inflation in 2004-05 has been mainly on account of the influence of international price movements in respect of crude oil and metals, particularly iron and steel. Over the rest of the year, pressures from international prices on domestic inflation are expected to moderate although considerable uncertainty surrounds the short-term movements in international crude oil prices, which would influence the domestic inflation outlook. Another important factor which would determine the inflation outlook in India is the progress of the monsoon, after taking into account the shortfalls and uneven spread of rainfall in July which is the sowing month of the *kharif* season. The overhang of liquidity would also need to be carefully monitored in view of its potential to pose demand pressures on prices. Domestic factors which could have a bearing on the inflation outcome include possible gaps in the availability of oilseeds, edible oil and cotton which have witnessed rising consumption levels relative to domestic production. Domestic iron and steel prices continue to remain at elevated levels even though international prices have plateaued. The outlook for headline inflation is, on current indications, less optimistic than what was envisaged at the beginning of the year. Price pressures could be a cause of some concern though it remains to be seen how the imported price shocks would evolve globally and be absorbed domestically. The comfortable level of foreign exchange reserves, however, provides the wherewithal for ensuring adequate supplies and for moderating inflationary pressures on the common man. It is relevant to note that inflation, as measured by the year-on-year changes in the consumer price index (for industrial workers), on a point-to-point basis, was 3.0 per cent in June 2004 and 3.4 per cent on an annual average basis. The consumer price index does not, to the same extent, reflect the price pressures from iron and steel and mineral oils because of the relatively low weight of these items in this index. In any case, the inflation environment needs to be monitored closely on a continuous basis for any unforeseen developments either in the global or in the domestic environment, with a view to considering prompt as well as measured responses, as appropriate.

7.17 Central Government finances were characterised by a higher growth in revenue receipts during April-June 2004 on account of higher growth in corporation tax, income tax and excise duties, partially offset by decline in customs duties and larger tax assignments to the States and the Union Territories. There was also a substantially higher growth in aggregate expenditure in comparison with the corresponding period of the previous year, primarily due to higher revenue expenditure. The growth in revenue deficit remained unchanged at 15.9 per cent as compared with the corresponding period of the previous year. The gross fiscal deficit, however, was higher by 8.0 per cent as against a decline of 2.4 per cent in the previous year.

7.18 Gross market borrowings [net of the Market Stabilisation Scheme (MSS)] of the Centre for 2004-05 are budgeted at Rs. 1,50,817 crore, while net market borrowings would amount to Rs. 90,365 crore. During 2004-05 (up to August 21, 2004), 36.5 per cent of the gross borrowing programme has been completed as compared with 59.8 per cent during the corresponding period of the previous year. An additional amount of Rs. 60,000 crore is expected to be absorbed under the MSS, of which, Rs. 52,231 crore has been raised so far. The gross allocation for the State Governments under their market borrowing programme during 2004-05 is kept at Rs. 42,020 crore, inclusive of Rs. 24,000 crore under the Debt Swap Scheme (DSS). During 2004-05 (up to August 21, 2004), the State Governments raised a gross amount of Rs. 22,259 crore. Going by the current indications, the borrowing of the States demonstrating better fiscal management could be completed comfortably as per the budgeted programme.

7.19 Money supply expanded faster in the first quarter of 2004-05 on a year-on-year basis, mainly on account of the large increase in net foreign assets of the Reserve Bank which drove up reserve money sharply in comparison with the preceding year. Broad money (M_3) grew at a higher rate of 15.7 per cent as on August 6, 2004 as compared with 11.7 per cent last year. Currency demand remained strong in consonance with the general improvement in economic activity, which was also reflected in the sharp increase in non-food credit. The revival of agricultural growth and the stepping up of procurement operations resulted in a turnaround in food credit from a decline of Rs. 6,228 crore in April-August 8, 2003 to an increase of Rs. 6,481 crore in the current year up to August 6, 2004. Financial markets experienced ample liquidity conditions with a liquidity overhang of about Rs. 1,00,000 crore or about 5 per cent of M_3 as compared with about 1.5 per cent of M_3 last year. With the institution of the MSS, there has been a shift of liquidity from the LAF to the MSS.

7.20 Financial market conditions have, by and large, remained stable during 2004-05. The weighted average call money rates have continued to hover close to the repo rate of 4.5 per cent during 2004-05 so far. Activity in the money market continued to shift to the collateralised segments such as the repo market. As regards the Government securities market, the market borrowing programme and pick-up in credit offtake have put some pressure on yields on Government securities, especially at the long end. The yield curve of Government securities has steepened with the yield of the 10-year benchmark security increasing by 139 basis points during April-August 10, 2004 to touch 6.54 per cent. Corporate bond yields also rose, with the spread of the five-year triple-A corporate bond over the Government security with similar maturity widening to 100 basis points by July 27, 2004 from 72 basis points on April 6, 2004. Stock markets recovered from a plunge on May 17, 2004 and currently display stable conditions. The foreign exchange market displayed orderly conditions. The rupee came under moderate pressure in May 2004 on account of turbulence in the equity market and the trends in global liquidity. Since April 1, 2004 the rupee depreciated against the dollar by 5.8 per cent (as on August 10, 2004). Reflecting the spot market conditions, the three and six month forwards have turned from discounts into premia in the recent period. As real activity is picking up globally and inflation is rising across the economies, several central banks have raised their key policy rates. The impact of the northward movement of international interest rates is likely to have some impact on domestic interest rates and financial markets would have to manage these challenges.

7.21 The pick-up in credit demand observed in the second half of 2003-04 continued to be in evidence in the current year, reflecting buoyant industrial activity and to an extent, a base effect as credit offtake in the comparable period of 2003-04 had slowed down significantly. After factoring in the base effect of higher growth in the latter half of 2003-04, the overall credit offtake during 2004-05 at 16-16.5 per cent, as projected in the May 2004 Annual Policy Statement, should be adequate to meet the credit needs of all the productive sectors of the economy.

7.22 The stance of monetary policy for 2004-05 continues to be guided by the objectives of provision of adequate liquidity for meeting credit growth and to support investment and export demand while keeping a very close watch on the movements in the price level. Consistent with the above, while continuing with the *status quo,* monetary policy would pursue an interest rate environment that is conducive to maintaining the momentum of growth as well as ensuring macroeconomic and price stability. The confluence of global factors - in particular, the rise in international interest rates - and domestic developments with respect to capital flows, liquidity management and the unforeseen impact of supply shocks have necessitated close and careful monitoring of price trends, keeping in view the policy preference for stability. In this background, the need, the extent and the timing of review of the policy stance would depend not only on these unfolding circumstances but also on the adjustments that take place in the financial markets, given their sensitivity to the global and domestic conditions.

7.23 Monetary policy would continue to enhance the integration of various segments of the financial market, upgrade credit delivery systems, nurture a conducive credit culture and improve the quality of financial services. There is also a need to consolidate the gains obtained in recent years from reining in inflationary expectations given the volatility in the inflation rate during 2003-04 and subsequent spikes in headline inflation during 2004-05 so far. It is important to appreciate that sustained efforts over time have helped to build up confidence in price stability. Inflationary expectations can turn adverse in a relatively short time if noticeable upward movements in prices continue to take place. While the economy has the resources and resilience to withstand supply shocks, the possible consequences of continued abundance of liquidity need to be monitored carefully. As such, the inflationary situation needs to be watched closely with a view to respond in a timely but measured manner and there is no room for complacency on this count. Maintaining confidence in price stability is a continuing policy objective.

REAL SECTOR

Agriculture

7.24 It is an imperative that the agricultural growth rate is enhanced to around 4 per cent per annum as the critical minimum in order to sustain an overall growth trajectory of the economy at 7 per cent and more. If agricultural growth were to continue at its long-term average of 2.5 to 3.5 per cent, it would be difficult for industry and services to grow in the range of 9-10 per cent that would be necessary to attain the overall growth rate of 7 to 8 per cent. To attain higher growth in agriculture, the major areas requiring attention in the financial sector are, *inter alia,* spread of insurance against crop losses, development of commodity-derivatives market to minimise the impact of price uncertainties and facilities for meeting the entire - not merely the credit - needs of the rural economy.

7.25 The recurring episodes of localised droughts in several meteorological sub-divisions raise concerns of crop failure even in a good monsoon year. Production of coarse cereals, pulses, cotton and sugarcane is most vulnerable to localised droughts. In this context, measures announced in the Union Budget for 2004-05 such as launching of a nation-wide water harvesting scheme, restoration of water bodies and restructured Accelerated Irrigation Benefit Programme (AIBP) are significant. If properly implemented, these measures would provide some relief to the drought-prone regions.

7.26 Sharp fluctuations in agricultural output in India over the past two decades have underscored the gaps in investment in agriculture. Gross capital formation in agriculture has undergone a sharp decline mainly on account of a steady erosion in the share of public investment. The increase in private sector capital formation has been concentrated in areas where water, power and other inputs are available uninterruptedly and with large subsidy. The inadequacy of private investment in fulfilling the capital requirements of agriculture has raised concerns about the state of the rural infrastructure which could turn into a binding constraint on growth. Irrigation coverage remains distinctly lower than the potential in terms of the gross cropped area. Insufficient village electrification has adversely affected the expansion of irrigation coverage, the growth of processing industries and cold storage facilities. The shortfall in capital formation relative to growth requirements in agriculture has also been reflected in poor road connectivity between farms and markets. Expanding investment in agriculture and in rural infrastructure would promote gains to the economy in terms of productivity, growth and poverty alleviation.

7.27 Dampening the fluctuations in output underscores the pressing need to promote the diversification of agriculture. Agricultural production has to be demand-driven with value addition. In recent years,