*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 (Appendix Table I.1). 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.

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 (Appendix Tables I.2 and I.3). 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

* 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.

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 (Box I.1). 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,

**Box I.1**

**Post-Cancun WTO Consultations**

The Fifth Ministerial Meeting of the WTO held at Cancun, Mexico during September 11-14, 2003 was expected to take stock of the progress in ongoing negotiations under the work programme adopted in the Doha Declaration and provide necessary political guidance, including decisions on launching negotiations on the “Singapore Issues”. The meeting, however, ended without reaching any agreement in view of sharp differences in the views and positions taken by members on the core agenda issues. The joint Ministerial Statement at the end of the conference noted that more work needed to be done in some key areas to proceed towards the conclusion of the negotiations in fulfillment of the Doha commitments. The post-Cancun consultations focused on four negotiating areas, *viz*., agriculture, market access for non-agricultural products (NAMA), Singapore issues and cotton.

Agriculture holds the key to progress in future trade negotiations. Of the three “pillars” of agricultural negotiations (export subsidies, domestic support and market access), market access is viewed as the most important issue and a number of alternative formulae have been proposed. Under the “blended” formula jointly put forward by the US and the EU, tariffs would be divided into three groups: duty free, tariffs reduced by a simple average with a minimum reduction per product (the Uruguay Round approach) and tariffs reduced under the “Swiss formula” (a harmonising formula that reduces higher tariffs by greater amounts, simultaneously setting a maximum tariff rate). At the first “agriculture week” after Cancun held during March 22-26, 2004 delegates agreed on the need for allowing developing countries to accord special treatment but differences remained on the conditions that would apply. Subsequently, three negotiating papers from the G-20, G-10 and G-33 were put forward seeking to bridge the differences amongst members. Furthermore, the EU promised to phase out farm export subsidies on the condition that other forms of subsidised export competition were also eliminated. The Framework Agreement adopted by the WTO General Council on August 1, 2004 brought negotiations back on track. The major decisions taken by the General Council included: elimination of all forms of subsidies in agriculture by an “end date”; reduction of all trade-distorting domestic support according to a “tiered formula”; and continuation of the flexibility available to developing countries in providing certain subsidies for export of agricultural products for a reasonable period, after the phasing out of all forms of export subsidies and implementation of all disciplines is completed.

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 (Box I.2).

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

**Box I.2**

**Market Stabilisation Scheme**

In pursuance of the recommendations of the Reserve Bank's Working Group on the Instruments of Sterilisation, a Market Stabilisation Scheme (MSS) was introduced on April 1, 2004 under a Memorandum of Understanding (MoU) between the Government of India and the Reserve Bank. Under the MSS, Treasury Bills and dated securities of the Central Government are issued for conducting sterilisation operations.

The Reserve Bank notifies the amount, tenure and timing of issuances under the MSS under a calendar of issuances. The ceiling on the outstanding obligations of the Government for the year 2004-05 under the MSS has been fixed at Rs.60,000 crore, which is subject to revision through mutual consultation. Treasury Bills/dated securities issued under the MSS by way of auctions have the same features as the existing Treasury Bills/ dated securities. An indicative schedule for the issuance of Treasury Bills/ dated securities under the MSS is being announced on a quarterly basis.

Money raised under the MSS is held by the Government in a separate identifiable cash account maintained and operated by the Reserve Bank. The amount held in this account would be appropriated only for the purpose of redemption and/or buyback of the Treasury Bills and/or dated securities issued under the MSS.

Any increase in the Reserve Bank's net foreign assets (NFA) would, thus, be matched by an accretion in Government balances under the MSS driving down the net Reserve Bank credit to the Government. The consequent decline in reserve money nullifies the monetary impact of the increase in the Reserve Bank's NFA.

The impact on the revenue/fiscal balance of the Government would only be to the extent of the discount on Treasury Bills and coupons on dated securities (net of premium/discount and accrued interest) issued under the MSS. The receipts and payments towards interest and premium/discount under the Scheme would be shown separately in the Union Budget.

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.