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, the consumption basket is getting diversified towards value added food products such as meat, poultry, fish, vegetables and fruits. It is important for production to respond to these shifts in consumption. There is also a growing recognition that agriculture is becoming increasingly unsustainable from the point of view of environmental balance due to practices such as mono-cropping, over exploitation of natural resources, excessive irrigation and the intensive use of chemical fertilisers. The focus, therefore, needs to be on crop diversification and broad-based agricultural development that will not only cater to the changing consumption pattern and reduce imports, but also take advantage of India’s global competitive strength in various agricultural products. The agro processing industry holds considerable potential in this context to emerge as the main driver of diversification of agriculture.

7.28 Efforts towards diversification must be complemented by a greater focus on recent gains from the impact of new advances in biotechnology and disease-resistance. Emerging areas like floriculture, horticulture, genetic engineering and organic farming hold high growth potential and have to be earmarked for prioritisation in investment. Furthermore, India has export potential in dairying, sericulture and horticulture which remains unexploited due to input heterogeneity and lack of marketing infrastructure.

7.29 The process of diversification calls for micro-level planning with emphasis on crop specific inputs, creating proper marketing infrastructure, cold storage, transportation facilities and supportive policies. There is a need for value addition in agricultural products through processing, packaging, and supply chain management so that farm incomes expand, employment is generated and rural poverty is alleviated. This cannot take place without directed policy actions, given the complexity inherent in diversified farming activity and the difficulties connected with the linking of farms to relevant markets. Policy action will itself have to be diversified keeping in view the needs of different agricultural and allied activities and the varied agro-climatic regions. Just as the spread of the Green Revolution was aided by a package approach across the country involving the coordinated supply of inputs, technology, seeds and extension of credit, there is clearly a need now for the creation of similar packages for diversification of agriculture in different regions. This also calls for vertical integration and public-private partnership in these activities, the modalities for which will have to be worked out. The thrust of diversification has to be on high value added products keeping in view the market demand both within and outside the country.

7.30 Efficient and well developed agricultural markets are necessary to enable farmers to deal with inherent risks associated with the perishability of their produce, to get remunerative prices and to secure smooth access to input supplies. Towards these objectives, the agricultural marketing system in the country needs to be integrated and strengthened. In this regard, speedy implementation of the Model Law on Agricultural Marketing and Contract Farming in all the States and the Union Territories would facilitate development of competitive agriculture markets in the private and the co-operative sectors and encourage contract farming.

7.31 Deceleration in the yields of many crops is an area of concern calling for research and development to evolve high-yielding and pest–resistant varieties of seeds, dry land farming and reclamation of waste lands. It is also recognised that adoption of new technology, especially new variety of seeds, entails higher risk than the use of traditional seeds. Measures to mitigate risks such as spread of irrigation facilities, better water management and adequate crop insurance must be emphasised.

Industry

7.32 The recovery of the industrial sector which began in the first quarter of 2002-03 has been steadily gaining momentum. Indian industry is engaged in a process of transformation due to competitive pressures, rapid technological progress, deregulation of product and financial markets and organisational change. Industrial restructuring has focused on niche strategies and core competencies while phasing out inefficient units. Enhanced quality consciousness through implementation of techniques like Total Quality Management (TQM) and Six Sigma have had a favourable impact on the quality of output of the manufacturing sector. Another significant development has been the changing composition of exports in favour of manufactures and technology-intensive products. There are also indications of improvement in the investment climate.

7.33 An issue of concern has been the fluctuations in industrial output in the second half of 1990s with adverse consequences for the competitiveness of manufactured products. While export demand imparts a competitive dynamism to industry, there is a need to broad-base competitiveness over a wider spectrum of products. Moreover, while strong export demand tends to support overall industrial demand, there is a need to generate domestic demand on a more enduring basis to sustain the growth momentum. In particular, concerted efforts need to be made to generate demand for those industries which are operating much below capacity levels such as 'food products', 'machinery and equipment (other than transport)', 'transport equipment and parts' and 'other manufacturing industries'. In industries in which production is approaching existing potential, the focus must be on building new capacities.

7.34 India has the potential to be a major beneficiary of the phasing out of the Multi Fibre Agreement (MFA). The dismantling of MFA import quotas in 2005 offers the textile sector significant opportunities to capitalise on the expansion of overseas markets. At the same time, however, competitive pressures will intensify and continuous improvement in product quality will become an imperative to defend existing market shares. It is crucial, therefore, to develop appropriate skills and upgrade technology to fully exploit the available opportunities. Industrial growth should typically accelerate in India's current stage of overall development. This acceleration has not taken place despite the wide-ranging industrial reforms in the 1990s. In a labour abundant country such as India, labour-intensive industries should be expected to grow faster. With the ongoing tariff reforms, some of the biases against labour-intensive industries have now been reduced. Further work needs to be done to identify policy actions that can help to induce high industrial growth that is particularly labour-intensive.

7.35 Small and medium enterprises (SMEs) occupy a unique position in the Indian economy due to their significant contribution to exports and value addition to domestic supply chains, employment generation, expansion of entrepreneurial base and diversification of the industrial sector. There is an urgent need for a comprehensive review of the policy framework for the small scale sector with a view to consolidating and carrying forward recent initiatives towards infrastructural support, technology upgradation, preferential access to credit, and preferential purchase policy. In particular, there is a need for a critical appraisal of the policy of reserving the items for production in the small scale sector. The Union Budget, 2004-05 has de-reserved 85 items for the small scale sector. While this is certainly a welcome policy change, there is a need for accelerated phasing out of the remaining reserved items. The focus should be on improving the competitive ability of SSI units through improvements in their efficiency and quality levels.

7.36 The persisting delay in execution of Central Sector Projects (CSPs) is another area which requires careful monitoring. While there has been some reduction in the cost overrun during 2003-04 as compared with the previous year, the proportion of delayed projects to total projects has increased. Many of the railway projects which are more than five years old are delayed due to inadequacy of funds and tardy progress in acquisition of land. The cost overrun of the delayed projects mainly relates to the projects in power and surface transport sectors. Issues regarding civil works, equipment supply, timely award of contract, feasibility studies and project appraisal continue to affect the speedy implementation of the CSPs. Adequate attention needs to be paid to ensure completion of projects in a time bound manner to avoid cost overruns.

Services

7.37 The services sector has emerged as the engine of growth of the Indian economy. The strength of the services sector needs to be leveraged in view of its enormous growth potential and positive externalities for the commodity producing sectors. While the rising share of services in the GDP is an encouraging sign of greater degree of diversification of the Indian economy, the corresponding decline in the shares of commodity producing sectors implies that overall productivity gains in the economy would depend increasingly on the degree of efficiency attained by the services sector.

7.38 The sustainability of high growth of services would hinge upon high quality of production and delivery, continuous improvement in productivity and pro-active supply responses in markets where tastes and patterns change rapidly. Customisation will be the hallmark of strategies for gaining market shares. The global market for the new drivers of service sector growth – Information Technology Enabled Services

(ITES) and Business Process Outsourcing (BPO) services – is becoming intensely competitive and is being compressed by protectionist pressures. Diversification of range of services offered as well as geographical markets, further innovations and ensuring customer satisfaction would remain crucial to maintaining India's competitive advantage in major international markets. Improvement in efficiency in the delivery of infrastructure services such as transportation, power, water supply and other urban services is critical to the enhancement of productivity in the commodity producing and services sectors alike. At this stage of development, construction activity holds the key for enhancing productivity and improving employment prospects across the economy. The modernisation of construction techniques would help in reducing overall costs in all infrastructure sectors and housing.

FISCAL POLICY

7.39 An important goal of fiscal consolidation through the implementation of FRBM Rules, 2004 is to eliminate the revenue deficit by 2008-09. This is sought to be achieved by raising the tax-GDP ratio through augmentation of tax receipts from sustained growth and better compliance. Moreover, emphasis needs to be on withdrawing exemptions and rationalising the tax structure so as to eliminate subjectivity in the tax system. In this context, it is also worthwhile to explore the applicability of a uniform tariff rate on imports. Given the downward rigidities characterising revenue expenditure, the attainment of the goals set out in the FRBM Rules would be contingent upon the realisation of the assumed revenue buoyancies. The Kelkar Task Force has made useful recommendations for boosting of revenues for the period 2004-05 through 2008-09 – a single goods and services tax (GST), removal of the plethora of exemptions granted to import and excise taxes, widening the net by expanding the service tax base and improving the tax compliance.

7.40 On the expenditure front, there is continued need for a review of the expenditure on subsidies and reorienting them so that the benefit accrues to the needy. It is also important to ensure that the quality of expenditure is enhanced by better targeting, elimination of waste in execution and emphasising value of output especially in delivery of services affecting the poor such as drinking water, sanitation, primary education and health. This, in turn, has wider ramifications for the productive capacity of the economy, given the paramount importance of public investment in critical areas of the Indian economy.

7.41 The emerging fiscal scenario of a number of State Governments underscores the need for concerted efforts towards achieving durable fiscal consolidation. This, in turn, entails appropriate user charges and cost recovery of social and economic services, apart from restructuring of state PSUs. The focus of adjustment, therefore, needs to be on fiscal empowerment and pro-active enactment of fiscal responsibility legislation by all the State Governments. In this regard, particular emphasis needs to be placed on strengthening the ability of the States to deliver efficiently the critical social services such as public health and primary education. The delivery of quality secondary education and medical services is also essential for further enhancement of the quality of life of all citizens.

EXTERNAL SECTOR

7.42 The growing strength of India's external sector has provided the enabling conditions to accelerate the pace of external liberalisation. This has considerably mitigated the inward-looking bias of past regimes and has brought forth a healthy response in terms of export earnings and the inflow of remittances. Liberalisation of foreign exchange transactions has to be backed up by price alignments in the form of reduction in tariff rates. The experience of most emerging markets suggests that internationally competitive tariff rates contribute towards export performance on a sustained basis.

7.43 The ongoing process of capital account liberalisation would deepen the foreign exchange market and make cross-border transactions increasingly sensitive to movements in interest rates and exchange rates. Capital account liberalisation is a process which has to be managed keeping in view the supply response of the economy and vulnerabilities or potential for shocks. Markets tend to react asymmetrically with a strong negative bias to reversals, unless there is already a crisis situation. The process of capital account liberalisation has to take into account the revealed preference for hierarchy in different types of capital flows. A key issue in managing the capital account is credibility and consistency in macroeconomic policies and the building up of safety nets to provide comfort to the markets. This also underscores the importance of prudential regulations over financial intermediaries in respect of their foreign exchange exposures and transactions, which are quite distinct from capital controls. It is the changing mix of controls that characterises the process of managing the liberalisation of the capital account. Furthermore, capital controls may be price based, including tax regimes, or may comprise administrative measures. Depending on the legal framework and governance structures, the mix between the two would vary. As liberalisation advances, the administrative measures would get reduced and price-based measures would be relied upon increasingly, but the freedom to change the mix should always be demonstrably available to assuage market sentiments in times of stress.

7.44 Outward FDI is receiving increased policy attention, not merely as a means of contending with capital inflows but also as a growing expression of competitiveness and entrepreneurial energy of Indian industry. FDI may be for resource-seeking, market-seeking, acquiring domain-knowledge or for business synergies. A greater integration with the global economy would be fostered and resilience imparted when India not only receives FDI but also promotes outward FDI.

FINANCIAL SECTOR

7.45 The Reserve Bank has been focusing on developing a competitive operating environment in the financial sector in terms of markets, institutions, products and practices. The increasing market orientation of the financial system helps in improving allocative efficiency of resources. At the same time, however, it exposes both public sector and private sector financial intermediaries to various risks, necessitating prudential regulation and supervision. The litmus test of regulatory design in a competitive environment is to strengthen financial stability while at the same time minimising the costs of financial regulation. This, in turn, implies that as the process of deregulation deepens, regulatory initiatives have to be reoriented towards more pro-active supervision of the financial system. It is in this context that the Reserve Bank's supervisory strategy has been to move away from micro-prescription oriented on-site supervision to risk-based supervision. A key element of a market-oriented risk-based supervisory strategy is to develop sound corporate governance practices, which would minimise the need for process-focussed supervision. The Reserve Bank, therefore, has been emphasising corporate governance and better risk assessment within banks and financial institutions, both public and private. The announcement in the Union Budget of a Task Force to examine the reforms required in the co-operative banking system, including the appropriate regulatory regime, is indeed welcome. The imperative of improving risk management systems must be seen as much from the angle of financial stability as from the process of economic development. Improved risk assessment systems are expected to enable banks to take greater exposures to sectors such as agriculture and small scale industries in which collateral valuations often pose difficulties. This is all the more important as the pattern of credit demand has been changing in recent years. Demand for bank credit from large corporates has been declining because of financial restructuring, improvements in productivity, optimisation of inventory cycles, better cash flow management, increased access to external commercial borrowings and improved internal generation of funds. With better risk assessment capabilities, banks should be able to shed their risk averse attitude and extend more finance to hitherto unbanked segments of agriculture, industry and services.

7.46 The critical challenge at this juncture is to improve the allocative efficiency of resources and at the same time guard against the risks of disruptive financial imbalances. The mandate of financial stability, in the Indian context, thus has to be seen in the broadest sense of the term, calling for a three-pronged strategy of ensuring uninterrupted financial transactions; maintaining a level of confidence in the financial system amongst all the participants and stakeholders; and ensuring orderly conditions in the financial markets to guard against potential adverse effects on real economic activity. The growing integration of financial markets, especially the increasing inter-linkages between domestic financial markets and the foreign exchange market, while desirable for economic efficiency, heightens the risk of contagion. As a result, special defence mechanisms need to be mounted for ensuring financial stability in the face of increasing uncertainties in the global financial scenario.

7.47 Management of the financial sector has been oriented towards gradual rebalancing between efficiency and stability and the changing shares of public and private ownership. Enhanced competition among diverse players has been encouraged. Regulation of urban co-operative banks is hampered by the system of dual control and speedy resolution of the issue is imperative to ensure the future health of the sector. Considerable improvements have taken place in prudential governance as also in moving away from administrative measures to market-orientation. Improvements in efficiency and stability are evident and there is merit in continuing with such rebalancing while refocusing on consolidation, governance and movement towards Basel II – *albeit* gradually, as in the past. Consolidation has started to encompass development finance institutions, public sector banks, private sector banks and non-bank financial companies. As the consolidation proceeds, it is necessary to design a road map so that over a period, there is a convergence between real sector reforms in India, a substantially liberalised capital account and an efficient but stable financial system, in particular the banking system, with an optimal diversity of players consistent with the growing size and complexity of the Indian economy.

7.48 The Reserve Bank favours a process of gradual convergence with international standards and best practices with suitable country-specific adaptations. This has also been the guiding principle in the approach to the New Basel Accord. Having decided, in principle, in April 2003 to adopt the Basel Accord, the Reserve Bank is overseeing a road map for migration to Basel II with reviews of the progress made at quarterly intervals. To begin with, all banks in India will adopt the Standardised Approach for credit risk and Basic Indicator Approach for operational risk. After adequate skills are developed, both in banks and at supervisory levels, some banks may be allowed to migrate to the Internal Ratings Based (IRB) Approach. The Reserve Bank is also putting in place supervisory policies to address the potential systemic risks arising due to operations of large and complex financial conglomerates.

7.49 There are, however, several areas which are likely to pose regulatory and supervisory challenges in the years ahead. First, the level of rating penetration is not yet adequate and it is restricted to issues (rather than issuers, as required by Basel II). Secondly, Basel II provides scope for the supervisor to prescribe higher than the minimum capital levels for banks for, *inter alia*, interest rate risk in the banking book and concentration of risks/ risk exposures. Thirdly, there are several issues in cross border supervision which have to be dealt with. Fourthly, although Basel II could actually imply a degree of pro-cyclicity of minimum capital requirements, there is a need to ensure that prudential norms are, in general, business cycle-neutral.

MONETARY POLICY

7.50 With the growing financial integration across borders, the conduct of monetary policy is becoming increasingly complex. It is not a coincidence that most of the uncertainties facing monetary policy at the present juncture are essentially international in character. The future evolution of international capital flows depends as much on the national fundamentals as on the stance of monetary policy followed by leading central banks in the world. The path of inflation is similarly governed not only by domestic economic activity, but also by the extent of liquidity emanating from capital flows and the movements in international commodity prices. Although the policy objectives remain rooted in the domestic macroeconomic circumstances, the process of monetary policy formulation has to factor in global macroeconomic developments, particularly, trends in world economic growth and trade, international price trends and movements in international interest rates and exchange rates.

7.51 The pursuit of price stability remains a key objective of monetary policy, especially in a country like India where a large majority of the population have no insurance against inflation. There is, thus, a need to consolidate the gains from reining in inflationary expectations especially as cross-country experiences suggest that public confidence can dissipate very quickly in the case of adverse movements in prices. An added dimension is the increasing sensitivity of domestic inflation to the movements in international commodity prices, with the opening up of the economy. The pursuit of price stability in future will call for a carefully crafted strategy in which monetary policy will not only need to address the demand side of the economy but also strike a fine balance in assessing the supply side of inflation, while enhancing prospects for growth.

7.52 Bank loans continue to be special in the Indian economy. This raises several issues in relation to credit culture, credit delivery and credit pricing. First, persistence of the large gap between lending rates and deposit rates remains a matter of concern. Policy-related barriers to reduction in the lending rate such as statutory pre-emptions and small saving interest rates have been eased considerably in recent years and asset quality has also improved. With almost all the structural rigidities having been reduced, bank-level efforts are now necessary to ensure that the benefits of low cost deposits are passed on to the customers. Secondly, there is the issue of stepping up loans to relatively disadvantaged sections of borrowers, including small and medium enterprises and the agricultural sector. To many of the borrowers in these sectors, it is, in fact, the availability of credit more than the price of credit which is of prime importance. This is especially so because interest rates in informal markets which serve as an alternative to bank finance, particularly in rural areas, are sometimes at usurious levels relative to the formal sector. The persistence of this large differential, *ipso facto*, implies that the formal credit mechanisms are not able to penetrate into the informal system. It is in this context that the recommendations of the Vyas and the Ganguly Committees assume significance. Whereas the Vyas Committee has recommended expansion of bank financing, especially direct lending, to agriculture, the focus of the Ganguly Committee has been on putting in place a strategy of lending to small scale industries in view of their potential for high growth.

7.53 To conclude, considerable progress has been made in preparing the ground for realising the full potential of the Indian economy. The drag imposed by high levels of unemployment, poverty and inequity has brought to the fore the urgency attached to actualising this potential. This is consistent with the renewed emphasis on equity in the reorientation of growth strategy that is underway. The process of structural reforms has imparted a resilience and a momentum to the economy even as the pursuit of macroeconomic and financial stability has produced gains in terms of low and stable inflation relative to several emerging economies and a vibrant and well-functioning financial system equipped with the wherewithal of intermediating the financing requirements of high and sustained growth. The regulatory and supervisory function is getting increasingly tuned to the fast changing financial environment. Issues in governance and transparency are at the forefront of this change even as efforts are being intensified to put in place the appropriate legislative framework for the smooth functioning of the financial sector.