THE ANNUAL REPORT ON THE WORKING OF THE RESERVE BANK OF INDIA

*For the Year July 1, 2008 to June 30, 2009**

PART ONE : THE ECONOMY - REVIEW AND PROSPECTS

I ASSESSMENT AND PROSPECTS

The Indian economy exhibited significant resilience in 2008-09 in the face of an intense global financial crisis and the subsequent severe global recession. The contagion from the global crisis, however, posed the challenge of responding to the evolving risks and heightened uncertainties, which warranted swift and appropriate use of fiscal and monetary policy measures with a view to ensuring orderly functioning of the markets, preserving financial stability, and moderating the dampening effects on growth. For the Government, this involved temporary deviation from the fiscal consolidation process embodied in the Fiscal Responsibility and Budget Management (FRBM) Act. The Reserve Bank had to contend with the challenges over two distinct phases during the year, which required contrasting monetary policy responses. In the first half of the year, inflation firmed up under the pressure of hardening international commodity and food prices, which necessitated an anti-inflationary policy response. In the second half, however, restoring orderly conditions in the market and subsequently supporting the growth momentum emerged as the key challenges. This required adoption of accommodative monetary policy stance, which was reflected in the provision of ample liquidity at lower interest rates. Consequently, the financial system functioned without disruptions and credit conditions did not operate as a constraint to growth.

Reverting to the high growth trajectory at the earliest remains the key policy challenge in the near to medium-term. The sustained expansionary fiscal and monetary policy stances, however, entail the risk of aiding inflationary pressures in the near-term and constraining the growth process in the medium-run. Timely exit from the current policy stance, thus, would be critical, given the emerging signs of inflationary pressures. Credible action plan on fiscal consolidation, with an emphasis on the quality of fiscal adjustment driven by rationalisation of expenditure and efficiency of public services would be necessary to revert to the high growth trajectory. The adverse impact of deficient monsoon on growth, inflation and social security needs to be carefully managed. Policies conducive to high domestic savings and promoting the role of innovations, technology and reforms in enhancing the productivity of investment may have to receive greater attention. The financial stability framework would need to be strengthened further taking into account the lessons from the global financial crisis.

* : 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, the data are analysed on the basis of the financial year. Where available, the data have been updated beyond March 2009. For the purpose of analysis and for providing proper perspective on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

I.1 The Indian economy witnessed moderation in growth in 2008-09 in comparison with the robust growth performance in the preceding five years. The deceleration in growth was broad based across three major constituent segments of GDP, *i.e.* agriculture, industry and services. Moreover, deceleration in industry and services sector also persisted over four consecutive quarters of the year. Reflecting the contraction in global demand, exports declined. Domestic aggregate demand also moderated due to sharp deceleration in the growth of private consumption demand. Reflecting the expansionary fiscal policy response to the slowdown in growth, government consumption demand increased by 20.2 per cent, and the contribution of government consumption expenditure to overall growth accordingly increased to 32.5 per cent from an average contribution of 5.9 per cent in the preceding five years. Corporate performance remained dampened, with significant fall in sales growth in the second half of the year, and decline in profits in last three consecutive quarters of the year. In 2009-10 so far, emerging signs of recovery are yet to indicate any clear trend, and the deficient monsoon and the depressed export performance have to be seen along with the improving growth in core infrastructure sector, recovering industrial production and more optimistic business outlook. Recognising the balance of risks to growth, the First Quarter Review of Monetary Policy for 2009-10 placed the projection for GDP growth at 6.0 per cent, with an upward bias. The inflation environment remained highly volatile during 2008-09; WPI inflation rose to a high of 12.9 per cent in August 2008 and declined sharply thereafter to below 1 per cent by the end of the year, before turning negative since June 2009. The currently observed negative inflation essentially reflects the impact of the high base of the previous year, and this transitory trend may not persist beyond few months. Within WPI, essential commodities continue to exhibit high inflation. Moreover, inflation expectations have not abated as much as the overall decline in WPI inflation, and inflation as per different consumer price indices remain stubbornly high. The adverse impact of the deficient monsoon on food prices, notwithstanding the record foodgrains production in 2008-09 and the high buffer stocks, also indicates upside risks to inflation, besides the evidence from the Reserve Bank's Survey of inflation expectations suggesting increase in inflation over the coming three months to one year. The First Quarter Review of Monetary Policy for 2009-10 took into account the emerging outlook on inflation and revised the inflation projection upwards from the earlier 4.0 per cent to 5.0 per cent, while reiterating 3.0 per cent as the medium term inflation objective.

I.2 The Indian economy exhibited five successive years of high growth with moderate inflation and macroeconomic stability during 2003-08, before encountering the contagion from the global economic crisis in 2008-09. The average GDP growth of 8.8 per cent achieved during this phase was not only the highest ever recorded in India's post independence economic history, but also one of the highest in the world in the recent period. More importantly, inflation in India averaged at about 5.3 per cent during this period. The macroeconomic environment remained stable and resilient to external shocks, despite rising degree of openness and significant reforms. India's ascent as a major emerging market economy with high potential for sustained robust growth was reflected in surges in capital inflows, which were in excess of the external financing needs as conditioned by the country's prudent emphasis on sustainable current account deficit as a means to stable growth. The impetus for growth emanated from the upsurge in the domestic savings rate from 23.5 per cent of GDP in 2001-02 to 37.7 per cent in 2007-08, which facilitated the step up in investment rate from 22.8 per cent to 39.1 per cent during the corresponding period. Fiscal consolidation and reforms unshackled the constraints to realisation of productivity and efficiency driven growth. Before the emergence of the global economic crisis in 2008-09, the high growth trajectory was generally seen as the sustainable critical threshold, and accordingly the policy focus was primarily shifting to address the growing infrastructure deficit and

make progress on remaining areas of reforms, while also ensuring that the growth process becomes more inclusive.

I.3 The Indian economy confronted one of the severest external shocks in 2008-09 in the form of an intense global financial crisis coupled with a global recession, but exhibited notable resilience, with GDP growth at 6.7 per cent. Orderly conditions prevailed in various segments of the financial system during the year. The cyclical growth deceleration witnessed in the first half of 2008-09 got amplified in the second half of the year on account of the dampening effects of the global recession. This happened notwithstanding the policy driven moderation in the adverse effects of the contagion on the economy. When the global markets turned dysfunctional in September 2008, with intense scramble for liquidity and subsequent credit freeze under the pressure of deleveraging, the Indian markets reverberated the shock, which was seen in the form of higher volatility in all segments of the financial markets and sharp corrections in stock prices. The macro-financial conditions remained exceptionally challenging from the stand point of the conduct of Reserve Bank's policies, as it had to respond to multiple challenges, starting from containment of inflation in the first half of the year to containing the deceleration in growth, preserving the soundness of the banks and financial institutions, ensuring normal functioning of the credit market and maintaining orderly conditions in the financial markets in the second half. At times, the Bank had to operate on multiple fronts simultaneously, and in constant consultation and coordination with the Government, with the overriding objective of limiting the adverse effects of the global crisis to the extent possible.

I.4 Global developments prominently influenced domestic developments in 2008-09. There were two distinct phases during which the transmission of global shocks posed different but significant challenges for the Reserve Bank. In the first half of the year, the world experienced simultaneous increase in both food and commodity prices, and there was a return of inflation after a phase of "great moderation". Dealing with supply side sources of inflation posed significant challenges for the conduct of Reserve Bank's monetary policy, particularly in the face of emerging signs of cyclical slowdown on the one hand and the risk of spiralling headline inflation affecting inflation expectations on the other. In the second half of the year, the global financial crisis and the subsequent global recession changed dramatically the nature of the challenge emanating from globalisation. The sharp swings in global conditions within the year were reflected in the fast slide of the world economy into a deep recession from a phase of high growth over the preceding four consecutive years. There was a sudden plunge to dysfunctional markets from a phase of growing market bubbles that had brought down risk premiums to historic low levels. Post-September 2008, developments in the financial systems of advanced countries revealed that irrespective of the degree of globalisation of a country and the soundness of its domestic policies, a global crisis could spread to every economy. The contagion could transmit through sagging consumer and business confidence, which, in the current context, is turning out to be more critical than the contagion transmitted through trade and capital flows. The international transmission of liquidity shocks was fast and unprecedented; while falling asset prices and uncertainty about valuation of the traded instruments affected market liquidity, failure of leading global financial institutions and the deleveraging process tightened the market for funding liquidity. Given the growing risk of illiquidity cascading into solvency problems, liquidity management acquired priority in most central banks, since it was critical for preserving normalcy in financial markets, and thereby avoiding the risk of snowballing effects of financial stress on the real economy.

I.5 The Reserve Bank could restore normalcy in the financial markets over a short time period through its liquidity operations in both domestic currency and foreign currency; the absence of any

direct exposure of the Indian banks and financial institutions to the troubled assets and failing financial institutions in the advanced countries helped in the avoidance of any serious stress in the financial system. The financial crisis in the advanced countries, however, precipitated into an intense synchronised global recession, which impacted the growth prospects of all countries through contraction in aggregate demand. With the earlier perception of decoupling fast turning out to be a myth, moderating the adverse effects of the contagion on growth emerged as a major globalisation-induced challenge in the second half of the year. The severity of the external shock had emerged as a test for the capacity of public policies to ensure soft landing in the face of persistent adverse global economic conditions.

I.6 India's capacity to withstand the global shock better than many other emerging market economies was partly on account of the sound macroeconomic and financial sector policy environment that had been put in place in the post-reform period by careful assessment of the opportunities and risks associated with reforms. After the balance of payments crisis in the early 1990s, as a matter of concerted policy effort, the extent of dependence on external finance for financing domestic growth has been limited to the sustainable level of the current account deficit, and capital flows in excess of the financing needs have resulted in comfortable foreign exchange reserves. The reserve management policy also assumes importance in the context of the market determined exchange rate regime where the Reserve Bank aims at containing undue volatility, recognising the adverse effects of a volatile exchange rate on trade, investment and growth. Despite significant pressures on India's balance of payments in the third quarter of the year, the foreign exchange reserves facilitated Reserve Bank's operations in the foreign exchange market to preserve orderly conditions, notwithstanding a phase of high volatility over a short period of time. The gradual and sequential approach to liberalisation of the capital account also prevented leveraging of the Indian financial system for taking positions in the troubled assets in the advanced economies. Despite significant financial sector reforms, adequate regulatory precautions have ensured that complex structures like synthetic securitisations do not contaminate the Indian markets, and prudential measures also limit the exposure of the banking system to sensitive sectors and asset price bubbles. Absence of structured products that could mask risk exposures, hide interconnectivity of market operators and allow excessive use of leveraged speculation has been a notable aspect of the Reserve Bank's prudence in regulation. Reserve Bank's mandatory SLR requirement of 25 per cent (now reduced to 24 per cent) also appeared relevant in the context of sharp deterioration in asset quality that was experienced by the leading international banks and financial institutions. More importantly, appropriate countercyclical regulations and provisioning requirements also contributed to preventing development of asset price bubbles in India.

I.7 The Reserve Bank had taken measures to modulate the monetary overhang that was building on account of sustained expansion in money growth; the withdrawal of monetary accommodation had in fact started in 2004 with gradual increase in both *repo* and *reverse repo* rates. Since April 2005 the Bank had also been expressing its concerns over the fast growth in credit, and the overdrawn state of the banking system to sustain the credit disbursement, given the mismatches between sources and uses of funds, and the associated increase in the credit-deposit ratios for certain banks. Recognising the unprecedented credit growth to the real estate sector during 2004-07, the provisioning requirements and risk weights were increased to prevent a build up of asset bubble. Absence of any sovereign issue in the international markets for financing the deficit of the Government has also helped in limiting the effects of adverse external shocks on the macroeconomic policy environment of the country. A large domestic market, reliance on domestic demand and domestic savings for growth, comfortable foreign exchange

reserves, prudent management of the capital account and a sound and resilient domestic financial system, thus, represent the key factors that helped in moderating the impact of the contagion on India in relation to many other countries around the world.

I.8 The deceleration in growth from an average of 8.8 per cent during 2003-08 to 6.7 per cent in 2008-09, however, warranted swift and comprehensive policy response, given the overriding policy focus of maintaining a growth rate of around 9 per cent as the key means to ensure higher living standards for all in an inclusive growth process. As the post-September 2008 global developments affected the Indian markets through the global liquidity spiral and sharp spurt in risk aversion, the Reserve Bank had to operate in several markets simultaneously, with the use of conventional and unconventional measures, given the overriding aim of restoring orderly market conditions and preserving smooth flow of credit for all productive purposes.

ASSESSMENT OF 2008-09

Economic Growth

I.9 The deceleration in growth, which started with the cyclical slowdown in the first half of 2008-09, got magnified in the second half due to the contagion from the global crisis. Deceleration in growth to 5.8 per cent in two successive quarters in the second half of 2008-09 represented the weakest growth in recent period; more importantly, while industrial growth turned negative in the last quarter, the deceleration in services persisted in all successive quarters of the year. The sharp moderation in GDP growth warranted appropriate fiscal and monetary policy response, which was delivered swiftly, that too in a forward looking manner in the second half of the year, in anticipation of the adverse ramifications of the global crisis on the domestic growth. The significant deceleration in private consumption demand and the slowdown in investment demand, and the associated contraction in output necessitated expansion in public sector demand, both consumption and investment, to ensure a credible deterrent to deceleration in growth. Due to the global recession, contracting external demand also affected export growth, which first decelerated, and then declined. The moderation in growth in 2008-09 was thus broad-based, spread across all three sectors (*i.e.* agriculture, industry and services) of the economy. The decline in growth in agriculture and industry, however, was more prominent compared to services. A major cause for policy concern was dampened growth in the Index of Industrial Production (IIP) since November 2008 with negative growth in one month, besides the sustained fall in exports since October 2008. Reflecting the demand augmenting policy, the growth in government final consumption expenditure increased sharply by 20.2 per cent in 2008-09 as compared with 7.4 per cent in 2007-08. The contribution of the government consumption demand to growth, as a result, increased from 8.0 per cent in 2007-08 to as high as 32.5 per cent in 2008-09.

The Fiscal Stance

I.10 The unprecedented magnitude and complexity of the challenge necessitated temporary deviation from the fiscal consolidation process embodied in the Fiscal Responsibility and Budget Management (FRBM) Act. The deviation from the fiscal consolidation path was evident from the revision to the Centre's fiscal deficit target from 2.5 per cent of GDP in the budget presented for 2008-09 in February 2008 to 6.0 per cent in the interim budget presented in February 2009 before the general elections and further to 6.2 per cent in the provisional accounts for 2008-09. In addition, special bonds amounting to 1.8 per cent of GDP were issued to oil marketing companies and fertiliser companies during 2008-09 to cover for their under-recoveries in the face of high international prices and lower administered prices, which had become necessary to contain the spiralling of inflation in the first half of the year. Besides the deterioration in the fiscal parameters

of the Centre under the compelling needs of fiscal stimulus, the fiscal deficits of the State Governments also witnessed some deterioration. The fiscal correction and consolidation process of the State Governments that was progressing during the previous few years was halted during 2008-09, although the consolidated revenue account of the State Governments continued to remain in modest surplus. Implementation of the Sixth Pay Commission award by some of the State Governments did exert pressures on the revenue expenditure of the States. The consolidated gross fiscal deficit (GFD) of States based on the revised estimates rose to 2.7 per cent of GDP from 2.1 per cent in the budget estimates on account of lower revenue surplus and non-debt capital receipts coupled with higher capital outlay. The combined fiscal deficit (Centre and States), including the special securities issued to oil marketing and fertiliser companies, thus, reached 10.7 per cent of GDP in 2008-09.

Financing of Fiscal Deficit

I.11 The challenge associated with financing of higher deficits emerged in the form of managing large borrowing programmes of the Governments without disrupting the markets, and more importantly, without exerting upward pressures on the interest rates. Significant moderation in inflation in the second half of the year; the deceleration in demand for non-food credit, reflecting the slowdown in growth; and the decline in non-bank sources of funding for the commercial sector created the headroom for smoother management of the borrowing programme. The net market borrowings of the Centre and the States jumped to Rs.4,02,302 crore (7.5 per cent of GDP) in 2008-09 from Rs.1,66,895 crore (3.5 per cent of GDP) in 2007-08; special securities outside the market borrowing programme increased to Rs.95,942 crore in 2008-09 from Rs.38,050 crore in 2007-08.

The Monetary Stance

I.12 The high growth in credit and broad money in 2004-08 was taken cognisance of by the Reserve Bank and its policy response gradually turned to modulating the monetary overhang, without restricting the growth in credit and money that was necessary for sustaining the high growth. Reflecting the cautious monetary stance, the *repo* and *reverse repo* rates were raised gradually since September 2004, along with higher reserve requirements. The tightening stance had to be pursued more aggressively in the first half of 2008-09 to contain the building inflationary pressures. Reflecting the moderation in growth in the second half and the contraction in aggregate demand, non-food bank credit, which was growing at 29.4 per cent in October 2008 (year-on-year basis) fell to 17.5 per cent by end-March 2009. Part of the high growth in credit up to October 2008 reflected the shift in the pattern of resource mobilisation by the corporates in the face of emerging global credit squeeze. The external funding was partly substituted by resort to domestic credit. Moreover, there was a sharp increase in credit to oil marketing companies which reflected the rising international oil prices and high cost of imported crude. After October 2008, however, with sharp fall in international oil prices, the demand from oil companies came down at the same pace. Moreover, decline in commodity prices, need for clearing the inventories accumulated at high cost in the face of falling demand and falling prices, as well as weakening business confidence contributed to the sharp drop in credit growth. Credit extended by private and foreign banks exhibited much sharper deceleration in growth in relation to the nationalised banks. More importantly, flow of resources from non-banking avenues (such as from the capital market, non-banking finance companies, ECBs, FCCBs, ADRs/GDRs and FDI) also fell by about 20 per cent over the level in the previous year. Relaxing all constraints on the expansion in credit at lower cost without dilution of the emphasis on asset quality emerged as a major challenge for the Reserve Bank. Many Central Banks around the world had to confront with the challenge of unfreezing the credit market; in India, however, the credit market functioned normally, and the deceleration in credit growth reflected slowdown in real activity. The Reserve Bank ensured ample

surplus liquidity in the system to ensure flow of credit to productive sectors, within the prudence necessary for preserving the asset quality of the banks.

Liquidity Management

I.13 The monetary aggregates – both broad money and reserve money – evolved during the year reflecting the fast changing inflation and growth outcomes, as well as swings in domestic and international liquidity conditions. This was reflected in sharp shifts in the composition of monetary aggregates on both sources and components sides. In recent years up to the first half of 2008-09, increase in net foreign assets of the Reserve Bank, reflecting the surges in capital flows, had become the dominant source for expansion of base money. In the third quarter of 2008-09, however, the balance of payments came under pressure, and the reserve drawdown that became necessary to finance the deficit in capital inflows, led to corresponding contraction in base money. The Reserve Bank had to more than offset the contraction in reserve money by expanding its net domestic assets (NDA) so as to ensure necessary growth in money supply consistent with the needs of economic growth, besides the provision of ample liquidity to alleviate any fear of liquidity shortage in the Indian markets. The Reserve Bank ensured the necessary expansion in NDA through conventional open market operations (OMOs) involving outright purchase of government securities in the secondary market, as well as provision of liquidity through acquisition of securities by *repos* under the LAF. Another instrument which allowed the Reserve Bank to expand liquidity was the unwinding of the MSS securities. MSS securities had become an important instrument of sterilisation to partly neutralise the expansionary effects of surges in capital flows in the earlier years. While dealing with the challenge of expanding the NDA to offset the impact of contracting NFA on reserve money, the unwinding of MSS balances not only created the scope for adequate liquidity expansion by the Reserve Bank without expanding its balance sheet, but the timing of the unwinding could also be modulated in such a way that the large borrowing programme of the Government was managed smoothly without exerting any market stress. The reduction in CRR from 9 per cent to 5 per cent represented release of large liquidity to the banking system. The monetary operations of the Reserve Bank, in the wake of addressing the impact of the crisis, thus, were significantly different from the experience of many central banks of the advanced economies, even though the ultimate objective was almost the same, which was to ensure adequate liquidity in the banking system.

I.14 The reduction in CRR by 4 percentage points released Rs.1,60,000 crore of liquidity to the banking system. While the first round immediate impact of a reduction in the CRR leads to corresponding fall in the reserve money, it implies higher money multiplier, which leads to higher increase in broad money. Since moderation in reserve money growth was the result of a deliberate expansionary policy action, the Bank had to emphasise the “adjusted reserve money” indicator to communicate the monetary developments to the public.

Monetary Transmission

I.15 Despite persisting with the expansionary monetary policy stance in the post-September 2008 period, which was reflected in 400 basis points reduction in CRR, 4.25 percentage point reduction in the repo rate, 2.75 percentage point reduction in *reverse repo* rate and several other conventional as well as non-conventional windows for access to liquidity (resulting in the availability of more than Rs.4,00,000 crore of additional actual/potential liquidity to the system by the end of the year), the transmission of monetary policy became a matter of concern. The complete transmission of monetary policy takes place with long and variable lags. But in the midst of a sudden reversal in risk perception, the risk premium could increase significantly to often more than offset the magnitude of fall in the policy rates. As a result,

the cost of funds may not decline for the customers, or may even increase, despite significant fall in the policy rates. This was experienced in several advanced economies, where the yield spreads increased significantly at some stage, reflecting heightened risk aversion. In India, while reassessment of risk was one of the factors constraining the transmission of monetary policy, there were several other structural factors in operation as well. First, the administered interest rate structure for small savings restricts flexibility on deposit rates for the banks, as small savings could potentially compete with deposits depending on the relative difference in the interest rates offered on both savings instruments. Second, depositors often lock their deposits at the high interest rate for longer term during a high interest rate phase; as a result, banks face the constraint of reducing the cost of lending in a phase of economic slowdown since their cost of funds remains high because of term deposits contracted earlier at higher rates. Till the term deposits become due for maturity, at which stage the deposits could be renewed at the lower rate, the banks experience structural rigidity in their balance sheet. Third, several concessional administered loans to sectors like agriculture and exports are linked to the BPLR, which works as a disincentive to revise the BPLR downwards even in the face of falling policy interest rates and use of moral suasion by the Reserve Bank to emphasise the need for lower lending rates as one of the means to support recovery in growth. Fourth, banks often compete to mobilise bulk/wholesale deposits, and they have to prevent shifting of such deposits to other banks, which creates the associated pressure to delay the revision in interest rate to the extent possible. In the conduct of its policies, the Reserve Bank, as a public institution, has to also remain sensitive to the interest of the depositors, given particularly the role of high domestic savings in India in the high growth phase of 2003-08 and the relatively higher degree of insulation of Indian growth compared to most other countries during 2008-09. Despite significant moderation in WPI inflation to below 1 per cent by the end of 2008-09 and then to sub-zero level, CPI inflation at the retail level continues to be high, and inflation expectations also have not receded at the same pace as the WPI inflation. In view of these reasons, monetary policy effectiveness continues to remain a challenge, which though is a universal concern and not specific only to India. Since the last quarter of 2008-09, however, the deposit and lending rates have started to moderate in response to the significant reduction in policy rates and sustained ample liquidity in the system, besides the Reserve Bank's constant emphasis on better policy transmission in the credit market.

Inflation Divergence

I.16 Headline inflation, as measured by year-on-year variations in the WPI, declined sharply to 0.84 per cent by end March 2009 from the peak of 12.91 per cent on August 02, 2008. The spurt in volatility in WPI inflation needs to be seen in the context of the behaviour of global commodity prices during the year. Reflecting the sharp increase in oil and metal prices in the global markets, WPI inflation had risen to double digits in June 2008 and remained elevated till October 2008. As the global commodity prices moderated from their peak levels, domestic prices also adjusted sharply thereafter. Excluding the volatile fuel and metals components in WPI, however, the WPI inflation was less volatile, in the range of 10.2 per cent in August 2008 to 4.8 per cent in March 2009. The pass-through of global commodity prices to domestic prices was incomplete because of administered price mechanism and fiscal interventions for several commodities, which helped in moderating the price pressures and containing the volatility in inflation. The prices of food articles, however, continued to rule high, as a result of which the consumer price indices (CPIs) remained firm near double digit levels, given the higher weight of food articles in CPIs. The Reserve Bank's Annual Policy Statement in April 2009 recognised the emerging significant divergences between inflation in WPI and CPIs and emphasised that for policy purposes it continuously monitors the full array of price indicators.

External Contagion and Financial Markets

I.17 In the post-September 2008 period, the major concern for the Reserve Bank was to deal with the knock-on effects of the global financial crisis. With sharp increase in the overnight call rate in India to 13 per cent on September 16, 2008 and further to a peak of 19.8 per cent on October 10, 2008, the volume under the LAF *repo* window of the Reserve Bank (which is used on a day-to-day basis by the banks for accessing liquidity) increased from around Rs.12,500 crore in the first half of September 2008 to Rs.68,000 crore in the second half of the month, and further to Rs.90,000 crore in early October 2008. Demand for liquidity had increased from many quarters, that too suddenly. Corporates had increased the demand for credit at home as a substitute for external financing in the face of global credit squeeze. Access to trade credit was becoming difficult, and the cost also had gone up. NBFCs and mutual funds, given the nature of their sources of funds, also faced major liquidity shortage. In view of the capital outflows and the pressures on the balance of payments in the third quarter of the year, the exchange rate came under pressure, which warranted intervention operations by the Reserve Bank to restore orderly conditions in the foreign exchange market. This, in turn, implied corresponding contraction in rupee liquidity in the banking system. The Reserve Bank, thus, had to ensure supply of adequate rupee as well as foreign currency liquidity to restore the call money rate within the LAF corridor and also to contain volatility in the exchange rate.

Reserve Bank's Responses to the Contagion

I.18 For enhancing the availability of domestic liquidity, besides the usual reduction in CRR, greater access under the LAF through *repos*, and unwinding of the MSS securities, several other conventional as well as unconventional instruments were also used depending on the nature and expected magnitude of the demand for liquidity, such as a second LAF window providing access to liquidity in the afternoon as against the normal LAF access in the morning, special 14 days *repo* facility using SLR eligible securities up to 1.5 per cent of NDTL for meeting the liquidity needs of NBFCs, housing finance companies and mutual funds, advance release of money at the request of the Government to the banks towards Agricultural Debt Waiver and Debt Relief Scheme, increase in export credit refinance limit for commercial banks, and special refinance facilities for specialised financial institutions such as the SIDBI, NHB and EXIM Bank. The additional liquidity that was made available exceeded Rs.4,00,000 crore (by the end of the year), which is unprecedented and amounted to 7.9 per cent of GDP.

I.19 For dealing with the excess demand conditions in the foreign exchange market, given particularly the objective of containing excessive large volatility, a number of measures were initiated to ease the supply situation by partly assuring greater access to the Reserve Bank's foreign reserves and partly by improving the inflows in response to specific measures. Besides the actual intervention sales in the foreign exchange market, the Reserve Bank also opened the forex swap facility for the banks. To ease the demand pressure from oil importing companies during the high and rising phase of international prices, the Bank had already started special market operations in the secondary market through commercial banks involving direct supply of forex liquidity against the oil bonds of the public sector oil marketing companies. The policy measures that aimed at improving the supply of forex liquidity included permitting banks to borrow from their overseas branches within prudential limits, relaxing further the external commercial borrowing policy, including allowing NBFCs and housing finance companies to borrow in foreign currency, and raising the interest rates on NRI deposits. Notwithstanding the demand pressure in the forex market, in view of depressed international asset prices, the corporates were permitted to prematurely buy back their FCCBs at prevailing discounted rates.

I.20 Recognising the difficult challenges in the credit market, the Reserve Bank had to balance the priorities of credit quality and improved credit delivery. As counter cyclical regulatory measures, the Reserve Bank reduced to normal levels the provisioning requirement for standard assets and risk weights for certain asset classes, which had been increased earlier during the period of rapid credit growth. With a view to further strengthening the domestic banking sector, the Reserve Bank also undertook a number of other regulatory initiatives, which include: (i) review of prudential framework for off balance sheet exposures of banks covering issues like risk weights, provisioning and credit conversion factors; (ii) strengthening of systems for monitoring large un-hedged foreign exchange exposure of corporates; (iii) enhancing cross border supervision and consolidated supervision of bank led conglomerates; (iv) reviewing supervisory framework for monitoring the activities of Special Purpose Vehicles(SPVs) and trusts set up by banks; (v) reviewing the appropriateness of the current supervisory framework for monitoring the overseas operations of Indian banks; (vi) issuing guidelines on managing maturity mismatch for addressing liquidity risks in the very short run; (vii) discouraging the practice of excessive reliance on call money borrowing by linking the borrowings to banks' capital; and (viii) modifications to guidelines on restructuring of advances. Despite the risk of contagion from the global financial crisis, the Indian banking system remained sound and resilient, as evident from the soundness indicators like capital adequacy, asset quality and profitability for 2008-09. While the capital adequacy level for the banking system was at 13.2 per cent at the end of the year, each individual bank was above the minimum 9 per cent capital adequacy requirement prescribed by the Reserve Bank. Stress-testing findings of the Committee on Financial Sector Assessment (CFSA) also suggested the resilience of the financial system and the adequacy of capital levels.

Impact of the Reserve Bank's Actions

I.21 Responding to the large and comprehensive domestic liquidity measures, the inter-bank call rate reverted to within the LAF corridor or around the ceiling by the end of October 2008 and the LAF window also moved from net injection to net absorption mode, indicating the surplus liquidity conditions in the system since November 2008. Reflecting the measures taken for improving the availability of forex liquidity, the average exchange rate of the rupee which had depreciated sharply from Rs.40.02 per US dollar at the beginning of April 2008 to Rs.51.23 per US dollar in March 2009, has appreciated since then to around Rs.48.0 per US dollar in the first half of August 2009. The 10-year benchmark government securities yield also softened from the October 2008 levels by the end of the year, despite significant increase in market borrowings in the second half of the year. Thus, the transmission of the Reserve Bank's policies to the money, forex and the government securities markets has been effective, thereby ensuring speedy restoration of orderly conditions over a short time span.

The Resilient External Sector

I.22 The external sector of the economy exhibited resilience despite significant pressures on the balance of payments through the trade and capital flows channels, particularly in the third quarter of the 2008-09, when the reserve loss (excluding valuation) was US$ 18 billion in just one quarter. While net capital flows remained negative even in the fourth quarter of the year, the reserve loss was negligible because of surplus in the current account. For the year as a whole, the current account deficit widened to 2.6 per cent of GDP in 2008-09 from 1.5 per cent of GDP in 2007-08, with a total loss of reserves of US$ 20.1 billion (net of valuation). Overall, there was substantial decline in net capital inflows from US$ 108 billion in 2007-08 to US$ 9.1 billion in 2008-09, with last two quarters of the year showing net outflows. The financial channel of the contagion from the global financial crisis, thus, was distinctly felt in the form of reversal in capital flows, which affected the domestic financial markets, in particular, the stock market and the forex market. The significance of maintaining comfortable foreign exchange

reserves, even with a largely flexible exchange rate regime, thus, became evident during the year when one of the severest external shocks could be managed without any exceptional measures to modulate the specific transactions in the current and capital accounts.

Managing Macroeconomic Challenges

I.23 The management of the macroeconomic environment during 2008-09, thus, was exceptionally challenging for the Reserve Bank, as the magnitude and pace of the external contagion had the potential to cause severe disruptions to critical segments of the economy. Preventing a liquidity scare, with ample provision of liquidity, both domestic and foreign currency, was the immediate challenge in the post September 2008 period, and both money market and forex market returned to normal conditions within two months in response to Reserve Bank's actions. With a sound banking system, the liquidity of non-banks like NBFCs, mutual funds and housing finance companies were also met to avoid the failure of any financial institution on account of lack of access to liquidity. In the wake of net capital outflows and difficult conditions for access to international markets, while assuring the market to provide the needed liquidity from the comfortable foreign exchange reserves, steps were taken to make certain inflows more attractive. Given the overriding importance of containing the moderation in flow of credit to the private sector for sustaining the growth momentum, counter cyclical prudential regulations were used to encourage banks to lend. The policy rates were also brought down significantly so as to lower the cost of funds and thereby spur consumption and investment demand. The fiscal stimulus, that involved significant increase in the government borrowing programme, posed the challenge of smooth completion of the borrowings without disrupting the markets.

I.24 Notwithstanding the Reserve Bank's actions that prevented the financial system from stress and thereby avoided any risk to the growth process from the financial system, the slowdown in domestic aggregate demand on account of the apprehensions spilling over to the consumers and investors from the severe global recession emerged as the key challenge to sustained high growth. In 2008-09, management of high inflation in the first half and preserving the soundness and resilience of the financial system in the second half were the key policy challenges. By the beginning of 2009-10 the major policy concerns were slow recovery in growth despite use of large fiscal stimulus and accommodative monetary stance, global recession weakening the export prospects, less than expected correction in real estate prices constraining a recovery in housing demand, high food and consumer price inflation and the risk of inflationary pressures firming up further due to the impact of sustained recovery-focused fiscal-monetary policy stance, implications of protracted growth slowdown for asset quality of banks, and the increasing possibility of large borrowing programmes limiting the options for monetary policy by potentially exerting upward pressures on market interest rates and competing with the credit demand from the private sector, and thereby constraining the return to the high growth path in the medium-term.

PROSPECTS FOR 2009-10

The Uncertain Global Outlook

I.25 The external economic environment is unlikely to remain congenial for supporting a faster recovery in India, because despite improved financial market conditions and thaw in the pace of contraction in global activity, the recession in advanced countries is widely perceived to persist in 2009. The IMF's outlook released in July 2009 suggests that global growth would contract by 1.4 per cent in 2009, and the volume of world trade would also decline by 12.1 per cent. The recovery is widely perceived to be gradual, and even with the upward revision to the IMF's growth outlook for 2010 at 2.5 per cent, that would represent just about half of the growth achieved in 2007. Moreover, despite diminishing uncertainty and improving confidence as well as receding financial stress,

bank lending conditions remain tight, housing markets are yet to bottom out, and banks' balance sheets need to be cleansed further. In the second quarter of 2009, while the rate of contraction in the US and Euro-area GDP slowed down significantly, Japan, Hong Kong, Germany and France recovered from the recession, and China and Korea exhibited acceleration in growth. Emerging signs of improvement in the global macro-financial conditions, however, need to gain roots for ensuring a sustained global recovery. According to the Global Development Finance of the World Bank June 2009, the industrial production in rich countries has declined by 15 percent since August 2008, and that in developing countries (excluding China) the decline has been by 10 percent. The external financing conditions for the developing countries has been viewed to remain difficult in 2009, with private capital flows expected to decline from US$ 707 billion in 2008 to US$ 363 billion in 2009. The IIF's June 2009 projections for capital flows to EMEs suggest that net flows could fall sharply to about US$ 141 billion in 2009 from US $392 billion in 2008. According to the July 2009 estimates of the World Bank, remittance flows to developing countries could decline to US$ 304 billion in 2009 from US$ 328 billion in 2008, suggesting that the impact on remittance receiving countries may not be as strong as the trade and capital flows channels. Rising unemployment, however, entails the risk of tighter immigration policies. The assessments of international agencies indicate that trade, capital flows and remittances may take some time to revive to normal levels and contribute to growth. If the protectionist response of some countries continues, global recovery may not immediately lead to corresponding revival in world trade. Moreover, rebalancing of the global growth to correct the accumulated global imbalances of the past years may also affect the growth prospects of many countries.

Return to the High Growth Trajectory

I.26 Reverting to the high growth path at the earliest and ensuring an inclusive growth process represent the overarching priorities of the Government, and the macroeconomic policy environment has to respond to this broad overall objective. As external demand operates as a major drag on the recovery, growth impulses have to depend even more on domestic demand than in the past and public expenditure has to take the lead in boosting aggregate demand in the face of deceleration in private consumption demand and investment demand. This realisation is reflected in the increase in government expenditure by 33.1 per cent in 2008-09 and by 13.3 per cent over the high base of the previous year, as budgeted for 2009-10.

I.27 The relatively higher resilience of Indian growth to the global economic crisis was on account of the dominant role of domestic demand and domestic saving. The increase in savings rate from 23.5 per cent in 2001-02 to 37.7 per cent in 2007-08 largely allowed a sustainable investment driven high average growth of 8.8 per cent over 2003-08, besides the congenial productivity enhancing influence of reforms. In the process of reverting to the high growth path, same level of support from domestic saving may be required, which, however, may be difficult in the immediate run due to the operation of two factors, which would have dampened the performance on the saving front. Public sector savings, which had been showing signs of improvement in recent years reflecting the disciplining influence of the FRBM, is expected to register some deterioration due to higher fiscal deficits as the outcome of using appropriate fiscal stimulus to contain the slowdown in growth, besides the expected subdued performance of the public sector enterprises in a phase of economic slowdown. Depressed corporate earnings associated with deceleration in aggregate demand could also lead to some erosion in savings of the private sector. The growth in overall domestic savings, thus, could be expected to decline modestly in 2009-10. This, however, may not operate as a constraint to growth in the short-run, since in relation to the aggregate demand adequate liquidity is available in the banking system. Moreover, during the phase of economic

slowdown, corporates could have undertaken efficiency enhancing restructuring of the production processes, which otherwise might have been difficult to implement in the preceding phase of high growth. This could help in strengthening the growth momentum once the recovery sets in. Inventory levels, which would have declined during the slowdown, may also support a faster revival when aggregate demand recovers. In the medium-run, as the fiscal stimulus is withdrawn gradually and the fiscal policy stance reverts to the path of consolidation and discipline, return to the same level of domestic savings that could be consistent with the sustainable growth level of 9 per cent would be feasible.

Aggregate Demand

I.28 The composition of aggregate demand had to tilt in favour of government demand, on account of the use of fiscal stimulus to contain the growth slowdown. In view of the payments made under the Farmer Debt Waiver Scheme, Sixth Pay Commission and fiscal stimulus measures, the share of government final consumption increased to over 11.1 per cent of GDP in 2008-09 from 9.8 per cent of GDP in the previous year. The revival in private consumption demand, however, is essential to not only stimulate investment demand but also to facilitate faster fiscal consolidation. In this context, promoting rural demand assumes significance not only in view of the higher share of rural consumption in aggregate private consumption but also because of greater vulnerability of rural consumption in an environment of deficient monsoon as well as high food articles inflation, both of which could erode rural disposable income. The share of rural consumption in total household consumption has remained consistently in the range of 55 per cent to 60 per cent in last one decade, and is expected to grow at a faster pace with rising inter-linkages and catching up with the urban life style. Recognising the importance of rural demand in moderating the impact of the slowdown, the Union Budget for 2009-10 increased outlays under several schemes significantly that could benefit the rural households directly, besides the income enhancing/supporting policies associated with the increase in MSPs and food subsidies.

Agricultural and Allied Activities

I.29 The agricultural growth prospects in 2009-10 have to be assessed taking into account the output impact of deficient monsoon. With almost 60 per cent of the agricultural land being rain-fed, Indian agriculture is still dependent on the performance of the monsoon, particularly the South-West monsoon. During the last ten years, large cumulative deficiency in rainfall was observed during 2002 (-19 per cent) and 2004 (-13 per cent). On both these occasions, there was an adverse impact on foodgrains production. While agricultural production had contracted by 7.2 per cent in 2002, the production level in 2004 had held up at the same level as in the previous year due to the robust growth in allied activities. The past experience, thus, suggests that the spatial and temporal distribution of the rainfall is critical in influencing the overall outcome for agriculture. According to the August 2009 revised monsoon rainfall projections of the India Meteorological Department (IMD), the rainfall deficiency in 2009 (during June-September) could be about 13 per cent. The actual position up to the second week of August 2009 shows that the cumulative shortage of rainfall is about 29 per cent in relation to the normal levels. Moreover, production weighted rainfall index of the Reserve Bank shows a shortfall of 36 per cent, which is higher than what is indicated by the cumulative rainfall pattern. Crop sowing position as on August 13, 2009 indicates that sowing of most pulses and coarse cereals are higher than last year's levels, though paddy sowing has been substantially lower, *i.e.* about 19 per cent below last year's level. Given the fact that kharif paddy contributes about 86 per cent of total rice production and 36 per cent of total foodgrains production in India, foodgrains production in 2009-10 could be adversely affected because of the deficiency in rainfall. According to the Food and Agriculture Organization (FAO),

India's paddy output in 2009-10 may decline by 2.5 per cent. Rainfall deficiency entails the additional risk of shortfall in hydro power generation, which may also add to the existing infrastructure constraint to growth, particularly when the energy demand increases with the recovery.

I.30 The rainfall deficiency during the kharif season, thus, could affect the growth and inflation outlook, besides rural disposable income. Rural demand that had remained buoyant so far on account of record food grains production last year, may also experience some moderation, which in turn could influence the recovery prospects of certain industries that benefited earlier from the robust rural demand. FMCG sector could be particularly affected, and the stock markets have already responded to the monsoon related outlook for different sectors as well as the overall economy. Notwithstanding the macroeconomic concerns associated with the rainfall deficiency, one needs to recognise the progress on effective diversification of Indian agriculture towards horticulture, livestock and fisheries, and their rising shares in the total output of the agricultural sector. Horticulture, livestock and fisheries contribute close to 60 per cent of the GDP originating from "agriculture and allied activities", and "cereals, pulses and oilseeds" grown during *kharif* account for only 20 per cent of the total agricultural output. As in the previous year, improved Rabi performance may also help in moderating the output effects of monsoon during the kharif, which though would depend on the rainfall pattern in the remaining phase of the South West monsoon as well as precipitation during North East monsoon. While the record foodgrains production in 2008-09 and comfortable buffer stocks of rice and wheat have enhanced the capacity to deal with price pressures in 2009-10 on account of the deficient rainfall, enhancing the agricultural output, driven by higher yield and diversification of crops, assumes importance. Higher investment backed by sustained research and extension activities could be critical for augmenting yield. Besides the policy focus on using higher MSP to generate supply response and public investment on expanding the irrigation potential, improving the market structure for agricultural commodities ensuring competitive pricing, hedging options for management of crop uncertainty, adequate warehouse facilities and improved rural roads enhancing better connectivity with urban markets also must receive greater policy attention. Better water management with an emphasis on water harvesting would be important for moderating the impact of below normal monsoon on farm output.

Industrial Sector

I.31 Despite positive growth and signs of recovery in the first quarter of 2009-10, the growth outlook for the industrial sector remains mixed. The pace of industrial output in a number of emerging and industrial economies had declined by double digit levels during the second half of 2008-09. In India also, the IIP registered a growth of 2.7 per cent in 2008-09, which is the lowest since 1992-93, with negative growth in one month of the year. The unregistered manufacturing sector has generally moved in line with the registered manufacturing sector, and the performance could be expected to have been equally subdued than the organised sector as micro and small enterprises (MSEs) often depend on large enterprises through forward and backward linkages. The concern relating to flow of credit to the SMEs also needs to be addressed. In view of the prevailing uncertainties, the Reserve Bank has set up an Industry Monitoring Group drawing members from external agencies as well as from concerned departments of the Bank in April 2009 to periodically assess the developments in Industry in relation to changes taking place in the global economy and the financial sector.

I.32 The manufacturing sector's performance in a competitive environment and in the face of risks of rising protectionism could encounter several challenges. Despite the advantages of a large domestic market, abundant availability of skilled labour force, and the proximity to the fast growing

Asian markets, productivity growth needs to catch up with the Asian economies, including China. This requires greater emphasis on quality, better adoption of technology, more flexible labour laws, significantly improved infrastructure and a policy environment supportive of the SMEs sector. The industry-education linkages must be strengthened vigorously. The technological breakthrough for product development, including patent protection, has often acted as a deterrent to attract sizeable investment into R&D in many industries, notably the drugs and pharmaceuticals. Persistent problems like delayed payments after delivery, frequent disruptions in the availability of power, and lack of stable demand also affect the performance of the manufacturing sector. The strong inter-linkage with the performance of the export sector has been a factor in affecting the industrial growth in the face of contracting external demand.

Services Sector

I.33 The underlying impetus of high growth in India has been the sustained robust performance of the services sector. This sector has not only exhibited minimum growth of 9 per cent in the recent five years, but its share in aggregate GDP has also increased to about 64.5 per cent. The significant progress made by the services sector has been partly possible because of the strong growth in services exports. The contribution of services exports in overall value added accelerated sharply from 6.9 per cent in 2000-01 to 21.6 per cent during 2008-09. Indian services sector has competitive edge in several knowledge based services segments *viz*., software, business processing and healthcare, while in the remaining areas, India may have to gain the competitive edge; the availability of modern physical infrastructure along with quality human resources would be important to spur the growth impulses in the services sector.

I.34 Historically, the services sector has consistently showed resilience since 1990-91, and remained largely unaffected by the past instances of external crises such as the Gulf crisis in 1991, East-Asian crisis in 1997 and the technology meltdown in 2000. The current global economic crisis being unprecedented in the recent history in terms of the magnitude of the impact as well its duration, the past resilience of the services sector could be tested in 2009-10. Unlike the impact on manufacturing that started in the second half of 2008-09, the impact on services may be felt with a lag, since the use of services as input to output growth in organised manufacturing has been rising in the past. The services sector competition also thrives on labour productivity as well as intensity, which is important in the context of the demography of India in favour of the young population as well as the need to absorb the surplus labour available currently in the agriculture sector. The direct contribution of global factors to the services output has been rising since 2001, with increasing global integration in services trade under the multilateral framework, favourable terms-of-trade and communication revolution providing strong fillip to both on and off-shore outsourcing of business processes, activities and knowledge. The protectionist tendencies in some of the countries affected by the ongoing economic crisis have created concerns for the prospects of external demand for Indian services , but India's comparative advantage continues to be strong.

I.35 Notwithstanding the high growth and resilience of the services sector in the recent past, the sector faces multiple challenges for sustained growth over the years. A number of services where India enjoys comparative advantages experience lack of clear policy thrust. For instance, despite the high quality of healthcare services, it attracts a number of regulations. Similarly, in education, multiple regulation points and lack of credible accreditation systems hamper the growth potential. Given the medium to long-term contribution of investments on education and health to growth and productivity, availability of these services at affordable cost while enhancing their global competitiveness must form part of the priority in India's development process. A number of services in India are either predominantly associated with

the Government or not liberalised enough to ensure growth through organised private initiatives. Services like professional, legal, postal, accountancy and insurance need further liberalisation to harness their potential.

Growth Outlook

I.36 The Reserve Bank's survey of professional forecasters conducted in June 2009 indicated an upward revision in the median growth outlook to 6.5 per cent from the earlier outlook of 5.7 per cent as per the previous Survey conducted in March 2009. Currently available projections of growth for India in 2009-10 generated by various international and domestic organisations suggest a range of 4.8 per cent to 7.5 per cent. Taking into account the global developments as well as the developments in domestic aggregate demand and the recent output outlook for the three broad constituent components of GDP (*i.e.* agriculture, industry and services), the first quarterly review of the monetary policy for 2009-10 conducted on July 28, 2009 placed GDP growth for 2009-10 at "6.0 per cent with an upward bias". Since the presentation of the policy statement, while the extent of rainfall deficiency associated with the South West monsoon has increased, the IIP figures for June 2009 released in August 2009 show significant recovery in Industrial output.

Inflation Outlook

I.37 In 2008-09, India witnessed large volatility in headline inflation, which exceeded 12 per cent at one point and then fell to below 1 per cent by the end of the year. Since June 2009, year-on-year WPI inflation has remained negative, primarily reflecting the high base effect of the previous year that resulted from significant increases in the prices of food and international commodities in the first half of 2008-09. The base effect could be expected to fade gradually and then disappear by October 2009, after which the positive WPI inflation will become visible. While WPI inflation has turned negative, other indicators of inflation based on CPI for June 2009 (point-to-point) continue to remain high at 11.5 per cent (for CPI-AL), 11.3 per cent (for CPI-RL), 9.6 per cent (for CPI-UNME) and 9.3 per cent (for CPI-IW). The significant divergent behaviour of the inflation is largely on account of the differences in the coverage of items and their weights in the WPI and CPI. At the disaggregated level, even within the WPI, inflation in food articles and essential commodities remain close to the inflation as per different indices of CPI. The divergent inflation pattern as per the WPI and CPI indices has increased the complexity in the assessment of inflation, and for policy purposes, the Reserve Bank monitors the full array of price indicators. Moreover, inflation expectations have not declined as much as the fall in WPI inflation and expansionary fiscal stance with an accommodative monetary policy may not lead to sobering of inflation expectations, even if the headline inflation remains negative for few months.

I.38 The steady increase in the WPI over its end-March 2009 level indicates the persisting upward momentum in inflation, and trends in global commodity prices in the first quarter of 2009-10 suggest that upside risks to inflation could persist from rebound in global commodity prices ahead of global recovery. Increase in Minimum Support Price (MSP), that may be seen as a measure to support the farmers in a below normal monsoon year could stoke inflation. More importantly, the deficient monsoon could affect the inflation outlook more than the growth prospects. The first quarter review of monetary policy conducted in July 2009 revised the inflation projection for the end of the year to 5 per cent from 4 per cent projected in April 2009, recognising the imminent signs of inflationary pressures, while highlighting the medium-term objective of 3.0 per cent inflation.

I.39 The divergent trends in inflation as measured by the WPI and CPIs have warranted a closer relook at the measurement issues as well as the choice of an appropriate price index for monitoring changes in price levels at the national level that could be used as the reference indicator for conduct of policies. In the absence of a nationwide single inflation indicator based on

consumer prices covering the entire population, the wholesale price index (WPI) has been used as the headline inflation indicator as it is more representative and provides information on prices on a weekly basis with the minimum lag. The current WPI series (with base year 1993-94) does not completely capture the nature of transactions in the economy, as considerable structural changes have occurred in the economy since then. In this context, the Government's decision to revise the base year to 2004-05 is expected to improve the representativeness of WPI, as more number of products, including from the unorganised sector, is proposed to be covered in the new series, along with reassigning of weights. The ongoing efforts for compiling nationwide consumer price indices for both rural and urban areas by the Central Statistical Organisation (CSO), as per the recommendation of the National Statistical Commission, would also improve the information base on price movements.

The External Sector Outlook

I.40 The outlook for the external sector suggests that despite persistence of the global recession in 2009, the external sector is unlikely to cause concern for growth and stability in India. The latest available trends for 2009-10 indicate that current account deficit as percentage of GDP would be lower than that in 2008-09. Both exports and imports continued to decline in the first quarter of 2009-10, but the decline in imports has been sharper than the decline in exports, resulting in a narrowing down of trade deficit. However, global oil prices have increased in recent months, which, if sustained, may put some pressure on the trade and current account deficits. The relative stability in the software services exports and inward workers' remittances, as witnessed in the previous year, could impart resilience to the current account in 2009-10. Even though net capital flows to EMEs are expected to decline during 2009, capital flows to India may increase because of better medium-term growth and faster recovery prospects. Early indications for the first quarter of 2009-10 suggest that NRI deposits, FII portfolio inflows and inward FDI flows have generally been strong, as against the net capital outflows witnessed in the last two quarters of 2008-09. The liberalised external payments regime has been facilitating the process of acquisition of foreign companies by Indian corporates, both in the manufacturing and services sectors, with the objectives of reaping economies of scale, improving access to technological knowhow and increasing strategic presence in offshore markets to face the global competition. Besides the lower current account deficit, reasonable debt sustainability indicators and comfortable foreign exchange reserves would ensure external stability, notwithstanding the persistent adverse global economic conditions.

I.41 The strong export growth of India in recent years before the global recession started has been driven by the productivity changes underway in the Indian industry. The import intensity of exports, however, has also been steadily rising as domestic entities have expanded access to internationally available raw materials and intermediate goods as well as quality inputs for providing the competitive edge to domestic production and enhance export capabilities. The prospects for recovery in exports have to be seen in the context of low external demand due to the global recession and the resultant pressure on export prices and margins, protectionist measures adopted by several countries, significant stimulus given by India's competitor countries to their exporters, and uncertainty faced by exporters about timely receipt of payments. For improving the prospects for exports on a more sustainable basis the emphasis should be on diversification, in terms of both markets and export items, and competitiveness, without making the sector to remain dependent on incentives like tax breaks, lower excise and customs duties on inputs used for exports, and concessional interest rates on financing for exporters, even though such incentives may be necessary in a phase of contraction in global demand as a temporary support to the export sector. Incentive dependent exports could hamper the

progress on productivity as the durable means to higher exports. South–South trade may also have to be recognised for its potential in augmenting exports growth in future.

I.42 The experience relating to surges in capital flows for successive years, followed by sharp reversals in the second half of 2008-09 highlight the importance of management of capital flows, given their ramifications for the exchange rate and the conduct of monetary policy, and more importantly, for the overall macroeconomic and financial stability. A diversified capital account, with a hierarchical preference for FDI over debt flows, and for long-term flows over short-term flows, should be the focus of external sector policy. Fuller capital account liberalisation remains a medium-term objective, recognising the growing ineffectiveness of micro controls in a world of growing trade and financial integration.

Fiscal Consolidation

I.43 The fiscal stance of the Government in the face of deteriorating global conditions and weakening domestic growth impulses was guided by the need for preventing a sharp contraction in growth in both 2008-09 and 2009-10, while recognising the need to revert to the path of fiscal consolidation as soon as possible. The fiscal consolidation during 2003-04 to 2007-08, driven by revenue buoyancy during the high growth phase, had created some fiscal space to activate discretionary counter-cyclical fiscal policy. The Union Budget for 2009-10 envisages further deceleration in revenue collection due to the economic slowdown, as also partly due to tax cuts that were undertaken earlier to support growth. The expenditure, in turn, was increased to support aggregate demand by enhancing allocation for the crucial sectors such as infrastructure in rural and urban areas, education and health, rural employment programmes and schemes for the weaker sections. On the taxation front, the changes in both direct and indirect taxes have been envisaged to address the concerns of growth and equity. The gross tax-GDP ratio is budgeted to decline to 10.9 per cent during 2009-10 from a peak of 12.6 per cent in 2007-08.

I.44 The quality of fiscal consolidation has to be given priority attention in view of the fact that even the post FRBM improvements in key deficit indicators were possible primarily on account of the revenue buoyancy. On account of the FRBM Act, revenue deficit and fiscal deficit came down from 2.5 per cent and 4.0 per cent of GDP in 2004-05 to 1.1 per cent and 2.7 per cent of GDP, respectively, in 2007-08. These improvements in fiscal indicators were largely revenue led. The revenue buoyancy improved significantly as a result of higher economic growth during this period and also due to deliberate policy action towards improvement in tax administration through computerised information system and institution of tax information network (TIN). The revenue receipts to GDP ratio increased from 9.7 per cent in 2004-05 to 11.5 per cent in 2007-08, which accordingly contributed to reduction in fiscal deficit to GDP ratio by 1.8 percentage points. On the other hand, contribution from compression in aggregate expenditure to reduction in fiscal deficit at 0.7 percentage points of GDP was much smaller. Decline in non-debt capital receipts (*i.e.* recovery of loans and disinvestment proceeds) by 1.2 per cent of GDP, however, led to partial offsetting of the positive impact of revenue buoyancy and expenditure compression on fiscal deficit. Not only that expenditure compression had the lowest contribution to fiscal consolidation, but even the composition of increase in expenditure tilted against capital expenditure. While the revenue expenditure to GDP ratio increased by 0.4 percentage points, that of capital expenditure declined by 1.1 percentage points, reflecting lack of focus on expenditure management in contributing to the quality of fiscal consolidation.

I.45 While the fiscal measures undertaken to revive growth have led to deviation in fiscal targets envisaged under the FRBM Act during 2008-09 and 2009-10, the Government has committed to return to FRBM mandate in the next two years. Though the stance of long-term fiscal policy beyond 2010-11 would emerge later this year when the Thirteenth Finance Commission presents its report, there are

several factors which could enable the Government in returning to the FRBM path. Expenditure on account of payment of Sixth Pay Commission arrears and farm loan waivers would be paid out by 2009-10. Frontloading of the plan expenditure approved for the Eleventh Five Year Plan as fiscal stimulus measures would also imply lower plan expenditure in the remaining years. As tax collections, particularly direct taxes are cyclical in nature, revenue buoyancy is expected to rise again with the pickup in growth momentum. The Government could also reverse the indirect tax cuts with the revival of the economy. Goods and services tax (GST) proposed to be introduced from April 2010 could also be expected to improve the revenue buoyancy. In this regard, the Government has also recognised the importance of institutional reform measures encompassing all aspects of budget such as subsidies, taxes, expenditure and disinvestment.

I.46 The fiscal consolidation path may have to involve considerable and careful rationalisation of expenditure. The capital outlay to GDP ratio has been around 1.5 percent for last several years. Capital outlay, which is budgeted at 1.7 per cent of GDP during 2009-10 would need to be stepped up significantly over time. Non-plan expenditure would have to be checked. During 2009-10, non-plan revenue expenditure consisting mainly of interest payments, defence expenditure, subsidies, wages and pensions and grants to States appropriated over 60 per cent of the total expenditure (about 10 per cent of GDP). In the near future interest payments, which represent a major non-discretionary component of expenditure, could appropriate over one-third of total revenue receipts. This underpins the need for fiscal consolidation. The quality of fiscal consolidation, based on successful international experience, suggests that it should be driven by expenditure rationalisation/ compression. A ceiling on the share of non-plan expenditure in total expenditure may be integrated into a medium-term plan for enhancing the quality of fiscal consolidation. Moreover, improving the productivity of public expenditure and quality of the public service should also be emphasised as an important part of the initiatives on expenditure led fiscal consolidation.

I.47 On the revenue front, introduction of goods and services tax (GST) is an important policy reform. The GST would facilitate greater vertical equity in fiscal federalism and reduce the cascading nature of commodity taxes, since the base for assessment would be the value addition. In the Union Budget for 2009-10 it has been indicated that the broad contour of the GST model would be dual GST, comprising Central GST and State GST. The Centre and States will legislate, levy and administer the Central GST and State GST, respectively. The Central Government has reiterated its commitment to facilitate the introduction of GST by April 1, 2010, after consultations with all stake holders. The share of services sector in total tax revenue is not commensurate with its share in GDP, although the services tax collections have witnessed an impressive growth during the period 2003-04 to 2008-09, from 0.3 per cent of GDP in 2003-04 to 1.2 per cent and budgeted at 1.1 per cent of GDP in 2009-10. Within gross tax revenue, the share of services has increased from 3.1 per cent in 2003-04 to 10.4 per cent in 2008-09 and budgeted at 10.1 per cent for 2009-10. With the introduction of GST, more number of services would also be brought into the tax net and consequently tax contribution from the services sector could be expected to increase substantially.

I.48 The fiscal consolidation process entails the risk of affecting social sector spending as much as infrastructure spending. The expenditure incurred on education and health in recent years as per cent to GDP showed marginal improvement from 0.4 per cent and 0.2 per cent in 2003-04 to 0.6 per cent and 0.3 per cent, respectively, in 2008-09. These are budgeted at 0.7 per cent and 0.4 per cent for 2009-10. Compared to other emerging market economies, expenditure on health and education is low in India. Given the already low level of expenditure on these crucial sectors, as a minimum, there is a need to maintain the gradual upward momentum witnessed in recent years. The

process of fiscal consolidation, therefore, should not be achieved at the cost of cut backs in expenditure towards these sectors.

Disinvestment

I.49 In the context of options for faster return to the fiscal consolidation path, mobilisation of resources through disinvestment has been highlighted in some quarters. The experience with disinvestment programme in recent years indicate that proceeds from disinvestment were the highest in 2003-04, amounting to Rs.16,953 crore, and no subsequent momentum has been achieved since then. With the setting up of National Investment Fund (NIF), all the proceeds from disinvestment of Central Public Sector Enterprises (CPSEs) are required to be routed to it, which is maintained outside the Consolidated Fund of India. The Fund is managed professionally to provide sustainable returns to the Government, that too without any depletion of the corpus. Only the annual income of the Fund can be spent, with 75 per cent for financing select social sector schemes in the field of education, health and employment and the balance 25 per cent for meeting the capital investment requirements of profitable and revivable CPSEs. There is a need to step up disinvestment for greater resources mobilisation.

Subsidies

I.50 Management of subsidy has posed a persistent policy challenge. The high fertiliser prices prevailing in global commodity markets during the first half of 2008-09 and the enhanced minimum support price for wheat and rice led to sharp increases in fertiliser and food subsidies in 2008-09 (RE) by Rs.44,863 crore and Rs.10,960 crore, respectively, over the budget estimates. Apart from these subsidies, which are explicitly provided for in the Budget, implicit subsidies provided for by way of issue of special securities to oil and fertiliser companies amounted to Rs.75,849 crore and Rs.20,000 crore, respectively, in 2008-09 so as to compensate for under recoveries. This has added to the subsidy burden of the Government, as the interest payments on these securities will impinge on the revenue deficit of the Government. The Union Budget for 2009-10 has lowered the provisions for fertiliser subsidy in 2009-10 by 34 per cent over the revised estimates for 2008-09, assuming that the prevailing lower prices of fertilisers will continue in the international markets. Food subsidies have been raised by 20 per cent in order to ensure food security for BPL families. Together with the provision for special securities to oil marketing companies, the total provision for major subsidies is budgeted to be around 2 per cent of GDP for 2009-10, as against 4.2 per cent of GDP in 2008-09. Moreover, expenditure by the States on subsidies has been at around 0.4 to 0.5 per cent of GDP in recent years. This order of subsidy of the Centre and States taken together is high for a country where budgetary resources have competing demands and which have stronger potential for contributing to growth and development. Without explicit mandated provisions to cap expenditure on subsidies, needs for greater public investment in infrastructure, both physical and social, could be sacrificed as an outcome associated with higher subsidies.

I.51 As regards fertiliser subsidies, the move towards nutrient based subsidy regime as announced in the Union Budget 2009-10 could ensure balanced application at reasonable prices. Furthermore, the move towards a system of direct transfer of subsidy to the farmers in due course will ease the pressure on fertiliser subsidies as leakages could be reduced. Over time, fertiliser prices need to be decontrolled. As irrigation is a critical factor determining the use of fertilisers, and has a significant impact on foodgrain production, public investment in irrigation could be a more efficient policy instrument rather than subsidy.

Infrastructure

I.52 India's high growth trajectory has exerted significant pressures on the available physical infrastructure, and infrastructure deficit is widely recognised as a major constraint to attracting foreign investment and promoting efficiency in

production in India. The Eleventh Five Year Plan envisages stepping up of the gross capital formation in infrastructure from 5 per cent of GDP in 2006-07 to 9 per cent of GDP by end of the Plan period in 2011-12, and this could be critical to achieve the 9 per cent growth. The large financing requirement that is necessary to almost double the investment in infrastructure has to be also seen in the context of challenges for investment in both public and private sectors. Public investment continues to dominate the infrastructure sector in India and when the Government is expected to go through an exit phase to revert to the fiscal consolidation path, accelerating the pace of public expenditure for infrastructure could become difficult. In attracting private investment to infrastructure projects, the challenge is to make the investment attractive enough in terms of expected return on capital while also being fair to the consumers and actual users of the infrastructure. Moreover, besides the current focus on growth, improving the quality of life through provision of modern physical and social infrastructure should also be given greater importance. During the implementation stage of the projects, more rigorous mechanism must be put in place to enhance the quality of the infrastructure. Development of infrastructure is the key to a sustainable high and inclusive growth process and is necessary for connecting producers to markets, lowering transaction costs and also providing a larger section of the population access to services like communication, education, and healthcare. India's rapid industrialisation and growing urbanisation continue to put pressure on infrastructure demand; as infrastructure projects are capital intensive with long gestation period, the return is uncertain and low in risk adjusted terms, which warrants provision of special preferential incentives in the policy framework for generating the desired supply response.

I.53 Addressing the growing infrastructure gap would be critical for both sustaining higher growth as well as improving the quality of life. The Eleventh Five Year Plan has estimated an investment requirement of US$ 502.88 billion (Rs.20, 11,521 crore) in infrastructure; financing this level of investment, however, remains a challenge ahead. Several new initiatives have been initiated in the recent years focussing particularly on the rural infrastructure development. To stimulate public investment in infrastructure, a special purpose vehicle - India Infrastructure Finance Company Limited (IIFCL) was set up for providing long-term financial assistance to infrastructure projects. The Union Budget for 2009-10 announced that IIFCL would, in consultation with banks, evolve a 'take out financing' scheme (which would address asset liability mismatch of commercial banks arising out of infrastructure financing) to facilitate incremental lending to the infrastructure sector. In recent years, some progress is discernible in attracting private investment in infrastructure sectors such as telecommunications, power generation, airports, ports, roads and the railways through public private partnerships (PPPs).

I.54 PPPs have grown in popularity around the world with governments otherwise finding it difficult to finance infrastructure investments through conventional revenue raising mechanisms like taxation or borrowings. In financing large-scale PPP programmes, there could be the constraint in terms of mobilisation of long-term funds. PPPs in India rely on commercial banks for funding, which by nature cannot be for very long-period. Bank financing for PPP projects exposes the banks to risk concentration, besides refinancing uncertainty at maturity, and the risk of changing interest rates and credit conditions over time. An active bond market could diversify risks, besides elongating the duration of finance. The financing challenges suggest the need for greater Government support, ranging from direct equity contribution to use of government guarantees and extension of tax breaks. To ease the financing constraints for infrastructure projects under the PPP mode, the Government has decided that IIFCL would refinance 60 per cent of commercial bank loans for PPP projects in critical areas over the next fifteen to eighteen months. The IIFCL was authorised to raise Rs.10,000 crore through Government

guaranteed tax free bonds by the end of 2008-09 and an additional Rs.30,000 crore on the same basis as per the requirement in 2009-10. The refinancing option is expected to leverage bank financing for PPP programmes to the extent of about Rs.1,00,000 crore.

Technology and Innovations

I.55 For sustaining the high growth, there has to be significant emphasis on raising the productivity levels, for which innovations and adoption of technology would be critical. Any contribution to growth that emanates from factors other than labour and capital is generally seen as the contribution of technology in growth accounting, which is broadly captured under "total factor productivity (TFP)". International as well as domestic empirical evidences recognise the role of technological progress in economic growth through increase in TFP. Factors ranging from education, rule of law, openness to trade and capital flows and institutional reforms could contribute to technological progress, besides innovations and adoption of new technology. For enhancing productivity, thus, expenditure on primary health, education, vocational training and R & D may be raised, besides facilitating larger flow of credit. Entrepreneurship needs to be incentivised for promotion of innovation and growth of old and new businesses. Enhanced credit availability to business start-ups is one of the measures to facilitate the growth of entrepreneurship. Start-ups are expected to have a higher failure rate, which may have to be recognised in the regulatory norms relating to asset quality. Innovations in areas in which India has gained expertise and competitive edge (*e.g.* ICT, pharmaceuticals and biotechnology) also need to be encouraged. FDI often brings with it modern technology and other practices which contribute to productivity; there is, therefore, a need for a more liberal FDI policies. In view of the low yield in Indian agriculture, productivity enhancing technologies are particularly required for more inclusive high growth and rural development. Entrepreneurs are generally innovators and known for their development and adaptation skills. They are creative and are driven by the animal spirit of making profits. They are also risk takers. Hence, a special Government funded scheme for providing necessary opportunities to existing and potential entrepreneurs could be appropriate.

Food and Energy Security

I.56 The global developments on the food and energy fronts in 2008 highlighted the importance of food and energy security for ensuring sustainable and inclusive high growth in India. Insulating the common man from the vulnerability associated with high food price inflation warrants a more robust food security system in India, which could allow high growth in agriculture without depressing the prices too much while also preventing escalation in food prices in the eventuality of production shortfalls. The extent of volatility that was witnessed in international food prices in 2008-09, and the specific measures that the Government of India had to undertake in terms of banning export of certain items and reducing the prices of certain imported items through lower tariffs, also highlight that India may have to put in place a more comprehensive food management system that is consistent with high growth and low inflation objectives while also ensuring adequate supply of food articles at the lowest possible prices to the vulnerable sections of the society. This is particularly relevant on account of the fact that a large segment of the Indian population has no access to any assured social safety fall back options. The current buffer stock policy may have to be better aligned to the goal of stabilising food price inflation while simultaneously promoting higher growth in agricultural output, so that despite the costs involved, surplus production could be absorbed in years of good agricultural production to avoid any sharp fall in prices, while also releasing adequate stocks from the available buffer stock during periods of shortfall in domestic production in relation to demand. Other growth enhancing measures could include higher public investment in agriculture, better crop balancing, research and extension services, and prevention of degradation in soil

productivity while enhancing the sustainability of available ground water for agricultural use. The emphasis should be also on diversification of agriculture, from rain-fed to dry land farming, from food crops to non-food cash crops, and from dependence on agriculture as the sole source of living to non-farm rural employment. Climate change related issues will assume greater prominence over time, and could potentially disturb the rainfall pattern in future; there could be gradual international consensus over time on emission limits for countries, which in turn would require larger public investment on clean technology.

I.57 Besides food security, energy security is another challenge, and the behaviour of energy prices in 2008-09 only highlights the urgency that should be assigned to this issue. Significant dependence on imports for ensuring assured supply of POL products in the domestic market warrants adequate strategic policies to contain any potential risk to future growth path arising from possible emergence of sudden deficits in energy availability. Incentives to private investment and higher public investment on exploration and production of crude and natural gas would be necessary. Any fiscal measures to moderate the impact of high oil prices over a sustained period could drag the fiscal position to unsustainable levels. Decontrol of prices for all POL products by linking the pricing directly to international prices, and delivering subsidies explicitly as a cash outgo affecting the budget deficit contemporaneously, instead of through oil bonds, could be the first step towards promoting energy security. The next important steps could involve provision of sufficient fiscal incentives for promoting energy conservation and efficient use, for attracting private investment in generation and conservation of power, and more importantly, research and extension activities on non-conventional clean energy.

Employment

I.58 The employment effects of the global economic recession have been a key driving factor behind the use of large stimulus packages all over the world. The May 2009 ILO Update on Global Employment Trends projects additional unemployment of over 50 million (in the worst case scenario) as a fallout of the global economic crisis in 2009. While no information is available at the macro-level in India on the unemployment scenario arising from the slowdown in growth, unemployment very much remains a concern, and there are evidences of some increase in unemployment in certain sectors. The Ministry of Labour in India had conducted two quick quarterly surveys for the period October-December 2008 and January-March 2009 in select business segments to assess the impact of the global contagion and domestic slowdown on employment. The survey found a decline in overall employment growth in industries like textiles, metals, automobiles, gems and jewellery, transport and IT/BPO by 1.0 per cent (or 0.5 million job losses) during the third quarter of 2008-09, with the gems and jewellery and transport segments showing (-8.6 per cent) and (-4.0 per cent) change in employment. While export oriented units exhibited pressure on employment, non-exporting units experienced modest employment growth.

I.59 The employment situation in the fourth quarter of 2008-09, however, improved, even in certain export-oriented segments, particularly textiles, IT/BPO, automobiles, gems and jewellery and handloom/powerloom; the employment situation though deteriorated in other export oriented sectors like leather, metals and transport, where employment remained below the September 2008 levels. The Reserve Bank's Industrial Outlook Survey conducted in April-May 2009 showed that as per expectations about employment in July-September 2009, there would be net hiring in the manufacturing sector.

I.60 The Government has undertaken several measures to promote growth in the sectors facing slowdown, and thereby prevent increase in unemployment. Prominent among these are establishment of two new mega clusters for handlooms and carpets, interest subvention on pre-shipment credit for labour intensive export oriented

sectors, enhanced ECGC cover, and reduction in basic customs duty and service tax exemption to select exports. Enhanced resource allocation in 2009-10 for national flagship schemes such as National Rural Employment Guarantee Scheme (NREGS) (rise by144 per cent), Bharat Nirman (rise by 45 per cent), National Highway Development Programme (rise by 23 per cent), Jawaharlal Nehru Urban Renewal Mission (JNNURM) (rise by 87 per cent) could help in generating additional employment, particularly in the un-organised sector, both in rural and urban areas during 2009-10. There have been reports of reverse migration – from urban industrial clusters to the rural areas within India – and the protectionist response of several countries in terms of tighter immigration policies on account of their own deteriorating employment conditions.

Urbanisation

I.61 Approximately 30 per cent of India's population resides in urban areas currently. The proportion of people living in urban areas is going to increase at a faster pace in the next thirty years on account of organic growth as well as the continued rural-urban migration. Considering the important role that urbanisation has played in economic development more recently in South-East Asia and China, the role of proper urban planning and management cannot be overemphasised. Focus is required not just on hard infrastructure such as water, sanitation, sewerage, urban transportation, power and communication, but also on softer areas such as education (primary, secondary, higher and vocational) and health. Traditionally, provision of public goods and services is financed by tax flows and public borrowings while that of private goods and services is financed through user charges. In India, the importance of user charges in developing and sustaining the urban infrastructure is well recognised. The Jawaharlal Nehru Urban Renewal Mission (JNNURM), launched in 2005-06, is by far the most ambitious programme aimed at improving the civic service levels in identified mission cities over a period of seven years. While sanctioning projects utilising the additional central assistance under the JNNURM, priority has been given to projects such as water supply, sanitation and storm water drainage, which benefit the common man and the urban poor. This process needs to be further strengthened.

Financial Sector Reforms

I.62 While India's financial sector remained resilient in the face of global shocks, there are a number of areas where the reforms would be needed to promote stability and generate growth impulses for the real economy. An important challenge is to channelise more savings to the financial system, particularly in rural areas and from the urban informal sector. This would need further penetration of the banking system. The Reserve Bank's emphasis on financial inclusion is important in attaining this objective over time. There is also enormous potential for expanding financial services in semi-urban and rural areas for productive activities, which may require strengthening the banking correspondent relationship, simultaneously enhancing the risk assessment and risk management capacities in order to maintain credit quality and sustain the credit growth in the informal sector. Further reduction in the cost of banking services may require greater competition among product lines, improved delivery mechanisms and increasing use of information technology. With a view to ensuring that domestic savings could finance long-term investment in projects having long gestation lags, the insurance and pension sectors, would be critical, due to the very nature of their liabilities, as well as a vibrant bond market. This may, however, require a number of reforms in the insurance sector such as increasing flexibility for the insurance companies to raise capital and bring in greater competition and enhance depth in the insurance and pension funds markets. Deep and liquid domestic markets with varied participation can absorb overall risk better and reduce the excessive volatility that often adds uncertainty to the investment climate. From this

perspective, the corporate bond market in India has lagged behind in comparison with other financial market segments, owing to many structural factors. Rationalising the primary issuance procedure, facilitating exchange trading, increasing the disclosure and transparency standards and strengthening the clearing and settlement mechanisms in the secondary market are necessary in this regard. Cross-border banking, in the post crisis period, has to be examined with greater caution, and future reforms in this area must be guided by progress on adequate mechanisms and systems to prevent the possibility of sudden and large external contagion creating systemic risks for the domestic financial system. For sustaining the high growth path, improving the investment climate and enhancing the absorptive capacity would be critical. In this context, financial sector reforms have to emphasise promoting financial inclusion, ensuring wide and deep financial markets and facilitating the growth of strong, competitive and sound financial institutions.

Financial Stability Architecture

I.63 The post-crisis revamping of the architecture for promoting financial stability as a precondition to growth could encompass macroeconomic policy issues as well as financial regulation and supervision. In the sphere of monetary policy, alongside the predominant emphasis on inflation, asset price bubbles driven by credit boom and excessive use of leverage has to receive greater attention, notwithstanding the current lack of clarity on how does monetary policy respond to asset prices? The fiscal policy stance has to recognise the limits of pro-cyclical fiscal stance, and the importance of adequate fiscal consolidation and sustainability as a necessary stimulus to high growth and stability. In the Indian context, inherent rigidities that constrain faster consolidation has to be taken into account; adequate fiscal space has to be built up as a cushion over time to deal with future shocks to the growth process. Leverage driven or export/capital flows dependent growth could increase the amplitude of the business cycle and the real costs of an external or financial sector shock could be disproportionately high. In the sphere of regulatory and supervisory architecture, alongside the current emphasis on the soundness of individual banks and institutions as a means to ensure systemic stability, increasing emphasis has to be laid on macro-prudential regulation that could promote and strengthen systemic stability.

I.64 In India, elements of macro-prudential regulation were visible even before the global crisis started, in terms of counter-cyclical use of risk-weights and provisioning norms. Macro-prudential analysis could provide the early warnings for timely identification of systemic risks, while macro-prudential regulation could prevent the emergence of systemic risk in the financial system. In view of the interconnectedness between banks and institutions, financial markets, and the economy, systemic risk analysis would involve interpreting the changing dynamics between these three segments on a continuous basis. Any vulnerability in any small segment of these broad areas could amplify and become systemic in view of the strong inter-linkages.

I.65 The international initiatives that could lead the process for strengthening the global financial systems would involve significant coordination among national regulators, besides revamping of national stability frameworks reflecting the global trends and country specific requirements. The ongoing international initiatives indicate a multipronged approach, covering several important aspects of stability: (a) introducing automatic stabilisers into the regulatory framework by adopting counter-cyclical capital charge, so that adequate cushion could be built up during the booming phase of the business cycle which could be used to deal with the asset quality problems that may arise during the waning phase of the business cycle; (b) adequacy and quality of capital as per Basel-II risk based capital framework, and simultaneous use of simpler measures such as the *leverage ratio*; (c) capital requirements for reputational and other risks in respect of

securitisation activities and activities undertaken by the sponsored or connected conduits/shadow banks; (d) capital treatment for trading book exposures, and the need for supplementing *value-at-risk* approach with *incremental risk charge* so as to minimise the incentive for regulatory arbitrage between banking books and trading books, (e) strengthened Pillar 2 supervision, focusing on risk concentration, off-balance sheet exposures, valuations of financial instruments, access to funding liquidly during hypothetical possibility of a financial crisis, stress test practices adopted in banks and system level stress-tests and their integration into capital and liquidity planning; and (f) promotion of market discipline under Pillar 3 through better disclosure and clarity on the risk associated with exposure to certain instruments. The international deliberations have also highlighted other important issues like the risk associated with distorted incentive structures for the market players, the inadequacy of self regulation for rating agencies, the deficiencies of models for risk analysis and measurement, and the need for improving market structure for derivatives. The emerging international standards and best practices would have to be carefully examined from the stand point of their relevance to India, while further strengthening the domestic financial stability framework to avoid systemic stress on the financial system.

I.66 As on March 31, 2009, all Indian banks, including the foreign banks, have migrated to the Basel II standardised approaches, and hence, they will be subject to the Supervisory Review and Evaluation Process (SREP) under Pillar 2 of Basel II for assessing the capital requirement as also the capital adequacy of each bank *vis-a-vis* its risk profile and the standard of its internal controls system and risk management practices. Consolidated supervision mechanism for the banking group with bank as parent entity has been put in place. Financial Conglomerate Monitoring Mechanism already is in vogue since June 2004 in India. Steps are being taken to strengthen Cross Border Supervisory Co-operation. With a view to strengthening and formalising a comprehensive financial stability framework, supporting pillars have been laid out through special exercises like periodical reviews of the banking sector, micro prudential reviews, interest rate sensitivity analysis, and vulnerability assessment. Tools such as stress testing and scenario analysis are also used, depending on the evolving financial/economic environment in the country. The counter cyclical approach to supervision, that is being highlighted internationally as a post-crisis reaction to revamp the architecture for financial stability, where the prudential requirements like build up of capital and / or provisions is enhanced during the good times, to meet the stress on the asset quality during financial downturns has been implemented in India even before the onset of the crisis.

I.67 The macro-prudential dimension of systemic risk assessment has become particularly important in the context of the current global financial crisis. Since risk assessment is a continuous process and stress tests need to be conducted taking into account the macroeconomic linkages as also the second round effects and contagion risks, consequent to the announcement in the Annual Monetary Policy Statement of 2009-10, an inter-disciplinary Financial Stability Unit has been set up to monitor and address systemic vulnerabilities. In addition to applying stress tests to the portfolios of individual institutions at the micro level, stress-testing in macro-prudential analysis is becoming more relevant for systemic risk analysis. The main objective of an economy and financial system level stress test is to help public authorities identify those structural vulnerabilities and overall risk exposures that could potential lead to systemic problems. The principles enunciated by BCBS on stress testing as per its final guidelines issued in May 2009 emphasize the importance of macro level forward looking stress testing for assessing the adequacy of capital and liquidity. The Reserve Bank is in the process of revising guidelines on stress testing and liquidity risk management taking into account the new guidance issued by BCBS. It is also considering to lay down a risk management and capital adequacy framework for bank

sponsored private pools of capital (*e.g.* private equity funds / venture capital funds), especially in view of the reputational risk arising from undertaking such activities.

I.68 There is a perception that the impact of the growth slowdown experienced in the second half of 2008-09 could be seen in the form of pressures on banks' asset quality during 2009-10, particularly if the recovery gets delayed. Restructuring of accounts permitted by the Reserve Bank in 2008-09 has also been highlighted as a factor that temporarily delayed the emergence of asset quality problems. It may have to be recognised that the objective of restructuring is to take a swift action based on detection of the weaknesses in viable entities which may be facing temporary cash flow problems due to internal or external factors, so as to preserve their economic and productive value. The exceptional regulatory treatment was not extended earlier to commercial real estate exposures as well as to capital market exposures and personal/ consumer loans in view of the possibility of fuelling asset price bubbles. The restructuring of accounts allowed up to June 30, 2009 aim at preserving economic value of units and not ever-greening of problem accounts. Banks, therefore, have to use their judgement before agreeing to restructure, so as to ensure that restructuring is undertaken only for viable units.

POLICY CHALLENGES

I.69 The macroeconomic conditions in 2009-10 so far, and the expected outlook for growth and inflation suggest that there are clear policy challenges for the Reserve Bank as well as for the economy as a whole. A major challenge for the Reserve Bank is to deal with the unpleasant combination of subdued growth with emerging risk of high inflation, which poses a complex dilemma on the appropriate stance of monetary policy. In such conditions, while withdrawal of monetary accommodation entails the risk of weakening recovery impulses, sustained accommodation and the associated protracted phase of high money growth can only increase inflation in future. Secondly, large borrowing programmes and high fiscal deficits complicate the challenge even further by accentuating inflationary expectations, which could worsen the actual inflation situation over time while also putting upward pressure on interest rates. Subdued growth with high inflation erodes the disposable income of the masses, and as a result, the recovery becomes even more difficult because of sustained depression in aggregate demand. Low inflation is an essential precondition to spur private demand, and monetary accommodation of the large fiscal stimulus could support recovery in growth only in a low inflation environment. Thirdly, for any early signs of recovery to gain momentum, private sector credit must grow. Better monetary policy transmission that could enhance the demand for credit is a key challenge, notwithstanding the usual dynamics of any credit market which may not respond to monetary policy actions. Finally, with the return of capital inflows to the pre-crisis period and revival in demand for credit from the private sector, the costs of any delay in withdrawal of monetary accommodation and fiscal consolidation could increase.

I.70 The emerging inflation outlook and the medium-term consequences of sustained accommodative monetary stance for inflation suggest that timing and pace of exit from the current accommodative monetary policy stance would be a major challenge for the Reserve Bank. If the stimulus is sustained longer, the imbalances left in the system could create market induced pressures, besides engendering the inflation situation, which may work against the recovery. The exit options for fiscal policy have to be seen in the context of the fact that economic recovery in itself could allow the automatic stabilisers to operate, by raising the revenues, and creating scope for reduction in public expenditure. What would be more important, however, is the discretionary unwinding measures to ensure reverting to the fiscal consolidation path as an essential requirement for returning to the high growth path. This cannot happen through expenditure compression alone, because of associated growth implications; hence part of the

adjustment has to come through revenue buoyancy, higher tax base and better compliance. For the monetary policy, which has to be primarily guided by the assessment of the likely path of the business cycle and the inflation cycle, balancing the goals of supporting growth and containing emerging inflationary pressures could become increasingly challenging over 2009-10, in the face of an expansionary fiscal stance.

I.71 For the Reserve Bank, thus, besides the near term challenges of emerging inflationary pressures, management of large borrowing programmes and the associated potential conflict between monetary and fiscal policy, there are other medium-term issues associated with globalisation as well international initiatives on revamping the architecture for promoting financial stability. While openness offers a number of benefits, it increases the risks from external demand and capital flows. Swings in capital flows and sudden stops can have a significant impact on exchange rates, domestic monetary and liquidity conditions and overall macroeconomic and financial stability. Global growth and monetary conditions, therefore, have an influence on domestic policies.

I.72 The single mandate linked to inflation objective has often been highlighted as a necessity for ensuring a better inflation environment, but given the importance of other objectives for a country of India's size and diverse needs, the operational relevance of an inflation-centric mandate has to be examined carefully. Supply driven large volatility in WPI inflation that was witnessed in 2008-09 could erode credibility of any inflation-centric monetary policy. Moreover, the WPI inflation has been quite different from the CPI based inflation in India in the recent period, and as a result which measure of inflation may be the most appropriate reference for conduct of monetary policy has also been an issue. The Reserve Bank operates with multiple objectives of price stability, growth and financial stability. In the pursuit of multiple goals, the available instruments are used optimally with a mix of interest rate changes, quantitative liquidity adjustment, prudential regulations and credit policy measures. For promoting financial stability, the new international initiatives in response to the global financial crisis have to be monitored and examined, with an emphasis on country specific relevance, and the future approach to financial sector reforms may have to be based on lessons from the recent crisis.

I.73 For the economy as a whole, the most critical challenge is to revert to the high growth path, which would be possible only with a faster recovery. The longer the growth impulses remain dampened, the fiscal policy will exhaust any available fiscal space, and the costs of large fiscal stimulus will also increase with time. Secondly, deficient monsoon and the possible adverse effects on agricultural output may not only put pressure on food prices but also increase the demand for more subsidies and relief measures. The pressure on the fiscal situation could only increase if drought related policy response involves further expansion in government expenditure, and the additional costs associated with possible import of essential commodities to improve domestic supply conditions. Given the fact that food prices remain high, despite low overall WPI inflation, and that all CPI indices exhibit little moderation in inflation, the supply side of food management would assume critical significance for the Government. Thirdly, the unemployment effects of a long phase of economic slowdown, with weakly developed social security system, suggest that the Government's preparedness for dealing with situations as in 2008-09 should be strengthened, which must include counter-cyclical fiscal stance allowing build up of significant cushion during periods of high growth. But despite the FRBM, fiscal consolidation process remained slow. More importantly, the public expenditure was also not reoriented to address constraints to high growth, such as physical and social infrastructure.

I.74 The macroeconomic outlook for 2009-10, in terms of expected gradual recovery in growth and the emergence of inflation pressures by the end of the year pose difficult challenge for the

conduct of policy, in terms of balancing the two key objectives. While the fiscal stance has clearly tilted towards the growth objective, the associated accommodative monetary policy stance, if sustained longer, entails the risk of higher inflation, which in itself may become a constraint to higher growth in the medium-run. In India, globalisation certainly had the associated benefits, directly in terms of exports and capital inflows, and indirectly in terms of global perceptions of India as a major emerging economic power. The manner in which Indian policies could manage the contagion from the global crisis would have only further improved the global perception of India. The global crisis, when it started to spread, did not differentiate countries on the basis of soundness of their macroeconomic policies. In a globalised world, consumers' and investors' perceptions could often be influenced by global developments, and hence, strengthened multilateral surveillance and effective global action to prevent the emergence of major global imbalances would have to be ensured so as to allow national policies the space for pursuing and achieving the high and sustainable growth objectives. Overall, Indian growth continues to be driven by domestic demand and domestic saving, with foreign capital supplementing within the prudent approach to sustainable current account deficit. Thus, return to 9 percent growth trajectory would largely be determined by the country's structural fundamentals and the responsive macro policy environment.