Annual Report 1998-99 (Summary)

The Annual Report on the Working of the Reserve Bank of India

For the Year July 1, 1998 to June 30, 1999[*]

PART ONE : ECONOMIC REVIEW

I POLICY ENVIRONMENT

1.1 The year 1998-99 provided yet another evidence of resilience of the Indian economy to withstand several domestic and international uncertainties. Not only was the real GDP growth estimated to be higher in 1998-99 than in 1997-98, but also the inflation rate was significantly lower. The foreign currency reserves increased substantially, while foreign exchange market, despite the uncertain international environment and deceleration in world trade, remained orderly in general. Agriculture made a recovery. The performance of the services sector remained significant. However, there was some slowdown in industrial output. Monetary – fiscal policy coordination ensured that aggregate demand-supply balance was secured without constraining growth impulses. Against this background, this report presents the policy environment under which the real, monetary, fiscal, financial market and external developments took place during 1998-99 and in the first quarter of 1999-2000.

DOMESTIC MONETARY MANAGEMENT

1.2 During 1998-99, monetary policy had to contend with a number of domestic and international economic uncertainties. The considerations in the domestic sphere called for careful balancing of objectives between growth and inflation control even as several adverse international developments had impacted on forex market and on the design and conduct of interest rate policy. The course of monetary policy was also influenced by fiscal developments, which required financing of Government deficit of a large magnitude with implications for interest rates and investment.

1.3 Monetary policy was conducted in conjunction with long-term structural and institutional reforms in the financial sector with a view to imparting stimulus to potential growth impulses. The reforms aimed to impart flexibility to the market participants in management of resources, improve the supervisory and regulatory framework for financial system and promote market integration towards enhancing allocative efficiency of resources and improving the transmission channels of monetary policy.

Policy Stance

1.4 The April 1998 monetary and credit policy was framed against the backdrop of the South-East Asian market crisis, and the need to accelerate industrial investment and output in the economy. The policy placed emphasis on maintenance of low rates of inflation, continued pursuit of financial sector reforms, reduction in interest rates and improvement in credit delivery mechanisms, particularly for agriculture and medium and small sectors. Given the comfortable

liquidity situation at the beginning of the year and the need to contain inflation and to ensure availability of sufficient credit to realise the potential growth in the economy, the target growth of broad money (M_3) was projected to be in the range of 15.0 to 15.5 per cent during 1998-99. However, given the limitations in the stability of money demand function in the short-run, it was felt useful to carefully monitor a multiple set of indicators also for policy purposes.

1.5 The monetary management during the course of 1998-99 had to cope with several unexpected developments which could not be fully anticipated in the April 1998 policy statement. First, the emerging international developments during the year posed a major challenge for monetary management. The SouthEast Asian economic crisis continued to remain serious and the contagion spread to Russia and major parts of Latin America. The world economy, as a whole, faced considerable uncertainty, with prospects of large scale decline in GDP of major economies and recession in world trade during the course of the year. Secondly, India was also confronted with some other related developments after the Pokhran nuclear test in May 1998, notably economic sanctions imposed by certain industrial countries, suspension of fresh multilateral lending, downgrading by some international credit rating agencies and reduction in net foreign institutional investment. Thirdly, there was a creeping rise in the annual rate of inflation mainly caused by supply shocks in a few food items up to October 1998.

1.6 The October 1998 monetary and credit policy undertook a mid-term review of developments in the macroeconomic and monetary front. The rate of growth of money supply at the time of the mid-term review was higher than necessary in relation to the expected real GDP growth and the prevailing inflation rate. On strict analytical grounds, this situation warranted monetary tightening measures in order to control liquidity and to maintain price stability. However, in the presence of persisting industrial slow down, monetary tightening measures like increases in cash reserve ratio (CRR) and in interest rates would have dampened emerging signs of incipient recovery in the real sector. This, in turn, could have resulted in lower revenue for the Government and the need for higher borrowing requirement of the Government. These conflicting considerations underlying the balancing of objectives between growth and inflation control reflected the monetary policy dilemma faced by the Reserve Bank at that juncture. Instead of resorting to increase in CRR or interest rates, the Reserve Bank continued to manage liquidity through active use of open market operations (OMO) and repo transactions. The policy of flexible use of interest rates to signal the Reserve Bank's stance regarding monetary conditions and management of liquidity emerged as an important feature during 1998-99. The Reserve Bank also felt that the rise in inflation rate up to October 1998 was due to temporary supply shortages in certain agricultural commodities and would reverse itself in subsequent months once the availability position improved. On balance of considerations, the Bank, therefore, did not resort to any monetary tightening measures in October 1998 and decided to wait until the impact of seasonal factors on the prices of agricultural commodities was clear. In the event, this judgement turned out to be correct and the annual rate of inflation declined very sharply later in the year.

1.7 The stance of monetary policy for 1999-2000 took into account the significant improvement that was achieved in the year-end price situation, agricultural production and stability of the external sector in 1998-99. Keeping in view the paramount need to improve industrial growth, the stance of monetary policy continued to place emphasis on facilitating availability of liquidity

in the economy along with stable medium and long-term interest rates, with policy preference for softening to the extent circumstances permitted. In April 1999 monetary expansion for 1999-2000 was projected within the range of 15.5-16.0 per cent, consistent with the objective of a real GDP growth of 6.0 to 7.0 per cent and inflation rate of around 5.0 per cent.

1.8 Developments in the money and forex markets during 1998-99 warranted intensive use of an approach based on a multiple set of indicators. The need for such a flexible approach stemmed particularly from the short-term policy challenges necessitating pre-emptive monetary policy measures to bring about required adjustments in interest rates so as to ensure stability of the foreign exchange market, support growth, contain inflationary pressures and facilitate public debt management operations.

Developments in Fiscal Policy

1.9 Co-ordination of monetary policy with the evolving fiscal situation emerged as an important aspect of the monetary management during the year. In view of the large market borrowing programme proposed in the Central budget for 1998-99 and the prevailing market uncertainties, the Reserve Bank had indicated on June 11, 1998 its intention to accept private placement of securities from time to time, depending on the market assessment of interest rates, and then release them to the market as conditions improved, in order to minimise the adverse effect of Government borrowing on interest rates. During the course of the year, the actual market borrowing of the Central Government far exceeded the budget anticipation, due to slippage in the fiscal position. Consequently, the Reserve Bank had to absorb a large part of the gross borrowings in its own portfolio and subsequently divest them through OMOs during the year. This practice was facilitated to a large extent by the availability of surplus liquidity in the system, stemming from a significant deceleration in the demand for non-food credit and injection of additional funds by way of the proceeds from the Resurgent India Bonds (RIBs) which flowed into the banking system in August 1998.

1.10 The overall impact of the Government's borrowing programme on the monetary situation is indicated by an increase in the growth of reserve money to 14.6 per cent in 1998-99 from 13.2 per cent in 1997-98. However, the approach of private placement combined with active OMOs proved effective in containing the adverse interest rate effect of the Government's large borrowing from the market without distorting the yield curve and market expectations regarding interest rates. The medium and long-term interest rates, therefore, remained fairly stable during the year.

Operating Procedures

1.11 During 1998-99, the operating aspects of monetary management were highlighted by the active use of the Bank Rate, repo rate and CRR to meet short-term monetary policy objectives. These policy instruments were used more than once in response to the emerging domestic and external situation. The Bank Rate and short-term repo rate announced by the Reserve Bank were increasingly perceived by the market as signals for movements in market rates of interest, in particular short-term rates. This development was significant in that it increased the range of instruments available to the Reserve Bank for influencing money market developments. While

the adjustment in the Bank Rate was kept to the minimum during 1998-99, the fixed repo rate was varied flexibly, in both directions, to influence the flow and cost of funds in the short run. Adjustments in CRR also served as one of the important instruments for regulating liquidity in the economy. Its active use in 1998-99 showed that intra-year variations in CRR could be an effective instrument in meeting the short-term challenges in domestic money and forex markets. While the long-term objective of monetary policy continued to be in the direction of reducing the average level of CRR, it became evident that in the short-term, the level of CRR could be varied in both directions depending on the assessment of the overall monetary situation.

1.12 A major innovation in the operating procedure in the current financial year (1999-2000) has been the introduction of an Interim Liquidity Adjustment Facility (ILAF) through repos and lending against collateral of Government of India securities. Pending the upgradation of technology and legal/procedural changes required to switch over to a system of electronic transfer and settlement, ILAF is intended to be an interim arrangement towards the transition to a full fledged liquidity adjustment facility by way of repos and reverse repos for providing a corridor for short-term interest rates. Such a facility enables the Reserve Bank to inject liquidity into the market at various interest rates and absorb when necessary at the fixed repo rate so as to promote stability of money market and ensure that the interest rates move within a reasonable range.

EXCHANGE RATE MANAGEMENT

1.13 The management of the exchange rate during 1998-99, particularly in the early part of the year, was a challenge in view of the turbulence in the South-East Asian financial markets, the spread of contagion to other markets such as Russia and Brazil, and the economic sanctions in addition to some domestic uncertainties. The exchange rate of the rupee moved sharply from Rs.39.73 per US dollar at the beginning of May 1998 to Rs. 42.38 per US dollar on June 11, 1998. The Reserve Bank announced a package of policy measures on June 11, 1998 to contain the volatility in foreign exchange market. These included: (a) announcement of the Reserve Bank's readiness to sell foreign exchange in the market to meet any mismatch between demand and supply; (b) allowing foreign institutional investors (FIIs) to manage their exchange risk exposure by undertaking foreign exchange cover on their incremental equity investment with effect from June 12, 1998; (c) advising importers as well as banks to monitor their credit utilisation so as to meet genuine foreign exchange demand and discourage undue build-up of inventory; (d) allowing domestic financial institutions, with the Reserve Bank's approval, to buy back their own debt paper or other Indian papers from international markets; (e) allowing banks/ ADs, acting on behalf of the FIIs, to approach the Reserve Bank for direct purchase of foreign exchange; and (f) advising banks to charge a spread of not more than 1.5 percentage points above LIBOR on export credit in foreign currency as against the earlier norm of not exceeding 2-2.5 percentage points.

1.14 Responding to the policy measures, the foreign exchange market returned to normalcy for some time and exhibited orderly conditions during most part of the second quarter. The foreign exchange market again came under pressure in August 1998, reflecting the adverse sentiment with the deepening of financial crisis in Russia and the fear of devaluation of the Chinese renminbi. Responding to these developments, the Reserve Bank announced a fresh package of

measures on August 20, 1998 in order to prevent speculative sentiments building up pressure on the orderly functioning of the market. These measures included: (a) a hike in CRR from 10.0 per cent to 11.0 per cent, (b) an increase in the repo rate from 5 per cent to 8 per cent, (c) enhancement of forward cover facilities to FIIs, (d) withdrawal of facility of rebooking the cancelled contracts for imports and splitting forward and spot legs for a commitment and (e) allowing flexibility in the use of Exchange Earners Foreign Currency (EEFC) accounts while restricting the extension of time limit for repatriation of export proceeds to exceptional circumstances.

1.15 These measures coincided with the launching of the scheme of Resurgent India Bonds in August 1998, in line with the announcement made in the Union Budget for 1998-99. The RIB scheme was designed to address the unusual events that followed the imposition of sanctions on India, which could have temporarily affected normal capital flows. The issue of RIBs was also to address the need to counteract the possible adverse sentiments in the international markets due to downgrading of India's sovereign rating and to set a benchmark for future corporate borrowings without disrupting the domestic and foreign exchange markets.

1.16 In contrast to cumulative sales by the Reserve Bank amounting to US $ 2,502 million during May-July 1998, the subsequent period from August 1998 to March 1999 witnessed cumulative purchases of US $ 4,143 million resulting in net market purchases at US $ 1,842 million for the year as a whole by the Reserve Bank. The exchange rate, by and large, remained stable during September 1998 – March 1999, moving within a range of Rs.42.27 to Rs.42.63 per US dollar. During the first quarter of 1999-2000, the rupee depreciated to Rs.43.36 per US dollar by end-June 1999.

BANKING SECTOR REFORMS

1.17 The progress already made in the reform of the financial sector in a substantial yet non-disruptive manner has generated confidence to give a further push to reforms in the banking sector. In this background, a Committee on Banking Sector Reforms (the Second Narasimham Committee) was constituted. The Committee submitted its Report in April 1998. In pursuing the objective of further improving the soundness of the Indian banking system, the Reserve Bank announced a package of reform measures in October 1998 in areas relating to prudential norms in conformity with the recommendations of the Second Narasimham Committee. These measures aim at increasing the minimum capital adequacy ratio in the banking system from 8 per cent to 9 per cent by March 31, 2000; recognising the market risks and prescribing a risk weight of 2.5 per cent in Government/approved securities by March 31, 2000; providing 100 per cent risk weight for foreign exchange and gold open position limits from the year ended March 31, 1999; moving towards tighter asset classification, income recognition and provisioning norms; putting in place a formal Asset-Liability Management (ALM) system with effect from April 1, 1999; and further enhancing transparency in accounting and disclosure practices.

1.18 Following the recommendations of the Second Narasimham Committee on converting the Development Financial Institutions (DFIs) into banks or non-bank finance companies, a Working Group (Chairman: Shri S.H. Khan) was constituted by the Reserve Bank to examine the harmonisation of the role and operations of the DFIs and banks. The Working Group submitted

its Report in April 1998 highlighting the need for eventually granting full banking licence to the DFIs, while in the interim they may be permitted to have banking subsidiaries. Subsequently, the Reserve Bank released a ‘Discussion Paper’ in January 1999 with a view to soliciting wider public debate on the issue. The ‘Discussion Paper’ emphasised the need for adoption of an approach whereby universal banking should be guided by international experience and domestic requirement and it should provide for transitional path for the DFIs to convert themselves into full fledged banking or non-banking institutions.

1.19 Out of the 27 public sector banks, 26 banks achieved the minimum capital to risk weighted assets ratio (CRAR) of at least 8 per cent by March 1998. While 19 banks had CRAR exceeding 10 per cent, 7 banks had CRAR between 8 and 10 per cent. Following the announcement in monetary and credit policy in October 1998 banks have been advised to maintain a minimum CRAR of 9 per cent by end-March 2000. During 1998-99, the Central Government contributed a sum of Rs.400 crore to the capital of three nationalised banks, *viz*., Indian Bank (Rs.100 crore), UCO Bank (Rs.200 crore) and United Bank of India (Rs.100 crore). The overall capital contributions by the Government to nationalised banks as at end-March 1999 amounted to Rs.20,446 crore, out of which Rs.642.8 crore was returned to the Government by four banks.

1.20 The Reserve Bank continued the process of strengthening the prudential accounting norms reflecting the criticality of reform in this area in the wake of the SouthEast Asian financial crisis. With a view to moving closer to international practices in regard to provisioning norms, banks were advised in October 1998 to make a general provision on standard assets of a minimum of 0.25 per cent from the year ending March 31, 2000. Besides, an asset should be classified as doubtful if it has remained in the sub-standard category for 18 months instead of 24 months by March 2001. Banks could achieve this norm for additional provisioning in two phases – provisioning of not less than 50 per cent as on March 31, 2001 on the assets which have become doubtful on account of new norm and provisioning of the balance amount carried forward from the previous year in addition to the provisions needed as on March 31, 2002 on that date. The ‘mark-to-market’ proportion of approved securities was enhanced from 70 per cent for 1998-99 to 75 per cent for 1999-2000.

1.21 As prudential measures against credit and market risks, risk weights in the following categories of securities were introduced: a) 2.5 per cent to cover market risks due to fluctuations in prices in respect of investments in Government securities and securities guaranteed by Central/State Governments by March 31, 2000; b) 20 per cent for State Government guarantees which have been invoked and have remained in default as on March 31, 2000; c) 20 per cent on investments in the Government guaranteed securities of Government undertakings which do not form part of the approved market borrowing programme from 2000-01; and d) a uniform risk weight of 20 per cent on investments in other approved securities not guaranteed by Central/State Governments and in the bonds/securities of certain specified public financial institutions (PFIs), effective the year ended March 31, 1999. The Reserve Bank advised the banks to put in place an ALM system, effective April 1, 1999 and set up internal Asset Liability Management Committees at the top management level to oversee its implementation. As per the final ALM guidelines issued in February 1999, banks were advised to ensure coverage of at least 60 per cent of their liabilities and assets in the interim and cover 100 per cent of their business by April 1, 2000.

1.22 Information technology and the communication networking systems have a crucial bearing on the efficiency of money, capital and foreign exchange markets and have manifold implications for the conduct of monetary policy. In India, banks as well as other financial entities have recently entered the world of information technology and computer networking.

1.23 The Indian Financial Network (INFINET), a wide area satellite based network using VSAT technology, being jointly set up by the Reserve Bank and Institute for Development and Research in Banking Technology (IDRBT) at Hyderabad would facilitate connectivity within the financial sector. The network has been inaugurated in June 1999. The INFINET would cover, in a phased manner, 100 commercially important centres and serve as the communication backbone of the proposed Integrated Payment and Settlement System (IPSS). It is planned to introduce the Real Time Gross Settlement (RTGS) system in about one and half year's time. A National Payments Council with a Deputy Governor as the Chairman and representative membership has been constituted.

1.24 The Reserve Bank in coordination with Indian Banks' Association (IBA), banks and other sectors of the financial system is pro-actively dealing with the Year 2000 (Y2K) problem. In order to address the Y2K problem, a High Level Working Group with members drawn from banking, regulatory, supervisory and information technology departments of the Reserve Bank, representatives of IBA, commercial banks and the National Institute of Bank Management (NIBM) has been constituted. The Working Group has been reviewing the progress made by banks, their subsidiaries and financial institutions in complying with the Y2K requirements at frequent intervals. Commencing October 1, 1998, banks have been advised to continuously validate their renovated systems through testing and to identify alternative approaches wherever required.

Rural Credit

1.25 In respect of agricultural credit, the Reserve Bank advised public sector banks to prepare Special Agricultural Credit Plans. For the financial year 1997-98, the aggregate disbursement to agriculture under the plan was Rs.14,808.35 crore as against the projection of Rs.16,069.04 crore. For 1998-99, the disbursement to agriculture under the plan was Rs.17,787.63 crore as against the projection of Rs.18,503.51 crore. Banks were advised in July 1998 to formulate a suitable scheme relating to quick settlement of chronic cases of overdue loans of farmers due to circumstances beyond their control. Under the scheme, public sector banks have settled 71,555 cases as at end-December 1998 involving loan amount of Rs.96.56 crore. In response to the Union Budget 1998-99 regarding formulation of a model scheme for issue of Kisan Credit Cards (KCCs) to farmers which would enable them to readily purchase agricultural inputs and draw cash for their production needs, all scheduled commercial banks were advised to introduce the scheme on the lines of the scheme formulated by NABARD in August 1998. As on March 31, 1999, the 27 public sector banks had issued 6,43,463 KCCs involving an aggregate credit limit of Rs.1,569.60 crore. In view of the targeted extension of the coverage to 20 lakh farmers in 1999-2000 as announced in the Union Budget 1999-2000, necessary instructions have been issued to the banks to fulfil this target.

Non-Banking Financial Companies (NBFCs)

1.26 The Reserve Bank had put in place a comprehensive regulatory framework for NBFCs in January 1998 to ensure that the NBFCs function on sound and healthy lines and that only financially sound and well run NBFCs are allowed to access public deposits. Protection of depositors' interest has been accorded prime importance and the Reserve Bank has initiated various measures in this regard. NBFCs accepting/ holding public deposits are subject to accounting standards, prudential norms of asset classification, income recognition and capital adequacy which are in alignment with those applicable to banks in India. NBFCs not accepting/holding public deposits are regulated only to a limited extent.

The Reserve Bank has put in place a supervisory framework for overseeing the implementation of regulatory framework, which comprises a system of compulsory registration, on-site examination of their books, off-site surveillance, a comprehensive market intelligence system and exception reports from statutory auditors of NBFCs.

1.27 In the light of the increased incidence of financial problems faced by NBFCs, policy announcements were made to strengthen the health of NBFCs and improve their operational transparency. Capital adequacy ratio was raised in a phased manner to 10.0 per cent and thereafter to 12.0 per cent to be achieved by end-March 1998 and end-March 1999, respectively. The credit concentration norms in respect of a single borrower and single group of borrowers were kept unaltered at 15 per cent and 25 per cent of the owned funds, respectively. The investment concentration norms stipulated that investments in a single company and in a group of companies be subject, respectively, to a ceiling of 15 per cent and 25 per cent of the owned funds of NBFCs. Composite limits on credit and investments by an NBFC in a single entity and a single group of entities were prescribed at 25 per cent and 40 per cent, respectively, of its owned funds. Certain restrictions have been placed on NBFCs' investment in real estate; such investments, except for their own use, should not exceed 10 per cent of their owned funds. Further, a ceiling has been prescribed for investment in unquoted shares of other than group/ subsidiary companies, the amount of which shall not exceed i) 10 per cent of the owned fund for equipment leasing and hire purchase finance companies; and ii) 20 per cent of the owned fund for loan/investment companies. Three years' time period has been allowed to the companies to bring down the excess assets held as also for disposal of such assets acquired by the company in satisfaction of its debts in case the company surpasses the ceiling.

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* 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 up to June 1999 and in some vital areas information beyond end-June 1999 is also discussed. For the purpose of analysis, and for providing proper perspectives on policies, reference to past years as also to prospective periods wherever necessary have been made in this Report.

II. THE REAL ECONOMY

MACROECONOMIC SCENE

2.1 The real GDP growth showed an improvement in 1998-99. During 1997-98 the real GDP growth had declined to 5.0 per cent from the three successive years' growth of over 7.5 per cent

achieved during 1994-95 to 1996-97. However, with a significant turnaround in the growth of agriculture and allied activities output from (-)1.0 per cent in 1997-98 to 7.6 per cent in 1998-99, the real GDP growth is estimated to have recovered to 6.0 per cent in 1998-99. The GDP estimates are according to the new series of national accounts data released by the Central Statistical Organisation (CSO). The quarterly estimates of real GDP now made available by the CSO indicated that the recovery occurred in the last two quarters of 1998-99, with the quarterly growth rates rising to 6.5 per cent and 8.4 per cent, respectively, in the third and fourth quarters from 3.9 per cent and 4.7 per cent, respectively, in the first and second quarters. The improved growth performance during 1998-99 compared to 1997-98 is significant in the light of a general deceleration of the world economy. Notwithstanding this improvement, the presence of many domestic and international uncertainties continued to affect the prospects of faster economic recovery than what was eventually recorded in 1998-99.

2.2 The real GDP growth originating in the industrial sector declined to 4.6 per cent in 1998-99 from 6.3 per cent in 1997-98, with 'manufacturing', `mining and quarrying' and 'electricity, gas and water supply' showing significant decline in growth rates to 5.2 per cent, (-)2.0 per cent and 6.3 per cent, respectively, in 1998-99 from 6.8 per cent, 2.7 per cent and 6.6 per cent in 1997-98. Growth in the services sector (including construction) declined to 5.8 per cent in 1998-99 from 7.8 per cent in 1997-98.

Saving and Capital Formation

2.3 According to the CSO's Quick Estimates, the rate of Gross Domestic Saving (GDS), after having peaked at 24.4 per cent of GDP in 1996-97, declined to 23.1 per cent in 1997-98. The decline in the saving rate by 1.3 percentage points coincided with the decline in the overall investment rate (24.8 per cent in 1997-98 compared with 25.7 per cent in 1996-97). Rates of both private corporate sector saving and public sector saving declined from the recent peaks of 4.8 per cent and 1.9 per cent, respectively, in 1995-96 to 3.8 per cent and 1.0 per cent in 1997-98. While low profitability conditions in 1997-98 could be the reason for the decline in the private corporate sector saving, the increased dissaving by government administration stemming from a fiscal slippage in 1997-98 contributed to the decline in the public sector saving.

2.4 Firm estimates of saving are not available for the year 1998-99. Owing to improvement in currency holdings, non-banking deposits, provident and pension funds, relief bond holdings and small savings, the rate of financial saving of the household sector is likely to move upward in 1998-99. However, with the increase in public sector dissaving and the generally limited improvement in corporate results, the overall domestic saving rate in 1998-99 may not be encouraging.

2.5 One of the important features of the Indian economy since 1992 has been the uptrend in the real GDP growth during the post-reform period (1992-93 to 1997-98). Interestingly enough, during four out of the six years of the post-reform period, the real investment rate (*i.e.*, real gross capital formation as a percentage of real GDP at market prices) has moved in an opposite direction to that of the movement in real GDP growth. Also in recent years there has been evidence of greater cyclical variability in real GDP growth and such cycles seem to be less correlated with cyclical changes in saving and investment rates. Both these trends suggest that productivity changes are playing an important role in the growth process of the Indian economy in the post-reform period, even though there are not many definite studies for the post-reform period to prove that total factor productivity has been the prime mover of the uptrend in real

growth rates.

AGRICULTURE

2.6 Agricultural production revealed a turnaround during 1998-99 with the crop production index estimated to record a growth rate of 7.6 per cent in contrast to a decline of 5.6 per cent during the previous year. This was significantly higher than average growth rate of 2.0 per cent during 1990-91 through 1997-98. Notwithstanding a series of weather-related aberrations, the total foodgrains production (quantum) is estimated to have increased to 202.5 million tonnes in 1998-99, crossing the 200 million tonnes mark for the first time, thereby surpassing the previous peak of 199.4 million tonnes attained in 1996-97. Among the non-foodgrains segment, major crops such as oilseeds, sugarcane, cotton as well as beverages, particularly tea, registered impressive growth in output compared with their respective levels in the previous year. Though the monsoon in 1998 was normal for the eleventh successive year, imbalance in weather in several parts of the country had adversely affected production of certain non-foodgrain crops. The excess heat conditions in the northern India during May-June 1998, floods in certain parts of eastern India during the monsoon season and heavy rainfall in late October 1998 affected *kharif* crops, cotton and fruits and certain vegetables such as potato and onion, whose supply shortage was acute during 1998-99.

2.7 Season-wise, the *rabi* foodgrains output peaked at 99.9 million tonnes during 1998-99 reflecting a sharp rise of 9.4 per cent over that in the previous year. The *kharif* foodgrains production, on the other hand, showed a modest rise of 1.5 per cent to 102.7 million tonnes in 1998-99. Rice, wheat and pulses output registered peak levels in 1998-99. The production of rice is estimated to have risen by 3.0 per cent to 84.7 million tonnes from 82.3 million tonnes in 1997-98. Wheat production estimated at 71.0 million tonnes in 1998-99 is not only higher by 7.7 per cent than the previous year's output of 65.9 million tonnes, but has surpassed the previous peak of 69.4 million tonnes attained in 1996-97. The production of pulses is estimated to have crossed the 15 million tonnes mark for the first time and is anticipated to rise by 21.6 per cent to 15.9 million tonnes in 1998-99. Foodgrains production would have been further high but for the lower outturn of coarse cereals, which at 30.9 million tonnes in 1998-99 showed a decline of 0.3 million tonnes from that in 1997-98.

2.8 In India, the stance of buffer stock policy is determined by a host of factors including the objective of containing price fluctuations. Sale of foodgrains to states' procurement agencies is voluntary for farmers at the minimum support price (MSP) fixed by the Government. In years of high production, the MSP virtually becomes the market price. Since the procurement prices are revised upwards periodically, every year, guaranteed returns to farmers over cost are assured, augmenting the flow of marketed surplus to the Food Corporation of India (FCI). The offtake of foodgrains depends upon the availability factor as well as the price differential between open market prices and the PDS prices. During the 'nineties so far, notwithstanding fluctuations, foodgrains production has remained comfortable and with successive MSP revisions, the incentive for farmers to sell at MSP has increased. Thus, increased procurement coupled with lower offtake from the PDS has resulted in substantial increase in stocks in the Central pool. The actual stocks of wheat and rice which declined below the minimum norms for most periods up to April 1993, subsequently remained above the minimum requirements in most quarters even when the norms were moved upward, since October 30, 1998.

2.9 Notwithstanding the recent increase in the procurement operations, the total availability has

suffered due to lack of proper storage facilities and poor marketing. As a result, it is roughly estimated that about 10 per cent of foodgrain production is lost before it reaches the consumer. It is, therefore, imperative that adequate storage facilities are provided to minimise the loss of availability of foodgrains. With this end in view, the Union Budget for 1999-2000 envisaged a new credit-linked capital subsidy scheme for construction of cold storage and godowns.

INDUSTRY

Overall Performance

2.10 The deceleration in industrial production witnessed from 1996-97 deepened during 1998-99, with the Index of Industrial Production (IIP) showing a growth of 4.0 per cent during 1998-99 as compared with 6.6 per cent in 1997-98. The current trend has been led by a contraction in the growth of manufacturing output to 4.4 per cent - the lowest since the mid 1990s so far - compared with that of 6.7 per cent during 1997-98. The output of the mining and quarrying sector declined by 1.8 per cent in contrast to an increase of 5.9 per cent during 1997-98, while the growth of electricity generation slipped down to 6.4 per cent from 6.6 per cent. Notwithstanding the steep deceleration in the manufacturing sector, its contribution to growth in overall Index of Industrial Production (IIP) rose from 82.2 per cent in 1997-98 to 89.1 per cent in 1998-99. The contribution of the electricity sector was also higher at 15.5 per cent than 9.6 per cent in 1997-98. The sector showing negative contribution was mining and quarrying whose share in the growth in overall index fell from 8.4per cent in1997-98 to(-)4.2 per cent during 1998-99. The data for the year 1999-2000 available so far indicate early signs of recovery in industry. The IIP grew by 5.6 per cent in April-June 1999-2000 as compared with 4.5 per cent in April-June 1998-99, mainly due to a significant improvement in manufacturing output growth to 6.5 per cent from 4.2 per cent. On the other hand, the electricity sector recorded a lower growth of 4.1 per cent in April-June 1999-2000 than 10.2 per cent in April-June 1998-99 and mining sector registered a growth of (-)0.6 per cent in April-June 1999-2000 as against (-)0.3 per cent in April-June 1998-99.

Manufacturing Sector

2.11 A disaggregated analysis of the manufacturing sector at the two digit level classification reveals that out of seventeen industry groups, twelve groups have shown positive growth during 1998-99. ‘Metal products and parts (except machinery and equipment)’ has shown the highest growth of 17.7 per cent followed by 15.9 per cent in ‘paper and paper products and printing, publishing and allied industries’ and 15.4 per cent in ‘transport equipment and parts’.

Use-based Classification

2.12 An important aspect of the industrial growth situation in 1998-99 is that the capital goods sector showed a sharp improvement with the growth rate in this sector rising to 12.7 per cent during 1998-99 from 5.3 per cent during 1997-98. Given the relatively low weight of capital goods sector in the overall index (9.69), high growth rate in this sector did not have significant impact on the overall industrial performance. However, it did give evidence of prospective domestic investment climate. The sharpest deceleration was recorded in the basic goods sector which grew at 1.5 per cent in 1998-99 as compared with 6.5 per cent during the preceding year. With a weight of 35.51 per cent in IIP, basic goods sector contributed 12.5 per cent to the industrial growth during 1998-99, which was much lower than that of 33.8 per cent during the previous year. Intermediate and consumer goods sectors also recorded lower growth rates. The

former registered a growth rate of 5.9 per cent during 1998-99 compared with 8.1 per cent during 1997-98, while the latter grew by 2.4 per cent in 1998-99 as compared with 5.7 per cent during the previous year.

2.13 The sluggish growth of the industrial sector during 1998-99 has come about notwithstanding the initiatives taken in the 'nineties to further deepen the industrial sector reforms. In order to appropriately reflect the effect of the structural changes taking place in the industry on the industrial output, the index of industrial production was revised in May 1998, by shifting the base year from 1980-81 to 1993-94.

2.14 Several domestic and external factors seem to have contributed to the current industrial slowdown. Among the major domestic factors, mention may be made of the lower demand for certain industrial products partly due to decline in agricultural production in 1997-98, depressed capital market and its associated dampening impact on the financial wealth and consumption of the households, the sharp build-up of excess capacities in some industries in the past, and lack of adequate infrastructure facilities. The growth in the composite index of six infrastructure industries (Base: 1993-94=100), *viz*., electricity, coal, steel, cement, petroleum crude and petroleum refinery products, declined to 2.4 per cent during 1998-99 from 5.7 per cent during the year 1997-98.

2.15 Mergers and acquisitions (M&A) are gaining increasing acceptance as a way of augmenting growth. This process in the Indian context seems to have started after 1994 when the necessity of formulating a new take-over code was felt by the regulating agencies. The present trend is towards restructuring firms through consolidation with growing awareness of concentrating on main line of activity so as to face intensified foreign competition. Many companies are coming out of their non-core activities by selling their non-profitable assets, hiving off their loss making divisions and reducing non-economical joint ventures. M&A deals worth Rs.151 billion were reported during the financial year 1998-99. There were 66 open offer documents filed with the SEBI as against 37 open offers in the previous year. Take-over bids by creeping acquisitions and asset bought-outs and mergers within the group companies to consolidate business activity were also on the rise. M&A activity was pronounced in industrial sectors like cement, steel, computer software, finance, pharmaceuticals, consumer durables, food products, agro-chemicals and textiles.

Small Scale Industries

2.16 The Small Scale Industries sector (SSI), with high potential for gainful employment opportunities, contributes nearly 40 per cent of the total industrial output. At 30.14 lakh units, the number of units under SSI has increased by 5.5 per cent in 1997-98, as against 4.9 per cent in 1996-97. However, the growth of production in SSI at constant prices has decelerated from 11.3 per cent in 1996-97 to 8.4 per cent in 1997-98.

Sick Industrial Units

2.17 An analysis of industrial sickness shows that there has been a decline in the number of sick/ weak units from 2,37,400 units as on March 1997 to 2,24,012 units as on March 1998, due to decline in the SSI sick units. However, the amount of outstanding bank credit to sick units has increased from Rs.13,787 crore to Rs. 15,682 crore during the same period, with the share of non-SSI units increasing from 73.8 per cent to 75.4 per cent. Sickness in the industrial sector is

attributed to a number of factors like inefficiency in management, over-ambitious projects, dispute among partners, non-availability of raw materials, power shortage, transport bottlenecks, adverse developments in marketing *etc*.

III MONEY, CREDIT AND PRICES

3.1 During 1998-99, monetary policy faced the difficult challenge of balancing the considerations that ensure adequate flow of credit to the productive sectors and contain adverse inflation expectations, while stabilising the foreign exchange market. The year was marked by some episodes warranting prompt and pro-active monetary policy intervention. During the first and the middle of the second quarters, maintenance of exchange market stability, in the face of the contagion emanating from the South-East Asian crisis, weighed heavily as an important concern of monetary policy. This challenge was addressed by measures that stemmed speculative tendencies and reduced undue arbitrage opportunities in the exchange and money markets. From September 1998, improvement in the external position and easing of exchange market pressure facilitated a gradual shift in emphasis to relaxing monetary conditions. However, with the inflation rate remaining relatively high for a prolonged period and peaking during the third quarter, essentially due to supply shortages in respect of a few primary articles, the need for a carefully crafted approach to monetary and credit policy assumed significance. With the abatement of inflationary pressures towards the fourth quarter and the prospects for the year ending with a significantly comfortable price situation looking bright, the monetary policy initiatives were channelled towards improving the liquidity situation with a view to lowering the interest rates and stimulating economic activities.

3.2 The flexibility in monetary management in addressing the challenges of growth, inflation and exchange market developments was, to a large extent, influenced by the evolving fiscal situation during the year. During 1998-99, the fiscal deficit of the Central Government as per the Union Budget for 1999-2000, exceeded the target set for the year by 0.8 percentage points of GDP, necessitating additional funding requirement from the market exceeding Rs.14,500 crore. Inspite of market borrowings of such a high order, the leeway for monetary policy during the year was made possible by slowdown in private domestic and external demand conditions, which helped to keep the pressure on prices at a manageable level.

3.3 Had the inflationary pressures in the economy persisted throughout the year and built up inflation expectations, the flexibility of monetary policy to address the price situation, in the face of a large increase in the fiscal deficit, would have been severely constrained. However, with inflation primarily driven by temporary supply shortages which reversed considerably during the last quarter of the year, the debt management objectives dictated a somewhat different strategy by which the Reserve Bank could balance the objective of funding a higher order of fiscal deficit from the market with the need to maintain reasonable interest rates or money supply. Thus, the technique of private placement of government securities with the Reserve Bank and the subsequent sale of these securities through open market operations, when liquidity situation so allowed, was actively pursued in 1998-99. As a result, the yield on medium-term government securities of 5-year maturity rose by only 7 basis points in 1998-99, while that on 10-year securities declined by 9 basis points. While the Reserve Bank's subscription to government dated securities increased by a large amount of Rs.38,205 crore, of which Rs.30,000 crore alone were on account of private placement, a subsequent sale operation through the open market window

combined with repo transactions, helped to bring down the growth in net RBI credit to Centre from Rs.12,914 crore in 1997-98 to Rs.11,800 crore in 1998-99 when the government accounts were finally closed. At the same time, the Reserve Bank stepped up its line of credit to banks and commercial sector, respectively, by 86.9 per cent (Rs.6,165 crore) and 49.4 per cent (Rs.4,040 crore) during the year, which not only helped to create a conducive environment for promoting growth but also provided liquidity support, *albeit* indirectly, to the market and paved the way for the success of open market operations. Such a work-out on the domestic credit side, notwithstanding the substantial accretion of Rs.15,183 crore (adjusted for revaluation) to the net foreign assets of the Reserve Bank, restricted the growth of primary liquidity in the system to 14.6 per cent in 1998-99 (13.2 per cent in 1997-98).

MONETARY SURVEY

3.4 Broad money (M_3) increased by 18.4 per cent (Rs.1,50,873 crore) during 1998-99, which was higher than 18.0 per cent (Rs.1,25,320 crore) during 1997-98. This growth reflected the increase in currency with the public by 16.4 per cent and in aggregate deposits of the order of 18.9 per cent. Aggregate deposits included inflows of Rs.17,945 crore on account of Resurgent India Bonds (RIBs) which accrued to the banking system under time deposits in August 1998. These flows are, however, needed to be excluded from the money supply, if the monetary survey should be based on the residency criterion as recommended by the Working Group on Money Supply (WGMS): Analytics and Methodology of Compilation (Chairman: Dr. Y.V. Reddy). In other words, residents' holding of domestic money balances alone would be included in money supply under such an approach.

3.5 From the components' side, M_3 growth reflected a sharp expansion in the currency with the public (16.4 per cent) as against an expansion of 10.2 per cent in 1997-98. Most of this increase was concentrated in the last quarter of 1998-99. As a result, the share of the currency expansion in the (net of RIBs) stood incremental M_3 higher at 17.9 per cent in 1998-99 than that of 10.8 per cent in 1997-98. The high growth of currency in 1998-99 could be attributed to factors such as the sharp turn-around in agricultural growth giving a boost to rural demand and a higher rate of increase in the prices of primary articles and consumer items requiring larger holding of cash balances for transaction purposes. On the other hand, aggregate deposits with the banking sector (including RIB inflows) decelerated to 18.9 per cent from 19.9 per cent in 1997-98. In particular, the slowdown in deposit accretion was pronounced in the last quarter of the year. In general, it reflected the overall slowdown in non-agricultural incomes and the impact of softening of deposit rates.

3.6 An important aspect of monetary growth in the past few years has been the increasing concentration on domestic credit as its source, giving rise to significant implications in the pursuit of the objectives of monetary policy *viz*., growth and inflation control. The April 1998 monetary and credit policy statement had emphasised the need to ensure availability of sufficient credit to the productive sectors of the economy at affordable rates of interest in view of the slowdown in industrial production, barring unexpected developments on the price front or in the foreign exchange market. During 1998-99, net domestic credit expanded by 14.9 per cent (Rs.1,13,608 crore) accounting for 75.3 per cent of the (85.5 per cent of total increase in M_3 the increase in M_3, net of RIBs). The distribution of the increase in domestic credit between the government and the commercial sector was, however, uneven. Net bank credit to government

increased by 17.1 per cent (Rs.56,554 crore) in 1998-99 against 14.5 per cent (Rs.41,977 crore) in 1997-98, primarily due to a large growth of 19.4 per cent in scheduled commercial banks' investments in government securities as against 17.7 per cent in 1997-98.

3.7 During 1998-99, reserve money increased by Rs.32,969 crore (14.6 per cent) as compared with the increase of Rs.26,416 crore (13.2 per cent) during 1997-98. The net RBI credit to the Centre increased by Rs.11,800 crore (8.8 per cent) in 1998-99, from Rs.12,914 crore (10.7 per cent) during 1997-98. The moderation in the Centre's monetised deficit in the face of the substantial gross subscription to fresh securities (Rs.38,205 crore at face value) was facilitated by large-scale open market operations (Rs.26,348 crore, including Rs.19,266 crore to commercial banks) especially in the second half of the year. The net RBI credit to State governments increased by Rs.5,579 crore as against the decline of Rs.1,936 crore in 1997-98.

Developments in Monetary Framework

3.8 In the recent past, several issues have cropped up regarding the effectiveness of monetary management in the economy. These issues concern the recent structural changes in the economy and their impact on the monetary transmission mechanism as well as changes in the instruments and targets of monetary policy in the wake of financial sector reforms.

3.9 Monetary policy has come under the influence of growing openness of the economy and the increasing significance of market related reforms during the past few years, which have contributed to increased sensitivity of economic activity to movements in interest rates and the exchange market conditions. These developments have had considerable importance for the operating procedures of monetary policy as well as the targets to be pursued. For example, growing sensitivity of money demand to interest rate changes has implied certain changes in the relationship between money, prices and output. Similarly, the monetary authority's control over monetary aggregates have been influenced by factors like capital inflows, exchange rate and evidences of financial innovations.

3.10 One of the major challenges of monetary policy has been in the area of transmission channel of policy. Besides, identification of lags in monetary policy has become critical for effective conduct of policy. The channels through which monetary policy works its way through to the real economy are complex and change over time, especially when new instruments emerge and as financial markets evolve and structural changes affect the interaction between the monetary and real variables. The inter-temporal response of economic activity to monetary changes would depend on the transmission lags which are subject to shocks stemming from the real economy as well as the financial system.

Interest Rates

3.11 During 1998-99, while the overall liquidity conditions in the economy showed a substantial improvement, the yield on government securities in the primary market remained relatively firm. Interest rates at the short-end of the market reflected the evolving liquidity conditions which were influenced by the forex and the money market developments. Interest rates on deposits and bank loans, however, showed a general downward trend, responding to the overall slack in aggregate demand, as well as to the monetary policy measures announced during the year.

3.12 Liquidity conditions improved significantly during the first quarter of 1999-2000 compared to the position prevalent in the last quarter of the previous year. Although money market rates

softened relative to the last quarter of 1998-99, these were higher than those during the corresponding period of the previous year. The call rates breached the ceiling of the informal corridor given by the fixed repo rate (6 per cent) and the refinance rate (8 per cent) during May-June 1999. The hardening of call money rates had a ripple impact on short-term Treasury Bill rates; the cut-off yields on14-day, 91-day and 364-day Treasury Bills were higher by 172, 118 and 212 basis points, respectively, than those in the corresponding quarter of the previous year. The typical effective discount rate on CP, however, declined by 101 basis points to 10.76 per cent during the first quarter from 11.77 per cent in the corresponding quarter on the previous year, reflecting a falling risk premia on the papers of top-rated corporates. The interest rates on CDs too declined by 274 basis points to 9.94 per cent from 12.68 per cent in the corresponding period of the previous year, partly reflecting the adjustment over the high rates of interest offered by banks during the first quarter of 1998-99.

COMMERCIAL BANK SURVEY

3.13 Banking sector trends during 1998-99 were marked by lower order of deposit growth, relatively more sluggish credit expansion and increase in investment in government securities.

3.14 The aggregate deposit growth of the commercial banks fell by 0.5 percentage point to 19.3 per cent in 1998-99 as against the successive increases of 3.3 and 4.4 percentage points during the preceding two years. Excluding the proceeds of Resurgent India Bonds (RIBs) of Rs.17,945 crore which flowed into the banking system during August 1998, the overall deposit growth was 16.3 per cent, as against the monetary policy target of 15.4 per cent, announced in April 1998.

3.15 Bank credit, which has been maintaining a sluggish growth since the beginning of the current cycle of industrial slowdown, showed further deceleration in 1998-99. Total bank credit grew by 13.8 per cent in 1998-99 as compared with 16.4 per cent in 1997-98, largely mirroring a deceleration in non-food credit to 13.0 per cent from 15.1 per cent in 1997-98. The growth in bank credit during 1998-99 was also lower than the average of 15.8 per cent during the 'nineties (up to 1997-98). A drop of 2.6 percentage points in bank credit during 1998-99 over the previous year largely reflected the subdued credit demand conditions in most part of the financial year.

3.16 The industry-wise distribution of gross bank credit reveals that out of 22 industries for which comparable data are available for both 1997-98 and 1998-99, only eight industries (*viz.*, 'coal', 'other metal and metal products', 'electricity', 'other textiles', 'food processing', 'vegetable oils', 'paper and paper products' and 'gems and jewellery') recorded a higher order of expansion in credit than those in 1997-98. In absolute terms, six industries – 'infrastructure', 'electricity', 'iron and steel', 'cotton textiles', 'other textiles' and 'chemicals' – witnessed sizeable credit expansion, accounting for 65.3 per cent of the total expansion of credit in the industrial sector. On the other hand, seven industries exhibited an absolute decline in credit during 1998-99 (two during 1997-98). The trends in the credit expansion to various industries followed broadly the growth pattern of the respective industries.

PRICE TRENDS

3.17 The year 1998-99 was marked by the high contribution of primary articles to the overall price increases, as measured by the changes in the index of wholesale price of all commodities (WPI). The year also saw high inflation rates in most months considering the experience of the recent years. However, by the year-end, on a point-to-point basis, the rise in the WPI showed a

marked deceleration. The point-to-point inflation rate declined to 4.8 per cent in 1998-99 from 5.3 per cent in 1997-98.

3.18 The inflation rate on the basis of the average of weeks, however, increased to 6.9 per cent in 1998-99 from 4.8 per cent in 1997-98. The wide difference observed between the inflation rate measured on a point-to-point basis and that on average of weeks basis in 1998-99 reflected the fact that the inflationary pressure was high in most months, with concentration in respect of certain food articles, particularly fruits and vegetables. As these articles have a short production cycle and cannot be easily supplemented with imports, the price fluctuation in these commodities could be reversed once their availability improved. Essentially, inflation in such cases would be supply-oriented. But where demand is maintained by high flush of liquidity, there will be a downward inflexibility, unless the supply improves and swamps the dominance of the demand factor.

3.19 A significantly higher consumer inflation than the headline inflation brought out the critical importance of sources of price rise for the cost of living conditions in the economy. Given the weighting pattern of the WPI and CPI-IW, a higher rate of inflation, fuelled by a rise in the prices of primary articles would affect the cost of living conditions more sharply through the CPI than if such an increase in inflation was due to a rise in prices of non-primary articles. The four major primary articles which set much of the trend in consumer inflation during 1998-99 were fruits and vegetables, condiments and spices, oilseeds and cereals. Prices of these food articles had soared during the year due to a combination of factors such as crop failure and temporary supply shortages. While the CPI came under the severe influence of the food price inflation, it was the significant moderation in the prices of manufactured products and fuel group, which played a major role in helping to contain the WPI inflation rate to a significant extent in 1998-99.

3.20 Relative roles of demand and supply side factors in causing the price rise during 1998-99 are difficult to determine. While the supply side factors appear to have played a relatively dominant role in creating pressure on prices of primary articles, the overall demand conditions alongwith the competitive cost conditions seem to have contributed significantly to the trends in manufacturing prices. The total production of foodgrains in 1997-98 had declined to 192.4 million tonnes from 199.4 million tonnes in 1996-97. While this would have generated some pressure on prices of foodgrains in 1998-99, a steady improvement in the foodgrains output to the record level of 202.5 million tonnes in 1998-99 and a simultaneous increase in the bufferstock of foodgrains to a level of 21.66 million tonnes in 1998-99 implied that the supply situation remained largely comfortable in so far as the main staple food is concerned. Supply bottlenecks were seen in the non-staple segments such as pulses and oilseeds where the total production slackened in 1997-98 and was not adequately compensated by production in 1998-99. In the edible oil segment, there had emerged a secular gap in the supply, which rose to 15.0 lakh tonnes in 1997-98, but fell to 12.0 lakh tonnes in 1998-99, primarily due to higher domestic production and imports. The supply shortage was, however, exceptionally acute in certain vegetable items such as onions and potatoes in most months of 1998-99 which raised the prices of the fruits and vegetables group to over 50 per cent in some months and provided the spike to the trends in inflation rate during the year.

3.21 In so far as the demand pressure on prices is concerned, the aggregate demand condition in the economy remained more or less favourable during 1998-99. A substantial increase in government sector demand was indicated by a large growth in centre’s fiscal deficit and the

expansion of broad money by 18.4 per cent during the year. According to the latest national accounts data, private consumption and investment demand decelerated to 8.4 per cent and 6.9 per cent respectively, in 1997-98, from 17.0 per cent and 18.0 per cent in 1996-97. The private consumption demand as percentage to GDP has consistently fallen from 64.7 per cent in 1993-94 to 61.4 per cent in 1997-98. On the other hand, private investment demand as a ratio to GDP, which was 16.7 per cent in 1996-97 declined to 16.1 per cent in 1997-98. The slow growth in domestic private demand has been reinforced by a sharp deterioration in foreign trade balance (in rupee terms) representing net external demand by 43.2 per cent in 1998-99 as compared with a decline of 19.8 per cent witnessed in 1997-98.

3.22 Apart from the usual demand and supply forces, price developments in the economy needs to be seen in the context of the general competitive environment facing the manufacturing sector. Manufacturing sector generally follows a mark-up pricing process. Both costs and mark-up are affected by a host of factors, including monetary growth. While costs are expected to vary positively with money supply growth and negatively with productivity growth, the mark-up is influenced by the demand conditions in the economy - a higher rate of monetary growth leads to higher demand for manufacturing products and higher mark-up for these products. However, this transmission process could be affected by several exogenous shocks such as increased price competition from abroad and demand shocks in the nature of changes in preferences of consumers. The relative importance of these factors in the recent behaviour of manufacturing prices in India needs to be fully explored. The world manufacturing prices have been falling since 1996; these declined by 3.9 per cent in 1998 as compared with a fall of 8.2 per cent in 1997, making imports cheaper. As a result, domestic industries have been coming under competitive pressure, which has an impact on the costs and mark-up rates in the manufacturing sector. To the extent that the growing openness of the economy and the resulting price competition is internalised by the domestic industries through higher productivity growth, slower increases in manufacturing prices would be reflected in improved competitiveness of the economy.

IV GOVERNMENT FINANCES

4.1 During 1998-99, there was a marked increase in the major deficit indicators in the area of fiscal management. In respect of the Central Government finances, gross fiscal deficit as well as revenue deficit moved up both in absolute amount and in relation to GDP. The year was also characterised by an increase in market borrowings. Given the already high government internal debt, the burden of debt servicing would increase, placing pressure on the Government's current accounts. The pay revisions of the government employees added additional strain on fiscal management. With the revenue falling short of budgeted target, the difficult fiscal position of both the Central and State Governments had spilled over to the arena of public debt management. The Reserve Bank as a debt manager had to face the challenges by devising appropriate strategies and optimising the objectives that modulate the pursuit of co-ordinated fiscal and monetary policy.

CENTRAL GOVERNMENT FINANCES

4.2 During 1998-99, the fiscal position of the Government came under severe strain. The deceleration in tax collection observed in 1997-98 continued during 1998-99. Furthermore, there were expenditure over-runs. As a result, the major deficit indicators in relation to nominal GDP exceeded the respective actuals since 1994-95 with the exception of monetised deficit in regard to 1995-96 and 1997-98. The overall resource gap, as measured by the gross fiscal deficit (GFD), was placed higher at Rs.1,03,737 crore in the revised estimates for 1998-99 as against Rs.91,025 crore as per budget estimates and Rs.88,937 crore in 1997-98. As a proportion to GDP, GFD amounted to 5.9 per cent as against the budgeted estimate of 5.1 per cent and an actual of 5.7 per cent in 1997-98. The sharp rise in revenue deficit, at Rs.60,474 crore (3.4 per cent of GDP) in 1998-99 was higher by Rs.12,406 crore over the level budgeted. The primary balance showed a deficit of Rs.26,489 crore, much higher than the deficit of Rs.16,025 crore in the budget.

4.3 The slowdown in industrial growth in 1998-99 exerted pressure on revenue growth. Gross tax collection of the Central Government fell by 0.4 percentage point of GDP from the budget estimates, led by a 0.2 percentage point fall in the Union excise duty collection, which was adversely affected by the deceleration in industrial output, and a decline in customs revenue by 0.3 percentage point, due to deceleration in imports. Total expenditure of the Central Government expanded by 0.9 percentage point of GDP over the budget estimates, with revenue expenditure increasing by 0.6 percentage point of GDP and capital expenditure by the balance 0.3 percentage point. The cyclically-induced budgetary gap, attributable to revenue shortfall and the increase in expenditure, particularly in capital account, however, provided some stimulus to aggregate demand and investment in the absence of pick up in domestic private investment and exports.

Central Government Budget: 1999-2000

4.4 Against the backdrop of the fiscal slippage in 1998-99, the budget for 1999-2000 has set the tone for fiscal correction as a part of the medium-term strategy to reduce the fiscal deficit to below 2 per cent of GDP and to eliminate revenue deficit by 2003-2004. The budget has adopted a six-fold strategy encompassing (i) a medium-term plan of revenue augmentation, (ii) reforms in indirect taxes to promote productivity and employment, (iii) deepening and widening of economic reforms in all sectors, (iv) safeguarding the economy from external shocks, (v)strengthening the knowledge-based industries, and (vi) revitalising and redirecting public programmes for human development. For the year 1999-2000, the budget has proposed a fiscal deficit target of 4 per cent of GDP (excluding loans against small savings to States) as against 5.9 per cent (including loans against small savings to States) in 1998-99. The revenue deficit budgeted at Rs.54,147 crore is expected to go down to 2.7 per cent of GDP from 3.4 per cent in 1998-99. The corrections proposed both on the revenue and expenditure sides would see the primary account turning to a surplus of Rs.8,045 crore from a deficit of Rs.26,489 crore in 1998-99.

STATE GOVERNMENT FINANCES

Budgetary Operations of State Governments: 1999-2000

4.5 An analysis of consolidated budgetary data of twenty-six State governments indicates severe fiscal stress as evidenced by the deterioration of major deficit indicators. The finances of State governments have been affected by further pressures on the revenue account, with the growth in

expenditure outpacing that of revenue receipts. The revenue deficit of States for 1998-99 more than doubled to Rs.40,539 crore from Rs.16,372 crore in 1997-98 registering an increase of 147.6 per cent. The revenue deficit for 1999-2000 is estimated to increase to Rs.43,236 crore even after taking into account Additional Resource Mobilisation (ARM) of Rs.2,946 crore by eleven States. In addition, it reflected the adverse effect that the deceleration in growth of revenue from Central taxes had on the devolution of resources from the Centre to the States. On the expenditure side, the additional expenditure on pay revision of State government employees and interest payments contributed in a major way to the worsening of the revenue account and to the rise in the overall borrowing requirements. As a result, the combined gross fiscal deficit (GFD) of the States is budgeted at Rs.80,223 crore (a steep 4.0 per cent of GDP) for 1999-2000, with the revenue deficit contributing to 53.9 per cent of GFD. The pre-emption of borrowed funds on current expenditures has in the process caused a sharp decline in States' capital outlay; the proportion of GFD being utilised on capital outlay has come down significantly to 34.5 per cent in 1998-99 from 51.5 per cent in 1997-98. For 1999-2000 it is estimated at 35.7 per cent.

4.6 The persistent deterioration in the revenue account of State governments has been a matter of serious concern and many State governments have taken initiatives to raise tax and non-tax resources. Nonetheless, while the revenue receipts of State governments are budgeted to rise higher by 15.0 per cent in 1999-2000 than 11.0 per cent in 1998-99, the revenue expenditure of States is budgeted to rise by 13.5 per cent on top of a steep rise of 23.0 per cent in 1998-99. As a result, the revenue deficit would widen to Rs.43,236 crore (2.2 per cent of GDP) in 1999-2000 as compared with Rs. 40,539 crore (2.3 per cent of GDP) in the previous year. Consequent upon States' efforts towards ARM, the States' own tax receipts are budgeted to show a rise of 18.8 per cent as compared with the rise of 15.2 per cent in 1998-99. However, the non-tax receipts indicate a slight deceleration with interest receipts for 1999-2000 being estimated lower than those in 1998-99.

COMBINED BUDGETARY POSITION OF THE CENTRE AND STATES

4.7 According to the budget estimates for 1999-2000, the combined gross fiscal deficit of Centre and States is estimated at Rs.1,52,799 crore or 7.6 per cent of GDP, lower than 8.5 per cent of GDP (Rs.1,49,592 crore) in 1998-99. The improvement in the overall gap in the combined budgetary operations primarily reflects moderation in Centre's GFD (4.0 per cent of GDP in 1999-2000 against 5.9 per cent in 1998-99). The other major deficit indicators *viz*., the combined revenue deficit and the net primary deficit are slated to decline to 4.9 per cent and 2.4 per cent of GDP, respectively, in 1999-2000 from 5.7 per cent and 3.5 per cent of GDP in 1998-99.

Market Borrowings

4.8 The Reserve Bank has taken a number of initiatives in the recent period to meet the liquidity requirement and facilitate market borrowings of Central and State governments:

(i) With the revision effected in March 1999, the normal WMA extended to States by the Reserve Bank has been enhanced by 65 per cent from Rs.2,234 crore in 1996 to Rs.3,685 crore in 1999. The limit on special WMA has been removed.

(ii) Since 1990-91, the borrowing programme handled by the Reserve Bank has increased nearly ten-fold, from Rs.11,000 crore to about Rupees one lakh crore for both Centre and States, while the SLR prescription has gone down from 38.5 per cent to 25 per cent over the same period.

(iii) The bulk of market borrowing programme has to be undertaken during the first six months, when there would be less pressure on the banks to lend to the commercial sector. Almost about 90 per cent of borrowing programme would need to be completed in the first half of the year. Magnitudinally, this implies that the Reserve Bank has to manage total Government borrowings amounting every month to roughly 1 per cent of GDP during the first half of the year.

(iv) Currently, as on July 16, 1999, banks are holding SLR securities to the tune of Rs.2,60,194 crore, and excess holding of securities amounting to over Rs.60,000 crore. Assuming that the deposit growth in the banking system is about 15-20 per cent during 1999-2000, which translates to an increase of about Rs.1,30,000 crore, SLR required to be maintained would be around Rs.32,500 crore, which is less than the level of excess SLR holding by banks. This would mean that the SLR prescriptions do not in reality under current circumstances obligate banks to buy fresh government paper. Further, as a result of rising level of borrowing, the ratio of interest payment to revenue receipts is rising. Therefore, there is a case for keeping the rising level of public debt (including other liabilities) under control by placing a statutory ceiling on public debt.

DOMESTIC PUBLIC DEBT

4.9 The accumulation of public debt (including all internal and external liabilities) and the rising servicing burden have become an issue in the sustainability of the fiscal position. This is reflected in combined domestic liabilities of the Government sector rising from 53.8 per cent of GDP to 54.9 per cent of GDP between end-March 1992 and end-March 1999. Had the debt servicing burden been contained, there could have been larger amount of resources spared for sectors such as health, education, social welfare and other productive sectors of the economy. This is especially so since a major portion of the rising proportion of borrowed funds is used for financing current consumption. Moreover, a disproportionate burden of debt is shifted on to the future generations by excessive growth in public debt and rising debt-servicing burden. Besides, net borrowing would progressively decline, if the present trends continue. For instance, the ratio between gross and net borrowing which was 1: 0.84 in 1991-92 has come down to 1: 0.67 in 1998-99.

4.10 An important source of potential debt problem for the Central Government is the steady increase in non-marketable debts which arises out of the public account operations in the budget. While the intended purpose of the public account operations has been to enable the Government to intermediate funds flow between the public and itself with a view to serving some special distributive or social security related objectives, in actual practice such borrowings have been used to enhance the resource base of the Government to finance the growing amount of fiscal deficit. Moreover, resources mobilised under 'other liabilities' like small savings, provident funds and special deposits are serviced at high effective cost. While the nominal interest rates offered on these instruments are kept attractive, some of these are also eligible for special tax rebates, under Sections 88 and 80L of the Income Tax Act. Consequently, the effective cost of borrowings to the Government, taking into account both explicit and implicit costs from these sources, is far higher than that on market loans.

In 1998-99, resource mobilisation through small savings, provident funds and special deposits together increased to Rs.43,588 crore from Rs.33,360 crore in 1997-98, constituting 42.0 per cent of fiscal deficit as compared with 37.5 per cent in the previous year.

Contingent Liabilities of Government Sector

4.11 The conventional debt statistics reported in the budget take into account explicit liabilities of the Governments arising from their own budgetary transactions, and exclude the implicit liabilities, which Governments may have assumed while providing guarantees to private sector or their own parastatals. While the conversion of an implicit liability into an explicit one at a later date depends on the financial status of the beneficiary of the guarantee, its exclusion from the conventional debt statistics is based on the presumption that all contingent liabilities are eventually vacated by the solvent borrower with no implication for government's financial health. But a clear idea of the magnitude of contingent liability is essential for accurate reflection of the net worth and strength of the public sector. The declining Government investment during the process of fiscal consolidation juxtaposed with the growing need for infrastructure requiring large investments with greater participation of the private sector has brought the issue of guarantees to the centre stage. The guarantees given by the Central Government in nominal terms has risen from Rs.50,575 crore to Rs.73,877 crore between end-March 1992 and end-March 1998. Recognising the implications arising from growing guarantees on the fiscal health, the Union Budget for 1999-2000 has proposed to establish a *Guarantee Redemption Fund* with a view to promoting transparency and moderating the growth of contingent liabilities.

4.12 At the State level, the demand for extending guarantees for developmental projects has been increasing on account of shrinking capital expenditure of States, on the one hand, and limited borrowing capacity along with the rapidly rising demand for basic infrastructure to achieve a higher growth trajectory, on the other. As a result, the guarantees given by States increased in nominal terms from Rs.40,159 crore at end-March 1992 to Rs.79,625 crore at end-September 1998. Most of the guarantees extended by States are concentrated in favour of financial institutions, which could be discouraging proper risk assessment of credit by such institutions, involving a moral hazard problem. Excessive counter guarantees by Governments to public financial sector, especially to enterprises which are not viable, could raise concern due to its potential adverse implications for the financial sector balance. In this context, the recent Technical Committee on State Government

Guarantees has recommended the setting up of a limit on guarantees, ensuring greater selectivity in calling for and providing of guarantees, adherence to transparency in reporting guarantees and constituting a Contingency Fund for guarantees to meet any eventual obligations. Although the Committee confined its recommendations only to States, the recommendations are also relevant for the Central Government, given the similarity of issues and problems.

V FINANCIAL MARKETS

5.1 Financial market activities during 1998-99 came under the impact of several domestic and international uncertainties. Responding to these developments, the Reserve Bank announced monetary policy measures from time to time during the year to counter the emerging volatility in the money and forex markets. As a result, barring brief periods of volatility, financial markets in general exhibited orderly conditions during the greater part of 1998-99. Short-term money market rates ruled generally low in 1998-99, reflecting the comfortable liquidity conditions on account of significant deposit growth juxtaposed with sluggish growth in non-food credit. While

short-term measures were initiated to address the financial market uncertainties, the Reserve Bank undertook several important structural reform measures in the financial sector that bear close affinity to the recommendations made by the second Narasimham Committee Report. In the process, the development of the financial market was further promoted. It was also facilitated by the improvement in the size and turnover of different market segments, and enlargement of the number of players and instruments. 5.2 Monetary policy was generally successful in influencing market expectations, with market participants responding reasonably well to policy measures. A persistent lack of investors' interest severely restricted the growth of primary equity market during 1998-99, while the private placement market (comprising mostly debt instruments) emerged as the leading source of mobilisation of funds, which again was dominated by top rated corporates. The term loan market exhibited the sentiments of the credit market, with deceleration in the assistance disbursed by financial institutions (FIs). The debt markets were, however, relatively more vibrant with activity than the equity counterpart. The government securities market came under pressure with the market borrowing of the Central and the State governments exceeding the budgeted amount by a large margin. However, an active debt management policy played a critical role in staving off the pressure in the government securities market, ensuring fairly stable interest rate condition in the medium and long-term segments of the market. As a result, there was a decline in the government's cost of borrowing through dated securities.

MONEY AND FOREIGN EXCHANGE MARKETS

5.3 During 1998-99, particularly in the first half of the year, money market conditions were strongly influenced by short-term developments in the forex market, and the response of the Reserve Bank to meet these challenges. The measures undertaken by the Reserve Bank in the money market segment were aimed at promoting efficient functioning of the market, while ensuring stability and liquidity in the system. The money market recorded heightened activity and formed the main passage for the transmission of monetary policy impulses. The market remained relatively calm for the large part of the year, responding as it was to the Reserve Bank's policy measures.

Call/Notice Money Market

5.4 The average call rates generally remained stable and moved within a limited range. In general, the movement was confined to an informal corridor set by the Bank Rate and the fixed repo rate during the year, barring a brief period in August 1998 and again in January and March 1999. During April 1 - August 19, 1998, the daily peak call rates remained in single digit. Following the policy measures (increase in CRR and fixed repo rate) announced on August 20, 1998 to squelch speculative pressure on the Rupee and reduce arbitrage opportunities in the domestic money market, call rates rose sharply to 30 per cent on August 21, 1998. While the rate receded for a brief period, it again rose to 21.0 per cent on August 29, 1998, the day when the 1 percentage point CRR hike was effected. Following the release of RIB funds by the State Bank of India, liquidity conditions eased considerably and call rates ruled in single digit in September 1998 (except on September 12 when it touched 12.5 per cent).

5.5 The second half of the financial year witnessed generally improving liquidity conditions and call rates moved in a range of 5.0-10.5 per cent except for a brief period during January 1999 and

March 1999. This was despite an active open market sale of securities by the Reserve Bank from its portfolio during this period. The favourable conditions in the call market mainly reflected the sluggish growth in non-food credit and liquidity injection by the Reserve Bank through refinance window and reverse repo operations with the PDs. As an aberration, call money rate touched 35.0 per cent during January 14-17, 1999. It was, however, a temporary phenomenon caused by incorrect estimation of liquidity situation by some banks, a panic reaction due to bank employees' strike and two consecutive holidays covering the reporting Friday at some centres. Call rates hardened again during the second half of March, ruling in double digits for 5 days (peaking at 14 per cent on end-March, 1999) reflecting the usual seasonal factors associated with the advance tax payments, year-end window dressing by banks and absence of financial institutions as lenders in the money market who had reportedly earmarked funds to meet their disbursement targets for the fiscal year. On the whole, call rates, however, showed a decline of about 50 basis points in March 1999 over February 1999, reflecting the monetary policy measures announced on March 1, 1999. During the first quarter of 1999-2000, call rates declined to 8.20 per cent in June 1999 from 8.46 per cent in March 1999. At this level call rates were nevertheless substantially higher than 6.63 per cent in June 1998. The smaller seasonal decline in non-food credit offtake coupled with large amounts of market borrowing by the Central Government during the first quarter exerted pressure on call rates.

Foreign Exchange Market

5.6 Foreign exchange market remained reasonably calm during 1998-99 except for some bouts of pressure in the early part of the year due to speculative activities in the wake of developments in South-East Asia and the fall-out of economic sanctions. Turnover in the foreign exchange market during 1998-99 at an average of US $ 109 billion per month remained almost unaltered from the level in 1997-98. The average monthly merchant turnover increased from US $ 18 billion in 1997-98 to US $ 21 billion in 1998-99. The rate of increase was, however, lower at 16.7 per cent during 1998-99 as compared with an increase of 38.5 per cent in 1997-98, reflecting some slowdown in merchandise trade and subdued capital transactions. The average monthly turnover in the inter-bank market fell from US $ 91 billion in 1997-98 to US $ 88 billion in 1998-99, reflecting the decline in speculative activity following the measures announced by the Reserve Bank during June and August 1998 to ensure orderly market conditions.

5.7 The merchant turnover continued to be dominated by spot transactions, which accounted for about 46 per cent of the total while the forward segment dominated the inter-bank market with a share of 41 per cent. The forward transactions were relatively higher in the early part of 1998-99 constituting 23 to 28 per cent and 44 to 52 per cent of the total turnover in merchant and inter-bank segments, respectively, reflecting the uncertainty in the forex market which had pushed up the forward premia.

Inter-linkages among Money and Forex Markets

5.8 The inter-linkages among the money, forex and repo markets continued to be a significant feature of the financial market activity in 1998-99. During the first quarter of 1998-99, excess liquidity characterised the domestic money market reflecting primarily a large decline in non-food credit. Despite a reduction in the fixed rate repo from 8 per cent at the beginning of April 1998 to 5 per cent by June 15, 1998, the repos continued to provide a profitable avenue for banks to park their surplus funds. With the repo rate acting as the floor, call rates exhibited a declining

trend tending to hug the lower repo rate. As call rates ruled well below the informal ceiling set by the Bank Rate (also the export credit refinance rate), borrowings by commercial banks from the Reserve Bank's export credit refinance window were small. From a net purchaser of foreign currency in April 1998, the Reserve Bank turned into a substantial seller in May and June 1998 to stabilise the forex market, and in the process draining out excess liquidity.

5.9 Despite substantial repos and OMO in August the market remained comfortable on liquidity. On the other hand, uncertainties in the forex market led to hardening of the forward premia. Consequently, the turnover in the inter-bank forex market and money market increased in the first fortnight. In view of the decline in exports, the rates on export credit refinance were reduced by 2 percentage points to 7 per cent (i.e. at 2 percentage points below the Bank Rate) on August 6, 1998 for the period up to March 31, 1999. This measure contributed to further augmenting of liquidity in the system as it provided banks with a channel of obtaining liquidity at a relatively cheaper cost. On August 20, 1998, a package of monetary policy measures was put in place to counter destabilising speculative activity in the forex markets. The repo rate was raised by three percentage points and CRR was increased by one percentage point to drain out liquidity. As liquidity was sucked out, call rates increased, and the turnover in the domestic and the inter-bank segments of the forex market declined. This not only arrested the speculative pressure on the exchange rate but also led to significant accretion to foreign exchange reserves.

Non-banking Financial Companies (NBFCs)

5.10 The Reserve Bank accorded registration to 607 NBFCs as deposit taking entities up to June 30, 1999 which are covered under the Bank's comprehensive regulatory/supervisory process while another 7,054 NBFCs were registered as non-deposit accepting/holding entities subject to, *inter alia*, their having the minimum required NOF.

5.11 The aggregate public deposits of NBFCs in terms of the survey data as reported by 1,724 NBFCs stood at Rs.20,237 crore as on March 31, 1998 and was equivalent of 3.4 per cent of the aggregate deposits of the commercial banks. Consequent upon the amendments to the Reserve Bank of India Act, 1934 during 1997, the Bank has narrowed down its focus by confining its regulatory attention only in relation to public deposits. Public deposit was a component of the regulated deposits. Hence, the quantum of public deposits mobilised by NBFCs as on March 31, 1998 does not lend itself to be compared with the regulated deposits reported for the earlier periods.

Housing Finance Market

5.12 The overall minimum target for 1998-99 for housing finance by commercial banks was fixed at 1.5 per cent of their incremental deposits over the previous year's level, or the amount of housing finance allocation fixed for the year 1997-98, whichever was higher. For 1999-2000, commercial banks have been advised to compute their share of minimum housing finance allocation at 3 per cent of their incremental deposits over the level of the previous year or the amount of housing finance allocation fixed for the year 1998-99, whichever was higher. Banks are, however, free to exceed this limit.

EQUITY, DEBT AND TERM LENDING MARKETS

5.13 The capital market exhibited a mixed trend during 1998-99. While the primary market showed some signs of revival in terms of resource mobilisation by way of new capital issues, the secondary market activity continued to remain depressed for most part of the year. The corporates, however, continued to raise sizeable funds from the private placement market while the new issues market was mostly dominated by a handful of mega issues. The secondary market suffered due to both internal and external factors. However, after the presentation of the Union Budget for 1999-2000 with a package of incentives for the capital market, the secondary market activity witnessed a sharp improvement in March 1999, which off-set most of the losses in the index in the previous months. Resource mobilisation by mutual funds suffered a major setback due mainly to net outflow of funds in respect of US-64 scheme of UTI in the latter half of the year.

5.14 During the last few years, private placement market has emerged as the major route for raising of resources by corporate entities. During 1998-99, banks, FIs and public and private sector companies mobilised Rs.49,664 crore (84.1 per cent of total resource mobilisation from the primary market) through this route, which was higher by 65.0 per cent than the amount of Rs.30,099 crore raised during the previous financial year. The public sector accounted for 65.8 per cent or Rs.32,681 crore of the amount raised through private placement. The public financial sector contributed about 41 per cent of the total amount raised through private placement while 24.8 per cent was contributed by the non-financial public sector. Resource mobilisation by private sector through the private placement route nearly doubled from Rs.9,202 crore in 1997-98 to Rs.16,983 crore in 1998-99, with private financial sector accounting for 24.5 per cent of the total mobilisation. The debt instruments, mostly bonds and debentures, constituted 95.3 per cent of the total amounts raised by way of private placement. The equity portion was raised in the form of preference shares. The interest rates on debt instruments floated by the public sector entities in the private placement market ruled in the range of 10.75-16.00 per cent for maturities ranging from 1 year to 5 years. The corresponding range on debt instruments of the private corporate sector was 10.00-16.50 per cent.

5.15 The recent growth of private placement market has brought to fore the issue of regulation, if this market should continue to play a major role in resource mobilisation by the corporate sector. At present, private placement does not come under the usual disclosure and protection of investors' interest norms as prescribed by the SEBI, even though most of the issues are rated by credit rating agencies. Default risk to investors could be a potential problem which may pose systemic risks if the investors involved happen to be large financial institutions.

GOVERNMENT SECURITIES MARKET

5.16 During 1998-99, developments in the Government securities market were influenced largely by the evolution in the fiscal position for the year, the liquidity conditions in the economy and the debt management strategy adopted by the Reserve Bank.

The year witnessed severe demand pressure in the Government securities market, as the fiscal deficit of the Government overshot the target by a wide margin, requiring additional funding requirements from the market to the extent of about Rs.15,000 crore. The notable deceleration in non-food credit off-take and injection of RIB funds to the market which enabled the banking sector to divert its surplus investible funds to the Government securities market, have helped to

ensure the success of the debt management strategy adopted by the Reserve Bank to balance the objectives of successfully funding the Government's fiscal deficit and avoiding, at the same time, the pressures on interest rates and inflation expectations. As already indicated, the Reserve Bank adopted a conscious strategy of having securities on its books on private placement basis and of subsequently unloading them through active open market operations (OMO).

5.17 The gross issues of Central Government dated securities nearly doubled from Rs.43,390 crore in 1997-98 to Rs.83,753 crore during 1998-99. After meeting the repayment liabilities of Rs.14,803 crore, the net borrowing amounted to Rs.68,950 crore in 1998-99 as against Rs.32,488 crore in 1997-98 representing an increase of 112.2 per cent. The Government raised an additional gross amount of Rs.10,200 crore through 364-day Treasury Bills, which together with dated securities implied gross market borrowing of Rs.93,953 crore in 1998-99 as compared with Rs.59,637 crore in 1997-98. However, considering the maturing 364-day

Treasury Bills of Rs.16,247 crore in 1998-99, the net amount raised through 364-day Treasury Bills was negative at Rs.6,047 crore, as against a positive amount of Rs.8,006 crore in 1997-98. Consequently, the net draft of resources from the market by the Central Government amounted to Rs.62,903 crore in 1998-99, showing an increase of 55.3 per cent over Rs.40,494 crore in 1997-98. Of the total amount of gross borrowing raised through dated securities, private placement with and devolvement on the Reserve Bank at Rs.38,205 crore formed 45.6 per cent as compared with 30.0 per cent (Rs.13,028 crore) in 1997-98. The devolvement on the primary dealers (PDs) increased to

Rs.3,125 crore in 1998-99 from Rs.1,903 crore in 1997-98. While the market (excluding PDs and the Reserve Bank) absorption of fresh issues of Central Government dated securities was to the extent of Rs.42,423 crore, the subsequent OMO by the Reserve Bank resulted in a substantial decline in its holding with the corresponding increase of the market's share in holding these securities. At end-March 1999, changes in the Reserve Bank's net holding of Central Government securities was of the order of Rs.10,235 crore for 1998-99, as compared with Rs.5,311 crore (exclusive of conversion of Special securities worth Rs.20,000 crore) in 1997-98.

VI EXTERNAL SECTOR

6.1 The external sector management posed a major challenge in recent years, in particular, since September 1997. In 1998-99, the East Asian crisis, which in recent months has shown some signs of abatement, continued to cast its shadow. In addition, the crises which affected Russia in August 1998 and Brazil in the early part of this year had some repercussions on the global economic outlook. The economic prospects of Japan as well as of the economies of Europe were uncertain. In addition to the unfavourable external situation, India was confronted during the year with certain other developments, *viz.*, the economic sanctions imposed by several industrial countries, the suspension of fresh multilateral lending (except for some sectors), the downgrading by international rating agencies and the reduction in investment by foreign institutional investors. Faced with these challenges, the Reserve Bank had to take recourse to monetary policy measures from time to time to bring about orderliness in the foreign exchange market. As a consequence, the developments in respect of both the exchange rate of the rupee and movements in foreign exchange reserves have turned out to be reasonably favourable.

Foreign currency assets have increased significantly in both absolute and in net terms. The successful launching of Resurgent India Bonds (RIBs) resulted in accretion to foreign currency assets of US $ 3,547 million over the end-March level of 1998. Moreover, the level of foreign exchange reserves after excluding forward liabilities at the end of March 1999 exceeded the total stock of short-term and portfolio flows.

6.2 Overall, the current account deficit was contained way below the acceptable limit, at 1.0 per cent of GDP and net capital flows were more than adequate to meet the current account deficit. Exports, however, recorded a decline of 3.9 per cent over the previous year. Imports also slowed down, *inter alia*, due to the softening of international oil prices and sluggish domestic industrial activity. With sufficient increase in exports of software and robust accretion through invisibles, the current receipts showed impressive growth and financed 93.3 per cent of current payments.

BALANCE OF PAYMENTS

6.3 During 1998-99, the balance of payments remained fairly stable. The moderation in merchandise imports, reflecting in particular, the slackening of industrial activity and the softening of international PoL prices translated into a sizeable reduction in import payments in US dollar terms. This helped to partially mitigate the erosion in export receipts. The net invisible surplus remained buoyant, notwithstanding the depressed international environment, containing the current account deficit. The reduction in capital inflows, foreign portfolio investment in particular, was more than offset by an accrual of US $ 4.2 billion under the RIB Scheme. The balance of payments, consequently, recorded an overall surplus of US $ 4,222 million for the third year in succession.

Merchandise Trade

6.4 According to the provisional data released by the Directorate General of Commercial Intelligence and Statistics (DGCI&S), India's exports at US $ 33.7 billion declined by 3.9 per cent during 1998-99, as against an increase of 4.6 per cent recorded during 1997-98, driven by the decline in exports of both primary products (10.4 per cent) and manufactured goods (2.8 per cent). This, *inter alia*, reflects the persistence of the domestic industrial slowdown, on the one hand and adverse external conditions, such as, the decline in world trade prices and contraction in import demand of the crisis-affected South-East Asian countries, on the other.

6.5 Imports at US $ 41.9 billion decelerated to 0.9 per cent during 1998-99 from 6.0 per cent during 1997-98. Oil imports declined by 21.2 per cent during 1998-99, over and above the fall of 18.7 per cent during the previous year, mainly on account of the decline in international oil prices. Growth in non-oil imports decelerated to 6.3 per cent from 14.5 per cent recorded during the previous year.

Invisibles

6.6 Invisibles transactions continued to be robust at US $ 9,208 million during 1998-99 as compared with US $ 10,007 million in 1997-98. The contribution of private transfers, in net terms, continued to account for a large share of net invisibles receipts followed by non-factor

services. The decline in private transfers during 1998-99 could be attributed to the fall in imports of gold and silver as baggage by returning Indians following the liberalisation of the gold import policy. In fact, private transfer receipts, excluding baggage gold and silver, increased from US $ 9,127 million in 1997-98 to US $ 10,114 million in 1998-99. Non-factor services further strengthened their position in balance of payments during 1998-99. Net earnings in non-factor services enlarged to US $ 2,165 million in 1998-99 as compared with a surplus of US $ 1,319 in 1997-98 mainly due to surge in software exports estimated at US $ 2,615 million in 1998-99. Software exports kept up their momentum with a rise of 49 per cent on top of increases of about 55 per cent in 1997-98 and of 46 per cent in 1996-97. In this context, mention may be made of the initiative being taken by the Government to strengthen the infrastructure for electronic data interchange and electronic commerce in view of the changing mode of trade transactions. Net investment income payments went up marginally in 1998-99 due to higher interest payments on external borrowings, off-setting higher earnings on the deployment of foreign exchange reserves. Official transfers, especially from Japan, weakened during 1998-99.

Current Account

6.7 The buoyancy in the surplus under the invisibles account coupled with decline in imports payments resulted in the current account deficit narrowing to US $ 4,038 million (1.0 per cent of GDP) in 1998-99 from US $ 5,500 million (1.3 per cent of GDP) in 1997-98. The improvement in the balance of payments reflects strong growth in current receipts which increased to 14.3 per cent of GDP as against an average of 13.2 per cent during the period 1993-94 to 1997-98. Furthermore, current receipts financed 93.3 per cent of current payments in 1998-99. The debt-service ratio declined from 19.1 per cent in 1997-98 to 18.0 per cent in 1998-99 on account of reduction in amortisation. Notwithstanding these improvements, the performance of merchandise exports has been a major area of concern. The impact of the reduction in exports was to some extent muted by the fact that import payments were contained mainly because of softening of international PoL prices. Besides, the continuing buoyancy in the invisible receipts, in particular the surge in software exports, technology related services and workers' remittances compensated for the sluggishness in merchandise export growth. While the channel for gold and silver imports for Indians returning from abroad received a lukewarm response, imports of gold and silver through the nominated agencies registered a significant growth in 1998-99. However, total imports of gold and silver are estimated to decline from US $ 5,872 million in 1997-98 to US $ 5,042 million in 1998-99.

Capital Account

6.8 The turbulence in the international financial markets continued to impinge on developments in the capital account as reflected by quantum, composition and degree of volatility in capital flows during 1998-99. Net capital inflows fell to US $ 8.6 billion as against US $ 9.8 billion during 1997-98. Inflows under foreign direct investment, external assistance and deposits under various nonresident schemes were relatively stable as against a steep fall in the portfolio investment by foreign institutional investors (FIIs). External commercial borrowing through traditional channels showed a sharp decline but it was more than compensated by the successful mobilisation of funds through the issue of RIBs. It may be noted that the proportion of relatively stable flows to total capital flows has also increased significantly in 1998-99 for the third

successive year.

Overall Balance of Payments

6.9 During the year, the overall balance of payments recorded a surplus of US $ 4,222 million (1.0 per cent of GDP) for the third year in succession as against that of US $ 4, 511 million (1.1 per cent of GDP) during 1997-98 and US $ 6,793 million (1.7 per cent of GDP) in 1996-97, as net capital flows at US $ 8,565 million more than offset the current account deficit during the year. The overall surplus in 1998-99 enabled repurchases of US $ 393 million from the IMF and resulted in accretion of US $ 3,829 million, excluding valuation changes, to foreign exchange reserves. The compilation and dissemination of BoP statistics in India now fully conform to the international best standards.

FOREIGN EXCHANGE RESERVES

6.10 India's foreign exchange reserves comprising foreign currency assets of the Reserve Bank, gold held by the Reserve Bank and Special Drawing Rights (SDRs) held by the Government increased for the third successive year during 1998-99. The reserves increased by US $ 3,123 million from US $ 29,367 million (Rs.1,15,905 crore) as at end-March 1998 to US $ 32,490 million (Rs.1,38,005 crore) as at end-March 1999; India's foreign exchange reserves had increased by US $ 4,736 million during 1996-97 and US $ 2,944 million during 1997-98. Significantly, the forward liabilities of the Reserve Bank declined from US $ 1,792 million at end-March 1998 to US $ 802 million at end- March 1999 and stood at US $ 972 million by end-June 1999. Net of outstanding forward liabilities to the Authorised Dealers (ADs) and use of the IMF credit, the Reserve Bank's foreign exchange reserves recorded a higher expansion of US $ 4,490 million during the year and stood at US $ 31,401 million at end-March 1999 (equivalent to almost 8 months of imports) as against US $ 26,911 million as at end-March 1998.

EXTERNAL DEBT

6.11 India's external debt declined from the peak of US $ 99,008 million at end-March 1995 to US $ 94,320 million at end-March 1998 but increased to US $ 98,231 million at end-March 1999. The major source of increase during 1998-99 was under commercial borrowings, particularly on account of Resurgent India Bonds. Although the proportion of concessional debt to total debt continued its declining trend falling from 39.2 per cent at end-March 1998 to 37.9 per cent at end-March 1999, there was a significant improvement in the composition of external debt and key indicators of debt sustainability. Short-term debt declined from US $ 5,046 million at end-March 1998 to US $ 4,329 million at end-March 1999 or from 5.3 per cent of total external debt to 4.4 per cent over the same period. While the external debt-GDP ratio declined from 23.8 per cent at end-March 1998 to 23.7 per cent at end-March 1999, the debt service ratio fell from 19.1 per cent in 1997-98 to 18.0 per cent in 1998-99. The ratio of short-term debt to foreign currency assets was as low as 14.7 per cent at end-March 1999 as against 19.4 per cent at end-March 1998.

EXCHANGE RATE MANAGEMENT

6.12 The management of the exchange rate during 1998-99, particularly during the early part of the year posed a severe challenge in view of the continuing turbulence in the South-East Asian financial markets and the spread of contagion to other markets such as Russia and Brazil apart from the presence of domestic uncertainties. Concerted policy efforts were, therefore, made in June and August 1998 to reverse the sentiments with a positive impact. The successful raising of funds under RIBs in August 1998, along with certain monetary and other measures taken by the Reserve Bank helped to restore confidence and normalcy in the Indian foreign exchange market. Consequently, during the second half of 1998-99, the exchange rate of the Indian rupee remained broadly stable resulting in a turnaround in the demand-supply mismatch in the foreign exchange market. In contrast to cumulative sales amounting to US $ 2,502 million during May-July 1998, the subsequent period from August 1998-March 1999 witnessed cumulative purchases of US $ 4,143 million resulting in net market purchases at US $ 1,842 million for the year as a whole by the Reserve Bank.

VII ASSESSMENT AND PROSPECTS

7.1 1998-99 proved to be a year of testing challenges to policy making in the face of a variety of domestic and international uncertainties. A number of policy initiatives were necessary to optimise gains emanating from the structural transformation of the economy as a whole and of the financial sector in particular. On the whole, despite some strains, the economy performed reasonably well with an overall growth of 6.0 per cent. The rate of inflation, on a point to point basis, was 4.8 per cent. The position in respect of the overall balance of payments outcome was also satisfactory with foreign exchange reserves reaching a record level of US $ 32,490 million.

Agriculture

7.2 Agricultural sector posted an impressive growth in 1998-99, but a large part of this outcome reflected the fact that in the preceding year, the growth was negative. Foodgrains production crossed the 200 million tonne mark for the first time in Indian economic history.

7.3 The turnaround in agriculture in 1998-99 should, however, be seen in a longer term perspective. The annual average rate of growth in agricultural production in the 'nineties so far has been low at only 2.6 per cent as compared with 5.2 per cent in the 'eighties. The decade of the 'nineties was also characterised by a larger volatility in year to year fluctuations in output, as measured by coefficient of variation, than the preceding decade. A further source of concern is that success in the sector is confined to a few crops, and that potentially high production areas have lagged behind in enhancing farm output. It also appears that the impact of seed technology in the cereal segment has reached a plateau. The losses of crops waiting to be marketed and the losses due to inappropriate handling and storage of grains are estimated to be large. Though total investment in agriculture has been showing a positive trend, public investment in the agricultural sector has been showing a downward trend. On the positive side, the terms of trade have been generally favourable to agriculture in recent years.

7.4 The buffer stocks of foodgrains stood at a high level of around 33 million tonnes at end-June 1999, higher than the 29 million tonnes a year ago. At these levels, stocks are considerably

higher than the stated norms from the point of view of food security. The build-up of buffer stocks has been facilitated by the minimum support price mechanism under which the minimum support prices (MSP) are often set higher than the prices recommended by the Commission on Agricultural Costs and Prices (CACP). Apart from the implication that such price setting has for the persistence of high cereal prices even in years of high production, it adds to the storage and maintenance costs in the presence of limited domestic offtake and limited opening up of agriculture for export. Besides, a very high level of stocks poses problems of safe storage. They also impose high fiscal costs, in the form of high food subsidies. There is, therefore, a need for a review of the actual prices being fixed under the MSP mechanism and for strengthening of the distribution arrangements with a view to alleviating the incidence of poverty to the extent possible. Moreover, storage infrastructure needs to be modernised in order to minimise the losses entailed in the existing stocking facilities.

7.5 Notwithstanding the reasonably good agricultural performance during 1998-99, prices of primary articles (and food articles in particular) increased significantly. At the wholesale market segment, the increase in average prices of cereals, pulses, fruits and vegetables, milk and milk products and eggs, fish and meat was generally higher in 1998-99 than in 1997-98. This phenomenon underscored the need for improving the supply and availability position of not only foodgrains but also other products such as fruits and vegetables, milk and milk products and eggs and fish. This aspect needs to be given full consideration in development policy, since it has implications for nutritional content in food intake and productivity.

7.6 Given the trend rate of growth in population and the need for improving the nutritional levels, there is the imperative of raising agricultural productivity through adoption of technologies suited to Indian climatic and soil conditions and through institutional mechanisms that integrate production, credit, marketing and distribution. Research and development, as much as measures for increased irrigation facilities and systems, improved soil conservation, farm mechanisation and extension services would need to be given top priority in agricultural development. The pro-active role of the State in providing forward momentum to these aspects may have to be strengthened.

Industry

7.7 The performance of the industrial sector in 1998-99, as reflected in the movement of the index of industrial production (IIP), was unsatisfactory, as compared to that in the preceding four years. A number of reasons are believed to have contributed to this outcome, *viz*., the low demand for certain industrial products partly due to decline in agricultural production in 1997-98, the reduction in the Central plan outlay, the sharp build-up of excess capacity in some industries, the continued deceleration in industrial commodity prices, the subdued capital market conditions and international uncertainties. In addition, import liberalisation and overall slack in aggregate demand imply the need to persevere with restructuring of the Indian industry in response to the challenges being posed by the compulsions to be internationally competitive. The restructuring is largely reflected in the growing number of mergers and acquisitions, the diversification of industrial units, the increase in technical collaborations and greater professionalism in corporate managements. It is expected that this will gain in momentum as competitive pressures in the real sector take place, and as manufacturing units take initiatives to

intensify research and development (R&D) efforts. Further improvements in productivity will lead to effective cost reductions and increased profitability. Such a process will receive impetus with strengthening of aggregate demand stemming from sustained improvement in the rate of growth.

7.8 In the first quarter of the current year, there has been some turnaround with the IIP registering an increase of 5.6 per cent as compared with 4.5 per cent in the corresponding period of 1998-99. This outcome is mainly due to the upsurge in manufacturing sector production (6.5 per cent as compared with 4.2 per cent in April-June of 1998). In particular, the capital goods sector has posted impressive gains although the base is still narrow. It should be possible to sustain the present momentum in the remaining months of the year, given the lagged effects of the increase in agricultural income during 1998-99.

Services Sector

7.9 A notable feature of the dynamics of structural transformation of the economy in recent years has been the rising contribution of the services sector which includes substantial value-added and skill-intensive services, such as software, to the overall output in the economy. It is important to note that the growth of the services sector has imparted much of the resilience to the overall growth of the economy, particularly in times of adverse agricultural shocks and industrial slowdown. But more importantly, the sector has emerged as the fastest expanding sector, with implications for productivity, employment, trade and fiscal prospects of the economy. Between 1990-91 and 1998-99, the share of services (inclusive of construction) in real GDP increased from 43.7 per cent to 51.2 per cent. The contribution of growth of the services sector to the overall growth of GDP has also increased significantly from 47.5 per cent in 1990-91 to 49.8 per cent in 1998-99. The bulk of the increase in shares has taken place in trade, communications and banking and insurance segments. There are areas where there has been a spurt of technical progress and also increased competition, mainly induced by economic reforms. On the other hand, there are other areas like construction, hotels and railways where the shares have moved up in fractional terms.

7.10 The recent trends in the services sector point to several implications. First, a relatively high growth of the services sector would be generally suggestive of gains in productivity in agricultural and industrial sectors, induced by technological progress and other innovations, which result in moving employment away from the non-services sector to the services producing sector. It also indicates a shift of real expenditure from manufacturing to value-added services, which is generally associated with the process of economic development. Secondly, while the rising share of the services sector in GDP is an encouraging sign of greater degree of diversification of the Indian economy, a corresponding decline in the share of industry and agriculture implies that the overall productivity gains in the economy will depend increasingly on what happens in the services sector. A large part of the services output continues to be non-tradeable in nature. This alongwith the shift of employment would point to the need for policy initiatives towards introducing greater competition and efficiency in the services sector for ensuring its sustained contribution to high long-term growth. Thirdly, the relative prices of the services sector have been moving at a faster pace than those of the industrial sector. The implicit GDP deflator for services moved up by 2.9 times during 1980-81 to 1992-93 and further by 1.4

times during 1993-94 to 1997-98 as compared to that of 2.6 times and 1.3 times, respectively, for the industrial sector. The contribution of the services sector to the overall inflation rate (measured by variation in GDP deflator), therefore, has been higher than the industrial sector. Finally, the growth of the services sector has long-run fiscal implications to the extent that this constitutes a potential tax-base for the government. Under the present tax regime, the services sector is generally under-taxed as it is not effectively brought under the tax base. A rising share of services in the GDP could result in lower growth of revenue to the government unless the indirect tax system is integrated under a single tax system such as the value added tax.

Aggregate Demand

7.11 The growth scene during 1998-99 was dominated by the performance of the agricultural sector, the deceleration in the industrial activity and the continued deterioration in net external demand. The aggregate demand situation in the economy would need to be seen from the viewpoint of autonomous, exogenous and policy induced components, broadly conforming to private, net external and government demand.

7.12 The overall private sector demand after keeping a steady upward trend up to the middle of 'nineties has decelerated since 1996-97, much of it due to private consumption expenditure. The contraction in the share of private consumption expenditure in GDP has emanated from non-durable consumption which declined from 61.7 per cent of GDP in 1994-95 to 59.7 per cent in 1997-98 whereas the durable consumption has maintained its share in the GDP at around 1.5 per cent during this period. Fixed investment of the private sector in terms of machinery and equipment and construction, has also shown evidence of tapering off; it picked up from 12.9 per cent of GDP in 1994-95 to 16.6 per cent in 1996-97 and then fell to 16.1 per cent in 1997-98. Inventory accumulation which has gone down from 1.5 per cent in 1994-95 to (–)0.2 per cent in 1996-97, increased to 0.4 per cent in 1997-98. The decline in private consumption and investment rates in 1997-98 also coincided with a negative demand shock from the external sector. The net external demand deteriorated from (–)0.3 per cent of GDP in 1994-95 to (–)1.1 per cent in 1996-97 and further to (–)1.3 per cent in 1997-98. The only offsetting factor to the demand deceleration has been the government sector consumption demand, which after falling marginally from 10.3 per cent of GDP in 1994-95 to 10.2 per cent in 1996-97, moved up to 11.1 per cent in 1997-98. The rate of fixed investment demand of the public sector, on the other hand, showed a sharp contraction from 8.6 per cent of GDP in 1994-95 to 6.6 per cent in 1996-97, but moved up to 6.8 per cent in 1997-98. These trends indicate that the government sector demand offset some part of the slack in private and external demand. A part of the increase in fiscal deficit was due to the decline in the tax revenue in response to the slowdown in industrial activity and import growth, and a noticeable expansion of policy induced government expenditure.

Fiscal Policy

7.13 The provisional accounts of gross fiscal deficit (GFD) of the Central Government at Rs.1,12,280 crore in 1998-99 amounted to 6.3 per cent of GDP as against 5.7 per cent in 1997-98 while the consolidated GFD of State Governments (26 States) touched a high of 4.3 per cent as against 2.8 per cent in 1997-98. The combined GFD of both the Centre (provisional accounts)

and States after netting inter-Governmental transactions, amounted to 8.9 per cent of GDP in 1998-99, which is significantly higher than 7.1 per cent in 1997-98. The large salary and pension bills that the State Governments had to bear in 1998-99, accounted for about 1.1 per cent of GDP.

7.14 Three characteristics of the 1998-99 fiscal developments need to be noted for their implications for fiscal evolution in future. First, the combined gross fiscal deficit of the Centre and States was one of the highest in the decade. Secondly, the GFD-GDP ratio of State Governments was the highest recorded in the Indian fiscal history so far. Thirdly, the revenue deficit of both the Centre and States has been very high, placing enormous burden on the capital account of the budgets. The revenue deficit in 1998-99 amounted to Rs.1,01,012 crore, up by about 61 per cent over the position in 1997-98. Such a high order of deficit cannot be sustained for long, even if India's real GDP grows at an average of 6.0 – 6.5 per cent per annum in the coming years for two main reasons. First, it would require a large mobilisation of revenue receipts which, given the rising share of relatively under-taxed services sector, cannot grow without bringing about sharp changes in tax structure and efficiency in tax collections. Secondly, it would imply a large reliance on market borrowings, placing pressure on market rates of interest and crowding out private initiatives.

7.15 Elimination of revenue deficits is vital for overcoming the growing problems associated with interest payments, wages and salaries and subsidy payments. The Union Budget for 1999-2000 envisaged that this objective should be realised in the medium term period of four years in so far as the Centre is concerned. The State Governments too would need to pursue a similar objective over the medium term. This may not be too difficult to achieve, since the combined GFD of States was placed at 2.3 per cent of GDP as recently as in 1993-94 provided States take action to cover at least part of the expenditure incurred by them through cost recovery.

7.16 Corrective actions to rein in the fiscal deficit are critical to help reduce the debt-GDP ratio and the debt service burden. But in the absence of a strong improvement in the tax to GDP ratio, the only way to maintain or reduce the debt-GDP ratio is to cut down aggregate expenditure. However, it needs to be ensured that expenditure adjustment is not at the expense of capital expenditure which, as a proportion of total expenditure of Central Government, has already declined sharply to 22.6 per cent in 1998-99 from 26.1 per cent in 1991-92. Expenditure adjustment also has to go hand in hand with efforts to raise revenues, improve cash flow management and promote the productivity of expenditures in order to contain Government's reliance on borrowings. The costs of financing through incurrence of debt are not to be seen merely in terms of debt servicing, but in terms of the high interest costs that investors outside the Government will have to bear to gain access to funds and the shift of burden of servicing of debt on to the next generation.

7.17 The weaknesses in state finances need to be attended to on a priority basis in view of the limited manoeuvrability that States have in applying fiscal adjustment measures. In recent years, there has been a tendency on the part of some State Governments to incur contingent liabilities like guarantees. Debt and liability financing of development, when carried beyond sustainable levels, would hinder implementation of serious fiscal reforms which should include, as part of the fiscal agenda, large scale investments in non-tradable infrastructure sectors such as power,

roads, and communications and upward revisions in electricity tarrifs and irrigation rates, besides the widening of tax base and tax coverage.

7.18 Against this background, the recommendations of the Eleventh Finance Commission would gain in critical importance. The initiatives taken recently by some States to have Memoranda of Understanding with the Centre for formulating medium term strategies to achieve lasting improvement in their finances augur well for the future of federal finance. Latest indications on Central finances show that tax receipts are rising at a satisfactory rate responding to the turnaround in industrial sector performance. To ensure that the objectives of the Budget are met, it is essential to press on with expenditure reforms and with the movement toward the introduction of zero based budgeting.

Monetary Policy

7.19 The conduct of monetary policy in 1998-99 and in the current year so far in terms of its impact on interest rates and prices needs to be placed against the perspectives obtaining from the evolving macroeconomic situation and economic uncertainties. For purposes of convenience, the issue of monetary policy, liquidity management, interest rates and economic activity may be examined separately from that of monetary growth and inflation dynamics, although it is well known that both the issues are very closely connected.

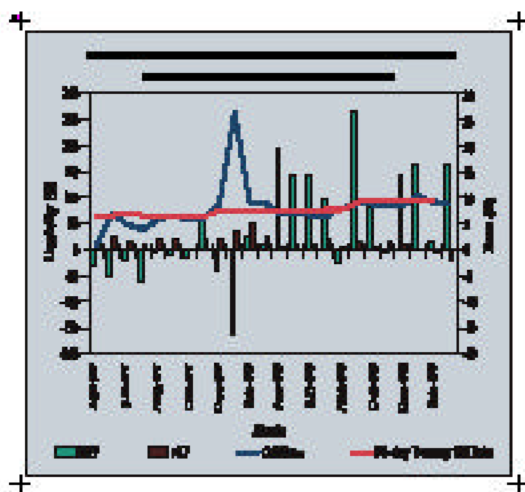
7.20 Monetary policy has had to facilitate the process of growth and inflation control without losing sight of the need to develop financial markets and to promote financial stability. For promoting these diverse considerations, a liquidity management strategy was put in place through an active use of fixed rate repo operations, refinance window, cash reserve ratio and the techniques of private placement of government securities combined with open market operations. The liquidity management strategy generally succeeded in containing the volatility in call money rate within the informal corridor of interest rates defined by the repo rate (acting as the floor rate) and the general refinance rate (acting as the ceiling rate). The other short-term interest rates *viz.*, the 14-day and 91-day Treasury Bill rates also closely followed the call rate and the liquidity conditions emerging from monetary policy action.

7.21 The liquidity condition during the year and the role of monetary policy in modulating it could be seen from the factors that brought about an autonomous influence on the interest rates and those that contributed to off-setting it. The factors governing the short-term interest rate movements may be viewed in terms of what may be regarded as the autonomous liquidity position (ALP) which emanates from the forces that give rise to some amount of independent movement of the central bank's balance sheet. Specifically, in the Indian context, the ALP could be defined as the sum of net RBI credit to Government (net of repos), RBI's net foreign exchange assets and Government's currency liabilities to the public adjusted for RBI's liabilities to non-bank sectors in the form of currency with the public, 'other' deposits with the RBI and net non-monetary liabilities (NNML). The ALP would broadly indicate a hypothetical liquidity position which would prevail if there are no monetary policy interventions. On the other hand, the net policy position (NPP) from the viewpoint of liquidity would broadly refer to a situation of either net withdrawal from or injection of liquidity by the Reserve Bank to the market through instruments such as net repo operations, refinance to banks and credit to the commercial sector

(including primary dealers) and changes in reserve requirements. Chart VII.1 presents the trends in ALP, NPP, call rate and 91-day Treasury Bill rate. It showed that ALP recorded a very subdued growth in 1998-99 compared to that in 1997-98 while there was a steep growth in policy-induced liquidity changes during the major part of the year, except for a brief spell in August 1998 when liquidity conditions were further tightened to stem the volatility in foreign exchange market. The short-term interest rates closely followed the net liquidity position, which tended to move up without exhibiting signs of instability.

7.22 The short-run market stabilisation is important and should be viewed in the context of balancing the objectives of inflation control and growth, while pursuing measures to control short-term market conditions and stem the build-up of adverse exchange rate expectations. As the condition on the inflation front was dominated by an adverse supply shock that was temporary and self-reversing in nature, monetary policy could lean more towards bringing down the medium and long-term interest rates for creating the necessary conditions for industrial recovery.

7.23 The effectiveness of monetary policy to influence the interest rates, particularly the long-term interest rates, depends *inter alia* on the level of development of financial markets, and their integration. In a well developed financial market, there is a close degree of convergence between the direction of movements of short and long-term interest rates, and the yield spread, which carries important information on the stance of monetary policy and the future economic activity. Monetary policy operations in these markets in most countries are carried out on the basis of a few instruments, normally through one or two short-term reference rates or some special arrangement such as the liquidity adjustment facility. A change in the short-term interest rate, transmitted by the monetary policy is carried through the long-term money and credit markets, depending on the market expectation regarding the persistence of monetary policy stance. In the emerging market economies, where financial markets are still evolving and have to acquire the required degree of depth and maturity, the control of monetary policy over long-term interest rates, through the use of a single monetary policy instrument such as a short-term reference rate or a liquidity adjustment mechanism, may not have a strong impact on inflation and growth.



7.24 Given the large borrowing requirements of Government and the present level of development of financial markets in India, monetary policy has to not only depend on a relatively large set of instruments –both direct and indirect – to exercise sufficient control over short-term market developments, but also focus on such instruments that could be of particular significance for the movement of long-term interest rates. Accordingly, the liquidity management strategy was combined with an active interest rate policy directed at stabilising or reducing the interest rates that influence investment. In order to influence the long-term interest rate, the Reserve Bank made active use of the Bank Rate, which is an important interest rate to transmit the signals of monetary policy. The Bank Rate was revised downward thrice during the year, from 10.5 per cent at end-March 1998 to 8.0 per cent by end-March 1999, leading to reduction in the prime lending rates by major public sector banks from

14.0-14.5 per cent to 12.0-14.0 per cent during this period. This was supplemented by the Reserve Bank's effort to soften the medium and long-term government security rates, either through direct devolvement or private placement, combined with open market operations. As a result of the pursuit of liquidity management with an active interest rate policy, the movements in the short-term and long-term interest rates helped to meet both the short-term market stabilisation objective and the long-term objectives of growth. The fact that this was achieved with an annual growth of 18.4 per cent year-end M_3 (16.2 per cent, excluding the RIB proceeds) revealed that the demand forces were contained within a reasonable level consistent with the prospects for price stability.

7.25 While the short-term interest rates showed a tendency towards hardening, the impact on the long-term interest rates was largely hived off through adjustment in other policy instruments. Consequently, the yield spread between the one-year and 10-year government securities declined, on an average basis, from 2.23 percentage points in 1997-98 to 1.73 percentage points in 1998-99.

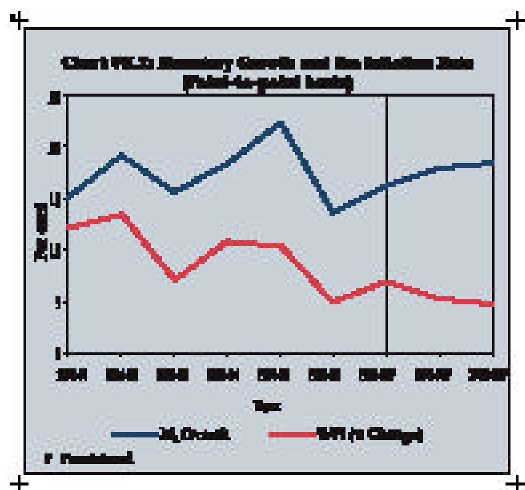
7.26 In so far as monetary impact on prices is concerned, the measurement of inflation has become a major issue since in the recent period, the inflation rate as measured by the point-to-point variation in the Wholesale Price Index (WPI) has shown a steady decline, reaching to one of the historical lows of 1.19 per cent as on July 24, 1999. On an averaging of weekly data basis, the inflation rate thus measured during this period has worked out to 5.64 per cent. The long-term inflation rate (for nearly three decades) was about 8.5 per cent a year. Monetary growth, as revealed by the trend in the growth of broad money has, on the other hand, remained close to its long-run rate of about 17 per cent. Thus, the current inflation rate seems to have diverged significantly from its long term trend.

7.27 It is well recognised by now that while monetary factors largely explain the long-run price situation, the divergence of inflation rate in the short-run from its long-run value could arise from several factors including the supply side shocks which temporarily disturb the underlying long-run relationship between monetary growth and inflation. Such a divergence was witnessed in many developed economies over 'seventies and 'eighties, caused by considerable instability in money demand function due to large scale financial innovation.

7.28 In India, historically, inflation has stayed within a moderate range, barring a few years of

exceptional price pressure arising out of oil price shocks and severe drought conditions. The decadal mean inflation rate (on average basis) at 9.0 per cent in ’seventies, 8.0 per cent in ’eighties, and 8.8 per cent in ’nineties so far (1990-91 to 1998-99) moved closely around the long term mean inflation rate of 8.5 per cent during the entire period of 1970-71 to 1998-99. This suggested that the year to year fluctuations in the inflation rate eventually revert to the average value and did not significantly alter the average inflation rate for the decade or for the sample as a whole. The trend inflation rate closely followed the which remained trend growth in M_3 within the range of 17 to 18 per cent in each of these decades. A simple correlation analysis of the inflation growth with one periodrate and M_3 lag suggested a fairly strong order of positive association between these two variables.

7.29 During ’nineties, the inflation rate (on a point-to-point basis) stayed above 10 per cent in four out of five years between 1990-91 and 1994-95, and thereafter declined to low levels reaching 4.8 per cent in 1998-99 and further to 2 per cent in the first quarter of 1999-2000. Chart VII.2 growth closely shows that while M_3 tracked the movement in inflation up to 1996-97, it deviated in the subsequent period, providing an indication of certain degree of overprediction of inflation rate by the growth. This deviation has been M_3 particularly significant in 1998-99 and during the current financial year up to June 1999.



7.30 The intra-year movement in the inflation rate during 1998-99 revealed a strong seasonal pattern, characterised by two distinct cycles—a steady increase from April to September 1998, followed by a gradual fall from October 1998 to June 1999. This seasonal trend was largely explained by inflation in the primary articles group which, with a weight of 32.3 per cent in the WPI, increased from 7.2 per cent in April 1998 to 16.8 per cent in November 1998, but declined thereafter to 3.3 per cent in June 1999. Much of this trend was led by the exceptional price pressure recorded in a few food articles and food products such as fruits and vegetables (mainly potatoes and onions), pulses, condiments and spices, raw cotton, oilseeds, sugar group and edible oils. The price rise in some of these commodities fluctuated from as much as over 50 per cent to (-)15.0 per cent between November 1998 and June 1999. The declining trend in primary articles inflation has been reinforced by the falling manufactured product inflation which, with a weight of 57.0 per cent, came down from 4.0 per cent in April 1998 to 2.2 per cent in June 1999. Even

the fuel group inflation has followed a similar pattern.

7.31 Whether the current inflation phenomenon could be reasonably explained by the monetary growth raises the issue of determining how much of this trend is due to permanent component and how much is in the nature of cyclical correction. As supply shocks played a dominant role in the inflation trend during the major part of 1998-99, a correction seems to have followed in the later months, exhibiting a kind of 'cobweb' response by producers to price signals. The bumper crop recorded in rice, wheat, oilseeds, sugarcane, pulses, and major fruit and vegetables in 1998-99 has led to excess supply conditions in some of these commodities, driving down their prices from the last year. The low primary articles inflation has also been contributing to reduction in the manufactured articles' inflation by bringing down the input cost of industries which are dependent on agricultural raw materials. Apart from supply shocks which have a transitory impact on prices, there has been the other type of 'real shocks' which seem to be at work in keeping the manufacture prices at a low level. For example, increased import competition together with the recent sharp decline in world manufacture prices seems to be contributing to low inflation in manufacturing sector in India through cost saving technological innovation and reduced mark up in domestic industries. Evidence also points towards positive productivity shocks in the post liberalisation period, which would normally contribute to improved price competition of industries in the domestic market.

7.32 The increasing share of the services sector in GDP and its inadequate reflection in WPI is yet another important source of recent divergence of the inflation rate from the money supply growth. To the extent that the economy is getting increasingly tertiarised, a price index based largely on goods inflation, would tend to deviate from the true level of inflation that can be explained by the overall demand and supply situation.

7.33 The money and inflation relationship also needs to take into account the transmission lag of monetary impulses, which can be both long and variable. Preliminary evidence in the Indian context shows that the full impact of a monetary shock on the inflation rate can take a long time to realise, and the lag could even exceed two years. Notwithstanding the fair degree of association between money and prices over a long horizon, the evolving transmission mechanisms in the more recent years, which are characterised by financial sector reforms and growing market integration, there would be increasing significance of the interest rate, with implications for the underlying relationship between the growth in money supply and inflation rate.

7.34 In the light of the transformation taking place in the growth projected in the economy, M_3 monetary and credit policy statement of April 1999 should be seen essentially as indicative of the stance of liquidity conditions. It should be utilised along with other indicators such as interest rates, exchange rates, fiscal and external positions, and flow of financial resources for purposes of monetary management. Such a multiple indicator approach, besides being informational, provides flexibility in conducting monetary policy as an essential part of the overall economic policy.

Financial Sector

7.35 Macroeconomic management to be effective requires the support of financial sector reforms, in particular those relating to the banking sector. It is for this reason that financial sector reforms were undertaken right from 1991-92. The reforms will not only promote allocative efficiency but also strengthen the soundness and stability of the financial system. In the process, however, financial entities will face severe challenges of competition in different segments and niches of the market. Financial market participants will have to put in place sound institutional mechanisms and risk management strategies that are backed by modern technologies, policies and delivery processes within a reasonable time frame so as to successfully overcome challenges of competition and improve customer satisfaction.

7.36 Commercial banks in particular have a critical role to play in such financial re-engineering. The performance of public sector banks, notwithstanding the improvement seen in recent years, has come under severe strain reflecting heightened market competition and other developments in the economy. Given the stickiness in the operating costs due largely to high staff costs, and the increasing requirements of provisioning on account of non-performing assets (NPAs), the profitability of banks has come under pressure. To overcome this problem, banks would need to expedite exercises towards consolidation, cost reduction and loan recoveries. The efforts of banks would need to be complemented by effective functioning of Settlement Advisory Committees and Debt Recovery Tribunals.

7.37 The working of the banks would need to be strengthened by undertaking legal reforms which encompass changes in the existing laws and introduction of new enactments. Delays in this area of reforms would be costly, in that it would lead to postponement of decisions by investors, and impede financial market development. Good legal support will enhance the soundness of banks which are presently seized with the problem of recovery of overdues. The establishment of debt recovery tribunals and the flexibility provided to banks to enter into compromise settlements have not as yet made much of an impact on the non-performing assets (NPAs) but would eventually turn out to be helpful, if they are supplemented by strong law enforcement and internal controls at banks.

7.38 From a medium-term point of view and for toning up operational efficiency of the financial system, it is imperative that banks adopt risk management and asset-liability management techniiques, efficiency promoting measures, enhanced transparency practices and prudential regulations consistent with the regulatory and supervisory concerns. These measures will help to improve the quality of lending. In addition, the banks will have to consciously adopt new technologies and modern systems and procedures, as well as network management to bring about improvement in productivity.

7.39 The Reserve Bank has taken a number of initiatives in this regard. Financial supervision has been comprehensive and has been brought close to international standards. The Reserve Bank has helped in the setting up of VSAT network and has worked out plans to modernise clearing and settlement systems. It also intends to adopt real time gross settlement system so that risks in payments are eliminated. These initiatives would need to be supported and strengthened by the Government through provision of adequate communication backbone and other infrastructure facilities.

7.40 As the financial sector grows, competition for improving share in it among different financial entities would intensify. In the process, institutions would get into those functional areas where growth prospects are perceived to be high. It is in this background, the issue of strengthening of development financial institutions (DFIs) and their regulation and supervision gain in importance. In the Indian context, DFIs have been the major providers of long-term and development finance in view of the somewhat underdeveloped state of the capital and debt markets. The Narasimham Committee on banking sector reforms suggested that DFIs should convert ultimately into either commercial banks or non-bank finance companies. The Khan Working Group held the view that DFIs should be allowed to become banks at the earliest. The RBI released a discussion paper on the subject. The feedback on the discussion paper indicated that while universal banking is desirable from the point of view of efficiency of resource use, both banks and DFIs should be cautious in moving towards such a system. Corporates continue to depend on DFIs for project finance. On the other hand, the necessary expertise and infrastructure facilities for extending short term finance lie with commercial banks.

7.41 The functioning of NBFCs has been a major source of concern in recent years. On its part, following legislative directions the Reserve Bank has exercised close oversight on NBFCs together with application of regulations that facilitate the growth of NBFCs on sound lines. It is essential to have a comprehensive and regular monitoring of all the critical areas of NBFCs' operations. NBFCs would need to be encouraged to adopt transparency practices and disclosure standards close to those applicable to commercial banks. This is necessary for giving confidence about the viability of the financial system and to enable NBFCs to play their legitimate role in the financial life of the country.

7.42 At present the regulatory and supervisory functions are performed by a number of agencies – the Reserve Bank of India, the SEBI, the NABARD and Registrars of Cooperative Societies. Within these organizations, these functions are performed in different Departments/Sections/ Units. While each organization attempts to coordinate its supervisory concerns and works out the required regulations, a co-ordination of oversight functions among the organizations, through a firmly established institutional arrangement, is vital for avoiding any systemic problems that may develop on account of the existence of interfaces among financial entities.

External Sector

7.43 Several unfavourable external sector developments during 1998-99 were addressed by policy initiatives, which eventually resulted in accretion of foreign currency assets, stability in exchange rate and improvement in foreign investor confidence. With the invisible receipts providing a source of strength, the external current account deficit in relation to GDP turned out to be about 1.0 per cent in 1998-99 as against 1.3 per cent in 1997-98.

7.44 While the outcomes turned out to be favourable, the perspectives on future policy actions need to reflect the concerns emerging from the interface between the domestic and international economies. The decline in exports in 1998-99 on top of the sluggish growth in the preceding two years is a matter that needs to be seriously addressed for two reasons.

First, a continuous negative net external demand will require the domestic demand to be

maintained at a high level, irrespective of the operation of economic cycles and trend factors. Secondly, it would reflect the lack of competitiveness as well as the absence of adequate economic diversification to cater to the changing tastes and preferences of international economy besides making the balance of payment situation unfavourable. Export policies that encompass technology and communications, marketing, standardisation and after sales services, should figure as an important requirement of the day, since they, along with the current efforts at providing adequate finances at competitive interest rates and maintaining stability in exchange rates, would help push exports in a sustained manner.

7.45 The external policy configurations in recent years have so far helped to contain the external current account deficit at a relatively low level, mainly because of dormant import demand coupled with subdued oil prices, and to enhance international reserves. The successful launch of the Resurgent India Bonds and the good accretion to NRI deposits during 1998-99 showed that international investors responded positively to domestic macro-economic environment and initiatives in building up financial soundness. It is important to persevere with the current policy of cautious and gradual easing of capital account items and to encourage non-debt creating flows to the extent possible. In this process, it is vital that external forward liabilities and short-term debt are continued to be kept within limits.

7.46 Detailed data dissemination and adoption of transparent practices have become major medium through which the interests of the investor community in India's economic development are maintained. In recent years, India has made enormous progress in this area, making use of the new technologies. An array of additional economic data in some areas (*e.g.*, balance of payments and GDP) has already been introduced and efforts to initiate such processes in other areas are underway.

Prospects

7.47 As we enter the New Millennium, there are clear signs of improved economic prospects with stability reflecting the gains from the adoption of prudent and carefully designed macroeconomic policies in recent years. Going by the latest indications, real GDP growth in 1999-2000 would be between 6.0 and 6.5 per cent. This would be in line with the average growth recorded in the five years between 1994-95 and 1998-99. Monsoon conditions seem to be once again good. Besides, incentive prices for kharif crops have already been announced. If the industrial recovery in the first three months is any indication, industrial production should increase at the rate averaged in the last four years, *viz.*, about 7.0 per cent. The very good output performance of capital goods industries augurs well, since this segment often acts as the main driving force of industrial growth. Services sector has been growing at a trend rate and has shown a tendency to post further gains whenever agricultural and industrial sectors perform well. The rate of inflation during the year is also likely to remain low and much below the long-term trend.

7.48 From the available indications, while fiscal developments in so far as the Central Government is concerned seem to be on course during the current year so far, it is important to ensure that the expectations of the Budget for 1999-2000 are fulfilled and fiscal deficit is not allowed to increase beyond the budgeted figure. Such a fiscal stance will help in keeping the

macroeconomic environment favourable for growth with price stability. The improvement in real growth prospects in recent months has enhanced the chances of augmenting revenues, and it is essential that growth in expenditures is also contained within the budgeted limits. Timely corrective action has also to be taken in this regard to reduce chances of further fiscal slippage in state finances. A deterioration in state finances also has implications for Centre's deficit. In this connection, the interest being shown by the State governments in undertaking fiscal reforms is welcome and has to be nurtured.

7.49 Monetary policy has rendered it possible to maintain liquidity conditions in support of financial market and real sector activities, with the result the interest rates have been fairly stable in the current year so far. The stance of policy enunciated in April 1999 has proved to be appropriate. The recent developments in the external sector show that the external current account deficit would once again be well within the sustainable level. Exports seem to have shown some signs of rebound in the first three months of the current year, and while import bill is likely to grow, under the impact of oil price increases, inward remittances continue to be buoyant. Capital flows have also been at a reasonable level to bridge the gap in current account deficit.

7.50 The gains at the turn of the new century need to be strengthened by persevering with structural measures that reduce institutional rigidities and further economic activity. Such a forward-looking approach alone will give the requisite added strength to meet the unexpected situations that may develop at home and abroad.

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

PART TWO : THE WORKING AND OPERATIONS OF THE RESERVE BANK OF INDIA

VIII BANKING AND EXCHANGE MANAGEMENT

COMMERCIAL BANKING

8.1 Some of the major policy reforms relating to commercial banking undertaken during 1998-99 have already been outlined in Section I of this Report. The thrust of the policy reforms in the banking sphere continued to be on moving towards internationally accepted best practices, including prudential norms, improved and transparent accounting framework, better disclosure norms and higher supervision and regulation standards. The fast changing financial environment has exposed Indian banks to risks in terms of interest rates and currency rates. The Reserve Bank, therefore, issued guidelines to banks relating to asset-liability management (ALM) and advised the banks to adopt appropriate ALM systems from April 1, 1999. It is expected that when the ALM stabilises, the banks would enable themselves to switch over to more sophisticated methods like 'duration gap analysis', 'simulation' and 'value at risk' models for interest rate risk management. Prudential, capital adequacy and provisioning norms, and valuation of the investment portfolio of banks were further strengthened during the year 1998-99 to move towards the international standards.

8.2 The present disclosure framework in bank balance sheets has shown that for more systematic analysis of the data and for undertaking meaningful scrutiny of the balance sheets to identify and analyse the key measures of returns and risks assumed by banks and to demonstrate the relationship between returns and risks, a uniform framework is required. A format has accordingly been devised to address this issue. The inputs and outputs that emerge out of the information sought through the format are broadly classified on the CAMELS basis, and are also utilised to measure the liquidity and interest rate risks assumed by banks.

Conversion of NRE Accounts of the Returning Indians into Resident Foreign Currency (RFC) Accounts

8.3 In April 1999, banks have been allowed to pay interest at their discretion, at the time of conversion of NRE account into RFC account even if the same has not run for a minimum maturity of six months, subject to the condition that the rate of interest does not exceed the rate payable on savings bank deposits held under the RFC account scheme and the request for conversion is received immediately on return of the NRE account holder to India.

Interest Rates on Deposits Accepted in Japanese Yen Under Foreign Currency Non-Resident Accounts (Bank)

8.4 The instructions relating to fixing interest rate of LIBOR minus 25 basis points on deposits accepted for six months and above but less than one year under FCNR(B) scheme was reviewed following the representation received from banks that this requirement resulted in negative interest rates for FCNR(B) deposits in Japanese Yen. It has, therefore, been decided that until further notice all scheduled commercial banks authorised to deal in foreign exchange may pay fixed/floating rate of interest 'not exceeding LIBOR' on deposits accepted by them in Japanese Yen for six months and above but less than one year under FCNR(B) Scheme. In respect of deposits of maturity of one year and above, the interest shall be paid within the ceiling of swap rates for the respective currency/maturity plus 50 basis points.

Performance Obligations and Commitments for 1998-99

8.5 In pursuance of the guidelines issued by the Reserve Bank in April 1992 which prescribed minimum capital adequacy norms by Indian banks in a phased manner, Government of India have been contributing additional capital to nationalised banks since 1993-94. The capital is being contributed on the condition that the banks would fulfil certain performance obligations and commitments required from them in respect of various business and functional parameters, in a time bound manner. Although no capital contribution was made by the Government to profit making nationalised banks since 1994-95, commitments from all nationalised banks were obtained and discussions held with them, as this exercise has been useful. However, starting from 1998-99, it was decided at the instance of Government of India, to hold such discussions with only those banks which did not qualify for autonomy in terms of prescribed standards of capital adequacy, non-performing assets and profitability.

Subsidiary for Credit Card Business

8.6 The State Bank of India was accorded approval for setting up a subsidiary for credit card business *viz.,* State Bank of India Cards and Payment Services Pvt. Ltd. (SBICPSL), jointly with GE Capital Corporation of USA, with a paid-up capital of Rs.100 crore, the bank's share being 60 per cent and the remaining 40 per cent being held by GE Capital Corporation. The SBICPSL commenced its credit card business from October 1998.

Bridge Loans

8.7 In January 1999, banks have been permitted to extend bridge loans, besides against the expected equity flows/issues, also against the expected proceeds of non-convertible debentures, external commercial borrowings, global depository receipts and/or funds in the nature of foreign direct investments, provided the bank is satisfied that the borrowing company has already made firm arrangements for raising the aforesaid resources/funds. The total amount of sanctions under such bridge loans should be accommodated within the ceiling of 5 per cent of incremental deposits prescribed for banks' investment in shares *etc*.

Issue of Shares by Private Sector Banks

8.8 The banks in private sector, hitherto, were required to obtain prior approval of the Reserve Bank for issue of all types of shares *viz*., public, preferential, rights/special allotment to employees and bonus shares. The working of these banks have been reviewed in July 1998 and it has been decided that in future, banks whose shares are listed on stock exchanges need not seek prior approval of the Reserve Bank for issue of shares, except bonus shares.

Liquidation and Amalgamation

8.9 As on December 31, 1998, 84 banks were in liquidation. The matter with regard to early completion of liquidation proceedings continues to be pursued with the concerned official/court liquidators. The Bareily Corporation Bank Ltd. has been amalgamated with the Bank of Baroda with effect from June 3, 1999.

Developments in Supervision

8.10 Following the Narasimham Committee report on Financial Sector Reforms, significant changes have taken place in the Indian banking system as well as in the regulatory and supervisory approaches and strategies. The Board for Financial Supervision (BFS), which was constituted in 1994 to suit the demanding needs of a strong and stable financial system functions under the aegis of the Reserve Bank. Under BFS, the Bank's supervisory strategy has changed from the system of periodic inspections to a system of 'continuous supervision and periodic inspections.' The key elements of the new supervisory strategy are: restructuring the system of bank inspections *i.e*., focus, process, reporting and follow-up; off-site surveillance as a supplement to on-site inspections; enhanced role for external auditors; and strengthened corporate governance and internal control and audit systems. In respect of on-site inspection, Reserve Bank's focus is now on the statutory mandate *viz*., protection of depositors' interests with concentration on a core assessment based on CAMELS model. The supervisory framework

prevalent in India is largely in compliance with the principles of the Basle Committee on "Core Principles for Effective Banking Supervision". However, some gaps were observed in the areas of risk management, consolidated supervision and inter-agency cooperation. In this connection the course of action following from the work done in the areas of risk management system for banks; amendments in banking legislation, structuring of the regime of penalties, introduction of consolidated supervision, home and host country relations, inter-agency cooperation and inter-department coordination are currently under implementation.

Off-site Monitoring and Surveillance

8.11 Off-site surveillance system was set up in 1995 for domestic operations of banks with the primary objective of estimating the evolving financial condition of banks in-between on-site examinations for purposes of undertaking any corrective actions, if needed. The off-site supervision has stabilised from the quarter ended March 1997 and a database on key banking parameters over the 10 quarters since then has already been built-up. The second tranche of four ALM returns covering liquidity and interest rate risk have been introduced with effect from June 30, 1999, initially on a quarterly cycle. To take on the increased volumes, the upgradation of banking statistics database work is in progress and the project is likely to put in place an off-site monitoring system by March 2000 with enhanced capabilities, which would further strengthen the supervisory system.

8.12 Besides off-site monitoring, quarterly on-site monitoring is undertaken in the case of newly licensed banks in their first year of operation as also private sector banks displaying weaknesses. Public sector banks displaying serious deficiencies are placed under special monitoring, while weak banks are monitored quarterly on the basis of structured financial data. As far as regular on-site inspection is concerned, all banks*i.e.*, public sector banks, foreign banks and private sector banks are inspected every year. The role of Reserve Bank nominee directors has been redefined with a view to improving their effectiveness and bringing in effective corporate governance at the Board level.

NON-BANKING FINANCIAL COMPANIES (NBFCs)

8.13 The Department of Non-banking Supervision (DNBS) has been entrusted with the responsibility of framing regulatory framework/policy as also of implementation of the provisions of the Reserve Bank of India Act, as amended, including registration of NBFCs with a view to bringing about necessary synergy between regulation and supervision. The synergy has been found to be indispensable for expeditious decision making on regulatory and supervisory concerns. All registered NBFCs with public deposits of Rs.50 crore and above will be inspected once in a year and registered NBFCs with public deposits between Rs.5 crore and Rs.50 crore once in two years by the Bank's staff. Registered NBFCs with public deposits of Rs.50 lakh but up to Rs.5 crore are inspected by engaging external auditors. One of the major planks of supervision of NBFCs is off-site monitoring. The NBFCs are required to submit to the Reserve Bank a set of periodical returns certified by their auditors. These returns which are very comprehensive in nature and coverage are analysed with extensive use of information technology for determining the quality of performance and adherence to regulatory standards prescribed by the Reserve Bank.

CO-OPERATIVE BANKING

8.14 The policy towards allowing new primary co-operative banks (PCBs) continued to be liberal depending upon the necessity and the prospects of achieving viability within a specified time frame. Relaxed Entry Point Norms continued to be extended to Mahila banks, PCBs for Scheduled Castes/Scheduled Tribes and for PCBs in North-Eastern States, and other least developed regions. During the period (July 1998-June 1999), 218 fresh proposals including 25 conversion proposals for setting up of new primary co-operative banks were received by the Bank. Of these, 107 proposals were cleared for registration, 3 proposals were closed for no response from the proposed banks and 77 proposals were rejected.

8.15 During the year licences were issued to 126 new urban co-operative banks for the commencement of banking business. Licences issued to the existing primary co-operative banks during the period June 1998-March 1999 were 21.

IX ORGANISATIONAL MATTERS

CURRENCY MANAGEMENT

9.1 The currency management function of the Reserve Bank received added momentum with the number of issue offices of the Bank (including two sub-offices) increasing to 18 in 1998-99 from 17 in the previous year and the number of currency chests operated by commercial banks and treasuries increasing to 4,163 from 4,140 in 1997-98. In all, the number of currency chests functioning as at the end of March 1999 stood at 4,181.

Monetary Museum

9.2 The Reserve Bank's Monetary Museum Website was inagurated on December 11, 1998. The site is the culmination of the Bank's endeavours to document and present India's rich monetary heritage to the domestic as well as international viewers. The site aims at depicting the evolution of money and banking in India. It includes representative Indian coinage from ancient times to the present, a retrospect of Indian paper money and other facets of India's financial history, like indigenous banking, financial instruments like hundies, share certificates, early GP notes *etc*. The site marks a beginning and will be updated from time to time (URL: www.rbi.org.in).

9.3 The Reserve Bank has been pursuing Year 2000 compliance in the banking and financial sector and advised banks and financial institutions to expeditiously achieve Year 2000 compliance of hardware, operating systems and application software, networking products, conversion of old data, *etc*. Besides, the Reserve Bank has been following vigorously to achieve Year 2000 compliance in different departments and offices of the Bank.

Computerisation of Central Office Departments

9.4 The previous year's Report contained a short description of the Human Resources

Information System (HRIS) developed by DIT for the Bank. The designing, development and testing of the HRIS package was done during this year. During 1998-99, DIT was actively associated in the development and modification of software for the use of Claims Section, 9 per cent Relief Bonds in dematerialised environment, Leave Package, RPCD, CAS Nagpur and Deposits Accounts Department. DIT was also involved in the development of System Requirement Specifications (SRS) and evaluation of packages for Bankers Training College, Inspection Department, Public Debt Office and Public Accounts Department of the Reserve Bank.

HUMAN RESOURCES DEVELOPMENT

9.5 The second phase of Satisfaction Survey indicated that the Net Satisfaction Factor (NSF), which is the difference in percentage terms between the number of responses indicating satisfaction (including high satisfaction) and the number of responses indicating dissatisfaction (including high dissatisfaction), has improved to 3.93 per cent as against an NSF of (-) 0.63 per cent in a similar survey held in February 1996.

9.6 Promotion policy in respect of class III employees was revised on the basis of the recommendations of the Study Group set up for reviewing the opportunities available for career growth of Bank's Class III employees. Furthermore, the career growth opportunities of security officers and Rajbhasha officers have also improved.

9.7 An HRD Workshop was held in February 1999 in Staff College, Chennai to discuss issues relating to promotion policy, recruitment, training and placement policies, work culture and organisational regeneration. Later, in April 1999 another workshop was held in CAB, Pune on the issues of promotion policy and setting up of a development centre. A cross section of officers including representatives of the officers' associations attended the workshop. HRD experts addressed the gathering. The workshops instilled a strong feeling of participative management among the participants and also provided inputs for policy reviews.

9.8 Under the Bank's Summer Placement Scheme for the year 1999, placements were offered to 17 summer trainees in Mumbai, Calcutta, Bangalore, Chennai and New Delhi offices of the Bank.

Regulations Review Authority

9.9 In pursuance of its constant endeavour towards making the organisation more responsive to the needs of its customers, the Reserve Bank has set up a Regulations Review Authority to seek suggestions from the public and various agencies for simplification of procedures/ regulations relating to the services rendered by the Bank. This is sought to be achieved by elimination of unnecessary circulars, cumbersome procedures and forms which do not fulfil their stated purpose, or which are no longer required in view of the changes that have taken place in technology, regulatory framework or market developments. The objective is to make the Reserve Bank regulations effective and simple and reduce unnecessary paper work in that process. Dr.Y.V. Reddy, Deputy Governor, Reserve Bank of India has been appointed as the Regulations Review Authority for one year with effect from April 1, 1999. The general response to the

setting up of the Regulations Review Authority has been quite encouraging. In the first three months itself more than eighty constructive suggestions have been received and they are under various stages of processing.

X THE BANK'S ACCOUNTS FOR 1998-99

10.1 The Bank has continued to maintain high standards of disclosure and transparency in the presentation of its accounts. In the background of policy developments elucidated in the preceding sections, the key financial results of the Bank's operations are presented in this section.

INCOME

10.2 The total income of the Bank for the year 1998-99, after various provisions, showed an increase of Rs. 5,136.69 crore (36.5 per cent) from Rs.14,083.64 crore to Rs.19,220.33 crore. The increase in income was mainly due to increase in earnings from domestic and foreign sources.

Income from Foreign Sources

10.3 During the accounting year ended June 30,1999, the Bank's net earnings from deployment of foreign currency assets including gold rose by Rs.619.25 crore (10.9 per cent) from Rs.5,687.34 crore in 1997-98 to Rs.6,306.59 crore in 1998-99. This was mainly due to higher average level of foreign currency assets at Rs.1,16,445 crore in 1998-99 as against Rs.96,659 crore in 1997-98.

Income from Domestic Sources

10.4 Domestic income rose by Rs.4,517.44 crore (53.8 per cent) from Rs.8,396.30 crore to Rs.12,913.74 crore reflecting increase in interest from holdings in Government securities, Ways and Means Advances to Central and State Governments and loans and advances to banks and financial institutions partially offset by decrease in commission income.

EXPENDITURE

10.5 Total expenditure of the Bank declined by Rs.217.02 crore (4.6 per cent) from Rs.4,762.11 crore in 1997-98 to Rs.4,545.09 crore. The decrease is mainly due to decline in expenditure on establishment and security printing which has been partly offset by increase in agency charges.

Interest Payment

10.6 Interest payment decreased marginally by Rs.22.59 crore (1.1 per cent) from Rs.1,999.23 crore in 1997-98 to Rs.1,976.64 crore in 1998-99 mainly due to decrease in payment in lieu of service charges on borrowings from IMF payable to Government of India, which has been offset partly by a small increase in interest paid to scheduled banks on their cash balances. While

decrease in IMF charges is due to reduction in Government's Liability to IMF, increase in interest paid to scheduled banks is mainly due to increase in the level of their balances eligible for reckoning of interest receivable.

APPROPRIATION

Net Disposable Income

10.7 The net disposable income for the year 1998-99 amounted to Rs.9,028.09 crore as against Rs.10,743.21 crore in 1997-98 (Table 10.1). Since 1991-92 significant transfers to statutory funds have been discontinued but pending amendment to the Reserve Bank of India Act, 1934 for vesting Bank with the discretion in the matter of transfer of amounts to statutory funds from the profits of the Bank, a token contribution of Rupees one crore each, has been made to the four statutory funds.

Surplus transferable to Government of India

10.8 For the year 1998-99, a sum of Rs.4,479 crore is transferable to the Government inclusive of Rs.1,479 crore towards interest differential on special securities converted into marketable securities. In the year 1997-98, Special Securities of the order of Rs.20,000 crore carrying interest at 4.6 per cent, held by the Bank were converted into marketable securities at market related rates to augment the stock of eligible securities in the Bank's investment portfolio for open market operations. The above transfer is intended to compensate the Government for the difference in interest expenditure, which the Government had to bear consequent on the conversion.

BALANCE SHEET

Liabilities

National Industrial Credit (Long Term Operations) Fund

10.9 The National Industrial Credit (Long Term Operations) Fund was established by the Bank in July 1964 with an initial corpus of Rs.10 crore and annual contributions from the Bank's disposable surplus in terms of Section 46C(1) of Reserve Bank of India Act, 1934. The Fund was applied for the purpose of making loans and advances to eligible financial institutions. Consequent on the announcement in the Union Budget for 1992-93, the Bank decided to discontinue the practice of crediting large sums to the said fund, except a token contribution. Simultaneously, no further disbursements from the fund have been made. It was decided in 1997-98 to transfer the unutilised balance in the fund to Contingency Reserve (CR) on a year to year basis. Accordingly, an amount of Rs.300 crore has been transferred to CR in 1998-99 as against Rs.400 crore transferred in the preceding year.

Exchange Fluctuation Reserve and Exchange Equalisation Account

10.10 Gains/losses on valuation of foreign currency and gold are not booked in profit and loss

account but in a separate account called Exchange Fluctuation Reserve (EFR), the balances in which represent accumulated net gain on valuation of foreign currency and gold. During 1998-99, there was a depletion of Rs.319.74 crore in the EFR reducing the balance to Rs.24,823.29 crore as on June 30, 1999 from Rs.25,143.03 crore as on June 30, 1998. This was mainly on account of depreciation in the international price of gold which was partially offset by appreciation in the value of foreign currency assets. EFR is also utilised for replenishing Exchange Equalisation Account (EEA) *inter alia* to meet exchange losses on accrual basis in respect of liabilities under schemes involving exchange guarantees provided by Reserve Bank in respect of funds parked by financial institutions like IDBI. The balance in the EEA as on June 30, 1999 amounted to Rs.618.61 crore and fully provides for the exchange difference on foreign currency funds parked by Indian financial institutions.

Contingency Reserve and Asset Development Reserve

10.11 The Bank maintains a Contingency Reserve to be able to absorb unexpected and unforeseen contingencies. The Bank has been pursuing a pro-active policy of strengthening the CR and has accordingly set an indicative target of 12 per cent of the size of the Bank's assets to be achieved in phases by the year 2005, subject to review, if considered essential. In order to be in a position to meet the internal capital expenditure and investments in its subsidiaries and associate institutions, the Bank had created in 1997-98 a separate 'Asset Development Reserve' (ADR) with the aim of reaching one per cent of the size of the Bank's assets within the overall target of 12 per cent set for CR.

ASSETS

Foreign Currency Assets

10.12 The foreign currency assets comprise foreign securities held in Issue Department, balances held abroad and a part of the investments with the Banking Department. Such assets which stood at Rs.1,01,830.77 crore as on June 30, 1998 rose to Rs.1,32,505.09 crore as on June 30, 1999. In US dollar terms, these assets rose from US dollar 23.98 billion as on June 30, 1998 to US dollar 30.56 billion as on June 30, 1999.

Investment in Government of India Rupee Securities

10.13 Investment in Government of India rupee securities which stood at Rs.1,42,417.43 crore as on June 30, 1998 rose by Rs.5,548.52 crore (3.9 per cent) to Rs.1,47,965.95 crore mainly due to devolvement and private placement of Government securities with the Bank, largely offset by Open Market Operations (sales).