VII ASSESSMENT AND PROSPECTS

7.1 Despite some continuing problems, the performance of the Indian economy during 1997-98 exhibited resilience and inherent strength to meet the many macroeconomic challenges posed by both domestic and international developments. The economy has steered clear of the kind of crises that engulfed some of the important South-East Asian countries during the year and the confidence in the capability and potential of the economy is well maintained.

7.2 The real GDP growth in 1997-98 is placed at about 5.1 per cent. This is lower than 7.5 per cent growth in 1996-97. The lower growth in 1997-98 largely reflected the decline in the output of 'agriculture and allied activities' and deceleration in industrial output. The trend growth rate during the 'nineties so far has averaged 6.1 per cent per annum as compared with 5.4 per cent in the 'eighties. Taking the entire 17-year period from 1980-81 to 1997-98, India's trend rate of growth has averaged 5.8 per cent per annum, which is significantly higher than the trended average rate for the developing world (about 4.7 per cent per annum) and advanced countries (about 2.4 per cent per annum). Indications of growth prospects in 1998-99 suggest that it is possible to maintain the trend rate of growth achieved in recent years.

7.3 The overall liquidity position in the fiscal year 1997-98 was comfortable, notwithstanding the strong monetary and credit policy measures undertaken in January 1998 to control the speculative tendencies in the foreign exchange market. It continues to be so in 1998-99. Financial intermediation through the organised banking system was at a high level, as reflected in the sharp growth in deposits of scheduled commercial banks and significant pick up in credit to the commercial sector. Inflation rate during 1997-98 (April-March) was low at 5.3 per cent on a point-to-point basis and 4.8 per cent on an average basis, compared with 6.9 per cent (on a point-to-point basis) and 6.4 per cent (on an average basis) during the preceding year. However, mainly due to seasonal factors, the inflation rate on a year-on-year basis has edged upward in the current year so far, causing considerable concern. The external sector position in 1997-98 remained strong, despite many uncertainties, with foreign currency assets going up by US $ 3.6 billion between end-March 1997 and end-March 1998. Recent international developments, however, have again been a matter of concern, requiring continuous watch and alert policy responses.

7.4 The downturn in industrial output, inflation, fiscal situation and slowdown of exports are the major areas which require to be addressed quickly by forward-looking monetary and fiscal policy initiatives.

Agriculture

7.5 Foodgrains output at 194.1 million tonnes in 1997-98 was lower by 2.6 per cent over the peak level of 199.3 million tonnes in the preceding year, mainly on account of the declines in the outputs of wheat and coarse cereals. Commercial crops other than tea and coffee too recorded output declines during the year. The price effect of this outcome is felt with a lag spilling over to the current year (*i.e.*, 1998-99). The composite food items index (consisting of food articles from the 'primary articles' group and food products from the 'manufactured products' group) estimated at 405.6 as on July 25, 1998 was higher by 10.1 per cent over the level of end-March 1998 as against an increase of 2.0 per cent in the corresponding period of 1997-98. The significance of this outcome becomes evident from the fact that the weighted contribution of the increase in the prices of food items in the rise in the 'all commodities' index of wholesale prices up to July 25, 1998 was as much as 70 per cent as against 42 per cent in the comparable period of last year.

7.6 The increase in the prices of food items, given the income levels, could translate into a wider inflationary phenomenon due to adverse price expectations. It is, therefore, necessary to signal to the markets the policy stance in respect of utilisation of buffer stocks of foodgrains (about 28.5 million tonnes at end-June 1998), while continuing with initiatives to reduce wastages and to bring about institutional changes such as the introduction of futures trading and application of definitive marketing practices and standards.

7.7 While these measures may be expected to have positive impact in the short end, enduring solutions to the problems of fluctuations in output and inflation expectations would be in improving agricultural productivity. The year-to-year fluctuations in the output of agriculture have been significant, imparting a degree of uncertainty to the needed balance between the real and financial sectors. The coefficient of variation in the index of agricultural production (triennium ending 1981-82 = 100) at 6.3 per cent in the 'nineties so far continues to be significant, though lower than that in the 'eighties. Given the share of agriculture in GDP at an average of about 26.8 per cent during the 'nineties, the variability in real GDP growth could be of the order of 150 basis points owing to fluctuations in agricultural output. Productivity gains which hold the key, would need to be facilitated by increasing cropping intensity, and application of regionally-differentiated production strategies, as well as farm technology upgradations including better water management and balanced ecological development. In addition, investments in irrigation and power as also creation and maintenance of rural infrastructure such as roads and warehousing would be vital for providing incentives to produce and opportunities to improve levels of income in the rural sector and linkages with the rest of the sectors of the economy.

Industry and Infrastructure

7.8 Industrial performance during 1997-98 was influenced by a host of domestic and international developments. The decline in agricultural production implied a fall in rural demand for consumer goods and for inputs in farming. Moreover, infrastructure bottlenecks, shifts in the pattern of production in anticipation of future demands and the consequential industrial restructuring, subdued capital market conditions, slackness in export demand and lower foreign exchange realisations on exports owing to an allround decline in international prices, especially of manufactured goods and uncertainties in the international economic environment and particularly in Asia have characterised the level and nature of industrial activity in the country.

7.9 Recent data on the index of industrial production in 1998-99, up to June 1998, show an improvement (5.4 per cent) over the position obtained during the corresponding period of the preceding year (3.7 per cent). Nevertheless, the delay in having a sustained upswing is a matter of concern. At the present juncture, the key to industrial revival lies in augmenting investment in economic infrastructure such as power, roads, ports and telecommunications. The investment requirements in this area are high and according to some estimates made in 1996, they could easily be anywhere of the order of Rs.4,000–4,500 billion over a five year period ending 2001. Such a large fund requirement cannot be met by the public sector alone, given the fiscal constraints. Private sector participation in this area is vital, and the Government has recently taken steps to have quick clearances for project proposals entailing large investments, both of domestic and foreign investors. More importantly, it is necessary to develop innovative instruments relating to both equity and debt markets for wider investor participation as also evolve approaches to have a transparent regulatory framework so as to bring about efficient mechanisms for risk allocation between the service providers and various entities in this process.

7.10 The large investment needs of the economy on account of infrastructure and social sector development, especially in the areas of human skills formation and health, cannot be satisfied unless the saving rate improves further from the present levels, even if there is an improvement in the productivity of investment. In particular, the financial saving rate would have to go up. The indication that this rate of the household sector saving has increased to 11.4 per cent in 1997-98 from 10.8 per cent in 1996-97 is an important signal that the saving potential of the economy would need to be tapped by suitable mechanisms of financial intermediation.

7.11 The transition to a more open and competitive system would offer new opportunities for growth in output and incomes but it also presents some challenges. The costs of industrial restructuring, which is reflected in growing number of mergers and acquisitions, can be high and have to be met by exploiting the economies of scale and scope. The pattern of production would have to move in line with market preferences, and business entities would need to learn to utilise information to improve their competitiveness. Economisation of inventories and planning of capacity improvements together with technological upgradations would have to be focal points of business decisions in the near future. These decisions could fructify in quicker time if infrastructure facilities are enhanced, coupled with improvements in both credit delivery and credit recovery systems.

Prospects for 1998-99

7.12 The prospects for agriculture for 1998-99 appear favourable. Till August 12, 1998, out of the 35 meteorological sub-divisions, only five sub-divisions have experienced scanty and deficient rainfall. The inter-temporal and inter-spatial distribution of rainfall this year is also considered to be good. There is, therefore, no reason why 'agriculture and allied activities' would not record a growth of over 3 per cent in 1998-99. Industry should also show a higher rate of growth than in the previous year in view of the expected stimulus from the rural demand and the planned initiatives in regard to infrastructure development. The services sector has been growing at 8-9 per cent in the medium term, and its share in real GDP is estimated at 48.6 per cent in 1997-98. On the basis of these trends, it should be possible to attain an overall GDP growth of about 6.5 per cent in 1998-99.

External Sector

7.13 The external sector developments in 1997-98 highlighted that macroeconomic fundamentals should be strong enough to take care of unanticipated external influences. The current account deficit, estimated at 1.7 per cent of GDP despite a sharp deceleration in exports, was easily sustainable. The year witnessed an accretion to international reserves of about US $ 3 billion, notwithstanding the pressures in the exchange markets, essentially reflecting inherent international confidence in the economy. After the onset of the South-East Asian crisis, there was an accretion of over US $ 2 billion to India's foreign currency assets during the period January to March 1998. What is significant to note is that foreign direct investment flows were sharply higher in 1997-98 (US $ 3,197 million) than in the preceding year (US $ 2,696 million) and were for the first time higher than portfolio investment flows (US $ 1,828 million). The composition of flows shows that inflows of relatively durable kind have formed a major proportion of total capital flows. While this trend would have beneficial effects, it is of utmost importance for effective long-term external adjustment that India's trade grows, and export competitiveness and export range are maintained at a high level. This would require that India's exports are cost competitive and of high internationally accepted quality. This point gains in critical importance when international prices of tradeables decline, as it had happened in 1997. Export growth in 1998-99, therefore, hinges not only on macro policies but also on micro policies that ease internal and industry specific constraints to growth of exports.

7.14 The accumulation of reserves based on non-debt creating flows has a favourable effect on the quantum of external debt and its sustainability. The available indications show that external debt expressed in US dollar terms remains sustainable. Total debt has gone up only by about US $ 1.0 billion during 1997-98, mainly under the impact of a large appreciation of the US dollar against major international currencies. It is important to note that debt service ratio, liability service ratio as also the short-term debt to total debt ratio have declined in 1997-98 as compared with those in the previous year. Short-term debt is placed at only US $ 5.0 billion at end-March 1998 as compared with US $ 6.7 billion at end-March 1997.

7.15 These indicators, together with reserve levels at over seven months of imports in 1997-98 and the relatively low current account deficit to GDP ratio (1.7 per cent) reflect continued international confidence in the Indian economy. It is, however, necessary to constantly monitor the external current account deficit position since this is often perceived as an important variable having a bearing on international confidence, as the recent South-East Asian country experiences demonstrate. Given the capital and invisible receipts, it appears reasonable to regard the current account deficit of about 2 per cent of GDP as sustainable. Recent developments in respect of the exchange rate of the Japanse yen and the Russian economy have added to the uncertainties, the implications of which are not clear at this stage. Nonetheless, the expected pick up in growth momentum in 1998-99 together with the relatively low level of oil prices in the international markets and the likely improvement in India's export competitiveness and invisible receipts should help maintain the current account deficit at a sustainable level.

Fiscal Policy

7.16 The fiscal position of the Government of India and state governments in the face of increasing social and economic responsibilities has been under considerable stress in recent years. There was on the one hand a less than estimated improvement in tax receipts partly on account of reduced income and partly on account of reduced tax rates. The increase in expenditures, on the other hand, was significant and was mainly on the revenue account, in part due to pay rises following the Fifth Pay Commission's recommendations, leading to a sharp widening of revenue deficit. The revenue deficit of the Centre has shot up to 3.1 per cent of GDP in 1997-98 as per the revised estimate as against 2.1 per cent in the budget estimates. This slippage has had an adverse impact on capital expenditures and social sector development. In 1998-99, the revenue deficit is estimated at 3.0 per cent of GDP, suggesting continued constraints on the feasibility of fiscal correction. Added to this, the high revenue deficits of state governments in recent years have placed high burden on the fiscal position. It is in this context that issues of reduction of subsidies, expenditure prioritisation and widening of the tax base gain in importance.

7.17 The growing reliance of the Government of India on the market to bridge the gap between its receipts and expenditures has posed a challenge to monetary management. Of the financial saving of the household sector, net of currency holdings and contractual forms, placed at Rs.1,16,056 crore in 1997-98, gross market borrowings of the Centre were as much as Rs.59,637 crore, forming about 51 per cent of the total. Private placements seem to have gone up sharply, amounting to Rs.27,069 crore as per the Reserve Bank's provisional data. This order of demand on financial saving of the household sector could be accommodated partly because of increase in the financial saving rate by 0.6 percentage point of GDP during the year. In 1998-99, however, gross market borrowings would go up sharply by over 33 per cent to Rs.79,376 crore, which would have to be accommodated by a substantial rise in household sector's financial saving. A number of private corporate entities in both financial and manufacturing sector activities, and public and joint sector entities are also likely to enter the market in the current financial year for raising funds through issuance of new equity, bonds/debentures and other marketable instruments. Hence there could be expectations of severe pressure on market interest rates but such expectations could get moderated by the fact that by August 18, 1998, 73.87 per cent of net borrowing programme of the Centre has already been met. It may be recalled that in the comparable period of last year, actual market borrowing was of a higher order and at the end of March 1998, the actual borrowing exceeded the planned borrowing by Rs.6,674 crore. It is essential to avoid the recurrence of borrowing in excess of planned amounts in the current year, in view of the risk this bears on rates of interest. Markets would closely watch the evolving fiscal position and in particular the progress in respect of disinvestment programme and collection of revenue receipts. Any indication of slippage in this regard could trigger unfavourable market expectations. As interest rates have impact on investment decisions, as well as on capital flows, it is imperative that fiscal management gives appropriate signals to the markets regarding its commitment to fiscal deficit reduction.

7.18 In regard to state finances, the quality and range of adjustment continue to present major challenges to overall fiscal management. The states' own taxes have been insufficient in relation to their growing expenditures. Apart from improving tax administration and compliance, the states would need to rationalise their tax structure and harmonise taxes (*e.g.*, moving to VAT from sales taxation), as also to explore newer avenues for raising resources (*e.g.*, tax on services). On the expenditure side, reduction of subsidies in non-merit goods sector is called for together with raising of user charges. Keeping in view the financial sector reforms, the states' market borrowing programme would also require to be conducted in a flexible manner, by gradually moving over from the fixed coupon rate system to an auction-based one. As of now, the states could exercise the option of borrowing 5 to 35 per cent of the amounts allocated to them through auctions. The states will also need to resist the demands on provision of guarantees, since they form part of contingent liabilities and have to be provided for to avoid defaults.

Financial Sector

7.19 One of the important features of the year is that economic developments in India were, to a noticeable extent, influenced by external uncertainties, especially relating to the South-East Asian crisis. This is because India's relations with the rest of the world have been growing not only through trade in goods and services but also through the financial system. During the last two years (1996-97 and 1997-98), capital account receipts (in the balance of payments sense) have been higher than export receipts and together with private transfers have been higher than external current receipts (excluding private transfers). It is because of this reason financial markets in India have become sensitive to changes in rate variables – exchange rates as well as interest rates, presenting challenges to macroeconomic policy making. Financial sector reforms and stability in conjunction with external adjustment have become important areas of interest for economic participants, both residents and non-residents.

7.20 Financial soundness and stability require that commercial banks and other financial entities follow prudential norms set for them and apply portfolio management strategies that optimise returns with minimal risk. Besides, the fiscal position would need to be strong, particularly where the role of the public sector is relatively significant, so that the financing needs of productive sectors are met at an appropriate cost. India has adopted prudential norms close to the international standards. All the public sector commercial banks, with the exception of two, have already attained the minimum capital adequacy ratio of 8 per cent. This ratio is to be raised to 9 per cent by the end of March 2000 and to 10 per cent thereafter at the earliest possible date.

7.21 The question of system stability is intimately connected with the level of non-performing assets (NPAs) and their ratio to total advances of public sector banks which account for about 85 per cent of total deposits of the scheduled banking system. NPAs, as per the first estimates, would, at the end of March 1998, be in the neighbourhood of Rs.40,000 crore. Net NPAs would amount to 8.69 per cent of net advances as against 9.18 per cent in 1996-97. It is necessary to reduce the level of NPAs not only by ensuring that fresh advances do not become NPAs through high quality credit appraisals and follow-up actions but also by strong programmes of loan recoveries. In this context, the suggestion of the Committee on Banking Reforms (Chairman: Shri M. Narasimham) to introduce asset reconstruction companies has been agreed to by Government of India for implementation on a pilot basis. Loan recovery tribunals would need to be set up expeditiously to speed up loan recoveries. Besides, to act as a deterrant to wilful defaulters and to safeguard the banks from risks of loan repayments, interest and liquidity, the legal framework would have to be fortified and put in place as quickly as possible to facilitate banks to improve their performance in respect of loan making.

7.22 The South-East Asian crisis has demonstrated the need for having strong supervisory arrangements not only for the sake of financial soundness but also for maintenance of international confidence in the economies. While the continuing capital account restrictions in India have played a part in reducing possibilities of strong capital outflows, the institutional apparatus in regard to financial supervision set up in the Reserve Bank as a part of the reforms process, has laid an important foundation stone on which the financial system can be modernised and strengthened. The Reserve Bank has been supervising not only commercial banks but also term-lending and other specialised financial institutions and non-banking financial companies. The emphasis is on putting into effect international best practices and on attaining CAMELS (capital adequacy, asset quality, management, earnings, liquidity and system) through offsite and onsite monitoring as also through institution of good transparency and auditing standards. This has helped to give two signals. First, the Reserve

Bank as much as the banks and other financial entities have sensitivised themselves to the need for promoting financial soundness. Secondly, international investors have been constantly monitoring the information about the financial sector strength and financial policies. In this context, India has taken a number of steps to disseminate as much economic information as possible through publications and through electronic media (websites) and in quick time. India has also accepted the Special Data Dissemination Standards (SDDS) and has already placed the required metadata on the bulletin board of the International Monetary Fund.

7.23 Soundness of financial sector should go hand in hand with quick credit delivery systems and processes for enabling the real sector activities to expand. The two areas where credit delivery system needs to be improved relate to rural lending and lending to small scale and tiny industrial units. Specialised apex institutions for these two areas have helped to enhance the amounts available for refinancing. New financial entities dedicated for the purposes, such as regional rural banks and rural branches and specialised branches of commercial banks, have provided credit but as various Committees have pointed out, there is a need for simplification of procedures for improvement of access and infrastructure as also for facilitating technology transfers.

Monetary Policy

7.24 Monetary policy during 1997-98 has had to contend with the slowdown in domestic economic activity and international developments. While the former required that bank credit flows into productive sector of the economy in appropriate quantities, the latter required that exchange rate stability and financial system soundness are maintained. The Reserve Bank responded to market developments with measures that have a bearing on liquidity and interest rates. Its actions were facilitated to a considerable extent by the relatively low inflation rates last year as measured by the changes in the index of wholesale prices of 'all commodities'. Reflecting the general slowdown in aggregate demand, the market interest rates softened considerably during the period, notwithstanding the relatively large Government borrowing from the market.

7.25 One of the important lessons of the 1997-98 experience is that monetary policy has to be continuously alert to market developments both at home and abroad, and corrective actions have to be appropriate and timely. While this may at times give rise to some discontinuities in the implementation of the pre-determined reform programme, such as the planned downward movement in cash reserve ratio, macroeconomic considerations dictate that stance of policies is adjusted periodically to the changing ground realities. Such an approach would lend a degree of flexibility to domestic monetary and exchange rate management. The effectiveness of this approach was amply demonstrated by the fact that the package of monetary policy measures announced on January 16, 1998 brought about, in quick time, orderly conditions in the foreign exchange market.

7.26 In pursuance of this approach, the monetary and credit policy for the first half of 1998-99 explicitly espoused the stance as reflecting the developments of the previous year and the broad objectives for the current year. While the fundamental objectives remain the same, structural measures have been given primacy of emphasis even as recognition is bestowed on the need for making short term adjustment in monetary policy measures. Banks have been advised to plan their credit operations in a manner that availability of credit would not be a constraint on growth of real output in the economy. An indication was also given that barring some unforeseen developments, sufficient liquidity should be available to finance additional production. In this context, the movement of broad money (M_3) growth for the year would serve as an important information variable. In addition, the Reserve Bank will, for policy formulation purposes, monitor multiple indicators such as interest rates, credits, fiscal position, capital flows, trade, inflation rate, exchange rate and foreign exchange transactions.

7.27 The fundamental issue in the conduct of monetary policy in a situation where markets are getting to be increasingly interlinked, relates to striking of a balance between the quantum of liquidity required to support economic activities and the interest rates which are reckoned in investment decisions. It would become necessary in not too distant a future to work out an indicator such as the monetary conditions index, and to evolve a model for liquidity forecasting on a periodic basis. This will provide a basis for a competitive and integrated domestic monetary and exchange rate management.

7.28 The role of open market operations (OMO) in such an environment is critical. While it is likely to overshadow instruments such as the cash reserve ratio over time, the Reserve Bank would have to, in the medium term, use Bank Rate, cash reserve ratio and refinancing in support of OMO. In order that OMO becomes effective, it is necessary to expeditiously bring about institutional changes that broaden and deepen the financial markets.

7.29 Since the beginning of the financial year 1998-99, there has been some evidence of excess liquidity in the system. M_3 growth, which had recorded a high of 17.6 per cent in 1997-98, has been increasing on a year-on-year basis by 17.3 per cent as of July 31, 1998 as compared with the increase of 16.8 per cent in the corresponding period ended August 1, 1997. The M_3 expansion is largely attributed to the increase in net bank credit to Government, especially in net Reserve Bank credit to Centre, and bank credit to commercial sector. This, in spite of a decrease in net foreign exchange assets of the banking sector, has resulted in excess liquidity. As strong industrial revival requires adequate credit support, it is of utmost importance that the pattern of credit disbursal is in favour of activities which generate output on a sustained basis. The present indications are that while food procurement credit has gone up, credit to petroleum companies has come down in the current year. As such, the remaining activities in the economy would be able to access the requisite credit, in view of the high deposit growth of about 20 per cent on a year-on-year basis as of July 31, 1998.

7.30 The annual inflation rate has been a little over 8.0 per cent on a point-to-point basis as of August 1, 1998 as against 3.86 per cent in the comparable period of last year. The dominant source of current inflation lies in the ‘primary articles’ group, within which major contributions were from ‘fruits and vegetables’, ‘oilseeds’ and ‘cereals’. Thus, the price situation seems to largely reflect shortage of supplies of certain primary articles and seasonal factors. However, the overall monetary situation would have to be carefully watched and brought under control so that inflationary pressures are eased. There is no trade-off between growth and price stability in the short run and the central bank of the country has to ensure that growth with price stability is achieved without compromising on the financial soundness of the system.

7.31 The international economic and financial situation continues to be uncertain and constitutes a major policy challenge for the world economy, in particular, for developing countries. The South-East Asian crisis which surfaced in July 1997 has shown some improvement at the beginning of 1998. However, in more recent months, many parts of the region and Japan encountered a number of economic problems. Apart from the pressures in the foreign exchange markets, capital markets have exhibited marked declines. Added to this situation, there have recently been unfavourable developments in the Russian economy. On the whole, the international scene has been unfavourable for developing countries as a whole. However, in so far as markets in India are concerned, the response has been fairly reasonable and less volatile than other countries in the region. It is necessary to persevere with prudent macroeconomic policies, particularly in regard to management of the external sector. It is also important to ensure that exports pick up and external current account deficit is sustainable. The current foreign exchange reserves position is strong, and the policy objective is to maintain a fairly high level of reserves in relation to current account position keeping in view uncertain international developments.