RBI Annual Report 2002-2003: Highlights

Assessment of 2002-2003

OVERALL PERFORMANCE

The Indian economy performed reasonably well in 2002-03, in spite of the impact of a number of adverse developments during the year, both internal and external. The country experienced its worst drought in fifteen years, which led to an estimated fall of 29 million tones in food production, the largest in a year since Independence. The tensions leading up to the Iraq war had resulted in a significant oil price rise. Furthermore, the global economy exhibited an environment of generalised uncertainty and low growth.

RESILIENT ECONOMY

A review of India's economy ever since Independence would show that the occurrence of any one of such shocks would have invariably produced an economic crisis involving a sharp loss of growth, higher inflation, balance of payments difficulties, and even financial instability in the economy. Seen in this context, the Indian economy exhibited remarkable resilience in the year gone by. Timely and coordinated supply management strategies were effective, with headline inflation remaining benign through most of the year; industrial activity witnessed a revival after a number of lean years; merchandise exports grew by 19.2 percent despite low world trade growth; foreign exchange reserves grew by US $22 billion, a record for any fiscal year for India. It is interesting to note that unlike other such difficult years in the past when India had to turn to the International Monetary Fund (IMF) for assistance, India actually became a creditor to the IMF under its Financial Transactions Plan.

INDUSTRIAL GROWTH

One notable feature of the country's economic performance in the last fiscal year has been the recovery of the industrial sector after an extended slowdown. Growth in sales and profits of large companies has shown encouraging trends. The fall in both nominal and real interest rates that has taken place over the past two years has aided this process of recovery. Industrial exports exhibited high growth on a broad basis, despite slow growth of world trade. The enhanced growth in non-oil non-gold imports in the current fiscal year is pointing to a continuing industrial recovery. Thus, industry is showing signs of increased competitiveness after a prolonged period of internal restructuring necessitated by competitive pressures emanating from both domestic and international sources.

MONETARY MANAGEMENT

Monetary policy was effective in ensuring stability and orderliness in the domestic money, debt and foreign exchange markets. The expansionary impact of large capital flows was managed through timely action in the form of open market sales and Liquidity Adjustment Facility (LAF) operations, supported by a sequenced liberalisation of outward international transactions. Interest rates declined in all segments of the market spectrum in response to the monetary policy stance of facilitating a softer interest rate regime that would support the revival of investment demand. The active management of liquidity conditions enabled the successful completion of the market borrowing programme of the Centre and the States. Public debt management was strengthened through prepayment of high cost external debt, debt swaps between the Centre and the States, along with a comprehensive restructuring of the scheme of ways and means advances and overdrafts for the States.

FINANCIAL STABILITY

Ensuring financial stability continued to be the dominant objective underlying the intensification of financial sector reforms during 2002-03. Prudential norms were strengthened further, consistent with the

strategy to bring about greater convergence with international best practices. Significant initiatives were taken to strengthen the balance sheets of banks. Better management of non-performing assets (NPAs) was enabled by the operationalisation of the Corporate Debt Restructuring (CDR) mechanism and the enactment of The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act. This will help the enforcement of creditors' rights and will also enable the establishment of Asset Reconstruction Companies (ARCs). The supervisory function was improved considerably through the institution of the Prompt Corrective Action mechanism as an early warning tool. The development of financial markets was carried forward by developing the infrastructure for the retailing of government securities by order driven, screen based trading in stock exchanges and the introduction of exchange traded interest rate derivatives. These developments will enable market participants to manage market risk better. The impact of financial sector reforms is reflected in an improvement in the profitability of banks and in the overall efficiency of the financial sector.

IN BRIEF

The Indian economy can, therefore, be seen as having matured, consequent to economic policy reforms and careful macroeconomic management. The role of substantial foreign exchange and food reserves in promoting such economic stability in the presence of domestic and international adversity needs to be explicitly recognised. Food grain reserves fell from about 63.1 million tones in June 2002 to 35.2 million tones a year later. There could have been significant price pressures had the food reserves been of a much lower magnitude. Similarly, the existence of large foreign exchange reserves has cushioned the economy from the emergence of any lack of international confidence that could have arisen from rising international oil prices.

Prospects for 2003-2004

GDP GROWTH RATE

The year 2003-04 has begun on a strong positive note. Excess rainfall relative to the long period average in July 2003 and revised projections suggesting a normal monsoon, have brightened the prospects for a substantial agricultural recovery this year. Based on information then available, the Reserve Bank had made a projection of 6.0 per cent growth in real GDP for 2003-04 in the Statement on Monetary and Credit Policy in April 2003. In light of the expected strong agricultural recovery along with a healthy industrial performance, that projection may now be exceeded significantly. However, a full reassessment of the projected growth rate for the current year will be attempted in the mid term review of the Monetary and Credit Policy in October 2003, by which time reliable information on the progress of the monsoon and spread of the industrial upturn will become available.

INFLATION

Inflation had exhibited a rising tendency toward the end of the last fiscal year, reaching a final rate of 6.5 per cent in the last week of March 2003. Based on a careful study of domestic and international price developments, the Reserve Bank had projected falling inflation from the second quarter of this year. That has indeed happened and headline inflation has fallen below 4 per cent now. In light of the normal monsoon and consequent agricultural recovery, inflation is expected to remain benign in the rest of the fiscal year, and could well fall below the projected rate of 5.0 to 5.5 per cent.

INFRASTRUCTURE REFORMS

Infrastructure reforms have begun to bear fruit. The past fiscal year witnessed rapid progress in the road sector, both in the National Highway Development Programme and rural roads. There have been palpable efficiency gains in ports through the privatisation of ports' services and berths: turn around time of ships has fallen significantly and waiting time for ships has been almost eliminated. The telecom sector has perhaps seen the most significant developments. Tariffs in the telecom sector have declined sharply in response to deregulation, competition and technology. Consequently, there has been a sharp increase in the growth of telephone lines, particularly in mobile services. Reforms in the power sector, however, are still in process, but are likely to accelerate after the passing of the Electricity Bill. The Ahluwalia report is now being implemented, with past

dues of State Electricity Boards being securitised, and the commitment of State Governments to be current on payments of dues henceforth. However, reforms in the civil aviation, urban infrastructure, and railways are still to take root.

Medium Term Issues

The Tenth Five Year Plan has projected an annual growth rate of 8 per cent in GDP as its target, a growth rate that is much higher than achieved so far in any Plan period. Achievement of such a growth rate will need increased investment rates accompanied by improvements in efficiency all round. Financing the increased investment rate will require a substantially enhanced domestic saving rate along with more efficient and higher absorption of foreign savings for investment. The ongoing reform process will therefore need to be intensified in all spheres, particularly in agriculture, industry and infrastructure.

AGRICULTURE

The drought of 2002-03 has renewed concerns relating to the high variability of agricultural output related to the performance of the monsoon. This is partly due to the concentration in the cropping pattern that has resulted from the Minimum Support Price policy favouring rice and wheat, and which skews the incentive structure away from other agricultural products. The issues arising from this policy are well known, as are its benefits. Whereas food security will need continuing emphasis through the assurance of adequate availability of essential food grains, and maintenance of food stocks, higher agricultural growth will now have to come from a much more diversified agriculture. Such diversification will need much more complex commercial linkages between farm and market, and greater attention to the potential for employment and value added provided by food processing activities. Investment in rural infrastructure such as rural roads, storage facilities, telecommunications, power and the like will need to be accelerated. The challenge will be to find appropriate sources of financing, and innovative processes for faster implementation and improved maintenance of such infrastructure assets. The forging of public private partnerships and greater participation of local governments will have to be pursued.

The successful introduction and implementation of the green revolution owed much to the support provided by the Indian agricultural research and extension system. Now this system must be geared to a reprioritisation of investment on new technologies so that agricultural diversification can be accelerated for the achievement of higher productivity levels. Effective adoption of new technologies in a wider variety of crops and other agricultural products will also require a different kind of extension system that is more flexible and customised to the needs of different farmer groups in different regions of the country. Here also the energies of the private sector have to be harnessed for the greater good.

INDUSTRY

It has now become evident that, in order to cope with the competitive rigours of the new globalising economic environment, the industrial sector has been undergoing very significant restructuring since the second half of the 1990s. The benefits of this ongoing process of restructuring are now being manifested through the improved industrial performance of 2002-03 and its continuation in this fiscal year, buoyant export performance of manufactured products, and better financial results of industrial companies. Further acceleration of this industrial recovery to achieve the 10 percent annual growth envisaged in the Tenth plan is a major challenge that will require a renewed emphasis on industrial reforms. First, the ongoing industrial tariff reform process towards lower tariff levels can be accelerated in view of the emerging competitiveness of Indian industry and consequent current account surplus. Industrial tariffs were reduced systematically during the 1992-97 period and then again since 2001. Industrial and export growth responded well in both instances. Second, good progress has been made recently in enabling potentially greater corporate flexibility in the face of a constantly changing economic environment. The reform in bankruptcy laws, implementation of the corporate debt restructuring mechanism, functioning of the Debt Recovery Tribunals and enactment of the SARFAESI Act are all steps in the right direction. These steps need to be reinforced through implementation of the proposed labour reforms, abolition of the urban land ceiling laws in the remaining states, and further progress in the removal of small scale industry reservations. The attainment of greater flexibility in the industrial sector will help in promoting greater growth in both industrial production and employment.

FINANCIAL SECTOR ISSUES

The overall policy environment has succeeded in fostering a significant degree of soundness in the financial system. Banks have gained from the falling interest rates that have enabled them to make significant gains from their large holdings in gilts. However, at the same time, banks need to make larger provisions for investment fluctuation reserves to take care of potential risks that are now inherent in a regime of flexible interest rates and exchange rates. In line with international best practices, the Reserve Bank announced a timetable to move to the 90-day norm for loan impairment, effective March 2004. Recent trends in exchange rate and interest rate movements have led to a greater demand from corporates for foreign currency loans from Indian banks. Since many of these loans could well be unhedged, banks need to put in place systems that monitor such unhedged external liabilities, along with measures to contain such risk. As the Indian economy opens further, such developments will need to be watched more carefully. Thus there is a general need for better risk management in the financial system through the pro active building up of investment fluctuation reserve, provisioning in respect of problem assets, sophisticated use of available derivatives, and the development of markets for risk management products.

Whereas the financial sector reforms have focused on improving the efficiency of the banking system, and more lately on risk management, it is important that banks continue to finance adequately activities that are of crucial importance to growth. The fostering of entrepreneurship in new industrial activities, in the emerging service sector and non-traditional agricultural activities, will all require proactive financing from banks and financial institutions. With the decline of the traditional term lending institutions, banks have to develop new appraisal capabilities so that these needs do not remain unmet. For the financing of larger corporates, the development of a vibrant corporate bond market is a must.

INFRASTRUCTURE

The key to more rapid industrial expansion in the medium term is the modernisation and deepening of physical infrastructure. Faster growth in infrastructure investment has been constrained by the lack of adequate cost recovery due to the levy of inadequate user charges, and inefficient collection mechanism. Provision for public goods has to be made from tax resources whereas private goods and services should be financed by the levy of user charges. Public private partnerships can also be used to beneficial effect in the efficient delivery of infrastructure services. It is at the State Government level that many infrastructure services are provided; hence reforms in the infrastructure sector, which also involve public sector reform, are equally important at both the central and state levels. Financing of infrastructure remains an important concern; it has to be addressed through a combination of greater facilitation of private investment, along with greater public investment as well. Improvement in the fiscal situation the country is, therefore, a primary requirement for accelerated all round growth.

FISCAL POLICY ISSUES

The main challenge that requires constant vigil in the macroeconomic sphere is that of reducing high fiscal deficits, at both the central and state levels. The issues governing fiscal problems are well known. The enactment of the Fiscal Responsibility and Budget Management Act is a very significant step in correcting the chronic fiscal imbalances that have emerged. Some states have also enacted similar legislations. Whereas expenditure compression must remain a continuing quest it is now difficult to make substantial savings because of rigidities in the composition of expenditure, except in the area of subsidies. The levy and collection of adequate user charges would help significantly in reducing non-merit subsidies at all levels. Much greater attention now needs to be paid to the revenue side. Despite healthy economic growth the tax/GDP ratio has fallen through the decade of the 1990s, and revenue deficits, therefore, now constitute more than two thirds of the fiscal deficit. This trend has to be reversed through more efficient and greater tax revenue collection at all levels. Use of information technology can revolutionise the systems of tax collection. The strength of the country's information technology sector can be put to good use for this purpose. These actions are essential to correct and reverse the trend of increasing public sector dissavings that have emerged in recent years. Positive public sector savings are necessary to finance essential physical and social sector investments that will crowd in private sector investments for the achievement of higher self-sustaining and accelerated growth.