

## Recent Economic Developments

### I. Review of Growth Performance in 2002-2003:and Outlok for 2003-04

- Growth in 2002-03 estimated to drop to 4.4% from 5.6% in 2001-02.
  - Quarterly growth rate indicates a decline from 5.8 % in Q2 to 2.6 % in Q3 of 2002-03.
  - Growth rate has slowed down from an annual average growth of 7.5 % during 1994-1997 to 5.4 % during 1997-2002.
  - During this period there has been a significant narrowing down of the output gap. The decelerating trend in the potential growth rate during the latter half of the 1990s reflects the persistence of structural constraints and may have implications for the medium-term growth outcome.
1. The slowdown in GDP is mainly due to sharp fall in agricultural growth by 3.1% in 2002-03 in comparison to a rise of 5.7% in 2001-02. Drought conditions during the south-west monsoon have led to an estimated decline of 28.9 mt. in foodgrains production. Impact mainly on rainfed cultivation – rice, coarse cereals and oilseeds.
  2. The slowdown was reinforced by a hesitant recovery of global output and trade. Compared to 2.3 % growth rate in 2001, world economy estimated to grow by 3.0 % in 2002.
  3. In sharp contrast to declaration in agricultural GDP, industry and services sector continued to provide inputs to growth.
  4. Industrial growth (GDP) is expected to accelerate to 5.8% in 2002-03 from 3.2% in the previous year.
    - a. The higher growth would be prominent in all the constituent sectors.
    - b. Industrial production (IIP) grew by 5.5 % in first ten months of 2002-03 compared to 2.6% in 2001-02.
    - c. Higher manufacturing growth of 5.8 % in first ten months of 2002-03 relative to 2.6% in 2001-02.
    - d. High-value additive and employment-intensive industries like: beverages & tobacco, food products, chemical, transport, basic metal & alloys, and textile products giving a fillip to the industry
  5. The incipient industrial recovery during 2002-03 emanated from:
    - a. Favourable impact on industrial demand from a revival of export demand and sharp expansion in construction activity.
    - b. Rising business confidence and consumer sentiments.
    - c. Conducive macroeconomic conditions like...
      - i. Pick up the infrastructural services.
        - Ø Impressive growth of 5.3 % achieved in first eleven months of 2002-03 compared to 3.2 % in 2001-02.
      - ii. Softening of interest rates.
        - Ø
      - iii. Slight increase in manufacturing inflation.
      - iv. Pick up in non-food credit offtake. Signs of recovery -

1. Grew by 18.8 % in Mar. 7, 2003 as against 5.6 % in corresponding period of previous year.
  2. Deployment of non-food credit more pronounced for medium and large-scale industries, housing and agriculture.
  - v. Turnaround by capital goods in 2002-03 – Feel good factor in industrial recovery
    1. Capital goods production grew by 10.6 % in first ten months of 2002-03 as against a decline of 4.8 % in 2001-02
    - 2.
6. The buoyancy in the services sector continued to strengthen during 2002-03. Services sector registered a growth of 7.1% in 2002-03 as against 6.5% and 5.8% in the previous two years.
- a. The robust services sector growth has been mainly driven by information technology and software services, growing by a phenomenal annual average growth rate of 50% during the second half of 1990's.
  - b. The growth in services sector is sustained by an increasing demand for producer and consumer services coupled with external demand. The contribution of public administration and defence in the growth process of the services sector has been limited.
7. Notwithstanding the agricultural led slowdown, the overall macroeconomic conditions were conducive to the growth process.
- a. In response to drought, better food management policies helped in containing price of food. The rises in prices of primary food articles were contained.
  - b. Inflation remained benign during 2002-03, increasing by 6.2 % in 2002-03. The edging up of inflation is partly due to base affects and rising international oil prices.
2. International economic prospects:
- a. World output is projected to increase by moderately to 3.7 % in 2003.
  - b. The geo-political uncertainty created by the US-led war on Iraq seems to be over and would augur well for recovery of the global economy.

### **III. Major Issues:**

1. Reinvigorating growth in agriculture would require.
  - a. Price system encouraging dissatisfaction towards high value added segments in response to the new demand structure in agricultural sector.
  - b. Rationalisation of subsidies (fertiliser and food) and economically viable user changes (power and water) to augment resources for productive investment in rural infrastructure.
  - c. Develop adequate storage facility to give boost to food processing industry, which have high growth potential.
  - d. Standardisation of product quality for encouraging exports.

2. The buffer stock of foodgrains at 40.1 mt in January 2003 is two-and-a-half times the minimum norms – after declining from a peak of 64.8 mt in May 2002 due to relief measures arising out of drought. Piling of buffer stock have both monetary and fiscal implications and have taken place primarily due to:
  - a. The price distortion with MSPs of rice and wheat rising continuously in contrast to the declining trend in international prices leading to higher procurement.
  - b. Off-take remained low due to rise in central issued price and shifts in the consumption patterns away from cereals to non-traditional foods items.
  - c. Requires corrections of the distorting trend in prices.
3. Indication of declining productivity growth (rising ICOR) in the latter half of the reform period reinforces the need for accelerating the pace of structural reforms like.
  - a. Rapid bankruptcy procedures.
  - b. Faster transformation of urban land use.
  - c. De-reservation of small-scale industries and undertaking technology upgradation to make them competitive.
  - d. Labour market flexibility.
4. Labour market flexibility should be supported by:
  - a. Replacing the Contract Labour Act by one, which recognises that outsourcing of services in a normal activity and would thereby promote unbundling of production and its distribution.
  - b. Reactivating VRS scheme:
    1. Doing away with the requirement of prior permission for closure of a unit.
    2. Creating a safety net by
      - I. Levying a cess on the corporate sector supplemented by budgetary support.
      - II. Creating annuity-based fund to finance VRS, workers' retraining and public sector restructuring.
  - c. Raising the floor for retrenchment for units employing to atleast 1,000 workers from the present level of 100 workers.
5. Poor performance of the public sector saving has eroded the investment capacity of the country, particularly public sector investment for generating higher economic growth.
  - a. Widening dissavings since 1998-99 : at -2.5 % of GDP in 2001-02.
  - b. Reversal of public sector dissavings would require.
    1. Major improvement in the tax GDP ratio.
    2. Rationalisation of user charges in the services rendered by public sector enterprises.
6. Real interest rates are significantly higher as compare to other emerging market economies. However, further lowering of interest rates would involve:
  - a. Check in the growth of market borrowings by the central government and reduction in the fiscal deficit.
  - b. The deposits and lending rates of banks continue to be sticky largely reflecting large order of NPAs on their books and administered interest rates in small savings instruments. This has blunted the effectiveness of monetary policy in the interest rate

channel of monetary policy transmission. To promote interest rate flexibility for the banks to pass on the rate cuts to the borrowers would require:

1. Improving the asset quality of the banks
  2. An efficient, productive and competitive banking sector operating on a narrow spread and low cost of intermediation and would thereby be in a position to absorb the reduction in interest rates.
  3. Adoption of floating rate deposits and flexibility in the interest rates of competing assets.
  4. An active asset-liability risk management by the banks.
7. The combined Centre and State fiscal deficit has reverted back to the previous peak level witnessed in early 1990s.
- a. The widening fiscal deficit has adversely impacted not only investment capacity but also the quality of expenditure. The deterioration in the fisc is due to:
    1. Decelerating tax-GDP ratio.
    2. Stickiness in current expenditures due to growth in committed expenses such as interest payments, subsidies, and wages and salaries.
    3. Slow progress of restructuring PSUs.
    4. The poor finances of the State Electricity Boards
    5. Simultaneously the growing public debt- mainly domestic debt has reached unsustainable proportions.
  - b. A durable fiscal consolidation can be achieved by:
    1. A phased reduction in the revenue deficit, which preempts much required resources for productive and capital expenditure.
    2. Prioritisation of expenditure entailing pruning of subsidies and streamlining and downsizing government administrative machinery.
    3. Adopting rule based fiscal policies and speedy implementation of proposed Fiscal Responsibility and Budget Management Bill.
    4. Accelerating the process of disinvestments and using its proceeds to retire high cost debt .
    5. Stepping up the tax GDP ratio through:
      - I. Rationalisation of the tax structure,
      - II. Widening of tax base by phased reduction in tax breaks / exemptions and
      - III. Bringing more services within the tax net.
    6. Restoration of fiscal balance of State governments would require:
      - I. Raising user charges.
      - II. Overhauling tax collection machinery to achieve better tax compliance.
      - III. Raising returns in State PSUs through appropriate pricing policies.
      - IV. Eliminating implicit subsidies
      - V. Implementing VAT which would eliminate competitive tax concessions to arrest the dampening of tax buoyancy across states
8. The widening fiscal deficit has adversely impacted not only investment capacity but the issue of fiscal dominance has led to complexities in monetary policy objectives:

- a. Weak credit demand enabled RBI to trade the surpluses of the banking system with the deficits on Government account by banks investing in gilts. At the same time the spurt in capital inflows over the last two years led to shrinking net domestic assets of the RBI, which could impose limits on the scope for sterilisation in the future.
  - b. The easy monetary condition could change very quickly if there is a sudden pick up in the industrial activity and/or if capital flows dry up. This is especially since banks already hold a large portfolio of government securities – well beyond the statutory requirements.
  - c. A solution to such contradictions between fiscal and monetary policy objectives could be reducing RBI's role in primary subscription and limiting the fiscal deficit in the near term and separation of internal debt management from monetary management functions in the long term.
9. The capital requirement of the banks is likely to increase in the coming years requiring the banks to generate sufficient funds internally due to the depressed capital market conditions. The capital requirement will increase with:
- a. the pick up in credit demand and
  - b. the implementation of the prescribed norms of the New Capital Accord in 2006 which accords greater emphasis on risk-sensitivity in credit allocation.
10. The recent enactment of the Enforcement of Security Interest Act, 2002 has increased the momentum for the recovery of NPAs. However, a speedy resolution of the NPA overhang would require:
- a. intensification of efforts by banks to recover their dues and
  - b. limit generation of fresh NPAs through appropriate credit appraisal techniques as opposed to risk-averse banking practice by investing in gilts.
11. Future banking operations would entail following prudent practices:
- a. To undertake proactive risk management by identifying, measuring and controlling risks through establishing sophisticated technical systems and management processes.
  - b. Inculcating corporate governance in terms of house keeping, audit and accounting practices, disclosures, asset-liability management and systems management.
  - c. Progressively reducing ownership in public sector banks to make them more amenable to market discipline and reduce the possibility of regulatory forbearance.
  - d. Forward-looking provisioning by banks to circumvent the countercyclical behaviour of NPAs in the event of a downturn in economic activity.
  - e. Introduction of a risk-based deposit insurance premium to provide a safety net for depositors.
12. Duality of control over co-operative banks by RBI and state governments has posed concern over the sharing of responsibilities among the regulatory and supervisory authorities. This needs to be resolved urgently.
13. With some DFIs converting themselves into banks or NBFCs, an important source of long-term funds may dry up and may not be compensated by term-lending operations by banks. To fill the gap would require:

- a. Development of a corporate debt market.
  - b. Development of a benchmark in the fixed securities market.
  - c. Development of secondary market for corporate debt to stimulate banks' investment in corporate securities.
14. To enhance the depth and liquidity in the forex market would require:
- a. Assumption of the role of market makers by large public sector banks who handle the major portion of the export-import transactions.
  - b. Pick up in the activity of forex derivatives would sequentially require the development of:
    - i. A deep and liquid inter-bank term money market.
    - ii. A liquid forward dollar-rupee market.
    - iii. Rupee-based derivatives.
15. Preponderance of privately placed debt issues has adversely affected the process of price discovery in the debt market. This could be corrected by:
- a. Strengthening the norms for corporate disclosure.
  - b. Revive the public issues segment of the primary market.

World trade recorded subdued growth of 2.9 % in 2002.

- Ø However, it is expected to pick up to 4.9 % in 2003 and 6.4 % in 2004

Exports staging a robust recovery in 2002-03 despite sluggish global trade

- Ø Exports grew by 16.8 % in first eleven months of 2002-03 compared to a decline of 0.7 % in 2001-02

- Ø Minerals & ores and Manufactured goods like gems & jewellery, handicrafts, engineering goods and chemicals leading the exports rally in 202-03.

• Growth in imports at 16.3 % in the first eleven months of 2002-03 compared to 0.9 % in 2001-02

- Ø Imports growth picking up in 2002-03 – mainly due to oil imports growing at 26.3 % in Apr 2002 – Feb 2003

- Ø Non-POL imports grew by 12.5 % in Apr-Feb. 2002-03, compared to 7.3 % in 2001-02

• Significant revival of growth in capital good imports in 2002-03 : 30.4 % in Apr.-Nov. 2002 compared to 5.3 % in previous year

- Ø Reflecting pick up in business confidence

Trade deficit narrowed substantially since 2000-01

- Ø Trade deficit at US \$ 9.8 bn. in Apr-Dec 2002 as against US \$ 10.4 bn. in the comparable period of previous year

Current account balance have been in surplus since 2001-02 (at 0.3 % of GDP).

- Ø In Apr-Dec 2002, current account balance is in surplus at \$ 2,819 mn compared to deficit of \$ 666 mn in Apr-Dec 2001.

Foreign investment has slowed down during 2002-03.

- Ø FII inflows showing a downward trend since 2000-01 - declining from

- Ø Foreign investment inflows during Apr.-Dec 2002 at US \$ bn. have been slightly lower than the corresponding period in the previous year (US \$ bn.)

Reserves accumulation in the last 24 months amounted to \$ 33.1 bn.

- Ø Reserve at US \$ 75.4 bn. at end-March 2003.

Significant improvement in external debt – India now classified as a low-indebted country.

- Ø Debt-GDP ratio declined to 20.1 % of GDP at end-Sep 2002 as against 20.9 % at end-March 2002.

- Ø Debt service ratio declined from 15.4 % of current receipts in 2000-01 to 13.6 % in 2001-02. During Apr-Sep 2002, the ratio is estimated at 14.2 %.

Fiscal deficit for 2002-03 at 5.9 % of GDP marginally higher than budgeted level of 5.3 %.

- Ø Despite lower than budgeted expenditure, fiscal slippage due to shortfall in realisation of revenue and disinvestment proceeds
- Ø Market borrowings by central government zoomed to 80 % of fiscal deficit in 2002-03.
- Ø Total debt of Central Govt. increasing since mid-1990s and at 63.8 % of GDP – close to the peak level in 1991-92.
- Ø Internal debt increased to unsustainable levels
- Ø Combined deficit estimated at 9.5 % of GDP in 2002-03 compared to 10.3 % in 1990-91.
- Ø For 2003-04, the fiscal deficit is budgeted at 5.6 % of GDP