

Macro-economic Scene and Emerging Issues

Friends, it is a pleasure and a privilege to be here among you today. We meet at a fortunate and opportune time.

1. Our foreign exchange reserves are at an all time high.
2. The Indian equity market has picked up with the BSE Sensex staging a 26-month high.
3. India has again become a creditor to the IMF after a brief period in 1978-80. India has been selected by the International Monetary Fund (IMF) to become a member of its Financial Transaction Plan (FTP) from the quarter September-November, 2002. The first transfer of SDR 5 million under India's participation in FTP was effected on May 07, 2003. The second transfer of SDR 200 million was effected on June 17, 2003.
4. Prof. Raghuram Rajan - an Indian has been appointed as the chief economist of the IMF – the youngest ever to have achieved this feat.
5. The Indian hockey team has returned home with success unprecedented in recent years.
6. Geeta Anand - an Indian has won the Pulitzer prize for her sensitive and responsible reporting with Wall Street Journal - one of the leading newspapers in the United States of America.

While all these developments will bring enough cheer to us, this is perhaps an appropriate juncture to introspect collectively on the challenges we face today.

1. The latest Human Development Report by the UNDP indicates that India's Human Development Index Ranking has slipped by three notches to 127 out of the 175 countries.

2. The Report highlights the fact that despite huge buffer stock foodgrains, Indian has earned the dubious distinction on homing one-third of the world's hungry people.
3. On education front too, the picture is quite grim for India. According to the Human Development Report, out of a total world population of 115 million children who do not attend school, India accounts for 40 million dropouts.
4. While diseases like HIV/AIDS, tuberculosis and malaria continue to plague India, there is also an urgent need to provide drinking water and sanitation facilities.

The approach for my discourse today is structured in the following manner:

1. Pressure Points in 2003-03
2. The Counter-Active interface with the pressures
3. Performance in 2002-03
4. Outlook
5. Concerns and Challenges

Pressures Points in the Economy in 2002-03

Let me first turn to the several challenges that the Indian economy faced during 2002-03.

1. Severe drought was experienced after an unbroken spell of normal monsoons for 13 years. The South-West monsoon of 2002 received rains measuring only 81 per cent of the Long Period Average (LPA) with only 15 out of the 36 meteorological sub-divisions receiving normal/excess rainfall. The north-east monsoon was also delayed with 26 sub-divisions receiving scanty/deficient rains. Moisture stress in 2002-03 was comparable in scale and intensity with the severe drought of 1987. Agricultural production contracted by as much as 12 per cent with the decline spread across-the-board – production of rice fell by 16.2 million tonnes, that of coarse cereals by 8.8 million tonnes and sugarcane by 20.8 million tonnes. While the drought situation generated some pressures on the price situation, the supply-side shocks in the form of hardening of international crude oil prices due to the military action in Iraq drove up the headline inflation rate to levels above 6 per cent by the close of the year. The slowing down of economic activity generated shortfalls in tax collection, while the imperatives of drought drove up food subsidies. Disinvestment lagged behind its budgeted targets. Thus, the combined gross fiscal deficit of the Central and State budgets overshot its budgeted level by one per cent of GDP.

2. Monetary policy had to contend with large capital inflows amounting to around US\$12.6 billion on top of the US\$ 10.6 billion which had poured in during 2001-02 testing, as it were, the balancing act of the monetary authority. The primary liquidity generated by this substantial accretion to the net foreign assets (NFA) was sterilised through active recourse to open market sales to the extent of Rs.53,780 crore, in net terms. Presence of excess liquidity necessitated daily repo operations under the liquidity adjustment facility (LAF),

averaging daily to more than Rs.10,000 crore during the year. As a result, the net domestic assets (NDA) of the Reserve Bank declined to barely 2.9 per cent at end-March 2003. Liquidity overhang frequently drove the overnight money market rates below the repo rate, representing the floor of the informal corridor set for the movements in the money market rates. The sovereign yield curve steepened during the year as the short-term rates generally ruled around the repo rate, while long-term yields softened substantially.

3. The external sector too faced its share of challenges. In particular, it had to confront weakness of the global recovery, a surge in import demand and declines in equity markets. Border tensions and geo-political uncertainties in Iraq too posed problems for the external sector.

The Counter-active Interface with the Pressures

The resilience of the Indian economy was manifested itself as we faced these challenges head-on. The efforts at building up of buffer stocks were vindicated as an inventory of over 50 million tonnes came in handy for mitigating the adverse effects of production shocks on food consumption. An increase in off-take of foodgrains by around 12.2 million tonnes was facilitated by decreasing the issue prices under Targeted Public Distribution System (TPDS) for above poverty line (APL) families and by increasing the monthly allocation for all the family groups. Central Government allocated 8.3 million tonnes of foodgrains to the drought-affected States. Supply side management reined in the WPI inflation rate from almost 4 per cent in September 2002 to 3.2 per cent in December 2002.

[A counter-drought fiscal policy stance was reflected with increased spending on food and input subsidies. The other expenditures were accordingly reined in to control the fiscal slippages. Defence expenditure, interest expenses,

pension outgoes and grants and loans to States and Union Territories were lowered. There was also a renewal of qualitative fiscal adjustment through monitorable reform programmes and appropriate incentive structures, especially at the sub-national level. Debt consolidation was carried forward and measures to improve tax buoyancy continued.]

Monetary policy also geared itself into mitigating the deleterious effects of the drought on farm output and rural incomes. Easy monetary policy was signalled through cuts in the repo rate (June and October 2002 and March 2003), in the Bank Rate (November) and in the CRR (June and October). Interest liabilities on farm loans were deferred and agricultural loans were rescheduled to provide a measure of financial relief to the drought-affected areas. Although money supply growth and deposit growth slowed down, supply of non-food credit by the banking system remained buoyant supporting industrial recovery. The increased off-take was well distributed across industries like infrastructure, housing, cement, cotton textiles, gems and jewellery.

The Performance in 2002-03

Timely counteractive policy measures enabled the real GDP to record a growth of 4.3 per cent during 2002-03. Though lower than the 5.6 per cent growth recorded in the previous year, in the foreground of several domestic and international shocks and generalised slowdown in the world economy, this attested to the underlying resilience of the Indian economy in recent years.

A broad-based revival in industry and resumption of growth in services supported the GDP growth in face of a contraction of output in agriculture. Industrial upturn started from the first quarter and moved towards its trend levels subsequently recording a growth of 5.7 per cent in its gross value added, much above that of 3.2 per cent in 2001-02. Sector-wise, the rebound came in manufacturing, and mining and quarrying. Upsurge in manufacturing was led

by five industry groups, comprising 'beverages, tobacco and related products', 'food products', 'transport equipment and parts' and 'basic metals and alloy industries'. Business confidence improved in all sectors in the foreground of improvements in the financial performance of the corporate sector, slowdown in inventory accumulation, and an expansion in capacity utilisation.

Industrial activity was broadly insulated from the impact of the drought, except in the durable consumer goods segment where the compression of incomes affected production. The trebled growth in consumer non-durables (12.3 per cent over the previous year) accounted for almost half of the increase in industrial growth. Basic goods also accelerated to a growth of 4.8 per cent from 2.6 per cent in 2001-02.

A striking feature of the industrial climate was the turnaround in the capital goods production from a contraction of 3.4 per cent in 2001-02 to an increase of 10.6 per cent as also doubling of the growth of capital good imports of around 30 per cent which augurs well for the economy. Intermediate goods shared in this expansion though on a more moderate scale. Production conditions improved in infrastructure with the growth accelerating to 5.2 per cent from 3.5 per cent. The acceleration occurred in finished steel industry due to a strong external demand as also buoyancy in the cement sector. Increased export demand, policy initiatives for the setting up of food parks and turnaround in the steel industry during the year on account of increase in international prices and the highway construction under the National Highway Authority of India (NHAI) for the 'golden quadrilateral' all contributed to the recovery in industrial activity.

[The process of industrial restructuring and consolidation through mergers and acquisitions was, however, subdued in 2002-03 as compared with the previous year. The most important deals in 2002-03 were either due to privatisation of major public sector undertakings or deals struck by major domestic companies belonging to big business houses and MNCs. As against 1,050 deals involving an amount of Rs.35,369 crore struck in the previous year,

there were only 777 acquisition deals involving an amount of Rs.21,356 crore in 2002-03.]

Services regained momentum and resumed the role as the principal driver of the Indian economy, accounting for 89.4 per cent of the overall growth. The reverting to the trend of over 7 per cent growth in services was enabled by a pick up in 'construction', 'financing, insurance, real estate and business services' and 'community, social and personal services'. This outweighed the deceleration in the growth of 'trade, hotels, transport and communication' which constitute a little less than half of the services sector.

India continued to maintain its internationally competitive edge in the production and exports of information technology (IT) services during 2002-03, despite a general contraction in this sector worldwide and intensifying competition. Revenues surged by 26 per cent, drawing from a major jump in IT enabled/Business Process Outsourcing (BPO) services. IT enabled services grew at over 65 per cent during 2002-03 on account of increased outsourcing by US firms to cut costs and to improve bottom lines which improved India's export prospects. Indian companies increased their share of global IT spending and began to increase market penetration in new destinations in the Asia-Pacific region.

A vibrant and diversified export performance at a growth above 19 per cent underpinned the growing vigour and resilience of India's external sector in 2002-03 notwithstanding a weak global recovery. Imports also exhibited an identical growth with industrial pick-up raising the non-oil imports.

[Hardening of international crude prices and increased refinery throughput amidst stagnant domestic oil production drove up the non-oil imports.]

India emerged as the world's fastest growing exporter after China amongst leading exporting nations and showed a current account of the balance of payments for the second successive year.

With the virtual absence of any external financing requirement, there was an unprecedented order of accumulation of foreign exchange reserves, the third largest increase among emerging market economies in that year. At the end of March 2003, the reserves were equivalent to around 14 months of imports or about seven years of debt servicing. The burgeoning reserves enabled a further consolidation of external debt during the year through prepayment of multilateral and commercial debt as well as shifts in the composition and maturity of non-resident deposit liabilities.

[As the industrial revival, a resurgent services sector and growing exports could not fully mitigate the dampening effects of contraction in agricultural activity, the real GDP growth slowed down to 4.3 per cent from 5.6 per cent. Nevertheless, in the context of a global slowdown, the Indian economy remained quite resilient. The halting recovery in aggregate demand reflected impetus coming only in terms of consumption as the fixed investment growth has slowed down to 3.2 per cent in 2001-02 from 7.6 per cent in 2000-01. On the other hand, gross domestic saving (GDS) rate has been increasing in recent years, buoyed by the rise in both physical and financial saving of the household sector. It has touched 24.0 per cent of GDP in 2001-02 after some drift in the preceding year. A major factor contributing to this increase has been a steady improvement in personal disposable incomes. The improvement in the financial saving of the household sector was mainly in the form of bank deposits and contractual instruments.]

Inflation rate remained low and stable over the first three quarters of 2002-03 in a benign international inflation environment. Inflation ruled below 4.0 per cent in the first three quarters and picked up only from mid-January onwards to close the year at 6.5 per cent, mainly due to hardening of international crude prices and pressures from drought related items like oil seeds and edible oils. Ample foreign exchange reserves and foodgrain stocks helped check inflationary spirals in the economy. Potential inflationary pressures were contained through judicious supply management strategies-step-

up in off-take, enhanced allocation for targeted employment programmes, release of foodgrains from ration shops at below stipulated prices and imports. Consumer price inflation eased during the year to 4.1 per cent from 5.2 per cent in 2001-02, reflecting lagged adjustments to agricultural supply disturbances. The rise in international oil prices had a significant impact on retail inflation as the major part of the domestic consumption is met through imports.

[Behaviour of financial markets during 2002-03 mirrored largely the presence of surplus liquidity conditions on account of sustained capital inflows, contraction in food credit and past liquidity overhang. Interest rates softened across the maturity spectrum though with a varied pace. Key money market rates hovered close to the repo rate except for transient firming in May 2002 and episodic spurts after October 2002. Excess supply conditions in the foreign exchange market led to a appreciation of spot exchange rate against the US dollar and an easing of forward premia. Repeated rallies of prices in the government securities market shifted the yield curve down and made it flatter. A sharper reduction of yields on corporate bonds narrowed their spreads over the sovereign yield curve reflecting lowering of risk premia. Bank deposit rates decreased but were not fully reflected in the reductions of the lending rates. Equity markets remained subdued during 2002-03.]

Outlook

Agriculture:

The growth prospects for the current financial year hinge around the sustainability of the industrial upturn and a recovery in agricultural performance. The performance of agriculture India continues to depend upon the monsoon. It is fortunate, therefore, that in spite of a delayed start, the monsoon is likely to be normal. Rainfall for the country as a whole for the month of June was 6 per cent above its long period average. As per the Indian Meteorological Departments long range forecast update, for the country as a whole the seasonal rainfall is likely to be 98 per cent of the long period average. It is, therefore, fair to expect the agriculture sector to turn around with concomitant benefits to industry in terms of enhanced rural consumption demand and easier supply conditions. Initial expectations support a rebound from the absolute declines in output recorded last year.

Industrial:

The climate for industrial revival is showing a distinct improvement in an environment of higher overall growth prospects, low and stable inflation, rising international competitiveness and favourable monetary and fiscal policies. The financial performance of the private corporate sector has shown substantial improvement in terms of sales and profitability. Leading indices of industrial activity are indicating stable growth ahead. The industrial outlook is optimistic with expectations of fresh capital investments in existing projects, increase in capacity utilisation and a stabilising of inventory levels. Export demand is expected to increase over the next six months, supported by a realistically valued exchange rate. Easing the constraints in terms of availability of power, procedural bottlenecks, the cost and availability of credit, and road and port facilities will entrench the industrial recovery. The buoyancy of the services sector would be contingent upon the strength of the symbiotic interface with the goods sector and the growth of 'new economy' activities.

[The Tenth Five Year Plan (2002-07) has envisaged an average annual growth of 8 per cent. India's growth experience over the Eighth and Ninth Plan periods demonstrates that this growth target is feasible.]

The future growth strategy will have to rely on a combination of increased investment and improvement in efficiency. Rapid dismantling of policy constraints, procedural rigidities and price distortions will play a critical role in the drive to a higher growth path. It will also require that the appropriate changes in institutional architecture are put in place. In these efforts, achieving a growth rate of 6.0 per cent in 2003-04 becomes a critical minimum.

To this end, leading indicators of industrial recovery like credit off-take offer reason for hope. Non-food credit off-take, which recorded a turnaround in the first quarter of 2002-03, has been buoyant. This is reflected in the industrial recovery gaining momentum. The industrial sector registered an accelerated growth of 5.7 per cent in May 2003 as compared to a growth of 4.1 per cent in May 2002. The growth of the manufacturing sector at 6.1 per cent in May 2003 was substantially higher than that in May 2002, with consumer durables goods recording positive growth after 12 months. In addition, growth in capital goods continues to be buoyant (8.1 per cent in April-May 2003 as against 2.3 per cent in the corresponding period of the previous year).

External Sector:

On the external front, inflows on account of net investments of foreign institutional investors in the first two months of the current financial year have exceeded the inflows during the entire previous year. Strong inflows took place in May and June as well. With the onset of a normal monsoon and the concomitant bullish sentiments in the capital markets, FII investments are likely to continue in the same vein. Large capital inflows witnessed in recent months have led to steady appreciation of the rupee against the dollar.

The Macroeconomic Concerns

1. 8% Target for Tenth Five Year Plan:

Despite the resilience of the Indian economy amidst the challenges faced in 2002-03, there are several concerns linger as an ambitious annual growth target of 8 per cent for the Tenth Five year Plan period is envisaged. In this context, I would like to flag two issues:

First, it is important to realise that growth and investment in the real economic activity in the Indian economy now are constrained by deficiency of demand rather than by availability of savings. A visible evidence of failure of investment demand to absorb foreign savings is voluntary external capital inflows in excess of the current account deficit since 1993 (except 1995-96). Furthermore, as both food stocks and foreign exchange reserves are ample there are no foreign exchange and wage constraints to growth.

Secondly, the growth rate is no longer driven entirely by the investment activity in the Indian economy. Although the average real investment rate moved up to 26.3 per cent of GDP during the Ninth Five Year Plan from 24.9 per cent during the Eight Five Year Plan, the average growth rate fell to 5.3 per cent from 6.7 per cent. On the other hand, the nominal investment rate came down in the Ninth Five Year Plan. The differential behaviour between nominal and real investment rates shows that while pace of capacity creation rose, the role of investment as a component of aggregate demand actually declined. This also points out to the existence of excess capacity rather than a decline in efficiency of investment during the Ninth Plan period and the level of excess capacity was estimated by the Planning Commission to be at 21 per cent of actual production in manufacturing.

2. Agriculture:

Agriculture continues to exhibit sharp fluctuation in output. Despite the fact that share of agriculture in real GDP has shrunk, rural expenditures have increasingly switched in favour of non-food items, thereby pointing to the rising indirect effects of change in agricultural growth through the demand for non-agricultural goods and services. Irrigation coverage remains distinctly lower than potential in terms of the gross cropped area. Poor rural road connectivity and insufficient rural markets are the other major infrastructure constraints on agriculture. Measures aimed at stabilising rural incomes, therefore need to be prioritised for growth sustainability. Secular fall in agriculture investment needs to be arrested with efforts to boost private investment, which has so far been inadequate and concentrated in areas where water, power and other inputs are available uninterruptedly and with large subsidy. It is also important to explore new frontiers in technology focusing on evolving location-specific and economically viable varieties of agricultural and horticultural crops by leveraging developments in the field of bio-technology.

3. Sustainability of Industrial Revival:

Earlier, I made a reference to the fact that there is overall a feel good factor about the industrial recovery. However, the upsurge in industrial activity to pick up on a sustainable basis and anchor the overall growth target of 8 per cent would crucially hinge on further reforms - what we like to term as second generation reforms. Such reforms would include labour reforms, easier exit and entry norms, complete dereservation of the small-scale industry while enabling them to compete in the export market, going ahead with further institutional reforms like corporate insolvency, corporate governance, patent laws.

4. Fiscal Consolidation

The burning issue confronting the Indian economy is perhaps the fiscal slippage - back to the 1990 level.

The combined gross fiscal deficit of the Centre and States increased from 9.4 of GDP in 1990-91 to 9.5 in 1999-2000 before declining marginally to 9.2 per cent in 2002-03.

The combined Revenue Deficit widened from 44.6 per cent of the Gross Fiscal Deficit in 1990-91 to as high as 72.0 per cent 2001-02. Some recent initiatives have brought down this ratio marginally to 68.4 per cent in 2002-03.

The combined public debt of the Centre and States has zoomed from 61.7 per cent of GDP in 1990-91 to 74.3 per cent in 2002-03.

5. Sterilisation of Foreign Investment Inflows:

In a scenario of limited stock of marketable instruments in the Reserve Bank's portfolio, the decline of NDA to near-zero levels poses the potential danger of approaching the limits of sterilisation. Moreover, the presence of excess liquidity has implied that the overnight money market rates have strayed below the floor rate of repo. The anchoring of the short-term rates to the repo rate on one hand and substantial easing of yields at the longer end of the maturity spectrum flattened the yield curve on the government securities. The surge in capital flows has also necessitated the balancing act to counter the undue pressures of appreciation in the Indian Rupee and arrest the crash in the swap premia. The average exchange rate appreciated by around 2.3 per cent and the three-month forward premia decreased by over 250 basis points to 6.1 per cent during the year.

6. Appreciation of the Rupee:

In this context I would like to address one of the common, though misguided apprehensions of Indian exporters. Some believe that a continuously appreciating rupee will hurt the interests of exporters who bring in their earnings only after a lag. However, two facts should set at rest any doubts on this score. First, while the rupee has been appreciating against the dollar it has in fact been depreciating against other major currencies including the Euro, the pound sterling and the yen. Second, due to cross country movement,

particularly the depreciation of the US dollar against the euro and other currencies, the real effective exchange rate of India continues to exhibit modest depreciation. I may also point out that India's export performance has been quite buoyant in recent months having increased by 13.5 per cent in May 2003 even in the face of nominal depreciation of the rupee.

Key Growth Strategy Ahead

Therefore, I feel that the strategy should be to bring into production the large unutilised capacities on the basis of non-private investment components of aggregate demand during the next couple of years of the Plan followed by a strong growth of private investment in the later years. As the export demand and consumption demand are already buoyant, the scope for enhancement of effective demand needs to be generated by public expenditure, especially in the form of investment at least in the next couple of years. In the current scenario of excess savings, the efforts to increase public expenditure in the coming years would merely utilise the idle investible surplus. This will enable crowding-in of private investment later. It is when the private demand picks up in a substantial measure, the possibility of crowding out may creep in. Furthermore, in order to maintain a high level of private consumption demand for non-agricultural goods, attention needs to be paid both to stability and growth in rural incomes.

Against this backdrop, growth strategies have to be put in place to propel the economy towards its full potential over the medium-term while emphasising on the quality of growth. Resumption of industrial activity and a robust export performance in the face of the global downturn has already set the tone for a strategic trade policy centred around doubling of exports from the current level and thereby raising India's share in global exports to 1 per cent by 2007. The Union Budget for 2003-04 aims at stepping up revenue mobilisation and persevering with expenditure management within an overall shift in emphasis to qualitative aspects of fiscal reform. The monetary and credit policy for 2003-04 undertook a structured stimulus to aggregate demand through reductions in the Bank Rate and the CRR, even while indicating the need for

continued vigil on inflation front. Several steps were taken to strengthen financial soundness and the content of regulatory supervision. The resurgence of positive expectations regarding the near-term was greatly facilitated by the passage of landmark reform legislations, setting the stage for intensifying structural reforms.

In conclusion let me state that these are interesting times. On the one hand, increased integration of global financial markets and the rapidity of capital flows have increased the vulnerability of all market agents to adverse international developments exogenous to them. On the other hand, technological developments and free trade have opened to Indian entrepreneurs a world of new opportunities to grow and prosper. It is up to us – market agents and policymakers – to advantage of opportunities that abound while moving with prudence and wisdom to mitigate the risks inherent in the present scenario

Thank you.