Y V Reddy: India – development and reform experience; and prospects

Address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Bank of Mexico, Mexico City, 13 September 2007.

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Governor Ortiz and Friends,

I am delighted to be here in Mexico to address this august gathering at the Bank of Mexico. I am honoured by the invitation extended to me. Governor Ortiz is among the most respected Central Bank Governors. His perceptions and words of wisdom, based on sound understanding of theory as well as compulsions of public policy making, are eagerly sought. In fact, Governor Ortiz heads the Central Bank Governance Group in the Bank for International Settlements of which I am a Member. The talk that he delivered in the Reserve Bank of India in November 2006 on Mexico's experience with Financial Stability is vividly remembered by all of us. Again, his elucidation of "Growth and Stability in Latin America and Asia" in the prestigious Sir Purushothamdas Thakurdas Memorial Lecture in India during the same visit is, in my view, a pioneering piece on the subject.

Mexico has successfully achieved the macroeconomic and financial stability that fosters rapid economic growth. A range of specific reforms implemented in Mexico, which include to improvement in business environment and corporate governance; development of human capital; incentive-based social assistance programs; and broader access for health insurance; have attracted international interest in the Mexican economy. Monetary policy has also been able to achieve and maintain a low inflation regime, which is vital for the social well-being in emerging economies. Mexico provides an appealing development model for many developing countries. I must compliment the leading lights of public policy in Mexico for these impressive outcomes.

I. India's development experience: pre-reform period

Some hold the view that India was a poor country for most part of the human history though there were pockets of prosperity and islands of riches. However, accounts of others, especially global travellers and those who invaded India indicate that India was a prosperous country at least till the 17th century. According to an OECD publication, in 1700 AD, broadly defined, India's gross domestic product (GDP) at US $ 90.8 billion was 24.4 per cent of world GDP (Maddison Angus, "The World Economy: A Millennium Perspective", OECD, 2001). Lord Meghnad Desai, while delivering the first P.R. Brahmananda Memorial Lecture in Mumbai in September 2004, noted that the story of the 19th century for India is not one of gloom and doom. He added that during the second half of the 19th century, where the data are best available, India was an open economy enjoying an export led growth but there was a drain of the export surplus to pay Home Charges. During the forty year period from 1860 to 1900, the per capita income growth was 0.5 to 1 per cent. According to Lord Desai, the first fifty years of the 20th century were much less favourable for the Indian economy than the last forty years of the 19th century. Further, in a book titled "The National Income of India in the Twentieth Century", Professor Sivasubramonian observed that in the first five decades of the 20th century (1900-01 to 1946-47), before we got our independence in 1947, the per capita GDP in India was stagnant, as the trend growth in GDP during this period was 0.9 per cent with population growing by 0.8 per cent (Sivasubramonian, S., Oxford University Press, 2000).

As compared with near stagnant growth in the first 50 years of the 20th century, it could be seen from Table 1 (Attached), the annual growth averaging around 3.5 per cent during the period 1950 to 1980 was comparatively better, while per capita growth broke out of the long period of inertia and averaged 1.1 per cent until around 1980. The average growth rate of

around 6 per cent since the 1980s, while embarking on a higher average growth path of 8.6 per cent in the last four years could be a paradigm shift.

The Indian experience clearly suggests that the mixed-economy model and planned development strategy in the first phase during the 1950s and 1960s, improved growth rate dramatically relative to previous decades, and also provided the essential building blocks and laid the strong foundations of an indigenous industrial base, vibrant entrepreneurial class, knowledge economy, with considerable improvement in vertical, social and economic mobility. However, the inward looking import substitution strategy pursued during the initial decades of the planning period resulted in declining productivity and high cost economy. Realizing this, significant changes in policy were initiated in the early 1980s, taking account of oil shocks in the 1970s and early 1980s. These policy measures took India into a higher growth trajectory in the 1980s but in its wake created some macroeconomic imbalances leading to a crisis in 1991 that triggered more comprehensive and sustainable reforms. The policies since 1991 provided ample opportunities to build on the strong foundations in economic, political and social sphere, laid during the pre-reform period of planned development.

II. Development experience: post-reform period

Triggers of reforms

The policy reforms in the 1980s provided impetus for high growth and enhanced competitiveness but the growth process turned unsustainable. It manifested in the growing macroeconomic imbalances over the decade in the form of high fiscal deficit, high levels of current account deficit, and increasing levels of short term external debt, besides a repressive and weakened financial system. The immediate provocation for the crisis in 1991 was also a combination of external events that generated liquidity problems on the external front.

The gulf crisis of 1991 not only affected India's oil imports due to soaring oil prices but also eroded export markets in West Asia, and caused a setback to inward remittances and tourist earnings. The deterioration in exports to Eastern Europe, with the break-up of erstwhile USSR, accentuated the crisis. Around the same time, India's credit rating was lowered, which restricted its access to commercial borrowings and there was unwillingness on the part of normal banking channels to renew short-term credit to Indian banks abroad. Exceptional financing measures became inevitable, and the overall deficit in 1990-91 was financed almost equally by recourse to IMF and drawdown of reserves. The severity of the balance of payments crisis in the early 1990s could be gauged from the fact that India's foreign currency assets depleted rapidly from US $ 3.1 billion in August 1990 to US $ 975 million on July 12, 1991.

I would now narrate the story of our exciting journey from the agony of 1991 to relative comfort in 2007, and conclude by mentioning prospects and challenges ahead of us.

Reform measures

During the crisis period, a conscious decision was taken to honor all debt obligations without seeking rescheduling and several steps, including some unconventional ones, like pledging gold with international institutions, were resorted to tide over the crisis. The immediate steps undertaken included, among others, tightening of non-essential imports and availing credit from the IMF and other multilateral and bilateral donors. A macroeconomic structural and stabilization programme encompassing trade, industry, foreign investment, exchange rate, public finance and the financial sector was put in place creating an environment conducive for the expansion of trade and investment. It was recognized that trade policies, exchange rate policies and industrial policies should form part of an integrated policy framework if the

aim was to improve the overall productivity, competitiveness and efficiency of the economic system, in general, and the external sector, in particular.

Features of economic reforms

It may be interesting to enumerate here some of the important features of the economic reform process undertaken by India since 1991.

First, the approach towards reforms in India has been cautious with appropriate sequencing of measures, complementary reforms across sectors (e.g., monetary, fiscal and external sector), and development of financial institutions and markets. The objective has been to progress with some harmony across sectors.

Second, the pace and sequencing of liberalization has been responsive to domestic developments, especially in the monetary and financial sectors, and the evolving international financial architecture. The reforms were debated intensely and designed essentially indigenously.

Third, the approach to reform was "gradual but steady" rather than a "big bang" approach. The reforms have generally been viewed as a process and not as an event. In this approach, the pace and sequencing of liberalization could be tempered keeping in view the degree of comfort in moving forward in a credible way.

Fourth, the major thrust driving the reform process was the quest for higher growth and efficiency along with macroeconomic stability. At the same time, the reforms had to be "inclusive" in the sense that the benefits of reforms are to be demonstrably shared by all sections, in particular, the vulnerable sections. This has easily been a very significant electoral issue in both provincial and national elections.

III. Select economic indicators

The major macroeconomic indicators for the last seven years are given in the Table 2 (attached) which broadly summarizes the quantitative achievements.

GDP growth

Over the last four years during 2003-07, the Indian economy has entered a high-growth phase, with the GDP growth averaging 8.6 per cent per annum. The acceleration of growth during this period has been accompanied by a significant moderation in volatility, especially in industry and services sectors. The structure of domestic output has distinctly shifted in favor of the services sector, while growth in industry is also accelerating. Indian industry appears to have responded well to global competition through restructuring and technological upgradation in recent years. India's growth is mainly driven by domestic consumption, which contributed, on an average, to almost two-thirds of the overall demand.

Saving and investment balances

A noteworthy feature of the ongoing structural transformation of the Indian economy is the significant increase in domestic saving and investment rates. Domestic investment rate increased from 24.3 per cent in 2000-01 to 33.8 per cent in 2005-06 and domestic saving rate from 23.7 per cent in 2000-01 to 32.4 per cent during 2005-06. The household sector continued to be the major contributor to gross domestic saving with its saving rate placed at 22.3 per cent in 2005-06, while on account of rise in profit, the saving rate of private corporate sector rose to 8.1 per cent in 2005-06. The public sector, which started posting positive saving beginning 2003-04, recorded a saving rate of 2.0 per cent in 2005-06 on account of continuing fiscal improvement as against a negative saving rate of 1.7 per cent in 2000-01. It may be noted that over 95 per cent of investment is financed by domestic

savings. Given the fact that Indian per capita income is increasing rapidly and policy efforts towards financial deepening for achieving a more inclusive growth are underway, savings rate in India could even rise further in the medium to long term. The level of saving rates should help continue to finance the investment needs of the economy domestically, without undue dependence on foreign savings.

Productivity and efficiency

In tandem with acceleration in the rate of investment in the economy, there has been evidence of a pickup in productivity and efficiency of capital use. Some of the recent studies relating to India have indicated an increase in total factor productivity (TFP) growth in recent years. For instance, Rodrick and Subramanian, in an IMF working paper of 2004, point out that India seems to have a large amount of productivity growth from relatively modest reforms. A more recent paper by Barry Bosworth, Susan Collins, and Arvind Virmani (2007) confirms this trend. They find that output per worker grew only 1.3 per cent annually during 1960-1980, when GDP growth was also at a low of 3.4 per cent. TFP growth was barely above zero, according to their calculations, indicating that growth in output was almost entirely driven by growth in inputs. In contrast, growth in output per worker nearly tripled to 3.8 per cent during 1980-2004, while TFP increased ten-fold to 2 per cent. The evidence of an increase in the growth of labour productivity is also available from other studies (Economic Intelligence Unit, 2007). A Study by Tata Services (2003) found that for the all-India manufacturing sector, labour productivity (output per unit of labour) has increased significantly during the post-reform period, compared with the pre-reform period.

Poverty and employment

The sustained economic growth since the early 1990s has also been associated with some reduction in poverty. Based on uniform recall period consumption distribution, the proportion of people living below the poverty line declined from 36 per cent in 1993-94 to 27.8 per cent in 2004-05. There is also evidence of pick-up in employment growth from 1.57 per cent per annum (1993-94 to 1999-2000) to 2.48 per cent per annum (1999-2000 to 2004-05). According to some reports and other anecdotal evidence, the benefits of recent surge in growth rate of GDP are not just restricted to large cities, but people in other urban and semi urban areas are also gaining. There is some evidence of reduction in under employment and disguised unemployment in the informal sector.

Money, prices and credit

The high growth in GDP in recent years has been accompanied by some moderation of inflation to an average of 4.9 per cent during 2003-07. Historically, India has not seen very high inflation. The headline inflation rate, in terms of the wholesale price index, has declined from an average of 8.2 per cent during the period 1980-81 to 1990-91 to 6.2 per cent during the post crisis period, i.e., 1992-93 to 2006-07, with a sharper moderation in the recent period.

During 2006-07, money supply (M3) increased by 21.3 per cent on a year-on-year basis and was well above indicative projections for the year. It largely reflected the surge in capital flows in the country. Non-food credit extended by the scheduled commercial banks (SCBs) increased by 28.4 per cent during 2006-07 on top of 31.8 per cent in the previous year. The growth of bank credit has favoured retail lending, particularly housing, real estate, trade, transport and professional services and non-banking financial companies – sectors which hitherto were not significant in the credit market. These developments led to a lively debate on the signs of overheating in the economy but subsequent moderation in inflation has diffused the attention.

IV. Monetary policy and regulatory framework

As regards the framework of monetary policy, the basic objectives of monetary policy, namely price stability and ensuring credit flow to support growth, have remained unchanged in India. Of late, considerations of macroeconomic and financial stability have assumed an added importance in view of increasing openness of the Indian economy.

In India, broad money (M3) emerged as an intermediate target from the mid-1980s based on the premise of a stable relationship between money, output and prices. In the late 1990s, in view of ongoing financial openness and increasing evidence of changes in underlying transmission mechanism with interest rates and exchange rates gaining in importance vis-à-vis quantity variables, the Reserve Bank adopted a multiple indicator approach in April 1998 whereby interest rates or rates of return in different financial markets along with such data as on currency, credit, trade, capital flows, fiscal position, inflation, exchange rate etc. are juxtaposed with the output data for drawing policy perspectives. The liquidity management in the system is carried out through open market operations (OMO) in the form of outright purchases/sales of government securities and daily reverse repo and repo operations under a Liquidity Adjustment Facility (LAF) and this has emerged as the main instrument for interest rate signalling in the Indian economy. In the context of large capital flows and sterilisation, the availability of policy instruments to manage liquidity has been strengthened further with open market operations through Market Stabilisation Scheme.

While the preferred instruments are indirect, and varied, there has been no hesitation in taking recourse to direct instruments also, if circumstances warrant them. In fact, complex situations do warrant dynamics of different combinations of direct and indirect instruments, in multiple forms, to suit the conditions – especially the transmission mechanism.

Similarly, while there is considerable merit in maintaining distinction between monetary and prudential policies of the central bank, the Reserve Bank did not hesitate to enhance the provisioning requirements and risk weights for select categories of banking assets, namely real estate, housing, consumer finance and capital market exposures. There has also been close monitoring of off-balance sheet exposures of banks. Detailed guidelines have been issued, for consultation, on product, accounting and prudential aspects of credit derivatives. A framework for governing banks' linkages with systemically important deposit taking and non-deposit taking non banking financial companies has also been put in place.

More generally, Reserve Bank's approach has been to recognise the positive contributions that financial innovations make to enhance efficiency of financial intermediation. At the same time, Reserve Bank considers, in a dynamic setting, appropriate safeguards to ensure stability, taking account of the prevailing governance standards, risk management systems and incentive frameworks in the foreign, public, private and cooperative banks as also related non-banks. Overall, these progressive but cautious policies have contributed to both efficiency and stability of the financial system and enables current growth momentum in an environment of macro stability.

Some of the important factors that shaped the changes in monetary policy framework and operating procedures in India during the 1990s were the delinking of budget deficit from its automatic monetization by the Reserve Bank, deregulation of interest rates, and development of the financial markets with reduced segmentation through better linkages and development of appropriate trading, payments and settlement systems along with technological infrastructure. With the enactment of the Fiscal Responsibility and Budget Management Act in 2003, the Reserve Bank has withdrawn from participating in the primary issues of Central Government securities with effect from April 2006. The recent legislative amendments enable a flexible use of the cash reserve and statutory liquidity requirements for banks, without being constrained by a statutory floor or ceiling on the levels of such prescriptions by the Reserve Bank.

V. Fiscal policy reforms and public debt management: centre and States

The fiscal system prevalent in the beginning of the 1990s was characterised by a sustained high fiscal deficit and mounting debt accumulation giving rise to inflation, financial repression, and overall deterioration in the macroeconomic fundamentals of the economy. The average gross fiscal deficit of the central government as per cent to GDP during the decade of 1980s was 6.8 per cent as against 3.8 per cent in the 1970s. A positive outcome in recent years is the marked improvement in the health of Government finances with the adoption of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 by the Central Government and Fiscal Responsibility Legislation (FRLs) by several State governments.

RBI and States

Under India's federal system of government, the Constitution allocates the revenue powers and expenditure functions between the Central and State Governments. In general, the functions required to maintain macroeconomic stability and international relations are assigned to the Centre, while provision of public services such as law and order, internal security, public health, sanitation, water supply and agriculture is largely entrusted to the States. Both government layers share responsibility for education, health and infrastructure, though States have a critical role.

In India, borrowing by the State governments is subordinated to prior approval by the national government. This is embodied in Article 293 of the Indian Constitution, under which, any State Government that is indebted to the Central Government, requires prior approval for borrowings. Central approval is embedded in the procedure for sale of State Government securities, and therefore, cannot be violated. Furthermore, State Governments are not permitted to borrow externally, unlike the Centre.

The Reserve Bank plays two crucial roles in relation to the Indian fiscal system, namely as the banker to and the debt manager of both Central and State Governments. The RBI Act allows the RBI by agreement with a State Government to undertake its banking operations and management of its public debt. While undertaking the role of banker for both the Central and State governments, the RBI also provides temporary support to tide over mismatches in their receipts and payments in the form of Ways and Means Advances (WMA).

The Reserve Bank has been organizing a biannual Conference of State Finance Secretaries since November 1997. This Conference, right from its inception, has provided a very useful forum for interaction among all the stakeholders (State Governments, Central Government and the Reserve Bank) on matters related to State finances and arriving at consensual solutions for issues of policy and operational significance. Among the areas that were deliberated, the more important one's relate to fiscal responsibility legislations at State levels; standardisation of budgetary, accounting and transparency practices; cash management; management of Consolidated Sinking Fund and Natural Calamities Fund; evaluation of fiscal guarantees etc. The Reserve Bank is proactive and responds from time to time, to the needs of States, as evident from two recent moves.

Faced with accumulation of large surplus cash balances and a negative spread earned on the investment of such balances, some State Governments had approached the Reserve Bank to arrange for the buy-back of their outstanding State Development Loans (SDLs). Accordingly, the Reserve Bank formulated a general scheme for the buy-back of SDLs with the concurrence of the Government of India. Following the recommendations of the Twelfth Finance Commission, external loans would be passed on to the States (in rupee terms) on a back-to-back basis. Consequently, the State Governments would now have to bear the foreign exchange risk in the context of such loans. Again, at the behest of the State Governments, the Reserve Bank recently organized a workshop on the management of foreign exchange risk, for the benefit of State Government officials.

The Reserve Bank interacts with States on several other fronts especially in regard to lending to agriculture, small industries, weaker sections, depositor protection, financial inclusion, financial literacy, responding to natural calamities etc. mainly through the regional offices.

Management of public debt

The aggregate stock of public debt of the Centre and States as a percentage of GDP is high, currently at around seventy five per cent. There are, however, several unique features of management of public debt in India, which are noteworthy. First, States have no direct exposure to external debt. Second, almost the whole of public debt is local currency denominated and held almost wholly by residents. Third, public debt, of both Centre and States is actively and prudently managed by the Reserve Bank of India ensuring comfort to financial markets without any undue volatility. Fourth, the government securities market has developed significantly in recent years in terms of turnover, depth and participants, and significant further improvements are underway.

Fifth, contractual savings supplement marketable debt in financing deficits. Finally, direct monetary financing of primary issues of debt has been discontinued since April 2006. Hence, the high stock of public debt relative to GDP has not so far been a matter of concern as far as stability is concerned, while it is recognised that long term sustainability would call for a gradual reduction to prudent levels.

VI. External sector reforms

Benefiting from a calibrated and sequenced strategy of liberalisation, India's external sector has become more resilient. Exports have been growing at an average rate of around 25 per cent during the last three years, while imports have grown by around 35 per cent during the same period. The current account remained in surplus during 2001-02 to 2003-04, before turning into a modest deficit since then. There was a significant strengthening in the capital account resulting in continued accretion to the foreign exchange reserves, which was around US$ 228.8 billion as on August 31, 2007. As could be seen from the table 2, there has been considerable improvement in liquidity and sustainability indicators of external debt.

The exchange rate of rupee became market determined from March 1, 1993 and by August 1994 India became current account convertible by accepting Article VIII of the Articles of Agreement of the IMF. There was simultaneously a significant rationalization of the tariff structure in a gradual manner providing opportunity for domestic industry to equip itself to face global competition. For instance, the customs duty on non-agricultural products has come down from 150 per cent in 1991-92 to 10.0 per cent in 2007-08. A qualitative change was brought about in the legal framework for liberalization by the enactment of the Foreign Exchange Management Act (FEMA) in June 2000. With this, the objectives of regulation have been redefined as facilitating trade and payments as well as orderly development and functioning of foreign exchange market in India.

The extent and timing of capital account liberalization is properly sequenced with other concomitant developments such as strengthening of banking sector, fiscal consolidation, market development and integration, trade liberalization, and the changing domestic and external economic environments. It is also recognized that there may be links between the current and capital accounts and hence procedures are in place to avoid capital flows in the guise of current account transactions. Further, a hierarchy is established in the sources and types of capital flows. The priority has been to liberalize inflows relative to outflows, but all outflows associated with inflows have been totally freed. Among the types of inflows, foreign direct investment is preferred for stability while excessive short-term external debt is eschewed. A differentiation is made between corporates, individuals, and banks. Operationally, the process of managing the capital account consists of operating two routes,

namely automatic and non-automatic. Consistent rebalancing in the desired direction is done by expanding the automatic route and by moving most of the prohibited transactions to the non-automatic but approval route and at a later stage, to an automatic or deregulated regime.

There has been a significant liberalisation of the policy framework with regard to capital outflows over the past few years. Each country has to design its policy regime for capital outflows keeping in view the specific country context, especially characteristics of the real sector, and not merely the contextual level of inflows and extant absorptive capacity of the economy. First, the current regime of outflows in India is characterised by liberal but not incentivised framework for corporates to invest in the real economy outside India, including through the acquisition route. The regime has served the country well since Indian corporates are increasingly able to establish synergies with overseas units, to make up for lack of scale that has been a legacy problem in India, and to quickly acquire domain knowledge through acquisition. Second, significant liberalisation of outflows by individual households has been implemented following recommendation of the Committee on Fuller Capital Account Convertibility (Chairman: Shri S. S. Tarapore, 2006). Further liberalization here would be done in the light of some international experience which shows that resident individuals often precede overseas investors in initiating outflows when the perceptions in regard to domestic economy's performance or stability appear to turn adverse. Third, as regards the regime for outflows through financial intermediaries, the approach is characterised by caution and quantitative stipulations whereby both prudential considerations and compulsions of management of capital account are relevant.

VII. Financial sector reforms

Major policy measures in the financial sector relate to phased reductions in statutory pre-emption like cash reserve ratio and statutory liquidity requirements and deregulation of interest rates on deposits and lending, except for a select segment. The diversification of ownership of banking institutions is yet another feature which has enabled private shareholding in the public sector banks, through listing on the stock exchanges, arising from dilution of the Government ownership.

The banking sector reform combines a comprehensive reorientation of competition, regulation and ownership in a non-disruptive and cost-effective manner. Indeed our banking reform is a good illustration of the dynamism of the public sector in managing the overhang problems and the pragmatism of public policy in enabling the domestic and foreign private sectors to compete and expand. The regulatory framework in India, in addition to prescribing prudential guidelines and encouraging market discipline, is increasingly focusing on ensuring good governance through "fit and proper" owners and directors of banks. The Reserve Bank has issues detailed guidelines on ownership and governance in private sector banks emphasizing diversified ownership. The Reserve Bank has also provided a significant thrust to implementation of information technology in the banking sector.

Foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to the prescribed guidelines. Again, 100 per cent foreign direct investment is allowed in 19 activities under the automatic route in Non-Bank Financial Companies (NBFCs). There are minimum capitalisation norms for such investments. Besides, 100 per cent NBFC subsidiary can also be established subject to clearance by Foreign Investments Promotion Board (FIPB), Government of India. There has been noticeable increase in the interest of foreign entities to acquire stakes in NBFCs. Policy initiatives have been taken in recent past to ensure that such NBFCs adhere to regulatory prescriptions spelt out for them.

In the cooperative segment, the urban cooperative banks (UCBs) had been suffering from the problem of multiple supervisory/regulatory authorities, as also the challenge of reconciling the democratic character with financial discipline. Therefore, several structural, legislative and regulatory measures have been initiated in recent years for urban co-

operative banks with a view to evolving a policy framework oriented towards revival and healthy growth of the sector. A vision document for their healthy growth has been formulated. Restructuring of the larger weak banks has commenced and is well under way. Similarly, issues relating to rural co-operative banking structures and regional rural banks (RRBs) have been considered actively and comprehensive measures have been planned and some of them are under implementation.

Financial markets reforms

Financial markets in India in the period before the early 1990s were marked by administered interest rates, quantitative ceilings, statutory pre-emptions, captive market for government securities, excessive reliance on central bank financing of fiscal deficit, pegged exchange rate, and current and capital account restrictions. A wide range of regulatory and institutional reforms were introduced in a planned manner over a period to improve the efficiency of financial markets. These included development of market micro structure, removal of structural bottlenecks, introduction/ diversification of new players/instruments, free pricing of financial assets, relaxation of quantitative restrictions, better regulatory systems, introduction of new technology, improvement in trading infrastructure, clearing and settlement practices and greater transparency.

Reforms in financial markets were carefully sequenced ensuring that they were in sync with the real sector. The reforms were also important for developing the environment for effective monetary policy making and monetary transmission mechanisms. A noteworthy feature is that the government securities and corporate debt market is essentially domestically driven since FII and non-resident participation in these markets are limited and subjected to ceilings.

The linkage between the money, government securities and forex markets has been established and is growing. The price discovery in the primary market is more credible than before and secondary markets have acquired greater depth and liquidity. The Reserve Bank has also initiated a number of steps – institutional, procedural and operational – for making the payment systems safe, secure and efficient. For efficiency enhancements and risk reduction, usage of the Real Time Gross Settlement (RTGS) System and other electronic payment mechanisms has been encouraged in a big way.

VIII. Financial inclusion and customer services

The Reserve Bank has undertaken a number of measures with the objective of attracting the financially excluded segment of the population into the structured financial system. The broad approach of the Reserve Bank is aimed at "connecting" people with the banking system. Measures relating to financial inclusion may be summarized as follows:

First, banks were advised to make available a basic banking "no-frills" account with nil or minimum balances as well as other charges to ensure outreach of such accounts to vast sections of the population. As there are many regional languages in India, banks are required to make available all printed material used by retail customers in the concerned regional language.

Second, banks have also been permitted to utilise the services of non-governmental organizations/self help groups (NGOs/SHGs), micro-finance institutions and other civil society organizations as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent (BC) models.

Third, banks are also entering into agreements with Indian Postal Authorities for using the large and well spread network of post offices as business correspondents, thereby increasing their outreach and leveraging on the postman's intimate knowledge of the local population and trust reposed in him. Similarly, banks in association with insurance companies, are

providing innovative insurance policies at affordable cost, covering life disability and health cover.

Fourth, the Reserve Bank has been encouraging the use of ICT solutions by banks for enhancing their outreach with the help of their Business Correspondents (BCs). A multilingual website in 13 Indian languages on all matters concerning banking and the common person has been launched by the Reserve Bank on 18 June 2007.

Several initiatives were also undertaken by the Reserve Bank to improve the delivery of customer services by banks.

First, the recommendations of the Standing Committee on Procedures and Performance Audit on Public Services set up in November 2003 covering an individual customer's dealing with a bank in the areas of foreign exchange, currency and government transactions, including pension, besides the main relationship as an account holder are being implemented.

Second, in order to bring together all activities relating to customer service in banks and the Reserve Bank of India in a single department, the Reserve Bank of India constituted a new department called “Customer Service Department” on July 1, 2006. The new department has facilitated a sharper focus to customer service issues.

Third, the Banking Ombudsman Scheme, which was introduced in 1995 to provide an expeditious and inexpensive forum to bank customers for resolution of their complaints relating to deficiency in banking services, was last revised in 2006. The Scheme has an enlarged scope now and is applicable to all commercial banks, regional rural banks and scheduled primary cooperative banks. The complainants can file their complaints in any form, including online.

Fourth, recognising an institutional gap in measuring the performance of the banks against codes and standards based on established best practices, RBI set up the Banking Codes and Standards Board of India in 2006. It is an autonomous and independent body, in the nature of a self-regulatory organisation. Banks register themselves with the Board as its members and provide services as per the agreed standards and codes. The Board in turn, monitors and assesses the compliance with codes and standards which the banks have agreed to. The Code of Banks' Commitment to Customers was released on July 1, 2006. The Code covers various aspects of transactions of individuals such as deposit accounts, interest rates, fees and charges, remittances, settlement of claims in respect of deceased account holders, loan products, safety locker, credit cards, guarantees, collection of dues and complaints and grievance redressal. The Reserve Bank has also made it obligatory for banks to display and update, in their offices/branches as also on their websites, the details of various service charges in a prescribed format.

Fifth, as lack of financial education on the part of customers of the bank contribute to rising number of complaints, especially relating to credit card operations, the Reserve Bank is according top priority for financial education which would ensure that the customers of banks take an informed decision. Individual banks have also started taking various steps in this regard such as “financial education posters”, “short films” and websites, etc.

IX. Prospects, challenges and strengths

Short term prospects

For monetary policy purposes, the Reserve Bank, in its Annual Policy Statement, placed real GDP growth for 2007-08 at around 8.5 per cent, assuming no further escalation in international crude prices and barring domestic or external shocks. The policy preference for the period ahead is strongly in favour of price stability and well-anchored inflation expectations with the endeavour being to contain inflation close to 5.0 per cent in 2007-08

and to the range of 4.0–4.5 per cent over the medium-term. For the purpose of monetary policy formulation, the Reserve Bank has projected the rate of money supply (M3) growth at around 17.0-17.5 per cent and non-food credit at 24-25 per cent for 2007-08 in consonance with the outlook on growth and inflation. While retaining the stance of the monetary policy, the Reserve Bank has flagged the importance of financial stability in the first quarter review of the Annual Policy Statement issued on July 31, 2007.

Data on recent developments is broadly in consonance with expectations for 2007-08. According to the Central Statistical Organization, during the first quarter of the financial year 2007-08 (April-June, 2007), the real GDP grew by 9.3 per cent on the back of 9.1 per cent in the last quarter of 2006-07 (January-March, 2007) and 9.6 per cent in the first quarter of the previous year (April-June, 2006). The wholesale price index, on a year to year basis, decreased to 3.79 per cent during the week ended August 25, 2007 as compared with 5.12 per cent a year ago. As on August 17, 2007, the broad money (M3) supply growth was 20.0 per cent on a year-on-year basis almost same as in the previous year. Though buoyant and broad based, there was a decline in non-food credit growth to 23.6 per cent as on August 17, 2007 as compared with 32.8 per cent a year ago. Exports continued its momentum, however, imports rose sharply, which led to widening of trade deficit to US $ 25.7 billion during the first four months of 2007-08 (April-July) as compared with US $ 15.8 billion during the same period of the previous year.

Available information indicates continuation of the growth momentum during 2007-08 so far at a strong pace with the impulses of growth getting more broad-based. Steady increases in the rate of gross domestic saving and investment, consumption demand, addition of new capacity as well as more intensive and efficient utilisation/capitalisation of existing capacity are expected to provide support to growth during 2007-08. The recent gains in bringing down inflation and in stabilising inflation expectations should support the current expansionary phase of growth cycle. It is, however, necessary to continuously assess the risks to the inflation outlook emanating from high and volatile international crude prices, the continuing firmness in key food prices and uncertainties surrounding the evolution of demand-supply gaps globally, as well as in India.

Risks from global developments continue to persist, especially in the form of inflationary pressures, re-pricing of risks by financial markets and danger of downturn in some asset classes. Excessive leveraging has enhanced the vulnerability of the global financial system. Large changes in liquidity conditions are obscuring assessment of risks, with attendant uncertainty. Given the flux associated with both financial markets and monetary policy settings globally, India cannot be immune to these developments. The policy challenge for Reserve Bank, now, is to manage the current transition to a higher growth path while containing inflationary pressures and focusing on financial stability. Contextually, we in the Reserve Bank are, therefore, maintaining enhanced vigilance to be able to respond appropriately to the prevailing heightened uncertainties in global financial, as well as, monetary conditions.

Medium term challenges

For a large and diverse economy with low per capita income but undergoing structural transformation in a highly uncertain global environment, challenges for public policy are manifold. I would focus on a few, which we in the Reserve Bank consider to be crucial for enhancing medium term prospects for equitable growth.

First, while over 60 per cent of the workforce is dependent on agriculture, the sector accounts for 20 per cent of the GDP. Further, the GDP growth generated from agriculture is only marginally above the rate of growth of the population, which is not adequate to ensure rapid poverty reduction. Volatility in agricultural production has not only implications for overall growth but also, as the experience of 2006-07 amply demonstrated, for maintaining low and stable inflation. Enhanced growth of the agricultural sector is vital for ensuring food

security, poverty alleviation, price stability, overall inclusive growth and sustainability of growth of the overall economy. Recently, our Honourable Prime Minister announced a major scheme to double the growth rate of agriculture to 4.0 per cent over the 11th Plan period. A time-bound Food Security Mission was also announced to counter rising prices of food products and to ensure visible changes in their availability over three years.

Second, the manufacturing sector has recorded robust growth, despite several infrastructure deficiencies. The inadequate availability of modern infrastructure and shortage of skilled manpower are the most critical barriers to the growth of the manufacturing sector. It is essential to augment the existing infrastructure facilities, particularly roads, ports and power, to provide the enabling environment for industry to prosper. The most important issues here are regulatory framework and overall investment climate, which are being addressed by the Government. One other concern has been the cost recovery, which is expected to improve with enlightened public-private partnership.

Third, a salient feature of the fiscal consolidation process in recent years even after accounting for cyclical elements has been significant reduction in the key deficit indicators. Our studies on State finances in the Reserve Bank of India give grounds for optimism in regard to their fiscal health. We recognize two important areas that, if addressed, would result in fiscal empowerment. One is elimination of subsidies, which are inappropriate and not directly targeted to the poor, and elimination of most of the tax exemptions, which are patently distortionary. Moreover, the delivery of essential public services such as education and health to a large section of our population is a major challenge.

Fourth, there is a growing recognition in India that governance reforms are critical to strengthen state capacity and enable it to perform its core functions. The task of improving the institutions of economic governance comprise, among others, many organizations and actions essential for good functioning of markets. It must be recognized that good governance can co-exist only when public sector functions fairly and efficiently, which is achievable by improving and not undermining it. The business community has therefore a vital stake in improving and empowering public institutions. I would like to endorse what Professor Avinash K. Dixit, President-Elect, American Economic Association said in the Second P.R. Brahmananda Memorial Lecture delivered by him in June 2007 in Mumbai.

“Finally, I think that the process of designing institutional reforms offers a good opportunity for fruitful collaboration between academic economists and businesspeople. Many academic economists used to dislike or disdain businesspeople and prefer a statist solution to economic problems. This is much less true in western countries these days, but the tendency may be more persistent in India. I hope even they will regard the task of improving the institutions of economic governance in a favorable light, seeing it as a way of constraining the opportunistic behavior of businesspeople. Many of them will also be attracted by the idea of a bottom-up rather than a top-down reform. There is a wealth of academic studies, theoretical and empirical, of the evolution, performance, and limitations of such institutions. Businesspeople have a clear perception of the specific governance needs of their industries. The two can combine their brains and energies to adapt the lessons of these studies to the Indian situations, and contribute to creating a better environment for continued rapid economic progress of the country.” (Dixit, Avinash K., Second P.R. Brahmananda Memorial Lecture, June 2007, Mumbai, pages 17-18)

Strengths

The Indian economy has some inherent strength, both quantifiable and non-quantifiable, which would facilitate in meeting the challenges ahead. I have already mentioned extensively the quantifiable strengths. Apart from these quantifiable strengths, there are certain “not easily quantifiable strengths” which our economy possesses and I would like to mention some of them. First, a vast pool of science and technology graduates and the millions of people who are familiar with English language are sources of strength. The familiarity with

multiple languages in India prepares the people to adapt better to multi-cultural situations, making it easier for them to fit into international systems smoothly. Second, India also enjoys the distinction of being the biggest democracy of the world. The existence of a free press provides some insurance against excesses and makes Governments at all levels more accountable than otherwise. Third, impressive are the initiatives of many States for empowerment of women which defend their rights and help to gain greater self-esteem and control over their own personal lives and social relationships. Fourth, the political climate is characterised by what may be termed as political system stability, despite the coalition cabinets and periodic elections both at the Centre and in several States. Fifth, India will remain one of the youngest countries in the world in the next few decades. This "demographic dividend" is seen as an inevitable advantage provided prerequisites such as skill-upgradation and sound governance to realize it are put in place. Sixth, in terms of business environment, the impressive growth coupled with market orientation of the economy has been a bottom-up exercise, with a very broad-based growing entrepreneurial class. These tendencies are perhaps reflective of a penchant for innovation among already large and growing entrepreneurial class in India, imbued with professionalism and seeking to be globally competitive.

Thank you.

Table 1: Growth and Inflation in India - A Historical Record

(Per cent)

Period (Averages)	GDP Growth Rate	WPI Inflation Rate
1951-52 to 1959-60	3.6	1.2
1960-61 to 1969-70	4.0	6.3
1970-71 to 1979-80	2.9	9.0
1980-81 to 1990-91	5.6	8.2
1991-92 (Crisis Year)	1.4	13.7
1992-93 to 1999-00	6.3	7.2
2000-01 to 2006-07	6.9	5.1

Table 2: India: Select Economic Indicators
(Fiscal Year is April 1 to March 31)

	Indicator	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Real Sector								
1	Gross Domestic Product (GDP), Nominal, US dollar billion*	460	478	508	602	696	806	911
2	GDP, Real, percent change	4.4	5.8	3.8	8.5	7.5	9.0	9.4
3	Per Capital Income, US dollar#	455	461	473	543	618	712	797
4	Industry GDP, Real, percent change	6.4	2.7	7.1	7.4	9.8	9.6	10.9
5	Services GDP, Real, percent change	5.7	7.2	7.4	8.5	9.6	9.8	11.0
6	Saving Rate, as percent to GDP	23.7	23.5	26.4	29.7	31.1	32.4	-
7	Investment Rate, as percent to GDP	24.3	22.9	25.2	28.0	31.5	33.8	-
Money, Prices, Credit								
8	Broad Money (M3), end March, year on year percent change	16.8	14.1	12.7	16.7	12.1	17.0	21.3
9	Broad Money (M3), end March, percent to GDP	62.5	65.7	69.9	72.5	72.0	76.5	80.2
10	Wholesale Price Index, end March, year on year percent change	4.9	1.6	6.5	4.6	5.1	4.1	5.9
11	CPI, Industrial Workers, end March, year on year percent change	2.5	5.2	4.1	3.5	4.2	4.9	6.7
12	Bank Credit, end March, percent to GDP	32.3	33.3	36.6	36.7	40.9	47.5	51.5
13	Non-food Credit, end March, year on year percent change	14.9	13.6	18.6	18.4	27.5	31.8	28.4
Fiscal Sector								
14	Gross Fiscal Deficit of Centre, percent to GDP	5.7	6.2	5.9	4.5	4.0	4.1	3.5
15	Combined Gross Fiscal Deficit, Centre and States, percent to GDP	9.5	9.9	9.6	8.5	7.5	6.7	6.4
16	Combined Debt to GDP, percent	70.8	76.4	81.0	81.6	82.5	80.5	77.0

External Sector								
17	Export of Goods, BoP, US dollar billion	45.5	44.7	53.8	66.3	85.2	105.2	127.1
18	Import of Goods, BoP, US dollar billion	57.9	56.3	64.5	80.0	118.9	157.0	192.0
19	Current Account Balance, (+ suplus/- deficit), US dollar billion	-2.7	3.4	6.3	14.1	-2.5	-9.2	-9.6
20	Current Account Balance (+ surplus/- deficit), percent to GDP	-0.6	0.7	1.2	2.3	-0.4	-1.1	-1.1
21	Net Capital inflows, US dollar billion	8.8	8.6	10.8	16.7	28.0	23.4	44.9
22	Foreign Direct Investment Inflows, US dollar billion	4.0	6.1	5.1	4.3	6.0	7.7	19.5
23	Foreign Direct Investment, Outflows, US dollar billion	0.8	1.4	1.8	1.9	2.3	2.9	11.0
24	Net Portfolio Flows, US dollar billion	2.6	2.0	0.9	11.4	9.3	12.5	7.1
25	International Reserves, end March, US dollar billion	42.3	54.1	76.1	113.0	141.5	151.6	199.2
26	Reserves to Debt, percent	41.7	54.7	72.5	101.1	114.9	119.9	128.5
27	Import Cover of Reserves, number of months	8.9	11.7	14.2	16.9	14.3	11.6	12.4
28	Openness, trade in goods and services as percent to GDP	29.2	27.6	30.7	31.5	39.5	44.8	49.2
29	Total External Debt, percent to GDP	22.4	21.1	20.4	17.8	17.3	15.8	16.4
30	Exchange Rate, Rupees per US dollar, financial year average	45.7	47.7	48.4	46.0	44.9	44.3	45.3
31	Real Effective Exchange Rate, percent change	5.3	-0.1	-4.9	1.5	2.6	5.4	-1.7
Financial Sector								
32	Banking Sector Assets, percent to GDP	67.1	73.3	75.3	77.6	82.8	86.9	-
33	Capital to Risk Weighted Assets Ratio (CRAR), percent	11.4	12.0	12.7	12.9	12.8	12.3	-
34	Gross Non-performing Assets, percent to gross advances	11.4	10.4	8.8	7.2	5.2	3.3	-
35	Market Capitalisation, percent to GDP	27.2	26.8	23.3	43.4	54.3	84.7	85.9

Note: - : Not Available ;
* Calculated by dividing GDP at Current Market Prices by average exchange rate during the financial year.
# Per Capita income is on annual basis taken from the World Economic Outlook database.
Source: World Economic Outlook, IMF; Global Financial Stability Reports, IMF; World Development Indicators, World Bank.