THE ANNUAL REPORT ON THE WORKING OF THE RESERVE BANK OF INDIA

*For the Year July 1, 2011 to June 30, 2012**

PART ONE: THE ECONOMY - REVIEW AND PROSPECTS

I ASSESSMENT AND PROSPECTS

Inflation slowed in response to past monetary tightening and growth deceleration in 2011-12. Growth during 2012-13 is expected to stay below trend at around the same level as in the previous year. Inflation is likely to remain sticky around 7 per cent with upside risks emanating from a deficient monsoon. Concurrently, the risk of twin deficits has accentuated causing concern for macro-financial stability. With limited fiscal and monetary space available to provide direct stimulus to growth without stoking inflation, an expenditure switching strategy is needed that reduces government's revenue spending by cutting subsidies with a step up in capital expenditure to crowd-in private investment. Over the medium-term, addressing issues impeding infrastructure investment have become important for stepping up India's growth potential which has been dented post-crisis. While the Reserve Bank is focusing on price stability and sustainable growth over the medium-term keeping in view its welfare implications, the human face of its financial policy can be buttressed with a greater thrust on effective financial inclusion.

I.1 Growth decelerated in 2011-12 after two years of relatively good performance and dropped to below the economy's potential. The drop in growth was a result of combination of domestic and global factors. Global macroeconomic and financial uncertainty, weak external demand, elevated level of prices, widening twin deficits and falling investment combined to adversely impact growth. The investment climate worsened due to structural impediments, policy uncertainty, inflation persistence and rising interest rates.

I.2 Two years of high inflation amidst wide fiscal and current account deficits would have had adverse consequence for welfare. It adversely affected saving and investment, particularly household saving in financial assets. Inflation changes the future consumption basket by reducing the real value of the amount saved today, thus making current consumption more attractive. Real value of savers' holdings of cash as well as fixed income products declines.

I.3 The most serious consequence of inflation is its adverse distributional impact on the poor, people without social security and pensioners. Poor households are unable to maintain the consumption levels at current prices and therefore, they are particularly worse off in an inflationary situation. During 2011-12, growth also slowed down, in part because of high inflation. This further reduced welfare of the common man as firstly, it had adverse impact on employment and incomes and secondly, with low growth, the trickle down benefits for poor also reduced.

I.4 In view of the adverse welfare consequences and its impact on sustainable growth, the Reserve Bank combated high inflation through monetary tightening. Several other factors combined with monetary tightening causing growth to slow down

* While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated beyond March 2012 based on information available till mid-August. For the purpose of analysis and for providing proper perspective on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

to the lowest in nine years. Even though inflation moderated later in the year, macroeconomic risks increased with slowing growth and rising twin deficits. This posed difficult challenges for macro-economic management. First, though India outperformed most of its peers in terms of growth, its potential and actual growth slowed. Second, the investment downturn extended and deepened due to above mentioned factors. Third, fiscal slippage put some pressure on interest rates and crowded out resources for private investment. Fourth, external sector soundness weakened, especially as current account deficit (CAD) widened, partly due to impact of large government spending on aggregate demand. Fifth, inflation moderation provided limited comfort given the suppressed inflation and incomplete pass-through of rupee depreciation.

I.5 Inflation persistence and widening twin deficits constrained the Reserve Bank's ability for counter-cyclical measures during 2011-12. After tightening monetary policy till October 2011, the Reserve Bank paused hiking policy rates as growth risks accentuated. Excessively tight liquidity conditions during Q4 of 2011-12 along with assessment that inflation would fall in line with the projected path, prompted the Reserve Bank to start easing monetary and liquidity conditions. Amidst macro-economic deterioration it used the available space in April 2012 to cut policy rates.

I.6 Going forward, the priority should be to bring down the twin deficits so as to support potential growth even if it means a slower pace of recovery in the short run. A stable macro-economic environment, coupled with complimentary macro and micro-economic policies to support saving, investment and inclusive growth could help restore India's potential to grow at 8-8.5 per cent on a sustainable basis over the medium term.

ASSESSMENT OF 2011-12

I.7 In 2011-12, growth decelerated in each successive quarter. On the other hand, average inflation remained high, though it moderated in the last four months of the year. In the context of the growth-inflation dynamics, an assessment of the role of both monetary and fiscal policy and the impact on growth slowdown on asset quality are set out below.

Role of monetary and non-monetary factors in growth slowdown

I.8 After recording a rise of 8.4 per cent during 2009-10 and 2010-11, growth dropped to 6.5 per cent in 2011-12. Growth in Q4 of 2011-12 of 5.3 per cent was the lowest in 29 quarters. Early indications are that activity levels continued to be slow during Q1 of 2012-13, with industrial growth stagnating, slack persisting in investment activity and consumption decelerating.

I.9 The Reserve Bank had gradually tightened monetary policy over last two years through 13 policy rate hikes that began in March 2010 and continued till October 2011, raising operational policy rates by 525 basis points (bps) from 3.25 to 8.5 per cent. It also hiked the Cash Reserve Ratio (CRR) twice, increasing it by 100 bps from 5 to 6 per cent of NDTL. Given these measures, there has been a perception that the Reserve Bank's monetary tightening has been predominantly behind the growth slowdown. In this context, there are two important factors to be considered. First, the initial rounds of increase were more in the nature of normalisation of policy from its crisis-driven excessive accommodative stance. Such normalisation could not have had an adverse impact on growth. Second, even at the current level of the policy rate, the real effective lending rates of banks are relatively lower in comparison with their pre-crisis levels. This highlights the fact that policy rates alone cannot explain the sharp growth slowdown observed in the last few quarters.

I.10 An exercise undertaken by the Reserve Bank to calculate Weighted Average Lending Rate (WALR) of scheduled commercial banks using the accounts-level data from Basic Statistical Returns (BSR) suggests that this effective lending rate in nominal terms increased during 2011-12 in response to monetary tightening. Preliminary data suggests that the WALR increased to 12.7 per cent,

which was slightly higher than the average of 12.4 per cent in the pre-crisis period. Nominal rates had fallen in the post-crisis period before hardening in 2011-12. Real (net of inflation) WALR also increased moderately to about 3.8 per cent in 2011-12, but remained lower than the average of about 7.0 per cent in the pre-crisis period of 2003-04 to 2007-08, when an investment boom took place. The fall in real lending rates in post-crisis period is even sharper if GDP deflators are used to calculate inflation instead of WPI. The fact is that real lending rates have secularly declined since 2003-04. During this period, investment boomed initially, but stalled in recent years even though real rates continued to decline.

I.11 Interest rates are only one of the many factors in an investment decisions. These decisions in any case depend on interest rate view over several cycles. Interest rates increased during 2011-12 and may have impacted investment, but they are clearly not the primary reason for the downturn. The decline in investment started earlier in H2 of 2010-11 for reasons that were linked to global uncertainties, structural constraints, loss of pro-reform policy momentum, persistent inflation and increasing business uncertainties.

I.12 Growth had decelerated in the Indian economy through successive quarters of 2011-12, dropping from 9.2 per cent in Q4 of 2010-11 to 5.3 per cent in Q4 of 2011-12. This steep 3.8 percentage point drop did prompt the Reserve Bank to shift its policy stance by first pausing and then front-loading the cut in the repo rate by 50 bps in April 2012.

I.13 Monetary policy is framed on several considerations of which inflation (the pace at which general level of prices changes) and growth (the pace at which national output increases) are the two main ones. Headline inflation was running at 9-10 per cent rate in each of the first eight months of 2011-12 – way above the Reserve Bank's comfort-level of 4-5 per cent. Thus, the inflation gap (actual less intended level of inflation) far exceeded the output gap (actual less potential output). While these gaps cannot mechanically determine the policy rate setting, they constitute an important consideration in calibrating monetary policy response. Any premature easing would have caused inflation risks to rise thereby adversely affecting growth over the medium-term.

I.14 In this context, it is important to appreciate as to what monetary policy can or cannot do. First, monetary policy can have a strong long-run impact on inflation, but can influence output in a more limited way by nudging growth towards potential when growth operates below or above potential. Importantly, monetary policy cannot bring about permanent or long-run changes in the levels of output, which are mainly driven by technology, productivity changes and fiscal policy, through its impact on thrift and investment behaviour.

I.15 Second, the adverse welfare consequences of high and persistent inflation are large. Slowdown does raise unemployment and lowers income and consumption, especially of those who lose jobs. In a country like India, business cycle fluctuations that cause output and job losses are more pronounced in organised than unorganised sector and impacts agricultural output relatively less. However, a rise in inflation generally lowers consumption across-the-board in varying degrees. It acts like a regressive tax and hurts the poor the most as they are virtually unhedged against inflation.

I.16 Since the April 2012 policy, the growth outlook has turned weaker, while the inflation path moved slightly higher. While core inflationary pressures remained low, they have not fallen commensurate to the growth slowdown. On the other hand, food inflation pressures have re-emerged and are likely to be exacerbated by drought conditions following the unsatisfactory monsoon so far. Consequently, monetary policy will need to be carefully calibrated to the evolving growth-inflation dynamics.

Fiscal consolidation is needed to sustain growth and reduce inflation

I.17 After an impressive period of fiscal consolidation during 2002-03 to 2007-08, there has been a marked deterioration in the fiscal position. The gross fiscal deficit (GFD)/GDP ratio that

dropped from 5.9 per cent in 2002-03 to 2.5 per cent in 2007-08 is back at almost the same level. The improvement in revenue and primary deficits have been more than reversed. India's fiscal deficit has widened both structurally and cyclically. On the external front, the CAD on the balance of payment side has averaged about 3.0 per cent during 2008-09 to 2011-12 after a marginal surplus on current account on an average basis during 2002-03 to 2007-08. The deterioration partly reflects the impact of wider fiscal deficits.

I.18 The wide fiscal deficit along with the wide CAD is symptomatic of macroeconomic deterioration. These have also dented India's relative attractiveness in the eyes of global investors and prompted some sovereign rating agencies to put India on a watch list for a possible sovereign rating downgrade. In this backdrop, it is important to give priority to the pending subsidies and tax reforms in India, so that the fiscal position gets structurally strengthened and it is also possible to better withstand cyclical downturns.

I.19 There are two main reasons for deterioration in India's fiscal deficits. First, expenditures on subsidies have risen from 1.3 per cent of GDP in 2005-06 to 2.4 per cent of GDP in 2011-12. Revenue constraints make it impossible to finance them in a sustainable manner. Second, resource mobilisation by the government has been rather insufficient with low tax/GDP ratio, poor non-tax revenue mobilisations and under-achieved disinvestment targets. Also, the fiscal stimulus through tax cuts in the aftermath of the 2008 financial crisis were prolonged and were rolled back only partially. There has been a structural as well as cyclical dimension to the rise in fiscal deficits in India. Stalled tax reforms have made it difficult to put fiscal consolidation back on rails after the significant gains made prior to the global financial crisis got substantially reversed.

I.20 As part of the tax reform agenda, the Government of India had envisaged introducing Direct Tax Code (DTC) and the Goods and Services Tax (GST) in the past few years. However, these reforms have been delayed and could not be carried out even as part of the 2012-13 union budget. This has been a setback for fiscal consolidation, even though some of the tax measures contemplated as part of these reforms have already been effected over the past two years to enable a smooth transition to the new tax regimes.

I.21 As per the study undertaken by the NCAER for the Thirteenth Finance Commission (ThFC), the implementation of comprehensive GST will increase India's GDP by about 0.9-1.7 per cent. Higher GDP would widen the tax base and improve tax revenues. In this context, while the shift towards 'negative list' services tax regime is a positive move, the time lag to phase in GST needs to be minimised so that cascading of taxation is avoided, and a seamless GST for Centre and States establishes a proper input-output network of indirect taxes.

I.22 Tax reforms also need to encompass a clear policy regime on measures like GAAR (General Anti Avoidance Rule) that has impacted investors' confidence. In this context, the recently released draft guidelines on GAAR are being examined by a committee and are expected to be finalised after widespread consultation with all stakeholders. Bringing about greater clarity in taxation of international capital flows would facilitate in financing the current account deficit.

I.23 There is a need to ensure that these legislations are quickly put in place to support resource raising efforts with a view to create fiscal space for financing of initiatives relating to inclusive growth. Such tax reforms are a positive sum game and would improve fiscal positions of both Centre and States.

Maintaining asset quality is important to financial stability

I.24 The deterioration in asset quality of the banks emerged as a concern within and outside the Reserve Bank during 2011-12. In any economic downturn, asset quality gets impacted and India was no exception to this. Asset quality deterioration during 2011-12 was particularly significant in the

case of public sector banks. The gross Non-performing Assets (NPAs) of the public sector banks increased to 3.2 per cent of gross advances at the end of 2011-12 from 2.3 per cent at the end of 2010-11. In net terms, their ratio went up to 1.5 per cent from 1.0 per cent over the same period. While the NPA levels are still low by historical trends or cross-country comparison, the restructured standard advances in the PSBs increased to 5.7 per cent of gross advances by at the end of 2011-12 from 4.2 per cent a year ago.

I.25 The slippage ratio increased and recovery slowed down, reflecting the stress arising in some sectors such as aviation and power. Deterioration in macroeconomic conditions put added pressures on asset quality. While some of these changes reflect the NPA cycle that generally tracks economic cycle, the sector-specific issues that include management and industrial relation issues need to be resolved. There has also been a significant rise in restructuring of loans during the year. Several firms opted for corporate debt restructuring. Restructuring increased substantially during Q4 of 2011-12, taking the restructured loans at the end of 2011-12 to about 5 per cent of the loan book of the scheduled commercial banks (SCBs), up from 3.9 per cent a year ago. Aviation, state electricity boards (SEBs), textiles, telecom, shipping, power and steel were amongst the sectors that reported stress contributing to the restructuring.

I.26 However, the increasing non-performing assets and restructuring of loans are not a systemic issue. While, some of strength of the bank balance sheets may have eroded, they are in line with the movement in the business cycles that have occurred before. The balance sheets are far from becoming fragile. The CRAR of the SCBs at the end of 2011-12 was 14.1 per cent, way above the prescribed 9 per cent norms and only marginally less than the 14.2 a year ago. Core CRAR, however, increased to 10.3 per cent at the end of 2011-12 from 10.0 per cent in 2010-11.

I.27 A series of stress tests carried out to study the impact of various adverse macro-financial shocks on the health of banks showed that the banking system remained resilient even under stress scenarios. For instance if macro-stress builds up during 2012-13 with growth falling to below 6 per cent, inflation remaining above 9 per cent and GFD/GDP ratio rising to 6.5 per cent in 2012-13, gross NPA ratios for the SCBs as a whole is expected to increase to 3.7-4.1 per cent at the end of the year from 2.9 at the end of the previous year. Their CRAR is expected to fall to 12.5 per cent from 14.1 per cent. An assessment of the stability of the banking system conducted through a series of banking stability measures did indicate that distress dependencies amongst banks had increased in recent years but remained well below the levels observed during the global financial crisis in 2008-09. This was earlier documented in the Financial Stability Report of June 2012 and reflects the collective assessment of the Sub Committee of the Financial Stability and Development Council (FSDC).

I.28 Keeping in view the increasing incidence of restructuring and for reviewing the guidelines in the light of experience gained, a Working Group (Chairperson: Shri B. Mahapatra) was constituted by the Reserve Bank. The group has recommended doing away with regulatory forbearance regarding asset classification, provisioning and capital adequacy on restructuring of loans and advances gradually over the two-year period. It has recommended increasing the provisioning requirement on stock of restructured loans from existing 2 per cent to 5 per cent in a phased manner over the two-year period along with the 5 per cent provisioning requirements on all newly restructured loans. It has also suggested increase in promoters' contribution to at least 15 per cent of the diminution in fair value of the restructured account or 2 per cent of the restructured debt, whichever is higher. A principle of higher amount of promoters' sacrifice in case of restructuring of large exposures under CDR mechanism may bring about an incentive-compatible mechanism for lending discipline. While the final change in the regulatory regime will be made after further

consultative process in August 2012, there is a clear intent on the part of the Reserve Bank to bring about an asset classification regime that does not allow banking fragilities to build up in the economic downturn. While the deterioration in asset quality during 2011-12 has been partly due to cyclical downturn, inadequate credit writing standards as well as weak credit administration has also played a role. The banks need to upgrade their systems to prevent slippages and improve post-sanction recovery process.

PROSPECTS FOR 2012-13

Growth Outlook for 2012-13

I.29 The growth outlook for 2012-13 remains weak as combination of global and domestic macro-economic factors that slowed down growth in the preceding year have persisted and show no signs of getting resolved. Globally, the sovereign and bank debt overhang is still keeping the financial markets under stress. The global trade outlook has deteriorated as growth in emerging markets is slowing down in addition to recession taking roots in euro area and US also headed for a slower growth.

I.30 On the domestic front, macro-economic conditions are unlikely to improve in near term as a spell of policy stasis, structural and cyclical problems have combined to slow down the economy. Growth is slowing down, while inflation remains sticky at above comfort levels. However, the Government in August 2012, promised to take several steps to address the macro-economic weakness. These would include, the return to path of fiscal consolidation, bringing in a clear and stable tax regime, encourage saving and investment, including foreign investments and work towards generating supply-side responses to lower inflation. Key decisions to put fiscal consolidation back on track such as hikes in administered fuel prices, slashing of other subsidies and introduction of Goods and Service Tax (GST) have been delayed and there is urgency to quickly move on the indicated lines to avert further deepening of problems. As these steps materialise, growth could gradually start improving later this year and trend growth can be restored by next year. At the current juncture there is no scope for complacency as fiscal slippage is likely during 2012-13 and CAD is likely to stay above sustainable level. With fluid situation for the global economy, macro risks from twin deficits remain large and need to be addressed forthwith.

I.31 Structural factors that are impeding growth remain unaddressed. Mining activity continues be stalled in absence of a streamlined regulatory and environmental framework. While growth in the interim may have suffered as a result of attempt at legal and environmental enforcement, ultimately an incentive-compatible framework for business that penalises fraud and encourages ethical practices while ensuring fair return alone can provide a conducive investment climate. Somewhat similar problems also prevail in telecom space. New power sector investments are falling as coal linkage and pricing issues are yet to be satisfactorily resolved and State Electricity Board (SEB) losses are large. Road projects are confronting multiple issues that include land acquisition problems as well as financing constraints for overleveraged road developers. As a result, road tendering has nearly stalled during Q1 of 2012-13 after a record pace of project tendering in 2011-12. These issues need to be quickly resolved while keeping lending discipline for banks.

I.32 Newer uncertainties for growth in 2012-13 have emerged from the unsatisfactory progress of monsoon so far which is likely to result in a contraction in foodgrains output during 2012-13. Despite the recent revival, cumulative rainfall up to August 16, 2012 was 16 per cent deficient. The Reserve Bank's production weighted rainfall index (PRN) showed an even higher deficit of 21 per cent. The spatial pattern of monsoon suggests that output losses could be substantial for coarse cereals and pulses, While this year the drought conditions in parts of country are marginally less severe than that during the 2009 drought, the monsoon has been unsatisfactory to a degree that has dampened the prospects for agriculture during

2012-13. During 2009-10, *Rabi* crop reached record levels, while the *Rabi* prospects this year remain uncertain and would depend crucially on September rains that will determine the soil moisture content and the reservoir levels.

I.33 Growth during the year is likely to stay below potential for the second consecutive year. The Reserve Bank in its First Quarter Review of Monetary Policy on July 31, 2012, revised downwards its growth projection for 2012-13 to 6.5 per cent from 7.3 per cent. The downward revision mainly reflects drought impact on agricultural output and contraction in IIP during Q1 of 2012-13. Given the greater integration of the Indian economy with global economy, decelerating global growth and trade volumes will adversely impact India's industry and services sector growth. In addition, the lagged impact of weak industrial growth is likely to weigh on services sector growth.

I.34 The key question, therefore, is: what can stimulate a recovery? In absence of signs of global conditions improving, the burden of adjustment would have to be borne by domestic policies. Structural impediments impacting business confidence need to be addressed immediately. This is particularly true of the mining and infrastructure sectors. With limited fiscal and monetary space available to provide a direct stimulus to domestic growth, an expenditure switching policy is needed that reduces government's revenue spending by cutting subsidies and using the resources so released to step up public capital expenditures. Such an action would also provide some space for monetary policy, but, importantly, lower interest rates alone are unlikely to jumpstart the investment cycle. Fast-tracking of infrastructure projects and pending regulatory clearances will help to boost investments. The Government has initiated some steps to augment the production potential of core sectors, in particular mining, in the recent period. However, a lot more needs to be done to boost the performance of core industries and lead revival of industrial growth.

Inflation Outlook for 2012-13

I.35 The inflation outlook for 2012-13 remains better than the previous year, though the inflation trajectory could remain sticky. Headline inflation averaged 7.3 per cent during April-July 2012, lower than the 8.9 per cent average for 2011-12. After dropping moderately in December 2011, headline inflation has neither risen nor fallen further in a perceptible manner. The Reserve Bank's proxy for core inflation, non-food manufacturing inflation, averaged 7.8 per cent in the first three quarters of 2011-12 but dropped noticeably to 5.9 per cent in the last quarter. It has now dropped further and averaged 5.0 per cent in Q1 of 2012-13, though it showed some uptick in July 2012 and remained above its decade average in the 2000s. While persistence of inflation is still worrisome, some relief has been provided by the decline in the recent period.

I.36 The Reserve Bank, in its First Quarter Review of Monetary Policy on July 31, 2012, revised upwards its baseline projection for headline inflation in March 2013 to 7.0 per cent from 6.5 per cent factoring in the upside risks to inflation. Earlier projection was based on the assumption of normal monsoon that has not materialised. Also, the moderation in non-food manufactured product inflation has not been commensurate with moderation in growth. Persistence of inflation, even as growth is slowing, has emerged as a major policy challenge.

I.37 Inflation control remains the cornerstone of monetary policy as upside risk to inflation remain. This is largely due to unsatisfactory monsoon, large upward revision in MSPs on back of cost escalation (averaging 26 per cent for *kharif*) and exchange rate depreciation during Q1 of 2012-13. Latest assessment suggests that there could be considerable upside pressure on prices of pulses. Some of this is already in evidence. Except for Myanmar, pulses crop has failed globally and options for imports are rather limited. Pressures to some extent can also emanate in case of edible oils, though soyabean crop can substantially offset

the groundnut shortfall. Risks to global commodity prices that had fallen in Q1 of 2012-13 also remain. The prevailing drought in the parts of US, Eurasia and Australia may add to price pressures on food in the global markets. Pass-through from moderation in global commodity prices to domestic inflation has in any case been partially offset by rupee deprecation.

I.38 Other upside risks arise from suppressed inflation in energy, especially diesel, electricity, coal and fertiliser prices that need to be adjusted upwards. The path of inflation could thus be impacted by the timing and magnitude of administered price revisions, though it must be emphasised that such adjustments have become necessary to reduce pressure on medium-term inflation from an expansionary fiscal policy. Continued pressure from wages and the structural nature of protein inflation could keep inflation high even with moderation in growth.

I.39 So while inflation risks in 2012-13 are on the upside, there is a need to distinguish between temporary and permanent supply shocks. Structural shocks evident in inflation emanating from protein food, oil and some commodities require appropriate short and medium-term responses from the supply side. However, notwithstanding the cause, persistent inflation, if left unchecked, could unhinge inflation expectations and lead to eventual generalisation of inflation as had happened in Q4 of 2010-11. Furthermore, demand pressures emanating from high rural wages and growing corporate staff costs would need to be factored in. In such situation, close vigil on inflation would be necessary during 2012-13 to prevent re-emergence of inflationary pressures.

Need to address twin deficits to contain risk to macro-financial stability

I.40 The emergence of twin deficits during 2011-12 was a major cause for macro-economic weakness. Current assessment suggest that they are likely to stay wide in 2012-13 in absence of sufficient policy response and no improvement in business cycle conditions.

I.41 With growth remaining slow, budgetary targets are at risk. On the receipts side, shortfall in indirect tax revenue is possible if growth remains low. With decline in corporate earnings, non-tax revenues from the earnings of public sector units (PSUs) could also fall short of the target. It would be hard to meet the divestment target in current market conditions. More importantly, expenditure overshooting arising from under-provision of petroleum subsidies is likely to put fiscal position under pressure. Consequently, some level of fiscal slippage may be unavoidable. In fact, estimates suggest that if no revision is made in administered fuel prices, this slippage may turn out to be large at the current level of crude prices (at about 0.4 per cent of GDP on this account alone). The fiscal policy for 2012-13 as announced in the Union budget directionally aims at aiding the growth revival through higher capital outlays and reducing key deficits. However, in order to make space for private credit to help investment cycle picks up a much stronger switch to capital expenditures is necessary without further increasing the deficits.

I.42 Restraining deficits is important as the budget mathematics still leaves fiscal marksmanship difficult. The focus of the rule-based consolidation, which seeks to achieve a correction of one percentage point in RD-GDP ratio and 0.8 percentage point in GFD-GDP ratio in 2012-13 (BE) critically depends on revenue augmentation through widening and rationalisation of indirect tax structure. While the Government has announced its intent to cap the expenditure on subsides to below 2 per cent of GDP in 2012-13, credible policy action without any further delay would be necessary to achieve this.

I.43 Adherence to expenditure control measures on the subsidy front would be challenging if administered fuel price hikes are delayed. The consequent subsidy burden on the Government could crowd-out public investment at a time when reviving investment, both public and private, is a critical imperative. In addition, the absence of pass-through from international crude oil prices to

domestic prices would prevent the much needed adjustment in aggregate demand. This could then spill over to higher inflation and wider CAD.

I.44 The Government has promised to unveil steps for fiscal consolidation soon. It has asked three reputed fiscal experts to help formulate plans for this within weeks and promised to make adjustments both on revenue and expenditure side, while sharing fiscal correction burden progressively in relation to income classes. A clearer and more stable tax regime with non-adversarial tax administration is also being worked upon. This would include a fair mechanism for dispute resolution. GAAR legal provisions and guidelines are being re-examined and taxation for IT sector and Development Centres are also being reviewed. While these steps should help improve the fiscal regime, there is an urgent need to evolve a political consensus on GST and DTC as part of the tax reforms and also cut subsidies in order to put the fiscal regime on a firmer footing.

I.45 CAD had widened to unsustainable levels in 2011-12 as it reached historical high of 4.2 per cent of GDP. This was mainly due to high imports of oil and gold. While growth in exports is likely to be lower in 2012-13 due to slowdown projected in the global trade volume, the trend in imports will be contingent on exchange rate pass-through and upon the pace of growth in domestic economy and trend in international commodity prices, particularly oil. Furthermore, measures taken to curb gold imports may have positive influence on trade balance.

I.46 Even though merchandise trade balance in Q1 of 2012-13 narrowed, trends in services trade in Q1 of 2012-13 are disconcerting. Preliminary estimates for Q1 of 2012-13 show services exports at US$33.4 billion, thus contracting 2 per cent y-o-y. Services imports at US$20.5 billion, increased by 16 per cent. In net terms, services exports at around US$ 12.9 billion in Q1 of 2012-13 were lower by 22 per cent as compared with those in Q1 of 2011-12. This indicates that CAD risks are maintained in 2012-13. Software exports are likely to moderate as global IT spending is expected to be lower. Major software exporters have already made steep downward revisions in their guidance on expected revenues during the year. Overall, CAD-GDP ratio may not correct significantly in 2012-13 unless there is substantial improvement in global economic conditions and domestic policy response.

I.47 With a lower growth, the sustainable level of CAD is now assessed at around 2.5 per cent of GDP. For minimising the possibility of external shocks further disrupting India's growth sustainability over next few years it is important not only to focus on financing of CAD, but also on compressing CAD to lower manageable levels. Otherwise, there are risks to CAD from both domestic and external events. In recent period, CAD has been managed by improving debt inflows. However, this has long-term costs for debt sustainability and increases refinancing risk over time. Therefore, there is an urgent need to step up non-debt creating inflows, especially in form of FDI. While there are pros and cons of greater FDI opening, the balance of risks overwhelmingly suggests the need to augment such inflows. With appropriate regulation and conditions, the negative fallout of foreign investments can be minimised so that net gains can accrue. This should be seen as part of the process of managing globalisation and reaping gains from it. India has become a far more open economy than ever. It is often not realised that India's exports and imports, including services trade now works out to over 55 per cent of GDP. This is much higher than the same indicator for the US.

MEDIUM-TERM CHALLENGES FOR THE INDIAN ECONOMY

Preserving India's growth story through revival of infrastructure investments

I.48 India's growth story in recent past has been substantially driven by large infrastructure investments. Foreign direct investments in this sector have not been very large, but large investments, both in public and private sectors

during last 10-years catapulted India to the rank of second fastest growing economy in the world after China. Yet, over the past year or two, infrastructure sector has reached a critical point of entanglement.

I.49 New investments have slowed down substantially and existing investments are at risk with elongated gestations and input supply shortages affecting viabilities of projects going on-stream. Reserve Bank's collation from banks and financial institutions show that envisaged total fixed investment by large firms in new projects which were sanctioned financial assistance during 2011-12 dropped by 46 per cent to about ₹2.1 trillion from ₹3.9 trillion a year ago. This drop was led by infrastructure and metals. Envisaged investment in infrastructure declined by 52 per cent to ₹1.0 trillion from ₹2.2 trillion in the previous year, with power and telecom accounting for most of this fall. Investment in telecom sector has dried up, while that in road, ports and airports has also decelerated sharply. More than half of the envisaged corporate fixed investment in large projects has been coming from infrastructure since 2008-09. Its share, however, dropped to 48.6 per cent in 2011-12 from 54.8 per cent in 2010-11. This has had a ripple effect on the economy. Order books of capital goods producing firms have declined as the size of the pie has reduced. Their share in the pie has also gone down as they have been outcompeted by cheaper imports by foreign firms.

I.50 In addition, investment climate in power sector has been affected by rising losses of public sector utilities. Though power tariffs has been raised by many SEBs over last two years and several other steps have been initiated to improve the financial health of the SEBs, drought in many parts of the country could put added pressure on their profit line during 2012-13. A large amount of bank finance getting locked in this sector has raised risks that a significant portion of these loans may require to be restructured and may even become non-performing. The exposure of banks to power sector is about ₹3.3 trillion as per sector-wise deployment of credit obtained from 47 scheduled commercial banks that account for 95 per cent of total non-food credit.

I.51 Lower coal production and supply shortages has emerged as a major bottleneck in infrastructure sector. As much as 54 GW of new power capacity was created during 11th FYP and another 60-75 GW of capacity may be planned during 12th FYP backed in part by Ultra Mega Power Projects (UMPPs). A large part of this new capacity is facing coal linkage issues. As a result, these investments are at risk due to coal shortages (see also Box II.6). A significant proportion of new capacity is without Power Purchase Agreements (PPAs). Besides coal shortages can affect a large chunk of power capacities in absence of Fuel Supply Agreements (FSAs). The current state is the result of inadequate planning and coordination between power and coal sectors, as also slow execution of coal projects. However, steps are now on anvil to resolve the problems that have impacted the coal and power sectors. Most of the distribution companies have raised power tariff over last one year. Even though in many cases the extent of revision remains below what is necessary, it would provide a positive momentum as the regulators are now seen to be active. Contemplated revisions in FSA structures and coal pricing pooling mechanism could also help, but all pending issues in respect of proposed new FSAs need to be resolved without any further delay. Private sector has added to the shortages by a dismal record of producing coal out of the mining rights given to them. Therefore, unused mining rights need to attract deterrent penalties. Coal production projections for the 11th Five Year Plan had to be revised downward due to delays in obtaining clearances, land acquisitions, rehabilitation and law and order problem. Although India has large coal reserves, demand for coal is outpacing its domestic availability substantially. Therefore, there is a need to resolve coal block auction issues in a fast-track manner, so that green growth objectives can be pursued in a manner consistent with economy's needs.

I.52 It is an anomaly that India with proven coal reserves of 114 billion tonnes has to import about 70 million tonnes of coal. A major investment initiative in India's mining sector is necessary. Steps

to attract FDI in this sector would be helpful in this context. A careful balancing of environmental and growth needs would be necessary. What are needed are quick time-bound decisions under a transparent framework and not necessarily quick clearances. Provisional clearances do not often help and where necessary must be accompanied by easily monitored conditions that can be fulfilled in a short span. There is a need to make doing business easy by adopting models like the one in Singapore, where multiple agencies/Ministries sit together to quickly give its decision clearing investment projects. The onus for such clearance clearly rests with the bureaucratic machinery. Businesses also need to rejig their strategies that aim at operating in a more competitive environment earning normal profits within the legal and environmental framework and not try to exploit rules and weak regulation to its advantage at cost of integrity.

I.53 Apart from capital expenditure slowdown in the power sector, investment in 2012-13 is also at risk from the falling interest in PPP projects in the road sector. National Highways Authority of India (NHAI) undertook a record road tendering during 2011-12, awarding contracts for 6,491 kms of road length; 28 per cent higher than in previous year (see also Chart II.10). Estimated spending on NHAI projects were also higher by 33 per cent at ₹362 billion. However, the road tendering activity has suffered significantly during Q1 of 2012-13.

I.54 Road projects have slowed down due to issues in land acquisition and problems with legal, procedural and environmental clearances. More lately, availability of finance has emerged as an added constraint. Financial conditions have tightened as road construction firms are already leveraged and are unable to raise more debt in absence of fresh equity. In current market conditions these firms are unable to raise new equity. Credit to road sector shows a deceleration in Q1 of 2012-13. A significant part of the panned investment during 2012-13 would materialise even in adverse condition as NHAI is planning to award tenders for 3,000 kms of road construction on the basis of Engineering, Procurement, Construction (EPC) contracts under which the builder procures material and does construction and is paid for the costs. However, steps would be needed to preserve predominance of PPP mode of road investments.

I.55 In respect of infrastructure financing during the year 2011-12, gross bank credit to infrastructure outstanding as of April 2012 was ₹6.2 trillion. However, the flow of bank credit to infrastructure has decelerated. Data on sector-wise gross deployment of bank credit shows that its year-on-year growth has declined to 14 per cent for 2011-12 as compared to 38 per cent for 2010-11.

I.56 From a macroeconomic perspective, India faces a huge energy deficit at present which is constraining its growth process. An estimated 40 per cent of India's energy requirements would need to be met through imports during the 12th Plan. As such, there is a need to expand domestic production in the critical sub sectors such as petroleum, natural gas and coal. Equally important is to migrate towards deregulation of pricing in the energy sector so as to rationalise and moderate demand and improve energy efficiency. Furthermore, alternative sources of energy would have to be developed for bridging the demand-supply gap and work towards ensuring energy security in the Indian economy.

I.57 The projected investment requirements for infrastructure at US$ 1 trillion for the 12th Plan present a formidable challenge in view of limited fiscal space available in the public sector. The Approach Paper for the 12th Plan envisages that about half of the investment requirements of infrastructure would have to be met through funding from the private sector. A notable concern, however, has been a lack of private sector participation in certain key sectors such as railways, irrigation, water supply and sanitation, ports and power distribution. There is also a need to create a conducive environment for private sector participation with a transparent and credible regulatory mechanism. In this regard, there is a need to identify the hurdles and weaknesses in regulatory, financing, and incentive structure (both

taxation and debt) and project implementation related issues that may be inhibiting.

Strengthening banking soundness through Basel III

I.58 During the year 2011-12, the Reserve Bank made significant strides towards implementation of Basel III norms that is intended to enhance the resilience of bank and strengthen banking system soundness further. The Basel III framework in India would be consistent with the new global standards. The Basel Committee on Banking Supervision that was first set up in 1974 by a group of central bank Governors from 10 countries have been providing such standards since 1988 when the Basel I Accord was signed. In 2004, a new accord know as Basel II was suggested with a view to make capital standards more risk sensitive.

I.59 To address the lesson of the 2008 global financial crisis, the Basel committee has introduced comprehensive reforms package through the Basel III framework to address both firm-specific and broader systemic risk. Basel III essentially enhances the regulatory framework introduced by the Basel II at the level of individual banks. It also sets up a macro-prudential overlay to limit systemic risk. The measures relate to enhancing the quality and quantity of capital, liquidity risk management, valuation practices dealing with procyclicality issues and dealing with systemically important banks. It also covers resolution mechanism, compensation practices, stress testing, disclosures to enhance transparency and reducing systemic risk in derivative markets by moving OTC derivatives to central clearing and settlement mechanisms *etc*. The Reserve Bank issued the guidelines on Basel III capital regulation, first in the draft form in December 2011 and then in its final form in May 2012. Banks in India are to begin implementation of these guidelines beginning January 1, 2013 and complete it in a phased manner by March 31, 2018.

I.60 In the guidelines, the minimum capital requirements have been kept one percentage above the norms laid down by the Basel Committee. Besides this, a few rules have also been kept tighter than the norms suggested by the Basel Committee.

I.61 As a prudent measure, the Reserve Bank has always prescribed 1 per cent higher capital requirement compared to 8 per cent prescribed by the Basel Committee under Basel I / Basel II capital adequacy framework. The higher prescription has served Indian banking system well over the years. The higher prescription is essentially on account of the fact that the Basel Committee norms are only the minimum norms. A higher norms covers up the possible inadequacies in the capital allocation process and model risks in banks. It may be mentioned that for similar reasons, several other jurisdictions have also proposed higher capital adequacy requirements than the minimum prescribed by the Basel Committee. Additional capital requirements over and above Basel minimum have had positive externalities. It has been noted by credit rating agencies as being rating positive and are expected to help banks access funds more easily in the markets. The higher prescriptions are not expected to put additional pressure on banks as globally banks have in fact, always operated at significantly higher level of capital adequacy than the prescribed minimum.

I.62 The broad level estimates suggest that in order to achieve full Basel III implementation by March 31, 2018, the public sector banks (PSBs) would require common equity to the tune of ₹1.4–1.5 trillion on top of internal accruals, in addition to ₹2.65–2.75 trillion in form of non-equity capital. Similarly, major private sector banks would require common equity to the tune of ₹200-250 billion on top of internal accruals, in addition to and ₹500-600 billion in form of non-equity capital. These projections are based on the conservative assumption of uniform growth in Risk Weighted Assets of 20 per cent per annum individually for all banks and individual bank's assessment of internal accruals (in the range of 1.0-1.2 per cent of Risk Weighted Assets). It is important to mention that banks would have continued to require additional capital to meet Basel II capital ratios had Basel III capital ratios not been implemented. Therefore, in case of PSBs, the incremental equity

requirement due to enhanced Basel III capital ratios is expected to be to the tune of ₹750-800 billion.

I.63 There have been some arguments whether the regulatory regime could be softer for public sector banks given the backstop they enjoy with the government which is the principal owner and stakeholder in such banks. However, from the regulatory standpoint, operating on the basis of such backstops and not on the basis of prudential standards would be detrimental of the financial system besides being unethical. The Reserve Bank is committed towards developing a level-playing regime for all banks irrespective of their ownership patterns.

I.64 Implementation of Basel III would be challenging but manageable. In this context, the observation of Mr. Jaime Caruana, General Manager, Bank for International Settlements is relevant. During his speech at CAFRAL/BIS Conference in November 2011, he stated that globally, banks have been able to improve their capital ratios, ahead of schedule and this without any noticeable impact on lending spreads or tightening of lending terms.

Financial Inclusion led Reserve Bank policies with a human face

I.65 With the growing dominance of market economy, the public perception about the Reserve Bank policies has been increasingly associated with how they are impacting interest rates and exchange rates as also the performance and health of the banking industry. There has been inadequate recognition of the fact that Reserve Bank is a multi-service central bank and has been discharging its responsibilities in a wide array of domains with a view to supporting long-run growth and enhancing welfare of the common man. In addition to its pursuit of inflation control that helps the poor the most, the human face of Reserve Bank is reflected in its policies in the area of rural credit and regulation of banks and non-bank financial intermediaries, foreign exchange regulation, currency management, payment and settlement system.

I.66 To impart a human face to the bank lending policies, the Reserve Bank has supported the directed lending route as an integral part of its bank lending policies. This has been mainly through the stipulation that banks must ensure that at least 40 per cent of their total advances go to the priority sectors. The prescription in respect of foreign banks was 32 per cent, but which has now been raised to 40 per cent in case the bank has twenty or more branches. The new stipulation is to be achieved over next five years. The priority sector lending (PSL) has improved the flow of credit to certain productive sectors of the economy that would otherwise have been crowded out of the bank credit market in presence of information asymmetries.

I.67 The Reserve Bank has faced criticism from extreme votaries of strong interventionist policies to promote financial inclusion and the detractors who argue that such directed lending leads to misallocation of resources. In practice, Reserve Bank has strived to ensure a balance between equity and efficiency considerations so that financial inclusion is furthered, but banks financial health is not hampered and its lending capacities are preserved.

I.68 Nothing represents the extent of human face of the banking than the progress it makes on the goal of financial inclusion. Financial inclusion was adopted as a formal agenda for Indian banking following the Report of the Committee on Financial Inclusion (Chairman: Dr. C. Rangarajan), 2008. The Report noted that 51 per cent of farmer households did not access credit, either from institutional or non-institutional sources. Further, despite the vast network of bank branches, only 27 per cent of total farm households were indebted to formal sources (of which one-third also borrow from informal sources). Access to formal institutional credit amongst farm households was as low as 4.1 per cent in North-Eastern, 18.2 per cent in Eastern and 22.4 per cent in Central Regions.

I.69 A World Bank study by Asli Demirguc-Kunt and Leora Klapper (April 2012) is revealing about

the dismal state of financial inclusion world-wide and even more so in India. Providing an analysis from a newly developed Global Financial Inclusion Database (Global Findex), that is drawn from survey data covering 148 countries shows that only half of the world's population hold accounts with formal financial institutions and only 9 per cent have taken out new loans from a bank, credit union or microfinance institution in the past one year. This study also shows that India scores rather poorly on financial inclusion parameters than the global average. In India, only 35 per cent of people had formal accounts *versus* an average of 41 per cent in developing economies. India also scored poorly in respect of credit cards, outstanding mortgage, health insurance, adult origination of new loans and mobile banking.

I.70 In the recent years, the Reserve Bank has taken several initiatives to push financial inclusion high on the agenda of Indian banking. It required banks to provide no-frills accounts, tried to improve the outreach of Indian banking through the business facilitator and business correspondent (BC) models and set up the goal for banks to provide access to formal banking to all 74,414 villages with a population over 2000. In June 2012, the process was refined further by advising all banks to prepare road maps covering all unbanked villages with population of less than 2000 with banking services. Yet, the Reserve Bank's assessment is that financial inclusion remains a substantially unfinished agenda. This is also suggested by independent appraisals through analysis of the banking data, evaluation studies and outreach activities. Latest figures indicate that there are over 110,000 BCs employed, which is not a large number in context of the under banked villages that exist.

I.71 The Reserve Bank had adopted the ICT-based agent bank model through BCs for ensuring door step delivery of financial products and services since 2006. The list of eligible individuals/entities who can be engaged as BCs is being enlarged from time to time. For-profit companies have also been allowed to be engaged as BCs. The BC model has not been very effective in addressing financial inclusion needs. The model, by itself, cannot serve the financial inclusion objective. It cannot substitute the services and the customer confidence that the brick and mortar bank branches provide. Also, most BCs are not adequately trained in the use of technology, knowledge of bank products and processes and have not imbibed the customer service culture. There is a need for mainstreaming financial inclusion. To improve the access of the poor to banking, banks need to open branches to provide low-cost intermediation with simple structures, minimum infrastructure for operating small customer transactions and supporting up to 8-10 BCs at a reasonable distance of 2-3 kms. This will lead to efficiency in cash management, documentation and redressal of customer grievances.

I.72 Following the Reserve Bank directive in November 2005, no-frills accounts have been accepted by banks as one of the important pillars of financial inclusion. Such accounts opened with nil or very low minimum balance have the potential to effectively combat credit rationing and provide the much-needed finance to a large section of the under-privileged population. In order to further encourage such accounts, the Reserve Bank in August 2012 asked banks to rechristen these as 'Basic Savings Bank Deposit Account', with a view to remove the stigma attached to earlier name and to integrate them as part of basic baking services. It also issued specific guidelines to bring about uniformity on basic banking services across banks. It specifically removed altogether the requirement of any minimum balance and has asked banks to offer deposit and withdrawal of cash at bank branch as well as ATMs.

I.73 The number of no-frills accounts by banks had increased to 103 million by March 2012. However, over three-fourths of such accounts are dormant. This raises the question whether the blanket supply-side thrust to financial inclusion is workable? For financial inclusion to work, it is necessary to replace the bank or the service provider approach with customer-centric approach. As such, more work is necessary for effective

strategy for implementation of the financial inclusion goals. The medium-term strategy for banks would need continue with a multi-facet approach with activities woven around linking of bank finance with Self Help Groups (SHGs) through MFIs or otherwise. BCs would need to be an integral part of the financial inclusion by banks and banks must ensure fair remuneration and help develop faith in these agents, but coexist, they cannot substitute but only complement banking infrastructure. Furthermore, banks need to actively leverage and develop delivery models that are technology driven. In doing so they must choose technology that can support up-scaling and customisation, as per individual requirements. BCs and SHGs can play a key role in developing customer-centric approach.

I.74 The task of financial inclusion is a colossal one. It cannot be outsourced to other layers even if they form important element of the strategy in place. These layers have to be integrated with mainstream banking. It is in banks' medium to long term interest to do so, as financial inclusion may be a short term pressure on banks profitability, but over the years could increase the size and scope of banking in India. It will add to the banks' revenue stream making it commercially viable.