1

GENERAL REVIEW

The last *Economic Survey* was written in sombre circumstances. Although the economic crisis of mid-1991 had been contained, and a programme of structural reforms initiated, inflation was still running high, the balance of payments remained under strain and industrial production was depressed. The economic situation has improved substantially in the year under review. There has been decisive progress in overcoming inflation and the rate of inflation has declined to seven per cent. The balance of payments situation, though still difficult, shows hopeful signs with a pick-up in exports to the hard currency area. Industrial growth is picking up slowly and is better than in the previous year. The policy initiatives introduced after June 1991 have been seen to work. This gives us confidence that the direction of our reforms is right, and that if we persevere with them, we can overcome the severe constraints on our economy and assure a more prosperous future for our people.

1.2 The year has not been without setbacks. The irregularities in securities trading in some banks damaged liquidity and temporarily raised questions of confidence. The riots in December 1992 and January 1993 disrupted transport, slowed the growth of exports and industrial production, and reduced revenue. Without these setbacks there would have been faster recovery in both output and employment in 1992-93.

Growth Performance

1.3 The latest CSO estimates for 1991-92 suggest that economic growth was only 1.2 per cent, significantly lower than the growth of 2.5 per cent projected in last year's *Economic Survey* (Table 1.1). The prospects for the current year are distinctly better and growth of GDP is expected to exceed four per cent in 1992-93.

1.4 After a slightly delayed start, the monsoon turned out to be very good in all areas other than the middle Gangetic plain. The kharif foodgrain harvest is likely to show a rise of as much as eight per cent. The coarse grain crop, estimated at 34.7 million tonnes is almost 32 per cent higher than 26.3 million tonnes in 1991-92. The sugarcane crop lacked rain in the North at a crucial time and the total crop is likely to be 7.7 per cent lower at 230 million tonnes. But the cotton crop, at 11.7 million bales, is excellent. The kharif oilseed crop is estimated to be 10.5 million tonnes, 17.7 per cent above last year and equal to the record crop of 1988-89. With another bumper harvest of mustard expected in the coming

TABLE 1.1

Key Indicators

	1987-88	1988-89	1989-90	1990-91	1991-92(P)	1992-93(P)	1987-88	1988-89	1989-90	1990-91(P)	1991-92(P)	1992-93(P)
	ABSOLUTE VALUES						PER CENT CHANGE OVER PREVIOUS YEAR					
Gross national product @ @ (Rs thousand crore)												
At current prices	292.2	349.0	400.1	465.8	535.1 @	610.0 *	13.2	19.4	14.6	16.4	14.9-●	14.0 *
At 1980-81 prices	168.1	185.7	196.1	206.3	209.3 @	218.2 $	4.1	10.5	5.6	5.2	1.4 ●	4.2 $
Gross domestic product (Rs thousand crore)												
At current prices	333.2	396.6	454.0	530.9	609.5	694.8 *	13.7	19.0	14.5	16.9	14.8	14.0 *
At 1980-81 prices @ @	170.3	188.9	199.5	209.8	212.3 ●	221.2 $	4.3	10.9	5.6	5.2	1.2 ●	4.2 $
Agricultural production (1)	151.3	183.2 (P)	187.0 (P)	192.0 (P)	186.6 (P)	195.9 *	-0.8	21.0	2.1	2.7	-2.8	5.0 *
Foodgrain production (million tonnes)	140.4	169.9	171.0	176.4	167.1	176.7 *	-2.1	21.0	0.6	3.2	-5.3	5.7 *
Industrial production (2)	166.4	180.9	196.4	212.6	212.4	208.3 (3)	7.3	8.7	8.6	8.3	-0.1	3.8 (3)
Electricity generated (TWH)	202.1	221.4	245.4	264.6	286.7	221.3 (8)	7.7	9.5	10.8	7.8	8.4	4.6 (8)
Wholesale price index (4)	148.5	156.9	171.1	191.8	217.8	231.0 (5)	10.7	5.7	9.1	12.1	13.6	7.8 (5)
Consumer price index for industrial workers (6)	153.0	166.0	177.0	201.0	229.0	244.0 (7)	10.9	8.5	6.6	13.6	13.9	8.4 (7)
Money supply (M3) (Rs thousand crore)	164.3	193.5	231.0	265.8	315.1	350.2 (8)	16.0	17.8	19.4	15.1	18.5	11.2 (8)
Imports at current prices												
(Rs crore)	22244	28235	35416	43193	47851	47480 (8)	10.7	26.9	25.4	22.0	10.8	38.7 (8)
(US $ million)	17156	19497	21272	24072	19411	16630 (8)	9.1	13.6	9.1	13.2	-19.4	16.5 (8)
Exports at current prices												
(Rs crore)	15674	20232	27681	32553	44042	37329 (8)	25.9	29.1	36.8	17.6	35.3	23.1 (8)
(US $ million)	12089	13970	16626	18142	17866	13075 (8)	24.1	15.6	19.0	9.1	-1.5	3.4 (8)
Foreign currency assets												
(Rs crore)	7287	6605	5787	4388	14578	13688 (9)	-4.7	-9.4	-12.4	-24.2	232.2	40.2 (9)
(US $ million)	5618	4226	3368	2236	5631	5237 (9)	-5.2	-24.8	-20.3	-33.6	151.8	38.8 (9)
Exchange rate (Rs / US$) +	13.0	14.5	16.6	17.9	24.5	25.9 (10)	1.4	10.5	13.0	7.2	26.7	6.8 (10)
Market rate (Rs / US$) # +						30.4 (10)						20.3 (10)

* Anticipated (P) Provisional @ Quick estimates ●● At factor cost. $ Advance estimates

\+ Per cent change indicates the rate of depreciation of the Rupee.

\# Indicative exchange rate as anounced by FEDAI

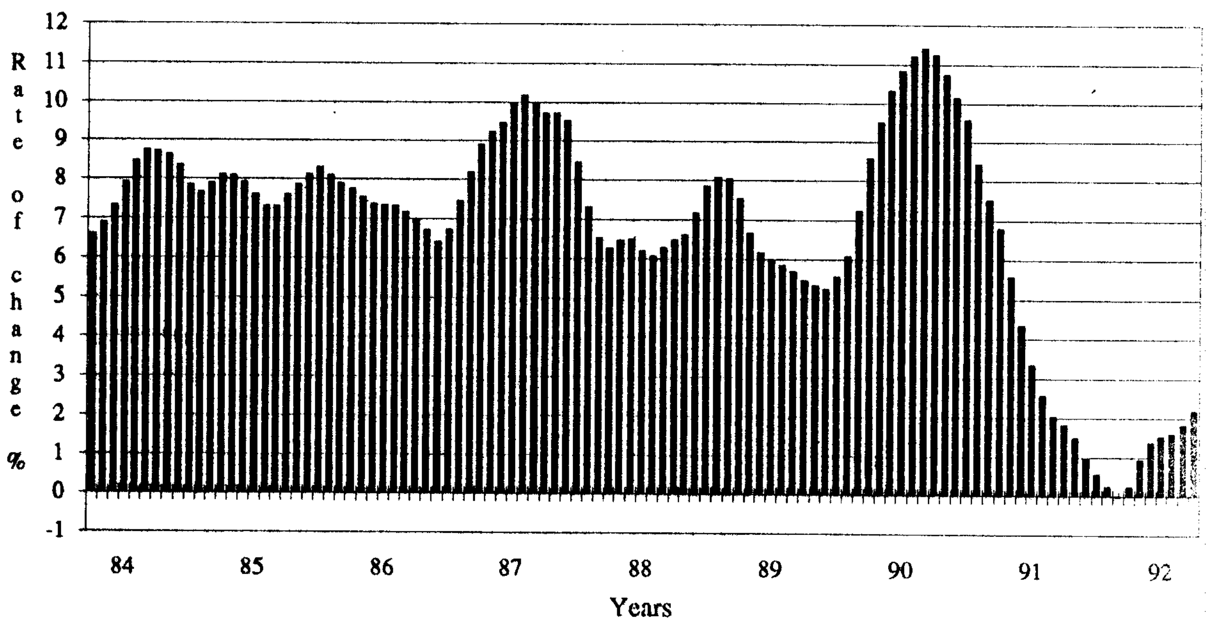
1. Index of agricultural production with base triennium ending 1969-70=100.
2. Index of industrial production 1980-81 = 100 .
3. April - October 1992 .
4. Index with 1981-82 = 100 .
5. As in end December, 1992 .
6. Index with 1982 = 100 .
7. As in November 1992.
8. April - December , 1992 .
9. As on January 31, 1993 for 1992-93 and at the end of March for previous years .
10. April-January,1993.

rabi, the supplies of edible oils are likely to be very comfortable. The agricultural situation this year is broadly satisfactory and even with a modest growth in rabi crop, agricultural output could be five per cent higher than in 1991-92.

1.5 In contrast, the industrial sector has continued to suffer from recessionary conditions through 1992-93, though performance is better than in 1991-92. Production in the period April-October 1992 shows a growth of 3.8 per cent. This is better than the marginal decline recorded in the same period of 1991-92, but it is well below the normal trend growth of industry. Industrial production in 1992-93 has been slow to recover for a number of reasons. Import restrictions which accounted for the poor performance in 1991-92 were completely removed by the end of 1991-92 when the new Liberalised Exchange Rate Management System was introduced. However, while quantitative restrictions on imports were not a constraining factor in 1992-93, the high cost of imported inputs, reflecting changes in the exchange rate, probably acted as a restraining factor in import-intensive industries. The new exchange rate will, however, help exports, and the resulting export stimulus would stimulate industrial production in more export-oriented sectors. However the export response will come only with a lag.

1.6 Credit restrictions introduced in 1991-92 needed to be continued in 1992-93 in view of continuing inflationary pressure at the start of the year. However, some relaxations were introduced during 1992-93 in light of the easing of inflationary pressure and keeping in mind the need to stimulate an industrial recovery. Interest rates were lowered in the course of the year and the volume of credit extended to industry was expanded considerably. Total bank credit to the commercial sector expanded by Rs.21012 crore up to January 8, 1993 compared with only Rs.7135 crore in the same period of 1991-92.

Figure 1.1. Annual growth of industrial production (12-month moving average), 1983-1992



1.7 There is evidence that industrial growth is accelerating. The moving average annual index of industrial production was stagnant 7 months earlier and now shows a growth rate of 2.2 per cent in the year ending October 1992 (Fig.1.1). The extent of disruption in December and January is not yet easily quantified but if the industrial recovery continues at the pace observed in recent months, the industrial growth rate for 1992-93 as a whole could reach four per cent.

1.8 Services account for an important proportion of GDP and have shown steady growth. In fact, the growth of 1.2 per cent in GDP in 1991-92 when both agriculture and industry showed negative growth was entirely accounted for by the growth in services. And this growth in services was real. Apart from the normal growth in services owing to the Government sector, there was a real increase in the output of important measurable services in 1991-92, as shown by Table 1.2 . This growth in road and rail transport, telephone connections, cargo handled and air passengers continues in 1992-93.

1.9 An important feature of the economic situation in the second half of 1992-93 has been the revival of investment activity. The total term loans sanctioned by the term lending institutions in the first quarter of 1992-93 had shown very little growth, but the position improved dramatically thereafter. For the period April-December 1992 the term loans sanctioned by the all India Financial Institutions show a growth of 70 per cent while disbursements show a growth of 47 per cent.

TABLE 1.2

Indicators of changes in the output of services, 1990-91 to 1992-93

	April- March		April-Dec		April- March Change over previous period		April-Dec
	1990-91	1991-92	1991	1992	1990-91	1991-92	1992
					(per cent)		
1	2	3	4	5	6	7	8
Railways' revenue-earning traffic(mt)	318	337	245	254	2.7	6.0	3.9
Road transport: diesel oil consumption (mt)	21.1	22.7	10.6*	12.6*	2.1	7.3	19.1*
New telephone: connections (thousand)	486	735	278	378	16.7	51.4	36.3
Cheques cashed (Rs. thousand crore)	1183	1376	342@	387@	39.8	16.3	13.3@
Major ports: cargo handled(mt)	153	158	122	114	3.2	3.3	6.7
Air passengers (million)	17.7	18.8	14.0	14.6	-11.2	6.2	4.1
Air cargo (Thousand t)	377	370	269	295	-9.2	-1.7	9.8

* April-September @ April-June m Million t Tonnes

The Balance of Payments

1.10 The balance of payments position, which had reached a point of near collapse in June 1991, slowly stabilised during the course of 1991-92. Although new policies to deal with the situation were quickly formulated by the new Government and implemented within a few months the external payments situation took time to stabilise primarily because it had been allowed to deteriorate to a state of near bankruptcy in June 1991. Foreign currency reserves had declined to $ 1.1 billion despite heavy borrowing from the IMF in 1990-91 and a substantial part of this was held in illiquid deposits which could not have been easily mobilised if needed. International confidence had all but collapsed, commercial borrowings had dried up and even letters of credit opened by Indian banks were being generally rejected unless accompanied by confirmation by foreign banks.

1.11 The strategy for the management of the balance of payments outlined in the Budget for 1991-92, which was presented in July 1991, relied upon a combination of macro-economic stabilisation and structural reforms in industrial and trade policy. It was recognised that in the medium term, the solution to the balance of payments problem would have to come from a much stronger export performance, but in the shorter run the strategy had to be underpinned by mobilisation of external financing from the multilateral agencies and from bilateral donors. Restoration of access to imports through liberalisation had to depend initially upon additional financing since the export efforts would take time to show results. Since access to external commercial borrowing was constrained the only other sources of funds were the bilateral and multilateral agencies. Visible support from the multilateral agencies was important for restoring international confidence.

1.12 Accordingly the Government negotiated a standby arrangement with the IMF in October 1991 for $ 2.3 billion over a 20-month period, a Structural Adjustment Loan with the World Bank of $ 500 million and a Hydrocarbon Sector Loan with the ADB for $ 250 million. Parallel with the effort to draw on multilateral sources, the Government also launched the India Development Bonds aimed at mobilising NRI sources of funds.

1.13 With the assurance of external support through these efforts, there was a gradual stabilisation of the balance of payments position in the course of 1991-92. Foreign exchange reserves were restored to more normal levels increasing from $ 1.1 billion in June 1991 to $ 5.6 billion at the end of March 1992.The entire amount of drawals from the IMF in 1991-92 ($ 1.24 billion) plus the accretion from India Development Bonds ($ 1.63 billion) together amounted to an inflow of $ 2.87 billion. This was less than the increase in reserves of $ 4.51 billion from June 1991 to end March 1992. In effect, the exceptional financing mobilised in 1991-92 was used primarily to build up reserves.

1.14 Import restrictions were gradually lifted in the course of 1991-92 as the balance of payments stabilised. By the end of 1991-92 the new Liberalised Exchange Rate Management System introduced in the Budget for 1992-93 eliminated import licensing in most capital goods, raw materials, intermediates and components and introduced a dual exchange rate system with one rate effectively floated in the market. The Budget for 1992-93 also reduced customs duties in line with declared Government policy in order to make the Indian economy more competitive and gradually exposing Indian industry to external competitive pressure. The trade and exchange rate policy regime for 1992-93 was therefore characterised by major progress in eliminating unnecessary administrative and discretionary controls over foreign trade which were contributing to making our economy uncompetitive.

1.15 The year 1992-93 saw a revival of imports to more normal levels. The total value of imports in US dollars in the period April-December 1992 increased by 16.5 per cent over the level in the corresponding period of 1991-92. The increase appears large only in comparison with a highly depressed level prevailing in 1991-92. In fact the level of imports in 1992-93 as a whole is expected to be around $ 25 billion which is somewhat lower than the level in 1990-91.

1.16 Exports in 1992-93 performed far better than in 1991-92. Total export growth in the period April-December was 3.4 per cent in dollar terms compared with an observed decline of 1.5 per cent in 1991-92. The performance of total exports is depressed by the decline of more than 60 per cent in exports to Russia and other States of the former Soviet Union in 1992-93. The growth of exports to the general currency area in the period April-December was 11.4 per cent. The average growth rate in April-December 1992 has been adversely affected by a decline in exports of 12.5 per cent in December, reflecting the disturbed conditions prevailing in that month. Figures for January are also likely to be depressed by the riots in Bombay. Total exports in 1992-93 may not exceed US $ 19 billion. But it is hoped that the export performance in subsequent months will return to the high growth rates of 15-16 per cent observed during September-November.

1.17 The current account deficit in 1992-93 is expected to be around $ 7 billion, reflecting the revival of imports to more normal levels. This deficit is being financed through a combination of traditional financing sources and exceptional financing.

1.18 However, there are important uncertainties in the balance of payments. The full impact of the disturbances in December 1992 and January 1993 on exports and imports is difficult to assess at this stage. Clearly, the receipts on account of tourism would be less than anticipated. The inflow of NRI deposits has in any case been small this year. The inflow of external assistance is also subject to some uncertainties consequent upon constraints that affect the rate of utilisation. A step-up in commercial borrowings was, in any case, not envisaged. Finally, there is the uncertainty arising from leads and lags. Interest rates and exchange rate expectations do affect the timing of receipt of export proceeds and payment of import costs. However, while these uncertainties justify a measure of caution in assessing prospects, the balance of payments in 1992-93 has performed more or less as expected.

Inflation

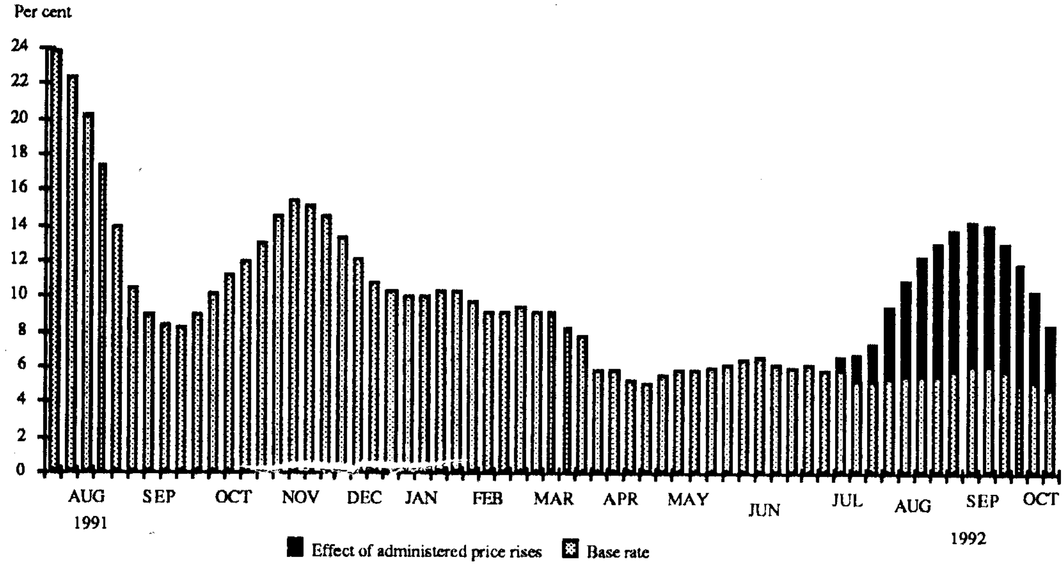
1.19 Inflation was by far the most pressing problem for the common man and woman in 1991-92, especially as the rate of inflation for food articles was much higher than for all commodities. The situation improved considerably in 1992-93 with a gradual decline in the annual rate of inflation in the course of the year. The annual rate of inflation as measured by the wholesale price index declined from 13.6 per cent at the end of 1991-92 to 6.9 per cent on 30 January 1993. The decline in inflationary pressure was especially marked in primary articles including foodgrains. The annual rate of inflation in foodgrains was -3 per cent on 30 January 1993 compared with 24.3 per cent at the same time in the previous year. The deceleration in inflation is a major achievement of economic management in the past year.

1.20 The conventional method of measuring the annual rate of inflation has been based on comparing the level of prices with the level a year ago. An alternative approach is to measure the current inflationary pressure by looking at the change in prices over a shorter period and calculating an annualised rate on this basis. Figure 1.2 shows the annualised rate of inflation calculated from a quarter's (13 weeks') observations of the wholesale price index after adjusting for seasonal factors and using final estimates only. The annualised rate of inflation is then estimated by means of log-linear regressions which give equal weight to all the observations in a quarter. The annualised estimate is centred on the 7th week of 13-week sequence.

1.21 The annualised rate of inflation measured in this way declined very rapidly from about 11 per cent at the beginning of 1992 to five per cent at the end of March, and remained near that figure till July. It then began to rise, reached a peak of almost 14 per cent in August, and then began to decline just as rapidly; the latest available figure for the end of September (i.e. centred on the last week of September) was almost ten per cent.

1.22 The rise in the quarterly rate of inflation was due to the increases in the administered prices of oil products and fertilisers in September. Figure 1.2 also shows the rate of inflation net of the *direct* effect of the administered price rise. This net figure continued to be around five per cent. The impact of administered price changes on the level of inflation obviously forms part of overall inflationary pressure but it has to be recognised that the increase in the prices of oil products and fertilisers caused a once-for-all rise in the general level of prices. This rise would be reflected in the quarterly rate of inflation for three months, after which the quarterly rate will return to its underlying trend level. This underlying trend, according to these estimates, is around five per cent.

Figure 1.2. Trends in inflation with and without the effect of administered price rises



1.23 The moderation in inflationary pressure in 1992-93 has been partly due to the good performance of agriculture but it is in large part also due to the reduction in the Central Government's fiscal deficit, which has been a key element in the strategy for macro-economic management and control of inflation. The progress achieved in reducing the fiscal deficit in the past two years has been substantial. The Central Government's gross fiscal deficit was reduced from 8.4 per cent of GDP in 1990-91 to 6.2 per cent in 1991-92 and the 1992-93 budget envisaged a further fall to 4.9 per cent. Thus the Centre's draft on domestic savings is scheduled to come down by 3.5 percentage points of GDP in two years. This massive fiscal correction has been a major disinflationary influence in the period.

1.24 Equally important are the changes in the sources of finance for financing the fiscal deficit. Of the decline of 3 per cent of GDP in the gross fiscal deficit between 1989-90 and 1992-93, 1.5 per cent or almost half has been in the budget deficit; the direct impact of this fall in the budget deficit is on the growth of high - powered or reserve money. Thus the disinflationary impact of reduced Central Government dissavings has been reinforced by their reduced contribution to the growth of money supply. This is reflected in the deceleration in money supply (M3) growth in 1992-93. After growing by 15.3 per cent in 1991-92 up to 10 January 1992 M3 has slowed down in the current year with a growth of 12.3 per cent in the period up to 8 January 1993. For the year as a whole M3 growth is likely to be contained at about 13.5 per cent.

1.25 It is interesting to note that although money supply growth has decelerated in line with the reduction in the fiscal deficit and its monetised component, the budgetary deficit, the growth of M3 remains higher than the targeted level of around 10.5 per cent for the year as a whole. This is in part due to the fact that although budget deficits as measured at the end of the year have been declining as a percentage of the total deficit, and also as a percentage of GDP, the average level of the deficit in the course of the year has not declined commensurately (Figure 1.3). The strategy of reducing the budget deficit needs to be reinforced by techniques of evening out the spread of Government expenditure within the year. Similarly evening out the inflow of revenue together with short-term money market operations will ensure that the budget deficit does not impart an excessive monetary stimulus at any time in the course of the year. Steps in this direction have been initiated in the current year. The pattern of instalments of advance income tax payment was revised to ensure a more even accrual to the Treasury. Periodic auctions of new 364-day treasury bills were also started by Reserve Bank of India. Further progress in this direction is necessary. Meanwhile, fiscal policy must continue to carry a large share of the burden of macro-economic management and inflation control.

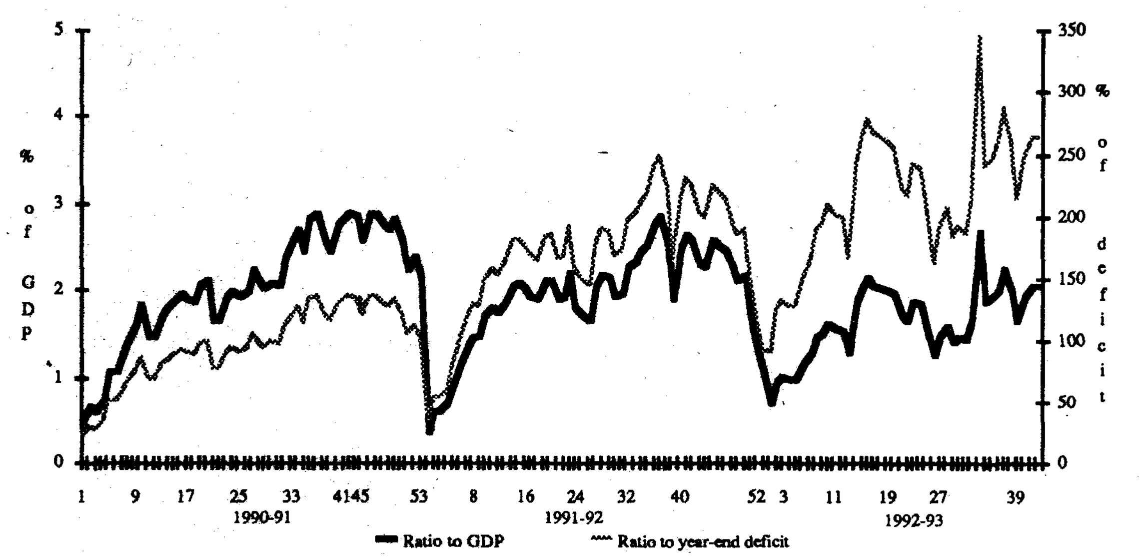
The Strategy for Economic Reform

1.26 The strategy of economic reform introduced in 1991-92 was based on a combination of measures aimed at economic stabilisation as well as structural reform. Stabilisation was necessary in the short run to restore balance of payments equilibrium and to control inflation. The reform measures are equally important in the medium term if our economy is to grow and become competitive in the world. The results achieved thus far are satisfactory. The phase of crisis management is over. Substantial progress has been made in bringing about fiscal correction and this is reflected in the deceleration in inflation in the course of the year. But a great deal remains to be done. The process of structural adjustment was expected to take at least three years and only half this period is now over. The main elements of the strategy, on which continuing emphasis is needed, are spelt out below.

Fiscal Policy

1.27 Although considerable fiscal correction has been achieved in the past two years with a reduction in the fiscal deficit from 8.4 to five per cent, the process must continue. Inflationary pressure can be said to have been purged from the system only after inflation has been brought down to no more than five to six per cent per year for two years. Besides, the current account deficit in the balance of payments is still too high and needs to be reduced from around 2.8 per cent in 1992-93 to less than one per cent of GDP in 1995-96. This reduction in current account deficit of a little less than two per cent of GDP over a three-year period will call for further reduction in the fiscal deficit and boost in exports. The reduction in the fiscal deficit is also necessary if we want to reduce the pressure of Government borrowing on the financial system without which interest rates cannot be reduced.

Figure 1.3. Centre's budgetary deficit as per cent of GDP and year-end deficit



1.28 Chronic reliance on compulsory borrowings is equally undesirable for the State Governments; their fiscal balance should also be improved until they can obtain access to the capital market on their own financial strength. The Central Government has, in the past year, worked towards this aim by raising the States' share of central revenue. The increase in personal tax and excise revenue would work to the advantage of the States. It would be desirable if these efforts of the Centre were supplemented by the State Governments with measures to reduce their budget deficits. The greatest opportunities in this regard lie in the elimination of the large losses presently being incurred in the provision of electricity, water and transport.

1.29 The quality of taxation also needs to be improved. The Tax Reforms Committee under the Chairmanship of Dr Raja Chelliah has submitted its final report. The Committee has made far reaching recommendations for reform in all the three major sources of Central revenue, income tax, excise and customs. Some of the recommendations of the Committee, based on its interim report submitted in 1991-92 were reflected in the Budget for 1992-93. The other recommendations deserve full consideration keeping in mind the Government's already declared policy of moderating tax rates, widening the tax base and improving compliance. Once the tax rates are brought down, better compliance can be expected and demanded. Tax revenues would be more responsive to the growth of the economy, and the need for drastic year-to-year tax changes would disappear, thus making a stable tax structure feasible. This is the direction in which the Centre is moving. The States would find similar advantage in moving to moderate and stable tax rates.

1.30 There may also be scope for a restructuring of the States' tax base. Some States rely heavily on certain taxes which distort the movement of goods and services across the country, negating one of our greatest economic advantages, that of a relatively large market. Some taxes, such as those on property and on movement of goods, are also subject to considerable evasion. The critical review of Central Government's tax base by the Chelliah Committee has led to considerable improvements and will lead to more. Expert scrutiny may lead to similar improvements in the States' fiscal effort.

1.31 Equally important is reform of expenditure. Almost all of welfare expenditure is administered by the States. This is particularly true of health, education, population control and poverty alleviation, as well as of agricultural investment such as investment in irrigation and mechanisation. All these activities are capable of fairly straightforward measurement of performance and quality; a continuous monitoring of performance could lead to significant improvements in cost-effectiveness.

Monetary Policy

1.32 The role of monetary policy has too long been a passive one, confined to financing the fiscal deficit at administered interest rates in order to minimise the cost to the Government. This has in the past encouraged fiscal profligacy with growing fiscal deficits, and larger and larger components of monetisation which in turn has generated inflationary pressure and has distorted the financial system raising interest rates to the productive sector. It is necessary to make a decisive break from this pattern. With the reduction in the fiscal deficit, the Government is working towards a situation where interest rate distortions are reduced and monetary policy can be actively used for short-term macro-economic management. The Government has progressed towards this aim in the past year with a number of initiatives. The statutory liquidity ratio has been reduced, releasing resources to the banks for deploying additional funds in the commercial sector. Government borrowing is also being shifted to market-related rates; the 364-day bills were introduced with market-related interest rates. Other interest rates on securities were raised to bring them closer to market rates. Reserve Bank of India also conducted repurchase operations in securities for short-term liquidity management. These initiatives at monetary management must continue over the coming years.

Financial Sector Reform

1.33 It is not enough, however, to change the rules of monetary management; what is required is a comprehensive reform of the banking system, the capital market and their regulation. The Narasimham Committee has made comprehensive proposals for reforms in this area. The irregularities and fraudulent manipulations in securities trading of certain banks and financial organisations, which surfaced in April 1992, have drawn attention to some systemic weaknesses in our banking system and capital markets which need urgent correction. The Government has taken a number of steps in this area but much more needs to be done. The main elements of the reform programme are outlined below.

1.34 A large proportion of commercial bank funds has in the past been pre-empted by Government borrowing at below-market rates through the satutory liquidity ratio (SLR) and by Reserve Bank of India through the cash reserve ratio (CRR). At one stage the combined pre-emptions on these accounts amounted to 63 per cent of incremental deposits. These pre-emptions have an adverse effect on bank profits; They limit the ability of the banks to pay a high enough interest rate on deposits and, at the same time, force them to charge very high interest rates on the commercial part of their portfolio. This is a major distortion in the financial system. It encourages disintermediation from the banks, whose preferred corporate clients go directly to the capital market to mobilise funds from savers by offering them much better returns than they can get from banks. These interest rate distortions were at least in part responsible for creating practices in the financial system which were deliberately misused by unscrupulous persons in the irregularities discovered earlier in the current year. In recognition of these problems the Government has decided progressively to reduce the pre-emption under the SLR and CRR and steps have been taken in this direction in the course of 1992-93. It is the intention of the Government to reduce the SLR to 25 per cent over the next three years and to reduce the CRR to below 10 per cent over a four-year period.

1.35 The freeing of financial institutions from compulsory investment in Government securities must go hand-in-hand with the development of a wider market for debt instruments. This has hitherto been prevented by the easy absorption of securities by the institutions required to hold them. Government securities must take a place in the capital market as a competitive form of investment. The Government will not necessarily borrow less, for there will be a demand for the safety and stability that Government securities can offer, but Government borrowings will be subject to the same discipline of the market as other users of funds.

1.36 With the proposed reduction in SLR pre-emptions and lower government deficits we can expect a reduction in the high interest rates being charged in the commercial sector. It is also necessary to rationalise the structure of lending rates. There is reason for having an element of cross-subsidy in interest rates so that loans to the weaker sections of society can be provided at preferred rates. However, the extent of cross-subsidy must be kept within reasonable limits. Progress has already been made in reducing the number of lending rates from six to four during 1992-93 (excluding the separate DRI rate). We should further rationalise the structure by reducing the number of rates to three. In the longer run we should consider the possibility of moving to just two rates, with one general rate and one concessional rate.

1.37 As the banks' profitability improves, more can also be done to reduce the costs of banking and to make the banking system more efficient. Amongst these steps would be encouragement of competition amongst banks and elimination of administrative restraints on such competition. All the three constituents of the banking system - the public sector banks, the private sector banks and the foreign banks - can contribute to this objective. Reserve Bank of India had earlier relaxed the restrictions on the opening, transfer and closing of branches. It has also recently issued guidelines governing the entry of new private sector banks.

1.38 The irregularities in security transactions have thrown up the issue of the extent and quality of bank regulation. A detailed account of the nature of these irregularities is given in Chapter 3. The scandal underlines the need for firm and fair regulation. But it should not lead to the obliteration of the distinction between the regulator and the manager. Modern bank transactions are vast in volume and multifarious in scope; they cannot be controlled, let alone run, by a central bank. Managements in the banks must be made more effective with better systems of internal control to ensure that banks conform strictly to regulations. The scandal brings home the need for effective bank managements and organisational structures. Steps are being taken to improve internal management systems and control structures within the banks. It is also necessary to improve the central bank's supervision. The Narasimham Committee had recommended the establishment of a separate Board for Financial Supervision under the aegis of Reserve Bank of India. Reserve Bank of India is taking steps to implement this recommendation.

1.39 The inadequacy of accounting norms in use in the banking system has been a major weakness. Indian norms with respect to income recognition for classification of assets and for provisioning for bad and doubtful debts have not been up to international standards. Similarly, Indian banks have not met internationally accepted capital adequacy standards prescribed by the Basle Committee. Reserve Bank has prescribed new norms in all these areas which are to be reflected in the accounts for 1992-93. With the implementation of these norms the balance sheets of the banks will progressively reflect the true financial position in accordance with international norms. It is estimated that most banks will need to make large provisions for bad and doubtful debts which will erode their profitability leading to considerable erosion of capital. The new capital adequacy norms will also require a substantial injection of capital into the banks over the next two years. It will be necessary for the Government to provide substantial support to the banks to help clean up the balance sheets. In order to minimise the burden on the budget it will be necessary to find ways of mobilising at least part of the additional capital from the capital market in the form of new equity. This may require legislative changes to permit minority non-Government holding in the public sector banks.

1.40 Parallel reforms have also been initiated in the capital market. The Securities and Exchange Board of India (SEBI) was set up in 1988 with the intention of ultimately making it a statutory body. This was done by the promulgation of an Ordinance on 30 January 1991. SEBI was reconstituted as a Board with statutory powers in February 1992. Subsequently, the Capital Issues Control Act was repealed and control on the volume and pricing of capital issues was abolished. The task of capital market regulation for investor protection and fair trading practices has devolved upon SEBI. A number of steps have been taken by SEBI in the course of 1992-93 aimed at creating a more transparent set of rules and regulations in the capital market which will ensure its healthy growth with strong investor protection.

1.41 There has been a manifold increase in the use of the capital market for raising funds in 1992-93. Greater transparency has been brought into public issues by the disclosure requirements of SEBI. Mutual funds have been inspected and disciplined. Stock exchanges are being persuaded to improve their trading practices. The experience gained is encouraging.

1.42 The relevance of investor protection goes beyond public capital issues and trading in securities. It is equally important that investors must receive prompt, efficient and fair service from companies. The services of company registries are still an untouched area. Some of the problems that arise here are the result of outdated law and practices. The volume of company securities has grown so much that the techniques of record and transfer developed over a century ago are no longer appropriate. Both the technology and the law need to be modernised in respect of corporate capital management; together with these will emerge new needs for regulation.

Trade and Exchange Rate Policy

1.43 Reform of trade and exchange rate policy is a critical element in structural reform and a great deal has been done in this area. The exchange rate adjustments in July 1991, and the trade policy announced subsequently, had considerably reduced the reliance upon licensing control of imports and created a more favourable exchange rate for exports, especially when account was taken of the premium on Eximscrips. The introduction of the Liberalised Exchange Rate Management System (LERMS) moved further in the direction of eliminating licensing control and allowing the exchange rate to reflect the scarcity of foreign exchange. The system has worked fairly well during 1992-93. Despite virtually complete removal of import licensing on all raw materials, components, intermediates and capital goods, the trade account has been managed fairly effectively without any undue pressure on the exchange rate. The difference between the free market rate and the illegal or hawala rate is fairly small, around eight per cent or so which is an important factor moderating the diversion of foreign exchange into illegal channels.

1.44 The present dual exchange rate, under which exporters get a weighted average of the official rate and the market rate has been criticised as amounting to a tax on exporters. There is validity in this criticism, though it needs to be pointed out that the extent of the implicit tax under the present system is much less than the implicit tax on exporters in the system prior to the new economic policies. This is because any system in which there is a difference between the exchange rate (including subsidies) facing exporters and the exchange rate (including tariffs) facing importers constitutes a tax on exporters and the difference between these two was quite large earlier because of high tariffs. The reduction in tariffs in the previous two Budgets, and the change in the exchange rate over this period, have obviously been of considerable benefits to exporters. This improvement is moderated, but by no means eliminated, by the implicit tax in the present dual rate. The Government has, however, indicated that this is a transitional arrangement. It is the intention of the Government to move towards full convertibility on the current account, including unification of the exchange rate, over a period of two to three years. The pace of movement will have to be determined by expectations regarding inflation and the overall balance of payments position.

1.45 Although licensing restrictions have been greatly reduced, they have not been entirely eliminated. A number of items of capital goods, raw materials, intermediates, etc. remain on the licensing list as also all consumer goods. There is need to review the remaining licensing restrictions and remove as many items as possible from licensing and canalisation. It is necessary to protect domestic production in many of these items but this objective is better served by fixing appropriate tariffs. Similarly, a very large number of items are subject to quantitative control of one kind or another for exports. These restrictions are out of place in today's situation of the balance of payments position. In many cases they are the remnants of old concerns which are no longer relevant. It is the intention of the Government to make a comprehensive review of these export restrictions and eliminate all except those that are absolutely essential for reasons of food security or strategic considerations.

1.46 Finally, the policy of progressively lowering customs tariffs is an essential element of any strategy for making the Indian economy internationally competitive. The last two Budgets took important steps in this direction; but Indian tariff rates, with a maximum tariff of 110 per cent at present (except for selected consumer items which are much higher) remain much above the levels prevailing in other countries. The Chelliah Committee has made recommendations for a bold reduction in tariffs to be phased over the next four years. It will be necessary to implement these recommendations in an appropriate manner.

1.47 Parallel with these developments, the rigours of exchange control have been mitigated. The Foreign Exchange Regulation Act was amended by Ordinance in January 1993 to remove a number of constraints on foreign exchange dealings and various restrictions on firms with foreign equity holdings. Legislation in this regard will be introduced in the Budget session.

Industrial Policy

1.48 The delicensing of industries in July 1991 has worked well. Competition has been intensified, and a certain dynamism has been imparted to Indian industry. The success of the experiment favours further progress in the same direction.

1.49 The sale of shares of some public enterprises has also brought a new dimension into their strategic thinking, and made them more conscious of profitability and long-term growth. Some public sector enterprises, such as Indian Petrochemicals Corporation Limited (IPCL), have sought permission and have been allowed to access the capital markets directly in order to raise funds for their own expansion. This is very different from the Government selling its shares with a view to raising resources and increasing participation by the public. Sale of Government shares did not lead to a resource inflow into the public sector units whereas sale of new equity to the public helps raise resources for investment.

1.50 Several initiatives have been taken to promote foreign investment such as automatic permission for foreign equity holdings up to 51 per cent in Appendix III industries, expeditious clearing of other foreign investment proposals by the Foreign Investment Promotion Board (FIPB), facilities for portfolio investment by foreign investment institutions, and permission to reputed Indian companies to float equity abroad. these constitute an important beginning. It is too early to judge the actual inflow of investment on this count but early results are encouraging. The total volume of foreign investment approvals at Rs.42.9 billion granted under the automatic and non-automatic route during August 1991 to December 1992 is more than three times the Rs.12.7 billion of foreign investment approved in the last decade. There is no doubt that there is a considerable increase in interest on the part of foreign investors including in some of our important priority areas such as power or petroleum refining.

1.51 Capital-intensive infrastructure industries such as power, irrigation and telecommunications are handicapped by a number of constraints. In some, market structures are sub-optimal. Where possible, these industries should eventually develop competitive market structures; where not, they would need to be regulated so as to ensure fairness to their customers. Wrong market structures are reinforced by administered pricing systems which discourage new entry and competition. Capital-intensive industries everywhere rely a good deal on fixed-interest funds; and inadequacies of our capital markets, especially the debt market, affects these industries the most. It is necessary to seek improvements in all the areas - pricing, regulation and finance.

1.52 Finally, our labour legislation, which was originally designed to provide workers with maximum security in terms of employment and wages, is now seen to present some problems. If an enterprise turns sick or closes down, it is difficult to secure to the workers rights which only healthy enterprises can afford to give. The economy faces various hazards - hazards of drought, payments crises, shortages etc - which have to be shared by the people. In addition there are risks faced by workers in any firm that are incident upon the industry or the firm. What security has been given has been available to a small number of organized workers; and the security has proved increasingly illusory with spreading sickness. In a competitive world, the fortunes of firms are inextricably linked with their performance and it is difficult to envisage a system which insulates workers from the misfortunes of the firms in which they work. This is why it is essential to ensure that credible social safety nets are developed so that the costs of adjustment as we transit to a more competitive and hopefully more dynamic economy are not borne exclusively by workers. The National Renewal Fund which was operationalised in 1992-93 is an important beginning in this direction. It provides a mechanism for compensating workers of public sector enterprises subjected to restructuring while also helping to restructure and modernise the enterprises. However, other mechanisms also deserve serious consideration. Some consideration of unemployment insurance and income stabilization arrangements may be necessary if workers' incomes are to be protected without reducing the flexibility of employment practices.

Agricultural Policy

1.53 With one-third of the GDP and two-thirds of the population still dependent on agriculture we cannot achieve our objective of accelerating overall growth in the economy, or improving the standard of living of our people, without a substantial acceleration in agricultural growth. The trend growth rate in Indian agriculture at present is a little over 2.2 per cent per annum. It needs to be raised to around three per cent if GDP growth is to be accelerated significantly in future. This acceleration in agriculture requires action on several fronts including raising the levels of investment, resolving problems of land tenure, increasing availability of credit, ensuring appropriate pricing policies and developing new technologies to increase productivity.

1.54 After rising steadily in the 1970s, real investment in the agricultural sector - both public and private - declined in the 1980s. The reasons for this decline are complex. In the case of public investment it reflects the resource constraints of the Central and State Governments and the fact that too large a proportion of available resources is absorbed by revenue expenditure, leaving little surplus available for investment. The total volume of public expenditure directed towards the agricultural sector has increased steadily in real terms, but the component of investment has declined. It is necessary to restructure expenditure in both the Centre and the States to contain the growth of current expenditure and increase investment. The decontrol of prices of certain fertilisers earlier in 1992-93, which substantially reduced the size of the fertiliser subsidy, is an important step in this direction as it frees resources which can be used to step up public investment in agriculture and rural development. Similar steps are needed in the State Governments where large losses on irrigation continue to be incurred in a situation when investment in irrigation, and indeed even maintenance activity is suffering.

1.55 Institutional constraints relating to land tenure, including especially the lack of progress in consolidation of holdings, continue to hold back productivity in many areas. Consolidation of land holdings is important if we are to produce a viable small farmer economy and programmes in this regard need to be vigorously pursued in the States.

1.56 Availability of credit is a critical element in any strategy of agricultural modernisation and top priority must be given to strengthening and expanding the existing structure. However, the existing credit structure suffers from serious weaknesses which need to be corrected urgently. The cooperative credit system has deteriorated in most States and become excessively dependent upon NABARD refinance. The culture of loan recoveries, crucial for an efficient credit system, has suffered greatly from loan write-offs and loan waivers. The present structure of interest rates for smaller loans is also out of line with the cost of raising funds through deposits; this militates against the emergence of a financially viable cooperative credit system. These problems have also affected the Regional Rural Banks which are making large losses and which cannot survive unless they are restructured. Efforts will have to be made to find solutions to these problems so that agricultural credit can expand in line with the requirements of the agricultural sector.

1.57 The pricing policies towards agriculture must ensure that the farmer gets a remunerative price for his product and substantial increases have been announced in procurement prices in 1992-93 to ensure that price incentives are maintained. There are limits to the extent to which we can follow a policy of subsidising inputs, which could put open-ended burdens on the Budgets. Some subsidies are justifiable but in general we should ensure that farmers are charged reasonable prices for their inputs and that these costs are appropriately reflected in the support prices announced by Government. In this context it is relevant to mention that agriculture will be a major beneficiary of the policy of reducing the high level of protection earlier given to industry. High protection to industry has typically meant that our industrial prices are much above world prices whereas our agricultural prices are much more in line with world prices and in many cases actually lower. We need to redress this imbalance by reducing industrial protection and simultaneously allowing, and indeed encouraging, agricultural exports. The scope for agricultural production for exports, including high-value products with some processing, is very substantial. This should be fully exploited, not only in the interest of the farmer but also in the interest of strengthening the balance of payments. Finally, the logic of liberalisation implies that agricultural products must be allowed to move freely within the country in response to market demand. We must move away from the use of administrative measures to restrict movement in agricultural products as has sometimes happened in the past.

1.58 Technology is equally important in the task of agricultural modernisation and here too a great deal needs to be done. We have built an extensive system of agricultural universities and research institutions; but there is reason to believe that the results on the ground fall considerably short of both expectations and potential. Part of the problem is the inadequacy of resources; but there are also organisational and management deficiencies. These need to be tackled on a priority basis.

Poverty Alleviation and Human Resource Development

1.59 The Government has built up a large number of programmes to alleviate poverty. But our country is large, and the poor are numerous. The reach of poverty alleviation programmes has thus been limited. The poor are entirely dependent on their own labour; hence it is important to ensure that national output and employment grow as rapidly as possible. But in the meanwhile,there will continue to be a need for preventing distress, addressing special hardships, and creating opportunities for the disadvantaged. Funds for programmes to serve these needs have been constrained in recent years because of severe pressure on budgetary resources. One consequence of restoration of fiscal balance would be that the Government would be able to devote larger resources to poverty alleviation programmes. It is the intention of the Government to begin this process of restoration straight away.

1.60 However, the effectiveness of poverty alleviation programmes will depend on how well the money is spent. It will be necessary to integrate these programmes into the overall strategy of decentralised rural development, sensitive to local needs and resources, and with greater emphasis on creation of durable social and economic assets. It will be necessary to use the immense potential of Panchayati Raj institutions to make a success of these programmes.

1.61 Poverty alleviation has to be an integral component of human resource development. Apart from the fulfillment of basic needs, all citizens must have access to basic social services such as elementary education, primary health care, safe drinking water and sanitation at affordable costs - services that empower the poor to better their circumstances. The Government will have to shoulder major responsibilities in this area. Its ability to devote larger resources to human resource development is crucially linked to the speed of fiscal consolidation, improvement in the efficiency and profitability of public enterprises and the overall success of the structural reforms designed to accelerate the pace of economic development and the resource-generating capabilities of the economy. The State Governments have a special responsibility in the area of social services.

1.62 Over the years, our educational system has expanded considerably. But our performance in this area needs further improvement. Our literacy level is still low in comparison to developing countries similar to us. The quality of primary education is poor; this has often been a major contributory factor to the high drop-out rate amongst the pupils. However, non-formal approaches to this problem have been a remarkably successful supplement to the formal schooling system, and some districts have reached or are on the point of reaching 100 per cent literacy. Universalisation of primary education has to be major national objective in the 1990s. Literacy should be promoted as an useful input in life and work. Once the grown-ups become literate, their children are much more likely to acquire learning. Educated mothers are likely to invest more into the education of their children and hence to have fewer children. Adult female education is perhaps the single-most effective instrument for population control.

1.63 For our circumstances, a flexible system of learning for people of various ages and circumstances would be more effective. This is particularly true of secondary and tertiary education; there is an urgent need to give these levels a vocational bias, to bring the education imparted closer to the skills that would be required in work, and in general to make the educational system more responsive to the needs of the productive system. A time has also come for the consolidation of higher education - for improving its quality and utility, and for that purpose to invest more in its infrastructure, such as libraries and laboratories. It is equally necessary to use new technologies to improve the cost-effectiveness and reach of educational services. Television aided by satellites could deliver instruction to the remotest villages at a fraction of the cost of conventional schools. Remote teaching cannot take over completely from schools and colleges, but could serve as a valuable complement.

1.64 As with education, the aim of the health care system should be to enhance the capacity of people for a productive and happy life. Our infant mortality is unacceptably high; this is only one obvious indicator of the room for improvement in health care. The emphasis should be on preventive health care - on the provision of safe drinking water, the prevention of waterborne diseases, and on the promotion of healthier ways of living. Health programmes need to be integrated with those for family welfare, and local communities need to be more closely involved in both.

Energy Policy

1.65 Under any conceivable development strategy, the demand for commercial energy is bound to go up. Since this happens to be a very capital intensive industry, the challenge ahead is to create an environment in which requisite resources, internal and external, can be mobilised. Government has taken major decisions to open up the hydro carbon and power sectors to private enterprises so as to supplement the effort of public sector. However, the magnitude of response will depend crucially on the reform of pricing and distribution arrangements.

1.66 This is an area where the dominant portion of public sector can not be wished away. It is therefore essential that organisational and pricing reforms are undertaken so that public enterprises can mobilise adequate resources for their expansion. The Government's decision to reorganise Oil and Natural Gas Commission as a corporation is a helpful first step. However, sooner or later, the problem of persistent underpricing of domestic crude oil will need to be faced.

1.67 In the power sector, the problem of low rate of return, in many states that of negative rate of return, and persistent organisational deficiencies in the functioning of State Electricity Boards (as evident from sub-optimal plant load factor and heavy transmission and distribution losses) will need to be squarely faced. It is also clear that private sector power generation companies will be attracted to invest only if the State Electricity Boards are in a sound financial position to ensure prompt payment for electricity bought by them. Alternatively, a fresh look will have to be taken at distribution systems, with the private power generating companies being able to sell their power to some bulk consumers. Energy planning in the future will also have to pay greater attention to environmental concerns. Maximum possible emphasis has to be laid on energy conservation to save on capital costs as well as to minimise the environmental hazards.

Conclusion

1.68 The prosperity achieved by many developing countries in Asia, and also in other parts of the developing world, would have been unimaginable fifty years ago. The standard and quality of life of the citizens of these countries can be explained by neither their natural resources nor their domination of other countries. It is explained by sustained efforts at improving the quality of human resources, by policies that encourage investment and place a premium on efficiency, and a sustained thrust towards international competitiveness.

1.69 The secret of success lies in the capacity for self-improvement. True self-reliance is to be found in the capacity for self-improvement, for continuous learning, borrowing, adaptation and innovation. It would be an error to think that only industrial countries can improve themselves, or that developing countries must only import improvements. The capacity to improve oneself encompasses the capacity to import, imitate and assimilate and adapt quickly, efficiently and sensibly. It also includes the ability to innovate within the capacity of the resources available. It would be equally wrong to think that the capacity for self-improvement depends upon scientific or technological capacity alone. All goal-oriented human activity is capable of self-improvement. Self-improvement is driven by human endeavour, but conditioned by the social, economic and political environment, for this environment determines the incentive patterns which drive endeavour. It is this environment that our structural reforms aim to change. They seek to create an environment of opportunity and challenge, freedom and excitement. The Government must continue to protect the weak and help the poor, to ensure peace and prevent mischief. But beyond this, our people should have the chance to exercise initiative and ingenuity, for in their endeavour lies the promise for the country. It is surely possible for even a poor country to become a better place with its own efforts. Towards this goal we have taken decisive steps in the past year and a half. They set a direction in which hope lies.