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RBI releases Annual Report for 2011-12

The Reserve Bank of India today released its Annual Report for 2011-12, a statutory Report of the Central Board of the Reserve Bank. It covers (i) the assessment of the macroeconomic performance during 2011-12 and the prospects for 2012-13, and (ii) the working and operations of the Reserve Bank and its financial accounts for the year 2011-12. Highlights of the Report:

- 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.

Assessment for 2011-12

- Growth decelerated in 2011-12 to below the economy's potential due to domestic and global factors. Inflation persistence and widening twin deficits constrained the Reserve Bank's ability for counter-cyclical measures. Going forward, the priority should be to bring down the twin deficits to support potential growth even if it means a slower pace of recovery in the short run (para I.1 and para I.6).

- After two years, high inflation moderated in the later part of 2011-12 in response to past monetary tightening and growth deceleration. High inflation had adverse consequences on welfare and on saving and investment, particularly household saving in financial assets (para I.2).

- The most serious consequence of inflation is its adverse distributional impact on the poor, people without social security and pensioners. As growth slowed down, in part due to high inflation, it further reduced the welfare of the common man through adverse impact on employment and incomes (para I.3).

- In view of the adverse welfare consequences and its impact on growth, the Reserve Bank combated high inflation through monetary tightening. Several other factors combined with monetary tightening caused growth to slow down (para I.4).
- Interest rates increased during 2011-12 and may have impacted investment, but they are clearly not the primary reason for downturn. Computation from accounts-level data shows that real (net of inflation) Weighted Average Lending Rates (WALR) was 3.8 per cent in 2011-12, lower than the average of about 7.0 per cent in the pre-crisis period of 2003-04 to 2007-08 when investment had boomed (para I.10-I.11).
- Fiscal consolidation is needed to sustain growth and reduce inflation. 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. Resource mobilisation has been insufficient and there is a need to push tax reforms (para I.17-23).
- Deterioration in asset quality of banks emerged as a concern during 2011-12, especially in case of public sector banks. While some of it was the result of economic slowdown, sector-specific issues needs to be resolved. With increasing restructuring there is a need for doing way with regulatory forbearance and introducing a principle of higher amount of promoters' sacrifice to bring about lending discipline (para I.24-I.28).

Prospects for 2012-13

Growth outlook

- Growth in 2012-13 is expected to stay below trend at around the previous year's level of 6.5 per cent. Growth outlook remains weak as factors that slowed down growth in the previous year persist and show no signs of getting resolved. The government in August 2012 promised to take several steps to address macro-economic weakness. As these steps materialise, growth could gradually start to improve later this year and trend growth could be restored next year (para I.29-30).
- Newer uncertainties for growth have emerged from unsatisfactory monsoon so far, which is likely to result in contraction in foodgrains output in 2012-13 (para I.32).
- 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 needs to be addressed immediately, especially in mining and infrastructure sector. Fast-tracking of infrastructure projects will help boost investment (para I.34).
- With limited fiscal and monetary space available to provide a direct stimulus, an expenditure-switching policy is needed that reduces revenue spending by cutting subsidies and using the resources so released to step up public capital expenditures. This would provide some space for monetary policy, but lower interest rates alone are unlikely to jumpstart investment cycle (para I.34).

Inflation outlook

- Inflation is likely to remain sticky at around 7 per cent with upside risks emanating from deficient monsoon, large upward revision in Minimum Support Prices (MSP) on the back of cost escalation and exchange rate depreciation during Q1 of 2012-13 (para I.34).

- Latest assessment suggests that there could be considerable upside pressure on price of pulses. The prevailing drought in parts of US, Eurasia and Australia may add to price pressures on food in global markets. Other upside risks arise from suppressed inflation in energy prices of diesel, coal and electricity (para I.36-I.37).
- While inflation risks in 2012-13 are on the upside, there is a need to distinguish between temporary and permanent supply shocks. If left unchecked, persistent inflation could unhinge inflation expectations. Furthermore, demand pressures emanating from high rural wages and growing corporate staff costs would need to be factored in. A close vigil on inflation would be necessary during 2012-13 to prevent reemergence of inflationary pressures (para I.39).

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

- The emergence of twin deficits during 2011-12 was a major cause of macro-economic weakness. Current assessment suggests that they are likely to stay wide in 2012-13 in absence of sufficient policy response and no improvement in business cycle conditions (para I.40).
- With growth remaining slow, budgetary targets are at risk. Shortfall in indirect tax revenue, decline in corporate earnings, difficulties with disinvestment and expenditure overshooting due to under-provision of petroleum subsidies are likely to put fiscal position under pressure (para I.41).
- Consequently, some level of fiscal slippage is unavoidable. Estimates suggest that if no revision is made in administered fuel prices, this slippage may turn out to be about 0.4 per cent of GDP at the current level of crude prices on this account alone. Such slippage could crowd-out private investment at a time when reviving investment, both public and private, is critical. This could through higher aggregate demand then spill over to higher inflation and wider current account deficit (CAD) (para I.41).
- CAD risks are maintained and overall CAD-GDP ratio may not correct significantly in 2012-13. Even though merchandise trade balance narrowed in Q1 of 2012-13, net services exports were 22 per cent lower on a year-on-year basis. Software exports are likely to moderate as global IT spending is expected to be lower (para I.46).
- With a lower growth, the sustainable level of CAD is now assessed at around 2.5 per cent of GDP. It is important not only to focus on financing of CAD, but also on compressing it to lower manageable levels (para I.47).
- In recent period, CAD has been managed by improving debt inflows. However, this has long-term costs for debt sustainability and increase refinancing risk over time. Therefore, there is urgent need to step-up non-debt creating inflows, especially in form of Foreign Direct Investment (FDI) (para I.47).

Medium-term Challenges for the Indian Economy

Key to improving growth lies in addressing medium-term challenges. Three illustrative medium-term challenges highlighted in the Report are:

(i) Preserving India's growth story through revival of infrastructure investments.

- India's growth story in recent past has been substantially driven by large infrastructure investments. However, new investments have slowed down and existing investments are at risk. Elongated gestation periods and input supply shortages have affected the viability of projects going on-stream (para I.48) .

- The Reserve Bank's collation from banks and financial institutions show that envisaged total fixed investments in new projects that were sanctioned financial assistance during 2011-12 dropped by 46 per cent to about ₹2.1 trillion. This drop was led by infrastructure and metals. Envisaged investment in infrastructure declined by 52 per cent to ₹1 trillion with power and telecom accounting for most of this fall (para I.49).
- Road projects have also slowed down due to problems relating to land acquisition, legal and environmental clearances as also tightening of financial conditions. Road tendering activity has suffered significantly in Q1 of 2012-13 after a record tendering by NHAI in 2011-12 (para I.53).
- Investment climate in power sector has been affected by State Electricity Board (SEB) losses and coal supply shortages. As much as 54GW of power capacity has been created during 11th Plan and another 60-75 GW of capacity may be planned during 12th Plan. A large part of this capacity is facing coal linkage issue. All pending issues in respect of proposed new Fuel Supply agreements (FSAs) and coal block auction need to be resolved without any further delay (para I.51).
- There is 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. Businesses also need to re-jig their strategies and 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 (para I.52).

(ii) Strengthening banking soundness through Basel III.

- The Reserve Bank has issued guidelines for implementation of Basel III capital regulation to be completed in a phased manner by March 31, 2018. In these, the minimum capital requirements have been kept one percentage above the minimum suggested by the Basel Committee (para I.59).
- Broad estimates suggest that for full implementation of Basel III, public sector banks 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. Major private sector banks would require common equity to the tune of ₹200-250 billion on top of internal accruals, in addition to ₹500-600 billion in form of non-equity capital (para I.62).
- There have been some arguments whether the regulatory regime could be softer for public sector banks given the backstop that they enjoy with the government as the principal owner and stakeholder in such banks. From a regulatory standpoint, this would be detrimental for the financial system. The Reserve Bank is committed towards developing level playing field for all banks irrespective of the ownership (para I.63).

(iii) Financial inclusion, led by the Reserve Bank policies with a human face.

- To impart a human face to the bank lending policies, the Reserve Bank has supported directed lending route as an integral part of its bank lending policies. As part thereof, banks priority sector lending target for foreign banks with 20 or more branches has been raised from 32 per cent to 40 per cent (para I.66).

- Notwithstanding the efforts, a recent World Bank study has revealed the dismal state of financial inclusion world-wide and even more so in India. India scored poorly on financial inclusion parameters than the global average in respect of percentage of population with formal accounts, credit cards, outstanding mortgages, health insurance, origination of new loans and mobile banking (para I.69).
- The Reserve Bank has adopted ICT-based bank agent model through Business Correspondents (BCs). This model has not been very successful in addressing financial inclusion needs and cannot substitute the services of brick and mortar bank branches. There is need for mainstreaming financial inclusion, while at the same time improving the BC functioning (para I.71).
- The Reserve Bank's assessment is that financial inclusion is a substantially unfinished agenda and the efforts need to be upscaled. The change from no-frills account to 'Basic Saving Bank Deposit Account' is an effort to integrate them as part of basic banking services. Financial inclusion may result in short term pressure on banks' profitability, but as size and scope of banking increase, it would add to their revenue stream (para I.72).

Real Economy

- In 2012-13, the south-west monsoon (up to August 16, 2012) was 16 per cent below the long period average. The deficiency as measured by the Reserve Bank's production-weighted rainfall index is even higher at 21 per cent. This has affected the *kharif* sowing with sowing for coarse cereals and pulses being 16 per cent and 12 per cent below normal, respectively. However, drought conditions are less severe than that during the 2009 (para II.1.16-II.1.18).
- Preliminary estimates show that the net financial saving of the household declined further to 7.8 per cent of GDP at current market prices during 2011-12 from 9.3 per cent in the previous year and 12.2 per cent in 2009-10. This was due to an absolute decline in small savings and slower growth in households' holdings of bank deposits, currency as well as life funds. High inflation and proclivity for investment in gold could have impacted household saving behaviour (para II.1.11).

Price Situation

- In recent period output gap has contributed to moderating inflation, but the moderation has been less in relation to fall in growth. Reserve Bank's empirical estimates show that output gap is a leading indicator of inflation. However, the pace and extent of moderation could be conditional on other determinants such as supply shocks from food, global commodity price movements, exchange rate pass-through, as well as the overall fiscal position (Box II.2).
- Cost-push inflation caused by sustained wage pressures is a dominant determinant of inflation. In India, wages in rural areas have increased at a faster rate than inflation, partly as MGNREGS is exerting pressure on the overall wage structure. Empirical estimates suggest a bi-directional causality between wage growth and prices, implying that there is some evidence of a wage-price spiral (Box II.8).

Money and Credit

- Monetary and liquidity conditions in the year 2011-12 were marked by two distinct phases. In the first half, monetary policy was tightened and liquidity conditions generally remained in line with the policy objective of maintaining moderate deficit. In the second half, the Reserve Bank paused its tightening cycle. Liquidity deficit, however, worsened due to forex interventions and sudden build up of government cash balances that persisted for a longer duration para II.3.1).

- In recent years there is significant evidence that the interest rate channels and credit channels of monetary transmission have been working effectively. Policy rate increases in India had a negative effect on output growth with a lag of two quarters and moderating effect on inflation with a lag of three quarters. As banks adjust portfolios, a 100 bps increase in policy rate was found to reduce credit by 2.8 per cent in nominal terms and 2.2 per cent in real terms (Box II.10).

Financial Markets

- A financial conditions indexed developed in-house shows that though financial conditions somewhat worsened in 2011-12 mainly due to stock and forex markets; however, they remain far better than in October 2008 (Box II.12).
- With housing and gold prices running ahead of inflation, there is a need for containing risks. The Reserve Bank will continue to monitor the asset prices ahead from a macro-prudential angle (para II.4.25).

Government Finance

- Current indications are that fiscal targets can again be missed in 2012-13, unless immediate remedial measures are undertaken. The risks to fiscal targets laid down for 2012-13 are large if the envisaged tax buoyancies are not realised and the cap on subsidies is not adhered to. During the first quarter of 2012-13, the fiscal deficit of the central government was more than one third of the budget estimate for the whole year (para II.5.3).
- Estimates of fiscal multipliers for India show that while impact multiplier on growth is higher for revenue and expenditures, the long-run multiplier is higher for capital outlays. In this context, credible fiscal consolidation accompanied with higher capital outlay is crucial for improving long-run growth prospects (Box II.16).

External Sector

- CAD-GDP ratio reached 4.5 per cent in Q4 of 2011-12, taking the full year ratio reached to an all-time high of 4.2 per cent. Going forward, the moderation in global oil prices from the earlier highs and softening of gold imports if sustained, are likely to have a favourable impact on CAD. Notwithstanding these factors, CAD may still stay wide enough to put strains, especially if capital flows remain moderate (para II.6.2-II.6.3).
- In view of the high dependence on debt flows to finance CAD during 2011-12, there is need for policy initiatives to augment non-debt creating flows, especially by improving FDI inflows into sectors such as insurance, retail, aviation and urban infrastructure. In recent years outward FDI has increased significantly and there is a need to balance the domestic investment interests in the overall FDI policy (para II.6.16).

Working and Operations of the Reserve Bank of India

Monetary Policy Operations

- Monetary policy in 2011-12 had to address the risks of entrenchment of inflation pressures and unhinged inflation expectations during the first half of the financial year and the significant slowdown in domestic growth even while maintaining its anti-inflationary stance during the second half.
- During 2012-13 so far, on growing evidence of slowdown in the economy, the Reserve Bank used available space to cut policy rates and frontloaded the policy action in April 2012, but maintained status quo later as inflation concerns persisted. It reduced Statutory Liquidity Ratio (SLR) in July 2012 to provide liquidity to facilitate credit availability to productive sectors (para III.19).

Credit Delivery and Financial Inclusion

- Improving credit delivery and financial inclusion have remained key priorities of the Reserve Bank. One major step in this direction was to introduce biometric smart card system for the kisan credit card (KCC), to be used in ATMs and hand held devices. The financial inclusion plan (FIP), under which the commercial banks set their targets for financial inclusion activities, has been making substantial progress (para IV.6).
- The Reserve Bank has recently issued guidelines on the implementation of electronic benefit transfer (EBT) and its convergence with FIP. Apart from providing a whole range of banking services, this will enable the beneficiaries to get the social security benefits (Box IV.2).

Development and Regulation of Financial Markets

- As the Indian financial markets, particularly foreign exchange market, turned volatile against the backdrop of weakening domestic macroeconomic fundamentals and the euro area sovereign debt crisis since august 2011, the Reserve Bank took a slew of measures to contain the volatility in the forex market and encourage foreign inflows (para V.22-V.31).
- The Reserve Bank also continued with its efforts to impart liquidity to the secondary G-sec market and to develop the corporate bond market further by providing for risk transfers. The Working Group on Enhancing Liquidity in the G-sec and Interest Rate Derivatives Market has made important recommendations in this respect (Box V.1).

Regulation, Supervision and Financial Stability

- During 2011-12, the banking sector remained robust with high capital adequacy, even though rising NPA levels emerged as a concern. The NPAs, however, are in part a reflection of overall slowdown in the economy. An analysis using data since June 2000 brings out this pro-cyclicality in asset quality of Indian banks (Box VI.1).
- The Reserve Bank has undertaken several initiatives like faster grievances redressal mechanism, facilitating better banking experience for the disabled and intra-bank transfer of deposit facility to benefit the common man (para VI.42-VI.61).
- The NBFC sector in India has undergone a significant transformation in the past few years, with growth of non-deposit taking systemically important NBFCs. In this backdrop, risks from regulatory gaps, arbitrage and systemic

interconnectedness have assumed importance. A Reserve Bank Working Group has made several recommendations to address these (Box VI.5).

Public Debt Management

- With inflation persisting at a high level, it would be a challenge to manage the relatively higher budgeted market borrowings of the central government as also the expected elevated level of borrowings of the state governments in 2012-13. In an environment of slowing growth and given the limited options regarding debt management, it is crucial that the fiscal deficit and its financing by way of market borrowings do not escalate beyond the budgeted level (para VII.13).
- Reflecting the impact of the change in interest rate cycle and large government borrowing, the weighted average yield of dated securities issued by the central government during 2011-12 rose by 60 basis points to 8.52 per cent. Also, the weighted average yield of state government securities issued during 2011-12 was higher at 8.79 per cent, compared with 8.39 per cent during the previous year (para VII.8).

Currency Management

- During 2011-12, the Reserve Bank continued with its efforts to strengthen security features of banknotes and increase public awareness to address the challenge of counterfeit notes (para VIII.2).
- There was a marked decline in the volume and value of small coins in circulation in 2011-12 as coins of denomination of 25 paise and below ceased to be legal tender from June 30, 2011. A committee constituted by the government is examining the issues relating to the increase in demand for coins and supply/distribution bottlenecks (Box VIII.2).

Payment and Settlement Systems and Information Technology

- The Reserve Bank continued its efforts at enhancing safety, security and efficiency of payment transactions coupled with low transaction costs and better risk management for system participants and to also improve the accessibility and affordability of the payment and settlement systems para IX.16).
- The Reserve Bank has furthered its social responsibility by enabling payment system services at low costs by promoting systems such as Indian Financial Network (INFINET) and Next Generation Real Time Gross Settlement (NG-RTGS) systems.

Governance, Human Resource Development and Organisational Management

- The Reserve Bank has initiated several measures to enhance its communication strategy to the public, apart from improved transparency in its governance. Though the governance practices by boards of the central banks differ widely, the Reserve Bank has taken several initiatives to improve transparency and accountability (Box X.1).
- The Reserve Bank has also taken several capacity building initiatives with a view to acquiring, grooming and enhancing the quality of its human resources. It has also taken several new research initiatives, besides initiatives to promote energy conservation and environment preservation in line with its corporate social responsibility (Box X.2).

The Reserve Bank's Accounts for 2011-12 (July-June)

- The balance sheet of the Reserve Bank expanded significantly by about ₹4 trillion or 22 per cent during the accounting year. A little over half of the increase was on account of open market purchases of government securities (domestic assets). The increase in foreign assets was mainly due to valuation effect arising from depreciation of the Indian rupee against the US dollar that more than offset the decline in net stock of foreign currency assets due to dollar sales during the year (para XI.5-XI.6).
- In 2011-12, the Reserve Bank's gross income increased by 43.4 per cent. The income from foreign assets declined for the third successive year, reflecting the low interest rates prevalent in international markets. The decline in income from foreign assets was more than offset by an increase in earnings from domestic assets (para XI.4).
- The transfer of surplus profit to the central government amounted to ₹160.10 billion compared to ₹150.09 billion in the previous year (para XI.11).

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