

Overview

Developments during 2003-04

1.1 The overall performance of the Indian economy during 2003-04 was characterised by a high real GDP growth rate of 8.2 per cent - the highest growth rate in 15 years and also the second highest growth rate among the emerging market economies after China. The growth in GDP was primarily driven by the turnaround in agriculture, also aided by broad-based industrial growth and a continued robust growth in the services sector. The inflation situation, by and large, remained stable during the year. The revised fiscal deficit of the Centre for 2003-04 at 4.8 per cent of GDP was lower than the budget estimates by 0.8 percentage points. Substantial forex inflows on account of sustained buoyancy of exports, invisibles and portfolio investments led to strengthening of the balance of payments position as reflected in the increase in foreign exchange reserves to US \$ 113 billion at end-March 2004. Against the above backdrop, the financial sector witnessed stable and easy conditions. Non-food credit of scheduled commercial banks (SCBs) showed a pick-up during the later half of 2003-04, in line with the resurgence in industrial growth. Non-interest income of SCBs also showed a rising trend. The SCBs continued to hold Government securities substantially in excess of the stipulated requirements in view of the attractive risk-free yields, and their income profile continued to be driven by treasury operations. There was a notable reduction in the ratio of non-performing assets (NPAs) to advances in response to various initiatives, such as improved risk management practices and greater recovery efforts, driven, *inter alia*, by the recently enacted Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

1.2 Co-operative banks recorded a higher growth in deposits and advances, and some improvement in both the asset quality and profitability. There was a marked recovery in the sanctions and disbursements of development finance institutions. There was an improvement

in the performance of the NBFCs as well. The Reserve Bank carried forward financial sector reforms during 2003-04 through a number of measures relating to deregulation, technological upgradation, tightening of prudential norms, and refinement of regulatory and supervisory oversight.

Macro Environment

1.3 Overall real GDP growth for 2003-04 at 8.2 per cent was much higher than the 4.0 per cent growth witnessed in 2002-03, facilitated primarily by a surge in agricultural GDP of over 9.1 per cent due to a healthy recovery from the drought of 2002-03. Industrial production continued its broad-based expansion with all the major components of industrial production witnessing growth rates in excess of 5.0 per cent. The services sector growth at 8.5 per cent continued to play an important role in propelling the GDP growth above the trend level, and consistently witnessed a growth rate higher than 7.0 per cent in all the four quarters of 2003-04. The annual rate of inflation (WPI, point-to-point), which was at 6.9 per cent in first week of May 2003, declined to 3.8 per cent by August 23, 2003. However, firming up of international crude oil and steel prices and their pass-through effect on domestic inflation coupled with increase in prices of fruits, edible oil and cotton textiles pushed up the WPI inflation to 6.6 per cent by January 10, 2004. The inflation rate, however, came down to 4.6 per cent by the end-March 2004. For the year 2003-04 as a whole, inflation (in terms of WPI), on an average basis, was two percentage points higher at 5.4 per cent than 3.4 per cent recorded in 2002-03.

1.4 Robust growth of merchandise exports and services, substantial capital inflows and record accretion to foreign exchange were the high points of the external sector developments in 2003-04. The current account surplus, at 1.4 per cent of GDP, continued for the third year in a row. Foreign investments, both direct and portfolio, which are mostly in the nature of non-debt creating flows, increased to an all time high of 3.0 per cent of GDP. India attracted the highest portfolio investment in Asia after Korea. These developments

resulted in a record accretion of foreign exchange of US \$ 36.9 billion during the year with the foreign exchange reserves touching US \$ 113 billion at end-March 2004 – the sixth largest in the world.

1.5 Liquidity conditions remained comfortable during the year. Broad money (M_3) increased by 16.6 per cent during 2003-04 compared with a growth of 12.7 per cent (net of the impact of the merger) in 2002-03; this was higher than the projected growth of 14.0 per cent. The large monetary expansion occurred despite a bullet redemption of the Resurgent India Bonds (RIBs) in October 2003. Domestic credit decelerated in step with food credit which declined due to lower food stocks and sustained higher offtake. There was, however, a sustained increase in credit flow to the commercial sector in the second half of 2003-04 reflecting the acceleration in industrial production. The flow of resources from non-banks, including issuance of shares and debentures, Euro issues, commercial papers (CP) and by way of external commercial borrowings (ECB) and assistance by financial institutions (FIs) improved substantially although it remained modest in comparison with bank credit.

1.6 The weighted average call money rates declined to 4.37 per cent in March 2004 from 5.86 per cent in March 2003. Similarly, the cut-off yields on 91-day and 364-day Treasury Bills also declined to 4.38 per cent and 4.45 per cent, respectively, in March 2004 from 5.89 per cent each in March 2003. The weighted average discount rate on commercial papers of 61 to 90 day maturity declined to 5.19 per cent in March 2004 from 6.53 per cent in March 2003. The market repo rate at 3.7 per cent was lower than the overnight call money rate in April 2004. The yields on Government securities with a five year and ten year residual maturity declined to 4.78 and 5.15 per cent in March 2004 from 5.92 and 6.21 per cent, respectively, in March 2003.

1.7 The term deposit rates of public sector banks (PSBs) for maturities up to one year moved down to 3.75-5.25 per cent by April 2004 from a range of 4.00-6.00 per cent in March 2003. Similarly, the interest rates on term deposits over one year had declined to 5.00-5.75 per cent from a range of 5.25-7.00 per cent during the period. Overall, there has been a considerable flattening of the term structure of deposit rates during the last three years.

1.8 Despite a fall in deposit rates and lowering of the cost of funds, the range of prime lending rates (PLRs) of PSBs remained sticky. In view of the downward stickiness of PLRs, the scheme of Benchmark PLR (BPLR) was mooted in the monetary and credit policy Statement of April 2003 to address the need for transparency in banks' lending rates as also to reduce the complexity involved in pricing of loans. For a smooth implementation of the new system by banks, as announced in the mid-term Review of November 2003, the Indian Banks' Association (IBA) issued a circular to its member banks outlining broad parameters to be followed by banks for the computation of BPLR. Almost all commercial banks have since announced their BPLR in place of the earlier system of tenor-linked PLR. The range of BPLR for PSBs is lower at 10.25-11.5 per cent as compared with their earlier PLR range of 10.0-12.25 per cent. PSBs have reduced their rates by 25 to 100 basis points while announcing their BPLR. The compression in the range of PLRs of foreign and private sector banks is more evident, moving from a wide range of 6.75-17.5 per cent in March 2003 to 10.5-14.85 per cent by March 2004. As at end-March 2004, public sector banks' median (representative) lending rate for the demand and term loans (at which maximum business is contracted), in the range of 11.0-12.75 per cent and 11.0-13.25 per cent, respectively, exhibited some moderation as compared with their corresponding levels of 11.5-14.0 per cent and 12.0-14.0 per cent, respectively, in March 2003.

1.9 Under the circumstances, the overall stance of the Reserve Bank's monetary and credit policy during 2003-04 continued to focus on the provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing with the preference for soft and flexible interest rates, along with a vigil on movements in the price level.

Scheduled Commercial Banks

1.10 The strong macroeconomic environment in 2003-04, supported by monetary and financial policies, helped to restore the growth momentum and improve financial performance of the Indian banks. Access to credit was marked by record growth in bank credit to the priority sector including agriculture, small industries, and other priority sectors such as, housing. High growth was also exhibited by some non-priority sectors,

especially, the retail sector. Despite low interest rates, the sharp increase in non-interest income and containment of overall expenditure enabled banks to maintain the high growth of profits witnessed in recent years. The operating profits of commercial banks increased by 29.5 per cent in 2003-04 as against a growth of 36.3 per cent in 2002-03. Their net profits grew by 30.4 per cent over and above the strong performance recorded in 2002-03. The ratio of operating profit to assets of SCBs improved further to 2.7 per cent from 2.4

per cent in 2002-03 (Table I.1). Notably, the increase in net profit was the highest for PSBs with a growth rate of 35 per cent, followed by foreign banks and private sector banks, which recorded growth rates of 23 per cent and 18 per cent, respectively.

1.11 In 2003-04, aggregate deposits recorded robust growth of 17.5 per cent accompanied by high growth of demand deposits at 32 per cent and of time deposits at 15 per cent. Banks continued

Table I.1: Select Financial Sector Indicators: 2002-03 vis-a-vis 2003-04

Financial entity	Indicator	2002-03	2003-04
1	2	3	4
1. Scheduled Commercial Banks	a) Growth in Major Aggregates (per cent)		
	Aggregate Deposits	13.4*	17.5
	Non-food Credit	18.6*	18.4
	Investment in Government Securities	27.3	25.1
	b) Financial Indicators (as percentage of total assets)		
	Operating Profits	2.4	2.7
	Net Profits	1.0	1.1
	Spread	2.8	2.9
	c) Non-Performing Assets (as percentage of advances)		
	Gross NPAs	8.8	7.2
Net NPAs	4.4	2.9	
2. Urban Co-operative Banks	a) Growth in Major Aggregates (per cent)		
	Deposits	9.1	7.5
	Credit	4.5	3.4
	b) Financial Indicators (as percentage of total assets) @		
	Operating Profits	1.5	1.8
	Net Profits	-1.1	0.6
	Spread	2.0	2.1
	c) Non-Performing Assets (as percentage of advances)		
	Gross NPAs	19.0	17.6
	Net NPAs	13.0	11.1
3. All-India Financial Institutions	a) Growth in Major Aggregates (per cent) ¹		
	Sanctions	-31.3	65.8
	Disbursements	-30.5	24.5
	b) Financial Indicators (as percentage of total assets) ²		
	Operating Profits	1.4	1.3
	Net Profits	0.9	0.9
	Spread	0.7	0.2
	c) Non-Performing Assets (as percentage of advances) ²		
Net NPAs	10.6	—	
4. Non-banking Financial Companies³	a) Growth in Major Aggregates (per cent)		
	Public Deposits	6.8	—
	b) Financial Indicators (as percentage of total assets)		
	Net Profits	0.9	—
	c) Non-Performing Assets (as percentage of advances)		
Net NPAs	2.7	—	

* Adjusted for merger. @ Relates to scheduled urban co-operative banks.

1. Comprise IDBI, IFCI, IIBI, IDFC, SIDBI, IVCF, ICICI Venture, TFCI, LIC, UTI, and GIC.

2. Comprise following nine FIs, viz., IDBI, IFCI, IIBI, IDFC, Exim Bank, TFCI, SIDBI, NABARD and NHB.

3. Data for NBFCs are available for the year 2002-03.

to hold a large part of their assets in Government securities during the year 2003-04. As at end-March 2004, the banking sector held 41.3 per cent of its net demand and time liabilities in SLR securities as against the statutory minimum requirement of 25 per cent. The share of investments in 'non-approved securities' in total assets of SCBs, however, declined in view of the tightening of norms relating to the private placement market. Within the loan portfolios, the term loan component increased for all the bank groups and accounted for about 90 per cent of expansion in term-deposits reflecting an improvement in asset-liability management.

1.12 In 2003-04, the private sector banks witnessed sharp growth in their deposits, especially demand deposits and hence, expanded their balance sheets. However, they also registered the sharpest growth in investments in Government securities. The rate of increase in income was the highest for the foreign banks followed by PSBs, new private sector banks, and old private sector banks. On the other hand, expenditure containment driven largely by the decline in interest expenditure, was evident for all bank groups. The trend of rising non-interest income was most pronounced in the case of PSBs as also in foreign banks. However, trading profit comprised the biggest component of non-interest income in case of PSBs and private sector banks, while fee-based income contributed the most to the non-interest income component of the foreign banks.

1.13 The Capital to Risk Weighted Assets Ratio (CRAR) of the banking sector improved further to 12.9 per cent in 2003-04 from 12.7 per cent in 2002-03. While CRAR increased for PSBs and old private sector banks, it declined in respect of new private sector banks and foreign banks. Only two banks, accounting for a negligible 0.5 per cent of the assets of the SCBs, could not satisfy the stipulated 9.0 per cent capital adequacy ratio.

1.14 The gross and net NPAs of SCBs declined in absolute terms for the second year in succession, notwithstanding the changeover to the 90 day delinquency norm. The decline in NPAs was brought about by a sharp increase in recovery, a modest increase in additions and write-offs of bad assets. Reflecting significant provisions, the net NPAs registered sharper decline during 2003-04. While the decline was witnessed across all bank groups, it was more pronounced in the case of

private sector banks especially the new private sector banks. Foreign banks recorded the lowest gross and net NPAs position. Improved risk management practices, greater recovery efforts, SARFAESI Act, 2002 and Corporate Debt Restructuring have contributed to the resolution of NPAs during 2003-04.

1.15 The indicator of management soundness, i.e., the ratio of operating expenses to total expenditure declined for PSBs, old private sector banks and foreign banks but increased marginally for new private sector banks. Comparative efficiency of Indian banks is evident from this ratio ranging between 24-35 per cent, much lower than the international benchmark of 60 per cent. The rationalisation of manpower following the VRS has sharply curtailed the wage bill of PSBs and brought down its share in total expenses to around 17 per cent in 2003-04.

Co-operative Banks

1.16 Co-operative banks showed a higher growth of assets during 2003-04 than in 2002-03. The policy induced changes in the composition of assets of Urban Co-operative Banks (UCBs), especially, growth in the investment in Government securities, led to a significant improvement in both the asset quality and profitability of scheduled UCBs. The net profit of the scheduled UCBs showed a substantial growth of 40.4 per cent, while the net losses for some of UCBs declined sharply. Tier I capital increased considerably from a negative Rs.10 crore in 2002-03 to a positive of Rs.297 crore in 2003-04. Tier II capital also recorded a modest increase of 21.2 per cent. NPAs declined both in absolute and percentage terms.

1.17 The performance of rural co-operatives remained below potential. Profitability of the state co-operative banks increased marginally during 2002-03. On the other hand, central co-operative banks as a whole continued to register losses during 2002-03. The NPAs of rural co-operatives continued to remain high – with the NPAs of the central co-operative banks being relatively higher than that of the state co-operative banks.

Financial Institutions

1.18 After a gap of two years, there was a reversal of the declining trend in growth of

financial assistance sanctioned and disbursed by All-India Financial Institutions (AIFIs) during 2003-04. Significantly, LIC has emerged as the biggest term lending institution with its disbursements exceeding the combined disbursements of IDBI, IFCI, IDFC, IIBI and SIDBI. However, the net flow of resources from major AIFIs continued to be negative after adjusting the gross flow for repayments. The change in the operating environment coupled with increased competition, sluggish capital market hindering mobilisation efforts and availability of alternative modes of finance to the corporates, the legacy of non-performing assets and organisational restructuring being faced by these institutions, *inter alia*, have led to the declining share of business for the AIFIs.

1.19 The balance sheet of select FIs, as a group, showed a growth of 7.3 per cent during 2003-04 over the growth of 5.6 per cent during 2002-03. Broad trends in the components of liabilities remained more or less the same with bonds and debentures contributing to nearly half the liabilities of the AIFIs. However, on the assets side there was a compositional shift away from loans and advances towards investments and holding of more liquid assets. Both the income and expenditure of the FIs declined leading to an unchanged profit ratio for the FIs. The CRAR remained much higher for all FIs except IFCI and IIBI, for whom there was a sharp deterioration in the asset quality and erosion of capital base. The net NPAs of AIFIs increased during 2003-04 on account of increase in cost overruns of projects and slippages in standard assets.

1.20 The resource mobilisation by mutual funds increased more than nine-fold during 2003-04. While the private sector mutual funds registered a phenomenal growth, the UTI also faced a turnaround and reported a positive mobilisation. The growth in resource mobilisation by the mutual funds was mainly on account of debt-oriented mutual funds.

Non-Banking Financial Companies

1.21 The number of non-banking financial companies (NBFCs) declined for the second year in succession, reflecting mergers, closures and cancellation of licenses. The number of public deposit accepting companies also came down because of conversion to non-public deposit accepting activities. The broad profile of the

NBFC sector during 2002-03 remained more or less the same in terms of the activity-wise distribution of assets. Although the assets of the NBFC sector declined marginally, the public deposits held by NBFCs, the focus of the regulatory oversight, witnessed a moderate increase with reduced regional concentration and lowered interest rates offered on them. In terms of prudential indicators, only a few reporting NBFCs (6.3 per cent) failed to achieve the stipulated minimum CRAR of 12 per cent. Indeed, almost three-fourth of them reported a CRAR of above 30 per cent. Although the gross NPAs reported a steady decline, the net NPAs witnessed a marginal increase as at end-September 2003 on account of recourse to lower provisioning.

1.22 During 2002-03, there was a turnaround in the financial performance of NBFCs from the losses witnessed during the previous two years. The decline in income was more than compensated by a fall in expenditure. This was mainly due to a sharper decline in the interest expenses of the NBFCs on account of softening of the interest rates. Among the components of income, the fee based income increased moderately although it continued to constitute a small part (7.4 per cent) of their income.

1.23 The enactment of the SARFAESI Act, 2002, the initiation of the Financial Companies Regulation Bill and the deliberations of the Working Group on the Development Financial Institutions is expected to impact positively on the functioning of the NBFC sector.

Developments during 2004-05

1.24 The broad based growth momentum continued for the first quarter of 2004-05. GDP growth at 7.4 per cent was higher by about two percentage points over the growth recorded in the first quarter of 2003-04. Output of major *Kharif* crops is expected to be lower this year as compared with the corresponding level of 2003-04. However, *Rabi* crop production is expected to be favourable. Seasonal (June-September) rainfall was excess/normal in 23 out of 36 meteorological sub-divisions and the remaining 13 sub-divisions registered deficient rainfall. While 56 per cent of the meteorological districts received excess/normal rainfall, the remaining 44 per cent received deficient/scanty rainfall. While the prospects are still somewhat unclear,

the current assessments clearly indicate that agricultural growth of 3.0 per cent, projected earlier, is unlikely to materialise. Industrial growth as indicated by the Index of Industrial Production (IIP) has registered higher growth of 7.9 per cent during April-September 2004 as compared with 6.2 per cent growth during April-September 2003. There are signs of sustained growth in the production of basic goods, capital goods, intermediate goods and consumer durables. Thus, the prospects for growth in industrial output have improved. Further, exports continued to remain buoyant and recorded a growth of 24.4 per cent in US dollar terms during April-September 2004 as against 8.1 per cent during April-September 2003. While the CSO estimate of GDP for the first quarter is consistent with the earlier projected growth of 6.5 to 7.0 per cent for the full fiscal year, the deficient rainfall in some parts of the country and its impact on *Kharif* crop impart a downward bias to this growth projection. In addition, the higher oil prices tend to have an adverse impact on GDP growth. At the same time, the improved prospects for growth in industrial output and continued buoyancy in exports are likely to have a positive impact on growth. On the whole, while the picture is not very clear, it may be reasonable to place the overall GDP growth during 2004-05 in the range of 6.0 per cent to 6.5 per cent as against the earlier expectation of 6.5 per cent to 7.0 per cent, assuming that the combined downside risks of high and uncertain oil prices, and sudden changes in international liquidity environment remain manageable.

1.25 Money supply (M_3) expansion in 2004-05 up to October 29, 2004 was lower at 6.6 per cent (Rs.1,32,428 crore) [6.4 per cent (Rs.1,28,859 crore), net of conversion] as compared with 8.9 per cent (Rs.1,53,474 crore) in the corresponding period of 2003-04. On an annual basis, growth in M_3 at 14.1 per cent (13.9 per cent, net of conversion) was, however, higher than 12.1 per cent during 2003-04. Annual inflation, as measured by variations in the wholesale price index (WPI), on a point-to-point basis, which rose from 4.6 per cent at end-March 2004 to 8.7 per cent by end-August 2004 declined to 7.1 per cent by October 30, 2004. On an average basis, annual inflation based on WPI was 6.3 per cent as on October 30, 2004 as compared with 5.0 per cent a year ago. While WPI inflation increased sharply on the back of a rise in international oil

and metal prices, the CPI inflation witnessed only a moderate increase. On an annual average basis, inflation as reflected in CPI was 3.6 per cent in September 2004 as against 3.9 per cent a year ago. However, CPI inflation could be impacted by WPI inflation with a lag. On current assessment, assuming that there would be no further major supply shock and liquidity conditions remain manageable, the point-to-point year-end inflation based on WPI for the year 2004-05 could be placed around 6.5 per cent as against 5.0 per cent as projected in the annual policy Statement of May 2004.

1.26 The growth rate in aggregate deposits of SCBs was lower at 7.5 per cent (7.2 per cent, net of conversion) up to October 29, 2004 as compared with 9.0 per cent in the corresponding period of 2003-04, mainly attributable to reduction in non-resident Indian (NRI) deposits with the banking system. On an annual basis, growth in aggregate deposits at 15.8 per cent (15.6 per cent net of conversion) was, however, higher than that of 11.8 per cent during 2003-04. During 2004-05 (up to October 29, 2004), credit by SCBs increased by 17.5 per cent (Rs.1,47,491 crore) [13.7 per cent (Rs.1,14,809 crore), net of conversion] which was substantially higher than the increase of 4.5 per cent (Rs.33,088 crore) in the corresponding period of 2003-04. Food credit increased by Rs.3,751 crore as against a decline of Rs.13,459 crore in 2003-04 reflecting a turnaround of about Rs.17,210 crore. During the same period, non-food credit posted a robust increase of 17.9 per cent (Rs.1,43,741 crore) [13.8 per cent (Rs.1,11,059 crore) net of conversion] as compared with an increase of 6.8 per cent (Rs.46,539 crore) in the corresponding period of 2003-04. The incremental non-food credit-deposit ratio was substantially higher at 127.8 per cent during 2004-05 (up to October 29, 2004) as against 40.4 per cent in the corresponding period of 2003-04. The detailed information on sectoral deployment of credit available from banks reveals that over two-third of credit flow during 2004-05 (up to August 2004) was on account of retail, housing and other priority sector loans. There has been a revival of investment activity in 2004-05 with some evidence of expansion and scaling up of production plans. Credit needs of industry, therefore, are likely to gain further momentum.

1.27 In recent years, investment in Government and other approved securities by SCBs has been much in excess of the required

SLR of 25 per cent. As at end-March 2004, such excess of SLR securities at Rs.2,67,328 crore constituted 16.3 per cent of NDTL of banks. However, during 2004-05 (up to October 29, 2004), the investment in Government and other approved securities of SCBs at Rs.28,955 crore (net of conversion effect) was lower than that of Rs.84,031 crore in the corresponding period of 2003-04 partly on account of pick-up in credit demand. Consequently, commercial banks excess holding of SLR securities was reduced to Rs.2,59,083 crore or 14.5 per cent of NDTL in 2004-05 (up to October 29, 2004). Since demand by the commercial sector is expected to remain buoyant during 2004-05, lower demand by banks for Government securities has implications for Government market borrowing programme.

1.28 During 2004-05 (April to October 31, 2004), financial markets have remained generally stable though interest rates have displayed some upward movement, particularly at the longer end. The average call money rate, 91-day and 364-day Treasury Bill rates and the yield on Government securities with one year, 10 year and 20 year residual maturity exhibited upward movements. The weighted average discount rate on commercial paper of 61 to 90 day maturity increased from 5.1 per cent in April 2004 to 5.4 per cent by end-October 2004. The market repo rate increased from 3.7 per cent to 4.7 per cent with an increase in daily volume during the same period. The typical interest rate on three-month certificates of deposit increased from 4.96 per cent in March 2004 to 4.75 per cent by mid-October 2004. The PSBs, however, reduced the deposit rates of over one year from 5.0-6.0 per cent to 4.75-5.75 per cent as on October 29, 2004. The BPLRs of public sector and foreign banks were in the range of 10.25-11.0 per cent and 11.0-13.0 per cent in October 2004 as against 10.25-11.5 per cent and 11.0-14.85 per cent, respectively, in April 2004. In contrast, the BPLRs for private sector banks moved from a range of 10.5-13.0 per cent in April 2004 to a range of 9.75-13.0 per cent by October 2004. The representative (median) lending rates on demand and term loans (at which maximum business is contracted) of public sector banks were in the range of 8.25-12.5 per cent in September 2004 as against 11.0-12.75 per cent in March 2004.

1.29 On the external front, merchandise export growth in the first half of 2004-05 has been robust and well above the target of 16 per cent in US dollar terms set for the year. India's exports during April-September 2004 increased by 24.4 per cent in US dollar terms as compared with 8.1 per cent in the corresponding period of 2003-04. Imports rose faster by 34.3 per cent as against an increase of 21.0 per cent in the corresponding period of 2003-04. Oil imports increased by 57.8 per cent as compared with 6.4 per cent, while non-oil imports increased by 25.8 per cent as against 27.4 per cent. The overall trade deficit widened to US \$ 12.7 billion from US \$ 7.4 billion in the corresponding period of 2003-04. The higher trade deficit during 2004-05, in substantial part, reflects the high oil imports bill in the wake of the hardening of international prices and also the growth in import demand emanating from a pick-up in economic activity as reflected in higher capital goods imports. During the first quarter of 2004-05, a widening trade deficit was more than offset by the surplus under invisibles leading to a current account surplus. Net capital flows has been at US \$ 5.6 billion in the first quarter of 2004-05, comparable with the flows of around US \$ 6 billion registered in the first quarter of 2003-04. The net capital flows in the 2004-05 has been driven mainly by foreign direct investment, commercial borrowings, and short-term trade credits. As a result, the net accretion to foreign exchange reserves, excluding valuation effects, amounted to US \$ 7.5 billion during April-June 2004.

1.30 Against the backdrop of these developments in different sectors of the economy during the first half of 2004-05, the overall monetary policy stance for the second half of 2004-05 is to be (i) provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability; (ii) consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability and maintaining the momentum of growth; and (iii) to consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations.