II RECENT ECONOMIC DEVELOPMENTS

Introduction

2.1 The striking features of the sustained growth momentum of the Indian economy are a continued upturn in the manufacturing sub-sector of industry and further acceleration in the services sector, fostered by sub-sectors construction; 'financing, insurance, real estate and business services'; 'trade, hotels, transport and communication'; and 'community, social and personal services'. Notwithstanding some moderation in the real Gross Domestic Product (GDP) growth in 2004-05, India was among the fastest growing economies in emerging Asia. Industrial growth fanned out, abetted by a congenial investment climate, favourable corporate results, growing manufacturing exports, upswing in domestic demand and a liberalised Foreign Direct Investment (FDI) regime. This was complemented by a firm pick up in non-food credit underscoring acceleration in investments, swelling production and imports of capital goods buttressed by buoyant capital markets. Business confidence indices were sanguine. Despite the late onset of South-West monsoon in fiscal 2005-06, buoyancy in non-food credit, expected momentum in investment activity and robustness in the services sector affirm that the macroeconomic outlook for the forthcoming financial year is upbeat. The Reserve Bank revised the growth projections of real GDP for 2005-06 from around 7.0 per cent in April 2005 to 7.0-7.5 per cent in the mid-term review of Annual Policy Statement (October 2005) and further to 7.5-8.0 per cent in January 2006 in the third quarter review of the Annual Policy Statement based on the assessment of a pick up in agricultural output besides the continued buoyancy in the industrial and services sectors. The advance estimates released by the Central Statistical Organisation (CSO) have placed the real GDP growth for 2005-06 at 8.1 per cent (1999-2000 prices), which is close to the Reserve Bank projections. The growth is backed by acceleration in agriculture sector, strong growth recorded by the industry and impressive performance of the services sector.

2.2 Inflationary pressures due to a sharp increase in international crude oil prices necessitated formulation of a forward looking policy response by the Reserve Bank while maintaining the desired growth momentum. Although inflation has remained well contained, a vigil is warranted due to the continued uncertainty in the international oil prices especially since the pass-through of the increase in international oil prices to the domestic economy has so far been incomplete.

2.3 Financial markets have remained stable and orderly through the fiscal year. The merchandise and invisibles exports have remained strong, while imports expansion (oil and capital goods imports) is boosting productivity levels and export growth. The current account during 2004-05 recorded a deficit after remaining in surplus for the preceding three years since 2001-02. Buoyancy in net invisibles earnings underlined the surplus position in the current account during the said period. The balance of payments position, nevertheless calls for cautious monitoring. A positive feature of the capital inflows has been a spurt in non-debt inflows; debt flows have remained moderate.

2.4 Against this overview, this chapter presents an account of macroeconomic developments in 2005-06 so far. Section I reflects on developments in the Real Sector. Section II presents glimpses of Central and State Government finances. Section III focuses on monetary and credit developments alongwith the inflation trends. Section IV discusses developments in the financial markets. Section V covers external sector and Section VI underlines the concluding observations.

I. REAL SECTOR

National Income

2.5 The Indian economy exhibited a strong growth performance during 2004-05. Real GDP growth was 7.5 per cent during 2004-05 (1999-00 prices) as compared with 8.5 per cent in 2003-04. Growth of real GDP originating from 'agriculture and allied activities' decelerated sharply to 0.7 per cent during 2004-05 from 10.0 per cent in the preceding year. This was on account of an uneven and deficient South-West monsoon besides the base effect of the high growth of 2003-04 (Table 2.1 and Chart II.1). The deceleration in the growth of 'agriculture and allied activities' was somewhat cushioned by firming-up of activities in the industry and services sectors. Accordingly, real GDP growth originating from industry rose to 7.4 per cent as the industrial recovery spread

Table 2.1: Real Gross Domestic Product (Base year : 1999-2000)

(Per cent)

Sector	2001-02	2002-03	2003-04 PE	2004-05 QE	2005-06 AE
1	2	3	4	5	6
Growth Rate					
1. Agriculture and Allied Activities	**6.2**	**-6.9**	**10.0**	**0.7 (1.1)**	**2.3**
1.1 Agriculture	6.5	-7.8	10.7	0.7	..
2. Industry	**2.4**	**6.8**	**6.6**	**7.4 (8.3)**	**8.0**
2.1 Manufacturing	2.5	6.8	7.1	8.1 (8.9)	9.4
2.2 Mining and Quarrying	1.8	8.7	5.3	5.8 (5.3)	1.0
2.3 Electricity, Gas and Water Supply	1.7	4.8	4.8	4.3 (6.3)	5.4
3. Services	**6.8**	**7.3**	**8.5**	**10.2 (8.6)**	**10.1**
3.1 Trade, Hotels and Restaurants	9.6	6.7	10.2	8.1 (11.3) $	11.1$
3.2 Transport, Storage and Communication	8.3	13.7	15.2	14.8	..
3.3 Financing, Insurance, Real Estate and Business Services	7.3	8.0	4.5	9.2 (7.1)	9.5
3.4 Construction	4.0	7.7	10.9	12.5 (5.7)	12.1
3.5 Community, Social and Personal Services	3.9	3.8	5.4	9.2 (6.0)	7.9
4. GDP at factor cost	**5.8**	**3.8**	**8.5**	**7.5 (6.9)**	**8.1**
Sectoral Composition					
1. Agriculture and Allied Activities	24.4	21.9	22.2	20.8	19.7
2. Industry	19.3	19.9	19.5	19.5	19.5
3. Services	56.3	58.3	58.3	59.7	60.9
4. Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Memo:					
Real GDP at factor cost (Rupees crore)	19,78,055	20,52,586	22,26,041	23,93,671	25,86,587

.. Not available. PE : Provisional Estimates. QE : Quick Estimates. AE : Advance Estimates.
$ Includes 'Trade, Hotels and Restaurants' and ' Transport, Storage and Communication'. Growth rate was 10.6 per cent in 2004-05 at 1999-00 prices.
Note : Figures in the parentheses are percentage growth according to the revised estimates (at 1993-94 prices) released by the CSO in June 2005.
Source : Central Statistical Organisation.

and strengthened during 2004-05, led by the manufacturing sector. The buoyancy in manufacturing sub-sector is propelled by a congenial domestic investment climate, improvement in world output, a liberalised foreign direct investment (FDI) regime and surging manufacturing exports. The services sector continued to anchor the growth process and recorded impressive growth backed by strong growth performance of all its sub-sectors.

2.6 The fiscal year 2005-06 commenced on a buoyant tone. The South-West monsoon rainfall was forecast as normal (98 per cent of Long Period Average (LPA) with a model error of +/- 4 per cent) for the year 2005 by the India Meteorological Department (IMD). Against the backdrop of buoyancy in industrial growth performance and the capacity of services sector to anchor the GDP growth alongwith an assessment of a pick up in the agricultural output, the Indian economy is poised for a robust growth performance in 2005-06. In view of this, the Reserve Bank revised its GDP growth forecast from 7.0-7.5 per cent in October 2005 in the mid-term review of Annual Policy Statement for the year 2005-06 to 7.5-8.0 per cent in the third quarter review of its Annual Policy Statement in January 2006 as against its initial projection of around 7.0 per cent in April 2005. Other national and international organisations have also forecast the real GDP growth rates proximate to this range (Table 2.2). As per the advance estimates of the CSO released on February 7, 2006, real GDP growth rate for 2005-06 is estimated at 8.1 per cent

Chart II.1: Annual Growth Rate of GDP at Factor Cost (At 1999-2000 prices)

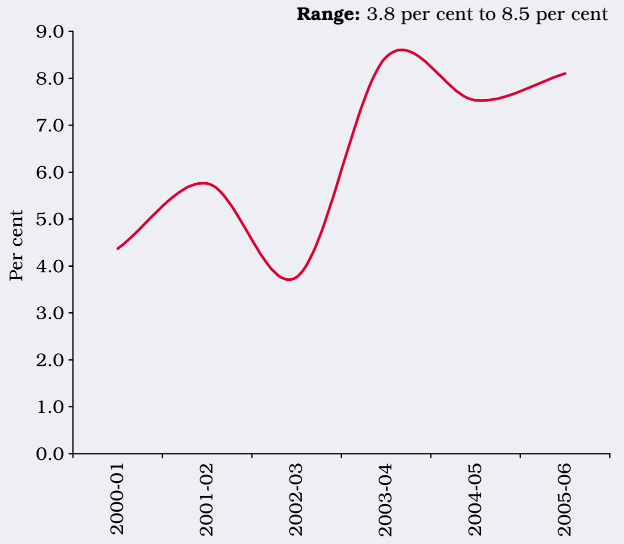


Table 2.2: Growth in Real Gross Domestic Product, 2005-06: Forecasts for India$

(Per cent)

Agency	Initial	Revised/ Latest	Month of Projection
1	2	3	4
Asian Development Bank	6.9	6.9	September 2005
Centre for Monitoring Indian Economy	6.6	7.8	Mid-February 2006
Confederation of Indian Industry	7.2	Over 8.0	End-February 2006
Credit Rating Information Services of India Limited	7.0	7.0	End-September 2005
National Council of Applied Economic Research	7.2	7.8	Early February 2006
International Monetary Fund	6.7	7.1	September 2005
Reserve Bank of India	Around 7.0	7.5-8.0	January 2006*
Memo:			
Range	6.6-7.2	6.9-8.0	

$ GDP forecasts are based on base year 1993-94, except CMIE's and CII's latest forecasts which are based on base year 1999-2000.
* Third Quarter Review of Annual Policy for the year 2005-06.

(base year: 1999-2000), which is close to the growth projections of the Reserve Bank. At the sectoral level, growth in agricultural and industrial sectors accelerated, the latter reflecting improvements in the growth of two of its sub-sectors, *viz.*, manufacturing and 'electricity, gas and water supply'. However, the growth in services in 2005-06 is marginally lower than that in 2004-05. This is due to deceleration in the growth of 'community, social and personal services', 'trade, hotels, transport and communication' and construction sub-sectors, notwithstanding improvement in the growth rate of the sub-sector 'financing, insurance, real estate and business services' (Table 2.1). The latest available data on the quarterly growth rates of real GDP (at 1999-2000 prices) indicate that the growth rates of real GDP are higher in the first three quarters of 2005-06 as compared with the corresponding quarters of the previous year. The increase in the growth rate of real GDP in the third quarter of 2005-06 *vis-à-vis* that in the corresponding quarter of 2004-05 was driven by a sharp recovery in agricultural sector growth. Industry and services sectors, on the other hand, registered deceleration in their growth rates during the third quarter of 2005-06 (Table 2.3).

2.7 India, growing at this rate, would continue to be one of the fastest growing economies among emerging market economies of Asia (Table 2.4).

Table 2.3: Quarterly Growth Rates of Gross Domestic Product (At 1999-2000 prices)

(Per cent)

	Industry	2004-05			2005-06		
		Q1	Q2	Q3	Q1	Q2	Q3
	1	2	3	4	5	6	7
1.	**Agriculture and Allied Activities**	**3.5**	**-0.2**	**-1.2**	**1.4**	**2.4**	**3.4**
2.	**Industry**	**6.6**	**8.0**	**8.1**	**9.9**	**6.7**	**7.1**
	2.1 Manufacturing	6.6	8.3	9.2	11.3	8.6	8.4
	2.2 Mining and Quarrying	8.2	6.0	5.7	3.7	-1.9	0.6
	2.3 Electricity, Gas and Water Supply	4.9	7.9	3.1	6.9	2.2	4.4
3.	**Services**	**10.1**	**8.4**	**10.7**	**10.0**	**10.0**	**9.7**
	3.1 Trade, Hotels, Transport and Communication	10.6	11.2	9.7	11.7	11.2	10.3
	3.2 Financing, Insurance, Real Estate and Business Services	8.8	7.5	9.7	8.7	9.8	9.1
	3.3 Construction	9.9	7.9	22.0	12.4	12.3	11.5
	3.4 Community, Social and Personal Services	10.7	4.8	8.5	7.0	7.3	8.1
4.	**Gross Domestic Product at Factor Cost**	**7.9**	**6.7**	**7.0**	**8.1**	**8.0**	**7.6**

Source: Central Statistical Organisation.

Table 2.4: Output Growth: Cross-Country Comparison

(Per cent)

Country	Average 1997-2005	1997	1998	1999	2000	2001	2002	2003	2004	2005 P
1	2	3	4	5	6	7	8	9	10	11
World	**3.8**	**4.2**	**2.8**	**3.7**	**4.7**	**2.4**	**3.0**	**4.0**	**5.1**	**4.3**
Advanced Economies	**2.7**	**3.5**	**2.6**	**3.5**	**3.9**	**1.2**	**1.5**	**1.9**	**3.3**	**2.5**
Other Emerging Market and Developing Countries	**5.2**	**5.2**	**3.0**	**4.0**	**5.8**	**4.1**	**4.8**	**6.5**	**7.3**	**6.4**
Argentina	2.0	8.1	3.8	-3.4	-0.8	-4.4	-10.9	8.8	9.0	7.5
Bangladesh	5.4	5.3	5.0	5.4	5.6	4.8	4.8	5.8	5.8	5.7
Brazil	2.3	3.3	0.1	0.8	4.4	1.3	1.9	0.5	4.9	3.3
Chile	3.9	6.6	3.2	-0.8	4.5	3.4	2.2	3.7	6.1	5.9
China	8.4	8.8	7.8	7.1	8.0	7.5	8.3	9.5	9.5	9.0
India	**5.9**	**5.0**	**5.8**	**6.7**	**5.4**	**3.9**	**4.7**	**7.4**	**7.3**	**7.1@**
Indonesia	2.3	4.5	-13.1	0.8	4.9	3.8	4.4	4.9	5.1	5.8
Malaysia	4.2	7.3	-7.4	6.1	8.9	0.3	4.4	5.4	7.1	5.5
Mexico	3.5	6.7	4.9	3.9	6.6	-0.2	0.8	1.4	4.4	3.0
Pakistan	4.3	1.8	3.1	4.0	3.0	2.5	4.1	5.7	7.1	7.4
Philippines	3.8	5.2	-0.6	3.4	4.4	1.8	4.4	4.5	6.0	4.7
Sri Lanka	4.5	6.4	4.7	4.3	6.0	-1.5	4.0	6.0	5.4	5.3
Thailand	2.4	-1.4	-10.5	4.4	4.8	2.2	5.3	6.9	6.1	3.5

P : IMF Projections.
@ RBI's projection for the financial year 2005-06, as indicated in the Third Quarter Review of Annual Policy Statement for the year 2005-06, is 7.5- 8.0 per cent.
Source: World Economic Outlook, September 2005.

Saving and Investment

2.8 The rate of Gross Domestic Saving (GDS), as a proportion to GDP at current market prices increased substantially from 26.5 per cent in 2002-03 to 28.9 per cent in 2003-04 and further to 29.1 per cent in 2004-05, on account of higher positive saving rate posted by the public sector and improvement in the saving rate of private corporate sector (Table 2.5 and Chart II.2). The rate of GDS at 29.1 per cent was

Table 2.5: Gross Domestic Saving and Investment
(Base year: 1999-2000)

(Per cent of GDP at current market prices)

Variable	1999-00	2000-01	2001-02	2002-03	2003-04 PE	2004-05 QE
1	2	3	4	5	6	7
1. Gross Domestic Saving (GDS) (1.1+1.2+1.3)	**24.9**	**23.5**	**23.6**	**26.5**	**28.9 (28.1)**	**29.1**
1.1 Household Saving	21.3	21.2	22.0	23.1	23.5 (24.3)	22.0
a) Financial Assets	10.5	10.2	10.8	10.3	11.5 (11.4)	10.3
b) Physical Assets	10.7	11.0	11.2	12.7	12.0 (13.1)	11.7
1.2 Private Corporate Sector	4.5	4.1	3.6	4.1	4.4 (4.1)	4.8
1.3 Public Sector	-0.9	-1.8	-2.0	-0.7	1.0 (-0.3)	2.2
2. Gross Domestic Capital Formation (GDCF)#	**26.0**	**24.2**	**23.0**	**25.3**	**27.2 (26.3)**	**30.1**
3. Saving-Investment Balance (1-2)	**-1.1**	**-0.6**	**0.6**	**1.2**	**1.6**	**-1.0**
4. Gross Capital Formation (4.1+4.2+4.3+4.4)	**26.1**	**24.3**	**24.3**	**25.3**	**26.3 (23.0)**	**28.5**
4.1 Household Sector	10.7	11.0	11.2	12.7	12.0 (13.0)	11.7
4.2 Private Corporate Sector	7.2	5.7	5.6	5.8	6.8 (4.5)	8.2
4.3 Public Sector	7.5	6.9	6.9	6.2	6.5 (5.6)	7.2
4.4 Valuables@	0.8	0.7	0.6	0.6	0.9	1.3

PE : Provisional Estimates. QE : Quick Estimates.
Adjusted for errors and omissions. @ Valuables cover the expenditure made on acquisition of valuables, excluding works of arts and antiques.
Notes : 1) Figures in parentheses pertain to that of quick estimates (base year: 1993-94) released by the CSO in January 2005.
2) Figures may not add up to the totals due to rounding off.
Source : Central Statistical Organisation.

Chart II.2: Saving by Institutional Sources (Base year: 1999-2000)

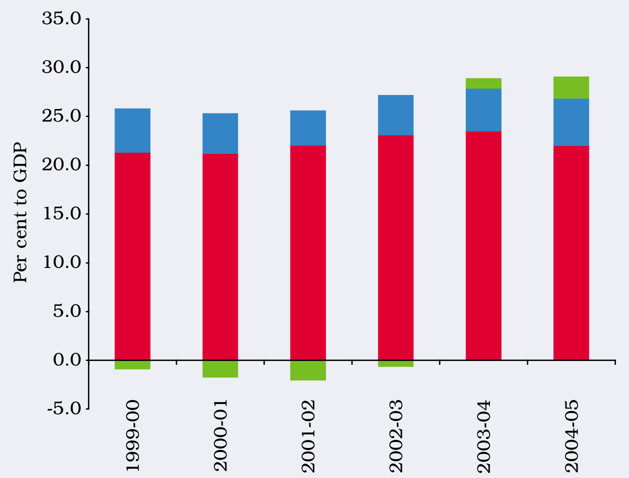
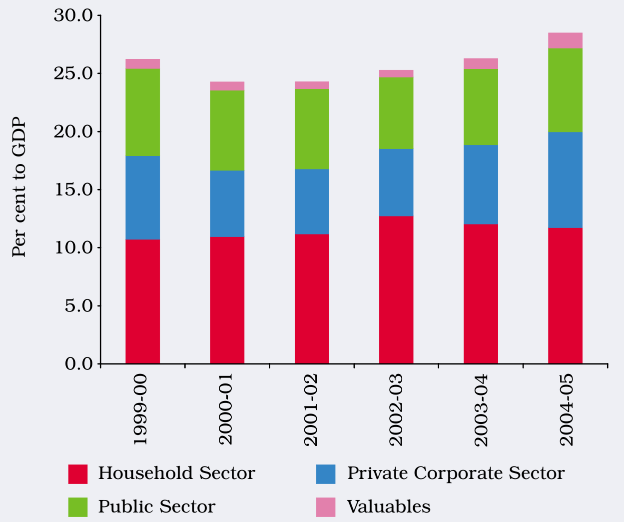


Chart II.3: Gross Capital Formation by Institutional Sources (Base year: 1999-2000)



the highest ever achieved. The household sector continued to be the major contributor to GDS with its saving rate placed at 22.0 per cent in 2004-05. Since 1999-00, the rate of household sector saving in the form of physical assets has been higher than that in financial assets. Private corporate saving has been increasing steadily since 2002-03 reflecting significant growth in profits. The public sector also posted positive saving rate of 2.2 per cent in 2004-05, up from 1.0 per cent in 2003-04 on account of better performance of public sector undertakings.

2.9 The rate of Gross Capital Formation (GCF) posted significant improvement in 2004-05 over that in 2003-04 due to improvements in both public and private corporate investments. The increase in the investment rate was even higher than the increase in the saving rate. This resulted in a deficit of -1.0 per cent in the overall saving-investment balance in 2004-05 as compared with a surplus of 1.6 per cent in 2003-04 (Table 2.6 and Chart II.3).

2.10 The important features of the recent high growth rate are excellent performance shown by the industry and services sectors. The services sector has in fact emerged as the growth driver of the Indian economy in the recent past in comparison with China and other emerging Asian countries where high

Table 2.6: Saving-Investment Balance (Base year: 1999-2000)

(Per cent of GDP at current market prices)

Item	1999-00	2000-01	2001-02	2002-03	2003-04 PE	2004-05 QE
1	2	3	4	5	6	7
Saving-Investment Balance (GDS-GDCF)	-1.1	-0.6	0.6	1.2	1.6	-1.0
Private Sector*	7.8	8.6	8.8	8.6	9.0	6.9
Public Sector*	-8.3	-8.7	-8.9	-6.8	-5.5	-5.0
Current Account Balance	-1.0	-0.6	0.7	1.3	2.3	-0.8
Memo:						
Valuables@	0.8	0.7	0.6	0.6	0.9	1.3

* Private and Public Investments refer to gross capital formation (GCF), unadjusted for errors and omissions.
@Valuables cover the expenditure made on acquisition of valuables that has been included in the Gross Capital Formation.
GDS : Gross Domestic Saving. GDCF : Gross Domestic Capital Formation.
PE : Provisional Estimates. QE : Quick Estimates.
Note : Derived from CSO and Reserve Bank of India data. Components do not add up to totals because of errors and omissions.

growth is led by the manufacturing sector. Manufacturing within the industry, in India has also recorded impressive performance in the past three years. Further, the rate of GDS at 29.1 per cent achieved during 2004-05, which is the highest rate since the 1950s is highly encouraging. The investment rate at 28.5 per cent during 2004-05 is also remarkable. Maintaining the saving and investment rates at such high levels to sustain high growth momentum, however, remains an area of concern.

Agriculture

2.11 Indian agriculture, after having received a setback in 2004-05, is poised for a turnaround during 2005-06. The rainfall activity, though subdued during the initial period of the season, revived subsequently and the consequent improvement in the moisture content augured well for the *kharif* production. As per the Second Advance Estimates, the total production of foodgrains during 2005-06 is estimated at 209.3 million tonnes indicating a growth of 2.3 per cent as compared with 204.6 million tonnes in the previous year. The Ministry of Agriculture formulated a crop-specific strategy for augmenting the production of crops covering measures such as ensuring timely and adequate availability of certified/quality seeds of location specific high yielding varieties, encouraging inter-cropping, promotion of water saving methods, balanced use of fertilisers, and disease management system.

2.12 In the backdrop of the forecast of a normal South-West monsoon for 2005 by the IMD, the monsoon on-set was late. Although initially the rainfall activity was subdued, it revived subsequently. The temporal progress of the monsoon was erratic but its spatial spread turned out to be satisfactory. The monsoon revival resulted in replenishment of the moisture content of the soil as well as that of the reservoirs.

2.13 The spatial distribution of rainfall during the South-West monsoon 2005 has been satisfactory with 32 out of 36 meteorological sub-divisions recording excess/normal rainfall and only 4 receiving deficient/scanty rainfall (Table 2.7 and Chart II.4). The temporal progress of monsoon was marked with large rainfall deficiency during the first three weeks of June, whole of August and the first week of September 2005. However, there was conspicuous improvement in the monsoon conditions with excess rainfall activity over the country, occurring from the last week of June, most of July and in the second and third week of September 2005. The cumulative area-weighted rainfall during the

Table 2.7: Cumulative Rainfall

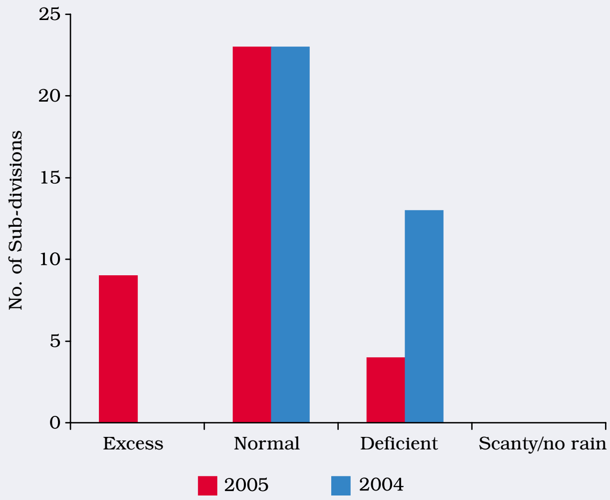
Category	Number of Sub-Divisions					
	South-West Monsoon			North-East Monsoon		
	2005	2004	2003	2005	2004	2003
	(June 1 to Sept. 30)			(Oct. 1 to Dec. 31)		
1	2	3	4	5	6	7
Excess	9	0	7	11	8	9
Normal	23	23	26	6	10	9
Deficient	4	13	3	5	17	6
Scanty/no rain	0	0	0	14	1	12

Source: India Meteorological Department.

South-West monsoon season (June 1 to September 30, 2005) turned out to be 1 per cent below the Long Period Average (LPA), in tandem with the prediction of the IMD.

2.14 Precipitation was 12 per cent below LPA during the month of June. However, during July, which is critical for sowing operations, the rainfall turned out to be excess, *i.e.*, 14 per cent above the LPA, thus providing a conducive backdrop for sowing operations. The monsoon was again subdued in August with a large deficiency of 28 per cent below the LPA. The rainfall was 17 per cent above the LPA in September that provided respite from moisture stress for late sown crops. Among the four regions, South-West monsoon rainfall over Central India, North-West India and South Peninsula was 110 per

Chart II.4: South-West Monsoon -Cumulative Rainfall (June to September)



Source: India Meteorological Department.

Table 2.8: Crop-wise Targets/Achievements

(Million Tonnes)

Crop	2003-04		2004-05		2005-06	
	T	A	T	A.E.$	T	A.E.@
	1	2	3	4	5	6
Rice	93	88.3	93.5	85.3	87.8	87.9
Wheat	76	72.1	79.5	72	75.5	73.1
Coarse cereals	34	38.1	36.8	33.9	36.5	34.0
Pulses	16	14.9	15.3	13.4	15.2	14.4
Total Foodgrains	**220**	**213.5**	**225.1**	**204.6**	**215.0**	**209.3**
Oilseeds	24.7	25.3	24.7	26.1	26.6	26.4
Sugarcane	320	237.3	270	232.3	237.5	266.9
Cotton*	15	13.9	15	17	16.5	16.5
Jute & Mesta**	12	11.2	11.8	10.5	11.3	10.7

T : Target. A : Achievement.
A.E.$: Fourth Advance Estimates.
A.E.@ : Second Advance Estimates.
* In million bales of 170 kilograms each.
** In million bales of 180 kilograms each.
Source: Ministry of Agriculture, Government of India.

cent, 90 per cent and 112 per cent of the LPA, respectively, while it was deficient by 20 per cent over North-East India. At the sub-division level, only one sub-division - Jharkhand recorded moderate drought conditions[1]. The progress of North-East monsoon (October 1 to December 31, 2005) was satisfactory with the cumulative rainfall at 10 per cent above LPA as against 11 per cent below LPA during the corresponding period of the previous year. Out of 36 meteorological sub-divisions, the cumulative rainfall was excess/normal in 17 sub-divisions (18 last year) and deficient/scanty/no rain in 19 sub-divisions (18 last year). The overall foodgrains production for 2005-06 has been targeted at 215 million tonnes (Table 2.8).

Kharif 2005

2.15 During the year 2004, *kharif* foodgrains production recorded a shortfall of over 12 per cent over the previous year due to unfavourable monsoon conditions. According to the Second Advance Estimates of the Ministry of Agriculture released on February 22, 2006, the production of foodgrains for *kharif* 2005 is estimated at over 108.2 million tonnes, marking an increase of 4.7 per cent over the preceding year. The higher production is likely to be contributed by increase in the production of rice, cereals and pulses. Among commercial crops, while the production of sugarcane, oilseeds, jute and mesta is expected to be higher, the production of cotton is likely to witness some slippage from the level attained in the previous year (Table 2.9).

Rabi 2005-06

2.16 As per the Second Advance Estimates, total *rabi* foodgrains production is estimated at 101.2

Table 2.9: Season-wise Agricultural Production

(Million Tonnes)

Crops	*Kharif*			*Rabi*		
	2003-04 A	2004-05 A.E.$	2005-06 A.E.@	2003-04 A	2004-05 A.E.$	2005-06 A.E.@
1	2	3	4	5	6	7
Rice	78.34	71.67	75.98	9.94	13.64	11.88
Wheat				72.11	72.00	73.06
Coarse cereals	32.37	26.7	26.70	5.75	7.22	7.30
Pulses	6.16	4.95	5.47	8.78	8.43	8.93
Total Foodgrains	**116.88**	**103.32**	**108.15**	**96.58**	**101.29**	**101.17**
Oilseeds	16.77	14.94	15.99	8.52	11.17	10.39
Sugarcane	237.31	232.32	266.88	..	..	..
Cotton*	13.87	17.00	16.45	..	..	..
Jute & Mesta**	11.23	10.49	10.65	..	..	..

.. Not Available. * In million bales of 170 kilograms each. ** In million bales of 180 kilograms each.
A : Achievement. A.E.$: Fourth Advance Estimates. A.E.@ : Second Advance Estimates.
Source: Ministry of Agriculture, Government of India.

[1] According to the IMD, the departure of aridity index from the normal value is expressed in percentage and accordingly drought is categorised as severe (more than 50 per cent), moderate (26-50 per cent) and mild (upto 25 per cent).

million tonnes, which is almost closer to the level attained in the previous year. While production of wheat, pulses and coarse cereals is expected to be higher, that of rice may be lower during the year as compared to the previous year. A crop-specific strategy was formulated by the Ministry of Agriculture for augmenting the production of *rabi* crops during 2005-06. The strategy covered a series of steps such as ensuring timely and adequate availability of certified/quality seeds of location specific high yielding varieties (particularly in the case of durum wheat), emphasis on timely sowing, encouraging inter-cropping and promotion of water saving devices, balanced use of fertilisers, propagation of soil ameliorants, promotion of zero till seed drills, seed-cum-fertilisers drills, strip drills and raised bed planter, promotion of integrated weed, pest, and disease management system, ensuring quality planting material and increasing the area under early maturing varieties in the case of sugarcane.

2.17 The Department of Agriculture and Cooperation has also put in place a new scheme for "Enhancing Sustainability of Dry-land Rain-fed Farming System" to address the problems of dry-land farming. The major thrust areas under this scheme are rainwater harvesting, water conservation and its efficient utilisation, emphasis on soil moisture conservation, use of organic manures, alternative use and adoption of improved dry-land farming technologies. Diversification from cereal-centric cropping system to more remunerative high value and less water consuming crops like oilseeds, pulses, floriculture, medicinal and aromatic plants is also being emphasised. The Union Budget for 2006-07 has proposed to allocate Rs.150 crore under the National Horticultural Mission to set up model terminal markets in different parts of the country by employing public-private partnership (PPP) model. The Department of Agriculture and Cooperation launched a centrally sponsored "Support to State Extension Programmes for Extension Reforms" scheme in May 2005 for implementation during the Tenth Plan to facilitate reforms in technology dissemination which are farmer-driven and farmer-centric.

Procurement, Off-take and Stocks of Foodgrains

2.18 The procurement of foodgrains (rice and wheat) during 2005-06 (upto February 28, 2006) at about 40 million tonnes, was marginally lower than that procured during the corresponding period of the previous year. The off-take of rice and wheat during 2005-06 (April 1 to December 31, 2005) was of the same order as that during the comparable period of the previous year. However, the off-take of rice and wheat was higher under Targeted Public Distribution System (TPDS) and Other Welfare Schemes (OWS). On the Contrary, there was a sharp fall in the off-take under Open-Market Sales (OMS).

2.19 The total stocks of foodgrains with Food Corporation of India (FCI) and other Government agencies as on January 1, 2006 declined by 11.2 per cent to around 19.3 million tonnes as compared with 21.7 million tonnes in the corresponding period of last year (Table 2.10).

2.20 The satisfactory South-West and North-East monsoon seasons coupled with better reservoir position augured well for agricultural production and total foodgrains production is slated to be higher than that a year ago. The foodstocks as on January 1, 2006 stood at a lower level than that a year ago.

Industry

2.21 The robust performance of the industrial sector since 2003-04 has further strengthened during the current year on the back of surging demand. The growth momentum of the industrial sector has been supported by the manufacturing sub-sector. While the basic, capital and consumer goods sectors witnessed accelerated growth during the year, the performance of the intermediate goods sector has not been encouraging. The increasing imports may impinge on the performance of the domestic industries as many of the industries are yet to achieve economies of scale and gain competitiveness to face the emerging competition in the globalised market.

2.22 The industrial resurgence that started in April 2002, strengthened in the subsequent years (Chart II.5). The upturn in industrial growth has continued during 2005-06 so far (April-December), abetted primarily by manufacturing sub-sector on account of expansion in external and domestic demand, capacity additions, ease in availability of finance and increased imports of capital goods. On the other hand, mining sector recorded decelerated growth during the year mainly due to the negative performance since July 2005 (Table 2.11). The Index of Industrial Production (IIP) during 2005-06 (April-December) registered a growth of 7.8 per cent.

2.23 The manufacturing sub-sector continues to be the main growth driver in the industrial production. During April-December 2005, at the two-digit level

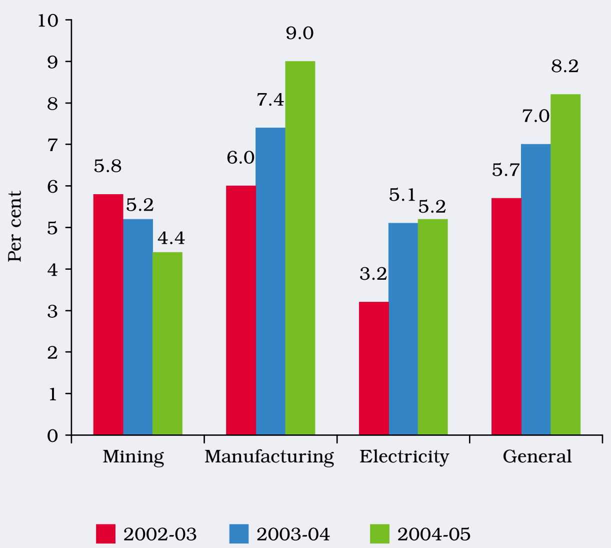
Table 2.10: Management of Foodstocks

(Million Tonnes)

Year/Month	Opening Stock of Foodgrains	Foodgrains Procurement	Foodgrains Off-take				Closing Stock	Buffer Stock Norms $
			PDS	OWS	OMS - Domestic	Exports		
1	2	3	4	5	6	7	8	9
2004								
April	20.6	15.7	2.0	0.5	0.0	0.3	32.4	15.8
May	32.4	3.0	2.3	0.6	0.0	0.1	32.3	
June	32.3	1.4	2.3	1.0	0.0	0.1	30.6	
July	30.6	0.5	2.4	1.0	0.0	0.1	27.2	24.3
August	27.2	0.5	2.4	1.0	0.0	0.1	23.0	
September	23.0	0.2	2.5	1.0	0.0	0.1	20.3	
October	20.3	7.4	2.4	0.8	0.0	0.0	23.7	18.1
November	23.7	1.9	2.4	0.6	0.0	0.0	21.8	
December	21.8	3.2	2.6	0.7	0.0	0.0	21.7	
2005								
January	21.7	3.9	2.7	0.8	0.0	0.0	21.5	16.8
February	21.5	2.3	2.7	0.9	0.0	0.0	20.0	
March	20.0	1.7	2.7	1.7	0.0	0.0	18.0	
April	18.0	14.0	2.4	1.0	0.0	0.0	28.5	16.2
May	28.5	3.1	2.5	0.8	0.0	0.0	27.9	
June	27.9	0.9	2.5	1.7	0.0	0.0	25.1	
July	25.1	0.4	2.8	0.8	0.1	0.0	21.4	26.9
August	21.4	0.9	2.6	0.8	0.1	0.0	18.4	
September	18.4	0.4	2.7	0.7	0.1	0.0	15.5	
October	15.5	7.6	2.2	0.5	0.0	0.0	19.8	16.2
November	19.8	2.7	1.8	0.5	0.1	0.0	19.0	
December	19.0	3.4	2.3	0.7	0.2	0.0	19.3	
2006								
January	19.3	3.8	0.0	0.0	0.0	0.0	..	20.0
February	..	2.5	0.0	0.0	0.0	0.0	..	
Memo:								
2004-05 April-December		32.9	21.3	7.1	0.1	1.0		
2005-06 April-December		33.3	21.8	7.5	0.6	0.0		

.. Not available.
$ Minimum Buffer Stock norms to be maintained, as on April, July, October and January, revised under New Buffer Stocking Policy with effect from March 29, 2005.
PDS : Public Distribution System. OWS : Other Welfare Schemes. OMS : Open Market Sales.
Note : Closing stock figures may differ from those arrived at by adding the opening stocks and procurement and deducting offtake, as stocks include coarse grains also.
Source : Ministry of Consumer Affairs, Food and Public Distribution, Government of India.

Chart II.5: Sectoral Growth of IIP



manufacturing groups, 12 out of 17 industry groups recorded positive growth. Other manufacturing industries recorded the highest growth at 23.8 per cent among various manufacturing sector groups, while textile products recorded a marked acceleration in growth at 18.6 per cent during April-December 2005-06 as compared to 14.8 per cent during the corresponding period of the previous year (Table 2.12). Beverages, tobacco and related products; basic metal and alloys; transport equipment and parts; cotton textiles; and machinery and equipments also recorded double-digit growth during the period.

2.24 In terms of use-based classification, all the sectors except intermediate goods sector recorded better growth performance during April-December 2005-06 in comparison with the corresponding period of the previous year (Table 2.13). Basic goods recorded moderate growth due to negative growth of phenol, benzene, superior kerosene, railway

Table 2.11: Index of Industrial Production - Monthly Growth

(Per cent)

Month/Weight	General (100.00)		Electricity (10.17)		Mining & Quarrying (10.47)		Manufacturing (79.36)	
	2004-05	2005-06	2004-05	2005-06	2004-05	2005-06	2004-05	2005-06
1	2	3	4	5	6	7	8	9
April	8.9	8.1	10.3	3.1	9.1	2.8	8.8	9.2
May	6.8	10.8	3.1	10.5	5.3	5.2	7.5	11.3
June	7.3	12.2	4.5	9.6	2.7	4.8	8.1	13.2
July	8.5	4.7	13.7	-0.9	4.2	-1.9	8.4	6.0
August	8.6	7.6	7.4	7.9	4.4	-2.5	9.1	8.5
September	9.8	7.2	7.7	-0.8	5.1	-1.9	10.5	8.9
October	10.6	9.1	3.5	7.7	6.2	-0.5	11.9	10.1
November	7.7	6.1	3.4	3.4	3.6	-0.6	8.6	7.0
December	8.9	5.0	4.5	2.9	4.8	-1.8	9.8	5.9
January	7.5	..	2.4	..	2.6	..	8.6	..
February	5.9	..	-0.8	..	-1.6	..	7.4	..
March	9.8	..	3.2	..	6.6	..	10.9	..
April-December	**8.6**	**7.8**	**6.4**	**4.8**	**5.1**	**0.4**	**9.2**	**8.9**

.. Not Available.
Source: Central Statistical Organisation.

materials, ferro manganese, *etc.* The consumer goods exhibited convincing growth aided by robust performance of both durable and non-durable segments. Growth in consumer non-durables was largely propelled by 'beverages, tobacco and tobacco products', textile products, milk powder, chocolate and sugar confectionary, sugar, sulpha drug, hair oil, *etc.* The intermediate goods sector witnessed subdued performance largely on account of negative growth of certain yarn items, finished leather, viscose staple fibre, gelatine, spun pipes and petroleum products, *etc*.

2.25 A notable feature of recent industrial rebound is the strong double-digit growth of the capital goods sector that has regained its position as the most buoyant segment. This sector posted a growth of 15.7 per cent during April-December 2005-06 over and above 13.8 per cent registered during the same period of 2004-05. Higher production of textile machinery, ship building and repair, laboratory and scientific instruments, locomotives, machine tools, material handling equipment, dumpers, boilers, and power distribution transformers, *etc*., propped up the capital goods sector. The acceleration in growth of the capital

Table 2.12: Growth of Manufacturing Industries (2-digit level Classification) – April-December 2005

Above 20 per cent	10-20 per cent	0-10 per cent	Negative
1	2	3	4
1. Other manufacturing industries (23.8)	1. Textiles products (including apparels) (18.6)	1. Chemicals and chemical products (9.7)	1. Wool, silk and man-made fibre textiles (-0.1)
	2. Beverages, tobacco and related products (16.4)	2. Non-metallic mineral products (9.4)	2. Leather and leather & fur products (-1.5)
	3. Basic metal and alloy (15.0)	3. Rubber, plastic, petroleum and coal products (3.8)	3. Food products (-2.2)
	4. Transport equipment and parts (12.5)	4. Jute and other vegetable fibre textiles (2.7)	4. Metal products and parts (-2.5)
	5. Machinery and equipment other than transport equipment (10.5)	5. Paper and paper products (0.5)	5 Wood and wood products, furniture and fixtures (-3.7)
	6. Cotton textiles (10.2)		

Note : Figures in brackets are growth rates.
Source : Central Statistical Organisation.

Table 2.13: Sectoral Contribution to IIP Growth - Use-based Classification (April-December)

(Per cent)

Industry Group	Weight in IIP	Growth			Relative Contribution		
		2003-04	2004-05	2005-06P	2003-04	2004-05	2005-06P
1	2	3	4	5	6	7	8
Basic Goods	**35.57**	4.6	6.0	6.0	22.7	22.1	23.8
Capital Goods	**9.26**	10.1	13.8	15.7	14.2	15.2	20.1
Intermediate Goods	**26.51**	6.5	6.9	2.2	27.9	22.8	7.9
Consumer Goods (a+b)	**28.66**	7.8	11.4	12.2	35.2	39.9	48.1
a) Consumer Durables	**5.36**	9.2	15.3	13.6	10.2	13.5	13.9
b) Consumer Non-durables	**23.30**	7.3	10.0	11.7	24.9	26.4	34.2
IIP	**100.00**	**6.6**	**8.6**	**7.8**	**100.0**	**100.0**	**100.0**

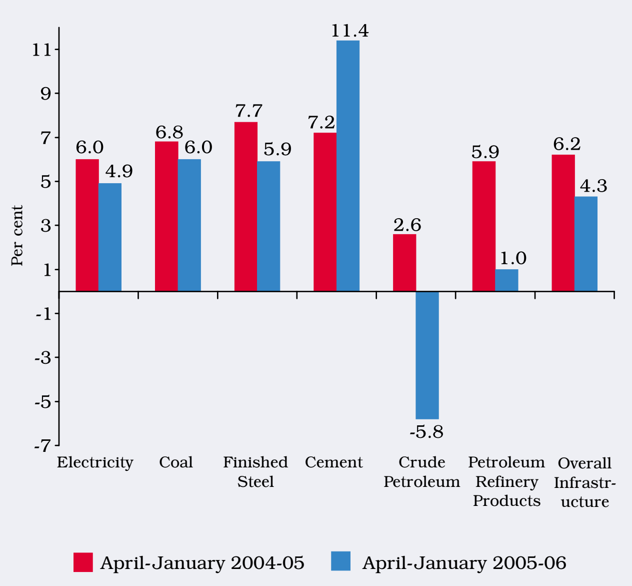
P : Provisional.
Source: Central Statistical Organisation.

goods sector is indicative of the capacity additions taking place across the industries. Concomitantly, there has been a substantial increase in capital goods imports. Non-electrical machinery and transport equipments contributed substantially to the growth of capital goods imports. The import of other capital goods such as professional instruments, optical goods, electrical machinery, machine tools and project goods have also increased significantly.

Infrastructure

2.26 During April-January 2005-06, the overall growth of core infrastructure industries was lower at 4.3 per cent as compared to 6.2 per cent during the corresponding period of the previous year (Chart II.6). The slowdown was mainly on account of the negative

Chart II.6: Growth of Infrastructure Industries



growth recorded by crude petroleum, lower growth in petroleum refinery products and deceleration in growth of other infrastructure industries except cement. Amongst the core sector groups, cement sector recorded accelerated growth of 11.4 per cent during the period.

2.27 Despite strong domestic demand, slowdown in steel exports from the country coupled with a lower base contributed to moderate growth in steel output. Rising domestic and external demand facilitated the strong growth of the cement sector. Lower than targeted production in Coal India Ltd., TISCO and IISCO mines owing to heavy rainfall during the monsoon season resulted in the lower growth in coal sector. The electricity sector recorded a lower growth on account of negative growth in electricity generation in July and September and inadequate availability of coal and gas with thermal power plants. Crude petroleum recorded a decline in output because of disruption in oil exploration activities in Mumbai High oilfield of the ONGC on account of outbreak of fire on July 27, 2005. Negative growth in production in one of the private sector oil refineries as well as two PSU refineries resulted in lower growth in petroleum refinery products.

Services Sector

2.28 The services sector maintained the growth momentum achieved during 2003-04 and recorded a robust growth of 10.2 per cent during 2004-05. The acceleration in services growth during 2004-05 was driven by construction followed by 'trade, hotels, transport and communication'. In fact, all the sub-sectors in services sector recorded impressive growth. As per the advance estimates, during 2005-06, the growth in services sector remained impressive, though marginally lower at 10.1 per cent as compared to that during 2004-05. Deceleration in the growth recorded by construction and 'community social and personal services' sub-sectors resulted in the slack performance of services sector despite improvement in growth rates of 'trade, hotels, transport and communication'; and 'financing, insurance, real estate and business services'. Further, the services sector has in the recent past anchored the growth process despite the uncertainty on agriculture front.

2.29 Construction activity in the country buoyed up on account of rise in demand for residential houses and capacity additions across various industries. The trade sector recorded strong double-digit growth as both exports and imports grew impressively by 18.1 per cent and 27.3 per cent, respectively during April-December 2005-06. Exports were driven largely by petroleum products, gems and jewellery and transport equipment, while imports were driven up by POL, gold, iron and steel and other commodities because of upsurge in industrial activities. Rise in domestic and international tourism, both business as well as leisure aided the growth of hotel industry. Burgeoning revenue earning freight traffic of railways, civil aviation and port traffic propped up the transport sector. Robust growth in the cellular subscriber base and steady growth in broadband connections supported the strong growth in communication sector. Healthy growth in bank deposits and non-food credit as well as increase in business process outsourcing-information technology enabled services exports buoyed up the 'financing, insurance, real estate and business services'. 'Community, social and personal services' showed growth acceleration due to increase in revenue expenditure on 'other economic services', 'defence revenue expenditure', plan revenue expenditure of the Central Government on 'social services', and pension payments.

Information Technology Enabled Services-Business Process Outsourcing

2.30 A significant dimension of sustained growth in the services sector has been the contribution of Information Technology Enabled Services (ITES) and Business Process Outsourcing (BPO) segments. According to the National Association of Software and Services Companies (NASSCOM), ITES-BPO revenue increased significantly in 2004-05 to US $ 28.2 billion, which constituted 4.1 per cent of the GDP. This could be attributed to rapid growth in demand from overseas and domestic consumers backed by technological advancement in addition to proactive policy reforms such as deregulation, opening up of FDI and generous tax incentives for this sector. The ITES-BPO market witnessed signs of maturity and consolidation with increased mergers and acquisitions within the sector, suiting the companies search for service providers that could provide the entire spectrum of services in an integrated manner. In addition to the revenue earnings, employment in the ITES-BPO sector also surged in 2004-05.

Industrial Outlook

2.31 The cyclical upturn in the performance of industry that started in April 2002 has been maintained. This facilitated consolidation, marked by upsurge in investment activity across industries. Demand conditions have also remained favourable. The contributory factors include a congenial investment climate, adequate availability of credit, sound corporate results, improved domestic and external demand, capacity additions across industries and persistent improvement in competitiveness. The capital goods sector recorded impressive double-digit growth and imports of capital goods surged on the back of capacity expansions. The scale up in the consumer goods segment during the year reflected acceleration in consumption demand aided by easy availability of retail credit. The outlook for the industrial sector is promising in the backdrop of robust expansion of non-food credit, which increased by 27.6 per cent during 2004-05 (Table 2.14). Further, during 2005-06 (up to December), non-food credit has increased by 22.3 per cent as compared with 18.2 per cent during the corresponding period of the previous year. The advance estimates for 2005-06 (at 1999-00 prices) have placed growth rate in industry at 8.0 per cent, with manufacturing sub-sector recording strong growth of 9.4 per cent followed by 'electricity, gas and water supply' at 5.4 per cent. The encouraging investment climate fuelled by buoyant industrial sentiment and rising corporate profits led to a record rally in the stock market and resulted in high market capitalisation. The commitment on part of the Government in augmenting infrastructure projects is expected to address the constraints and unleash the growth potential. Further, considerable progress is expected in roadways and aviation projects during the current fiscal. On the whole, industry is expected to maintain its ongoing momentum arising from strong demand linkages strengthened by increase in investment, consumption and exports. Nevertheless, high crude oil prices, surge in prices of some non-ferrous metals, hardening of interest rates, and sluggish performance of the core sector could pose downside risks.

Table 2.14: Performance of the Industrial Sector - Selective Indicators

(Growth in Per cent)

Year	IIP	Manufacturing IIP	Capital Goods	Consumer Goods	Non-Food Credit	Import of Capital Goods	Export of Manufactured Goods
1	2	3	4	5	6	7	8
1994-95	9.1	9.1	9.2	12.1	29.8	22.5	22.5
1995-96	13.0	14.1	5.3	12.8	22.5	44.1	16.4
1996-97	6.1	7.3	11.5	6.2	10.9	1.9	3.6
1997-98	6.7	6.7	5.8	5.5	15.1	3.4	7.9
1998-99	4.1	4.4	12.6	2.2	13.0	16.3	-2.8
1999-00	6.7	7.1	6.9	5.7	16.5	-8.2	15.2
2000-01	5.0	5.3	1.8	8.0	14.9	5.1	15.6
2001-02	2.7	2.9	-3.4	6.0	13.6	15.4	-2.8
2002-03	5.7	6.0	10.5	7.1	18.6	38.6	20.6
2003-04	7.0	7.4	13.6	7.1	18.4	28.6	14.4
2004-05	8.2	9.0	13.3	11.5	27.6	20.7	17.3
2004-05 #	8.6	9.2	13.8	11.4	18.2	31.4@	23.0@
2005-06 #	7.8	8.9	15.7	12.2	22.3	28.2@	14.3@

\# Pertains to April-December period. @ Pertains to April-November period.

Source: Reserve Bank of India, Central Statistical Organisation and DGCI&S, Government of India.

2.32 Various business expectation surveys suggest that the industrial activity is likely to remain buoyant. The 'Industrial Outlook Survey' of the Reserve Bank suggested the expectation of overall business situation for the quarter October-December 2005 at a higher level of confidence at 51.3 per cent as compared with the previous quarter at 45.5 per cent. Dun and Bradstreet's composite business optimism index for the quarter October-December 2005 improved by 7.1 per cent, reflecting healthy economic scenario. FICCI's business confidence index improved and scaled up from 73.5 during the first quarter to 75.2 during the second quarter of 2005-06. FICCI's survey revealed that the corporate houses are upbeat about the medium to long-term business outlook. The NCAER business confidence index (BCI) inched up from 146.0 for July-September 2005 to 151.4 for October-December 2005. This is the highest level that the NCAER business confidence index has attained since November 1994.

2.33 The performance of the industrial sector during 2005-06 (April-December) has been well diversified. A noteworthy feature of the manufacturing sector growth is that while the high performance industries during 2004-05 such as machinery and equipment (weight 9.565) and chemical and chemical products (weight 14.002) have decelerated during the current year so far, the industries like textile products, beverages, tobacco, basic metal and alloy industries, transport equipment and parts, cotton textiles, non-metallic mineral products, *etc.,* which recorded lower or negative growth during 2004-05, achieved strong growth during the current year and contributed more than 50 per cent to the manufacturing sector growth. The share of manufacturing exports in the total exports which constituted about 75 per cent has also aided the manufacturing sector performance. Resultantly, on account of improving profitability of the corporate sector, increase in the investment activity and capacity additions are currently underway in the industrial sector. The surge in capital goods imports has also facilitated the on-going expansion of the industrial sector.

II. FISCAL SITUATION

Central Government Finances

2.34 The Union Budget 2006-07 was presented against the backdrop of an impressive growth performance, moderate inflation, strong and resilient external sector coupled with strong non-food bank credit off-take. The Budget considers its 'unrelenting emphasis' on fiscal prudence through enhanced revenues and expenditure control, monetary stability and management of external debt to be the key factors behind strong macroeconomic performance. The Budget commits to resume fiscal consolidation set out in the Fiscal Responsibility and Budget Management (FRBM) Rules, 2004 with the proposed reductions in the revenue deficit and fiscal deficit.

2.35 The major thrust of the Budget is to spur economic growth and provide justice to the disadvantaged sections of society. There has been a significant increase in the allocation for the eight flagship programmes of the Government covering the areas of education, health and rural employment. The Budget continues to reiterate its focus on agriculture, promoting employment, enhancing investment and augmenting infrastructure.

2.36 The Union Budget 2006-07 emphasises the need to increase the tax/GDP ratio without impeding the growth momentum. The strategy in respect of direct taxation is to minimise distortions in tax structure by expanding the tax base and moderating tax rates on the one hand and improve the efficiency of tax administration and increase the deterrence level on the other so as to encourage voluntary compliance. The strategy in respect of indirect taxes is to continue the tariff reform process towards mean ASEAN levels of customs tariff, convergence towards CENVAT rate for excise duty, widening of service tax base and phased move towards a fully integrated goods and services tax by April 1, 2010. While the Budget does not alter the rates in respect of personal income tax and corporate income tax, it has, *inter alia* raised the rates of Minimum Alternate Tax (MAT), Securities Transaction Tax (STT) and service tax.

Revised Estimates 2005-06[2]

2.37 The key deficit indicators, *viz.*, revenue deficit and gross fiscal deficit, relative to GDP, were placed lower in the revised estimates for 2005-06 than their budgeted levels. In this context it may be recalled that while presenting the budget for 2005-06, in view of the additional resource requirements for implementing the recommendations of Twelfth Finance Commission (TFC), the Government had pressed a 'pause button' in fiscal correction in terms of targets prescribed under FRBM Rules, 2004. The reduction in deficit indicators in the revised estimates over the budgeted levels was mainly on account of reduction in non-Plan expenditure in respect of interest payments, subsidies, grants to States and defence expenditure. In addition to the reduction in non-Plan expenditure, availability of disinvestment proceeds as a budgetary receipt (although the Union budget for 2005-06 had sought to discontinue the practice of treating disinvestment proceeds as budgetary receipts) and lower non-defence capital outlay also enabled a reduction in fiscal deficit.

2.38 The revenue deficit in the revised estimates was lower by 3.7 per cent and constituted 2.6 per cent of GDP as against the budgeted level of 2.7 per cent (Table 2.15). Decline in revenue deficit was on account of a reduction in revenue expenditure to the extent of Rs.6,217 crore (1.4 per cent) which offset the shortfall of the order of Rs.2,726 crore (0.8 per cent) in revenue receipts. The reduction in revenue deficit coupled with availability of disinvestment proceeds and a decline in capital outlay resulted in a lower gross fiscal deficit (4.1 per cent of GDP) than the budgeted level (4.3 per cent of GDP). Primary deficit at 0.5 per cent of GDP was lower by 6.1 per cent in the revised estimates for 2005-06 than the budget estimates. In terms of GDP, however, primary deficit remained at the budgeted level of 0.5 per cent (Table 2.15).

2.39 Revenue receipts in the revised estimates for 2005-06 declined marginally by 0.8 per cent over the budgeted level. The decline in revenue receipts was due to lower non-tax revenue than the budgeted level. The shortfall in non-tax revenue was mainly on account of lower interest receipts than the budget estimates. The gross tax revenue in the revised estimates for 2005-06 remained almost at same level as in the budget estimates. Collections from corporation tax, personal income tax and excise duties in the revised estimates were lower than the budgeted level whereas collections from customs duties and

Table 2.15: Deficit Indicators of the Centre

(Rupees crore)

	Item	2004-05	2005-06 (BE)	2005-06 (RE)	2006-07 (BE)	Variation (per cent)	
						Col. 4 over 3	Col. 5 over 4
1		2	3	4	5	6	7
1.	Gross Fiscal Deficit	1,25,202	1,51,144	1,46,175	1,48,686	-3.3	1.7
		(4.0)	*(4.3)*	*(4.1)*	*(3.8)*		
2.	Revenue Deficit	78,338	95,312	91,821	84,727	-3.7	-7.7
		(2.5)	*(2.7)*	*(2.6)*	*(2.1)*		
3.	Gross Primary Deficit	-1,732	17,199	16,143	8,863	-6.1	-45.1
		(-0.1)	*(0.5)*	*(0.5)*	*(0.2)*		

BE: Budget Estimate. RE : Revised Estimate.
Note : Figures in parentheses are percentage of GDP.

2 All comparisons of 2005-06 in this Section are with budget estimates unless stated otherwise.

service tax significantly exceeded the budgeted level. Among the new taxes, securities transactions tax is estimated to yield Rs.2,389 crore and banking cash transaction tax, Rs.350 crore in 2005-06. The net tax revenue [gross tax revenue less States share in Central taxes and amount transferred to National Calamity Contingency Fund (NCCF)] showed an increase of 0.2 per cent over the budgeted level (Table 2.16).

2.40 Despite a decline in recovery of loans, non-debt capital receipts were higher than the budget estimates due to inclusion of an amount of Rs.2,356 crore under the disinvestment proceeds, although the Union Budget for 2005-06 had sought to discontinue the practice of treating disinvestment proceeds as budgetary receipts (Table 2.16).

2.41 Revenue expenditure in the revised estimates for 2005-06 was lower by 1.4 per cent than the budget estimates whereas capital expenditure was marginally higher (Table 2.17). Revenue expenditure was lower on account of interest payments, grants to states and subsidies. In the capital expenditure, while capital outlay was lower, loans and advances were higher than the budgeted level.

Budget Estimates 2006-07[3]

2.42 The Union Budget for 2006-07 proposes to resume the process of fiscal correction stipulated in FRBM Rules, 2004 after a ‘pause’ in the preceding year. Accordingly, key deficit indicators, *viz.,* gross fiscal deficit (GFD), revenue deficit (RD) and primary deficit (PD), as per cent of GDP, are budgeted lower than the previous year’s levels at 3.8 per cent, 2.1 per cent and 0.2 per cent in 2006-07 as compared with 4.1 per cent, 2.6 per cent and 0.5 per cent, respectively, in 2005-06 (Table 2.15).

2.43 The revenue receipts in 2006-07 are budgeted to increase by 15.8 per cent against the growth of 13.9 per cent in 2005-06, primarily on the basis of continued high growth in tax revenue. Gross tax revenue is budgeted to increase by 19.5 per cent in 2006-07 resulting in an improvement in the budgeted tax-GDP ratio to 11.2 per cent from 10.5 per cent in 2005-06. High growth in gross tax revenue is budgeted mainly on the basis of buoyant collections under corporation tax, customs duties and service tax. Excise duty collections are, however, budgeted to show a lower growth of 6.3 per cent than 13.0 per

Table 2.16: Receipts of the Centre

(Rupees crore)

Item	2004-05	2005-06 (BE)	2005-06 (RE)	2006-07 (BE)	Variation (per cent)	
					Col. 4 over 3	Col. 5 over 4
1	2	3	4	5	6	7
Total Receipts (1+2)	**4,97,682**	**5,14,344**	**5,08,705**	**5,63,991**	**-1.1**	**10.9**
1. Revenue Receipts	3,06,013	3,51,200	3,48,474	4,03,465	-0.8	15.8
i. Tax Revenue (Net)	2,24,798	2,73,466	2,74,139	3,27,205	0.2	19.4
ii. Non -Tax Revenue	81,215	77,734	74,335	76,260	-4.4	2.6
2. Capital Receipts	1,91,669	1,63,144	1,60,231	1,60,526	-1.8	0.2
of which :						
Market Borrowings	50,940	1,03,792	1,01,082	1,13,778	-2.6	12.6
Recoveries of Loans	62,043	12,000	11,700	8,000	-2.5	-31.6
Disinvestment of Equity in Public Sector Undertakings	4,424	0	2,356	3,840	–	63.0
Memo Items:						
Gross Tax Revenue	3,04,958	3,70,025	3,70,141	4,42,153	0.0	19.5
Of which :	*(9.8)*	*(10.5)*	*(10.5)*	*(11.2)*		
i. Corporation Tax	82,680	1,10,573	1,03,573	1,33,010	-6.3	28.4
ii. Taxes on Income other than Corporation Tax	49,259	66,239	63,500	73,409	-4.1	15.6
iii. Customs Duty	57,611	53,182	64,215	77,066	20.7	20.0
iv. Union Excise Duty	99,125	1,21,533	1,12,000	1,19,000	-7.8	6.3
v. Service Tax	14,200	17,500	23,000	34,500	31.4	50.0
vi. Securities Transaction Tax	590	–	2,389	3,500	–	46.5
vii. Banking Cash Transaction Tax	–	–	350	500	–	42.9
viii. Taxes of UTs (Net of Assignments to Local Bodies)	819	733	849	903	15.8	6.4
ix. Other Taxes and Duties	1,264	265	3,004	4,265	1,033.6	42.0

BE: Budget Estimate. RE : Revised Estimate. – Nil/negligible.
Note : Figures in parentheses are percentage of GDP.

[3] All comparisons of 2006-07 in this Section are with revised estimates for 2005-06 unless stated otherwise.

Table 2.17: Expenditure Pattern of the Centre

(Rupees crore)

Item	2004-05	2005-06 BE	2005-06 RE	2006-07 BE	Per cent	
					col. 4 over 3	col. 5 over 4
1	2	3	4	5	6	7
Aggregate Expenditure (1+2)	4,97,682	5,14,344	5,08,705	5,63,991	-1.1	10.9
1. Revenue Expenditure	**3,84,351**	**4,46,512**	**4,40,295**	**4,88,192**	**-1.4**	**10.9**
Interest Payments	1,26,934	1,33,945	1,30,032	1,39,823	-2.9	7.5
Subsidies	43,653	47,432	46,874	46,213	-1.2	-1.4
Grants to States	52,686	77,275	70,971	83,098	-8.2	17.1
Defence Revenue	43,862	48,625	48,625	51,542	0.0	6.0
2. Capital Expenditure	**1,13,331***	**67,832**	**68,410**	**75,799**	**0.9**	**10.8**
Loans and Advances	28,910	5,652	11,417	8,861	102.0	-22.4
Defence Capital	31,994	34,375	33,075	37,458	-3.8	13.3
Non Defence Capital Outlay	19,752	27,805	23,918	29,480	-14.0	23.3

BE: Budget Estimate. RE : Revised Estimate. * Includes repayments of Rs.32,675 crore to National Small Savings Fund.

cent in the preceding year. The Budget proposes to arrest the decline in non-tax revenue with a marginal increase in 2006-07, mainly on the basis of improved collections under dividends and profits. The recoveries of loans and advances from the State Governments are estimated to decline marginally in 2006-07. The Budget records estimated receipts of Rs.3,840 crore on account of partial disinvestment of Government equity in Central Public Sector Undertakings (CPSUs) but earmarks these receipts for the National Investment Fund (NIF) under capital outlays in 2006-07, thereby making the transaction deficit neutral (Table 2.16).

2.44 One of the salient features of Budget estimates has been the control in revenue expenditure, particularly in the non-Plan components. Expenditure on subsidies is budgeted to decline in the 2006-07 whereas interest payments and defence revenue expenditure are budgeted to increase at relatively lower growth rates. In subsidies, except food and petroleum, all the major components are budgeted to decline during 2006-07. Capital expenditure is budgeted to increase by 10.8 per cent in 2006-07 as against a reduction of 39.6 per cent in 2005-06 mainly on account of an increase in both defence and non-defence capital outlay (Table 2.17).

2.45 The financing pattern of the gross fiscal deficit indicates that the net market borrowings (excluding enabling allocations budgeted under MSS) would finance 76.5 per cent of the GFD in 2006-07 as compared with 69.2 per cent in the previous year. Deposits and advances would finance a higher portion of GFD while the share of reserve funds in financing GFD is budgeted to decline in 2006-07. The budget estimates have not made any provision for draw down of cash balances as compared with 10.3 per cent of GFD in the preceding year. Securities against small savings, which financed only 0.9 per cent of the GFD in 2005-06, are expected to finance 2.0 per cent in 2006-07 (Table 2.18).

Table 2.18: Financing Pattern of Gross Fiscal Deficit

(Rupees crore)

Item	2005-06(RE)	2006-07 (BE)
1	2	3
Gross Fiscal Deficit	1,46,175	1,48,686
Financed by		
Market Borrowings	1,01,082	1,13,778
	(69.2)	(76.5)
Securities against Small Savings	1,350	3,010
	(0.9)	(2.0)
External Assistance	7,515	8,324
	(5.1)	(5.6)
State Provident Fund	5,500	6,000
	(3.8)	(4.0)
NSSF	-7,332	648
	-(5.0)	(0.4)
Reserve Funds	3,526	1,725
	(2.4)	(1.2)
Deposit and Advances	4,654	11,013
	(3.2)	(7.4)
Postal Insurance and Life Annuity Funds	1,215	1,265
	(0.8)	(0.9)
Draw down of Cash Balances	15,037	0
	(10.3)	(0.0)
Others #	13,627	2,923
	(9.3)	(2.0)

BE: Budget Estimate. RE : Revised Estimate.

Includes savings (taxable) bonds 2003 and Deposits Scheme for Retiring Employees.

Note: Figures in parentheses are percentages to GFD.

State Government Finances

2.46 The evolving policy environment for the State Governments has been shaped by three significant developments, *viz.*, (i) on-going fiscal and institutional reforms at the State-level facilitated and supplemented by initiatives of the Central Government and the Reserve Bank, (ii) general acceptance of the recommendations of the Twelfth Finance Commission (TFC) by the Union Government, which would form the basis of fiscal federal relations over the five-year period beginning 2005-06 and (iii) implementation of the Value Added Tax (VAT) by twenty two States with effect from April 1, 2005, which is an important milestone in the area of tax reforms. The consolidated fiscal position of the State Governments budgeted for 2005-06 could be examined in the backdrop of the TFC recommendations. Large corrections have been envisaged during 2005-06 against the fiscal scenario of 2004-05 (RE).

2.47 The Reserve Bank on its part finalised the Report of the Working Group on Model Fiscal Responsibility Legislation (FRL) at the State level in January 2005 and released it in March 2005. The Report provides a framework for FRL and leaves it to discretion of the States to work out the specifics in respect of various parameters. Sixteen States, *viz.*, Karnataka, Kerala, Punjab, Tamil Nadu, Uttar Pradesh, Orissa, Maharashtra, Gujarat, Assam, Chhattisgarh, Himachal Pradesh, Haryana, Rajasthan, Madhya Pradesh, Tripura and Andhra Pradesh have so far enacted the FRLs. Manipur has introduced the FRL Bill in 2005-06. Meghalaya and Uttaranchal have also proposed to introduce FRL in their budgets for 2005-06.

2.48 The TFC report, a blueprint of fiscal federalism over the medium-term, recommended a higher amount of transfers so as to reverse the decline in the volume of transfers relative to GDP and to ensure minimum vertical transfers (between Centre and States) while correcting the horizontal imbalance (among States). Total resource transfers from the Centre to the States (comprising shareable tax revenue and grants) have been placed at Rs.7,55,752 crore for the period 2005-06 to 2009-10, which is nearly 74 per cent higher than that of Rs.4,34,905 crore for the period 2000-01 to 2004-05 recommended by the Eleventh Finance Commission.

2.49 The TFC has emphasised the need for fiscal consolidation for the Centre and the States through institutional fiscal frameworks and setting up targets for various fiscal parameters. The major recommendations of the TFC include enhanced devolution of grants to the States, State-specific grants, discontinuation of Central plan assistance to the States, increased share in taxes and duties, debt relief through restructuring and write-offs and emphasis on devolution to local bodies. The TFC has also incentivised the enactment of fiscal legislations by the States by making it a pre-condition for availing debt relief. The VAT has been implemented by 22 States during 2005-06 so far. Avoidance of the cascading effects of taxation and promotion of tax compliance through a system of self-assessment, which are intrinsic to the VAT, would not only lead to enhanced economic efficiency but also, over a period of time, facilitate acceleration in the rate of growth of the States' own tax revenues. The Union Budget for 2005-06 includes a provision of Rs.5,000 crore as compensation to the States on account of shortfall in the revenue that may arise due to implementation of State-level VAT. A major issue which the Empowered Committee would revisit during 2005-06 is phasing out of the inter-State or Central Sales Tax (CST). The States mobilise around Rs.15,000 crore revenue annually from this source.

2.50 The State Budgets for 2005-06 have continued to place emphasis on fiscal consolidation through curtailment of unwarranted expenditure. Some States have proposed to review the policy of providing free power to certain sections of society and also to implement 'Contributory Pension Funds' in order to address their large pension obligations. Initiatives to clear the arrears of defaulting Public Sector Undertakings as well as according high priority to power sector reforms are also evident in the State budgets. Some of the States have also initiated rehabilitation and welfare measures for those affected by the Tsunami disaster of December 2004.

Budget Estimates - 2005-06[4]

2.51 The State budgets for 2005-06 envisage a sharp correction of fiscal imbalances. All the major deficit indicators are budgeted to be much lower than their levels in the previous year (Table 2.19). The revenue deficit would be reduced further to nearly half of its level in the previous year.

2.52 Improvement in the revenue account during 2005-06 would be brought about mainly by containment of growth in non-interest revenue

[4] The analysis of State Finances for 2005-06 budget estimates is based on the Budget documents of 29 State Governments, of which one is a *Vote-on-Account*. All data are provisional.

Table 2.19: Major Deficit Indicators of State Governments

(Rupees crore)

Items	1990-95 (Avg.)	1995-00 (Avg.)	2000-03 (Avg.)	2003-04 (Accounts)	2004-05 BE	2004-05 RE	2005-06 BE	Percentage variation Col.7/6	Col.8/7
1	2	3	4	5	6	7	8	9	10
Gross Fiscal Deficit				1,23,070	1,14,647	1,23,635	1,10,070	7.8	-11.0
	(2.8)	(3.4)	(4.2)	(4.5)	(3.7)	(4.0)	(3.1)		
Revenue Deficit				61,145	45,425	44,302	24,770	-2.5	-44.1
	(0.7)	(1.6)	(2.5)	(2.2)	(1.5)	(1.4)	(0.7)		
Primary Deficit				41,306	23,789	35,737	16,772	50.2	-53.1
	(1.1)	(1.4)	(1.5)	(1.5)	(0.8)	(1.1)	(0.5)		

Avg.: Average. BE: Budget Estimates. RE: Revised Estimates.

Notes : (1) The figures in parentheses are percentages to GDP.
(2) GDP from 1990-91 to 1998-99 are on old base (1993-94) while the same is on new base (1999-2000) from 1999-2000 onwards.

Sources : (1) Data on fiscal variables have been compiled from budget documents of State Governments.
(2) Data for GDP have been obtained from the website of Central Statistical Organisation (CSO).

expenditure. The growth rate of almost all major developmental heads under revenue expenditure are likely to record deceleration. Within the non-developmental revenue expenditure, the growth rate of administrative services is expected to accelerate while growth rate of interest payments is likely to decelerate. Capital outlay would be enhanced during 2005-06, though, as a ratio to GDP, it would remain at the previous year's level. In the aggregate, the ratio of developmental expenditure to GDP would record a larger decline than that of non-developmental expenditure to GDP during 2005-06 (Table 2.20).

Table 2.20: Expenditure Pattern of State Governments

(Rupees crore)

Items	1990-95 (Avg.)	1995-00 (Avg.)	2000-03 (Avg.)	2003-04 (Accounts)	2004-05 BE	2004-05 RE	2005-06 BE	Percentage variations Col.7/6	Col.8/7
1	2	3	4	5	6	7	8	9	10
Aggregate Expenditure				13,31,748	11,23,935	12,30,076	11,53,938	9.4	-6.2
(1+2=3+4+5)	(16.0)	(15.3)	(16.7)	(48.2)	(36.2)	(39.4)	(32.7)		
1. Revenue Expenditure				3,77,681	4,20,006	4,28,741	4,55,040	2.1	6.1
of which	(12.8)	(12.6)	(13.8)	(13.7)	(13.5)	(13.7)	(12.9)		
Interest payments				81,763	90,858	87,899	93,298	-3.3	6.1
	(1.7)	(2.0)	(2.7)	(3.0)	(2.9)	(2.8)	(2.6)		
2. Capital Expenditure				9,54,068	7,03,929	8,01,335	6,98,898	13.8	-12.8
of which	(3.2)	(2.7)	(2.9)	(34.6)	(22.7)	(25.7)	(19.8)		
Capital outlay				52,426	60,828	68,231	76,764	12.2	12.5
	(1.6)	(1.4)	(1.5)	(1.9)	(2.0)	(2.2)	(2.2)		
3. Developmental Expenditure				2,80,099	2,89,223	3,16,172	3,25,672	9.3	3.0
	(10.8)	(9.6)	(9.6)	(10.1)	(9.3)	(10.1)	(9.2)		
4. Non-Developmental Expenditure				1,69,021	1,99,770	1,93,602	2,11,368	-3.1	9.2
	(4.3)	(4.9)	(6.0)	(6.1)	(6.4)	(6.2)	(6.0)		
5. Others*				8,82,627	6,34,942	7,20,303	6,16,898	13.4	-14.4
	(0.9)	(0.7)	(1.2)	(32.0)	(20.4)	(23.1)	(17.5)		

Avg.: Average. BE: Budget Estimates. RE: Revised Estimates.

* Comprises Compensation and Assignments to local bodies, Grants-in-Aid and Contributions, Reserve with Finance Department, Discharge of Internal Debt, Repayment of loans to the Centre till 2002-03. Since 2003-04, it also includes Inter-State Settlement, Contingency Fund, Small Savings, Provident Fund, *etc.*, Reserve Funds, Deposit & Advances, Suspense & Miscellaneous, Appropriation to Contingency Fund and Remittances.

Notes : (1) Figures in parentheses are percentages to GDP.
(2) Capital expenditure starting with 2003-04 includes corresponding heads of public account, which were hitherto included on a net basis under capital receipts. The figures, therefore, are not comparable with that of earlier years. The comparable figures on a net basis for Aggregate Expenditure for the years 2003-04 (Accounts), 2004-05 (BE), 2004-05 (RE) and 2005-06 (BE) are 19.1 per cent, 17.9 per cent, 19.0 per cent and 16.4 per cent, respectively. The comparable figures on a net basis for Capital Expenditure for the years 2003-04 (Accounts), 2004-05 (BE), 2004-05 (RE) and 2005-06 (BE) are 5.4 per cent, 4.3 per cent, 5.3 per cent and 3.5 per cent, respectively.
(3) GDP from 1990-91 to 1998-99 are on old base (1993-94) while the same is on new base (1999-2000) from 1999-2000 onwards.

Sources : (1) Data on fiscal variables have been compiled from budget documents of State Governments.
(2) Data for GDP have been obtained from the website of Central Statistical Organisation (CSO).

2.53 On the receipts side, the ratio of States' own tax revenue to GDP would show a further marginal increase (Table 2.21). The implementation of VAT by twenty two State Governments would have an important bearing on the growth rate of States' own tax revenues during the year. The States' own non-tax revenues, as a ratio to GDP would, however, decline in 2005-06 mainly as a result of a sharp decline in interest receipts. Current transfers from the Centre, as a ratio to GDP, are budgeted marginally higher at 4.8 per cent as against that of 2004-05 (RE). According to the Union Budget 2005-06, the total impact of recommendations of the TFC on the Centre (and as a mirror image, on the States) for the year 2005-06 would be of the order of Rs.26,000 crore. States are likely to gain from higher tax devolution, enhanced grants as well as the debt relief schemes. In terms of the Union Budget 2005-06, the increase in gross devolution and transfers (through tax sharing, grants and loans) to the States in 2005-06 over the revised estimates of the previous year is around Rs.17,000 crore.

2.54 The financing of the GFD shows that share of small savings of the State Governments is budgeted to increase during 2005-06 *vis-à-vis* 2004-05 as against a decline in the share of market borrowings (Table 2.22).

2.55 Loans from the Centre, which showed net repayment during the previous three years (2002-03 to 2004-05), were budgeted to finance a considerable proportion of the States' borrowing requirements, since the states had not taken account of the TFC recommendations recommending cessation of Central Government lending to State Governments. The provisional net allocation under market borrowing programme for State Governments is placed at

Table 2.21: Aggregate Receipts of State Governments

(Rupees crore)

Items	1990-95 (Avg.)	1995-00 (Avg.)	2000-03 (Avg.)	2003-04 (Accounts)	2004-05 BE	2004-05 RE	2005-06 BE	Percentage variations	
								Col.7/6	Col.8/7
1	2	3	4	5	6	7	8	9	10
Aggregate Receipts (1+2)				13,30,584	11,18,716	12,23,312	11,55,807	9.3	-5.5
	(16.1)	(15.2)	(16.8)	(48.2)	(36.0)	(39.2)	(32.7)		
1. Total revenue receipts (a+b)				3,16,536	3,74,581	3,84,438	4,30,270	2.6	11.9
	(12.1)	(10.9)	(11.3)	(11.5)	(12.1)	(12.3)	(12.2)		
(a) States own Revenue				1,98,109	2,35,217	2,36,596	2,61,795	0.6	10.7
	(7.3)	(6.9)	(7.2)	(7.2)	(7.6)	(7.6)	(7.4)		
States own tax				1,59,921	1,85,605	1,87,415	2,15,243	1.0	14.8
	(5.4)	(5.3)	(5.7)	(5.8)	(6.0)	(6.0)	(6.1)		
States own non tax				38,189	49,612	49,181	46,552	-0.9	-5.3
	(1.8)	(1.6)	(1.5)	(1.4)	(1.6)	(1.6)	(1.3)		
(b). Central Transfers				1,18,426	1,39,364	1,47,843	1,68,475	6.1	14.0
	(4.9)	(4.0)	(4.2)	(4.3)	(4.5)	(4.7)	(4.8)		
Shareable taxes				67,079	77,952	80,755	90,003	3.6	11.5
	(2.6)	(2.4)	(2.3)	(2.4)	(2.5)	(2.6)	(2.6)		
Central Grants				51,348	61,413	67,088	78,472	9.2	17.0
	(2.3)	(1.6)	(1.9)	(1.9)	(2.0)	(2.1)	(2.2)		
2. Capital Receipts (a+b)				10,14,047	7,44,135	8,38,873	7,25,537	12.7	-13.5
	(4.0)	(4.2)	(5.5)	(36.7)	(24.0)	(26.9)	(20.6)		
(a) Loans from Centre@				26,127	34,040	32,940	31,216	-3.2	-5.2
	(1.2)	(1.0)	(1.0)	(0.9)	(1.1)	(1.1)	(0.9)		
(b) Other Capital Receipts				9,87,920	7,10,095	8,05,933	6,94,321	13.5	-13.8
	(2.9)	(3.2)	(4.4)	(35.8)	(22.9)	(25.8)	(19.7)		

Avg.: Average BE: Budget Estimates. RE: Revised Estimates.

@ With the change in the system of accounting with effect from 1999-2000, States' share in small savings which was included earlier under loans from Centre is included under internal debt and shown as special securities issued to National Small Savings Fund (NSSF) of the Central Government. The data for the years prior to 1999-2000 as reported in this Table, however, exclude loans against small savings, for the purpose of comparability.

Notes : (1) Figures in parentheses are percentages to GDP.

(2) Since 2003-04, the data on capital receipts are on a gross basis and therefore, not comparable with that of earlier years. The comparable figures on a net basis for Aggregate Receipts for the years 2003-04 (Accounts), 2004-05 (BE), 2004-05 (RE) and 2005-06 (BE) are 19.1 per cent, 17.8 per cent, 18.9 per cent and 16.5 per cent, respectively. The comparable figures on a net basis for Capital Receipts for the years 2003-04 (Accounts), 2004-05 (BE), 2004-05 (RE) and 2005-06 (BE) are 7.6 per cent, 5.7 per cent, 6.5 per cent and 4.3 per cent, respectively.

(3) GDP from 1990-91 to 1998-99 are on old base (1993-94) while the same is on new base (1999-2000) from 1999-2000 onwards.

Sources : (1) Data on fiscal variables have been compiled from budget documents of State Governments.

(2) Data for GDP have been obtained from the website of Central Statistical Organisation (CSO).

Table 2.22: Decomposition and Financing Pattern of GFD of States

(Per cent)

Items	1990-95 (Avg.)	1995-00 (Avg.)	2000-03 (Avg.)	2003-04 (Accounts)	2004-05 BE	2004-05 RE	2005-06 BE
1	2	3	4	5	6	7	8
Decomposition (1+2+3)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
1. Revenue Deficit	24.7	44.7	58.5	49.7	39.6	35.8	22.5
2. Capital Outlay	55.3	43.2	34.7	42.6	53.1	55.2	69.7
3. Net Lending	20.0	12.1	6.8	7.7	7.3	9.0	7.8
Financing (1 to 11)	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
1. Market Borrowings	16.0	16.1	19.9	38.4	24.0	26.4	14.6
2. Loans from Centre	49.0	40.6	6.6	11.5	13.8	4.7	15.8
3. Loans against Securities Issued to NSSF	–	28.9*	41.6	16.9	34.1	43.4	47.8
4. Loans from LIC, NABARD, NCDC, SBI and Other Banks	1.8	2.8	5.5	3.4	4.6	2.3	7.3
5. State Provident Fund	14.3	13.4	9.2	5.8	9.1	7.8	7.2
6. Reserve Funds	6.8	5.5	4.3	5.2	5.2	5.0	3.8
7. Deposits & Advances	9.8	9.8	4.6	-0.3	0.1	-1.0	-2.5
8. Suspense & Miscellaneous	4.3	2.7	0.4	-4.4	-1.6	0.5	-1.3
9. Remittances	-1.4	-3.6	0.3	1.5	1.0	-0.8	1.5
10. Overall Surplus(+)/Deficit(-)	4.4	-2.6	1.2	-0.9	-4.6	-5.5	1.0
11. Others	-5.0	9.5	6.4	23.0	14.2	17.1	4.7

Avg.: Average. BE: Budget Estimates. RE: Revised Estimates. – Not applicable.

* Pertains to 1999-2000 as it was introduced from that year only. The sum of items will not be equal to 100 for 1995-2000 (Avg.).

Notes : (1) Overall surplus/deficit would be matched by increase/decrease in cash balance since 2003-04. This is due to Cash Balance Investment Account now included under 'Suspense and Miscellaneous' while WMA/OD from RBI is included under 'Internal Debt'.

(2) 'Others' (item no.11) includes miscellaneous capital receipts, Contingency Fund, Inter-State Settlement, WMA/OD from RBI, *etc*.

Source : Budget Documents of State Governments.

Rs.16,112 crore during 2005-06. Taking into account the repayments of Rs.6,274 crore and additional borrowing allocation of Rs.3,202 crore, the gross allocation amounts to Rs.25,589 crore. The States during 2005-06 so far (up to February 28, 2006), have raised the amount of Rs.19,909 crore (Table 2.23). The weighted average interest rate of market loans during 2005-06 so far (up to February 28, 2006) firmed up to 7.62 per cent as compared with 6.44 per cent during the corresponding period of the previous year (Chart II.7).

2.56 States have generally not taken into account the recommendations of the TFC. Reckoning the net Central loans for State plans as reported in the Union Budget, 2005-06 and assuming that the State plans are maintained at the budgeted level, the market borrowings during 2005-06 would not be substantially higher than the provisional net allocation amount on account of higher devolution of taxes and grants as envisaged in the Union Budget in accordance with the TFC recommendations and larger receipts from the National Small Savings Fund (NSSF).

2.57 The weekly average utilisation of the Ways and Means Advances (WMA) and overdraft by the States during 2005-06 so far (up to end-February 2006) amounted to Rs.481 crore which was significantly lower than Rs.2,914 crore in the corresponding period of the previous year (Chart II.8).

2.58 The improvement in the overall cash position of the States was reflected in a spurt in the investments in 14-day Intermediate Treasury Bills. The weekly average investment by the States in the 14-day Treasury Bills during 2005-06 so far (up to end-February 2006) amounted to Rs.34,045 crore, which was considerably higher than that of Rs.9,945 crore in the corresponding period of the previous year (Chart II.9). Nine States resorted to overdraft during 2005-06 so far (up to February 28, 2006) as compared with 13 States during the entire year in 2004-05.

Outlook

2.59 The year 2005-06 is significant not only because it is the first year of the award of the TFC but also because it witnessed the long-pending implementation of the State-level VAT, an important milestone in the area of tax reforms. The TFC has recommended a substantial increase in devolution and transfers to the States, which should help ease the pressure on their budgets. At the same time, the TFC has incentivised the enactment of FRL by the States by making it a pre-condition for availing debt relief. Furthermore, the TFC recommendation that States may need to access the market (instead of the Centre) to finance their annual plans is likely to induce fiscal discipline and lead to the formulation of more realistic State plan outlays. It is expected

Table 2.23: Market Borrowings of the State Governments during 2005-06 (as on February 28, 2006)

(Rupees crore)

Items	Date	Cut-off Rate (%)	Tenor (years)	Amount Raised
1	2	3	4	5
(A) Tap Issues				
First Tranche	May 17-18, 2005	7.77	10	7,554
Second Tranche	September 13, 2005	7.53	10	2,931
Third Tranche	January 16, 2006	7.61	10	700
Total (A)				**11,185**
(B) Auctions				
i. First	April 20, 2005	7.45	10	300
ii. Second	June 14, 2005	7.39	10	2,181
iii. Second	June 14, 2005	7.35	10	210
iv. Third	August 4, 2005	7.32	10	250
v. Fourth	September 27, 2005	7.45	10	367
vi. Fourth	September 27, 2005	7.42	10	146
vii. Fourth	September 27, 2005	7.50	10	327
viii. Fifth	November 17, 2005	7.34	10	375
ix. Sixth	December 15, 2005	7.33	10	361
x. Seventh	January 19, 2006	7.32	10	317
xi. Seventh	January 19, 2006	7.33	10	166
xii. Eighth	February 27, 2006	7.65	10	950
xiii. Eighth	February 27, 2006	7.67	10	619
xiv. Eighth	February 27, 2006	7.68	10	600
xv. Eighth	February 27, 2006	7.70	10	628
xvi. Eighth	February 27, 2006	7.75	10	328
xvii. Eighth	February 27, 2006	7.85	10	599
Total - B (i to xvii)				**8,724**
Grand Total (A+B)				**19,909**

that these measures would expedite the implementation of fiscal reforms by the States and thus help them to travel the requisite distance as envisaged in the restructuring plan of the TFC. The States would accordingly need to formulate concrete and transparent strategies to attain these goals.

Chart II.7: Weighted Average Interest Rate on State Governments' Market Borrowings

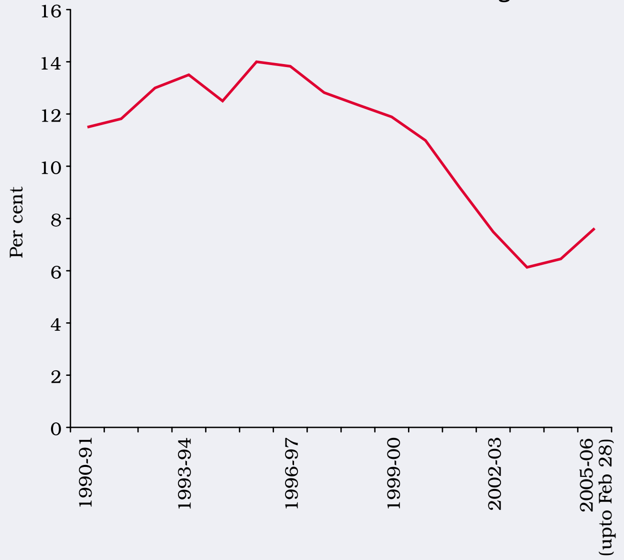
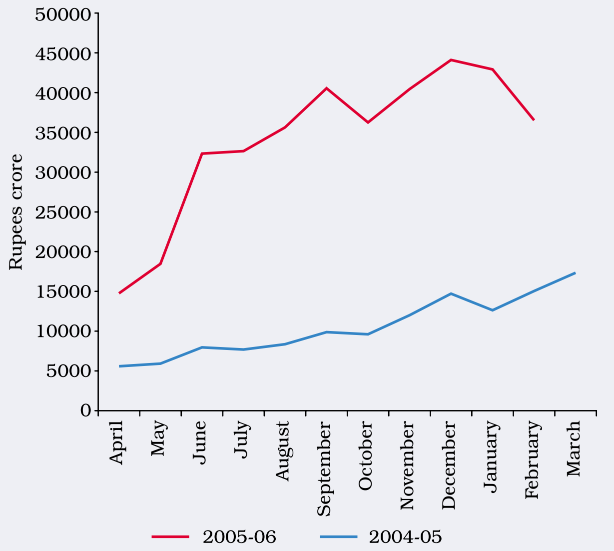


Chart II.8: Utilisation of WMA and Overdraft by States (Weekly Average)

Chart II.9: Investment in 14-day Intermediate Treasury Bills by State Governments (Weekly Average)



2.60 Against this backdrop, the State Budgets for 2005-06 show substantial fiscal correction from the levels in the previous years. The evaluation of the emerging fiscal scenario may, however, need to take cognisance of the differences in data on devolution and transfers between those recommended by the TFC and shown in the Union Budget, and those reported in the State Budgets.

2.61 The year 2005-06 has been marked by twenty two States adopting VAT in the place of Sales Tax. Reflecting the initial difficulties in the implementation of the VAT, the loss in revenue of few States has been compensated by the Government of India. Further, several States have enacted FRLs that have been incentivised by the TFC. In a move to carry forward the process of fiscal reforms, the State Governments have contemplated policy initiatives in their Budgets which include introduction of new taxes and modification of the existing ones, expenditure rationalisation, institutional reforms and introduction of new pension scheme based on defined contributions. Further, the current fiscal has witnessed substantial decline in recourse to the WMA by the State Governments concomitant with the sharp rise in their surplus cash balance holdings with the Reserve Bank, as reflected in their investment in 14-day Intermediate Treasury Bills.

Public Debt

2.62 The combined outstanding liabilities of the Central and State Governments, as a proportion to GDP, are budgeted to decline to 80.7 per cent at end-March 2006 from 82.1 per cent at end-March 2005. The budgeted decline in debt-GDP ratio is mainly on account of envisaged fiscal consolidation at the State level (Table 2.24).

III. MONETARY AND CREDIT SITUATION

Monetary Conditions

2.63 The Section assesses the conduct of monetary policy during 2005-06 and covers developments in monetary and credit aggregates followed by a discussion on liquidity management operations by the Reserve Bank in an environment of high credit growth and redemption of the India Millennium Deposits (IMDs) while ensuring price stability. Inflation management in the context of large increases in crude oil prices is also examined.

Table 2.24: Combined Liabilities and Debt-GDP Ratio

Year (end-March)	Outstanding Liabilities (Rupees crore)			Debt - GDP Ratio (Per cent)		
	Centre	States	Combined	Centre	States	Combined
1	2	3	4	5	6	7
1990-91	3,14,558	1,28,095	3,68,764	55.3	22.5	64.8
1995-96	6,06,232	2,50,813	7,28,132	51.0	21.1	61.3
2002-03	15,59,201	7,97,684	19,82,061	63.6	32.6	80.9
2003-04	17,36,678	9,22,263	22,50,837	62.9	33.4	81.5
2004-05 RE	19,81,514	10,40,834	25,62,822	63.5	33.3	82.1
2005-06 BE	22,31,886	11,52,530	28,47,587	63.2	32.7	80.7

RE : Revised Estimates. BE : Budget Estimates.

Note : Ratios to GDP for the years 2002-03 onwards are based on the new series of National Accounts Statistics with base year 1999-2000.

Source: Budget documents of the Central Government and 'A Study of State Budgets of 2005-06', Reserve Bank of India, December 2005.

2.64 In line with the stance of the Annual Policy Statement announced in April 2005, the mid-term review of the Annual Policy Statement (October 2005) of the Reserve Bank indicated that it will continue to ensure that appropriate liquidity is maintained in the system so that all genuine requirements of credit are met, consistent with the objective of price stability, ensuring an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the growth momentum and further to consider measures in a calibrated and prompt manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

2.65 The third quarter review of Annual Policy Statement for 2005-06 (January 24, 2006) of the Reserve Bank noted that based on an informed assessment of macroeconomic developments including the outlook on growth and inflation in a forward looking manner, and barring the emergence of any adverse and unexpected developments in various sectors of the economy, the overall stance of monetary policy at the current juncture will be:

- To maintain the emphasis on price stability with a view to anchoring inflationary expectations.
- To continue to support export and investment demand in the economy for maintaining the growth momentum by ensuring a conducive interest rate environment for macroeconomic, price and financial stability.
- To provide appropriate liquidity to meet genuine credit needs of the economy with due emphasis on quality.
- To consider responses as appropriate to evolving circumstances.

Reserve Money Survey

2.66 Reserve money expansion, year-on-year (y-o-y), at 18.3 per cent as on February 24, 2006 was higher than 15.3 per cent a year ago. The higher growth in reserve money for most part of the current fiscal was driven largely by net injection of liquidity through LAF operations and unwinding of Market Stabilisation Scheme (MSS) (Table 2.25).

2.67 During 2005-06 (up to February 24, 2006), the Reserve Bank's market operations injected liquidity into the system in view of the marked increase in merchandise trade deficit and the pick-

Table 2.25: Variation in Major Components and Sources of Reserve Money

(Rupees crore)

Item	2004-05	2005-06 (upto Feb. 24)	2004-05				2005-06		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8	9	10
Reserve Money	**52,623**	**63,100**	**-6,812**	**-6,285**	**31,546**	**34,174**	**7,177**	**1,072**	**25,428**
Components									
1. Currency in circulation	41,633	54,808	14,317	-4,166	16,467	15,015	19,877	-9,479	29,130
2. Bankers' Deposits with RBI	9,631	9,615	-19,665	-2,874	14,769	17,401	-10,680	9,780	-2,967
3. Other Deposits with the RBI	1,359	-1,323	-1,463	755	310	1,757	-2,021	771	-736
Sources									
1. RBI's net credit to Government	-62,882	51,593	-34,143	-6,179	184	-22,744	9,275	-25,251	19,879
of which: to Central Government	-60,177	56,904	-30,029	-4,499	203	-25,852	14,600	-25,251	19,812
2. RBI's credit to banks and commercial sector	-833	248	-2,985	-740	3,726	-835	1,155	-1,869	101
3. NFEA of RBI	1,28,377	12,985	57,525	-5,260	31,462	44,651	-14,595	24,823	23,741
4. Government's Currency Liabilities to the Public	152	1,170	37	9	89	17	384	910	-124
5. Net Non-Monetary Liabilities of RBI	12,191	2,895	27,245	-5,885	3,916	-13,085	-10,957	-2,460	18,169
Memo items:									
1. Net Domestic Assets	-75,754	50,116	-64,336	-1,025	84	-10,477	21,771	-23,751	1,687
2. FCA, adjusted for revaluation	1,15,044	25,598	33,160	-3,413	29,858	55,440	5,034	23,665	11,998
3. Net Purchases from Authorised Dealers	91,105	-4,812	30,032	-9,789	22,771	48,091	–	17,027	–
4. NFEA/Reserve Money (per cent) (end-period)	125.3	113.3	126.1	126.7	124.9	125.3	120.5	125.3	123.7
5. NFEA/Currency (per cent)	166.2	147.8	158.8	159.2	160.7	166.2	154.0	164.4	158.4

NFEA : Net Foreign Exchange Assets. FCA: Foreign Currency Assets.

Note : Quarterly variations are based on March 31 for Q4 and last reporting Fridays for other quarters.

Table 2.26: Phases of Reserve Bank's Liquidity Management Operations

(Rupees crore)

Item	April 1 - July 22, 2005	July 23 - August 12, 2005	August 13, - October 28, 2005	October 29, 2005- February 24, 2006
1	2	3	4	5
A. Drivers of Liquidity (1+2+3)	**-6,737**	**27,792**	**-15,127**	**-60,036**
1. RBI's Foreign Currency Assets (adjusted for revaluation)	6,412	19,348	5,193	-5,355
2. Currency with the Public	-15,274	-1,529	-7,940	-29,490
3. Others (residual)	2,125	9,973	-12,380	-25,191
3.1 Surplus cash balances of the Centre with the Reserve Bank	6,053	5,972	-7,421	-15,515
B. Management of Liquidity (4+5+6+7)	**1,329**	**-24,567**	**16,187**	**71,349**
4. Liquidity impact of LAF Repos	8,845	-26,565	16,210	33,555
5. Liquidity impact of OMO (net)*	0	0	0	0
6. Liquidity impact of MSS	-7,516	1,998	-23	37,794
7. First round liquidity impact due to CRR change	0	0	0	0
C. Bank Reserves # (A+B)	**-5,408**	**3,225**	**1,060**	**11,313**

+ Indicates injection of liquidity into the banking system.
- Indicates absorption of liquidity from the banking system.
Includes vault cash with banks and adjusted for first round liquidity impact due to CRR change.
* Adjusted for Consolidated Sinking Funds (CSF) and Other Investments.

up in domestic credit demand (Table 2.26). During December 2005, the banking system faced some liquidity pressures in the context of the redemption of IMDs. Accordingly, the Reserve Bank injected liquidity through repo operations and unwinding of the MSS.

2.68 The net Reserve Bank credit to Centre, reflecting its market operations to modulate liquidity conditions, increased by Rs.56,904 crore during 2005-06 so far (February 24, 2006) as against a decline of Rs.43,800 crore during the corresponding period of the previous year (Table 2.27).

Table 2.27: Net Reserve Bank Credit to the Centre - Variations

(Rupees crore)

Variable	2004-05	2005-06 (up to Feb. 24, 2006)	2004-05				2005-06		
			Q1	Q2	Q3	Q4	Q1	Q2	Q3
1	2	3	4	5	6	7	8	9	10
Net Reserve Bank Credit to the Centre (1+2+3+4-5)	**-60,177**	**56,904**	**-30,029**	**-4,499**	**203**	**-25,852**	**14,600**	**-25,251**	**19,812**
1. Loans and Advances	0	0	3,222	-3,222	0	0	0	0	0
2. Treasury Bills held by the Reserve Bank	0	0	0	0	0	0	0	0	0
3. Reserve Bank's Holdings of Dated Securities	12,323	25,975	-2,900	22,176	14,095	-21,048	8,221	-17,243	19,378
4. Reserve Bank's Holdings of Rupee Coins	57	53	175	-10	-94	-14	-40	-33	157
5. Central Government Deposits	72,558	-30,874	30,525	23,443	13,799	4,791	-6,419	7,974	-277
Memo Items*									
1. Market Borrowings of Dated Securities by the Centre +	80,350	1,21,000	28,000	26,000	14,000	12,350	42,000	39,000	24,000
2. Reserve Bank's Primary Subscription to Dated Securities	1,197	0	0	847	0	350	0	0	0
3. Repos (+) / Reverse Repos (-) (LAF), net position	15,315	32,045	-26,720	34,205	27,600	-19,770	9,660	-14,835	18,635
4. Net Open Market Sales #	2,899	3,718	429	427	871	1,171	1,543	941	261
5. Mobilisation under MSS	64,211	-32,253	37,812	14,444	353	11,602	7,469	-4,353	-19,713
6. Primary Operations $	-6,625	-12,237	37,353	-30,484	-36,984	23,490	18,205	-24,689	-38,715

* At face value.
+ Excluding Treasury Bills.
# Excludes Treasury Bills but including Consolidated Sinking Funds (CSF) and Other Investments.
$ Adjusted for MSS and Centre's surplus investment.

Note: Quarterly variations are based on March 31 for Q4 and last reporting Fridays for other quarters.

Monetary Survey

2.69 The year-on-year (y-o-y) growth in broad money (M_3) was 16.3 per cent on February 17, 2006 as compared with 13.0 per cent a year ago (Table 2.28). The higher M_3 growth reflected higher credit to the commercial sector as well as the base effects. Growth in demand deposits remained high in tandem with the sustained pick-up in non-food credit and a buoyant primary capital market, with funds getting temporarily parked in demand deposits. Growth in time deposits was higher during most part of 2005-06, partially reflecting the base effects. Time deposits growth, however, decelerated in January 2006 reflecting IMD redemption. Bank credit to the commercial sector increased (y-o-y) by 28.5 per cent as on February 17, 2006 on top of an increase of 22.0 per cent a year ago. The increasing demand for commercial credit was met by the banks largely by curtailing their incremental investment in Government papers.

Bank Credit

2.70 Demand for bank credit which had exhibited a sharp acceleration in the second half of 2004-05 continued its momentum in 2005-06. As on February 17, 2006, the y-o-y non-food credit extended by scheduled commercial banks grew by 33.6 per cent on top of 26.6 per cent (net of conversion) growth in the corresponding period of the previous year (Table 2.29 and Chart II.10). In the face of the sustained pick up in credit demand, banks restricted their incremental investments in Government securities.

2.71 Demand for bank credit has been broad-based led by agriculture, industry and housing sectors. Credit to the agricultural sector continued to record strong growth, reflecting various policy initiatives to improve flow of credit to the sector (Table 2.30). The increase in industrial credit in consonance with the pick-up in industrial activity was

Table 2.28: Monetary Indicators

(Rupees crore)

Variable	Outstanding as on February 17, 2006	Variation (year-on-year)			
		2004-05		2005-06	
		Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6
I. Reserve Money*	5,52,235	62,004	15.3	85,577	18.3
II. Broad Money (M_3)	25,80,002	2,55,294	13.0	3,61,783	16.3
a) Currency with the Public	4,11,448	36,748	11.7	61,810	17.7
b) Aggregate Deposits	21,63,650	2,17,652	13.2	2,99,434	16.1
i) Demand Deposits	3,53,867	42,255	18.2	79,737	29.1
ii) Time Deposits	18,09,783	1,75,397	12.4	2,19,696	13.8
of which: Non-Resident Foreign Currency Deposits	56,063	-255	-0.3	-19,499	-25.8
III. NM_3	25,96,791	2,62,210	13.7	3,86,563	17.5
of which: Call Term Funding from Financial Institutions	77,155	7,298	31.4	11,448	17.4
IV. a) L_1	26,98,623	2,78,885	14.1	4,02,527	17.5
of which: Postal Deposits	1,01,832	16,675	24.1	15,964	18.6
b) L_2	27,00,274	2,73,674	13.8	4,02,527	17.5
of which: FI Deposits	1,651	-5,211	-75.9	0	0.0
c) L_3	26,52,955	2,68,237	13.8	4,06,749	18.1
of which: NBFC Deposits	21,694	-403	-2.0	1,796	9.0
V. Major Sources of Broad Money					
a) Net Bank Credit to the Government (i+ii)	7,77,319	12,342	1.7	18,337	2.4
i) Net Reserve Bank Credit to Government	24,754	-39,506		26,792	
of which: to the Centre	24,796	-35,030		29,313	
ii) Other Banks' Credit to Government	7,52,565	51,848	7.4	-8,455	-1.1
b) Bank Credit to Commercial Sector	15,85,853	2,16,567	22.0	3,52,128	28.5
c) Net Foreign Exchange Assets of Banking Sector	6,61,279	97,481	18.8	45,472	7.4

* Data pertain to February 24, 2006. FIs: Financial Institutions. NBFCs: Non-banking Finance Companies.

Notes: 1. Data are provisional.

2. Variations of select aggregates are adjusted for the effect of conversion of a non-banking entity into a banking entity effective October 11, 2004.

3. L_3 pertains to December 2005.

Table 2.29: Scheduled Commercial Banks: Variations in Select Banking Indicators

(Rupees crore)

Item	2003-04		2004-05		Year-on-year Variation 2004-05 (up to Feb. 18, 2005)		Year-on-year Variation 2005-06* (up to Feb. 17, 2006)	
	Absolute	Per cent	Absolute	Per cent	Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6	7	8	9
Aggregate Deposits	2,23,563	17.5	1,92,269	12.8	2,10,255	14.3	2,86,458	17.0
Demand Deposits	54,733	32.1	23,005	10.2	39,462	19.5	75,804	31.4
Time Deposits	1,68,830	15.2	1,69,264	13.2	1,70,793	13.5	2,10,655	14.6
Bank Credit	1,11,570	15.3	2,26,761	27.0	2,12,987	26.2	3,40,709	32.2
Food Credit	-13,518	-27.3	5,159	14.4	6,214	17.6	-954	-2.3
Non-food Credit	1,25,088	18.4	2,21,602	27.5	2,06,772	26.6	3,41,663	33.6
Investments	1,30,042	23.8	49,373	7.3	36,999	5.5	-8,679	-1.2
Government Securities	1,31,341	25.1	52,031	8.0	39,754	6.1	-11,421	-1.6
Other Approved Securities	-1,299	-5.4	-2,658	-11.6	-2,755	-11.9	2,743	13.4

* Provisional.

Note: Data exclude the impact of conversion of a non-banking entity into a banking entity from October 11, 2004. Data also reflect the impact of IMD redemption on December 29, 2005.

mainly on account of automobiles, infrastructure, construction, petroleum, gems and jewellery, other metal and metal products, textiles and rubber and plastic products. Credit to the housing sector continued to be strong, benefiting from low interest rate and tax incentives.

2.72 In addition to bank credit, the corporate sector has also been increasingly relying on non-bank sources of funds in recent years. Equity issuances increased during April-December 2005, benefiting from buoyancy in capital markets. Mobilisation through issuances of commercial paper also remained strong, *albeit,* somewhat lower than a year ago. Net drawals under external commercial borrowings (ECBs) during April-September 2005 were almost the same as a year ago, reflecting buoyant economic activity (Table 2.31).

Chart II.10: Non-food Credit

Price Situation

2.73 Inflation firmed up in a number of economies during the third quarter of 2005, reflecting the impact of sharp increases in international crude oil prices. Strong growth in global demand especially from the US and China, low levels of global spare production capacity and economic resilience to higher energy costs have supported oil prices at elevated levels despite periodic increases in supply by the Organisation of the Petroleum Exporting Countries (OPEC). International crude oil prices in the US market reached a historic high crossing US $ 70 a barrel on August 30, 2005 in the immediate aftermath of Hurricane Katrina, amidst concern over supply disruptions due to tropical storms in the US, instability of supplies from the Middle East due to geo-political uncertainties and speculative purchases (Chart II.11). During the fourth quarter, although inflation eased marginally due to some moderation in energy prices, it continues to remain at elevated levels.

2.74 The impact of record high crude oil prices on global economic activity and inflation expectations

Table 2.30: Deployment of Non-food Bank Credit

(Rupees crore)

Sector / Industry	Outstanding as on October 28, 2005	Financial Year Variations			
		April-October 2004		April-October 2005	
		Absolute	Per cent	Absolute	Per cent
1	2	3	4	5	6
Non-food Gross Bank Credit	**11,57,769**	**92,054**	**12.6**	**1,57,981**	**15.8**
of which					
Agriculture and Allied Activities	1,41,612	11,267	12.4	16,362	13.1
Industry (Small, Medium and Large)	4,75,915	26,738	8.5	49,023	11.5
Small Scale Industries	78,780	1,322	2.0	4,192	5.6
Trade	69,315	7,580	30.5	11,367	19.6
Housing	1,53,267	N.A.	N.A.	24,539	19.1
Advances against Fixed Deposits	30,283	-651	-2.5	433	1.5
Real Estate Loans	20,148	2,663	47.7	6,846	51.5
Non-Banking Financial Companies	25,672	604	3.6	3,188	14.2
Memo:					
Priority Sector	**4,33,422**	**26,181**	**9.9**	**51,946**	**13.6**
Industry (Small, Medium and Large)	**4,75,915**	**26,738**	**8.5**	**49,023**	**11.5**
Food Processing	26,259	-361	-1.7	1,826	7.5
Textiles	48,229	-44	-0.1	4,252	9.7
Paper and Paper Products	7,910	181	3.0	1,028	14.9
Petroleum, Coal Products and Nuclear Fuels	20,549	3,533	28.8	4,980	32.0
Chemical and Chemical Products	40,723	-847	-2.8	1,231	3.1
Rubber, Plastic and their Products	5,596	249	9.6	1,930	52.6
Iron and Steel	42,138	10	0	6,137	17.0
Other Metal and Metal Products	13,968	1,006	12.3	2,332	20.0
Engineering	32,694	-1,033	-3.9	3,298	11.2
Vehicles, Vehicle Parts and Transport Equipments	15,825	262	4.9	3,963	33.4
Gems and Jewellery	17,880	2,323	25.3	3,574	25.0
Construction	10,726	1,716	28.7	2,604	32.1
Infrastructure	96,639	14,169	27.6	17,630	22.3

N.A.: Not available.

Note: 1. Data are provisional and relate to select scheduled commercial banks which account for about 90 per cent of bank credit of all scheduled commercial banks.

2. Due to change in classification of sectors/industries and coverage of banks, data for 2005-06 are not comparable with earlier data.

seems to have been largely muted so far compared to the earlier oil shocks (Chart II.12 and Table 2.32). This could be attributed to declining oil intensity in advanced economies, increased competition fostered by globalisation, declining role of commodity prices in final output, limited pass-through of international

Table 2.31: Select Sources of Funds to Industry

(Rupees crore)

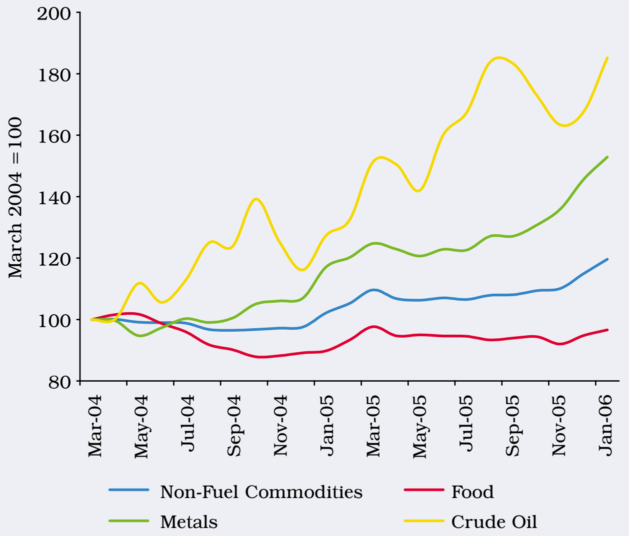
Item	April-September 2004	April-September 2005
1	2	3
I. Bank Credit to Industry (Small, Medium and Large) (up to October)	26,738	49,023
II. Flow from Non-banks to Corporates		
1. Capital Issues* (i+ii) (up to December)	7,971	11,628
i) Non-Government Public Ltd. Companies (a+b)	5,287	11,628
a) Bonds/Debentures	0	118
b) Shares	5,287	11,510
ii) PSUs and Government Companies	2,684	0
2. ADR/GDR Issues + (up to December)	1,642	5,165
3. External Commercial Borrowings (ECBs) $	15,872	16,264
4. Issue of CPs (up to December)	4,141	2,946
III. Profit After Tax £	23,400	34,895
IV. Depreciation Provision £	11,340	14,754

* Gross issuances excluding issues by banks and financial institutions. Figures are not adjusted for banks' investments in capital issues, which are not expected to be significant. + Excluding issuances by banks and financial institutions. $ Including short-term credit.

£ Data are based on audited/unaudited abridged results of select sample of non-financial non-Government companies.

Note : Data are provisional.

Chart II.11: International Commodity Prices



Source: International Monetary Fund.

Table 2.32: Annual Consumer Price Inflation

(Per cent)

Country/Area	2000	2001	2002	2003	2004	2005P
1	2	3	4	5	6	7
Advanced Economies	**2.2**	**2.1**	**1.5**	**1.8**	**2.0**	**2.2**
US	3.4	2.8	1.6	2.3	2.7	3.1
Japan	-0.9	-0.7	-1.0	-0.2	0.0	-0.4
Euro Area	2.1	2.3	2.3	2.1	2.1	2.1
Other Emerging Market and Developing Countries	**7.3**	**6.7**	**5.9**	**6.0**	**5.8**	**5.9**
Developing Asia	1.9	2.7	2.1	2.6	4.2	4.2
China	0.4	0.7	-0.8	1.2	3.9	3.0
India	**4.0**	**3.8**	**4.3**	**3.8**	**3.8**	**3.9**

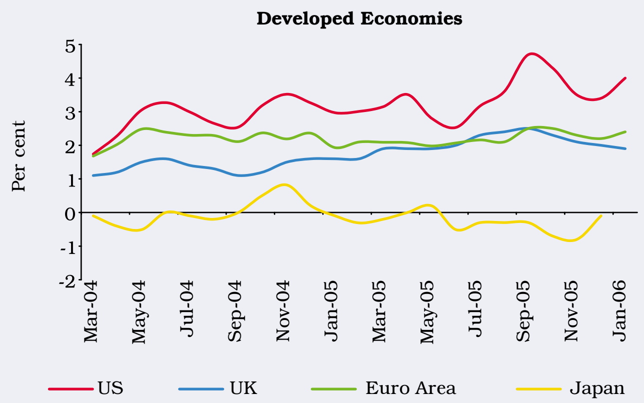
P : IMF Projections.
Source : World Economic Outlook, September 2005, IMF.

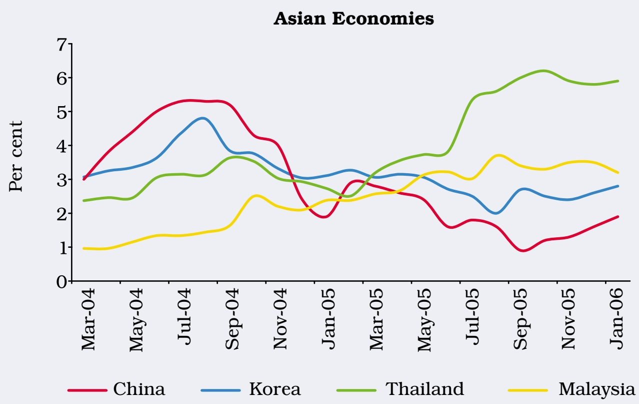
oil prices to domestic prices of oil due to sharing of the burden by the Governments, especially in a number of emerging economies, and pre-emptive monetary tightening by major central banks to contain the second-round effects.

2.75 Reflecting the upward pressures on inflation, a number of central banks have tightened their monetary policies, especially in emerging Asia. In the US, consumer price inflation, which had accelerated to 4.7 per cent in September 2005 reflecting sharp increase in energy costs eased to 4.0 per cent in January 2006. On the back of strong economic activity and the incipient inflationary pressures, the US Federal Open Market Committee (FOMC) persevered with its measured pace of monetary tightening raising its target Federal Funds rate by 175 basis points (25 basis points hike at each of its seven meetings) since end-March 2005 - to 4.50 per cent on January 31, 2006. In the UK, CPI inflation which had increased to 2.5 per cent in September 2005 (1.1 per cent a year ago) due to higher oil prices eased to 1.9 per cent in January 2006. The Bank of England, which had cut the policy repo rate by 25 basis points on August 4, 2005 in response to the weakening of economic activity, has since maintained the policy stance. In the Euro area, inflation, measured by the Harmonised Index of Consumer Prices (HICP), rose above the target to 2.5 per cent in September 2005 and was 2.4 per cent in January 2006. Taking into account the potential second-round effects of ongoing oil price rises, and further increase in administered prices and indirect taxes seen as upside risks, the ECB raised the key policy rate by 25 basis points on December 1, 2005 to anchor inflation expectations in the Euro area.

2.76 In emerging Asia, inflation in Indonesia, Thailand, the Philippines and Malaysia has remained high under the impact of higher oil prices, although

Chart II.12: Consumer Price Inflation





there has been some easing in the recent months. The central banks of these countries, therefore, raised their policy rates during 2005 (Table 2.33). In China, on the other hand, consumer price inflation was 1.9 per cent in January 2006 - same as last year - reflecting incomplete pass-through of higher oil prices to domestic oil prices.

2.77 In India, the headline inflation, measured by y-o-y changes in the wholesale price index (WPI), eased to 4.0 per cent on February 11, 2006 from 5.1 per cent at end-March 2005 (and 5.1 per cent a year ago). The average WPI inflation rate eased to 4.6 per cent from 6.4 per cent a year ago (Chart II.13). Despite hikes in petrol and diesel prices (7-8 per cent each in June and September 2005) and increase in electricity prices in June 2005, the moderation in headline inflation reflected calibrated monetary and fiscal measures and base effects. However, it needs to be recognised that the pass-through of high international crude oil prices to domestic prices remains incomplete as it has been restricted to only petrol and diesel.

2.78 Inflation during 2005-06 so far has been dominated by mineral oil prices which have alone contributed over one-third to the headline inflation. The y-o-y WPI inflation, excluding the fuel group, was lower at 3.0 per cent as on February 11, 2006.

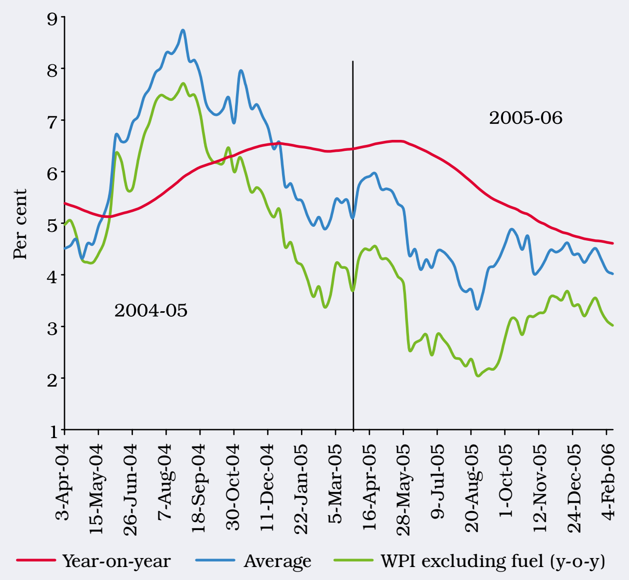
Table 2.33: Central Bank Policy Rates

(Per cent)

Country	January 1, 2003	January 1, 2004	January 1, 2005	February 28, 2006
1	2	3	4	5
Australia	4.75	5.25	5.25	5.50
Brazil	25.00	16.50	17.75	17.25
Canada	2.75	2.75	2.50	3.50
Euro Area	2.75	2.00	2.00	2.25
India*	**5.50**	**4.50**	**4.75**	**5.50**
Indonesia	12.93	8.31	7.43	12.75
Israel	8.90	4.80	3.70	4.75
Japan	0.10	0.10	0.10	0.10
Korea	4.25	3.75	3.25	4.00
New Zealand	5.75	5.00	6.50	7.25
Poland	6.50	5.25	6.50	4.25
Sweden	3.75	2.75	2.00	2.00
Switzerland	0.25-1.25	0-0.75	0.25-1.25	0.50-1.50
Thailand	1.75	1.25	2.00	4.25
United Kingdom	4.00	3.75	4.75	4.50
United States	1.25	1.00	2.25	4.50

* : Reverse repo rate.
Source : Central Bank Websites.

Chart II.13: Annual Wholesale Price Inflation



2.79 Apart from the fuel group, vegetables, eggs, meat and fish and sugar prices posed some upward pressures on domestic inflation. With foodgrains production expected to be higher than last year, primary agricultural commodity prices are expected to moderate. Higher sugarcane output is expected to contain sugar prices, which have so far remained high and volatile in line with international trends. Overall, the fuel group (41.2 per cent) contributed the maximum to the y-o-y WPI inflation as on February 11, 2006, followed by manufactured products (31.9 per cent) and primary articles (27.5 per cent) (Table 2.34).

2.80 Consumer price inflation during December 2005 increased from its level in March 2005 reflecting higher food and fuel prices (Table 2.35).

2.81 Thus, the inflation outcome during 2005-06 has so far been dominated by record high international crude oil prices. While some pass-through of higher international oil prices to domestic oil prices has taken place, its second round impact is yet not apparent. Although the Government has moderated the impact on domestic prices through modifications in the tax structure, such fiscal manoeuvrability is getting limited. The liquidity overhang has been managed well through liquidity management operations (LAF and MSS) as well as monetary actions such as increases in cash reserve ratio (50 basis points during September-October 2004) and reverse repo rate (25 basis points each in October 2004, April 2005, October 2005 and January 2006) which sought to

Table 2.34: Annual Point-to-Point WPI Inflation by Component (Base 1993-94=100)

(Per cent)

Group/ Item	Weight	Annual Variation 2002-03	2003-04	2004-05	Variation 2004-05 (Feb. 12)	2005-06 (Feb. 11)	Weighted Contribution 2004-05 (Feb. 12)	2005-06 (Feb. 11)
1	2	3	4	5	6	7	8	9
All Commodities	**100.0**	**6.5**	**4.6**	**5.1**	**5.1**	**4.0**	**100.0**	**100.0**
I. Primary Articles	**22.0**	**6.1**	**1.6**	**1.3**	**1.3**	**5.1**	**5.7**	**27.5**
i) Cereals	4.4	4.0	-0.3	2.9	1.7	5.6	1.4	5.9
ii) Pulses	0.6	0.3	-2.6	-2.6	-3.1	20.7	-0.4	2.8
iii) Fruits and Vegetables	2.9	-1.2	-4.9	11.6	4.0	9.5	2.3	7.0
iv) Raw Cotton	1.4	34.3	12.3	-23.8	-26.9	3.1	-7.6	0.8
v) Oilseeds	2.7	30.0	-1.2	-6.5	-5.8	-12.1	-3.1	-7.4
vi) Sugarcane	1.3	11.5	6.5	-0.7	-0.7	0.7	-0.2	0.3
II. Fuel, Power, Light and Lubricants	**14.2**	**10.8**	**2.5**	**10.5**	**10.2**	**7.6**	**41.6**	**41.2**
i) Mineral Oils	7.0	18.4	0.0	16.0	14.9	11.9	32.7	36.1
ii) Electricity	5.5	3.4	4.9	0.8	1.6	2.7	2.4	5.1
iii) Coal Mining	1.8	0.0	9.2	17.1	17.1	0.0	6.4	0.0
III. Manufactured Products	**63.7**	**5.1**	**6.7**	**4.6**	**4.7**	**2.3**	**52.7**	**31.9**
i) Sugar	3.6	-15.0	16.9	19.7	20.7	6.6	10.9	5.1
ii) Edible Oils	2.8	27.4	6.6	-8.4	-8.2	-3.4	-4.0	-1.8
iii) Oil Cakes	1.4	40.3	5.0	-17.4	-8.4	-3.8	-2.7	-1.3
iv) Cotton Textiles	4.2	8.3	15.6	-12.7	-14.1	-0.2	-11.7	-0.2
v) Man Made Fibre	4.4	17.4	-0.4	0.6	1.5	-4.1	0.7	-2.3
vi) Fertilisers	3.7	2.1	-0.1	3.3	3.3	0.2	2.2	0.1
vii) Iron and Steel	3.6	9.2	34.6	21.3	19.8	-2.8	15.7	-3.2
viii) Cement	1.7	1.1	1.3	10.2	5.5	7.0	1.6	2.6
ix) Non-electrical Machinery	3.4	2.5	4.7	10.0	11.2	3.6	6.7	2.9
x) Electrical Machinery	5.0	-1.3	1.7	4.1	4.2	1.6	2.6	1.2
xi) Transport Equipment and Parts	4.3	-0.9	1.4	6.2	6.2	1.8	4.3	1.6

moderate inflationary expectations by demonstrable commitment to price stability. Finally, the comfort provided by food stocks and forex reserves has contributed to maintaining and stabilising inflation expectations in the economy. On balance, the underlying inflationary pressures appear to have been contained and inflationary expectations maintained.

2.82 To conclude, monetary and liquidity conditions have remained comfortable during 2005-06 so far despite sustained and broad-based credit demand from the commercial sector. Banks were able to finance the increased demand for credit largely by restricting their incremental investments in Government securities. Against the backdrop of a

Table 2.35: Consumer Price Inflation (CPI) in India (year-on-year)

(Per cent)

Inflation Measure	March 2003	March 2004	December 2004	March 2005	June 2005	September 2005	October 2005	December 2005
1	2	3	4	5	6	7	8	9
CPI-IW	4.1	3.5	3.8	4.2	3.3	3.6	4.2	5.6
CPI-UNME	3.8	3.4	3.6	4.0	3.9	4.8	4.5	5.7
CPI-AL	4.9	2.5	3.0	2.4	2.7	3.2	3.2	4.7
CPI-RL	4.8	2.5	3.0	2.4	2.7	3.2	3.2	4.9
Memo:								
WPI Inflation (end of period)	6.5	4.6	5.7	5.1	4.3	4.3	4.8	4.4

IW : Industrial Workers. UNME : Urban Non-Manual Employees. AL : Agricultural Labourers. RL : Rural Labourers.

lower order of accretion to the Reserve Bank's net foreign assets, continued credit demand and some pressures in December 2005 emanating from the redemption of the IMDs, the Reserve Bank injected liquidity through repo operations as well as by cancelling auctions of TBs under the MSS. All these operations were by and large able to stabilise domestic financial markets.

2.83 Domestic inflation as well as inflation expectations remained well-contained reflecting timely and calibrated monetary and fiscal measures since the second half of 2004. Inflation conditions, both in India and elsewhere, during 2005-06 have been driven by international crude oil prices reaching a historic high. Under the influence of oil prices, headline inflation edged up sharply in a number of economies in the second half of 2005. Nonetheless, the impact of higher oil prices on economic activity as well as inflation expectations remained muted relative to the earlier oil shocks. Although second-round impact of high oil prices on headline inflation has been contained so far, the possibility of a higher degree of second-round effects in the context of high and volatile oil prices and its implications for inflation expectations continue to be a matter of concern for central banks.

IV. FINANCIAL MARKETS

Money Market

2.84 Money markets continued to perform smoothly in equilibrating demand and supply of short-term funds and by and large markets cleared without excessive volatility. Money market interest rates during 2005-06 moved largely in alignment with the stance of the monetary policy. As monetary policy reacted with calibrated measures to stabilise inflation expectations, interest rates in various segments of the money markets responded to monetary policy actions. Market operations through LAF and MSS mopped up surplus liquidity to a considerable extent and in view of the changing scenario, the Reserve Bank in its forward looking assessment, began to unwind sterilised liquidity in a calibrated manner since September 2005. This helped in liquidity management during the redemption of IMD liability of US$ 7.1 billion in December 2005, when from sustained surpluses, the system moved to a near neutral position in terms of marginal liquidity.

2.85 Money markets, for the larger part of 2005-06, have been marked by comfortable liquidity conditions, with average daily call money borrowing rates generally anchored to the reverse repo rate (Table 2.36). Call rates edged up by about 25 basis points in tandem with the fixed reverse repo rate which was increased by 25 basis points to 5.00 per cent on April 29, 2005. Towards the end of June 2005, call rates rose above the reverse repo rate reflecting the pressures emanating primarily from liquidity mismatches on account of banks preferring to maintain higher than required reserves early in the reporting fortnight, advance tax payments to banking system and auction of Central Government securities. Liquidity conditions improved by the second half of July 2005 due to cancellation of some scheduled Treasury Bills auctions on account of incessant rainfall in Mumbai disrupting normal financial activities and return of advance tax payments to the banking system. Large foreign currency purchases from the authorised dealers during July-August 2005 also improved the liquidity conditions. As a result, on an average, balances under LAF reverse repos jumped from Rs.10,754 crore in July to Rs.34,832 crore in August 2005. The call money market, thus, remained broadly stable during August 2005 and first half of September 2005. During the second half of September 2005, the call money market witnessed mild pressure, reflecting advance tax outflows and scheduled auctions. In October 2005, in view of the current macroeconomic and overall monetary conditions, the Reserve Bank decided to increase the reverse repo rate by an additional 25 basis points, while retaining the spread between reverse repo rate and repo rate at 100 basis points. Accordingly, effective October 26, 2005 reverse repo and repo rate were fixed at 5.25 and 6.25 per cent, respectively. With surplus liquidity declining in October and November 2005, reflected in the decline of average LAF reverse repo levels from Rs.31,570 crore in September to Rs.3,268 crore in November, the call rates firmed up. Making a forward looking assessment, the Reserve Bank had begun to unwind MSS from September 2005. Further, the call rates firmed up distinctly in the later half of December 2005 due to advance tax outflows and IMD redemption pressures. Injection of liquidity by the Reserve Bank under the repo window and the unwinding of MSS helped to manage liquidity appropriately. The additional window in the form of SLAF also expanded the options for banks amidst relative tightness in liquidity in December and January 2006. In January 2006, in view of the current macroeconomic and overall monetary conditions, the reverse repo and repo rates were increased by 25 basis points while retaining the spread between the two at 100 basis points. Accordingly, effective January 24, 2006, the reverse repo and repo rates were fixed at 5.50 and 6.50 per cent, respectively.

Table 2.36: Domestic Financial Markets - Select Indicators

Year/ Month	Call Money		Govt. Securities		Foreign Exchange				Liquidity Management		Equity			
	Average Daily Turnover (Rs crore)	Average Call Rates* (Per cent)	Average 10-year Yield@ (per cent)	Average Daily Turnover (Rs. crore) +	Average Daily Inter-bank Turnover (US $ million)	Average Exchange Rate (Rs. per US $)	RBI's net Foreign Currency Sales (-)/ Purchases (+) (US $ million)	Average Forward Premia 3-month (Per cent)	Average MSS Outstan-ding# (Rs. crore)	Average Daily Reverse Repo (LAF) Outstan-ding (Rs. crore)	Average Daily BSE Turnover (Rs. crore)	Average Daily NSE Turnover (Rs crore)	Average BSE Sensex**	Average S & P CNX Nifty**
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
2004-05														
April	12,916	4.29	5.10	10,029	10,302	43.93	7,427	-0.36	14,296	75,006	2,243	5,048	5,809	1,848
May	10,987	4.30	5.19	6,202	8,882	45.25	-220	-1.33	27,518	74,502	2,188	4,710	5,205	1,640
June	10,973	4.35	5.50	5,860	7,847	45.51	-413	0.93	35,283	61,981	1,681	3,859	4,824	1,506
July	8,632	4.31	5.91	4,206	7,756	46.04	-1,180	2.25	43,739	59,594	1,793	4,265	4,973	1,568
August	11,562	4.41	6.38	4,173	5,974	46.34	-876	2.85	48,541	42,692	1,736	3,948	5,144	1,615
September	17,088	4.45	6.08	5,854	7,348	46.10	19	2.20	52,421	31,589	1,800	4,023	5,423	1,692
October	16,667	4.63	6.73	3,636	7,262	45.78	-99	2.87	53,660	10,805	1,730	3,785	5,702	1,795
November	13,820	5.62	7.14	2,607	9,929	45.13	3,792	2.16	54,157	-5,066	1,787	4,102	5,961	1,874
December	19,527	5.28	6.73	4,305	9,447	43.98	1,393	2.03	52,085	7,570	2,184	5,026	6,394	2,022
January	16,534	4.72	6.68	3,566	9,114	43.75	0	2.50	53,790	18,721	2,310	5,249	6,307	1,978
February	16,041	4.76	6.58	4,640	11,583	43.68	4,974	1.99	58,141	19,895	2,484	4,999	6,595	2,067
March	15,293	4.72	6.65	2,835	11,286	43.69	6,030	1.82	63,737	29,809	2,706	5,139	6,679	2,096
2005-06														
April	17,213	4.77	7.02	3,001	9,880	43.74	0	1.96	65,638	30,675	1,890	4,136	6,379	1,987
May	15,269	4.99	7.13	3,805	10,083	43.49	0	1.57	68,539	22,754	1,971	3,946	6,483	2,002
June	20,134	5.10	6.88	6,807	10,871	43.58	-104	1.40	70,651	13,916	2,543	4,843	6,926	2,134
July	20,046	5.02	7.12	3,698	11,003	43.54	2,473	1.56	70,758	10,754	3,095	6,150	7,337	2,237
August	16,158	5.02	7.04	4,239	11,749	43.62	1,552	0.69	71,346	34,832	3,451	6,624	7,726	2,358
September	16,292	5.05	7.04	5,207	11,040	43.92	0	0.62	67,617	31,570	3,871	6,923	8,272	2,512
October	17,169	5.12	7.14	2,815	13,087 P	44.82	0	0.69	68,602	18,608	2,955	6,040	8,220	2,487
November	22,620	5.79	7.10	3,314	11,228 P	45.73	0	0.67	67,041	3,268	2,635	5,479	8,552	2,575
December	21,149	6.00	7.13	2,948	13,632 P	45.64	6,541	1.51	52,040	1,452	3,516	6,814	9,162	2,773
January	17,911	6.79	7.16	3,094	16,365 P	44.40	..	2.60	40,219	-15,386	3,966	7,472	9,540	2,893
February	13,497	6.87	7.32	2,584	..	44.33	..	2.85	33,405	-13,532	3,688	7,125	10,090	3,019

.. Not Available. * Average of daily weighted call money borrowing rates. + Outright turnover in Central Government dated securities.
Average of weekly outstanding MSS. ** Average of daily closing indices. @ Average of daily closing rates. P : Provisional.

2.86 Liquidity management in face of IMD redemptions was carried out to contain disequilibrium while retaining monetary policy stance with a medium-term objective. Outflows on account of the redemptions were met by smooth arrangements worked out in this regard. Temporary tightness in liquidity was met by release of liquidity through repo window (including the second LAF) averaging about Rs.23,000 crore per day in the last week of December coinciding with the IMD redemptions, outflows due to advance tax payments and the continued surge in credit off-take. Short-term money market rates eased remarkably in the first week of January 2006 reflecting smooth redemptions of IMDs, indicating growing maturity of the financial markets and the strength of the liquidity management system that has been put in place. The call money rates, however, firmed up again from second week of January 2006, reflecting demand pressures emanating from scheduled auctions of Government securities and robust credit demand.

2.87 The Reserve Bank in the third quarter review of Annual Policy Statement (January 24, 2006), continued with its policy of active demand management of liquidity through OMO including MSS, LAF and CRR, and use of all the policy instruments at its disposal flexibly, as and when the situation warrants. Based on an informed assessment of macroeconomic developments including the outlook on growth and inflation in a forward looking manner, and barring the emergence of any adverse and unexpected developments in various sectors of the economy, in order to maintain the emphasis on price stability with a view to anchoring inflationary expectations by ensuring a conducive interest rate environment for macroeconomic, price and financial stability, the Bank Rate has been kept unchanged at 6.0 per cent. While the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, on a review of the current liquidity situation, it was decided that the present level of CRR at 5.0 per cent will remain unchanged.

Table 2.37: Interest Rates in Money Markets

(Per cent)

	March-2002	March-2003	March-2004	March-2005	September-2005	December-2005	January-2006
1	2	3	4	5	6	7	8
Call Money	6.97	5.86	4.37	4.72	5.05	6.00	6.79
CP (61-90 days)	7.78	6.53	5.11	5.84	5.87	6.70	7.29
CD	5.00-10.03	5.00-7.10	3.87-5.16	4.21-6.34	4.66-7.00	5.50-7.25	5.40-7.75

Interest Rate Scenario

2.88 Simultaneous increase in demand and supply of funds has resulted in interest rates remaining generally stable during 2004-05 and the current year so far. During this period, the interest rate environment remained benign due to adequate supply of liquidity although demand for credit from industries as well as from other sectors rose sharply. The range of interest rates offered on deposits broadened during this period. Share of sub-BPLR lending increased during the year. However, some softening in lending rates was recorded during the current year upto December notwithstanding hardening of sub-BPLR lending rates subsequently.

2.89 During 2004-05, financial markets remained generally stable, though interest rates showed some intra-year upward movement. Similar trends in interest rates have continued in the current financial year so far. At the shorter end of the market, the weighted average call money rate increased by 35 basis points from 4.37 per cent in March 2004 to 4.72 per cent by March 2005 and further to 6.87 per cent in February 2006. The weighted average discount rate on commercial paper (CP) of 61 to 90-day maturity increased by 73 basis points from 5.11 per cent to 5.84 per cent by March 2005, ruled around the same level in September 2005 increased to 6.70 per cent in December 2005 and further to 7.29 per cent in January 2006 (Table 2.37).

Bank Deposit and Lending Rates

2.90 The term-deposit rates offered by the public sector banks for maturities upto one year moved from a range of 3.75-5.25 per cent in March 2004 to 2.75-6.0 per cent in March 2005 and further to 2.25-6.00 per cent in February 2006. Interest rates on term-deposits over one year moved from a range of 5.00-6.00 per cent in March 2004 to 4.75-7.00 per cent in March 2005 and further to 5.50-7.00 per cent in February 2006. The benchmark prime lending rates (BPLRs) of public sector banks moved from a range of 10.25-11.50 per cent in March 2004 to 10.25-11.25 per cent in March 2005 and remained thereon in February 2006. BPLRs of foreign and private sector banks moved from a range of 11.00-14.85 per cent and 10.50-13.00 per cent in March 2004 to 10.00-14.50 per cent and 11.00-13.50 per cent, respectively, in March 2005 (Table 2.38). The BPLR ranges for

Table 2.38: Movements in Deposit and Lending Interest Rates

(Per cent)

Interest Rates	March 2002	March 2003	March 2004	March 2005	December 2005	February 2006 *
1	2	3	4	5	6	7
Term Deposit Rates						
Public Sector Banks						
a) Up to 1 year	4.25 - 7.50	4.00 - 6.00	3.75 - 5.25	2.75 - 6.00	2.00 - 6.00	2.25 - 6.00
b) 1 year up to 3 years	7.25 - 8.50	5.25 - 6.75	5.00 - 6.00	4.75 - 6.50	5.50 - 6.50	5.50 - 6.50
c) Over 3 years	8.00 - 8.75	5.50 - 7.00	5.75 - 6.00	5.25 - 7.00	5.80 - 7.00	5.80 - 7.00
Private Sector Banks						
a) Up to 1 year	5.00 - 9.00	3.50 - 7.50	3.50 - 7.50	3.00 - 6.25	3.00 - 6.25	3.00 - 6.25
b) year up to 3 years	8.00 - 9.50	6.00 - 8.00	5.75 - 7.75	5.25 - 7.25	5.50 - 7.00	5.50 - 7.00
c) Over 3 years	8.25 - 10.0	6.00 - 8.00	6.00 - 8.00	5.75 - 7.00	6.00 - 7.25	6.00 - 7.25
Foreign Banks						
a) Up to 1 year	4.25 - 9.75	3.00 - 7.75	3.00 - 7.75	3.00 - 6.25	3.00 - 5.75	3.00 - 5.75
b) 1 year up to 3 years	6.25 - 10.0	4.15 - 8.00	3.50 - 8.00	3.50 - 6.50	4.25 - 6.00	4.25 - 6.00
c) Over 3 years	6.25 - 10.0	5.00 - 9.00	4.75 - 8.00	3.50 - 7.00	5.00 - 7.00	5.00 - 7.00
BPLR						
Public Sector Banks	10.00 - 12.50	9.00 - 12.25	10.25 - 11.50	10.25 - 11.25	10.25 - 11.25	10.25 - 11.25
Private Sector Banks	10.00 - 15.50	7.00 - 15.50	10.50 - 13.00	11.00 - 13.50	11.00 - 13.50	11.00 - 13.50
Foreign Banks	9.00 - 17.50	6.75 - 17.50	11.00 - 14.85	10.00 - 14.50	10.00 - 14.50	10.00 - 14.50

* As on February 3, 2006.

private and foreign banks remained unchanged in February 2006. During 2004-05, a substantial part of banks' lending was at sub-BPLR rates given the competitive conditions in the credit market. The share of sub-BPLR lending in total lending of commercial banks with credit limit over Rs.2 lakh, excluding export credit, increased from about 50 per cent in March 2004 to over 60 per cent by March 2005, which was largely sustained also in December 2005. As at end-December 2005, public sector banks' median (representative) lending rate for both demand and term loans (at which maximum business is contracted), in the range of 8.00-11.63 per cent, exhibited moderation as compared with their corresponding levels of 9.00-12.50 and 8.38-12.00 per cent each in March 2005. Thus, the movement in lending rates was in the desired direction keeping in view the concern expressed in the mid-term review of November 2003 regarding the observed rigidities in the downward movement of lending rates.

Interest Rates on Export Credit

2.91 In April 2002, the Monetary and Credit Policy Statement, indicated that linking domestic interest rates on export credit to PLR has become redundant in the present circumstances as effective interest rates on export credit in rupee terms were substantially lower than the PLR. In the mid-term review announced on October 29, 2002, the Reserve Bank indicated that the PLR-linked ceiling rate has lost its significance in view of the freedom given to banks for lending at sub-PLR rates to creditworthy borrowers. Exporters being prime borrowers could normally avail of export credit at sub-PLR rates. Therefore, with a view to encourage competition among banks and also to increase the flow of credit to the export sector, the Reserve Bank liberalised the interest rates on export credit in rupee terms. The ceiling rate of PLR plus 0.5 percentage points on pre-shipment credit beyond 180 days and upto 270 days and post-shipment credit beyond 90 days and upto 180 days was deregulated with effect from May 1, 2003. Further liberalisation would be considered at a later date and it will be examined whether the ceiling rates on pre-shipment credit up to 180 days and post-shipment credit up to 90 days should also be discontinued to encourage greater competition among banks for export credit. The present ceiling on interest rate on pre-shipment (up to 180 days) and post-shipment (up to 90 days) on rupee export credit is valid upto April 30, 2006. The ceiling rate on PCFCs remained unchanged at LIBOR+75 basis points for the corresponding currencies.

Call Money Market: Key Trends

2.92 An interesting development in the money market during 2004-05 was the increase in the relative size of the collateralised segment *vis-à-vis* the uncollateralised segment. The combined average daily transactions of market repo and collateralised borrowing and lending obligation (CBLO) was proportionately higher than those in the uncollateralised call/notice money market. It may be noted that after phasing out of non-bank participants, except primary dealers from the call/notice money market, the supply of institutional funds from insurance companies and mutual funds has shifted to the collateralised market, which also offers funds at the rates, generally lower than in call money market. The call/notice money turnover increased broadly during August 2004-December 2005, but declined subsequently.

Relative Market Shares

2.93 The relative shares of different constituents in this market have undergone significant changes (Table 2.39). Banks' share of borrowing from the call market declined gradually over the years till 2003-04 because of the overall reduction in the need to borrow in the wake of excess liquidity in the economy, substantial scaling down of CRR, and generally higher Reserve Bank reverse repo rate *vis-à-vis* those in the money market segments, *viz.*, call market, repo and CBLO. An obvious consequence of this situation had been higher placement of funds in the Reserve Bank's reverse repo window. In the scenario of shrinking turnover in call money market, PDs, whose demand was guided by the volume of market borrowing programme, emerged as the largest borrower group in 2003-04.

Table 2.39: Relative Shares in Call/ Notice Money Market

(Per cent)

Year	Borrowing		Lending		
	Banks	PDs	Banks	PDs	Non-banks
1	2	3	4	5	6
2000-01	67	33	47	12	41
2001-02	62	38	65	10	25
2002-03	53	47	69	2	29
2003-04	36	64	57	2	41
2004-05	65	35	70	1	29
2005-06*	76	24	95	1	4

* Upto February 2006.

2.94 However, the situation changed during 2004-05 with banks once again emerging as the largest borrower group following pick-up in credit, increase in CRR maintenance by 50 bps in two stages September and October 2004 and reduction in market borrowing programme of the Government following which borrowings by PDs were less.

2.95 On the lending side, the shares of non-bank entities had gone down during 2001-02 and 2002-03 following the commencement of the process of their phasing out from call/notice market. Thereafter, their shares increased during 2003-04 in relative terms against the background of marked shrinkage in the aggregate turnover of call market. From September 2004 the share of the banking sector has been rising, and following the phasing out of non-banks since August 2005, only banks and PDs remain in the call market.

Policy Developments

2.96 In view of the encouraging developments in the functioning of NDS/CCIL, the process of moving towards a pure inter-bank call/notice money market to facilitate further deepening of repo/term money market was accelerated. Accordingly, with effect from the fortnight beginning June 26, 2004, non-bank participants were allowed to lend, on an average in a reporting fortnight, upto 45 per cent from the previous 60 per cent of their average daily lending in call/notice money market during 2000-01. Further, with effect from fortnight beginning January 8, 2005, this limit was reduced to 30 per cent of their daily average lending in call/notice money market in 2000-01. Thereafter, with effect from the fortnight beginning June 11, 2005, non-bank participants were allowed to lend, on an average in a reporting fortnight, upto 10 per cent of their average daily lending in call/notice money market during 2000-01 and subsequently with effect from August 6, 2005, non-bank participants, except primary dealers, have been phased out from the call/notice money market completely.

2.97 Further, the benchmark for fixing prudential limits on exposures to call/notice money market in the case of scheduled commercial banks has now been linked to their capital funds (sum of Tier I and Tier II capital) from the fortnight beginning April 30, 2005. With a view to improving transparency, in the Annual Policy Statement 2005-06, a screen - based negotiated quote-driven system for dealings in call/ notice and term money transaction was proposed.

2.98 To further fine-tune the management of liquidity, market participants have been provided with an additional window in the form of Second Liquidity Adjustment facility (SLAF) which is operationalised since November 28, 2005 in response to suggestions from the market participants. SLAF is conducted on all working days except Saturdays and bids for SLAF are received between 3.00 p.m and 3.45 p.m. The salient features of SLAF are the same as those of LAF. However, the settlement of the LAF and SLAF is conducted separately and on gross basis. The SLAF will be subject to review and modification as needed, based on experience.

Certificates of Deposit (CDs)

2.99 The outstanding amount of CDs issued by scheduled commercial banks increased markedly from Rs.4,461 crore in March 2004 to Rs.12,078 crore in March 2005. The typical discount rate (for 3-month maturity) on CDs increased from 4.96 per cent in March 2004 to 5.90 per cent in March 2005. Total CDs outstanding constituted 3.9 per cent of the aggregate bank deposits of banks issuing CDs as on March 18, 2005. During 2005-06 so far, the outstanding amount of CDs issued by scheduled commercial banks increased further from Rs.14,975 crore in April 2005 to Rs.34,521 crore in January 2006 and the typical discount rate (for 3-month maturity) on CDs moved upto 7.21 per cent from 5.87 per cent. At the system level, total CDs outstanding form 3.1 per cent of the aggregate bank deposits of the banks issuing CDs as on January 20, 2006.

2.100 The narrower set of issuers in an environment of easy liquidity when banks generally do not issue CDs, reflects that it is the bank-specific factors which have been driving the growth of CDs in recent period. In this context, it has been found that select foreign and private sector banks have been raising resources through issuance of CDs on account of not only lesser number of branches but also their cost effectiveness. Even then, the steady issuance of CDs has been on account of a number of macro factors which include revised guidelines by the Reserve Bank on investments by banks in non-SLR debt securities, reduction in stamp duty on CDs effective March 1, 2004, no tax deduction at source, no prepayment or premature closure as in the case of fixed deposits and greater opportunity for secondary market trading. On the demand side, the Securities and Exchange Board of India (SEBI) placing a bar on Mutual Funds (MFs) from parking funds in bank deposits coupled with improved funds position with MFs provided an impetus for the CD market. An encouraging development that ensued was that some of the top - rated banks had been getting their CDs rated for better access to the market even when such rating is not mandatory under the extant guidelines.

Policy Developments

2.101 Keeping in view of the reduction of minimum period for term deposits and commercial paper, the minimum maturity period of CDs was reduced from 15 days to 7 days with effect from April 28, 2005. This has provided an additional option to banks to raise short-term resources through CDs.

Commercial Paper (CP)

2.102 The market for CPs continued to remain buoyant during 2004-05. The outstanding amount of CP increased from Rs.9,131 crore in March 2004 to Rs.14,235 crore in March 2005. The discount range on CP moved from a range of 4.70-6.50 per cent to 5.20-7.25 per cent during this period and the weighted average discount rate (WADR) moved up from 5.11 per cent to 5.84 per cent. The preferred maturity of CP had been periods ranging from “61 to 90 days” and “181 days and above”.

2.103 With regard to the classes of issuers, it was found that there was a secular decline in the amount of CP being issued by manufacturing companies over time. Reflecting this trend, the share of manufacturing and other companies in the aggregate amount of CP raised stood at 31 per cent during 2004-05 (44 per cent during 2003-04). Finance/leasing companies on the other hand accounted for 56 per cent (38 per cent during 2003-04) and FIs accounted for 13 per cent (18 per cent during 2003-04).

2.104 The market for CP continued to remain buoyant during 2005-06. The outstanding amount of CP increased from Rs.15,598 crore in April 2005 to Rs.16,173 crore as on February 15, 2006. The discount range on CP moved from 5.50-6.65 per cent to 7.03-8.50 per cent during this period. The weighted average discount rate (WADR) increased from 5.84 per cent to 7.87 per cent over this period. The preferred maturity of CP had been periods ranging from “61 to 90 days”; “91 days to 180 days”; and “181 days and above”.

2.105 With regard to the classes of issuers, the share of manufacturing and other companies in the aggregate amount of CP raised stood at 19.1 per cent whereas finance/leasing companies accounted for 80.9 per cent during 2005-06 upto February 15, 2006.

2.106 Issuance of CP increased during this period following large investment interests seen from mutual funds on account of the Reserve Bank’s guidelines on investment in non-SLR debt securities by banks. Further, reduction in stamp duty on CP effective March 1, 2004 also boosted its issuance. Though CP market was overwhelmingly dominated by first - class prime - rated issuers (*i.e.*, P1+ and above of CRISIL or its equivalent), it has been found that their shares in issuances of CP have declined from 91.9 per cent during 2002-03 to 88.2 per cent in 2004-05. Correspondingly, those of medium-rated issuers have increased from 8.1 per cent to 11.8 per cent over this period.

2.107 Although corporates having net worth of Rs.4 crore or more have been allowed to raise short-term resources through CP, it has been observed that during 2005-06 (April-February 15, 2006), around 92 per cent of CP were issued by the corporates having net worth of more than Rs.50 crore.

Policy Developments

2.108 In order to further develop the CP market, a software was developed and implemented for reporting of CP issuance on NDS platform by Issuing and Paying Agents (IPAs), with effect from April 16, 2005. Further, information on CP issuance, such as issue date, maturity date, issue amount discount/ interest rate, unconditional and irrevocable guarantee and credit rating of the guarantor, as reported by the IPAs on the NDS platform, had been made available on the Reserve Bank website with effect from July 1, 2005.

Forward Rate Agreements (FRAs)/Interest Rate Swaps (IRS)

2.109 There has been a sharp increase in volume in the FRAs/IRS market during the financial year 2004-05. Both in terms of number of contracts and outstanding notional principal amount, FRAs/IRS transactions, rose from 13,960 contracts amounting to Rs.3,72,896 crore in April 2004 to 37,864 contracts for Rs.10,62,242 crore in March 2005. During 2005-06 so far, the number of contracts and outstanding notional principal amount rose from 38,386 contracts amounting to Rs.10,76,513 crore in April 2005 to 59,285 contracts for Rs.13,42,335 crore in the first fortnight of October 2005.

2.110 In this context, there is a need for appropriate legal framework for removing legal ambiguity of derivative contracts. The Reserve Bank has made suggestions to the Central Government for appropriate legislative changes. The Union Budget 2005-06 had also proposed steps for removal of legal ambiguity of OTC derivatives contracts.

Collateralised Borrowing and Lending Obligation (CBLO)

2.111 By March 2005, 110 members had been admitted in CCIL's CBLO segment out of which 56 were active members. The market witnessed substantial growth in the last two years. The daily average turnover in CBLO increased from Rs.2,496 crore in April 2004 to Rs.9,625 crore by March 2005. By February 2006, 150 members had been admitted in CCIL's CBLO segment out of which 78 were active members. The daily average turnover in CBLO segment increased from Rs.10,369 crore in April 2005 to Rs.34,162 crore in February 2006. Mutual funds and insurance companies are the largest suppliers of funds in the CBLO segment whereas on the demand side, public sector banks, private sector banks, co-operative banks and PDs are the major borrowers of funds.

Standing Liquidity Facility

2.112 Export Credit Refinance (ECR) facility is now provided on the basis of banks' eligible outstanding rupee export credit both at the pre-shipment and post-shipment stages. Effective April 1, 2002, ECR facility is being provided to scheduled banks to the extent of 15 per cent of the outstanding export credit eligible for refinance as at the end of second preceding fortnight. The normal facility (at a rate linked to Bank Rate) and back-stop facility (at a rate linked to LAF operations or NSE-MIBOR) had been merged with effect from March 29, 2004 and accordingly, ECR is being provided at a single rate at the repo rate of the Reserve Bank. Since repo rate under LAF has been revised from earlier 6.00 per cent to 6.25 per cent effective October 26, 2005, ECR was provided at 6.25 per cent from that date. Consequent upon increase in repo rate from 6.25 per cent to 6.50 per cent *w.e.f.* January 24, 2006, ECR is being provided at the current repo rate.

Trends in Utilisation of the Export Credit Refinance Facility

2.113 The aggregate export credit increased from Rs.69,059 crore as on March 18, 2005 to Rs.83,601 crore as on February 3, 2006. The export credit refinance limit which stood at Rs.4,928 crore as on March 18, 2005, increased to Rs.5,526 crore as on February 3, 2006. During this period, the export credit refinance facility was utilised occasionally upto December 2005. Due to the firmness in call money rates since December 2005 and tight liquidity conditions in the market, the daily average utilisation of ECR increased from Rs.1,412 crore as on January 6, 2006 to Rs.2,469 crore as on February 3, 2006.

Mobilisation of Resources by Select Financial Institutions (FIs) under the Umbrella Limit

2.114 Till the year 1990, the FIs were not subjected to market discipline but were predominantly the instruments for providing capital as per Plan priorities and industrial licensing prescriptions of the Government of India. They were funded through concessional resources by way of Government guaranteed bonds and advances from Long-Term Operations (LTO) Funds of the Reserve Bank. Currently, an FI can raise resources, short-term as well as long-term, such that the total outstanding of such funds at any time do not exceed 10 times its Net Owned Funds (NOF) as per its latest audited balance sheet. Within this overall ceiling, nine institutions, *viz.*, IDBI, IFCI, EXIM Bank, SIDBI, IIBI, TFCI, NABARD, IDFC and NHB had umbrella limits to raise resources equivalent to 100 per cent of their NOF as per their latest audited balance sheet. The number of select FIs has, however, come down to eight consequent upon IDBI converting itself into a scheduled bank, IDBI Ltd., with effect from October 1, 2004. Incidentally, IDBI Ltd. had a merger with IDBI Bank Ltd. with effect from April 2, 2005. The aggregate limits of these select financial institutions for raising resources through instruments such as term money, term deposit, inter-corporate deposits (ICDs), certificates of deposit and commercial paper increased from Rs.16,160 crore as on April 1, 2005 to Rs.17,046 crore as on December 23, 2005.

Trends in Mobilisation of Resources

2.115 The aggregate amount of outstanding resources raised by the financial institutions by way of these instruments declined marginally from Rs.2,862 crore (17.7 per cent of limits) as on April 1, 2005 to Rs.2,002 crore (11.74 per cent of limits) as on February 3, 2006. On an average basis, commercial paper was the most preferred instrument (Rs.1,900 crore), followed by term money borrowings (Rs.50 crore), certificates of deposit (Rs.26.66 crore), term deposits (Rs.25 crore) and ICDs (Rs.0.25 crore). Significantly, only four institutions, *viz.*, IDFC, EXIM Bank, NHB and SIDBI were active in mobilising resources through these instruments during the current year 2005-06 so far (April-February 3, 2006).

2.116 Money markets are growing in depth with increasing volumes of a number of instruments. Many significant developments have taken place in recent times to enhance the efficiency and stability of these markets in order to meet the varied objectives, including that of transmitting monetary policy impulses (Box II.1). Major such developments include emergence of call money market as pure inter-bank market with only banks and PDs as eligible entities and shifting of non-bank entities to new collateralised instruments of CBLO and market repo. Opening of an additional LAF window in the form of Second LAF has also strengthened the liquidity management. Large and volatile foreign exchange flows, however, continue to pose the biggest challenge for liquidity management. As Government cash flows also have low predictability, liquidity management has to be carried out with some uncertainty. In this backdrop, containing volatility in short-term interest rates in recent times has been a matter of considerable success for monetary policy operations in India.

Government Securities Market

2.117 The Reserve Bank continued to pursue the twin objectives of minimisation of cost over time and lengthening of the maturity profile of debt for both the Centre and the States in a scenario of upward shifting yield curves during the current year so far. The market borrowings of the Central Government during 2005-06 were significantly higher than in the corresponding period of the previous year, while those of State Governments were lower, mainly reflecting the termination of the debt swap scheme (DSS) in 2004-05. The weighted average yield of the Central Government securities issued during the year firmed up somewhat whereas the weighted average maturity increased slightly on account of larger issuances of long-term bonds. Comfortable liquidity position in the system coupled with more salubrious market perceptions regarding the prospective financial health of certain State Governments - induced in some measures by their enactment of Fiscal Responsibility Legislation-seemed to have contributed to the success of the auctions with lower spread (over the corresponding GOI securities) *vis-à-vis* the tap issuances. To fine-tune the management of liquidity and in response to suggestions from the market participants, a Second Liquidity Adjustment Facility was operationalised with effect from November 28, 2005. The Reserve Bank in the third quarter review of Annual Policy Statement for the year 2005-06 (January 24, 2006) announced that it would continue to ensure that appropriate liquidity is maintained in the system so that the genuine requirements of credit are met, consistent with the objectives of price and financial stability. Accordingly, keeping in view the current macroeconomic and overall monetary conditions, fixed reverse repo rate under the liquidity adjustment facility of the Reserve Bank has been increased by 25 basis points from 5.25 per cent to 5.50 per cent, while the spread between the reverse repo rate and the repo rate is retained at 100 basis points, as at present. The fixed repo rate under LAF would, therefore be 6.50 per cent, with immediate effect, *i.e.*, from the operationalisation of SLAF on January 24, 2006.

2.118 During 2005-06 so far (up to February 28, 2006), the market borrowing programme of the Central and State Governments has been successfully managed mainly on account of comfortable liquidity conditions. During the current year so far, a substantially larger number of States opted for the auction route for raising resources under the market borrowing programme. The weighted average cost of market borrowings of the Centre as well as the States continued to increase during the current year so far, reflecting the upturn in

Box II.1
Reserve Bank's Technical Advisory Committee on Monetary Policy

With a view to further strengthening the consultative process in monetary policy, the Reserve Bank has set up a Technical Advisory Committee (TAC) on Monetary Policy in July 2005, with four external experts in the areas of monetary economics, central banking, financial markets and public finance. The Governor, Reserve Bank of India is the Chairman of the TAC with the Deputy Governor-in-charge of Monetary Policy Department as the internal member. Other Deputy Governor(s) and any expert, depending on the requirement, would be special invitees to the meetings of the TAC with Heads of Department of Economic Analysis and Policy and Monetary Policy Department in attendance. Monetary Policy Department has been designated as the secretariat to the Committee.

The terms of reference of the Committee are to review macroeconomic and monetary developments and to advise on the stance of the monetary policy. The Committee is required to meet at least once in a quarter and its views would be discussed in the following meeting of the Committee of the Central Board of the RBI. The tenure of the present Committee is up to January 31, 2007.

global interest rates, buoyant domestic growth and tightening of liquidity conditions during November-February 2006. The weighted average maturity of the primary issuances of Centre and States under the market borrowing programme during the year has also been higher. During the current year so far, the Central Government has availed the WMA only on two occasions (May 3, 2005 and June 4, 2005), reflecting its comfortable liquidity position. The utilisation of WMA by the State Governments also declined significantly as compared with the previous year. Correspondingly, a majority of the States and the Centre accumulated large surplus cash balances.

Market Borrowings of Central Government 2005-06

2.119 The Union Budget estimate of the net market borrowings of the Central Government for 2005-06 has been placed at Rs.1,10,291 crore (inclusive of net issuance of 182-day Treasury Bills). Including repayments of Rs.68,282 crore, gross market borrowing is estimated at Rs.1,78,573 crore. An indicative issuance calendar in respect of dated securities for the first half of the year 2005-06 was issued in consultation with the Government for an aggregate amount of Rs.83,000 crore. The actual issuances, however, amounted to Rs.81,000 crore on account of reduction in the notified amount from Rs.4,000 crore to Rs.2,000 crore for maturity of 29.27 years in the auction held on May 3, 2005. On September 19, 2005, the issuance calendar for dated securities under the market borrowing programme of the Central Government for the second half of the current financial year (October-March) was released. The calendar proposed to raise Rs.58,000 crore through dated securities by end-February 2006. The actual issuance during the period amounted to Rs.40,000 crore as all the bids were rejected in the auction of 11.83 per cent Government Stock 2014 for Rs.6,000 crore held on October 6, 2005 due to conservative bidding, while the other scheduled auction for Rs.4,000 crore was cancelled on account of surplus liquidity with the Central Government. Further, on February 7, 2006, an amount of Rs.3,000 crore was raised through the issuance of dated security with a tenor of 11.56 years instead of Rs.6,000 crore as announced in the calendar. On February 20, 2006, the scheduled auction for Rs.5,000 crore of dated security with a tenor ranging between 10-14 years was cancelled.

2.120 During 2005-06 so far (upto February 28, 2006), gross market borrowings raised by the Central Government (excluding issuances under the MSS) were at Rs.1,58,339 crore (net Rs.95,589 crore) as against Rs.1,04,491 crore (net Rs.46,044 crore) raised during the corresponding period of the previous year (Table 2.40). All issuances were reissues except a 30-year dated security issued on September 8, 2005 and were by way of fixed coupon securities. During 2005-06 so far, the share of reissue of the total securities issued worked out to 97 per cent as against a share of 60 per cent during the corresponding period of the previous year. There has been no devolvement/ private placement during the year so far, as compared with Rs.847 crore and Rs.985 crore of devolvement on the Reserve Bank and Primary Dealers, respectively and Rs.350 crore issued by way of private placement during the previous year.

Dated Securities

2.121 Continuing with the trend in 2004-05, the weighted average yield of the dated securities issued during 2005-06 so far moved upwards. The weighted average yield of the dated securities issued during 2005-06 so far (upto February 28, 2006) was higher at 7.30 per cent as compared with 6.11 per cent during the corresponding period of the previous year as also for the full previous year. The weighted average maturity of the dated securities issued during 2005-06 so far also increased, reflecting larger issuances of long-term securities. The weighted average maturity of the dated securities issued during the year so far worked out to 15.86 years as compared with 14.13 years during the corresponding period of previous year as well as for the full previous year.

Treasury Bills

2.122 During the year 2005-06, the notified amounts (excluding under MSS) of 91-day and 364-day Treasury Bills for each auction were kept unchanged at Rs.500 crore and Rs.1,000 crore, respectively. The auction of 182-day Treasury Bills was re-introduced with a notified amount of Rs.500 crore. Besides, through the auction of 91-day Treasury Bills, Rs.1,500 crore were to be raised under the MSS, while Rs.1,000 crore each were to be absorbed through the auctions of 182-day and 364-day Treasury Bills during 2005-06. The notified amount under 91-day Treasury Bills was increased to Rs.4,000 crore (Rs.500 crore for regular auction and Rs.3,500 crore under the MSS) for five auctions between August 31, 2005 and September 28, 2005. Since the auctions of Treasury Bills held on November 16, 2005, the issuance of MSS component was discontinued taking into account the overall liquidity position of the system.

Table 2.40: Central Government's Market Borrowing

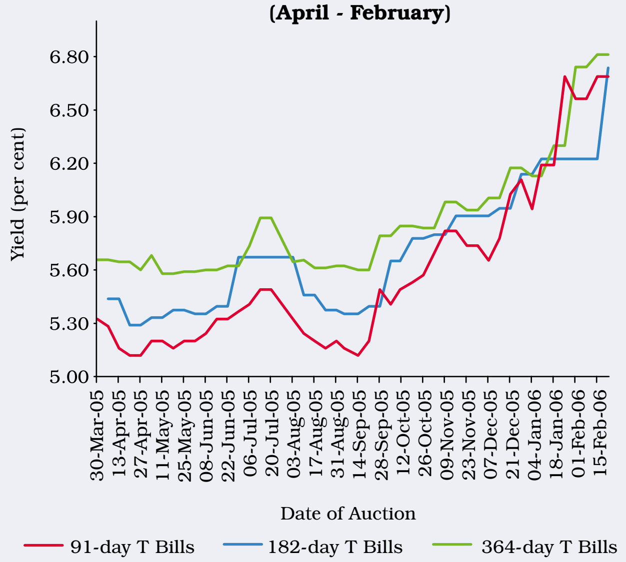
(Rupees crore)

Item	2004-05		2004-05 (April-February)		2005-06 (April-February)	
	Gross	Net	Gross	Net	Gross	Net
1	2	3	4	5	6	7
1. Budget Estimates*	1,50,817	90,365			1,78,573	1,10,291
Of which:						
(i) Dated Securities	1,24,817	90,501			1,39,573	1,03,942
(ii) 182-day T Bills	0	0			13,000	6,500
(iii) 364-day T Bills	26,000	-136			26,000	-151
2. Completed so far @	1,06,501	46,050	1,04,491	46,044	1,58,339	95,589
Of which:						
(i) Dated Securities	80,350	46,034	80,350	46,034	1,21,000	88,370
(ii) 182-day T Bills	0	0	0	0	12,088	6,109
(iii) 364-day T Bills	26,151	16	24,141	10	25,251	1,110
3. Private Placements	350		350		0	
4. Devolvements	1,832		1,832		0	
(i) RBI	847		847		0	
(ii) PDs	985		985		0	
5. Weighted Average Yield on dated securities (per cent)	6.11		6.11		7.30	
6. Weighted Average Maturity of dated securities (Years)	14.13		14.13		15.86	

* For the full financial year.
@ Actuals for 2004-05.

2.123 The primary market cut-off yields of 91-day and 364-day Treasury Bills increased by 137 basis points and 115 basis points, respectively to 6.69 per cent and 6.81 per cent, in the auctions held on February 22, 2006 and February 15, 2006, respectively as compared with end-March 2005 (Chart II.14). The primary market cut-off yield of 182-day Treasury Bills also increased by 130 basis points since its re-introduction on April 6, 2005 to 6.74 per cent in the auction held on February 22, 2006.

Chart II.14: Movement of Primary Yields of Treasury Bills-2005-06 (April - February)



Market Borrowings of State Governments

2.124 During the current fiscal year so far (upto February 28, 2006), the gross borrowings of the State Governments amounted to Rs.19,909 crore [Rs.11,186 crore (56.2 per cent) through tap issuances and Rs.8,723 crore (43.8 per cent) through auctions], as compared with Rs.38,668 crore [Rs.37,783 crore (97.7 per cent) through tap issuance and Rs.885 crore (2.3 per cent) through auctions] in the corresponding period of the previous year. It may be noted that the gross allocation during 2004-05 amounting to Rs.42,058 crore included Rs.18,805 crore and Rs.2,351 crore under the DSS and Rural Infrastructure Development Fund (RIDF), respectively, while the gross allocation for 2005-06 was placed at Rs.25,589 crore.

2.125 The weighted average yield of State Government securities issued during 2005-06 so far (up to February 28, 2006), worked out to 7.62 per cent as compared with 6.44 per cent during the corresponding period of the previous year and 6.45 per cent during 2004-05 as a whole. All the issues during the current financial year were of 10-year maturity while the weighted average maturity of the State Government securities issued during the corresponding period of the previous year worked out to 9.99 years. During the current year so far (up to February 28, 2006), Twenty States opted for auction route for raising the resources under the market borrowing programme as compared with only three States in the last year. During 2005-06 so far (February 28, 2006), while the cut-off yield in the auctions of State Development loans ranged between 7.32-7.85 per cent, the coupon of the tap issues ranged between 7.53-7.77 per cent.

Open Market Operations

2.126 Since January 2004, the Reserve Bank has not conducted any outright OMO sales. The OMO sales (entirely on account of the amount of securities sold to the State Governments for investment of surplus/ reinvestment of maturity proceeds of GOI securities and investment on account of the Consolidated Sinking Fund and Guarantee Redemption Fund) during 2005-06 so far (up to February 24, 2006), aggregated Rs.3,718 crore as against OMO sales of Rs.2,493 crore during the corresponding period of the previous year.

Market Stabilisation Scheme

2.127 The total outstanding amount absorbed under the Market Stabilisation Scheme (MSS) as on February 28, 2006 declined to Rs.31,958 crore as compared with Rs.64,211 crore as on March 31, 2005 (Table 2.41). On August 25, 2005, Rs.6,000 crore (face value) was absorbed under the MSS through re-issuance of a dated security with a residual maturity of 1.76 years. It may be noted that Rs.20,000 crore absorbed (face value) under MSS through dated securities in 2004-05 matured on September 3, 2005.

2.128 On August 27, 2005, the indicative schedule for auctions of Treasury Bills and dated securities under MSS for the second quarter (July-September) was revised to increase the notified amount for the auctions of 91-day Treasury Bills by Rs.2,000 crore to Rs.3,500 crore for the five auctions between August 31, 2005 and September 28, 2005 to impound an additional surplus liquidity of Rs.10,000 crore. The notified amounts of 182-day and 364-day Treasury Bills under MSS remained unchanged. The absorption under MSS through the auctions of Treasury Bills was discontinued since the auctions of TBs held on November 16, 2005 taking into account the overall liquidity position in the system.

Liquidity Adjustment Facility

2.129 Liquidity conditions remained generally comfortable during the financial year so far upto October 2005 but tightened thereafter mainly on account of sharp increase in currency in circulation due to the festival season as also increase in the surplus cash balances of Government of India, partly reflecting advance tax outflows in mid-December and IMD redemptions which took place on December 29, 2005. The net average daily liquidity absorption during April 2005 was at Rs.30,765 crore, which declined gradually to Rs.10,754 crore during July 2005. The net average liquidity absorption increased to Rs.34,832 crore during August 2005 but declined sharply to Rs.3,268 crore during November 2005 and further to Rs.1,452 crore during December 2005 and turned negative at Rs.(-)15,386 crore during January 2006 and Rs.(-)13,532 crore during February 2006. As a result, repo bids were received and accepted for seven consecutive working days during November 9-18, 2005 ranging between Rs.200 crore and Rs.5,175 crore, 11 consecutive working days during December 16-30, 2005 ranging between Rs.1,085 crore-Rs.30,110 crore, 18 working days during January 2006 ranging between Rs.50 crore-Rs.33,290 crore and 19 working days during February 2006 ranging between Rs.4,515 crore-Rs.24,145 crore.

Secondary Market Transactions in Government Securities

2.130 The volume of secondary market transactions increased from Rs.1,75,527 crore (47.98 per cent of

Table 2.41: Outstanding under MSS

(Rupees crore)

Instruments	March 31, 2005	June 30, 2005	September 30, 2005	February 28, 2006
1	2	3	4	5
Dated Securities	25,000	25,000	11,000	11,000
91-day Treasury Bills	19,248	19,251	23,557	0
182-day Treasury Bills	–	5,844	9,815	3,919
364-day Treasury Bills	19,963	21,585	21,777	17,039
Total	**64,211**	**71,680**	**66,149**	**31,958**

these transactions were outright and the rest on account of repos) in April 2005 to Rs.1,81,854 crore (23.8 per cent of these transactions were outright and the rest on account of repos) during February 2006. While the volume of outright transactions declined from Rs.84,225 crore during April 2005 to Rs.43,306 crore in February 2006, the volume of repo transactions increased significantly from Rs.91,302 crore during April 2005 to Rs.1,38,548 crore during the same period. The turnover during February 2006 (calculated as twice the outright transactions and four times the repos) increased to Rs.6,40,805 crore from Rs.5,33,658 crore during April 2005.

2.131 During February 2006, the five most traded securities in NDS accounted for 68.3 per cent of the total transactions as compared with 78.5 per cent during April 2005, implying somewhat increased dispersal of liquidity across securities.

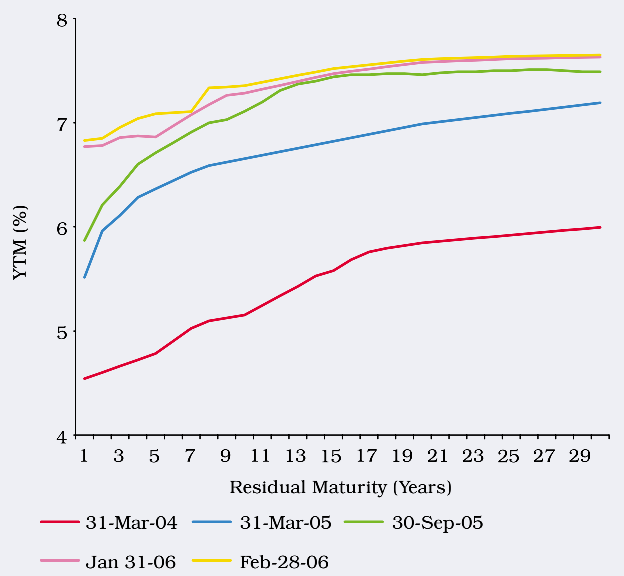
Yield Movement and Yield Curve

2.132 During April 2005, the yields firmed up sharply in the backdrop of rising global crude oil prices and the concerns over the domestic fuel price hike. The reverse repo rate hike by 25 basis points in the Annual Policy Statement announced on April 28, 2005 triggered sell-off and the 10-year yield firmed up by 11 basis points during the day. The 10-year yield closed at 7.31 per cent on April 30, 2005, higher by 66 basis points over the end-March 2005.

2.133 The yields, however, retraced during May 2005 amidst a comfortable liquidity position and benign crude prices. The US treasury yields also bolstered the sentiment. The prices of securities were range-bound during June and July. The markets rallied briefly in July when the reverse repo rate hike expected by the market participants did not materialise in the first quarter review of the Annual Policy Statement on July 26, 2005. The hardening of global crude prices was the main concern for the participants in July and August 2005 and the trading was lacklustre. The screen-based order matching system (NDS-OM) operationalised effective from August 1, 2005 enhanced trading activity in the secondary markets. The 10-year yield closed at 7.09 per cent on August 31, 2005 (Chart II.15). Prices rallied in the first half of September 2005 due to fall in global crude oil prices with the 10-year yield closing at 6.99 per cent on September 15, 2005. Thereafter, yields firmed up to 7.11 per cent on September 30, 2005 on account of rising crude oil prices and concern over a possible higher inflation rate, while the announcement of the issuance calendar of dated securities for Rs.58,000 crore under the market borrowing programme of the Central Government for the second half of the current year was in line with the market expectations.

2.134 During October 2005, prices rallied in the beginning of the month but remained range bound thereafter with no sharp movements as the mid-term review of the Annual Policy Statement was in line with the expectations of the market. The 10-year yield declined marginally to 7.10 per cent on October 31, 2005 from 7.11 per cent on September 30, 2005. In the beginning of November 2005, prices fell slightly due to tight liquidity conditions and auctions of two Government of India (GOI) securities on November 8, 2005. The cut-off yield arrived in the auction of 7.49 per cent Government Stock 2017 was as per the market expectations, while the cut-off for 7.40 per cent 2035 was higher than the market expectations. The 10-year yield increased to 7.12 per cent on November 11, 2005 from 7.10 per cent on November 4, 2005. Security prices remained range bound as the market sentiment remained positive with the cancellation of the MSS auctions and the expectations of cancellation of scheduled auction. The 10-year yield declined marginally to 7.11 per cent on November 18, 2005. Thereafter, there was some softening of G-sec yields due to easing of the tight liquidity conditions in the domestic market, expectations of pausing of the Fed-Reserves tightening cycle and steady oil prices. The 10-year yield eased to 7.08 per cent on November 30, 2005. During December 2005, the G-sec yields firmed up in the short-term due to tight liquidity

Chart II.15: Government Securities Yield Curve



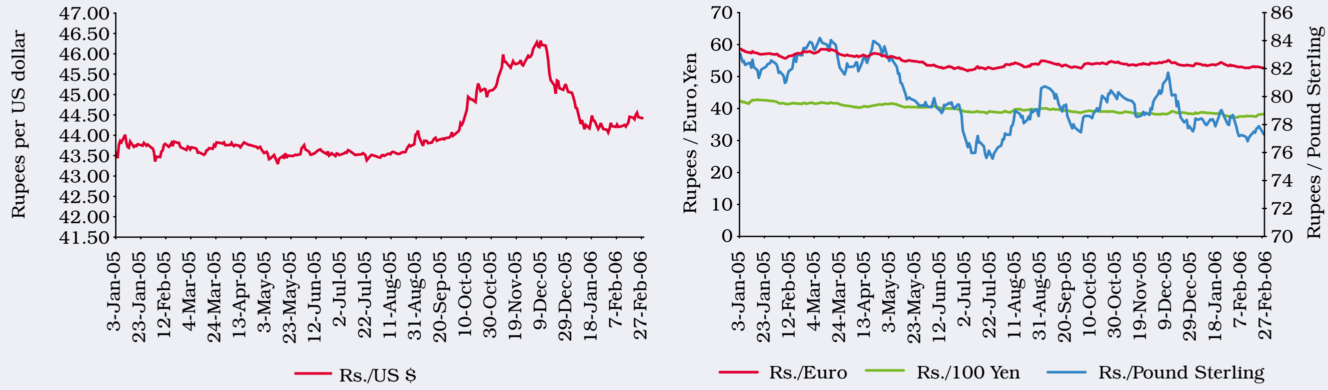
conditions while the yields in the long end showed a softening trend following proposal to reduce EPF rates and good response to G-sec auction of longer maturity. During the period between January 1 to 23, 2006, Government securities yields were generally range bound. Yield curve flattened marginally due to softening of yields at longer end. However, the 10-year yield increased sharply to 7.41 per cent on January 24, 2006 on account of hike in both the reverse repo and repo rates to 5.50 per cent and 6.50 per cent, respectively. Thereafter, there has been softening of yields mainly due to earning of tightness in liquidity and value buying. The 10-year closed at 7.28 per cent on January 31, 2006. In the beginning of February 2006, security prices rallied on account of easing of global crude oil prices and lower inflation. Subsequently, the reduction in the notified amount from Rs.6,000 crore to Rs.3,000 crore in the scheduled auction of dated security on February 8, 2006 further eased the liquidity concerns of the market. The 10-year yield closed at 7.30 per cent on February 3, 2006. Thereafter, security prices remained range-bound due to continuation of tight liquidity situation. However, the cancellation of auction of dated security for Rs.5,000 crore scheduled between during February 14-22, 2006 led a small *albeit* short-lived rally in security prices. Yield hardened on account of announcement of auction of State Government security for Rs.3,700 crore. The 10-year yield closed at 7.37 per cent on February 28, 2006.

2.135 The market borrowing programmes of the Central and the State Governments have been conducted successfully during the year so far. With effect from fiscal year 2006-07, the Reserve Bank will withdraw from the primary market for Central Government securities. While this would impart greater flexibility and manoeuvrability in the conduct of monetary policy, the Government securities market needs to be further developed in order to obviate undue volatility. The issue of liquidity in State Government securities also needs to be addressed. With the implementation of the Twelfth Finance Commission recommendations, no provision was made for Central loans for State plans during 2005-06 and States were encouraged to access the market to raise commensurate resources. The continued success of the market borrowing programme of the States in the future would depend on the sustained fiscal reform process. The States, therefore, need to adopt a prudent fiscal policy with enabling legislations for fiscal consolidation.

Foreign Exchange Market

2.136 The foreign exchange market has generally exhibited orderly conditions during 2005-06 so far (up to February 28, 2006). The exchange rate of the Indian rupee *vis-à-vis* the US $ has moved within a range of Rs.43.30 - 46.33 per US $ during the year 2005-06 (upto February 28, 2006). During April-May 2005, despite outflows by FIIs and a higher merchandise trade deficit, the rupee firmed up against the US $ from Rs.43.76 at end-March 2005 to Rs.43.30 per US $ on May 12, 2005. In the subsequent weeks, the Indian rupee depreciated to Rs.43.76 per US $ on June 2, 2005 due to strengthening of the US $ in the international markets. With the revaluation of the Chinese Yuan on July 21, 2005, the rupee under appreciation pressures stood at Rs.43.46 per US $ on August 1, 2005. It, however, depreciated throughout the month thereafter. The Reserve Bank made net market purchases of US $ 4.0 billion during July-August 2005. The rupee again came under pressure in the last week of August 2005 and reached Rs.44.12 per US dollar (September 1, 2005), under the impact of oil prices touching a peak of US $ 70.8 per barrel in the international market of Hurricane Katrina. Subsequently, the rupee recovered marginally and stood at Rs.43.99 per US dollar (September 29, 2005). The rupee came under pressure from the first week of October 2005 in the face of a sharp increase in the current account deficit and a strong US dollar. The rupee continued its depreciating trend throughout the months of October and November reflecting the spill over effect of the depreciation of major international currencies against the US dollar and FII outflows. The exchange rate depreciated till the second week of December and stood at Rs.46.33 per US $ on December 8, 2005. Subsequently, the rupee strengthened against the US dollar in tandem with a global rally of some of the major currencies, especially a huge jump in the value of Japanese Yen and FII inflows. It appreciated and reached Rs.44.44 per US $ on February 28, 2006. The Indian rupee depreciated by 1.5 per cent against US dollar during the current financial year (up to February 28, 2006). However, the rupee appreciated against the Pound Sterling, the Euro and the Japanese Yen by 6.2 per cent, 7.4 per cent and 6.7 per cent, respectively during the same period (Chart II.16). During the financial year so far (up to February 28, 2006), 6-currency (trade-based weight) monthly average REER appreciated by 0.5 per cent and the NEER has appreciated by 0.6 per cent.

Chart II.16: Movement of Rupee *vis-à-vis* Major Currencies



2.137 The forward markets reflected the developments in the spot segment of the foreign exchange market. Spot market conditions kept forward premia low during the first quarter of 2005-06. Forward premia declined in May 2005 in view of the announcement to phase out the Mumbai Inter-bank Forward Offered Rate (MIFOR) as a benchmark for pricing interest rate derivative deals for non-banks. The forward premia continued to decline with the narrowing of interest rate differential following the hikes in the US interest rates. The 1- month forward rate, however, has shown a rise since September 2005 (Chart II.17).

Capital Market

2.138 Resources mobilised through public issues, private placements and Euro issues continue to remain higher during the current financial year so far than the corresponding period of the last year. To ensure orderly functioning of domestic stock markets and to bring them at par with international stock markets, several reforms are currently being implemented, including demutualisation and corporatisation of stock exchanges, strengthening of surveillance systems, setting up of National Institute of Securities Market and development of the corporate debt market. The stock markets in India are currently at their historical peak levels.

Primary Market

2.139 During the current financial year so far (April-January 2005-06), the primary market depicted an encouraging trend with increase in both the number of issues and the resources raised. The resource mobilisation through 101 public issues increased substantially by 53.2 per cent to Rs.22,670 crore during April-January 2005-06 from Rs.14,799 crore through 42 public issues in the corresponding period of the previous year. Of these, 5 public issues were in the public sector, accounting for 23.3 per cent of the total resources raised and the remaining 96 public issues were in the private sector during April-January 2005-06 (Table 2.42). Further, out of 101 public issues floated during April-January 2005-06, 100 public issues were equity issues, constituting 99.5 per cent of the total resource mobilisation.

2.140 Resource mobilisation through private placement as well as Euro issues registered substantial increases. Mobilisation of resources through private placement increased by 37.6 per cent to Rs.67,288 crore during the April-December 2005 as compared with Rs.48,887 crore during April-December 2004. Public sector entities dominated the private placement market. During April-December

Chart II.17: Movement of Forward Premia

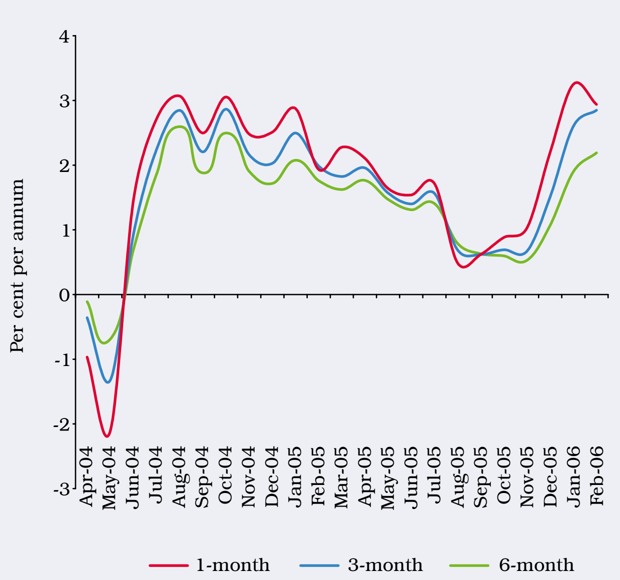


Table 2.42: Mobilisation of Resources from the Primary Market*

(Rupees crore)

Item	2003-04		2004-05		April-January # 2004-05		April-January # 2005-06	
	No. of Issues	Amount	No. of Issues	Amount	No. of Issues	Amount	No. of Issues	Amount
1	2	3	4	5	6	7	8	9
A. Prospectus and Rights Issues @	**47**	**7,851**	**59**	**21,892**	**42**	**14,799**	**101**	**22,670**
I. Public Sector	9	4,176	5	8,410	3	5,018	5	5,291
II. Private Sector	38	3,675	54	13,482	39	9,781	96	17,379
B. Private Placement	**874**	**63,901**	**914**	**84,052**	**654**	**48,887**	**780**	**67,288**
I. Public Sector	234	45,141	198	48,308	121	23,345	108	37,741
II. Private Sector	640	18,760	716	35,744	533	25,543	672	29,547
C. Euro Issues	**18**	**3,098**	**15**	**3,353**	**11**	**2,606**	**40**	**9,526**

* Including both debt and equity. # For private placement, data pertain to April-December. @ Excluding offer for sale.
Note: Estimates based on information gathered from arrangers, FIs and newspaper reports.

2005, they raised Rs.37,741 crore (56.1 per cent of total mobilisation by private placement) as compared with Rs.23,345 crore (47.8 per cent of total) in April-December 2004 (Table 2.42).

2.141 Resource mobilisation through Euro issues, which includes American Depository Receipts (ADRs), Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs), increased sharply during April-January 2005-06. There were forty Euro issues during April-January 2005-06, amounting to Rs.9,526 crore as compared with eleven issues, aggregating Rs.2,606 crore during April-January 2004-05 (Table 2.42). Most of the issues were by way of GDRs.

2.142 Resource mobilisation by mutual funds (net of redemptions) increased substantially by 419.3 per cent during April-January 2005-06 to Rs.35,555 crore due mainly to increase in resource mobilisation both under income/debt oriented schemes and growth/equity oriented schemes. UTI Mutual Fund and public sector mutual funds witnessed net inflows of Rs.545 crore and Rs.6,646 crore during April-January 2005-06 as against net outflows of Rs.3,071 crore and Rs.529 crore, respectively, during the corresponding period of the previous year. The private sector mutual funds recorded a net inflow of Rs.28,364 crore during April-January 2005-06 as compared with a net inflow of Rs.10,447 crore during April-January 2004-05 (Table 2.43).

Secondary Market

2.143 The stock market, which receded during April-May 2005, made a speedy recovery during June-September 2005 with the BSE Sensex and S&P CNX Nifty touching all time highs in line with the other emerging markets. Strong macroeconomic fundamentals of the economy, encouraging investment climate, continued FII inflows and robust performance by the Indian corporates contributed to the upward trend in the domestic stock markets. Settlement of disputes in the Reliance industries, satisfactory progress of monsoon, decline in domestic inflation rate, surge in Indian ADR prices and support from domestic institutional investors also enthused the market sentiment.

2.144 During the month of October 2005, the market sentiment turned weak mainly due to rising international crude oil prices, cautious approach adopted by investors ahead of the second quarter financial results of the companies and slowdown in investments by foreign institutional investors (FIIs). However, buoyancy in the markets was resumed in

Table 2.43: Net Resource Mobilisation by Mutual Funds

(Rupees crore)

Category	2003-04	2004-05	April-January 2004-05	April-January 2005-06
1	2	3	4	5
I. Unit Trust of India*	1,667	-2,722	-3,071	545
II. Private Sector	42,544	7,600	10,447	28,364
III. Public Sector	2,597	-2,677	-529	6,646
Total (I+II+III)	**46,808**	**2,201**	**6,847**	**35,555**

***** Erstwhile UTI has been divided into UTI Mutual Fund (registered with SEBI) and the Specified Undertaking of UTI (not registered with SEBI). Above data contains information only in respect of UTI Mutual Fund.

Source : Securities and Exchange Board of India.

the month of November 2005, which has continued so far. The declaration of strong financial results by corporates during second and third quarters, higher growth estimates of GDP (8.1 per cent) for 2005-06 by the CSO, announcement of fresh reform measures in banking sector such as allowing foreign private sector banks to acquire weak private sector banks in India, continued FIIs investments in the Indian equity markets and firm trends in major international and Asian equity markets boosted the market sentiment. The measures announced in the Union Budget 2006-07 further kept the market sentiment upbeat. The policy announcements included increase in FIIs investments limit in Government securities and corporate debt to $2 billion (from $1.75 billion) and to $1.5 billion (from $0.50 billion), respectively, ceiling on aggregate investment by mutual funds in overseas instruments to be raised from $ 1 billion to $ 2 billion with the removal of requirement of 10 per cent reciprocal share holding, allowing a limited number of qualified Indian mutual funds to invest cumulatively up to $ 1 billion in overseas exchange traded funds, setting up of investor protection fund under the aegis of SEBI, taking steps to create a single unified exchange traded market for corporate bonds, inclusion of fixed deposits of scheduled banks for a term of not less than 5 years in Section 80 C of the Income Tax Act, reduction in peak customs duties, rationalisation of excise duties in select sectors and relaxation in Fringe Benefit Tax (FBT). As a result, both the BSE Sensex and the S&P CNX Nifty closed at all-time high levels of 10370.24 and 3074.70, respectively on February 28, 2006. At this level, the BSE Sensex recorded an increase of 59.7 per cent over end-March 2005. On a y-o-y basis, the BSE Sensex increased by 54.5 per cent as on February 28, 2006. On an average basis, the BSE Sensex increased by 42.1 per cent in the financial year so far (up to February 28, 2006) over the corresponding period of the previous year.

2.145 With the rise in stock prices, market capitalisation of the BSE surged to 76.7 per cent of GDP on February 28, 2006 from 54.6 per cent of GDP at end-March 2005 and daily turnover (BSE and NSE combined) in cash segment crossed over Rs.11,000 crore on several days. The spurt in stock prices has been broad-based, encompassing all indices (BSE 500, BSE Small-cap, BSE Mid-cap and BSE Sensex) and across all sectors (auto, banks, capital goods, consumer durables, IT, oil & gas, pharma, *etc.*). Turnover, market capitalisation, price/earning ratio and also the volatility on the BSE and the NSE have remained higher in the current year so far, than those in the corresponding period of the previous year (Table 2.44).

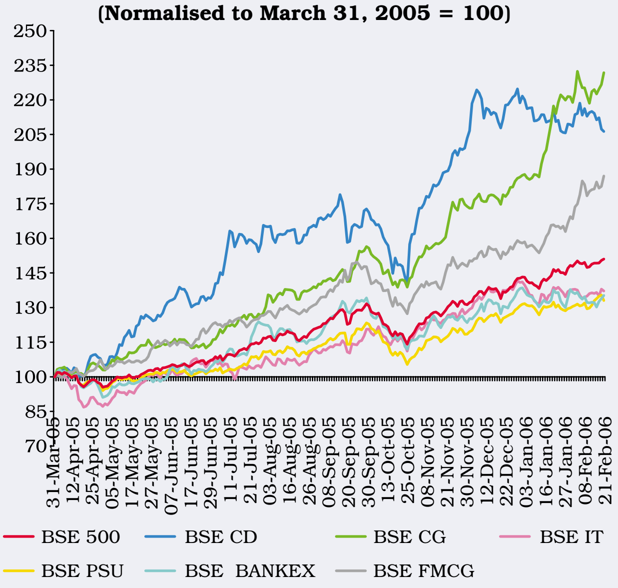
2.146 Most of the sectoral indices, including capital goods, consumer durables, fast moving consumer goods (FMCG), information technology (IT), banking, and PSU registered gains. The capital goods stocks have risen due to a pick-up in investment activity and strong industrial performance. The consumer durables stocks were buoyant due to stock-specific activities such as mergers, strong growth in sales and good financial results of some of the companies. The FMCG stocks recorded higher growth due to satisfactory progress of monsoon, which in turn boosted demand for consumer goods. Banking sector scrips registered gains mainly due to allowing the foreign banks to acquire upto 75 per cent stake in the weaker private sector banks in India, pick up in non-food credit of the banks, RBI's permission to Banks to issue perpetual bonds and other hybrid instruments and raising funds through fresh equity issues by both private and public sector banks during the current financial year so far. The PSU stocks also gained on account of allowing oil companies to issue special bonds to strengthen their balance sheets (Chart II.18).

Table 2.44: Trends in Stock Markets

Item	BSE		NSE	
	April-February 2005-06	April-February 2004-05	April-February 2005-06	April-February 2004-05
1	2	3	4	5
Average BSE Sensex/ S&P CNX Nifty	8,033	5,652	2,444	1,778
Volatility (Coefficient of Variation)	14.66	10.54	13.70	10.72
Turnover (Rs.crore)	6,97,307	4,59,188	13,60,160	10,27,016
Market Capitalisation (end-period) (Rs.crore)	26,95,542	17,30,940	25,12,083	16,14,597
P/E ratio (end-period)	19.06	16.09	18.27	15.02

Source : The Stock Exchange, Mumbai (BSE) and The National Stock Exchange (NSE).

Chart II.18: Trends in Sectoral Stock Indices (Normalised to March 31, 2005 = 100)



2.147 As per the SEBI data, during the current financial year so far (April-February 2006), FIIs investment in the Indian equities continued to remain strong. However, investment by FIIs in debt instruments turned negative during the same period. Mutual funds made substantial investments in equities during April-February 2006 in line with the trends in resource mobilisation under equity-oriented schemes. Investment by mutual funds in debt instruments also remained buoyant during the same period (Table 2.45).

2.148 The total turnover in the derivatives segment on NSE continued to remain substantially higher during April-February 2006 as compared with turnover in the cash segment during the same period (Table 2.46). In view of the significant increase in retail participation in the derivatives market, SEBI decided to permit the mutual funds to participate in the derivatives market at par with the FIIs.

Table 2.45: Institutional Investments

(Rupees crore)

Year	FIIs		Mutual Funds	
	Equity	Debt	Equity	Debt
1	2	3	4	5
2001-02	8,067	685	-3,796	10,959
2002-03	2,528	60	-2,067	12,604
2003-04	39,959	5,805	1,308	22,701
2004-05	44,123	1,759	448	16,987
2005-06 (April-February)	42,112	-7,075	9,825	33,836

Source : Securities and Exchange Board of India.

Table 2.46: Turnover in Derivatives Market *vis-à-vis* Cash Market in NSE

(Rupees crore)

Year	Derivatives	Cash
1	2	3
2001-02	1,01,925	5,13,167
2002-03	4,39,863	6,17,989
2003-04	21,30,612	10,99,535
2004-05	25,46,986	11,40,071
2005-06 (April-February)	40,89,333	13,60,160

Source : The National Stock Exchange Ltd.

2.149 The bullish trend in stock prices has been sustained for more than a year now on the back of strong macroeconomic fundamentals, robust corporate earnings, congenial investment climate and sound business outlook. The current rally has been driven mainly by strong FII investment in equities and supported by domestic institutional investors. The upsurge in Indian stock markets is in line with the firm trend in other emerging market economies.

Financial Sector

2.150 The banking sector in recent years has witnessed adherence to sound prudential regulation in order to reduce risks, strengthening of the disclosure and governance standards and alignment towards the international best practices. The year 2004-05 continued the process with renewed emphasis on improvement in credit delivery, customer service and financial inclusion. Banks have taken steps for migration towards Basel II norms and containment of impaired loans. Various measures have been introduced to improve the health of the non-banking and the cooperative banking sectors to bring them in alignment with the banking sector. Improvements in ownership and governance standards, competition, consolidation and enhancement of efficiency through improvement in the technological infrastructure have been the other focus areas. The banking sector, nevertheless, needs to adopt new technologies, implement sound processes of credit and risk appraisal, diversify product range, enforce robust internal controls and corporate governance and improve human resource management.

2.151 Robust macroeconomic performance continued to underpin the business and financial performance of scheduled commercial banks (SCBs) during 2004-05. Bank credit exhibited robust growth during the year reversing the decelerating trend of the previous year. The credit off-take was also broad-based with agriculture, industry, housing and retail segments being the drivers in the demand for credit. Profitability of public sector and new private sector banks improved despite hardening of sovereign yields. Reflecting the strong growth in credit volumes, net-interest income increased sharply, mitigating to a large extent the impact of a sharp decline in non-interest income. Thus, the banks, in general, were successful in weathering the impact of upturn in interest rate cycle.

2.152 The rising credit penetration in the economy during recent times is also a testimony of confidence gained by the borrowers and lenders. The overall bank credit to GDP ratio increased sharply since 2001 reflecting the broad-based growth of credit towards retail and other non-traditional service sector. The y-o-y non-food credit growth presently is at all time high in India.

2.153 Asset quality of Scheduled Commercial Banks (SCBs) improved further during 2004-05 resulting in the decline in gross non-performing assets in absolute terms for the third year in succession despite the switch over to the 90-day delinquency norm with effect from March 2004. Banks' capital base kept pace with the sharp increase in risk-weighted assets. Improved business and financial performance was reflected in sharp rise in prices of most of the bank stocks.

2.154 Aggregate deposits of SCBs increased at a lower rate of 15.4 per cent during 2004-05, as compared with 16.4 per cent during the previous year, on account of a slowdown in demand deposits and savings deposits. Deceleration in demand deposits was mainly due to the base effect as demand deposits had witnessed an unusually high growth last year. Interest income, which is the major source of income, rose sharply by 6.1 per cent as against 2.6 per cent during the previous year. Banks were able to maintain capital to risk-weighted assets ratio (CRAR) more or less at the previous year's level despite sharp increase in risk-weighted assets. While CRAR increased for new private sector banks, it declined marginally in respect of all other bank groups (Table 2.47).

2.155 The gross and net NPAs of SCBs declined in absolute terms over and above the decline during the previous few years. The decline in net NPAs was witnessed across all bank groups. Various factors such as improved risk management practices, greater recovery efforts, SARFAESI Act, 2002 and Corporate Debt Restructuring mechanism, *inter alia,* contributed to the decline in the NPAs.

2.156 Reversing the trend of the previous year, assets of scheduled urban cooperative banks (UCBs) expanded during 2004-05. This largely reflected the impact of increased resource mobilisation by way of deposits, borrowings and internal generation, which grew sharply during 2004-05. On the assets side, loans and advances increased at a healthy rate in contrast to the decline during the last year. Investments also increased sharply. Despite improvement in net interest income, the profitability of the scheduled UCBs declined mainly due to sharp decline in non-interest income. Asset quality of UCBs did not witness any significant change during the year (Table 2.48). The rural cooperative banks exhibited divergent trends during 2003-04. Despite expansion of operations at a higher rate, the profitability of the state cooperative banks declined. The trend was opposite for the central cooperative banks. The grass-root layer of the rural cooperative banking structure, *i.e.,* the primary agricultural cooperative societies (PACS) expanded their membership, even as their borrowing members declined sharply. Overall operations of PACS, however, continued to expand despite decline in deposits. Although there was some improvement in their asset quality, overdues continued to remain very high. The operation of the longer-term rural cooperatives structure, *i.e.*, the State Cooperative Agriculture and Rural Development Banks (SCARDBs) and Primary Cooperative Agricultural and Rural Development Banks (PCARDBs) witnessed a moderate growth although their financial performance remained unsatisfactory. The asset quality of all the layers of the rural cooperative banks, other than PACS, deteriorated.

2.157 Financial assistance sanctioned and disbursed by all-India financial institutions (AIFIs) declined during 2004-05. Resources mobilised by AIFIs (excluding erstwhile IDBI) increased, with NABARD mobilising the largest amount, followed by EXIM Bank, NHB and the IDFC. Borrowings by way of bonds/debentures continued to be the main source of funds for AIFIs. Loans and advances which represent the main avenue for deployment of funds by AIFIs registered a healthy growth. The spread (net interest income) and the operating profits increased both in absolute terms and as a ratio to total assets. The capital to risk-weighted assets ratio (CRAR) remained much above the norm of 9 per cent as at end of March 2005 for all AIFIs with the exception of IFCI and IIBI. The asset quality showed significant improvement during 2004-05 on account of substantial recovery of dues and increased provisioning (Table 2.49).

Table 2.47: Important Parameters of Select Bank-Groups

(Per cent)

Item/Bank Group	1996-97	2001-02	2002-03	2003-04	2004-05
1	2	3	4	5	6
Operating Expenses/Total Assets					
Scheduled Commercial Banks*	2.9	2.2	2.2	2.2	2.2
Public Sector Banks*	2.9	2.3	2.3	2.2	2.1
Old Private Sector Banks	2.5	2.1	2.1	2.0	2.0
New Private Sector Banks	1.9	1.1	2.0	2.0	2.1
Foreign Banks	3.0	3.0	2.8	2.8	2.9
Spread/Total Assets					
Scheduled Commercial Banks*	3.2	2.6	2.8	2.9	2.9
Public Sector Banks*	3.2	2.7	2.9	3.0	3.0
Old Private Sector Banks	2.9	2.4	2.5	2.6	2.7
New Private Sector Banks	2.9	1.2	1.7	2.0	2.2
Foreign Banks	4.1	3.2	3.4	3.6	3.3
Net Profit/Total Assets					
Scheduled Commercial Banks*	0.7	0.8	1.0	1.1	0.9
Public Sector Banks*	0.6	0.7	1.0	1.1	0.9
Old Private Sector Banks	0.9	1.1	1.2	1.2	0.3
New Private Sector Banks	1.7	0.4	0.9	0.8	1.1
Foreign Banks	1.2	1.3	1.6	1.7	1.3
Gross NPAs to Gross Advances					
Scheduled Commercial Banks*	15.7	10.4	8.8	7.2	5.2
Public Sector Banks*	17.8	11.1	9.4	7.8	5.5
Old Private Sector Banks	10.7	11.0	8.9	7.6	6.0
New Private Sector Banks	2.6	8.9	7.6	5.0	3.6
Foreign Banks	4.3	5.4	5.3	4.6	2.8
Net NPAs to Net Advances					
Scheduled Commercial Banks*	8.1	5.5	4.4	2.9	2.0
Public Sector Banks*	9.2	5.8	4.5	3.0	2.1
Old Private Sector Banks	6.6	7.1	5.5	3.8	2.7
New Private Sector Banks	2.0	4.9	4.6	2.4	1.9
Foreign Banks	1.9	1.9	1.8	1.5	0.9
CRAR					
Scheduled Commercial Banks	10.4	12.0	12.7	12.9	12.8
Public Sector Banks	10.0	11.8	12.6	13.2	12.9
Old Private Sector Banks	11.7	12.5	12.8	13.7	12.5
New Private Sector Banks	15.3	12.3	11.3	10.2	12.1
Foreign Banks	..	12.9	15.2	15.0	14.0

.. Not Available. * Excluding the impact of conversion of a non-banking entity into a banking entity for the year 2004-05.
Source : Balance Sheets of banks and returns submitted by banks.

Table 2.48: Urban Cooperative Banks-Select Financial Indicators

Indicator	2001-02	2002-03	2003-04	2004-05
1	2	3	4	5
Growth in Major Aggregates (Per cent)				
Deposits	15.1	9.1	1.7	0.7
Credit	14.1	4.5	3.4	-1.5
Financial Indicators @ *(as percentage of total assets)*				
Operating Profits	1.5	1.5	1.4	0.9
Net Profits	-0.9	-1.1	0.4	0.3
Spread	2.2	2.0	1.6	1.9
Gross Non-Performing Assets *(as percentage of advances)*	21.9	19.0	22.7	23.0

@ Relates to Scheduled Urban Co-operative Banks.

2.158 The number of NBFCs continued to decline largely on account of conversion of large sized deposit taking companies into non-deposit taking companies. Assets of NBFCs (excluding RNBCs), which contracted sharply during 2003-04, increased marginally during 2004-05 (Table 2.50). Financial performance of NBFCs improved in 2003-04 and 2004-05 mainly on account of containment of expenditure. While gross NPAs declined in 2003-04 and 2004-05, net NPAs increased somewhat during 2004-05. The CRAR of NBFCs continued to be comfortable with most of the NBFCs continuing to hold CRAR significantly above the regulatory minimum prescribed.

2.159 Financial performance of RNBCs was lacklustre during 2003-04 and 2004-05. Assets of

Table 2.49: Financial Institutions – Select Performance Indicators

Indicator	2002-03	2003-04	2004-05
1	2	3	4
Balance Sheet Indicators			
(as percentage of assets)			
Operating Profits	1.4	1.7	2.5
Net Profits	0.9	1.2	2.0
Spread	0.7	1.1	1.7
Resource Flows (Rupees crore)			
Sanctions	16,374	17,770	15,605
Disbursements	10,611	9,647	10,025

Note: Data on balance sheet indicators cover eight FIs, *viz.*, IFCI, IIBI, IDFC, EXIM Bank, TFCI, SIDBI, NABARD and NHB while that on resource flows cover IFCI, IDFC, IIBI and SIDBI.

RNBCs declined steadily during the period 2002-03 to 2004-05. Their operating and net profits showed a persistent decline during the aforementioned period mainly due to increase in expenditure (Table 2.51).

2.160 Strong global and domestic growth and stable financial markets provided the backdrop for the banks to expand their operations and improve their bottomlines. On the back of strong industrial recovery, credit to industry (medium and large) registered a healthy growth during 2004-05. The credit off-take was also broad-based with agriculture and industry joining the housing and retail segments in driving up the demand for credit. Reversing the decline in the previous two years, food credit increased during the year due to higher procurement operations. Credit growth in respect of wholesale trade and priority sector was also robust. The hardening of sovereign yields, however, partly prompted the banks to reduce their incremental exposure in Government and other approved securities resulting in a sharply reduced

Table 2.50: Consolidated Balance Sheet of NBFCs

(Rupees crore)

Item	(As at end-March) 2003	2004	2005
1	2	3	4
Liabilities			
1. Paid up Capital	2,860	2,327	2,106
	(7.6)	(7.1)	(6.2)
2. Reserves and Surplus	4,745	4,414	3,855
	(12.6)	(13.5)	(11.4)
3. Public Deposits	5,035	4,317	3,646
	(13.4)	(13.2)	(10.8)
4. Borrowings	24,480	20,852	21,842
	(64.9)	(63.7)	(64.5)
5. Other Liabilities	589	844	2,394
	(1.6)	(2.6)	(7.1)
Total Liabilities/Assets	**37,709**	**32,754**	**33,843**
Assets			
1. Investments			
i) SLR Investments	1,453	1,707	1,772
	(3.9)	(5.2)	(5.2)
ii) Non-SLR Investments	2,885	2,110	1,736
	(7.7)	(6.4)	(5.1)
2. Loans and Advances	13,398	12,363	11,301
	(35.5)	(37.7)	(33.4)
3. Hire Purchase Assets	13,031	11,649	14,200
	(34.6)	(35.6)	(42.0)
4. Equipment Leasing Assets	5,816	3,036	1,971
	(15.4)	(9.3)	(5.8)
5. Bill Business	450	436	464
	(1.2)	(1.3)	(1.4)
6. Other Assets	676	1,453	2,398
	(1.8)	(4.4)	(7.1)

Note : 1) Number of reporting companies declined to 777 companies in 2004 from 875 during 2003.
2) Figures in parentheses are percentages to total liabilities/assets.

Table 2.51: Profile of Residuary Non-Banking Companies (RNBCs)

(Rupees crore)

Item	(As at end-March) 2003	2004	2005
1	2	3	4
A. Assets (i to v)	**21,104**	**20,362**	**19,057**
(i) Unencumbered Approved Securities	6,129	5,824	2,037
(ii) Fixed Deposits with Banks	1,470	2,033	4,859
(iii) Bonds or Debentures or Commercial Papers of Govt. Companies/Public Sector Banks/ Public Financial Institutions/ Corporations	6,553	6,048	9,225
(iv) Other Investments	912	2,059	1,639
(v) Other Assets	6,040	4,398	1,297
B. Net Owned Funds	**809**	**1,002**	**1,065**
C. Total Income (i+ii)	**1,801**	**2,055**	**1,532**
(i) Fund Income	1,801	2,055	1,530
(ii) Fee Income	–	–	2
D. Total Expenses (i+ii+iii)	**1,435**	**1,813**	**1,396**
(i) Financial Cost	1,212	1,368	1,196
(ii) Operating Cost	105	129	146
(iii) Other Cost	118	316	74
E. Taxation	**134**	**32**	**48**
F. Operating Profit (PBT)	**366**	**242**	**136**
G. Net Profit (PAT)	**232**	**210**	**88**

– Nil/negligible.

Note : 1. PBT - Profit before tax.
2. PAT - Profit after tax.

incremental investment-deposit ratio. The banks, in general, were successful in weathering the impact of an upturn in the interest rate cycle and the profitability of public sector and new private sector banks improved. Banks were also successful in maintaining the momentum of improvement in their asset quality. Increase in their capital base also kept pace with the increase in risk weighted assets. The other segments of the financial sector witnessed a mixed performance. While the urban cooperative banking sector and many segments of the rural cooperative banks increased their operations, their profitability and asset quality remained less satisfactory. While the sanctions and disbursements by the financial institutions declined, their profitability and asset quality improved. The NBFCs expanded their operations, improved their profitability and also maintained the asset quality and capital adequacy. The RNBCs on the other hand, witnessed a decline in their assets and their financial performance remained lacklustre.

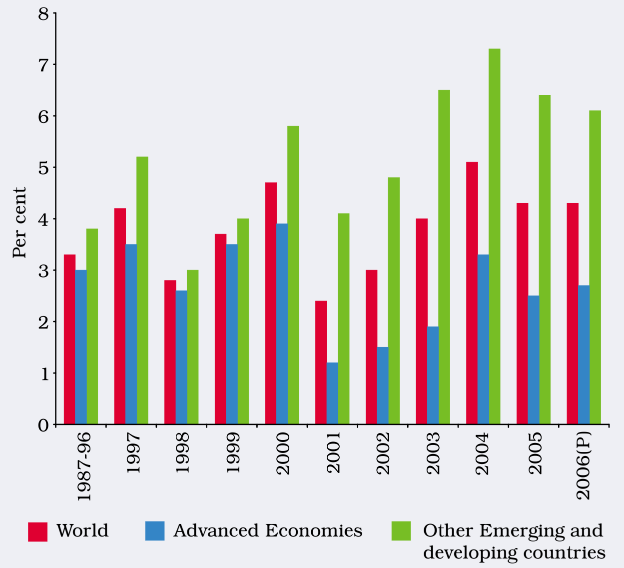
V. EXTERNAL SECTOR

Global Economic Outlook

2.161 Global growth at 5.1 per cent during 2004 was the highest in about three decades which was supported by an impressive 10.3 percent increase in trade volumes. The expansion remains broadly on track, with global growth forecast for 2005 at 4.3 per cent by the IMF, although risks are still slanted to the downside (Chart II.19). Following a temporary slowdown in mid-2004, the global GDP growth picked up through the first quarter of 2005, with robust services sector output more than offsetting slowing global growth in manufacturing and, more recently trade as well.

2.162 During 2005, the global economy continued to expand at a fairly robust pace. Though there are indications of a gradual moderation of growth in some countries in the first and second quarters of 2005, including the United States, the growth in China continued to maintain the momentum witnessed in 2004 and was placed at 9.9 per cent in the fourth quarter of 2005. The persistence of robust growth in China reflects thriving exports and domestic overheating as well. Despite witnessing a downtrend in public investment, the Japanese economy continued to recover in the fourth quarter and recorded a growth of 4.2 per cent as compared to 2.9 per cent in the third quarter. This has been facilitated by continued rise in exports, industrial production and steady private consumption. Similarly, growth rate in the Euro area which had slipped to 1.1 per cent in

Chart II.19: World Output Growth



the second quarter increased to 1.5 per cent and 1.7 per cent in the third and fourth quarters, respectively (Table 2.52). Persistent rise in global imbalances coupled with high and volatile oil prices continue to be the medium-term risks for global growth outlook.

2.163 World trade volume, which grew by 10.3 per cent during 2004, almost double than that during 2003, is projected to moderate at around 7.0 per cent during 2005 as per the IMF. Growth in world trade prices of manufactures is also expected to decelerate to 6.0 per cent in 2005 as against 9.7 per cent in 2004 (Chart II.20). Private net capital flows to emerging and developing countries are projected to fall to US$ 132.9 billion during 2005 from US$ 232.0 billion during 2004.

2.164 Financial market conditions during 2005 so far remained largely benign. Low level of long-term interest rates across the globe remains a conundrum for the financial markets reflecting low and well anchored inflationary expectations and difference in desired and actual global saving and investment. Global equity market remained resilient on account of strong corporate profits and solid balance sheets. Despite widening of the US current account deficit, the US dollar appreciated modestly in trade weighted terms during 2005 as a whole.

2.165 International crude oil prices continued to be high and volatile mainly due to short-term supply fears. Although oil prices spiked briefly to touch US$ 70 a barrel in end-August, they eased thereafter. Between April 1, 2005 and March 3, 2006, international crude oil prices of WTI, Brent and Dubai Fateh varieties increased by US$ 6.4 (from US$ 57.27 to US$ 63.67

Table 2.52: Quarterly Growth Rates of GDP in Select Countries

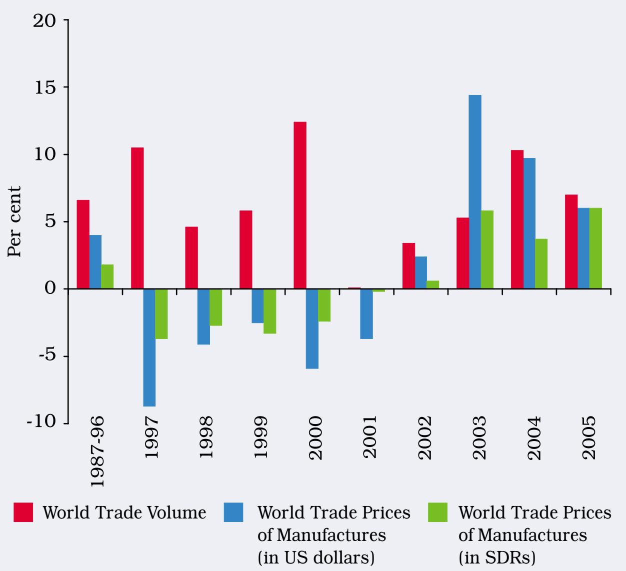
(Per cent)

Country	2004	2004-Q1	2004-Q2	2004-Q3	2004-Q4	2005-Q1	2005-Q2	2005-Q3	2005-Q4
1	2	3	4	5	6	7	8	9	10
US	4.4	4.7	4.6	3.8	3.8	3.6	3.6	3.6	3.2
Euro Area	2.1	1.4	2.2	1.8	1.5	1.4	1.1	1.5	1.7
Japan	1.7	3.7	2.8	2.4	0.4	1.4	2.6	2.9	4.2
China	9.5	9.8	9.6	9.1	9.5	9.4	9.5	9.4	9.9
Malaysia	7.1	7.6	8.0	6.8	5.6	5.7	4.1	5.3	5.2
Indonesia	5.1	4.4	4.3	5.0	6.7	6.4	5.5	5.3	4.9
South Korea	4.6	5.3	5.5	4.7	3.3	2.7	3.3	4.4	5.2
Thailand	6.9	6.7	6.4	6.1	5.1	3.3	4.4	5.3	..
Brazil	5.2	4.0	4.7	5.3	4.2	2.6	3.9	1.0	1.4
Argentina	9.0	11.3	7.1	8.7	9.1	8.0	10.1	9.2	..
India	6.9@	8.4	7.9	6.7	7.0	7.0	8.1	8.0	7.6

@ FY 2004-05. .. Not Available.
Source : The Economist, Bank of Japan and Central Statistical Organisation.

per barrel), US$ 7.5 (from US$ 55.15 to US$ 62.69) and US$ 11.1 (from US$ 48.38 to US$ 59.51), respectively. The International Energy Agency, in the Oil Market Report released on January 17, 2006, has revised the global demand to 85.1 million barrel a day (mbd) in 2006 as compared to 83.3 mbd in 2005. According to the IMF, a permanent 10 per cent increase in crude oil prices is estimated to reduce global GDP by 0.1-0.15 percentage points over a year assuming that it is demand driven and there is only a limited impact on inflationary expectations. There has been slight pick up in global headline inflation in response to higher oil prices but core inflation appears generally contained in major industrial economies, while there has been some rise in inflationary pressures in emerging markets.

Chart II.20: Growth in World Trade Volume and Prices



India's Merchandise Trade

2.166 Foreign trade sector has displayed remarkable buoyancy in recent years. Merchandise exports, according to the DGCI&S, clocked a growth of 26.2 per cent in US dollar terms during 2004-05 and the average annual growth rate for the three-year period 2002-05 worked out to 22.5 per cent. The growth in merchandise imports (39.7 per cent in 2004-05 and 28.8 per cent during 2002-05) turned out to be higher. The trade deficit widened to US $ 28.6 billion in 2004-05, double the level of the preceding year. The trade deficit increased by 48.4 per cent during 2005-06 (April-January), amidst moderation in the growth rates of both exports and imports.

2.167 India's merchandise trade showed a sharp acceleration during 2004-05, attributable to increasing international competitiveness of the manufacturing sector in an environment of expanding trade integration, a supportive domestic policy framework, sustained recovery in global demand and an increase in international commodity prices. In 2004, India was one of the fastest growing exporters next only to China and Korea (Table 2.53). With significant expansion in the Indo-Chinese trade, China has emerged as a major trading partner of India in recent years. China's share in India's total exports moved up to 6.6 per cent in 2004-05 from 3.7 per cent in 2002-03. Similarly, China's share in India's total imports rose to 6.2 per cent in 2004-05 from 4.5 cent in 2002-03.

2.168 Merchandise exports growth at 26.2 per cent during 2004-05 was the highest in the last three decades and substantially higher than the annual target of 16 per cent set by the Ministry of Commerce and Industry. During 2005-06 (April-November),

Table 2.53: Global Merchandise Export Growth

(Per cent)

Country/Region	January-December 2004	January-October 2004	January-October 2005
1	2	3	4
World	**21.2**	**20.8**	**13.0**
Industrial Countries	**17.9**	**17.4**	**9.1**
United States	13.0	13.4	10.1
Germany	21.3	21.1	9.3
Japan	19.9	20.9	5.8
Developing Countries	**26.3**	**26.1**	**18.7**
China	35.4	34.5	31.1
India	**29.8**	**32.6**	**19.1**
Korea	31.0	33.2	12.3
Singapore	24.6	24.9	14.6
Indonesia	12.6	10.3	20.8
Malaysia	20.5	21.8	11.1
Thailand	19.8	19.7	15.3

Source: IMF, IFS.

India's merchandise exports witnessed some loss of growth momentum in an environment of deceleration in world trade. Export growth at 18.9 per cent during April-January 2006 was, however, in line with the anuual export growth target set by the Government of India (Table 2.54).

2.169 Imports registered a sharp increase of 39.7 per cent in 2004-05 - a record since 1980-81 - on top of 27.3 per cent in 2003-04, led by both oil and non-oil imports. Oil imports accelerated by 45.1 per cent in 2004-05, mainly on account of the surge in international crude oil prices. In volume terms, the growth rate of oil imports slowed down to 5.5 per cent in 2004-05 from 10.6 per cent in 2003-04. Non-oil imports maintained the growth momentum in 2004-05 in tandem with the pick-up in domestic manufacturing activity. During 2005-06 (April-January), import growth remained strong (26.8 per cent). The rise in petroleum, oil and lubricants (POL) imports (46.8 per cent) in April-January 2005-06 was due to a sharp increase in international crude oil prices. Non-oil imports maintained the surge, posting a growth of 18.9 per cent during April-January 2005-06 (35.5 per cent a year ago).

2.170 The merchandise trade deficit at US $ 28.6 billion during 2004-05 touched a historic peak with the increase in non-oil imports (US $ 21.7 billion) being the major contributing factor. The non-oil trade balance, which remained in surplus during 2000-01 to 2003-04, turned into a deficit of US $ 5.6 billion during 2004-05 (Table 2.54). During 2005-06 (April-January), trade deficit stood at US $ 33.8 billion, higher by 48.4 per cent than a year ago (US $ 22.8 billion), led by the expansion in oil imports (US $ 11.3 billion) and in non-oil imports (US $ 11.7billion) during April-January 2005-06.

Table 2.54: India's Foreign Trade

(US $ million)

Item	April-March 2002-03	April-March 2003-04	April-March 2004-05	April-January 2004-05	April-January 2005-06
1	2	3	4	5	6
Exports	**52,719** **(20.3)**	**63,843** **(21.1)**	**80,540** **(26.2)**	**63,042** **(26.7)**	**74,981** **(18.9)**
Oil	2,577 (21.6)	3,568 (38.5)	6,798 (90.5)	5,587 (94.4)	..
Non-Oil	50,143 (20.2)	60,274 (20.2)	73,743 (22.3)	57,455 (22.6)	..
Imports	**61,412** **(19.4)**	**78,149** **(27.3)**	**1,09,173** **(39.7)**	**85,816** **(37.7)**	**1,08,784** **(26.8)**
Oil	17,640 (26.0)	20,569 (16.6)	29,844 (45.1)	24,038 (43.8)	35,300 (46.8)
Non-Oil	43,773 (17.0)	57,580 (31.5)	79,329 (37.8)	61,778 (35.5)	73,484 (18.9)
Trade Balance	**-8,693**	**-14,307**	**-28,633**	**-22,775**	**-33,803**
Oil	-15,063	-17,001	-23,047	-18,452	..
Non-Oil	6,370	2,694	-5,586	-4,323	..

.. Not available.
Note: Figures in Parentheses are annual growth rates.
Source : DGCI&S.

2.171 Commodity-wise trends during 2004-05 indicate that exports growth was broad-based across major product groups (Table 2.55). Primary products exports were triggered by a substantial increase in the exports of ores and minerals, mainly on account of iron ore exports to China. Manufactured exports maintained growth momentum due to a sharp pick-up in demand for engineering goods in East Asia, China and non-traditional markets like Latin America and Africa. Technology intensive items like metal, machinery and instruments, transport equipment, and iron and steel were the key drivers of export growth. Gems and jewellery exports registered a sharp increase, reflecting the benefits of various promotional measures as well as recovery in major markets like the US. Exports of petroleum products surged by 90.5 per cent, reflecting the expansion in domestic refining capacity and higher international prices of refined products. India emerged as the sixth largest petroleum refining country in the world in 2004.

2.172 In 2005-06 (April-November), the primary products exports maintained a robust growth (19.2 per cent), led by exports of raw cotton, rice and coffee. Marine products showed a turnaround during April-November 2005 from the negative growth a year ago due to pick-up in demand from the major markets like Japan. Manufactured goods exports grew at 14.3 per cent during April-November 2005 recording a significant loss of momentum as compared with the previous year (23.0 per cent). Notwithstanding the moderation, engineering goods and chemicals were the major driver of export growth. Among other items, gems and jewellery continued to maintain strong export growth (20.2 per cent) in April-November 2005. In the textiles segment, readymade garments remained the mainstay and the growth in exports was driven by strong demand in major markets, *i.e.*, the US and Europe. Exports of petroleum products posted 51.4 per cent growth during April- November 2005 on top of 94.0 per cent a year ago.

2.173 Destination-wise, exports were well diversified across Asia, Europe, North America and Latin American regions during 2004-05. Exports to East Asian countries including South Korea, Singapore and Malaysia also recorded a pick-up in growth. Exports to the OECD countries and the US increased due to improvement in demand conditions (Table 2.56). In 2005-06 (April-November), Latin America emerged as the fastest growing region for India's exports followed by East Asia, Africa, European Union and South Asia. Singapore, China, Korea, Hong Kong, the Netherlands, France and the UK were the major markets for India's exports.

2.174 As regards imports, growth in the non-oil imports was due to 'mainly industrial inputs' (non-oil imports net of gold and silver, bulk consumption, manufactured fertilisers and professional instruments), which posted a higher growth of 37.0 per cent during 2004-05 as compared to 29.1 per cent a year ago. Imports of capital goods (mainly comprising metals, machine tools, machinery and electronic goods), in particular, posted a significant growth of 33.8 per cent during 2004-05 on the top of 35.4 per cent growth

Table 2.55: India's Principal Exports

Item	April-March				April-November			
	US $ million		Growth Rate (Per cent)		US $ million		Growth Rate (Per cent)	
	2003-04	2004-05 P	2003-04	2004-05P	2004-05	2005-06P	2004-05	2005-06P
1	2	3	4	5	6	7	8	9
Primary Products	**9,902**	**12,994**	**13.7**	**31.2**	**7,393**	**8,814**	**34.3**	**19.2**
Agricultural & Allied Products	7,533	8,158	12.3	8.3	5,002	5,669	16.9	13.3
Ores & Minerals	2,369	4,836	18.7	104.2	2,391	3,146	94.6	31.5
Manufactured Goods	**48,492**	**58,596**	**20.5**	**20.8**	**36,305**	**41,514**	**23.0**	**14.3**
Leather & Manufactures	2,163	2,324	17.0	7.4	1,511	1,546	14.6	2.3
Chemicals & Related Products	9,446	11,897	26.7	25.9	7,281	8,080	29.9	11.0
Engineering Goods	12,405	16,685	37.3	34.5	10,026	12,028	37.4	20.0
Textiles & Products	12,792	12,788	10.1	-	8,296	8,851	8.8	6.7
Gems & Jewellery	10,573	13,735	17.1	29.9	8,422	10,121	21.2	20.2
Handicrafts	500	368	-36.4	-26.4	257	272	-22.4	5.8
Carpets	586	596	10.0	1.7	391	451	10.3	15.5
Petroleum Products	**3,568**	**6,798**	**38.5**	**90.5**	**4,387**	**6,643**	**94.0**	**51.4**
Total Exports	**63,843**	**80,540**	**21.1**	**26.2**	**49,369**	**58,651**	**29.0**	**18.8**

Source : DGCI&S.

Table 2.56: Major Destinations of India's Exports

Country	April-March				April-November			
	US $ million		Growth (Per cent)		US $ million		Growth (Per cent)	
	2003-04	2004-05P	2003-04	2004-05P	2004-05	2005-06P	2004-05	2005-06P
USA	11,490	13,272	5.5	15.5	8,748	10,065	21.1	15.1
UAE	5,126	7,139	54.0	39.3	4,168	4,668	48.5	12.0
UK	3,023	3,514	21.1	16.2	2,213	2,953	20.3	33.5
Hong kong	3,262	3,660	24.8	12.2	2,245	2,815	6.8	25.4
Germany	2,545	2,675	20.8	5.1	1,661	1,926	8.8	15.9
China	2,955	5,345	49.6	80.9	2,477	3,457	74.3	39.6
Japan	1,709	2,019	-8.3	18.1	1,227	1,369	11.7	11.6
Belgium	1,806	2,453	8.7	35.8	1,531	1,672	33.0	9.3
Singapore	2,125	3,825	49.5	80.0	2,229	3,545	107.3	59.0
Italy	1,729	2,181	27.4	26.1	1,282	1,318	25.2	2.8
Bangladesh	1,741	1,607	48.0	-7.7	962	919	-11.3	-4.4
Sri Lanka	1,319	1,355	43.2	2.7	891	1,258	10.9	41.3
France	1,281	1,609	19.3	25.6	999	1,171	33.6	17.2

Source : DGCI&S.

during 2003-04 (Table 2.57). In 2005-06, capital goods were the key drivers of import growth. The expansion of capital goods imports, accompanied by a strong growth of domestic production of capital goods in April-November 2005, reflects substantial build-up in capacity of the industrial sector.

2.175 Source-wise, import growth during 2004-05, was well-distributed across major regions. In 2005-06 (April-November), China emerged as the largest source of India's imports followed by the US, Switzerland, Germany, Belgium, the UAE and Australia (Table 2.58).

2.176 While the growth rate of exports decelerated during 2005-06 (April-January) mainly due to the decline registered in the month of November 2005, the growth performance remained broad-based across product-groups and markets. The sustained pick-up in imports of capital goods in tandem with the robust growth in domestic capital goods production bears out the optimism in investment climate.

Table 2.57: India's Principal Imports

Commodity	April-March				April-November			
	US $ million		Growth Rate (Per cent)		US $ million		Growth Rate (Per cent)	
	2003-04	2004-05	2003-04	2004-05	2004-05	2005-06	2004-05	2005-06
1	2	3	4	5	6	7	8	9
Petroleum, Petroleum Products & Related Material	20,569	29,844	16.6	45.1	19,362	27,752	51.4	43.3
Edible Oil	2,543	2,427	40.1	-4.6	1,625	1,323	-10.4	-18.6
Non-Ferrous Metals	949	1,262	42.3	33.0	810	1,028	53.1	26.9
Metalliferrous Ores & Metal Scrap	1,296	2,395	24.9	84.8	1,447	2,159	72.4	49.2
Iron & Steel	1,506	2,595	59.6	72.3	1,529	2,833	65.8	85.2
Capital Goods	18,279	24,458	35.4	33.8	13,482	17,282	31.4	28.2
Pearls, Precious & Semi-Precious Stones	7,129	9,422	17.6	32.2	5,144	6,711	21.9	30.5
Textile Yarn, Fabric, *etc.*	1,258	1,508	29.6	19.9	945	1,218	16.4	28.9
Chemicals, Organic & Inorganic	4,032	5,410	33.3	34.2	3,402	4,034	35.2	18.6
Gold & Silver	6,856	10,940	59.9	59.6	6,242	7,352	37.4	17.8
Total Imports	**78,149**	**1,09,173**	**27.3**	**39.7**	**66,166**	**86,403**	**37.6**	**30.6**

Source : DGCI&S.

Table 2.58: Sources of India's Imports

Country	April-March				April-November			
	US $ million		Growth Rate (Per cent)		US $ million		Growth Rate (Per cent)	
	2003-04	2004-05	2003-04	2004-05	2004-05	2005-06P	2004-05	2005-06P
1	2	3	4	5	6	7	8	9
USA	5,035	6,833	13.3	35.7	3,926	4,614	25.8	17.5
Belgium	3,976	4,567	7.1	14.9	2,676	3,271	13.4	22.2
China	4,053	6,769	45.2	67.0	4,167	5,977	73.3	43.4
UK	3,256	3,498	17.3	7.4	1,949	2,493	0.8	27.9
Germany	2,919	3,892	21.4	33.3	2,339	3,353	32.2	43.3
Switzerland	3,313	5,818	42.2	75.6	3,304	4,294	37.0	30.0
South Africa	1,899	2,163	-9.3	13.9	1,194	1,519	-17.9	27.2
Japan	2,668	3,142	45.3	17.8	1,906	2,036	17.8	6.8
South Korea	2,829	3,429	85.9	21.2	1,983	2,509	26.8	26.5
Malaysia	2,047	2,246	39.7	9.8	1,429	1,397	13.2	-2.2
Australia	2,649	3,583	98.2	35.2	2,249	2,832	59.0	25.9
Indonesia	2,122	2,537	53.7	19.5	1,602	1,673	17.6	4.4
UAE	2,060	4,567	115.2	121.7	2,418	2,935	150.5	21.4

Source : DGCI&S.

Invisibles and the Current Account

2.177 The developments in the external sector during the first half of 2005-06 (*i.e.,* April-September 2005) were mainly driven by a sharp widening of the trade deficit. The high level of international crude oil prices and their persistent downward rigidity, alongwith robust import demand for capital goods and export related items and acceleration in imports of gold and silver, were the key factors which contributed to more than doubling of the trade deficit in the first half of the fiscal as compared to last year. To a significant extent, the high trade deficits were neutralised by the continuing pace of surpluses recorded in the invisibles account. These were reinforced by steady remittances from overseas Indian workers, software and travel earnings. Further, capital inflows accelerated during the first half of 2005-06 despite turning of interest rate cycle in the industrial countries. Steady inflows through equity investments to India, sharp pick up in FII inflows into the stock market, acceleration in overseas borrowings by the Indian corporates - all reflected the sustained pace of domestic economic activity. The buoyant capital inflows, despite financing a large current account deficit (US $ 13 billion), led to some accretion to the reserves.

2.178 Early indications for 2005-06 suggest that the invisibles surplus is expected to be buoyant as in the recent past (Table 2.59 and Chart II.21). Net invisibles surplus during the first half of 2005-06 was underpinned by remittances from expatriate Indians, software exports and travel earnings. Net investment income continued to remain negative. During April-September 2005, services payments increased sharply in relation to 2004-05 reflecting the impact of growth in outbound tourist traffic, transportation and insurance payments associated with merchandise trade and expanding demand for imports of business services such as business and management consultancy, engineering, and technical and distribution services. Software exports have continued to remain strong belying the fears of protectionist pressures. During April-September 2005, software exports posted a rise of 32.0 per cent.

2.179 Buoyant software exports reflect the initiatives towards market diversification, moving up the value chain, focus on high-end processes and setting up of Research and Development Centres for off-shore partners. In the recent past, there are clear signs of the BPO industry heading towards consolidation. Acquisitions of leading Indian BPO firms by global giants, setting up of captive BPO operations by multinationals in India, overseas acquisitions by the Indian companies and rise in venture capital investments indicate growing maturity of the BPO segment of the software industry. Finance and accounting have drawn the maximum venture capital attention. These moves towards consolidation bring with them benefits like access to a large base of established clientele/acquired knowledge and business practices, leverage against competitors while also enabling the merged entities to improve their higher level consulting skills.

Table 2.59: India's Current Account

(US $ million)

Item	2002-03	2003-04	2004-05	April-September 2004-05	April-September 2005-06
1	2	3	4	5	6
I. Merchandise Balance	-10,690	-13,718	-36,629	-14,768	-31,635
II. Invisibles Balance (a+b+c)	17,035	27,801	31,229	14,283	18,679
a) Services	3,643	10,144	14,199	5,980	9,512
i) Travel	-29	1,435	985	-38	-1,073
ii) Transportation	-736	879	259	251	-1,440
iii) Insurance	19	56	187	18	327
iv) G.n.i.e.	65	28	67	66	-120
v) Miscellaneous	4,324	7,746	12,701	5,683	11,818
Of which:					
Software Services	8,863	12,324	16,526	7,569	9,842
b) Transfers	16,838	22,162	20,844	10,220	12,245
i) Official	451	554	591	252	202
ii) Private	16,387	21,608	20,253	9,968	12,043
c) Income	-3,446	-4,505	-3,814	-1,917	-3,078
i) Investment Income	-3,544	-3,757	-2,669	-1,430	-2,417
ii) Compensation of Employees	98	-748	-1,145	-487	-661
Total Current Account (I+II)	**6,345**	**14,083**	**-5,400**	**-485**	**-12,956**

G.n.i.e. : Government not included elsewhere.

2.180 Inward remittances from Indians working abroad have continued to surge, maintaining India's position as the leading recipient of remittances in the world. During April-September 2005, workers' remittances remained the mainstay of the current account, accounting for about 26 per cent of gross invisibles receipts. The increase in net invisibles surplus partly off-set the sharp increase in the trade deficit. The current account deficit more than doubled during July-September 2005 over the corresponding quarter of the previous year (Chart II.22).

2.181 For the year as a whole, while invisibles surplus may finance a large part of the enlarged trade deficit, the current account deficit is expected to remain within acceptable limits that can be financed

Chart II.21: Invisibles Surplus

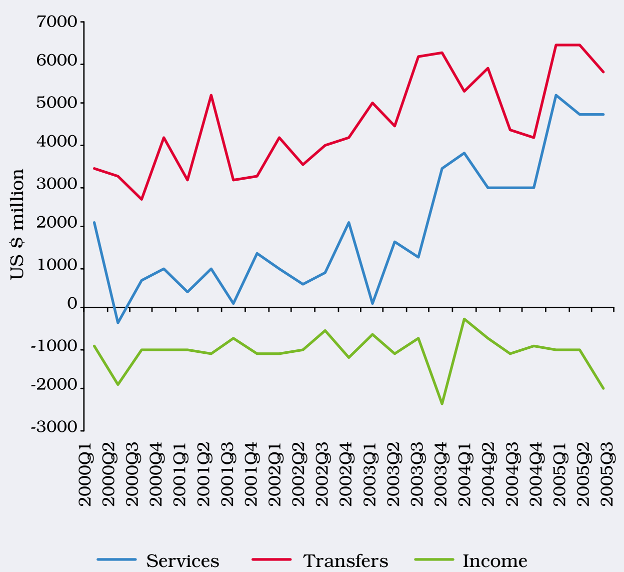
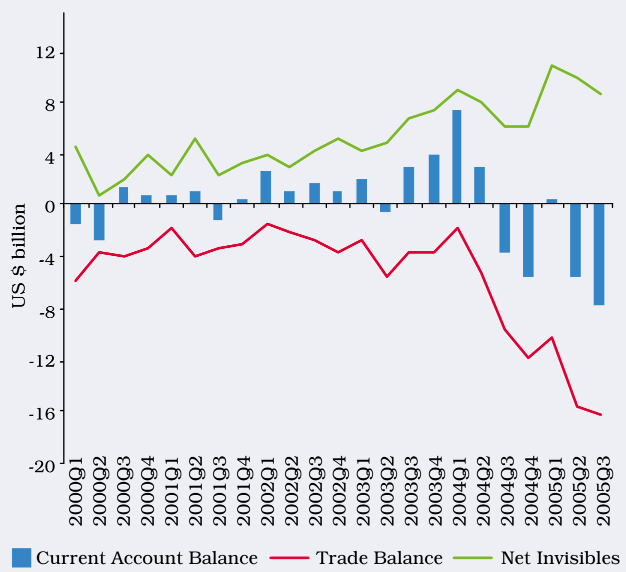


Chart II.22: Current Account Balance



by normal capital flows. Notwithstanding a marginal increase in invisibles surplus, the sharp expansion in trade deficit turned the current account into a deficit of US $ 13.0 billion in April- September 2005 (deficit of US $ 0.5 billion in corresponding period of 2004).

Capital Account

2.182 Net capital inflows have remained buoyant during 2005-06 so far. During the first half of 2005-06 (April-September), net capital flows at US $ 18.7 billion were mainly driven by foreign direct investment, external commercial borrowings (ECBs), banking capital and FIIs (Table 2.60). FDI inflows increased substantially, mainly into industries such as cement, sugar, plastic, synthetic and rubber industries, and hotels with Mauritius and the US remaining dominant investor countries. FII inflows recorded a turnaround in June with a net inflow of US $ 1.3 billion during the month. Inflows through ADRs/GDRs also remained buoyant. Banks in India drew down foreign currency assets held abroad while NRI deposits recorded net positive inflows of small magnitude. The turnaround in short-term trade credit to net outflows occurred as oil companies increased their recourse to domestic financing, and repayments accelerated. Foreign investment inflows in the current financial year so far are mainly attributable to investors' confidence in the Indian economy. International liquidity conditions and portfolio diversification by investors also contributed to foreign investment inflows during the year (Table 2.61)

2.183 The inflows under FDI have continued to be robust in 2005-06 so far (April-September 2005) backed by policy support and optimism about the investment opportunities being offered by several sectors. The improvement in FDI flows reflected the impact of recent initiatives aimed at creating an enabling environment for FDI and for encouraging infusion of new technologies and management practices. The Budget Statement for 2005-06 states that the automobile, software, telecommunication and electronics sector have benefited from the FDI and have assimilated themselves into the global production chain. There are opportunities in other sectors as well, such as mining, trade and pensions.

2.184 Portfolio investment flows through issuances of American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) remained buoyant during April-November 2005 as compared with the position a year ago (Table 2.61). After remaining subdued during April-May 2005, Foreign Institutional Investors (FIIs) made large purchases in the Indian stock markets in the subsequent months (Chart II.23). The net cumulative FII inflows during April- December 2005 amounted to US $ 5.1 billion (US $ 4.7 billion during corresponding period of the previous year). FIIs registrations with SEBI have continued to surge with the number increasing to 861 as on end-February 2006 (685 as on March 31, 2005). With a series of

Table 2.60: Capital Flows (net)

(US $ billion)

Component	April - March		April-September	
	2003-04	2004-05	2004-05	2005-06
1	2	3	4	5
Foreign Direct Investment	2.4	3.2	2.0	2.3
Portfolio Investment	11.4	8.9	0.5	5.1
External Assistance	-2.9	1.9	0.3	0.4
External Commercial Borrowings	-2.9	5.0	1.5	2.8
NRI Deposits	3.6	-1.0	-1.3	0.2
Other Banking Capital	2.4	4.9	2.0	2.8
Short-term Credit	1.4	3.8	2.0	0.9
Other Capital	1.3	4.3	0.4	4.2
Total	**16.7**	**31.0**	**7.4**	**18.7**

Table 2.61: Foreign Investment Flows by Category

(US $ million)

Item			April-November	
	2004-05P	2003-04R	2005P	2004
1	2	3	4	5
A. Direct Investment (I+II+III)	**5,653**	**4,322**	**4,377**	**3,454**
I. Equity (a+b+c+d+e)	3,778	2,229	3,489	2,534
a. Government (SIA/FIPB)	1,062	928	890	774
b. RBI	1,259	534	1,206	847
c. NRI	–	–	–	–
d. Acquisition of shares*	930	735	1,253	649
e. Equity capital of unincorporated bodies	527	32	140	264
II. Re-invested earnings $	1,508	1,460	738	754
III. Other capital $$	367	633	150	166
B. Portfolio Investment (a+b+c)	**9,313**	**11,377**	**5,771**	**4,519**
a. GDRs/ADRs #	613	459	1,715	394
b. FIIs **	8,684	10,918	4,042	4,122
c. Offshore funds and others	16	–	14	3
C. Total (A+B)	**14,966**	**15,699**	**10,148**	**7,973**

* Relates to acquisition of shares of Indian companies by non-residents under Section 6 of FEMA, 1999. Data on such acquisitions have been included as part of FDI since January 1996.

$ Data for 2004-05 and 2005-06 are estimated as average of previous two years.

$$ Data pertain to inter-company debt transactions of FDI entities.

Represents the amount raised by Indian corporates through GDRs and ADRs.

** Represents fresh inflow of funds by FIIs.

R : Revised. P : Provisional.

Chart II.23 :Net Inflows/Outflows by Foreign Institutional Investors

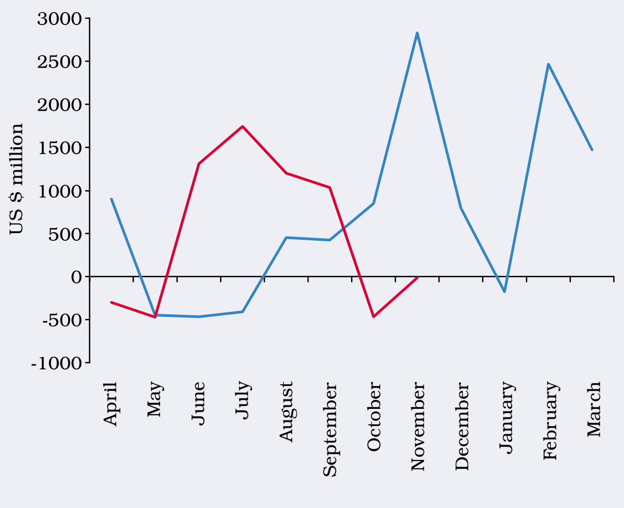
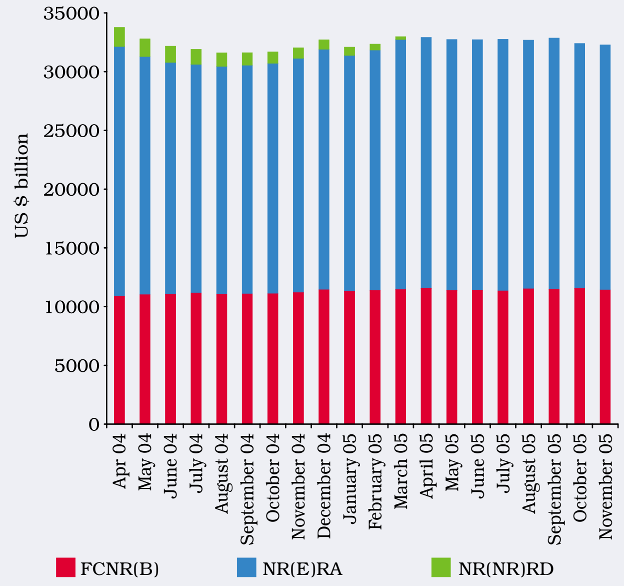


Chart II.24: NRI Deposits Outstanding



India-centric funds being floated overseas, FII inflows are likely to remain robust in the near term.

2.185 NRI deposits have registered modest inflows during 2005-06 so far (upto November 2005) as against outflows during April-November 2005 (Table 2.62 & Chart II.24).

2.186 During the first quarter of current financial year, ECBs have remained steady. Approvals data for the subsequent months also indicate an increasing appetite for ECBs (Table 2.63). Under the automatic route, the companies have resorted to ECBs mainly for the import of capital goods, project financing, capital investment/ modernisation of plants and expansion of activity which can be considered as a sign of capacity and investment expansion. Under the approval route, the ECB approvals have been granted primarily to financial institutions (for the purpose of on-lending to exporters), Power Finance Corporation (for power projects) and banks (that have participated in steel/ textile restructuring packages).

2.187 FDI by the Indian corporates abroad is assuming increasing significance as they have started to explore new expansion opportunities outside the national boundaries in areas of their competitive advantage. Access to markets, natural resources, distribution networks and foreign technology are some of the factors that have driven the process of formation of strategic alliances by Indian corporates with the international business partners. Mergers and acquisitions, and joint venture route have been the commonly adopted modes for FDI by Indian corporates. The sectors that are being preferred for outward FDI include IT, steel, telecom, oil exploration, power and pharmaceuticals.

Table 2.62: Inflows under NRI Deposit Schemes

(US $ million)

Scheme	April -March		April -November	
	2004-05	2003-04	2004-05	2005-06P
1	2	3	4	5
1. FCNR (B)	492	762	235	-23
2. NR (E) RA	84	4,695	-693	271
3. NR (NR) RD @	-1,538	-1,816	-850	–
Total	**-962**	**3,641**	**-1,308**	**248**

@ Discontinued with effect from April 1, 2002.
P : Provisional.

Table 2.63: External Commercial Borrowing Approvals

(US $ million)

Month	Automatic Route	Approval Route	Total
1	2	3	4
April 2005	504	40	544
May 2005	722	-	722
June 2005	1,066	51	1,117
July 2005	609	-	609
August 2005	1,102	2	1,104
September 2005	2,035	512	2,547
October 2005	600	11	611
November 2005	951	16	967
Total	**7,590**	**631**	**8,221**

Foreign Exchange Reserves

2.188 India's foreign exchange reserves comprising foreign currency assets, gold, Special Drawing Rights (SDRs) and Reserve Tranche Position in the Fund (RTP) reached US $ 141.59 billion on February 24, 2006. (Chart II.25). During the third quarter of 2005-06, the surplus in the invisibles account and net capital flows were able to finance the trade deficit. India's foreign exchange reserves decreased by US $ 4.3 billion during the quarter. Overall, the foreign exchange reserves in the current financial year upto February 24, 2006 have declined by US $ 0.7 billion as compared with a rise of US $ 22.7 billion in the corresponding period of 2004-05. The reserves declined mainly due to India Millennium Deposits (IMD) redemption on December 29, 2005.

Chart II.25: Accretion to Foreign Exchange Reserves

2.189 India's total external debt at US $ 124.3 billion at end-September 2005 increased by US $ 2.2 billion over the previous quarter (Table 2.64). The increase primarily reflected higher recourse to commercial borrowing and export credit. Short-term debt also increased on account of increase in trade credits to finance higher imports.The US dollar continued to dominate the currency composition of India's external debt at end-September 2005 (Chart II.26). There has been a perceptible improvement in external debt indicators over the years reflecting the growing sustainability of external debt of India. Although there has been a rise in the ratio of short-term to total debt and short-term debt to reserves during the second quarter of 2005-06, they remain quite modest (Table 2.65). India's foreign exchange reserves exceeded the external debt by US $ 18.7 billion providing a cover of 115.1 per cent to the external debt stock at the end of September 2005. The share of concessional debt in total external debt continued its declining trend reflecting a gradual surge in non-concessional private debt in India's external debt stock. Nonetheless, the concessional debt continues to be a significant proportion of the total external debt, especially by international standards.

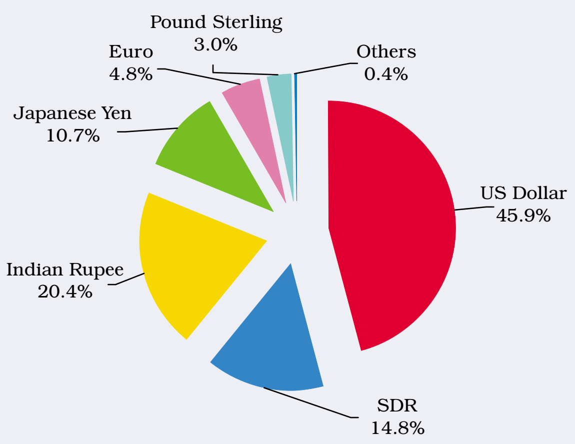
2.190 Notwithstanding the sharp rise in oil imports, the BoP position remained comfortable. The growth in merchandise exports was supplemented by exports of services and buoyant remittances. Foreign direct investment inflows have recorded a significant increase responding to improved growth prospects

Table 2.64: India's External Debt

Item	end-June 2005		end-September 2005		Variation during the Quarter	
	Amount (US $ million)	Percentage to total	Amount (US $ million)	Percentage to total	(US $ million)	(Per cent)
1	2	3	4	5	6	7
1. Multilateral	31,289	25.6	31,401	25.3	112	0.4
2. Bilateral	16,293	13.3	15,883	12.8	-410	-2.5
3. IMF	0	0.0	0	0.0	0	0
4. Export Credit	5,212	4.3	5,290	4.2	78	1.5
5. Commercial Borrowings #	27,173	22.2	28,527	22.9	1,354	5.0
6. NRI Deposits (long-term)	32,730	26.8	32,802	26.4	72	0.2
7. Rupee Debt	2,146	1.8	2,120	1.7	-26	-1.2
8. Long-term Debt (1 to 7)	1,14,843	94.0	1,16,023	93.3	1,180	1.0
9. Short-term Debt	7,275	6.0	8,303	6.7	1,028	14.1
10. Total Debt (8+9)	**1,22,118**	**100.0**	**1,24,326**	**100.0**	**2,208**	**1.8**

Includes net investment by 100 per cent FII debt funds.
Source : Reserve Bank of India and Ministry of Finance, GoI.

Chart II.26: Currency Composition of External Debt as at end-September 2005



as well as the ongoing liberalisation measures to attract higher FDI in critical areas such as infrastructure. Portfolio inflows have revived in the recent months. Overall, capital flows are expected to remain buoyant, in view of positive sentiments on India. The overall approach to the management of India's foreign exchange reserves in recent years has reflected the changing composition of the BoP, and has endeavoured to reflect the 'liquidity risks' associated with different types of flows and other requirements. The policy for reserves management is thus judiciously built upon a host of identifiable factors and other contingencies. Taking these factors into account, India's foreign exchange reserves are at present comfortable and consistent with the rate of growth, the share of the external sector in the economy and the size of risk-adjusted capital flows.

2.191 Though in the recent months there has been some slowdown in the pace of both exports and imports, the resilience of the external sector during the current fiscal year reflected in that a record level of current account deficit was financed through normal capital flows without any recourse to reserves. The high level of current account deficit, in fact, mirrored the strong pace of domestic economic activity. Another important aspect of the current account has been a sharp acceleration in non-software services exports partly emanating from underlying dynamism in export of business and professional services. However, a significant part of acceleration is attributed to the miscellaneous category, for which specific service heads are not known. The balance of payments developments during the first half of 2005-06 indicate that the external financing did not pose any problems despite record level of trade deficits. With the momentum maintained in capital inflows in the second half of the current financial year, particularly reflected in sharp resumption in FII inflows and the continuing pace of FDI inflows, ADR/GDRs and FCCBs, the financing of large trade deficit is not likely to pose problems.

Table 2.65: Debt Indicators

(Per cent)

Indicator	March 2005	September 2005
1	2	3
Concessional debt/ Total debt	33.3	31.6
Short-term debt / Total debt	6.1	6.7
Short-term debt/ Reserves	5.3	5.8
Reserves / Total debt	114.8	115.1

Source : Reserve Bank of India and Ministry of Finance, GoI.

VI. CONCLUSIONS

2.192 Notwithstanding the downside risks emanating from erratic South-West monsoon conditions in the initial season-period and persistent uncertainty on international oil prices front, the Indian economy maintained impressive growth performance during 2005-06 so far. After recording a historic peak of US$ 70.8 per barrel on August 30, 2005, the international oil prices eased somewhat thereafter but remain high and volatile. The consensus presently appears to be that the oil prices would remain at elevated levels. The global risks to recovery of growth thus emanate from three quarters namely, unwinding of macroeconomic imbalances, the consequential currency adjustments and the future course of international oil prices. A heartening feature of the growth process in India, however, has been that domestic factors dominate the global factors. Further, a significant improvement in the growth-inflation trade-off the world over, including in India has resulted from increases in productivity on account of greater domestic competition and increasing integration of the economies.

2.193 The Annual Policy Statement of the Reserve Bank of India, April 2005 projected the real GDP growth for 2005-06 at around 7.0 per cent, assuming normal monsoon and continued growth momentum in industry and services. Subsequently, however, the macroeconomic trends revealed a more optimistic scenario on the counts of better than expected crop output, high corporate profitability, buoyant business confidence, congenial investment climate, firm non-food credit off-take, moderate inflation, upsurge in trade, increasing tourists inflows, increased cargo handled at ports, higher revenue earning freight traffic (of railways), increasing railway and air passenger traffic, growth in cellular subscriber base, broadband connections growth, housing demand upsurge facilitated by softer interest regime and rise in exports of BPO and IT related services, *etc.* These factors congregated and resulted in an upward revision of the real GDP growth projections for 2005-06 to 7.0-7.5 per cent in October 2005. However, based on the assessment of a pick up in agricultural output and the sustained momentum in industrial and services sectors, the real GDP growth in 2005-06 was revised and projected to be in the range of 7.5-8.0 per cent as per the third quarter review of the Annual Policy Statement for the year 2005-06 .The advance estimates released by the Central Statistical Organisation (CSO) have placed the real GDP growth for 2005-06 at 8.1 per cent, which is marginally higher than the Reserve Bank's projections of 7.5-8.0 per cent.

2.194 The recovery in agriculture and resilience of the non-agriculture sectors during 2005-06 have firmly anchored the growth momentum. The skewed temporal progress of the South-West monsoon, during the course of the season, was more than off-set by even spatial distribution of rainfall and resultantly, the *kharif* production during 2005-06 is likely to surpass last year's level of 103.32 million tonnes to reach 108.15 million tonnes. The industrial activity firmed up further during 2005-06 aided by persistent buoyancy in the manufacturing. Further, basic and capital goods sectors have posted consistent uptrend. The robust double digit export growth reflects India's competitiveness in the international markets and growing demand for Indian exports in the world economy. Strong growth in capital goods production, accompanied by increase in imports of capital goods reflected capacity build-up in the industrial sector. Consumer goods also recorded an impressive growth emanating from non-durable segment. Echoing similar perceptions, various Business Expectation Surveys, *viz.*, Business Confidence Index of the National Council of Applied Economic Research, FICCI's Business Confidence Index and RBI's Industrial Outlook Survey foster optimism. The constraining influences on growth that deserve careful watch include the enlargement of trade deficit and infrastructural constraints.

2.195 Headline inflation and inflation expectations have remained well contained during 2005-06 so far despite large increases in international crude oil prices. Fiscal and monetary measures undertaken since mid-2004 to reduce the impact of imported price pressures on domestic inflation and to stabilise inflationary expectations have generally been successful in containing inflation towards the desired trajectory during the financial year so far.

2.196 Financing conditions in emerging markets remained favourable reflecting improved economic fundamentals, the increased presence of long-term investors and continued pursuit for yields. Financial markets, though operating in an environment of oil prices uncertainty, upturn in global interest rate cycle and political perplexity in the European Union, remained broadly stable. The Indian stock markets outperformed the stock indices of major economies. The interest rate environment remained benign due to adequate supply of liquidity although the credit off-take continued to remain strong and broad-based. The foreign exchange market remained orderly, with the Chinese revaluation exerting moderate upward pressure on the exchange rate. Yields in the Government securities market which had hardened in April 2005, reflecting higher crude oil prices and increase in the reverse repo rate have since been range-bound. The foreign exchange market has generally exhibited orderly conditions during 2005-06. The primary market segment of the equity market gathered momentum with increase in both the number of issues and the resources raised on the back of a buoyant secondary market and strong macroeconomic fundamentals. The secondary market staged a strong rally which pushed the BSE Sensex to new highs touching 10370.24 mark on February 28, 2006.

2.197 All the key deficit indicators in the revised estimates for 2005-06 were placed lower than the budgeted targets mainly on account of containment in expenditure particularly in non-Plan components. The budget estimates for 2006-07 project a decline in all the key deficit indicators, relative to GDP, on the basis of improved tax revenues as well as containment of expenditure, particularly in respect of subsidies. The Union Budget 2006-07 proposes to continue to follow a prudent tax policy based on a balanced tax structure with reasonable rates and minimal exemptions covering a wider class of taxpayers. It also commits to augment the tax collections and improve the tax/GDP ratio by aiming, *inter alia*, at liquidation of arrears of tax revenues and prevention of further accretions to the stock.

2.198 The resilience of the external sector during the current fiscal year reflected in that a record level of current account deficit was financed through normal capital flows without any recourse to reserves. Software exports have continued to remain strong belying the fears of protectionist pressures. India's position as the leading recipient of remittances in the world has been maintained on the continued surge of inward remittances. For the year as a whole, while invisibles surplus may finance a large part of the enlarged trade deficit, the current account deficit is expected to remain within acceptable limits that can continue to be financed by normal capital flows. Though international liquidity conditions and portfolio diversification by investors also contributed to foreign investment inflows during the year, it is investors' confidence in the Indian economy that drives the trend. A series of India-centric funds being floated overseas reflect that the FII inflows are likely to remain robust in the near term. There has been a perceptible improvement in external debt indicators over the years, reflecting the growing sustainability of external debt of India. Further, capital inflows accelerated mainly driven by foreign direct investment, external commercial borrowings (ECBs), banking capital and FIIs during the first half despite turning of interest rate cycle in the industrial countries.

2.199 Against this backdrop, barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy for the remaining part 2005-06 will be to maintain the emphasis on price stability with a view to anchoring inflationary expectations, to support export and investment demand in the economy for maintaining the growth momentum by ensuring a conducive interest rate environment, to provide appropriate liquidity to meet genuine credit needs of the economy with due emphasis on quality, and to consider responses as appropriate to evolving circumstances.